John C. Coffee Jr., Columbia University’s Berle Professor of Law, presented the 107th Sibley Lecture titled “Death, Taxes and Systemic Risk: Planning for the Inevitable,” where he analyzed the effectiveness of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in 2010, and discussed whether or not it could prevent another 2008-style financial crisis.

The act was created to curtail systemic risk and, while the drafters invested heavily in the areas of prevention, regulatory controls and monitoring, Coffee questioned if these efforts would be enough.

“Systemic risk will still occur, in light of this act, because of inherent bank fragility, the regulatory sine curve [tight regulation after a crash, followed by gradual relaxation thereafter] and cognitive limitations that cause new risks to be perceived only after the fact,” Coffee said.

This is not surprising, Coffee argued, because banking has always been characterized by liquidity crises.

Traditionally, central banks such as the Federal Reserve Bank and the Federal Deposit Insurance Corporation assume the role of “lender of last resort.” Their core job in a crisis is to identify the truly insolvent, terminally ill banks from those simply facing a liquidity crisis. Then the central bank liquidates the former while advancing funds to the latter.

“This process occurred with little political controversy until 2008,” Coffee said. “That year changed everything for many reasons.”

First, he said, it was not the banks, but “shadow banks” (Lehman Brothers, AIG, etc.) that had to be either bailed out or liquidated. Also, it was not depositories, but sophisticated counterparties, who were being protected at taxpayer expense, and the rationale was that all financial institutions were interconnected in a global market and a major failure would cause a domino effect.

“The various political agendas that surfaced from the 2008 crisis led to the Dodd-Frank Act,” Coffee said. “But did these different agendas fit together to produce a coherent reform package? The answer depends on how we diagnose the cause of the 2008 meltdown.”

In the “executive compensation story,” Coffee theorized that the crisis was caused by option-based compensation formulas that led financial managers to take on excessive risk and leverage. Coffee believes the new act directly addresses this scenario by authorizing limits on executive compensation and giving shareholders enhanced power over managers with the hope of increasing corporate accountability. However, he argued this fix may have problems as the more “shareholder friendly” the governance structure of a financial institution is the greater its exposure to insolvency in a crisis will be.

“Greater shareholder accountability for financial institutions may have unintended and perverse consequences,” Coffee added.

The second scenario Coffee offered for the 2008 crisis was the “too big to fail discount.” As investors did not want to believe that large financial institutions would be allowed to fail, they lent excessively and at too “cheap” a rate to the entities, Coffee explained.

To combat this, the Dodd-Frank Act directly limits the ability of the FRB and the FDIC to lend to solvent, but troubled, financial institutions. Yet Coffee noted that the act also authorized the FDIC to liquidate a failing financial institution but not to assist a troubled one.

“How will the regulators intervene before the institution actually collapses?” Coffee asked.

“Contingent capital, or debt that converts to equity security and cannot default or cause bankruptcy, is a better solution.”

In his final theory for what could have caused the 2008 financial meltdown, the “sorcerer’s apprentice story,” Coffee explained how few understood the risks in over-the-counter derivatives, the degree to which those risks were concentrated at one firm or how unreliable credit ratings can be.

According to Coffee, Dodd-Frank does not seek to heighten transparency, but it mandates clearinghouses to prevent the failure of a swap dealer. He added that clearinghouses may not be enough.

“Clearinghouses protect counterparties at the cost of concentrating risk. A clearinghouse failure would be the financial equivalent of a magnitude-nine earthquake, and the risk is real.”

As a result, despite all the regulation in the Dodd-Frank Act, Coffee believes a fail-safe remedy that does not depend on the wisdom of regulators or on the political contingencies of a particular movement is still needed.

“The Dodd-Frank reforms will work for a time, but the regulatory sine curve implies that the intensity of oversight will relax over time,” Coffee said. “And then what will happen?”

Established in 1964 by the Charles Loridans Foundation of Atlanta, the Sibley Lecture Series honors the late John A. Sibley, a 1911 graduate of the School of Law. The series hosts renowned legal academics known throughout the country for their exceptional scholarship.

—Curry Andrews

Watch Coffee’s lecture online at www.law.uga.edu/lecture-series.