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THE PERFECT STORM IS BREWING ONCE AGAIN: WHAT SCALING BACK DODD–FRANK WILL MEAN FOR THE CREDIT DEFAULT SWAP

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I. INTRODUCTION—TWO PERFECT STORMS

In late October 1991, the crew of the *Andrea Gail* faced a dilemma.[1] The gamble they had taken by fishing the outer waters off Nova Scotia had paid off.[2] Stored in the ice chests below deck were thousands of pounds of valuable swordfish, the first big catch they had made in months.[3] But their recently repaired ice machine was failing once again, and their only hope for preserving the

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[1] SEBASTIAN JUNGER, THE PERFECT STORM: A TRUE STORY OF MEN AGAINST THE SEA 15 (2010).

[2] *Id.* at 88. The outer Grand Banks were normally unpopular with sword fisherman at that time of year. *Id.* at 38.

[3] *Id.* at 88.

haul was to immediately begin the three-day journey home.[4] At the same time, weather warnings reported a storm beginning to form directly in their path.[5] They could either risk the passage or wait the four days it would take to dissipate, by which time their catch would have spoiled.[6] Like many career fisherman of Gloucester, Massachusetts, the crew came from humble means and most were seriously indebted.[7] Neither they nor their families could afford another disappointing excursion, so they decided to risk it.[8] That weather system would later be coined a "perfect" storm—an unlikely culmination of separately destructive weather events that occurs once every fifty to one-hundred years.[9] The *Andrea Gail* and her six crewmembers were lost at sea; their last reported position was 180 miles northeast of Sable Island on October 28, 1991.[10]

That same year, in a boardroom of the Bankers Trust Investment Bank, the beginnings of another kind of perfect storm were forming—one that would ultimately prove more destructive and cost more lives and livelihoods than that Halloween storm of 1991.[11] A key lending client posed a problem to the investment bankers: how could the client minimize credit exposure on a sizable corporate loan while keeping the loan on its own balance sheet and avoiding syndicating it to other banks.[12] At the time, lending limits prevented even large banks from

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[4] *Id.*

[5] *Id.* at 104.

[6] *Id.* at 53.

[7] *Id.* at 10, 29.

[8] *Id.*

[9] *See* Alvin L. Mcghaee, *The Perfect Storm: October 1991*, NOAA NATIONAL CLIMATIC DATA CENTER, http://www.ncdc.noaa.gov/oa/satellite/satelliteseye/cyclones/pfctstorm91/pfctstorm.html (last updated Aug. 20, 2008). The colder high pressure system that forms over the northern United States and Canada had been unusually stagnant that year, growing larger than normal. *Id.* At the same time, the weather over the North Atlantic had been warmer than the yearly average, creating a strong low pressure system. *Id.* When the two systems met, the resulting low pressure system was strong enough to cause Hurricane Grace, which had been dissipating on its trajectory towards Greenland, to perform a hairpin turn and become enveloped into a new storm. *Id.* Its moist air contributed to the violence of the new super-storm, with wave heights in excess of forty feet recorded. *Id.*

[10] JUNGER, *supra* note 1, at 45. They were William Tyne Jr. (captain), David Sullivan, Dale Murphy, Alfred Pierre, Michael Moran, and Bobby Shatford. *See generally* JUNGER, *supra* note 1.

[11] *See* Aaron Reeves, Martin McKee, & David Stuckler, *Economic Suicides in the Great Recession in Europe and North America*, 205 BRIT. J. PSYCHIATRY 246 (2014). As a reminder of the very real cost of financial crises, a report published in the British Journal of Psychiatry found as many as 10,000 suicides that can be directly attributed to the severe economic downturn following the 2007 crash. *Id.* The combined stresses of lost employment, evictions, and unmanageable personal debt were cited as the leading reasons, especially amongst those with histories of mental illness. *Id.*

[12] Fanni Koszeg, *The Evolution of Credit Default Swaps and Efforts to Regulate Them: What Will be the Impact of J.P. Morgan Chase's Recent $2 Billion Trading Loss?*, BLOOMBERG LAW (Jul. 16, 2012), https://www.bna.com/evolution-credit-default-n12884910685/.

extending credit beyond certain leverage ratios—a safety mechanism that effectively required parties that were reaching their respective limits to sell off their loans.[13] As a solution to the problem, they devised the first clearly-identifiable synthetic credit-derivative contract.[14] The lender would make the loan, securitize it (or have an outside investment bank securitize it), and sell those securities to institutional investors, confident in the ability of the underlying corporation to repay.[15] The credit risk of the lender was thereby transferred, as their leveraged position was offset by the income from the sale of the derivative.[16] In doing so, the bankers created the prototype for what would become known as the credit default swap.[17]

The CDS is cited as a leading protagonist in the 2007–2010 financial crisis.[18] In the immediate aftermath, many called for the outright abolition of such products, famously dubbed "financial weapons of mass destruction."[19] The extensive regulatory response, outlined in Dodd–Frank, elected to preserve the CDS, albeit with fundamental changes to its creation and trading.[20] More recently, the Trump administration has expressed an intention to scale back and even "get rid of" Dodd–Frank, precipitating a spike in banking stocks.[21] While bipartisan criticism of certain parts of the act is undoubtedly warranted, Dodd–Frank's approach to regulation of the CDS remains staunchly defended by a plu-

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[13] *Id.*

[14] *Id.* Derivative contracts had existed in some form or another for centuries, particularly in the pastoral context, but this is the first evidence we have of banks realizing the utility of synthetically outsourcing their risk without losing the underlying asset (the loan). *Id.* While this structure is more akin to a collateralized debt obligation than a CDS, it proved only a short step for insurance companies to also offer banks and other investors this same type of "protection" in the form of CDS. The first true CDS was created by J.P. Morgan in 1994. *See id.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] James B. Kelleher, *Buffett's "Time Bomb" Goes off on Wall Street,* REUTERS (Sept. 18, 2008), http://www.reuters.com/article/us-derivatives-credit-idUSN1837154020080918. Warren Buffett made the historic analysis of derivative contracts in 2003. *Id.*

[20] *See* Koszeg, *supra* note 12.

[21] Marilyn Geewax, *Trump Team Promises to 'Dismantle' Dodd–Frank Bank Regulations,* NPR (Nov. 10, 2016), http://www.npr.org/sections/thetwo-way/2016/11/10/501610842/trump-team-promises-to-dismantle-dodd-frank-bank-regulations. The KBW Nasdaq Index, which expresses the relative health of banking stocks, has gained more than seven percent since President Trump won the election. *Id.* Furthermore, in response to these pronouncements by both President Trump and his team, ratings agency Moody's issued a statement which concluded in part: "While a reduction in regulatory compliance costs would bolster bank earnings, reduced oversight and a roll-back of requirements would also result in a weakening a of banks' capital and liquidity positions, a negative from a credit perspective." *Id.*

rality of interested groups, including the Democratic Party.[22] With the lines clearly drawn, this Article will ask the timely queries: Did Dodd–Frank "cure" the CDS of its potential for wreaking financial havoc? If so, would scaling back Dodd–Frank reinstate such destructive potential?

It must be stated at the outset that Dodd–Frank is a voluminous piece of legislation, designed to correct multiple regulatory weaknesses exposed by the crisis. The effect of its potential repeal overall is accordingly beyond this Article's scope. Instead, its narrow focus is on the CDS, whether the chosen regulatory response was justifiable, and what the effect of repealing such regulation of the CDS may be.[23] The approach taken is to first highlight the particular type of CDS at issue—the one that proved so destructive in world financial markets almost a decade ago—before properly identifying what attributes caused it to be so harmful.[24] Once highlighted, these underlying "mischiefs" will form the crucible against which competing theories on how the CDS ought to have been regulated will be tested.[25] This analysis will show that the theories are not so much competing as they are tackling the overall problem from different angles—that is, tackling separate mischiefs associated with the CDS.[26] Because it was the combination of these mischiefs that caused the "perfect storm" of a CDS, no one theory can be said to be better than another. In fact, they all prevent the perfect storm. Dodd–Frank's "cure," which was to tackle excessive leverage instead of excessive speculation, is perhaps better grounded in pervading U.S. policy and has preserved a highly lucrative financial market.[27] A more insurance-like regulatory approach would have resulted in less long-term volatility, but at the cost of a $14 trillion financial market.[28]

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[22] Jeff Cox, *Why it Won't be Easy for Trump to Repeal Dodd-Frank*, CNBC FINANCE (Nov. 21, 2016), http://www.cnbc.com/2016/11/21/repeal-dodd-frank-it-wont-be-easy-for-donald-trump-to-end-the-rule.html. Perhaps the only real weakness to Dodd–Frank that entertains bipartisan support is that the cap the Act imposes on its safe harbor, which excludes small banks from the more stringent requirements, is too low at $50 million. *Id.* Senator Frank himself has suggested that this number be revised to $150 million, as small banks find themselves expending too much of their limited resources in attempting to meet these requirements. *See id.*

[23] *See infra* Part VI.

[24] *See infra* Part II.

[25] *See infra* Part IV.

[26] *See infra* Parts IV–VI.

[27] *See infra* Part V.

[28] Mary Childs, *The Incredible Shrinking Credit-Default Swap Market: Trading Credit-Default Swaps Isn't What it Used to Be,* BLOOMBERG (Jan. 31, 2014), http://www.bloomberg.com/news/articles/2014-01-30/credit-default-swap-market-shrinks-by-half. According to the Bank for International Settlements, the notional outstanding amount of CDSs as of the end of 2015 was $14.596 trillion; which, although down from the highs of the crisis (some $56 trillion), remains a considerable sum. BIS, *OTC, Credit Default Swaps, by Type of Position*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/statistics/d10_1.pdf (last visited Mar. 7, 2017).

Whether Dodd–Frank's response to CDSs was the best approach (hopefully) remains to be seen. As will be shown, it certainly constitutes a justifiable approach.[29] This analysis demonstrates that attempts at scaling back Dodd–Frank would reinstate the exact same conditions in which the subprime mortgage meltdown occurred, and such a position ultimately cannot be justified.[30]

II. THE PERFECT CREDIT DEFAULT SWAP

If one were tasked with designing a financial instrument most likely to cause global financial ruin, one would probably have come up with the CDS that did exactly that from 2007–2010. Officially, a "credit default swap" is understood as an obligation by an underwriter to make the holder of the swap whole, should an uncertain "credit event" in a "reference obligation" occur.[31] That is, it is a form of protection against financial loss.[32] The underwriter is normally a large insurance company, while the swap holder is a party that seeks to claim compensation in the event of, say, a downgrade in the value of a portfolio of mortgage backed securities.[33] The downgrade is the credit event; the portfolio is the reference obligation.[34] Parties can then "swap" the stream of payments they would have expected from the portfolio "but for" the credit event, with a compensatory stream of payments from the insurance company.[35] So far, such products seem no more dangerous than any other financial-guaranty insurance contract. That is until one adds two features to their basic structure.

A. First Feature: Speculation

The first feature abandons the requirement that the holder of the swap must have an economic interest in the reference obligation (i.e., they need not own any portfolios of mortgage backed securities in order to buy protection on them).[36] These swaps became known as "naked" CDSs, as opposed to those

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[29] *See infra* Part V.

[30] *See infra* Part VI.

[31] Christian Schmaltz & Periklis Thivaios, *Are Credit Default Swaps Credit Default Insurances?*, 30 J. APPLIED BUS. RES. 1819, 1822–23 (2014).

[32] *Id.*

[33] Arthur Kimball-Stanley, *Insurance and Credit Default Swaps: Should Like Things Be Treated Alike?*, 15 CONN. L. REV. 241, 244–46 (2008), http://insurancejournal.org/wp-content/uploads/2011/07/72.pdf.

[34] Schmaltz & Thivaios, *supra* note 31, at 1823.

[35] Kimball-Stanley, *supra* note 33, at 244–46.

[36] Charles W. Murdock, *Credit Default Swaps: Dubious Instruments,* 3 HARV. BUS. L. REV. ONLINE 133, 136–137 (2013), http://www.hblr.org/2013/03/credit-default-swaps-dubious-instrumen

"covered" CDSs that required an interest in the underlier.[37] This factor transforms the CDS into a very capable speculative tool. It does so in two ways.

First, it drastically increases the potential size of the market for CDSs.[38] Because purchasers are not required to hold personal risk to hedge against, they can actively seek out those reference obligations that they feel are likely to suffer a credit event.[39] Purchasers then buy "protection" against such events transpiring—much like one would purchase protection against a neighbor's house burning down.[40] If the purchaser wishes, they can then sell that protection to a third party (someone from a different neighborhood, perhaps), unrestrained by any obligation to possess an interest in the underlier.[41] This in turn creates a thriving secondary market in such products.

The knock-on effect of this secondary market was another particularly toxic form of financial alchemy—the creation of "synthetic" collateralized debt obligations (CDOs).[42] This worked as follows: the underlying obligation (e.g., the mortgage in the case of the 2007 crisis) was bundled with other obligations (or "securitized") to form ordinary CDOs, before being sold to investors.[43] Speculators, who doubted the strength of those underlying loans (as well as those looking to hedge against their potential default), purchased corresponding CDSs.[44] When the amount of actual mortgages that fed these CDOs began to reach their natural cap, financial alchemists began looking for another stream of payments that could form an underlying asset.[45] It was not long before they realized the CDSs protecting the CDOs themselves provided a steady stream of premium payments, much like the mortgage repayments on home loans.[46] This allowed them to create "synthetic CDOs," where the reference obligation was no longer a package of mortgage repayments, but rather a package of CDS premiums.[47] Through this process of repackaging CDS premiums into synthetic CDOs, which in turn spawned CDSs to protect against their potential default, the ability

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[37] *Id.*

[38] *Id.* at 138.

[39] *Id.* at 136–37.

[40] *Id.*

[41] *Id.*

[42] *Id.* at 134.

[43] *Id.* at 137.

[44] Jennifer O'Hare, *Synthetic CDOs, Conflicts of Interest, and Securities Fraud*, 48 U. RICH. L. REV. 667, 669–71 (2014); *see also* Murdock, *supra* note 36.

[45] O'Hare, *supra* note 44, at 669–71.

[46] O'Hare, *supra* note 44, at 669–71.

[47] O'Hare, *supra* note 44, at 669–70.

to expand the amount of synthetic CDOs and corresponding CDSs in circulation was theoretically endless.[48] As such, by the end of 2008, the notional value on these swaps had reached $62.2 trillion.[49]

Second, the deal offered by the CDS contract effectively becomes too good to be true. It does so by altering the fundamental truism of investing: reward tends to track risk.[50] This becomes clear when one compares the CDS contract to an ordinary insurance contract. When considered in the abstract, an insurance contract makes for a remarkably good investment; with the payment of a small premium, the insured stands to gain a large payout upon the occurrence of an uncertain future event.[51] Theoretically, this allows for significant profit on the part of the purchaser. However, a safety mechanism inherent in all insurance contracts prevents them from being dangerously speculative.[52] The "insurable interest" qualification requires the insured actually suffer harm to the amount they were protected against in order to receive a payout.[53] In this way, the popularity of such contracts is kept in check as the insured is not making a profit but rather is being made whole.[54]

When that insurable interest requirement is removed, however, speculators are able to pay low premiums for potentially large payouts without suffering any personal loss should the credit event occur.[55] Put differently, the profit becomes real with no significant downside. The investment becomes almost irresistible to the rational investor.

B. Second Feature: Leverage

The second feature added to the basic structure of CDSs was that they

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[48] *See* O'Hare, *supra* note 44, at 680–81.

[49] *News Release: ISDA Publishes Year-End 2007 Market* Study, INT'L SWAP AND DERIVATIVES ASS'N, INC. (Apr. 16, 2008), http://www.isda.org/press/press041608market.html ("The notional amount outstanding of credit default swaps (CDS) grew 37 percent to $62.2 in the second half of 2007 from $45.5 trillion at mid-year."). O'Hare, *supra* note 44, at 669–71.; *see also* Reed Ablergotti, *Heard the One About the CDO that Actually Wasn't? Don't Ask,* WALL ST. J. (July 30, 2013) http://www.wsj.com/articles/SB10001424127887324170004578635851745597268.

[50] Kimball-Stanley, *supra* note 33, at 243–46.

[51] *Id.*

[52] *Id.* at 246–49.

[53] *See* Eric A. Posner & E. Glen Weyl, *An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First-Century Financial Markets,* 107 NW. U. L. REV. 1307, 1332–33 (2013) ("A covered CDS cannot be used for gambling because its value is negatively correlated with the value of the bond. But by the same token, it is unattractive for investors."); *see also* Kimball-Stanley, *supra* note 33.

[54] Posner & Weyl, *supra* note 53, at 1332–33.

[55] *Id.*

were not required to be traded on regulated financial exchanges or clearing houses.[56] Instead, they could be traded "over-the-counter" (OTC), facilitated by middlemen (usually investment banks) who connected willing buyers with willing sellers.[57] Holders of such swaps could resort to ordinary legal proceedings to have them enforced.[58] This effectively meant that the issuers of swaps were not subject to the basic margin and capital requirements that exchanges would have mandated, allowing them to achieve oftentimes dangerous leverage ratios.[59]

Accordingly, CDSs with these two attributes (naked and OTC), and not CDSs in general, wreaked havoc on world financial markets almost a decade ago.[60] As highlighted, such CDSs allowed for two potentially dangerous financial practices: excessive-speculation[61] and excessive-leverage.[62]

III. THE PRE-CRISIS REGULATORY REGIME

In determining whether Dodd–Frank tackled these risks effectively, it is instructive to look briefly at the regulatory history of such products. Of particular interest is how CDSs were able to legally acquire these dangerous features. It appears fault may be found on two fronts: the legislative encouragement of speculation and excessive-leverage through sweeping deregulation, and the lack

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[56] Kimball-Stanley, *supra* note 33, at 243–44.

[57] *Id.*

[58] *Id.* at 244.

[59] AIG, the single largest underwriter of CDO's before the crisis, exercised a previously unheard of leverage ratio of 17 to 1. Robert Mcdonald & Anna Paulson, *AIG in Hindsight* 8 (Fed. Res. Bank Chi., Working Paper No. 2014–07). While a multitude of factors have been cited as contributing to the financial crisis of 2007–2010, scholars note the potential collapse of insurance giants such as AIG as truly risking an economic depression. *See id.* AIG's potential collapse was due in large part to its exposure in credit default swaps. Yevgenia Nayberg, *What Went Wrong at AIG? Unpacking the Insurance Giant's Collapse,* KELLOGG SCH. MGMT. NW. U. (Aug. 3, 2015), https://insight.kellogg.northwestern.edu/article/what-went-wrong-at-aig ("The company's credit default swaps are generally cited as playing a major role in the collapse, losing AIG $30 billion."). Indeed, in former Secretary of the Federal Reserve Bank Hank Paulson's memoir, he recounts experiencing his greatest concern for the world economy when Jeffrey Immelt, CEO of General Electric (GE), raised fears over GE's inability to sell asset-backed commercial paper. Jeff Gerth, *Paulson Book: Behind the Scenes, GE's Top Exec Confided Credit Woes,* PROPUBLICA (Feb. 5, 2010), https://www.propublica.org/article/paulson-general-electric-immelt-financial-crisis-022010. GE's struggles to sell what were previously considered "safe" investments flowed from the drastically increased prices in credit insurance (i.e., CDSs) for anything longer than overnight commercial paper. *Id.* This indicated to Paulson the potential contagion to other industries a failure to rescue AIG might cause. *Id.*

[60] Posner & Weyl, *supra* note 53.

[61] This speculation was caused by traders in CDSs. *See* discussion *supra* Part II.A.

[62] This leverage was caused by the underwriters of CDSs. *See* discussion *supra* Part II.B.

of any robust response to such products from the insurance authorities.[63]

On the legislative front, pre-crisis regulation took two very different forms, depending on which "era" one analyzes. Prior to the 1990s, derivatives contracts were largely subject to the common law "rule against difference contracts."[64] This rule did not outlaw speculative bets per se, it merely refused to enforce them.[65] If a party to a "hedging" contract could not show actual loss as a result of the underlying risk transpiring, that contract was deemed speculative and would not be enforced at law.[66] This did not mean such contracts were not traded altogether; rather, traders in derivatives established de facto enforcement and protection mechanisms.[67] They did this by moving their trades onto exchanges and clearing houses, which mandated basic margin and capital requirements that kept excessive leverage in check to help ensure that parties could honor their obligations.[68]

The United Kingdom began the process of deregulation with its passage of the Financial Services Act of 1986.[69] The United States followed suit with several special exemptions for specific types of derivatives contracts.[70] The high water mark for deregulation in the United States came with the passage of the Commodity Futures Modernization Act (CFMA) in 2000.[71] It legislated that the rule against difference contracts did not apply to derivatives, including CDSs.[72] Many traders, who could now protect their derivative obligations at law, no longer saw the need to constrain their activities to clearing houses and exchanges, which also required fees for their services.[73] With this change, the over-the-counter market in CDSs began in earnest.[74]

On the "insurance regulator" front, most financial guaranty insurers in the

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[63] *See generally* Posner & Weyl, *supra* note 53; Letter from Eric R. Dinallo, Superintendent of Insurance, N.Y. St. Ins. Dep't to all Authorized Financial Guaranty Insurers (Sept. 22, 2008) (Circular Letter No. 19).

[64] Lynn A. Stout, *How Deregulating Derivatives Led to Disaster, and Why re-Regulating Them can Prevent Another*, 723 CORNELL L. FAC. PUBLICATIONS 4, 6 (2009), http://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=1824&context=facpub.

[65] *See id.* In this way, it operated almost identically to the insurable interest requirement in insurance law. *Id.* at 6.

[66] *Id.* at 5.

[67] *Id.* at 6.

[68] *Id.* at 6–7.

[69] *Id.* at 7.

[70] *Id.*

[71] *Id.*

[72] *Id.* at 4.

[73] *Id.* at 7.

[74] *Id.*

United States fall under the jurisdiction of the New York State Insurance Department (NY Insurance Department).[75] In June of 2000, the NY Insurance Department issued an opinion stating that CDSs would not be considered financial guaranty insurance because, in such contracts, "the Seller's payment is not conditioned upon a loss incurred by the Buyer."[76] In other words, CDSs were not considered insurance because they did not require an insurable interest.[77]

While this would appear to have paved the way for insurers like AIG to begin "underwriting" CDSs, there was another hurdle to overcome. Insurance law regulation imposed a long-standing requirement that registered insurers could only sell insurance products, and not other financial instruments (ostensibly to prevent insurers from excessively leveraging themselves at the risk of defaulting on obligations to those they insured).[78] The insurers circumvented this requirement by establishing special purpose vehicles (SPVs), which would issue CDSs.[79] The insurers would then provide financial guaranty insurance to those SPVs, ultimately securing them against default.[80] The NY Insurance Department stated it was satisfied with this arrangement.[81]

IV. OPTION 1: REGULATE AS INSURANCE

Following the burst of the credit bubble, with effectively no regulation in place, the drafters of Dodd–Frank were faced with the complex query: how should CDSs be regulated? A particularly strong case was made for regulating these products as insurance.[82] While the drafters ultimately elected not to regulate in this way, an analysis of the option helps explain why their support for their ultimate approach was nonetheless justified.

As highlighted, the similarities between a CDS and an ordinary financial guaranty insurance contract are striking. Under common law, an insurance contract exists when one party, the insurer, agrees to indemnify another, the insured, against a predefined category of risks, which, should any of them occur, would

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[75] Sherri Venokur et al., *Comparing Credit Default Swaps to Insurance Contracts: Did the New York State Insurance Department Get it Right?*, FUTURES & DERIVATIVES L. REP., Dec. 2008, at 3 (explaining that most of the financial houses requiring such insurance are based in New York and, accordingly, so are their insurers).

[76] *Id.* at 7.

[77] *Id.* at 3.

[78] *Id.*

[79] *Id.* at 12.

[80] *Id.*

[81] *Id.*

[82] *See* Letter from Eric R. Dinallo, *supra* note 63.

cause a loss for the insured.[83] The insurer agrees to do so in consideration for a paid premium.[84] Moreover, where a party does not have an insurable interest in the protected item, the insurance contract is unlikely to be enforced.[85] A "naked" CDS meets all but one of these requirements.[86] It includes the promise by the insurer to compensate the purchaser, upon the occurrence of a predetermined risk,[87] in consideration for a paid premium.[88] Only the insurable interest requirement is lacking.[89]

Therefore, it is little wonder that many called for CDSs to be regulated in precisely the same way as financial-guaranty insurance—requiring that CDS holders have an insurable interest in the underlier.[90] This "CDS as insurance" approach eliminated the "excessive speculation" mischief associated with these products (in such a case, CDSs are not freely alienable and do not offer a high reward at a low risk to the purchaser).[91] Conversely, the approach did not focus on insurance companies' "excessive leverage" risk, whereas Dodd–Frank's ul-

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[83] Emeric Fischer, *The Rule of Insurable Interest and the Principle of Indemnity: Are They Measures of Damages in Property Insurance?*, 56 IND. L.J. 445, 445–46 (1981), http://www.repository.law.indiana.edu/cgi/viewcontent.cgi?article=3544&context=ilj.

[84] *Id.* at 449.

[85] *Id.* at 445.

[86] *See* Posner & Weyl, *supra* note 53.

[87] *See id.* I.e., the "credit event." *See* Venokur et al., *supra* note 75.

[88] *See* Venokur et al., *supra* note 75.

[89] *See id.* The doctrine was largely developed under English law. *See* Sharo Michael Atmeh, *Regulation Not Prohibition: The Comparative Case Against the Insurable Interest Doctrine,* 32 NW. J. INT'L L. & BUS. 93, 98–99 (2011). Until the passage of the Marine Insurance Act of 1745, wagering on the potential loss of maritime property was legally permissible. *Id.* at 98–100. Concerned with the growing amount of fraudulent destruction of the reference assets in such policies, the Act required any party claiming compensation to show they had actually suffered the loss. *Id.* at 100. While the doctrine was extended to life insurance a short time later, it was with the passage of the Gaming Act of 1845 that insurable interest became a standard feature of most insurance contracts. *Id.* at 99–100. The Gaming Act enforced the strongly held puritan view of the time that wagering was a morally reprehensible practice. *Id.* As the mores of society developed and ill will towards wagering began to slacken, the Gaming Act saw a gradual erosion of its insurable interest requirement. *See generally id.* The death knell came in 2005 with the passage of the Gambling Act. In an attempt to legalize gambling so that it may be better regulated, this latest Act effectively abolished the insurable interest qualifier as a per se requirement for most hedging contracts. *Id.* at 101. It appears most state laws in the United States took the same trajectory, as the mores of American society largely mirrored those in England. *Id.* Accordingly, although gambling remains illegal in most states, underlying ethical qualms with speculation are not represented at the national level. *Id.* at 102–05.

[90] *See* Kimball-Stanley, *supra* note 33.

[91] *The Role of Derivatives in the Financial Crisis*, Financial Crisis Inquiry Commission Hearing 1–2 (2010) (testimony of Michael Greenberger), http://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1036&context=cong_test.

timate approach did.[92] It is now apparent that most of the initial arguments against the insurance approach can be criticized.[93] Current arguments in favor of the approach, however, also fail to take account of what putting an end to speculation might actually mean.

A. Arguments Against Regulating CDSs as Insurance

The week after Lehman Brothers filed for bankruptcy, the N.Y. Insurance Department published a letter to financial guaranty insurers (Circular 19) in which it seemingly proposed to regulate CDSs as a form of financial guaranty insurance.[94] The circular only proposed to regulate "a CDS in which the buyer of protection holds, or reasonably expects to hold, a 'material interest' in the reference obligation."[95] It was, in other words, proposing to regulate only "covered" CDS contracts where an insurable interest by the holder already existed, and not naked CDSs, which contributed so significantly to the crisis.[96] Those critical of the "CDS as insurance" argument latched on to this statement, declaring it constituted clear evidence for why naked CDSs were not to be considered insurance contracts.[97]

It would appear that the reasoning employed by the Insurance Department, however, is inherently circular. It does not follow that a naked CDS escapes liability under insurance law merely because it lacks an insurable interest. Rather, that contract is unenforceable.[98] In other words, it seems such a position fails to separate those requirements that define an insurance contract from those that determine whether an insurance contract is valid. Insurable interest is not a definitional requirement of insurance; rather, it goes to validity of the contract.[99] If the Insurance Department accurately applied its own stated definition for what con-

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[92] Dennis Kelleher, *Speculators are Driving up Gas Prices*, CNN (Mar. 21, 2012), http://money.cnn.com/2012/03/21/markets/oil-gas-prices-speculators/.

[93] *See infra* Part IV.A.

[94] Letter from Eric R. Dinallo, *supra* note 63. Two months later, the Department issued another press release stating it would indefinitely delay regulating CDSs as insurance, in the hopes that CDSs could be brought under a single, comprehensive regulatory regime. *Id.*

[95] *Id.*

[96] *Id.*

[97] Venokur et al., *supra* note 75.

[98] *See infra* Part II.

[99] "'Insurance contract' means any agreement or other transaction whereby one party, the 'insurer,' is obligated to confer benefit of pecuniary value upon another party, the 'insured' or 'beneficiary,' dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event." Definitions; Doing an Insurance Business, N.Y. Ins. Law § 101, http://www.dfs.ny.gov/insurance/r_other/1101.pdf.

stitutes an insurance contract, it would have likely found that a naked CDS does, in fact, fall within its ambit.[100]

There are other less popular attempts at distinguishing CDSs from insurance. One such attempt focuses on the fact that CDS premiums are paid quarterly, while typical financial guaranty insurance is paid on a yearly basis.[101] Unfortunately, such assertions leave unexplained how the frequency of premium payments changes the nature of a premium. So long as it remains a premium, it meets that definitional aspect of insurance. Another suggestion is that the buyer of a CDS, unlike the insurance purchaser, will be subject to a cancellation fee should they cancel the contract.[102] It appears the only way in which such a fee could validly distinguish insurance from a CDS would be if no insurance contracts were subject to cancellation fees, while all CDSs were. This distinction is untrue in reality.[103] Yet another asserted distinction is that a CDS typically exists for a fixed term, while an insurance contract will continue indefinitely so long as the premium is paid.[104] Again, this claim appears unsubstantiated, as fixed term insurance is a mainstay of the insurance market.[105]

B. Arguments for Regulating CDSs as Insurance

Proponents of the "CDS as insurance" approach focus on two basic mischiefs associated with unregulated CDSs. The first is the more amorphous "moral hazard" concern.[106] Unlike the purchaser of insurance, who stands to recoup only losses actually suffered, the holder of a naked CDS only stands to lose premiums already paid—they will enjoy a net gain.[107] While such losses, if widespread enough, will certainly have a negative effect on the broader economy, the CDS holder nonetheless wishes for the loss to occur so that they may receive their personal benefit.[108] This sets up a personal incentive that is at odds

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[100] *Id.*

[101] Nat'l Ass'n of Ins. Comm'rs, *Financial Guaranty Insurance Guideline*, MODEL REG. SERV., Oct. 2008, at 1626–17, http://www.naic.org/store/free/GDL-1626.pdf.

[102] Venokur et al., *supra* note 75, at 8–9.

[103] Robert Chung, *Financial Guaranty Insurance Policies: Keep Your Eyes Open for Potential Pitfalls*, CORP. COUNSEL (Sept. 2008), http://www.andersonkill.com/webpdfext/CorporateCounsel-Sep2008.pdf.

[104] *See* Nat'l Ass'n of Ins. Comm'rs, *supra* note 101.

[105] *See e.g.*, *What is Term Life Insurance?*, USAA, https://www.usaa.com/inet/pages/insurance_life_level_term?akredirect=true (last visited Feb. 21, 2017).

[106] Kimball-Stanley, *supra* note 33, at 242–43; Posner & Weyl, *supra* note 53, at 1345.

[107] Posner & Weyl, *supra* note 53, at 1345.

[108] *Id.*

with what is best for society.[109] This "negative incentive" is considered a moral hazard.[110] As such, by requiring the CDS holder to have an insurable interest in the reference obligation (i.e., by requiring it be treated as insurance), the holder will no longer "profit" from the loss in the reference obligation and will not be incentivized to see such loss occur. Moral hazard is thereby avoided.[111]

The second concern leads more practically from the first, and highlights the systemic risk associated with unchecked speculation in CDSs. One need only take a brief look at the causes of the 2007 crisis, outlined above, to realize this concern is valid.[112] Requiring insurable interest in the reference obligation would go a long way towards preventing such systemic risk. It would essentially uphold only those CDSs that legitimately hedge against risk while finding any naked CDSs unenforceable at law.[113]

That said, after a brief exploration of the hypothetical scenario where CDSs are indeed regulated as insurance, at least three criticisms of this proposition become apparent. The first is that it fails to account for the fact that such a "remedy" would have a blunt and potentially devastating impact on a lucrative global market, with possible knock-on effects for other industries.[114] While such regulation would certainly end speculation in naked CDSs, in so doing it would bring a halt to trillions of dollars worth of global trade.[115] While this Article does not presume to explore the practical consequences of such a ban, even if phased in over time, it appears safe to suggest that severe market uncertainty is one of many probable outcomes.[116]

The second criticism relates to the moral hazard argument, which does not appear to be a legitimate consideration in the context of modern financial markets. Posner and Weyl suggest that worry over moral hazard made sense at a time when holders of insurance were able to play some personal role in the destruction of the underlying asset (or more darkly, the life of a person in the case

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[109] *Id.*

[110] *See id.*

[111] *Id.*

[112] *See generally* Stout, *supra* note 64.

[113] *Id.* at 6.

[114] Posner & Weyl, *supra* note 53, at 1351–52; *see also* Paula S. Greenman et al., *Regulation of Over-the Counter Derivatives Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, https://www.skadden.com/newsletters/FSR_A_Regulation_of_Over-the-Counter_Derivatives.pdf (last visited Mar. 7, 2017) (discussing how even the slightly less market invasive steps taken by the Dodd–Frank Act may still have several unintended consequences).

[115] Childs, *supra* note 28.

[116] See *id.*

of life insurance).[117] Such a concern appears largely antiquated in the case of a CDS, as the size and spectrum of the market on which the asset is based tends to place its "direction" firmly out of the hands of speculators.[118] It is only when speculation reaches levels as extreme as those seen leading up to 2007 that they may cause hazardous "externalities" and begin to drive the market itself.[119] Accordingly, while moral hazard remains a concern, it does so only in particularly limited circumstances.

The third critique is that the insurable interest qualifier in the CDS context may be at odds with the current mores of the United States.[120] This is because such a qualifier would preclude speculation in CDSs entirely, at a time when speculation is not per se unlawful in other contexts.[121] On the contrary, it appears speculation has oftentimes been actively supported by the legislature.[122] As illustrated, the passage of the Commodity Futures Modernization Act saw excessive legislative support of "free-market" speculation.[123] Another example is the fact that short selling, while under legal pressure elsewhere,[124] has been met with only half-hearted resistance in the United States.[125] It appears, as with wagering contracts, that society no longer finds such practices as morally reprehensible as it once did.[126]

V. OPTION 2: THE DODD–FRANK APPROACH

To reiterate, those who claim CDSs cannot fit within the definition of insurance appear to employ an inherently circular argument.[127] On the other hand, the claim that CDSs ought to be regulated as insurance seems to disregard the potential impact such a rule would have, is premised on largely antiquated moral hazard concerns, and can also be seen as out of step with the current mores of society.[128]

Perhaps mindful of these complexities, the drafters of Dodd–Frank did not

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[117] Posner & Weyl, supra note 53, at 1345–46.

[118] *Id.*

[119] *Id.*

[120] See Atmeh, supra note 89, at 101–05.

[121] Posner & Weyl, supra note 53, at 1345.

[122] See Stout, supra note 65, at 6–7.

[123] *Id.*

[124] Murdock, supra note 36, at 137–38.

[125] *Id.*

[126] Posner and Weyl, supra note 53, at 1345.

[127] *See supra* Part IV.A.

[128] *See supra* Part IV.

attempt to regulate CDSs as insurance, and instead elected to tackle their other associated "mischiefs," namely the excessively leveraged positions of the insurance companies selling these instruments.[129] As stated, a thorough account of all the means employed in Dodd–Frank to achieve this goal is beyond our current scope. With that said, several high-level rules marking the biggest departures from the previous regime are highlighted below.

First, Dodd–Frank implements mandatory clearing and exchange trade requirements for certain types of swaps.[130] This means that in the view of the Commodity Futures Trading Commission (CFTC), swaps that have the potential to cause systemic risk if traded OTC will now be forced to register and trade through clearing houses or on exchanges.[131] The effect of this rule is twofold. On the one hand, it provides for increased transparency as exchanges and clearing houses are subject to certain reporting requirements on the nature and volume of trades that occur.[132] On the other hand, because the exchanges and clearing houses require that their members post capital towards a default fund and provide minimum margins on their trades, it sets a cap on the potential exposure such products may obtain.[133]

Second, Dodd–Frank introduces the terms "swap dealer" and "major swap participant" to the Commodity Futures Act.[134] A swap dealer is typically a registered financial institution that trades in swaps (such as an investment bank), while a major swap participant refers to parties that are un-regulated financial institutions, but nonetheless have significant exposure to "naked" swaps.[135] Parties falling under either definition are required to register with the CFTC and maintain certain margin and capital requirements.[136]

Third, Dodd–Frank requires that swap dealers and major swap participants

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[129] *See generally supra* Part II.B.

[130] 7 U.S.C. § 2 (2012); 15 U.S.C. § 78c-3 (2012).

[131] 15 U.S.C. § 78l (2012). While the manner in which Dodd–Frank divides regulatory authority between the CFTC and the SEC is largely irrelevant for our current purposes, a clarification as to why no mention of the SEC is made here may be necessity. Dodd–Frank defines three types of swaps: swaps, security-based swaps, and mixed swaps. *Id.* §§ 78c(68)(A) & (D), (69). The types of CDSs that we are concerned with, and that contributed so significantly to the crisis, fall under the first "swaps" category. Security-based swaps typically refer to swaps based on a single underlying asset or obligation, like a single home-loan, and do not refer to the types of securitized assets that naked CDSs covered. *Id.* Swaps are regulated by the CFTC, while security-based swaps are regulated by the SEC. Mixed swaps, which also do not include CDSs, are regulated by both agencies.

[132] Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111–203 §§ 712, 124 Stat. 1376, 1641 (2010).

[133] Greenman *et al.*, *supra* note 114, at 7–8.

[134] 7 U.S.C. § 1a; 15 U.S.C. § 78c(a) (2012).

[135] 7 U.S.C. §§ 1a(49)(A), (33)(A).

[136] 7 U.S.C. §§ 6s(a)(1)–(2), (e).

meet certain minimum public reporting and record keeping requirements.[137] These even apply to those end users who possess these instruments only as legitimate hedges against risk.[138] Although not often cited as a substantive factor, the effect that the lack of transparency in OTC trades had in contributing to the crisis cannot be underestimated.[139] World markets were caught unaware of the exact amount of overall exposure to OTC swaps, precisely because the extent of such exposure was almost impossible to ascertain.[140] Some have suggested that institutions such as Lehman Brothers, which were not "saved" with government bailouts, did not fall victim to increased exposure insomuch as they fell victim to market ignorance as to the extent of their exposure.[141] Had reporting requirements been in place, potential investors in Lehman Brothers would have been able to make a more informed analysis on the extent of Lehman's exposure, and may possibly have decided to buy the company.[142]

VI. REPEALING DODD–FRANK

In determining the possible effect of repealing Dodd–Frank, it is important to distill exactly what the Act does in the case of the CDS. Technically, Dodd–Frank only regulates covered CDS type contracts as insurance (which it then excludes from its ambit via a safe harbor provision).[143] A naked CDS is regulated, just as any other financial derivative. The continued debate over whether CDSs ought to have been regulated as insurance is therefore rendered largely academic for the time being.

Dodd–Frank nonetheless represents a marked change from the post-CFMA regime, which was an effective "open gate" policy allowing all OTC derivative contracts to be freely speculated and enforced at law. In comparison to the pre-CFMA era, however, it appears the current regime differs, at least formally, in two key respects. First, it does not recognize an insurable interest requirement in any form, whereas previously such a requirement was recognized at common law in the rule against difference contracts. Second, some amount of

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[137] 7 U.S.C. §§ 6s(f)–(g).

[138] *Id.*

[139] Viral Acharya & Robert Engle, *A Case for (Even) More Transparency in the OTC Markets,* VOX (Aug. 29, 2009), http://www.voxeu.org/article/case-even-more-transparency-otc-markets.

[140] *Id.*

[141] James B. Stewart & Peter Eavis, *Revisiting the Lehman Brothers Bailout that Never Was,* N.Y. TIMES (Sept. 29, 2014), http://www.nytimes.com/2014/09/30/business/revisiting-the-lehman-brothers-bailout-that-never-was.html?_r=0.

[142] *Id.*

[143] 7 U.S.C. § 2(a)(1); 15 U.S.C. § 78a.

over-the-counter speculation is still officially "sanctioned," as registered speculators who meet the CFTC's requirements are able to enforce their obligations at law. On a substantive level, however, Dodd–Frank can be seen as a return to the pre-CFMA regulatory stance. This is because although that regime applied the rule against difference contracts, the effect of the rule was to force trades onto clearing houses and exchanges. The regulatory authorities were content with this result, as participants on those forums nonetheless had to maintain basic margin and capital requirements. Accordingly, even though some OTC swaps can still be traded and enforced at law, the net result of maintaining a basic "floor" of security on those trades seems to reflect the pre-CFMA era.[144]

It appears that Dodd–Frank mostly achieves the correct balance. It does not impose a blanket insurable interest requirement, which would have been criticized for the reasons described above, yet it mitigates true financial crisis by placing a ceiling on the extent of loss that can theoretically occur. Furthermore, its requirement for reporting and disclosing trades should allow market actors to monitor defaults, which may forewarn the bursting of a credit bubble, and calculate the potential effect of mass defaults, thereby reducing the likelihood of an ignorance fueled panic.

At least one effect of repealing the parts of Dodd–Frank that force derivative trades onto exchanges and clearing houses is clear. Simply put, we will see a return to the CFMA regime. The CFMA regime, as explained, was essentially a repeal of any regulation of financial derivatives.[145] Whether we would see a return of the great recession, therefore, appears to be more a question of faith. Faith in the ability and wherewithal of financial institutions to self-regulate.

VII. CONCLUSION

As with any disaster, no single element can be cited as its root cause. It is rather the coming together of a perfect storm of factors that leads to eventual collapse. The standout factors in the 2007–2010 crisis were the excessive leverage and unadulterated speculation that sweeping deregulation allowed. The devastation wrought on the broader economy demanded a remedy, and that remedy required a culprit. The credit default swap, and the synthetic CDOs it fueled, were highlighted as prime suspects due to the unparalleled market turmoil they caused. Calls for regulating the CDS like its identical twin, the financial guaranty insurance contact, quickly gained traction (and still entertain much debate almost ten years later). Half-hearted counterarguments were made in re-

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[144] *Id.*

[145] *See supra* text accompanying note 75.

sponse, intent on finding false distinctions between CDSs and insurance contracts. Nonetheless, the legislature, mindful of the effect such "insurance-like" regulation would have, sought a middle ground—one that seemingly reflects current attitudes towards speculation and moral hazard. It cannot be denied that scaling back Dodd–Frank's response to the CDS would see a return to the fertile conditions in which the crisis of the last decade was born. While some may argue that investment bankers are more likely to self-regulate this time around, the following exchange before the Congressional Financial Crisis Enquiry Commission between Chairman Angelides and Mr. Blankfein (the current CEO of Goldman Sachs) is perhaps instructive:

> Blankfein: "After ten benign years… in the context… how would you look at the risk of our hurricane?"
>
> Chairman Angelides: "Mr. Blankfein… having sat on the board of the California Earthquake Authority, acts of God we'll exempt. These were acts of men and women."[146]

APPENDIX: IN THE WORDS OF THE CEOS

Taken from testimonies before the first public hearing of the Financial Crisis Enquiry Commission in January 2010, on their understanding of the causes of the financial crisis and their suggestions for stronger regulation. The most salient excerpts to this Article are highlighted below.

Jamie Dimon, J.P. Morgan Chase, on the causes of the financial crisis:

I would be remiss if I did not touch briefly on some of the factors I believe led to our current economic situation. This is necessarily a truncated recitation, as economists, historians and policymakers will no doubt debate the causes—and fill books with their views on them—for years to come. I believe the key underlying causes of the crisis include: the creation and ultimately the bursting of the housing bubble; excessive leverage that pervaded the system; the dramatic growth of structural risks and the unanticipated damage they could cause; regulatory lapses and mistakes; the pro-cyclical nature of policies, actions and events; and the impact of huge trade and financing imbalances on interest rates, consumption and speculation. Each of these causes had multiple contributing factors, many of which were known and discussed before the crisis.

As the housing bubble grew, new and poorly underwritten mortgage prod-

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[146] Fin. Crisis Inquiry Comm'n, *The Official Transcript: First Public Hearing of the Financial Crisis Enquiry Commission*, ROCK CENTER FOR CORP. GOVERNANCE AT STAN. U. 36–37 (Jan. 13, 2010), http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0113-Transcript.pdf.

ucts helped fuel asset appreciation, excessive speculation and far higher credit losses. Mortgage securitization had two major flaws that added risk: nobody along the chain had ultimate responsibility for the results of the underwriting for many securitizations, and the poorly constructed tranches converted a large portion of poorly underwritten loans into Triple A-rated securities. In hindsight, it's apparent that excess speculation and dishonesty on the part of both brokers and consumers further contributed to the problem.

Excessive leverage by consumers, some commercial banks, most U.S. investment banks and many foreign banks, pervaded the system. This included hedge funds, private equity firms, banks using off-balance sheet arbitrage vehicles, non bank entities, and even pension plans and universities.

Several structural risks or imbalances grew in the lead-up to the crisis. Many structures increasingly relied on short-term financing to support illiquid, long-term assets. A small structural risk in money market funds that allowed investment in up to 180-day commercial paper or longer term asset-backed securities became a critical point of failure when losses on such securities encouraged investors to withdraw their funds and liquidity was not available to meet redemptions. Over time, repo financing terms became too loose, with some highly leveraged financial institutions rolling over this arrangement every night. Financial institutions were forced to liquidate securities at distressed prices to repay short-term borrowing. Investors caused enormous flows out of the banking and credit systems they collectively acted in their own self-interest.

In many instances, stronger regulation may have been able to prevent some of the problems. I want to be clear that I do not blame the regulators. The responsibility for a company's actions rests with the company's management. However, it is important to examine how the system could have functioned better. **The current regulatory system is poorly organized with overlapping responsibilities, and many regulators did not have the statutory resolution authority needed to address the failure of large, global financial companies.**

While banks in the mortgage business were regulated, most of the mortgage industry was not or lacked uniform treatment – mortgage brokers were not regulated and insurance regulators were essentially unaware of large and growing one-sided credit insurance and credit derivative bets by some companies. Basel II capital standards, which were adopted by global banks and U.S. investment banks, allowed too much leverage. Extraordinary growth and high leverage of Fannie Mae and Freddie Mac were allowed where the fundamental premise of their credit was implicit support by the U.S. government.

The abundance of pro-cyclical policies has proven harmful in times of

economic distress. Loan loss reserving causes reserves to be at their lowest levels at times when high provisioning is needed the most. Although we are a proponent of fair value accounting in trading books, we also recognize that market levels resulting from large levels of forced liquidations may not reflect underlying values. Continuous credit downgrades by credit agencies in the midst of a crisis also required many financial institutions to raise more capital.

Many macroeconomic factors also contributed to the crisis, including the impact of huge trade and financing imbalances on interest rates, consumption and speculation. The U.S. trade deficit likely kept U.S. interest rates low, and excess demand kept risk premiums depressed for an extended period of time.[147]

John J. Mack, Morgan Stanley, on the role of government in stabilizing the financial system:

We at Morgan Stanley recognize how close the global financial system came to collapse during the fall of 2008 and the critical role that the federal government, and TARP in particular, played in restoring stability to the financial system. We and our employees appreciate the support provided to our industry by the U.S. government, Congress and the Administration during this challenging period, and we are proud of the fact that we were one of the first firms to repay the TARP funds that we received.

The financial crisis laid bare failures of risk management at individual firms across the industry and around the globe. **But, more significantly from a policy perspective, it made clear that regulators simply didn't have the tools or the authority to protect the stability of the financial system as a whole. That's why we need a systemic risk regulator with the ability and responsibility to ensure that excessive risk-taking never again jeopardizes the entire financial system. We cannot and should not take risk out of the system—that's what drives the engine of our capitalist economy. But no firm should be considered "too big to fail." If a firm mismanages its risks, regulators need the authority to unwind it in a way that minimizes instability to the system.**

It is also clear that the complexity of financial markets and financial products has exploded in recent years, but regulation and oversight have not kept pace. While many of these complex products were designed to spread out risk, they often had just the opposite effect - obscuring where that risk was concentrated and to what degree. Regulators and investors need to have a fuller

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[147] Fin. Crisis Inquiry Comm'n, *Testimony of Jamie Dimon: Chairman and CEO, JPMorgan Chasehe & Co.*, ROCK CENTER FOR CORP. GOVERNANCE AT STAN. U. 8–10 (Jan. 13, 2010), http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0113-Dimon.pdf.

and clearer picture of the risks posed by increasingly complex financial instruments and contracts, as well as the true value of those products. We should also aim to make more financial products fungible to ensure they can be transferred from one exchange or electronic trading system to another. **To improve oversight and transparency, I believe that we need to establish a federally regulated clearing house for derivatives or require reporting to a central repository. This will help create a truly efficient, effective and competitive market in futures and derivatives, which would benefit investors and the industry as a whole.**

Finally, today's financial markets are global and interconnected, and we believe our regulatory regime needs to be as well. Risk cannot be defined or contained by geographic borders. The U.S. must work with countries across the globe to coordinate and synchronize standards and enforcement. Otherwise, inconsistent regulation can result in "regulatory arbitrage" in which some market players seek competitive advantage by exploiting such differences, thereby distorting the competitive marketplace.[148]

Bank of America, Brian T. Moynihan, on the "too big to fail" question:

Too-big-to-fail is a legitimate problem, but not well understood and somewhat overstated.

Obviously, I am somewhat biased on this front, as Bank of America will be on anyone's list of TBTF institutions. But some of the proposals seem to be contrary to what we have just learned.

The institutions that effectively opted out of the Gramm-Leach Bliley Act's repeal of Glass-Steagall and remained monoline investment banks (or mortgage lenders) are the ones that failed: Bear, Lehman, WaMu, Wachovia (which had a capital markets business but ultimately was brought down by Golden West, a thrift). J.P. Morgan Chase was relatively healthy and acquired Washington Mutual and Bear Stearns; we were relatively healthy and acquired Countrywide and Merrill Lynch. Those arguing for a return of Glass-Steagall are effectively arguing that Bear Stearns was a more stable entity than JP Morgan Chase. I don't see how that is tenable. Bank holding companies clearly proved the most durable structure in the current crisis. Indeed, one could argue persuasively that the mistake in Gramm-Leach-Bliley was in not requiring investment banks to affiliate with banks and become regulated bank holding com-

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[148] Fin. Crisis Inquiry Comm'n, *Written Submission of Morgan Stanley to the Financial Crisis Inquiry Commission: John J. Mack, Chairman*, ROCK CENTER FOR CORP. GOVERNANCE AT STAN. U. 14–16 (Jan. 13, 2010), http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0113-Mack.pdf.

panies. And this is just one side of the equation.

The other is: what structure serves American businesses, and ultimately the American consumer and economy, better. Financial firms able to offer an integrated suite of financing options, or balkanized firms that that do not? We believe that a company looking to choose among loans, debt financing, and equity underwriting options is best served by having each firm able to offer all of those options.

To develop sound policies, I believe we need to go carefully examine the policy questions behind the acronym "TBTF." I can think of three:

The initial concern is that TBTF creates moral hazard, as large banks can leverage themselves unduly given that markets are willing to lend on non-market terms, on the assumption they will be bailed out. This is a legitimate concern, and justifies capital and liquidity requirements to restrain the ability to operate with greater leverage and less liquidity than the market would ordinarily require.

It is also worth noting, though, that the moral hazard here, while certainly existent, is not terribly distorting. Obviously, the inability of banks during the recent crisis to issue bank debt of any tenor longer than overnight shows investors they did not take a lot of comfort from TBTF—and this was after bondholders at Bear had been bailed out. CDS prices continue to indicate real risk to investors in large banks. Large bank debt pricing is extremely sensitive—one might even say unduly sensitive—to ratings—something one wouldn't expect if the markets were assuming TBTF.

The second concern is that taxpayers will lose money when a TBTF institution is bailed out.

Here, at least for the banking industry, recent history is comforting. Bank of America alone has paid $2.73 billion in dividends, and none of the original nine TARP banks has imposed any losses on taxpayers. Those same nine large banks have paid tens of billions of dollars in special assessments to pay for the resolution costs of small banks. We certainly appreciate the assistance we received and are pleased that we've been able to pay it back in full with interest.

Finally, we need to consider the downside of debilitating larger financial firms, by requiring them to shed economies of scale or permitting them to service only part of a corporate customer's needs. It is worth reminding ourselves that the U.S. has the most banks of any country in the world, and the smallest concentration of assets in its largest banks. All other major countries allow the affiliation of bank lending with underwriting and dealing in securities. This is no accident, as there is considerable evidence, in no way inconsistent with the recent crisis, that there are economies of scale in banking, and that corporations seeking financing prefer an integrated model.

In an increasingly global environment, our major competitors for any corporate assignment include foreign banks, and we need to ensure that the U.S. financial services system—and in our case, the approximately 300,000 associates employed by Bank of America—are able to compete for that business. There is of course a ready, though not simple alternative to shrinking or underleveraging our strongest financial institutions. And that starts with recognizing that "interconnectedness" and not "bigness" is what led to the need for taxpayer bailouts.

Washington Mutual was an extraordinarily large institution, and resolved in due course. AIG did not receive what may prove to be, along with Fannie Mae and Freddie Mac, the most expensive bailout to American taxpayers because of the large asset size of its insurance divisions; it received the bailout because of the counterparty credit risks imposed by its far smaller financial products division. We can do much to diminish the risks and distortions of too big to fail by carefully considering issues like resolution and liquidity and the potential for products like CDS to increase contagion risk. I hope this Commission will be an important part of that work.

Thank you again for the opportunity to express my opinions on this important subject. I look forward to answering any questions the Commission might have.[149]

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[149] Fin. Crisis Inquiry Comm'n, *Brian T. Moynihan, Chief Executive Officer and President, Bank of America: Testimony to Financial Crisis Inquiry Commission (FCIC)*, ROCK CENTER FOR CORP. GOVERNANCE AT STAN. U. 12–13 (Jan. 13, 2010), http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0113-Moynihan.pdf.