Keynote Address
Damon Silvers

Let me begin by giving you my Congressional Oversight Panel disclaimer. They say that elections have consequences, and one of them is that I have to give a disclaimer. I am the Deputy Chair of the Congressional Oversight Panel but my remarks today, although the will touch on some of the Congressional Oversight Panel’s findings, are my own. They are not Panel’s, its staff’s or its chair’s remarks.

Jamie has asked me to talk to you today about the challenges of and the state of regulatory reform. I have the challenge of following the last panel; some of what you will hear me say will sound familiar to you. You’ve had the pleasure of hearing from the real thought leaders on this subject already. I’m going to try to give you some of the legislative context as well as a few ideas about this.

The financial crisis proved what I think of as a series of propositions about financial regulation, which a number of folks had been trying to articulate throughout the deregulatory period. In certain respects it began in the 1970s, but it really began with a vengeance in the 1990s. We’ve heard a lot about some of these propositions, for example, the proposition that risk needs to be backed with capital. That proposition you’ve seen a lot of newspaper commentary on. I think we’ve also seen a lot of commentary about the proposition, and I think President Obama said it best in his speech to Cooper Union during the campaign, that we ought to regulate based on the economic reality of financial activity, not based on what the lawyers call it. Those types of propositions have, I think, been relatively well covered.

I think there is a more fundamental one (that has been forgotten in the post-post- New Deal environment) that is at the heart of what went wrong in our regulatory system, and that is at the heart of the battle underway today in Congress over financial reform. That proposition is that regulation of the financial markets is not a matter simply of protecting the weak. This may seem sort of counterintuitive. Liberal public policy, I believe, since the 1970s increasingly focused on the idea that we could regulate interactions of large sophisticated parties with the weak – consumers, workers and the like – and leave transactions between large, sophisticated parties to the parties themselves. It’s a way of allocating regulatory resources and it was an idea that kind of captured the romance of markets that was predominant in policy thinking over the last generation.

It’s directly contrary to the thinking of the New Deal. The fundamental thinking of the New Deal was that if you leave big parties to deal with themselves as they see fit, they will endanger the economy as a whole, perhaps the society as a whole. The regulation of the behavior and interaction of large sophisticated parties was key to the regulatory structures of the New Deal era. Recapturing that notion of regulation is key to whether regulation succeeds in this era.
I’ll belabor the point here a little bit. If we allow large operating companies like Enron to interact with large banks like JP Morgan Chase in an unregulated fashion, we will get exactly the financial frauds that we got with those two institutions in 1999, 2000, and 2001. If we allow the large hedge fund community to interact with non-bank providers of credit in an unregulated fashion, we will get the kind of systemic catastrophes that led policy-makers like Ben Bernanke and Hank Paulson to bail out Bear Stearns when the knew, and admitted, that it was completely contrary to good policy, that Bear Stearns was not an insured entity, that public policy of the United States had never been to bail out broker/dealers, and yet they felt they had no choice.

Unregulated opaque dealings between large institutions are a public problem. The question is whether we will have the political will and the technical skill to regulate them. When the regulatory process began in a serious way, you had a blueprint. The first thing we really had on the table was a blueprint leftover from the Bush administration. That blueprint was drawn up by Paulson and his staff in close consultation with Ben Bernanke’s folks at the Fed and released to the public in the spring of 2008. It was a blueprint for trying to build a financial regulatory system – on the model of the FSA, more or less, in the United Kingdom – aimed at weakening, in particular, that part of our regulatory system that is aimed at creating transparency and fair dealing in the securities markets, while strengthening a kind of broadly discretionary regulation of large financial institutions. It was a regulatory model designed to make the world safer for large financial institutions. That model had a strange kind of provenance. It was attacked roundly by a whole lot of people when it came out. Yet there was a feeling that it continued to bubble away alive underneath, that there was considerable intellectual and political continuity in key policy making circles that kept that model alive in the quiet recesses and corners of Washington.

The Congress of the United States in enacting the TARP (Troubled Asset Relief Program) legislation mandated that the Congressional Oversight Panel present Congress with regulatory reform recommendations. They gave us about six weeks to do it, from when we were empanelled, including Thanksgiving and Christmas. But we did manage to get this report out in January of 2009.I am going to summarize what this report said because I think it represents a different approach than the Paulson approach.

We had eight major recommendations, and they will sound familiar to you. First, there needed to be intensified regulation of any financial institution that posed systemic risk. Secondly, there needed to be hard limitations on leverage in American financial institutions. Thirdly, we needed to re-regulate the shadow financial system, with particular emphasis on derivatives, hedge funds and private equity funds, and off-balance sheet financing in banks, with brief reference to tax and regulatory havens. Fourth, there needed to be a new consumer protection agency to consolidate consumer protection in the financial services sector focused on consumer credit and other types of consumer financial products that are essentially unavoidable if you want to be integrated into the American economy. That may sound familiar to you because it has
become the centerpiece of public reform agenda articulated by President Obama. Fifth, there needed to be reform of executive pay in financial institutions around time horizons and risk exposure. Sixth, credit rating agencies needed to be reformed, and something needed to be done about the basic business model of credit rating agencies. Seventh, establishing a global regulatory floor needed to be made a US diplomatic priority. You couldn't really effective regulate here in the US, not that we shouldn't try; but in the long run it wasn't going to be effective if people could just run away to regulatory havens and continue to participate in our markets and other large national markets around the world. Eighth, we need to plan for the next crisis; we need to have structures for looking over the horizon and around the politics and influence that can tend to dominate regulators in Washington, no matter how well-designed.

Those were our eight recommendations. The promulgation of those recommendations (I am now giving you the history of the effort for strong financial regulatory reform) was followed by the formation of something called Americans for Financial Reform, essentially a broad coalition of groups that do not represent the banking system. The entirety of the labor movement and all of its factions are part of this coalition; the AARP, the Leadership Conference on Civil Rights, the Consumer Federation of America, several hundred community based organizations and housing advocacy and the like. Basically, the constituency base of the Democratic Party is completely within this coalition as near as I can tell. What the coalition did initially was to endorse the regulatory reform recommendations I just went through with you. The second move the coalition made was to digest those down to four priorities. It is the fate of those four priorities I am going to spend the rest of my remarks addressing.

The four priorities were: 1) address the crisis in the mortgage market around foreclosures and around the abuses of consumers and the weakening of civil rights standards; 2) create a consumer financial protection agency; 3) regulate the shadow markets; and 4) establish effective regulation of systemic risk by a fully public body. “Fully public body” is code for the Federal Reserve System in its current form; current governance structure, interpenetrated by the banks themselves, is unfit for that task.

It didn’t feel like it was necessary initially, but it has become clear that we need to add a footnote to number four. Panel One talked about this a great deal. The footnote is we can’t do bailouts the way TARP was done any more. By that, I mean we cannot bail out the stockholders of financial institutions. No public purpose is served by doing so. The first task in doing a bailout is to figure out which among the creditors of a failing financial institution can be haircut. By the way, this is precisely what occurred in the auto companies. This is what has occurred in every successful bank bailout that the Congressional Oversight Panel reviewed in our April report on historical and international comparisons in financial rescue strategies. It is clear, based on both the drafts of the legislation we have seen and the history of TARP, that if you don’t write legislation to make this clear, it will be done over and over and over again.

So, where are we on these four priorities? I think it is a good thing that those four priorities have largely become the structure, the discussion, in financial reform. I wish I could say that’s
because of the great influence of the progressive community in America’s politics. I think it’s actually because these four things are kind of unavoidable. They are the center of the action. The housing market, consumer protection, derivatives and hedge funds, and systemic risk – it’s pretty commonly understood that’s where the action is.

I think people may be familiar, but I will just review the state of the bidding in terms of the formal regulatory reform process. Last summer the Treasury Department issued a White Paper on regulatory reform. That White Paper included significant positive steps in all four areas. It was strongest in consumer protection and, I would say, most problematic in the area of systemic risk, where it sought to give broad power (effectively to bail out banks using public money) to the Federal Reserve. It was positive in the area of systemic risk in that it envisioned resolution authority that could be used to do bank bailouts the right way. It’s been my view, and I think the view of some of the speakers that you’ve heard from already, that in reality, the government has always had that kind of power even over bank holding companies and non-bank financials. When a firm of that type is in trouble the government has enough leverage to be able to force a restructuring. But it’s been the government’s position that they don’t and that they need those levers. So, getting that type of resolution authority in the administration’s proposal, we felt, was a good thing.

We started with the Treasury White Paper and then two legislative processes in parallel started. One is in the House, where the House Financial Services Committee, chaired by Congressman Barney Frank, took up, more or less, the White Paper’s agenda in a series of discreet bills marked up in committee one after the other. The design is to combine them all and bring them to the House floor. At the same time, Chris Dodd, chair of the Senate Banking Committee, moved forward on more or less the same broad subject areas but with one consolidated bill. Barney is in the middle of the process I just described. Chairman Dodd dropped a discussion draft of a comprehensive bill earlier this week. I am going to now review these four areas and what they do in each area.

First in the area of mortgage market regulation – really neither bill addresses it. The issue of relief for homeowners facing foreclosure seems for now to be more or less in the hands of the Treasury Department and programs it has initiated under TARP. The question of whether those programs are going to be adequate is very much open. My own view is that, while well-intentioned and far better than what the Bush administration had done, we still aren’t anywhere near addressing the foreclosure problem. In one respect, there is in the mortgage area an important element in the Dodd bill that is not in the Barney bills. The Dodd bill envisions moving authority for enforcing the Community Reinvestment Act from the safety and soundness bank regulators to the new consumer protection agency. In the long run, that is likely to strengthen protections for communities of color faced with exploitive practices in the mortgage markets. But set mortgages aside for the moment.

Second, both committees have brought forward strong bills creating a new consumer protection agency for financial services that will have inspection authority in the banks and rule-
making authority. These bills do not preempt state and local efforts. These are the key
dimensions to creating the consumer protection agency, and it is no accident they are strong in
this area. Here is an example where presidential leadership really matters. I am convinced that
President Obama views this particular aspect of financial reform as what is most important for
his presidency to accomplish. He has communicated clearly both to his administration’s
economic team and to the leaders in Congress that he wants a strong bill in this area. And, so
far, we are getting a strong bill, but it has been tough to get it. The resistance from the banking
industry, and through their friends in the Democratic caucus, has been intense and we haven’t
even yet seen the full battle in the Senate. The key issues here are going to be: will this
agency have inspection authority, and will there be pre-emption? Pre-emption is extraordinarily
dangerous in the context of the fact that administrations in Washington can become captured. I
think we have all learned that. That’s consumer protection in a nutshell.

Thirdly, shadow market regulation. Here, unfortunately, the story is not so nice, despite the fact
that the administration’s White Paper proposed fairly strong regulation of the derivatives
markets. The strong regulation was to address what Americans for Financial Reform and the
AFL-CIO felt were the three key principles in derivatives regulation. First, make sure that
derivatives were regulated by the same regulator that regulates the underlying asset. So, if you
are writing a derivative on a public security, the SEC needs to regulate the derivative. If you
are writing a derivative tied to a commodity, the CFTC (Commodity Futures Trading
Commission) needs to regulate it. That principle is embodied in both bills, more or less. The
second idea is that there has to be capital, that if you are going to take risks in the form of
derivatives you’ve got to have capital set aside to cover those risks. That principle, together
with the principle of transparency in derivatives transactions – which gets at the extraordinary
margins that most of us believe exist in the derivatives business for derivatives dealers
(mentioned by Rob Johnson in the prior panel) – that set of ideas was embodied in the notion
that derivatives ought to be cleared by a clearinghouse and posted on an exchange. Those
propositions have not fared so well in Congress. Both the Financial Services Committee and
the Agriculture Committee’s bills (as marked up on derivatives) contain a series of loopholes
that basically will exempt the majority of the derivative markets from exchange trading and
clearing, from having to have capital requirements in the markets themselves and from any
kind of transparency. Democrats in Congress have taken something of a hit in the press for
writing those exemptions. Behind that is the persistent rumor that, in fact, the large banks and
their law firms more or less drafted those provisions of those bills as they came out of the
House. On hedge funds and private equity funds: the Barney Frank bill, which was actually
introduced by Representative Kanjorski, provides for the registration of the advisors to these
funds (which is an important first step) and requires that registration by both hedge funds and
private equity funds. The bill does not do what it should do, which is provide the SEC with the
authority to regulate the funds themselves. It does envision that the Federal Reserve and the
Systemic Risk Council (which I’ll come to in a moment) could label a hedge fund, or a private
equity fund, as a systemically significant financial institution and regulate it directly from a
safety and soundness perspective. This regulation provides some basic investor protections,
for pension funds and endowments and the like, that invest in those vehicles. It does not really
create either transparency into the broader market or an ability on the Commission’s part to regulate their activities in the broader markets, from the perspective of maintaining fair markets for other participants. We have those kinds of rules for mutual funds. Even allowing that we might want to allow hedge funds to behave in ways that might be more aggressive in certain respects than mutual funds, the idea that there is no jurisdiction over them is deeply troubling. However, this is the one area where Barney’s bill is better than Dodd’s bill – because Dodd’s bill doesn’t include private equity funds in the registration requirement. From the AFL-CIO perspective, that is perhaps this single largest weakness in Dodd’s bill in comparison with Barney’s bill. On derivatives, while Dodd’s bill has some loopholes for what they call end users, it doesn’t have the wide range of loopholes that the House bill has.

Now finally I come to systemic risk. There are two issues with systemic risk; one is the regulation. As I said earlier, the House bill in its current form provides that, while there would be a Systemic Risk Council, that Council would essentially be captive of and staffed by Treasury. The real power to make decisions about whom to bailout and how to regulate those who might need to be bailed out would rest, in the first instance, with the Federal Reserve. In the discussion draft, the crafting of the powers for the Fed in its systemic risk capacity left no question that it would be able to undertake pretty much any kind of financial transaction to support a troubled institution. Despite the fact that much of the wording seems to be couched with limitations that would seem to be designed to avoid a repetition of the TARP, in terms of the kinds of abuses that I mentioned earlier, when you actually parse the words in the discussion draft, those limitations evaporate. Chairman Frank has promised that’s going to be fixed in later drafts. But, as of today, I can’t say that that has happened yet. The Dodd bill ensures that systemic risk regulatory power resides in an independent agency with its own staff, a chair appointed by the President; the regulators sit on the agency, and then there are two further independent presidential appointees to that agency. In my view, that’s a far superior structure to what the House bill has in mind. It steps away entirely from, “What do you do about the interpenetration of the banks and the Fed? How do you avoid essentially giving the banks the power to bail themselves out with the public’s money?” There is a second problem with this, which I alluded to earlier, about whether or not we are really shutting the door to the kind of abusive tactics that we saw in TARP. It’s not clear how different Dodd’s bill is, and we are trying to figure that out right now. It is a very long bill. We are hopeful that, as both Chairman Dodd and Chairman Frank have said that they don’t want any more TARPs, it will be possible to improve the language.

I have described these bills, these two behemoths moving through the committees with the leadership’s backing. In the last few days, something else is happening. Other members of Congress are beginning to introduce bills and amendments that go right at a number of the issues that this group is very interested in, and seem to be creating all sorts of political openings. It is unclear how those things will play. Two examples: in the area of “too big to fail,” Representative Kanjorksi, who is the second highest ranking Democrat on the House Financial Services Committee, is proposing a bill that would essentially break up too-big-to-fail institutions and give that power to the systemic risk regulators. Banks are very worried about
that. There are a number of bills circulating to implement what Paul Volcker has been calling for (which the AFL-CIO very much supports), which is that we shouldn’t allow depository institutions to engage in proprietary securities and derivatives trading, that having insured institutions having affiliates that do that is just insane. If Paul Volcker says it’s insane and Rich Trumka says it’s insane, it’s probably insane. That’s actually what a swing Senator said about Sarbannes-Oxley, “I got calls from Paul Volcker and Rich Trumka in the same day. That’s a new one on me. If they agree, it’s probably a good idea.” That was a few years ago. Then you have a bill from Senator Maria Cantwell from Washington, who is one of the leaders of a group of senators that has been very militant on the subject of regulating derivatives. Her bill essentially bans naked derivatives. It bans the taking of positions using the derivatives markets that amount to insurance on a risk that you don’t actually have. This is a longstanding principle in insurance law. I can’t insure your house or your life. It’s weakened a little bit in the area of what they call dead peasant insurance, which is really a noxious thing. This is very fundamental principle in insurance; we don’t allow people to do that, because of the drain of assets that the gamble represents, and because the perverse incentives it creates. A marvelous example of the perverse incentives it creates happened in the auto bailout, where the administration wanted to negotiate concessions for bond holders only to discover that many of the bond holders had credit default swaps that paid off 100 cents on the dollar if the auto companies defaulted. So that, in fact, they didn’t want to cut a deal. They were not rational actors in relation to the finance of that firm because a default was better for them than a structured settlement. That’s an example of why this principle is so important. That bill would wreak a radical change in the derivatives markets and confine them more or less to be a straightforward, wholesale, long-term insurance market. You can imagine that some people are fighting that one pretty hard. But the history of that particular group of Senators is that, around derivatives, they can be very tough. This is the group that effectively bottled up Gary Gensler’s nomination until Gary committed that he would get tough on derivatives regulation. I must say that it was sort of a strange interaction, because, so far, no one has been tougher on derivatives regulation. He deserves a lot of credit.

What’s going to happen here? I think that we are going to see financial reform pass. I think it is likely that we are going to see a pretty robust consumer protection agency. I’m not certain about that; there was certainly strong opposition here and there, and we made compromises, but I think we are headed that way. I think it’s very unlikely that at the end of the day the House version of systemic risk is going to be enacted, because the depth of suspicion and opposition to giving more power to the Fed in the Senate is very great and bipartisan and from all directions – moderates, conservatives, progressives. That could change were the Fed to do some self-evaluative exercise of the type that SEC has done around Madoff, around the gross failure of bank holding company regulation during the crisis; that might change some people’s views of the Fed. Similarly, governance changes that would remove the banks themselves from the control of regional Fed boards might change some people’s minds about the governance of the Fed. Certainly it would be of some consequence in the views of the AFL-CIO. It’s critical to understand that the Fed’s regulatory capacity, which is after all what we are talking about when we talk about systemic risk, resides in the regional banks. It does not
Reside here in Washington. This is where the macroeconomists and the money supply folks are, the bank regulators and the regional banks working for boards of directors that are actually controlled by the banks themselves. This is particularly true in the New York Fed. That’s at the heart of what is wrong with the proposal to give the Fed the type of systemic risk authority that is in the House bill.

I think there is room for some optimism here, but it’s not clear how the final picture will settle out, how these powers will be used. (I am going to bring this back to TARP and then I am going to close.) There is a fundamental problem about regulation. As I said at the beginning, there is the issue of whether we really are going to regulate the interactions of the big players. Right now, political will for serious reform is strongest in the consumer financial protection agency - the interaction of the big players with the weak. That’s good but it’s insufficient. Political resistance to real reform is strongest in those areas that are most about regulating the activities of powerful players as they deal with each other – derivatives, private equity, hedge funds and the like. So, how that’s going to come out is unclear.

It is also unclear whether or not we are going to fundamentally deal with the failed financial business model of the last ten years. This goes to all these issues I just talked about, where there is this tension between the leadership bills and the amendments coming in from the side. Are we building a regulatory system to manage a banking system where four banks are the majority of bank assets? Is our design to maintain and manage that system, or to change it? Are we building a regulatory system to maintain and manage a world in which those very large banks I just mentioned have large proprietary trading desks, taking huge risks in the securities and derivatives markets while they have effectively the majority of ensured deposits? Or are we going to change that? Those are the big questions on the table and there are increasingly loud voices saying we should change it.

Back to the Paulson blueprint, looking at the things that are not in the administration’s White Paper and the ways in which the White Paper was weakened as it moved through the House, you see the shadow of the Paulson blueprint returning. That political tension is unresolved, and it interacts with the strategy undertaken by this administration and the last one in TARP. The strategy that TARP has been about is buying time and trying to maintain asset prices within the financial system. That has been a disappointment to the banks, which I think wish to be straight-up rescued. The original idea of buying up assets at inflated prices has been a disappointment to them because it hasn’t really happened. It has been a disappointment to those of us who thought that there was a pretty well-established model for dealing with banking crises. People like Simon Johnson have laid it out. It goes back to the Reconstruction Finance Corporation. There are a lot of conservatives who were for it actually. There is an established model of doing this. It involves firing the executive who caused the mess, doing an accurate write-down of the assets, and, to the extent you put public money in, taking full value in terms of bank upside for every public dollar you put in.

Neither of those things has happened. Instead, there has been this time-buying exercise. A
serious re-regulatory effort around issues like, for example, proprietary trading – separating that from commercial banking – might not be compatible with the time-buying exercise, just as a serious effort to deal with foreclosures might not be compatible with the time-buying exercise. On the other hand, the time-buying exercise may not be compatible either with the long-term health of the US economy and the world financial system. Nor may it be compatible with the short-term needs (of our country and this administration) to address the pressing crises of real people in the areas of unemployment and housing.

How this all gets sorted out in the next six months seems to me critical for the question of the fate of the Obama administration and the hopes for progressive policy direction in our country going forward. Because, fundamentally, I believe the voters are going to be asking three economic questions. The first one is, “When I go to the polls, am I afraid of losing my job or have I lost my job?” The second question is, “Have the people and the institutions who caused this mess been held accountable, or have I (the voter) rescued them?” And the third question is, “Have we fixed this so we don’t do it again?”

Those questions are open questions – each one of them today. If they are answered properly, as, to be blunt, Franklin Roosevelt answered them properly, then I think there is a great future for this administration and for the values it represents, which I think are the best values of our society. If they are answered wrong, the best we can hope for is a re-do of the domestic policy paralysis of the Clinton administration. And there are a number of worse scenarios beyond that.

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