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Financial Industry Overhaul

Will the new law avert another crisis?

On July 15, three Republican senators crossed the aisle to help pass the most sweeping financial-regulation overhaul since the Great Depression. Supporters of the 2,300-page legislation say the new rules will rein in investment risk-taking by big financial firms that otherwise might endanger the economic system again. Trading in complex investments known as derivatives will also get closer scrutiny. But some critics say that the law's effectiveness depends on the same federal regulators who missed the signs of the last impending crisis. Other critics say the new law is nowhere nearly as tough as it needed to be. They point out, for example, that the law doesn't prevent banks from growing to enormous size, which many analysts say makes financial institutions unmanageable and leads to conflicts of interest.

The financial system overhaul passed by Congress on July 15 is designed to prevent the kinds of risky housing loans that led to millions of foreclosures and global economic chaos.

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Financial Industry Overhaul

BY MARCIA CLEMMITT

THE ISSUES

When 30-year-old Chris Fargis applied for a job on Wall Street a couple of years ago, he didn't have a business degree or experience in finance. His ace in the hole was poker. Fargis had played online since about 2001 — playing up to eight hands at a time — and Toro Trading sought his gambling skills when it hired him as a trader.

"If someone's been successful at poker, then there's a good chance they could be successful in this business," said company founder Danon Robinson.

Robinson isn't the only financial executive who thinks so. "There's a certain maturity and ability to deal with risk that is hard to get any other way — unless you put the money on the table at some point in your life," said hedge fund executive Aaron Brown. [1]

Nevertheless, ever since several big Wall Street firms tumbled to the verge of collapse in 2008, helping precipitate a worldwide recession, economists, lawmakers and the public have grown skeptical of Wall Street's "casino culture" and obsession with risky bets. [2]

Huge "financial supermarkets" like Citigroup and JP Morgan Chase engage in investing that resembles "gambling more closely than banking," even as they ask depositors to trust them with their personal savings, complained Nouriel Roubini, a professor of economics at New York University's Stern School of Business, and Stephen Mihm, a professor of history at the University of Georgia. [3]

Getty Images/Scott Olson

An independent consumer protection bureau created by the financial system overhaul has the power to regulate consumer loans, credit cards and mortgage-lending practices. However, lawmakers bowed to pressure from the auto industry and exempted automobile dealers from oversight by the agency.

Banks' increasingly single-minded pursuit of fast profits rather than longer-term value investments — and the growing use of large amounts of "leverage," or debt, to make trades — has harmed the whole economy, says Dean Baker, chief economist at the Center for Economic and Policy Research, a liberal Washington think tank.

"The reason why we're sitting here with 10 percent unemployment is that we had a housing bubble that was driving the economy down the wrong path," focusing homeowners on the illusory "housing wealth" they believed they were gaining as house prices rose and encouraging investors to buy packages of mortgage loans rather than stock in companies that could have been long-term job creators, he says.

Based on such concerns, when Democrats took control of the White House and both houses of Congress in 2009, debate began on legislation to tighten banking rules to limit the possibility that risky investing with borrowed funds would again sink the financial system. The year-and-a-half struggle to enact the legislation is a testament to both the issue's complexity and banks' political power and intense struggle to fight off new rules. Three Republican senators, Scott Brown of Massachusetts and Maine's Susan Collins and Olympia Snowe finally crossed the aisle to give supporters of the overhaul the 60 Senate votes they needed to overcome a final Republican filibuster of the plan on July 15, and President Obama signed the measure into law on July 21.

In the wake of the debate, questions persist about whether increased bank regulation is a good idea and whether current proposals would be effective.

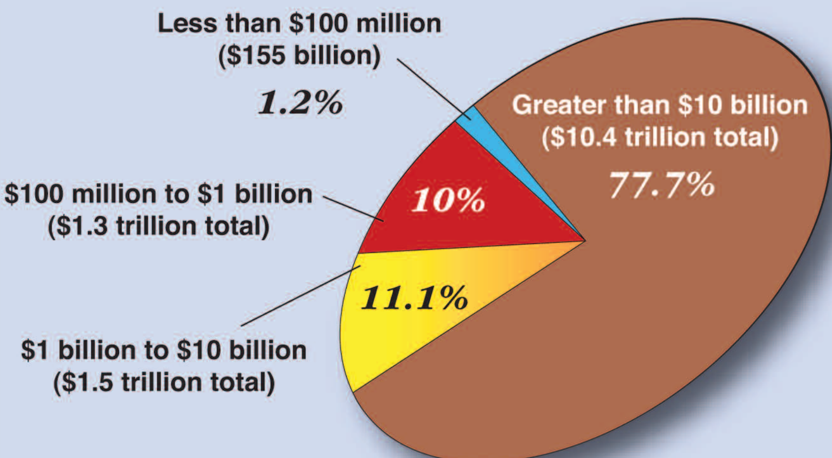
Most conservative analysts assert a strong "No" to both.

Government regulation actually encourages carelessness, said Peter J. Wallison, a fellow at the free-market think tank American Enterprise Institute. "Market participants believe that if the government is looking over the shoulder of the regulated industry, it is able to control risk-taking," so customers stop trying to determine for themselves whether a financial firm is behaving responsibly.

'Too Big to Fail' Banks Hold Most Assets

Banks in the U.S. banking system with assets worth more than $10 billion each are collectively worth $10.4 trillion — or 78 percent of the entire sector — making them "too big to fail" in the eyes of many experts. Smaller banks worth less than $100 million each only make up 1 percent of the system.

Banks by Asset Size, March 2010
(in $ billions)



Source: Federal Deposit Insurance Corporation

Regulation also "impairs innovation" and raises prices, Wallison said. [4]

But while the new legislation won't forestall the next economic crash, rules are valuable, and current proposals are a "definite improvement" over the status quo, says Baker.

For example, there will be closer scrutiny of complex investments known as derivatives, whose value is derived by a formula based on the shifting values of some asset or assets, such as the value of the Japanese yen compared to the U.S. dollar. Under the legislation, most derivatives now will "be traded in some regulated way" rather than in unsupervised trader-to-trader deals, says Baker. Supervised trading will pose fewer risks to investors, Baker says.

"Also a clear plus is the Consumer Products Financial Services Agency," says Baker. "People get burned on financial products all the time" so having a government office to look out for consumers' interests will be a help, he says.

In the 2008 crash, the federal government stepped in with taxpayer funds — the Troubled Asset Relief Program (TARP) — to prevent some of the biggest financial firms from collapsing. Policymakers figured the biggest firms were so deeply entwined with the rest of the economy that their demise would take other firms down with them. In short, the mega-firms were "too big to fail," or TBTF.

As a result, many expected legislative efforts to limit banks' size or the scope of activities a single firm could pursue. The Obama administration and many in Congress steadfastly opposed this approach, however.

"The trickiest banks" — the ones good at figuring out ways to circumvent rules to maximize profits — "tend to be large," said Richard W. Fisher, president of the Federal Reserve Bank of Dallas. That being the case, there is "only one way to get serious about [TBTF] — . . . 'shrink 'em,' " he said. "Banks that are TBTF are simply TB — 'too big.' We must cap their size or break them up." [5]

Today's biggest banks have attained a scale "that's impossible to run prudently," says James K. Galbraith, a professor of economics at the Lyndon B. Johnson School of Public Affairs at the University of Texas, Austin.

But while the desire to break up super-big institutions is "understandable," it's "ultimately futile," said Mark Zandi, chief economist for Moody's Economy.com, a West Chester, Pa.-based financial research company. Breaking up banks "would be too wrenching and would put U.S. institutions at a distinct competitive disadvantage vis-à-vis their large global competitors," he said. [6]

Also hotly debated is how big a role unethical conduct played in the crisis. In April, the Securities and Exchange Commission (SEC) filed a civil lawsuit charging the big New York investment bank Goldman Sachs with fraud for selling investors mortgage-backed securities the bank knew were intended to fail. Some analysts say the system's future soundness depends on whether the government will continue to crack down.

Many of today's financial-industry practices amount to "fraud" or "outright criminal negligence," charges Galbraith. When it comes to selling investments made up of packaged mortgage loans — so-called mortgage-backed securities — for example, fraudulent behavior was evident throughout the system, he says.

First, "you had a massive issuance of mortgages to people who couldn't pay them. The guy who made those loans" committed fraud "because he knew they couldn't pay" but made the loans anyway "to generate a fee" for himself, Galbraith says. Then the ratings agencies — companies such as Fitch, Moody's and Standard & Poor's that assess investments according to relative risk — extended the fraud by "labeling these things triple A," or very low-risk securities. "That's the same thing as money laundering. It takes something dirty and makes it clean," Galbraith argues.

Finally, investment firms that marketed mortgage-backed securities to pension funds and other traditionally low-risk investors misled buyers — by passing off bad goods to suckers, he says. Charging companies who commit such frauds "is the only hope we have" of cleaning up the industry, he says.

But most bankers deny unethical conduct.

"I am saddened and hurt by what happened in the market," said Fabrice Tourre, the 31-year-old Goldman Sachs vice president whom the SEC has charged with helping the bank engineer a fraudulent deal in which two European banks lost $1 billion. "I believe my actions were proper." [7]

As lawmakers, economists and the public wonder whether financial reforms will prevent the next financial-market meltdown, here are some of the questions that are being asked:

Are tougher rules for financial firms needed?

Over the past three decades, many rules governing financial firms have been rescinded as policymakers embraced the philosophy that markets function best when left alone. Following the 2008 crash, however, some economists have called for reinstating stricter curbs on banking.

"I hope it's no longer controversial" to say that a hard-line free-market philosophy has been "thoroughly discredited," says Texas' Galbraith. "When people say this today, they're just covering for the fact that they're backing what special interests want."

"Taxpayers are providing a substantial benefit to the shareholders and creditors of institutions considered too big to fail" by putting up bailout funds, said Zandi of Moody's Economy.com. In return, big financial firms should "be subject to greater disclosure requirements, required to hold more capital, satisfy stiffer liquidity requirements, and pay deposit and other insurance premiums commensurate with . . . the risks they pose to the system." [8]

"The financial reform bill goes in the right direction . . . but it doesn't go far enough," however, said New York University's Roubini. An effective law would have to restructure the industry by limiting bank size and the number of different financial businesses one institution could pursue, he said. [9]

Baker of the Center for Economic and Policy Research would like to see a provision "with teeth" requiring commercial banks, which take deposits and lend to individuals and businesses, to be separate entities from investment banks, which issue, price and trade stocks and bonds.

The legislation is "probably better than nothing," says Galbraith. Nevertheless, "I'm disappointed in it, and if I were a member of Congress, I'm not sure whether I'd vote yes or no."

Behind-the-scenes deals between lawmakers and financial firms turned the legislative process "into a victory lap for Wall Street," charged Simon Johnson, a professor of entrepreneurship at the Massachusetts Institute of Technology's Sloan School of Management. After the 2008 bailout, "administration officials promised they would be back later to fix the underlying problems. This they — and Congress — manifestly have failed to do. Our banking structure remains unchanged . . . and the incentives and belief system that lie behind reckless risk-taking has only become more dangerous." [10]

"Regulatory changes in most cases represent a too-late attempt to catch up with the tricks of the regulated," who will quickly find ways to circumvent new rules, said Dallas Fed chief Fisher. [11]

In addition, many financial regulators come from the banking industry, and that fact will always compromise enforcement, says Baker. "Imagine if we had a Labor Department where most people were from the United Auto Workers. It would be very hard for them to take an independent view" of labor issues and crack down on former colleagues, he says.

But many conservative commentators challenge the notion that the financial industry needs more rules.

As it stands, the legislation is "worse than nothing," says Mark A. Calabria, director of financial regulation studies at the libertarian Cato Institute. There's no need to re-regulate banks because they were never actually deregulated, and any claim that deregulation

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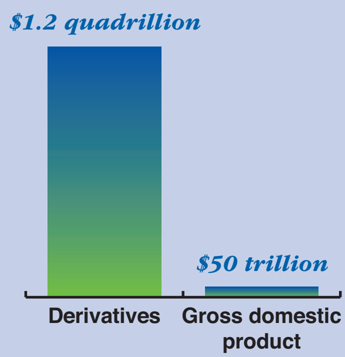
Derivatives Market Dwarfs Global GDP

The value of the worldwide trade in derivatives — financial instruments that represent bets on shifting prices, not real assets — exceeds $1 quadrillion, or more than 20 times the value of the world's gross domestic product.

Value of Worldwide Derivatives Market and GDP



Source: Peter Cohan, "Big Risk: $1.2 Quadrillion Derivatives Market Dwarfs World GDP," Daily Finance, *June 2010*

Lawmakers Reject 'Rainy Day' Fund for Banks

Global finance ministers rejected creation of a similar fund.

While deliberating new banking rules that might mitigate future financial crises, U.S. lawmakers and banking officials considered and rejected a plan to have banks put funds upfront into a fund that would pay creditors and depositors should a large bank fail. Some financial-industry analysts say that such advance preparation for the likely inevitable failure of more big financial firms down the line is a plan well worth pursuing.

"An advance-payment bailout fund was a House proposal that didn't get nearly enough attention," says Dean Baker, chief economist at the Center for Economic and Policy Research, a liberal think tank. The final congressional bill instead included what Baker calls a misguided proposal to have banks ante up such funding only after financial firms actually crash.

Having such a fund available before a crisis "would allow the regulators to shut down" ailing institutions in a quick, orderly fashion before problems worsened and spread, Baker says, Without it, "regulators won't have the tools to shut down" ailing big banks. Furthermore, the plan is a proven idea "that we already have in place" in the Federal Deposit Insurance Corporation (FDIC) and use routinely for smaller banks, Baker says.

Without an advance fund, if a big bank fails, "government regulators can go to Congress and ask for money" to address that specific emergency, "but Congress might say they don't want to provide the money" or ask the financial industry for it, or the request might get tangled up in a legislative logjam of some kind, he says.

The provision might not be needed if the only problems in the system came from a handful of "rogue institutions," says Baker. "But what we got in 2008 was not rogue. You didn't so much have rogue players as a system that was totally out of whack," he says. "A fund that's ready and waiting would be a backstop" for the day when a large firm was "suddenly insolvent."

When failing banks are closed, the money to pay creditors "shouldn't take the form of a post-crisis tax," says Amy Sepinwall, an assistant professor of legal studies and business ethics at the University of Pennsylvania's Wharton School. "I think there should be a perpetual tax on the players" in recognition of the fact that, no matter what laws and regulations are in place, there will always be the possibility of some financial institution taking too many risks and failing.

"People on Wall Street are incredibly intelligent" and may "develop strategies to circumvent whatever rules Congress" puts in place to rein them in, says Sepinwall. "Maybe that's the way it's supposed to be," since the circumvention often leads to innovation, some of which is very valuable. At the same time, however, it's obvious that some financial-market innovations will be extremely risky, she says.

For that reason, requiring regular payments from the whole industry into a fund that could serve as a backstop for firms whose innovative financing arrangements go south is probably a good idea, she says. "One could key the tax to the size of the bank," she says. Such an upfront fund would constitute a "recognition of the principle of 'moral luck' " — the idea that, while many people may drink and drive, for example, only some will have an accident, but that everyone who engages in the risky behavior, not just those who crash, actually bears some degree of responsibility, Sepinwall explains.

Like Congress, finance ministers and central-bank chiefs of the G20 — 19 nations and the European Union — considered but rejected an international version of the bank shutdown fund in deliberations this summer. Given the increasingly international nature of the financial system, the European Union and some others want each country to tax its banks to create a pool to be used to resolve failed banks, to avoid delaying the process or sticking taxpayers with the bill.

Some countries that impose limits on how much risk banking institutions may take on, such as Canada, object to the idea. [1] They argue that "since their regulatory systems are strong," their local institutions "shouldn't have to pay for what happens in riskier countries" without the foresight to ban risky practices up front, says Sepinwall.

In the U.S. debate over financial reform, key congressional Republicans persistently demanded that the fund be removed from the bill on the grounds that it might actually be used to keep faltering institutions alive. "The bill reported out of committee sets up a $50 billion fund that, while intended for resolving failing firms, is available for virtually any purpose that the Treasury secretary sees fit," wrote Alabama's Sen. Richard Shelby, the top-ranking Republican member of the Senate Banking Committee. "The mere existence of this fund will make it all too easy to choose bailout over bankruptcy. This can only reinforce the expectation that the government stands ready to intervene on behalf of large and politically connected financial institutions." [2]

The fact-checking website *PolitiFact* notes, however, that Shelby's statement — which was widely echoed by other Republican and conservative commentators — ignores specific bill language that bans use of the funds for any purpose except those connected with closing large firms that falter. "The legislative language is pretty clear that the money must be used to dissolve — meaning completely shut down — failing firms," said *PolitiFact*. "The fund cannot be used to keep faltering institutions alive." [3]

— Marcia Clemmitt

[1] For background, see "Canada Urges G20 to Stop Bank Tax Talk," CTV television online, June 1, 2010, www.ctv.ca.

[2] Quoted in "Sen. Richard Shelby Overlooks Safeguards in Financial Regulation Bill," *PolitiFact.com*, http://politifact.com/truth-o-meter/statements/2010/apr/16/richard-shelby/sen-richard-shelby-overlooks-safeguards-financial-/.

[3] *Ibid*.

Continued from p. 633
helped trigger the 2008 crisis ignores history, he says.

As evidence, Calabria points to studies showing that government "outlays for banking and financial regulation increased from only $190 million in 1960 to $1.9 billion in 2000 and to more than $2.3 billion in 2008 (in constant 2000 dollars.)" The annual average of new financial-industry rules proposed by the Treasury Department grew "from around 400 in the 1990s to more than 500 in the 2000s." [12]

Misguided regulation has actually been the key driver of the financial meltdown, not actions financial firms took on their own, Calabria argues.

For example, federal rules "micromanage the relationship between capital and assets," specifying, for example, that banks must hold more capital in reserve to back their lending to corporations than for their lending to national governments, he says. But the recent financial meltdown of Greece demonstrates that government's so-called "sovereign" debt can be far riskier than corporate debt, Calabria argues.

Furthermore, when the Federal Reserve lowered interest rates after the Sept. 11, 2001, terrorist attacks, to jump-start business expansion and consumer spending, Fed Chair Alan Greenspan left the low rates in place too long, fueling the over-borrowing spree that led to the current troubles, Calabria says. The lowered rate "was needed for six months, not three years," he says. "Did the Fed just not get that they were setting up bad incentives" that encouraged too many people to take out mortgages?

The call for more regulation is a "new culture war" launched by pro-government liberals, said American Enterprise Institute president Arthur C. Brooks. The panic the economic downturn engendered among Americans is allowing liberals to "attack free enterprise openly and remake America in [their] own image" by "expand[ing] the powers of government" to rigorously control an industry that was not at fault, Brooks said. "In truth . . . government housing policy," which encouraged too many Americans to take out mortgages to buy homes, "was at the root of the crisis." [13]

Was unethical behavior by bankers a major factor in the economic crash?

Some observers are convinced that financial markets are hotbeds of unethical conduct, but others point out that seeking profit is not only legal but is what the public demands that financial firms do.

Goldman Sachs is "a great vampire squid wrapped around the face of humanity . . . little better than a criminal enterprise that earns its billions by bilking the market, the government, and even its own clients in a bewildering variety of complex financial scams," fumed financial reporter Matt Taibbi. [14]

In 2006, Goldman sold $76.5 billion in mortgage-backed investments, of which about $59.1 billion — more than three-quarters — consisted of hundreds of home loans that either were made to people with very bad credit or had other serious problems, such as risky terms like a no down-payment requirement, Taibbi said. Then, "some Dutch teachers' union that a year before was buying ultra-safe U.S. Treasury bonds . . . runs into a Goldman salesman who offers them a different, 'just as safe' AAA-rated investment that, at the moment anyway, just happens to be earning a much higher return than Treasuries. Next thing you know, a bunch of teachers in Holland are betting their retirement nest eggs on a bunch of meth-addicted 'homeowners' in Texas and Arizona. . . . This isn't really commerce, but much more like organized crime . . . a gigantic fraud perpetrated on the economy that wouldn't have been possible without accomplices in the ratings agencies and regulators willing to turn a blind eye," said Taibbi. [15]

"It is unacceptable to continue allowing Wall Street to put their short-term gambles ahead of the long-term prosperity of Main Street America," said Sen. Jeff Merkley, D-Ore., who sought to ban so-called "proprietary trading" — banks trading securities for their own profits rather than on behalf of customers — but secured only minor limitations on such trades. "We've seen how proprietary trading can cause conflicts of interest when firms bet against securities they help put together for their clients," Merkeley said. [16]

Sen. Carl Levin, D-Mich., who cosponsored Merkeley's proposal, labeled many bankers' primary motivation "extreme greed." [17]

In many cases, both sellers and buyers of the complex investments called "derivatives" are "cheaters," charged Frank Partnoy, a professor of law and finance at the University of California, San Diego, and a former associate at the New York City-based financial services firm Morgan Stanley. Some derivatives allow people to avoid taxes by making their investment portfolios appear to have a different mix of risks and assets than they actually do, he said. In a so-called "equity swap," a "bank that sells the swap makes money, and the purchaser . . . makes money because they effectively get to liquidate a portion of their stock position without paying tax. They both win," but the public loses a legitimate part of the tax base, Partnoy said. [18]

"Ethical rot" and "perverse incentives . . . caused the ongoing financial crisis," said William K. Black, an associate professor of economics and law at the University of Missouri who was a federal bank regulator during the savings and loan meltdown of the late 1980s. For example, "executive compensation and the compensation systems used for appraisers, accountants and rating agencies were designed" to create a business climate in which "fraudulent and abusive lending and accounting practices drove good practices out of the marketplace." [19]

"I don't think those who went into finance are greedier or more deficient

What's in the New Financial Regulation Law

Here are key provisions of the sweeping 2,300-page financial reform law signed by President Obama on July 21, 2010:

Overseeing the system's financial health: A new 10-member council of financial regulators, drawn from several different agencies, will monitor not just individual financial firms but their interactions, to help head off emerging risks for an economic crash. [1]

Breaking up big banks: Regulators get new authority to seize and break up troubled financial firms whose large size means their troubles could damage the economy. The Treasury would fund the initial costs of winding down the bank, but regulators could recoup those funds from the failed bank and from special fees imposed on all big financial firms.

Curbing financial-market speculation: A watered-down version of part of the so-called Volcker Rule limiting but not entirely banning banks from using depositors' money to speculate in financial markets.

Limiting banks' derivative trading: Phased in over several years, banks are required to spin off some derivatives trading into separate, affiliated companies. For the first time, many derivatives must be traded through clearinghouses or public exchanges, rather than over the counter.

Overseeing insurers, hedge funds, and private equity funds: A new Federal Insurance Office in the Treasury Department will monitor, but not regulate, the insurance industry, which previously has been overseen only by states. Hedge funds and private equity funds must register with the SEC as investment advisers and provide information on trades to help regulators monitor financial-system risk.

Improving how securities are rated: The SEC will conduct a two-year study on whether to create a federal board to assign ratings agencies to each security deal. Some lawmakers had pushed for immediate random assignment of rating agencies as a way to end banks "shopping" for securities they trade.

Overseeing the Federal Reserve: The Fed faces a one-time audit of the emergency loans and other actions it took to help financial firms weather the 2008 crisis, but the central bank's decision-making about monetary policy — how it sets interest rates — will not be audited.

Protecting consumers: An independent consumer financial protection bureau will regulate and police consumer-loan, credit-card and mortgage-lending practices. This provision was enacted despite strong objections from the financial industry and from congressional Republicans. Automobile dealers won an exemption from oversight by the agency.

Cleaning up mortgage lending: Lenders must verify borrowers' income and determine in advance whether they can meet the loan payments before originating a mortgage, thus ending the risky "liar loans" implicated in some home foreclosures.

Curbing executive pay: Shareholders of all publicly traded companies, not just financial firms, get a nonbinding advisory vote on how executives are compensated.

[1] See Open Congress website, www.opencongress.org/bill/111-h4173/text; Alison Vekshin and Phil Mattingly, "Overhaul of Financial Regulation on Path to Obama's Desk," Bloomberg/*Business Week*, June 26, 2010, www.businessweek.com.

in moral scruples than others," but the incentives in the way financial markets currently operate "led them to behave" as if they were, said Joseph E. Stiglitz, co-winner of the 2001 Nobel Prize for economics and a professor of economics at Columbia University. The idea that "you have to pay me more if I succeed in increasing profits" became "conventional wisdom," leading bankers to neglect the fact that banks "are a means to an end" in the economy, "not an end in themselves." [20]

"A good financial system" manages risk, allocates capital and runs the economy's payment system "at low transaction costs," said Stiglitz. "Our financial system created risk and mismanaged capital, all the while generating huge transaction costs" — financial firms' outsized profits compared to other industries. While bankers claim that products like derivatives created real value in the economy, "it is hard to find evidence of any real growth associated" with these "so-called innovations," Stiglitz said. [21]

"So deceptive were the systems of creative accounting" employed in pursuit of large returns that bankers "didn't even know their own balance sheets, and so they knew that they couldn't know that of any other bank," Stiglitz said. No wonder then that lending between banks — which allows bankers quick access to cash they can then loan to businesses — froze up in a crisis of trust that helped topple the world's economy, he said. [22]

Financial-industry executives mostly reject such charges.

Far from ignoring obligations to society, most bankers embrace their social purpose, said Goldman Sachs Chairman Lloyd Blankfein. "I know I could slit my wrists and people would cheer," but accusers don't realize that the bank does "God's work," Blankfein said. "We help companies to grow by helping them to raise capital. . . . This, in turn, allows people to have jobs that create more growth and more wealth. It's a virtuous cycle." [23]

Some bankers have exhibited a "failed moral compass" by "hiring people and promoting people based simply . . . on commercial productivity" rather than the "many other criteria that could be used," acknowledged Brian Griffiths, vice chairman of Goldman Sachs International. Nevertheless, "my reading of [Scottish philosopher and economist] Adam Smith is that self-interested actions," though "they may sometimes be selfish," produce social good, he said. (Smith's 1776 treatise *An Inquiry into the Nature and Causes of the Wealth of Nations* theorizes that an "invisible hand" guides the free market to produce and price things correctly, despite seeming chaos.) "I think that the injunction of Jesus to love our neighbors as ourselves is a recognition of self-interest" as a positive social force, said Griffiths. [24]

Banks do only what society asks of them, says Amy Sepinwall, an assistant professor of legal studies and business ethics at the University of Pennsylvania's Wharton School. "We live in a get-rich-quick culture, and we ask people [in the financial industry] on our behalf to make as much money as possible in as little time as possible, so in a way we're sort of licensing this."

"Individuals prefer to spend rather than save, and, as a result, demand the kind of financial alchemy that can transform one's house into a virtual ATM or one's exceedingly modest savings into a fiscal cushion that can sustain a long, comfortable retirement," Sepinwall said. Thus, the risk that crashed the system "is the inevitable price of our preferences for leisure over toil and consumption over savings." [25]

Should big banks be broken up?

Proponents of limiting the size and scope of each individual bank argue that today's biggest firms are too large to be effectively managed. But other analysts say that the real problem is not overlarge banks but misguided government policies, such as bailing out institutions the government deems "too big to fail." No matter how large the company, if it fails financially, it should go bankrupt, rather than being rescued, these commentators say.

"The best way to prevent a bank from becoming too big to fail is preventing it from becoming too big in the first place," said Robert Reich, secretary of Labor in the Clinton administration and a professor of public policy at the University of California, Berkeley. Lawmakers should cap the deposits any one bank can hold, reinstate the so-called Glass-Steagall ban on combining an investment bank and a commercial deposit-holding bank in one company and force banks to spin off their derivatives-trading operations into separate companies, Reich said. (Only a limited form of the last of these provisions survives in the current legislation.) [26]

"If they're too big to fail, they're also becoming too big to be saved, too big to be bailed out and too big to be managed," said New York University's Roubini. "No CEO can monitor the activities of thousands of separate profit and loss statements" [27]

"Where within one institution you have commercial banking, investment banking, underwriting of securities, market-making and dealing, proprietary trading, hedge fund activity, private equity activity, asset management, insurance," it "creates massive conflicts of interest," said Roubini. "These institutions are always on every side of every deal. That's an inherent conflict of interest that cannot be addressed" by simply setting up internal barriers within the company. [28]

Bank "swaps desks" that trade in certain risky derivatives should be spun off into separate enterprises that do not have "access to government backstops," said Dallas Fed chief Fisher and Federal Reserve Bank of Kansas City President Thomas M. Hoenig. [29]

Some commentators argue that the biggest banks generally became big through sweetheart deals with the government, and since that makes them both tools and symbols of dangerously consolidated government power, they should be broken up.

"Big banks are bad for free markets" because "they are conducive to what might be called 'crony capitalism,'' said Arnold Kling, an adjunct scholar at the Cato Institute. Thus, "there is a free-market case for breaking up large financial institutions: that our big banks are the product, not of economics, but of politics."

The key example cited by Kling and many other conservative and libertarian commentators is Fannie Mae and Freddie Mac — two huge stockholder-owned but government-sponsored institutions that buy and securitize mortgages. "Created by the government," these two institutions "always benefited from the perception that Washington would not permit them to fail," a fact that "gave them important advantages in credit markets and allowed them to grow bigger than they otherwise would have," he said. [30]

Some of the biggest private banks also have pursued "public purposes imposed on them by Congress" — such as increasing mortgage lending to expand home ownership — in an attempt to woo lawmakers into regulating them more lightly over the years, said Kling. At the government's instigation, big banks, along with Fannie Mae and Freddie Mac, created a market in which high-risk mortgages were "securitized" — packaged to be sold as investments — driving house prices sky high, and the bursting of this price bubble caused the financial crash, he said. The root cause, however, was "banks' being big enough to achieve real political power. To expand free enterprise, shrink the banks." [31]

But shrinking banks "wouldn't really solve our problems, because it's perfectly possible to have a financial crisis that mainly takes the form of a run on smaller institutions," said Paul Krugman, a professor of economics and international affairs at Princeton University and winner of the 2008 Nobel Prize for economics. In the Great Depression of the 1930s, the "Federal Reserve believed that it was OK to let [the small banks] fail," but "as it turned out, the Fed was dead wrong: the wave of small-bank failures was a catastrophe for the wider economy," he said. Regulators should limit risky lending and the use of borrowed funds to buy investments, rather than trying to cap banks' size, Krugman said. [32]

Unilaterally limiting the size of U.S.-based banks would put the country at a competitive disadvantage because big U.S. companies with international operations would end up using the bigger banks that were based elsewhere, said Rob Nichols, president of the Financial Services Forum, a banking industry trade group. [33]

Rebuilding the Glass-Steagall wall between depository banks and investment banks is completely beside the point because, in fact, "very few financial holding companies decided to combine investment and commercial banking activities," even after Congress allowed them to do so in 1999, says Cato's Calabria. Bear Stearns and Lehman Brothers, "the two investment banks whose failures have come to symbolize the financial crisis, . . . were not affiliated with any depository institutions," and, in fact, if they had had "a large source of insured deposits, they would likely have survived their short-term liquidity problems" rather than going under and precipitating a wider crisis, he said. [34] ■

BACKGROUND

Early Bank Battles

Money is power, and even in the earliest days of the republic, lawmakers debated the benefits and dangers of having a large central bank. They worried that big financiers might join with politicians or the wealthy to turn the democratic republic into an oligarchy — a state run for the benefit of a powerful few. [35]

The first such debate centered on whether to establish a single bank with close ties to the federal government. Backers of the idea, like Treasury Secretary Alexander Hamilton, pointed out the value of having a bank large enough to offer credit to government, issue paper money — currency — that could be used nationwide, and facilitate payments among businesses in multiple states. [36]

Skeptics, like Thomas Jefferson, worried about centralizing economic power. A large bank might easily become a kingmaker and make unilateral decisions about how much currency to issue, for example, Jefferson and others said. "I sincerely believe . . . that banking establishments are more dangerous than standing armies," the future third president wrote. [37]

Hamilton won the day, and in 1791 President George Washington signed a law chartering the First Bank of the United States, with 80 percent private and 20 percent government ownership.

During its 20-year charter as the sole federally affiliated bank, the firm collected tax revenues on behalf of the government and issued the only currency accepted as payment of federal tax bills.

State-chartered banks issued the lion's share of paper money in circulation. But the First Bank's role in clearing state-to-state payments meant that it held large amounts of state currency and could demand that states fork over gold or silver reserves to redeem those notes. This gave the bank enormous power to determine the country's money and credit supplies — decisions that affect prices and whether businesses can get loans.

By and large, the bank was a boon rather than a bane to the young republic, helping businesses to thrive. By 1825, when the young United States and the old United Kingdom "had roughly the same population . . . the United States had nearly 2.5 times the amount of bank capital as the UK," as well as a stock market "able to attract capital from around the world," wrote MIT's Johnson and business consultant James Kwak in their 2010 book *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*. [38]

The Federal Reserve

In the 1830s, President Andrew Jackson — who believed that only gold and silver rather than paper currency should be used as money — railed against what he called a dangerous monopoly held by the Second Bank, chartered in 1816. The battle marked the seventh president as somewhat old-fashioned in an age when industrialization and urbanization created a need for centralized banking, but the behavior of Second Bank president Nicholas Biddle also provided evidence that there was reason to fear big banks' power.

An ally of Jackson rival Kentucky Sen. Henry Clay, Biddle expanded the bank's lending to win support for Clay and the bank. Jackson nevertheless defeated Clay in the 1832 presidential election, but afterwards Biddle drastically cut lending and demanded that states pay gold and silver to redeem their currencies, contracting the money supply and causing loan interest rates to double. "The bank is trying to kill me," Jackson fumed. [39]

Jackson vetoed renewal of the Second Bank's charter. But, at least partly as a result of having no big bank to manage the money and credit supply, "the U.S. economy . . . suffered through severe business cycles" — booms and depression-level busts — "through the rest of the 19th century," Johnson and Kwak write. [40]

Nevertheless, American industry thrived, as railroad, oil and chemical companies launched new products. Then, near the end of the 19th century, many companies in industries like steel merged into huge corporate entities, dubbed "trusts" — monopoly or near-monopoly enterprises that executives argued cut costs. But Presidents William McKinley, Theodore Roosevelt and William Howard Taft tried to break up the trusts, saying they had power to raise prices and lower wages without restraint.

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Chronology

1900s-1920s

Federal Reserve system is launched to curb the cycle of steep economic booms and busts, but stock market crashes, triggering economic collapse.

1930s-1970s

Banking rules are tightened. Following the Great Depression, the economic boom-and-bust cycle stabilizes.

1933
Glass-Steagall Banking Act separates investment banks from commercial — deposit-holding — banks and establishes federal deposit insurance.

1934
Securities and Exchange Commission established to regulate stock trading.

1935
Fed's regulatory powers expanded.

1936
Commodity Exchange Act requires commodity futures to be traded on public exchanges.

1938
Federal National Mortgage Association (Fannie Mae) established.

1974
Congress creates Commodity Futures Trading Commission (CFTC).

1980s-1990s

Banking regulations ease, and new products like adjustable-rate mortgages and mortgage-backed securities are introduced.

1980
Congress allows banks to compete for deposits by offering higher interest, expands loans savings & loans (S&Ls) may make, and bans state caps on first-mortgage interest rates.

1984
Congress eases rules to allow investment banks to package and sell mortgages as securities with varying risk levels.

1989
Resolution Trust Corp. created to take over insolvent S&Ls.

1994
Congress lifts restrictions on interstate banking.

1995
Nearly a third of S&Ls have failed and been shut down.

1998
Losses on derivatives bought with borrowed funds sink big hedge fund Long-Term Capital Management.

1999
Gramm-Leach-Bliley Act repeals 1933 ban on combining investment and commercial banking in one company.

2000s-2010s

Housing price bubble swells then pops, triggering worldwide recession.

2000
Commodity Futures Modernization Act deregulates derivatives trading.

2006
High-risk loans, such as interest-only and no-documentation loans, account for 13 percent of new mortgages, up from 2 percent in 2003.

2007
Two hedge funds run by investment firm Bear Stearns go bankrupt. . . . German bank IDK suffers heavy losses on subprime investments. . . . May foreclosure filings up 90 percent from May 2006. . . . Government takes over Fannie Mae and Freddie Mac, the two big government-sponsored institutions that buy and securitize mortgages.

2008
Federal Reserve lends JP Morgan Chase $29 billion to buy Bear Stearns. . . . Lehman Brothers investment firm goes bankrupt. . . . Fed creates $85 billion loan fund to rescue insurer AIG. . . . Congress passes $700 billion bailout plan — the Troubled Asset Relief Program (TARP) — devised by Bush Treasury Secretary Henry Paulson to buy up risky investments held by "too big to fail" financial firms.

2009
Congress restricts compensation for highly paid workers at firms bailed out with TARP funds. . . . Congressional Oversight Panel for TARP says the Treasury paid more than market value for bank assets. . . . Bank of America and Citigroup return their TARP funds to the government.

2010
SEC charges Goldman Sachs bank with fraud in derivative-trading case; in July Goldman settles the case for $550 million. . . . On July 15, Congress passes sweeping legislation tightening rules for the financial industry. . . . A White House report says that many banks overpaid their executives during the financial crisis. . . . Federal Financial Crisis Inquiry Commission threatens to audit Goldman's derivatives-trading business.

Did Weakened Regulations Fuel the Economic Crisis?

Critics of regulation say "constant vigilance" by bank customers is the only answer.

The weakening or elimination of many banking and investing regulations over the past three decades contributed to the financial crisis, many analysts say. Conservative commentators, on the other hand, argue that most regulation fails to address the real problems behind troubled financial markets and only hinders financial firms in finding creative solutions.

Even small rules can make a big difference, some analysts say.

In June 2007, for example, the Securities and Exchange Commission eliminated a Depression-era rule intended to keep traders from driving down a company's stock to the point of ruin when market prices were falling. The so-called "uptick rule" imposed limits on "short selling" — borrowing, rather than buying, stocks whose price was dropping; selling them; and then buying them back at a lower price and pocketing the difference between the two prices before giving the stocks back to their real owner.

The uptick rule had banned short selling unless a stock's price had recently "ticked up," thus eliminating some of the profit motive in quick sales rather than longer-term investments. In the 1930s, the SEC determined that short selling by people who were not really investing in a company but merely trading borrowed stock in search of quick profits had worsened the stock-market crash and ruined some companies. [1]

The rule's repeal is partly responsible for recent financial-market plunges, said Muriel Siebert, former state banking superintendent of New York state and the first woman member of the New York Stock Exchange. [2] "The SEC took away the short-sale rule and when the markets were falling . . . investors just pounded" some companies' stocks.

Reinstating the rule "might have had some benefit" in mitigating the 2008 crash, said Federal Reserve Chairman Ben S. Bernanke. [3]

To have their full effect, the new rules Congress created should cover all kinds of financial traders, but mostly won't, many industry critics say.

"Current reforms won't deter the reckless financial engineering, investing, and inflation of values" that create speculative financial "bubbles" whose collapse can bring down the system, said Nomi Prins, a senior fellow at Demos, a New York City-based liberal research and advocacy group. [4]

For example, drafters of current legislation largely have ignored the "shadow-banking system," a group of financial players who take big risks but because most regulation doesn't apply to them never will have to pay for problems they exacerbate, said Prins. Investment groups called "private-equity funds," for example, "are financial-pyramid bottom-feeders. . . . They buy distressed companies or assets, load them up with debt, extract near-term profit, and are gone before any collapse occurs," she said. Such actions increase the risk of a system collapse because they usually buy complex, poorly understood assets that may be very risky and use borrowed money to do so, just as happened in the mortgage meltdown, said Prins.

Instead of ignoring some financial enterprises, lawmakers should require "leveraged funds" of all kinds — that is, any organizations that borrow money to invest — to register with the SEC, report their borrowing and trading activities to regulators in detail, and have limits on how much they can borrow, she said. [5]

The Federal Reserve system — the public-private banking network that not only regulates banks but also makes key decisions about the country's credit and money supply — also got too little attention from lawmakers this year, some analysts say. Although Congress approved some additional auditing for the Fed, lawmakers left too many of its activities in darkness, says Robert D. Auerbach, a professor of public affairs at the University of Texas, Austin.

The Fed has "done a lot of devilish things" over many decades, such as secretly lending money to foreign governments at the

Continued from p. 638

The rise of the trusts ushered in a new era of big banking, this time allied with big industry, rather than government. The banking empire of Connecticut-born J.P. Morgan had become financier of choice for fast-consolidating industries, lending money to buy stock and helping arrange mergers. By 1900, Morgan's banks were raising 40 percent of all industrial capital in the United States.

In 1907, however, a failed scheme by some investors to manipulate the price of copper stocks panicked Wall Street, triggering a run on New York banks and a market crash that saw stocks lose nearly 50 percent of their value. The so-called Banker's Panic demonstrated that while a large corporation-allied bank like J.P. Morgan's may help industries grow, it does not promote economic stability the way a federal bank could, by managing money and credit supplies. Although Morgan used his own cash to help keep the banks afloat, the federal government ultimately had to deposit $25 million into banks in New York to bail out the banks and prevent economic meltdown.

After the panic, bankers pushed for a government-affiliated bank to act as lender of last resort to head off crashes. Rep. Charles A. Lindbergh, Sr., R-Minn., father of famed aviator Charles A. Lindbergh, Jr., grumbled that it was "a wonderfully devised plan specifically fitted for Wall Street securing control of the world," using taxpayer cash. [41]

Democratic President Woodrow Wilson engineered a compromise proposal to create a central banking system that would be privately owned but receive some government input.

behest of the White House, and "there should be checks and balances. They should tell Congress" of their activities because in many ways, "they run the country, as unelected officials with no accountability," Auerbach says. What's required is not full public disclosure but merely disclosure to the members of Congress with oversight authority. "If the CIA can make disclosures" to congressional oversight panels, then the Fed can do so without damage also, he says.

But many conservative commentators argue that regulation simply can't be the answer to creating a sounder banking system.

"Regulation as protection is a false promise, and to the extent that any new regulation is presented to the public as a protection" against future harms, "people are being misled," says Marvin Goodfriend, a professor of economics at the Carnegie-Mellon Tepper School of Business in Pittsburgh.

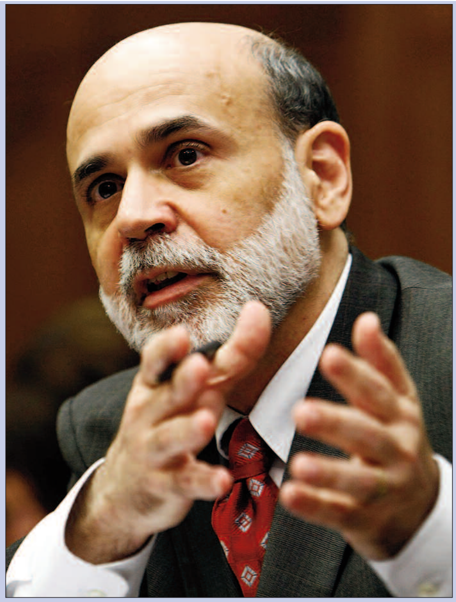
History has plenty of examples showing that financial regulation often does not work, Goodfriend says. "There were plenty of regulations in the mortgage markets, for example, but they didn't protect people. There is a role for regulation, but it should not be oversold." For example, "a too big to fail" rule — should one be enacted — "could be gotten around by the industry, and they would get around it," he says.

Instead, to create a well-functioning market in which frauds and risk are at a minimum, "there is no solution except constant vigilance" by "informed customers," — borrowers, depositors, stockholders, and investors, among others — who "discipline firms" by their vigilant search for value, Goodfriend says.

On that basis, rather than rules per se, he would like to see more standardization of financial products. "Standardization is a public good" because it leads to more informed customers who can keep banks honest. "I want to be able to compare" investments.

Goodfriend says that he'd start an effort to standardize financial-product descriptions by examining how more transparent labeling was achieved for other products, such as nutritional labeling on food. Because of that history, "we're not flying blind" in trying to accomplish standardized labeling for investments, he says. Transparency might extend to all types of investments, including initial public offerings — IPOs — of company stock, he says.

— Marcia Clemmitt



Getty Images/Win McNamee

Federal Reserve Chairman Ben S. Bernanke said a rule regulating "short selling" might have softened the 2008 economic crash.

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[1] For background, see Robert Holmes, "Uptick Rule: Meaningful or Meaningless," *The Street.com*, Feb. 27, 2009, www.thestreet.com.

[2] Quoted in Gretchen Morgenson, "Why the Roller Coaster Seems Wilder," *The New York Times*, Aug. 26, 2007.

[3] Quoted in Jesse Westbrook, "Bernanke Says There May Be Benefit to Uptick Rule," Bloomberg.com, Feb. 25, 2009, www.bloomberg.com.

[4] Nomi Prins, "Shadow Banking," *The American Prospect*, May 4, 2010, www.prospect.org

[5] *Ibid.*

The Federal Reserve Act of 1913 established a network of private regional banks empowered to use public funds to shore up troubled banks, loosely overseen by the presidentially appointed Federal Reserve Board.

The system exists today in much the same form in which it was created. To get some idea of its power, one need only observe that "every dollar bill in the country says 'Federal Reserve Note' on it," says Robert D. Auerbach, a professor of public affairs at the University of Texas, Austin.

Regulation, Deregulation

It soon became clear, however, that the system was no panacea for financial busts.

In the 1920s, good times rolled, industry grew and stock prices soared, tempting more stock investors into the game, with a growing number buying securities with "leverage," or using borrowed cash.

The young Federal Reserve had considerable power to affect the money and credit supply and thus slow an economy where debt was growing excessive. But slowing a boom is "never popular with politicians concerned about the next election, banks making large profits . . . or ordinary people benefiting from a burgeoning economy," so the Fed kept interest rates low, said Johnson and Kwak.

In October 1929, an increasingly unstable stock market began experiencing unnerving one-day price drops. At the same time, housing prices were dropping around the country. Panic about financial firms' stability led to bank runs that helped trigger the Great Depression of the 1930s.

Mystery of the May Mini-crash

Did big banks use ultra-high-speed trading to spook Congress?

By April 2010, the Dow Jones Industrial Average had climbed to 11,205 — nearly 70 percent over its March 2009 level — and Wall Street seemed to have put the 2008 financial-market crash behind it. Then, on May 6, a so-called "flash crash" sent the Dow plummeting 998 points — nearly a tenth of its value — in just a few minutes, before regaining about 600 of those points by day's end. [1]

High-frequency trades (HFT) — instantaneous stock trades generated by computers — were widely blamed for the dizzying drop.

Only a handful of big firms, such as the investment bank Goldman Sachs, use HFTs, but the trades represent about 75 percent of overall trading volume and have enormous power to push the market sharply up or down, "usually without fundamental or technical reason," charged financial blogger Tyler Durden. High-frequency traders can make lightning-quick trades and thus turn a profit based on market shifts that are actually created by HFT itself, he said. [2]

As a result, "based on a few lines of code" in a big bank's HFT computers, "retail investors," who don't understand that the market is being driven by computerized buying rather than real-world events, "get suckered into a rising market that has nothing to do with" factors that might legitimately raise stock prices, such as "some Chinese firms buying a few hundred extra Intel servers," Durden said. [3]

Some in Washington are sounding alarms. "I'm afraid that we're sowing the seeds of the next financial crash," said Sen. Ted Kaufman, D-Del., who holds an MBA from the University of Pennsylvania's Wharton School and was a longtime aide to Vice President Joseph Biden. "We're dealing with something highly complex and completely unregulated. The last time we had that mix, with the practitioners telling us, 'Don't worry about it,' things didn't end well." [4]

Moreover, some high-frequency traders use their speed advantage to profit in ways that are, if not illegal, at least highly unfair, said David Weild, a former vice chairman of the NASDAQ stock exchange. Some HFT firms use their high speed and the slower trading algorithms used by investors like pension funds to buy the next stock those investors will want, and then sell it back at a higher price. "It is increasingly clear that there are quite a number of [such] high-frequency bandits in the high-frequency-trading community," said Weild. [5]

Some commentators even suspect that big-bank, high-frequency traders deliberately created the May 6 market tumble to warn Congress of what havoc bankers could cause if lawmakers passed a tough banking law. On the day of the 998-point drop, Congress was deliberating two provisions that were anathema to the financial industry — a forced breakup of the nation's six largest banks and a requirement for an independent audit of the Federal Reserve's

President Franklin D. Roosevelt, inaugurated in March 1933, sought a law to stop banks from making risky Wall Street investment bets with Main Street depositors' money. The Banking Act of 1933 — dubbed the Glass-Steagall Act after cosponsors Sen. Carter Glass, D-Va., and Rep. Henry B. Steagall, D-Ala. — required traditional "commercial" banks — which take deposits and make loans — to be separate entities from "investment" banks, which help raise corporate capital and issue and trade securities. It also created the Federal Deposit Insurance Corporation to insure bank deposits and facilitate an orderly shutdown of commercial banks that got into trouble.

Decades of moderate business cycles, without steep booms and busts, followed, although historians disagree about whether stricter banking laws were largely responsible. By the late 1970s, however, a new school of free-market economists joined with banks to press for loosening the restraints.

Beginning with the Reagan administration, in 1981, banking rules were relaxed, and financial firms got larger and took on a more varied and riskier mix of investments, loans and deposits.

At the same time, Americans became more comfortable with borrowing; and workers whose companies once offered pensions now had to invest retirement money in stocks and bonds. Wages stagnated, leading to increased borrowing as Americans sought the higher standard of living that by now was considered an American birthright.

A new era of steeper booms and busts was about to begin.

In the 1980s, savings and loan associations (S&Ls) — local institutions that took deposits and made mortgage loans — were among the first financial firms to be deregulated. Initially, profits soared. Between 1986 and 1995, however, regulators closed 1,043 failing S&Ls — about a third of the total — mainly because they'd lent to risky borrowers who defaulted. By 1999, around $124 billion in taxpayer money had shielded S&L depositors from losing their savings. [42]

The advent of fast computers allowed financiers to design new investment instruments — "derivatives" — whose values, often based on complex formulas, could make them effective "hedges" against failing bets on traditional investments, like a company stock. Mostly traded over-the-counter rather

2008 bailout of the banks. That the "flash crash" occurred during discussion of these proposals suggests it "could have been an act of financial terrorism," wrote liberal blogger David DeGraw. [6]

"The amalgamation of events is eerily similar to what took place on Sept. 29, 2008," when the House of Representatives voted to reject the federal bailout plan for banks, the Troubled Asset Relief Program (TARP), said DeGraw. "Immediately after the vote, big banks made the market plunge a record 778 points, sparking widespread . . . panic that helped convince Congress to eventually pass" the measure. [7]

Many in the HFT community dismiss such claims as nonsense, however, and argue that HFT did not cause the May 6 crash. "This crisis was precipitated by panic selling by humans," not HFT, because "we just had had a huge run-up in the equities markets, we were in the midst of a 10 percent correction before the mayhem unfolded, and on top of that you had very vexing news" about the financial collapse of the Greek government, said Manoj Narang, founder of the New York City-based HFT information firm Tradeworx. [8]

Meanwhile, the Securities and Exchange Commission is proposing additional "circuit-breaker" mechanisms that would halt securities trading briefly if any stock price declined by a large amount within a five-minute period, to forestall panic sell-offs that turn into market crashes. [9]

But some analysts say that ever-rising trading speeds simply make the market too difficult to control by such mechanisms. "There's a speed that's too fast, and right now we're at it," said Michael Goldstein, a professor of finance at Babson College, a business school in Wellesley, Mass. "Like our highways have a minimum speed and a maximum speed, maybe it's time for our highways in trading to have a minimum speed and a maximum speed as well." [10]

— Marcia Clemmitt

[1] For background, see Matthew Philips, "Fast, Loose, and Out of Control," *Newsweek*, June 1, 2010, p. 42.

[2] Tyler Durden, "Goldman's $4 Billion High Frequency Trading Wildcard," Zero Hedge blog, July 2009, http://zerohedge.blogspot.com.

[3] *Ibid.*

[4] Quoted in Philips, *op. cit.*

[5] Quoted in Timothy Lavin, "Monsters in the Market," *The Atlantic*, July/August 2010.

[6] David DeGraw, "Was Last Week's Market Crash a Direct Attack by Financial Terrorists?" AlterNet web site, May 10, 2010, www.alternet.org.

[7] *Ibid.*

[8] Quoted in "'Flash Crash,' the Untold Story by Tradeworx's Manoj Narang, at High-Frequency Trading Leaders Forum," press release, Golden Networking web site, June 2, 2010, www.prlog.org.

[9] Jim Puzzanghera, "New Circuit Breakers Will Likely Prevent 'Flash Crash,' Experts Say," *Los Angeles Times*, June 3, 2010, p. B3.

[10] Quoted in *ibid.*

than in managed exchanges as stocks are, derivatives are essentially bets on how some shifting quantity or quantities will change. A derivative's value can derive from literally any changing quantity, such as stock prices, the value of one nation's currency in terms of another, or even how many sunny days a region will experience. Derivatives can theoretically be designed to hedge against any risk.

Derivatives markets boomed in the 1990s, with many individual and institutional investors borrowing millions or even billions of dollars to buy them. Nevertheless, as the investments grew more complex, their risks became harder to discern, triggering huge losses for some.

In the late 1990s, Brooksley Born — then chair of the Commodities Futures Trading Commission (CFTC), which oversees the "futures contracts" that help farmers lock in favorable prices for wheat and other crops — sought to have her agency designated to oversee derivatives trading. Born made her pitch after the spectacular demise of Long-Term Capital Management (LTCM), a huge "hedge" investment fund that collapsed "because it had $1.25 trillion worth of derivative contracts at the same time as it had less than $4 billion in capital to support them" and thus was utterly unable to make good on its losing bets. [43]

But financial firms and policymakers, including Federal Reserve Board chairman Alan Greenspan, shot down Born's proposal, arguing that the LTCM crash was an aberration.

In 2000, President Bill Clinton signed the Commodity Futures Modernization Act, eliminating a longstanding legal rule that over-the-counter derivatives "contracts" were valid only if one of the trading parties actually owned the security that they were betting against, explained Lynn A. Stout, a professor of corporate and securities law at the University of California, Los Angeles. [44]

Under the new law, even a person who does not own a particular security may invest in an over-the-counter derivative that will pay off if that security fails. Supporters argued the change would keep American investment firms competitive with those in countries that do not restrict derivatives trades. But Stout compares it to permitting "the unscrupulous to buy fire insurance on other people's houses." In that case, "the incidence of arson would rise dramatically," she notes dryly. Similarly, under the 2000 law, some derivatives dealers certainly design some securities to fail, just so they can make surefire bets against those failures, she said. [45]

Nevertheless, as regulations loosened, the financial industry increased its profitability and thus its importance to the country's overall financial picture. Between 1980 and 2005, financial-sector profits grew by 800 percent, compared to 250 percent in other industries. [46]

Crash of 2008

The economy enjoyed a wealth boom as the 21st century began. Home ownership soared as borrowers took advantage of low interest rates set by the Federal Reserve to keep the economy moving after the 9/11 terrorist attacks.

New kinds of mortgages — with ultra-low introductory interest or requiring no downpayment — enticed many to take out second mortgages to get cash to spend. Speculators buying houses today so they could "flip" them at higher prices to other buyers tomorrow helped drive real-estate prices skyward and, along with them, Americans' perception that their personal wealth was soaring. Another computer-based banking innovation, "securitization," increased mortgage availability by allowing banks to package hundreds of mortgages and sell them to investors, thus getting the loans off banks' own books and freeing them to make new loans. [47]

In 2007 the wheels came off the wealth machine.

Some of the riskiest mortgage holders were defaulting. And since not local banks but investors owned the "securitized" debt — as well as derivatives based on the mortgage-backed securities, which many had taken on large amounts of additional debt to buy — financial losses from the unpaid mortgages quickly spread around the globe.

The amount of apparent wealth that a highly leveraged system with multiple complex paper assets can produce is enormous. Currently, the worldwide derivatives market alone is said to have a value of about $1.2 quadrillion, or about 24 times the value of the entire world's annual gross domestic product (GDP). Such a wealth bubble may quickly deflate, however, if the value of underlying assets wanes or grows suspect, as happened with high-risk mortgage loans in the 2000s and with sketchy start-up companies in the 1990s' Internet stock bubble. [48]

Most banks knew they had risky securities on their books and, suspecting that other banks did too, refused to offer them the short-term credit they needed to make business loans. The supply of home buyers dried up, and house prices dropped, wiping out the paper wealth against which many consumers had borrowed their spending money. The economy ground to a halt, and some financial institutions that were believed — rightly or wrongly — to have the riskiest investment portfolios stumbled.

Beginning in 2008, the Treasury Department and the Federal Reserve worked together to save some "too big to fail" financial institutions, — while allowing others, like the financial-services firm Lehman Brothers, to go under.

In March, the Federal Reserve lent $29 billion to help the JP Morgan Chase bank acquire the failing investment firm Bear Stearns. In September, the Federal Reserve put up $85 billion — later increased to over $180 billion — to save AIG, Inc., an insurance firm that had helped investors "hedge" bets with a risky derivative called a "credit default swap." When investments tumbled in value in the general slump, AIG was unable to pay off its many CDS obligations. Also in September, the government seized the government-sponsored mortgage giants Fannie Mae and Freddie Mac, as mortgage defaults swelled.

Despite the taxpayer-funded "bailout" of big financial companies, however, a deep economic recession spread worldwide and persists. ■

CURRENT SITUATION

Reform Legislation

After a long and intense battle on Capitol Hill, financial reform legislation is now in place.

The fierce 2010 congressional battle to enact the legislation was Washington's response to widespread anger over the Wall Street bailout and public distaste for companies many believe handed out huge bonuses to the very executives who put profits ahead of customers' interest and helped precipitate the economic crash.

Passing the legislation has not been easy, however. The year-and-a-half struggle to get a majority of House members, 60 senators and the White House to agree on just what new rules are needed reveals both the issue's complexity and banks' enormous political clout. In the early morning hours of Friday, June 25, a House-Senate conference committee agreed on final details to merge separate versions of financial-reform legislation passed earlier this year by the two chambers. No conference-committee Republican voted to approve the bill, arguing that it would cripple the financial industry and the economy, although it contains far less stringent curbs on banks than many economists, and even some bankers, recommend.

In the full Senate, however, three Republicans, Scott Brown, (Mass.) and Maine's Susan Collins and Olympia Snowe, crossed the aisle on July 15 to give supporters the 60 votes they needed to overcome a final Republican filibuster of the plan, and President Obama signed the measure into law on July 21.

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At Issue:

Do Fannie Mae and Freddie Mac bear primary responsibility for the financial crisis?

MARK A. CALABRIA
DIRECTOR OF FINANCIAL-REGULATION STUDIES, CATO INSTITUTE

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Perhaps it should come as no surprise that Sen. Christopher Dodd, D-Conn., and Rep. Barney Frank, D-Mass, the 2010 financial-reform bill's primary authors, would fail to end the numerous government distortions of our financial and mortgage markets that led to the crisis. Both have been either architects or supporters of those distortions.

Nowhere in the bill will you see even a pretense of rolling back the endless federal incentives and mandates to extend credit, particularly mortgages, to those who cannot afford to pay their loans back. After all, the popular narrative insists that Wall Street fat cats must be to blame for the credit crisis. Despite the recognition that mortgages were offered to unqualified individuals and families, banks will still be required under the Dodd-Frank bill to meet government-imposed lending quotas.

Apologists for government-mandated lending are correct in pointing out that much of the worst lending was originated by state-chartered lenders, such as Countrywide, and not federally chartered banks. However, they either miss or purposely ignore the truth that these non-bank lenders were selling the bulk of their loans to Fannie Mae, Freddie Mac or the government corporation Ginnie Mae. About 90 percent of loans originated by Countrywide, the largest subprime lender, were either sold to Fannie Mae or backed by Ginnie Mae. Subprime lenders were so intertwined with Fannie and Freddie that Countrywide alone constituted over 25 percent of Fannie's purchases.

While one can debate the motivations behind Fannie and Freddie's support for the subprime market, one thing should be clear: Had Fannie and Freddie not been there to buy these loans, most of them would never have been made.

And had the taxpayer not been standing behind Fannie and Freddie, they would have been unable to fund such large purchases of subprime mortgages. Yet Congress believes it is more important to expand federal regulation and litigation to lenders that had nothing to do with the crisis rather than fix the endless bailout that Fannie and Freddie have become.

Nor has there been any discussion in Congress about removing the tax preferences for debt. Washington subsidizes debt, taxes equity and then acts surprised when everyone becomes extremely leveraged.

Until Washington takes a long, deep look at its own role in causing the financial crisis, we will have little hope for avoiding another one.

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FROM TESTIMONY BEFORE FINANCIAL CRISIS INQUIRY COMMISSION, JAN. 13, 2010

Since the problems in the subprime market became evident in early 2007, many in the mortgage industry evaded responsibility by blaming the borrowers.

However, the stereotypes of the risky borrower or the borrower overreaching to purchase a McMansion turn out to be false. Research shows that an elevated risk of foreclosure was an inherent feature of the defective, exotic loan products that produced this crisis. Loan originators frequently specialized in steering customers to higher-rate loans than those for which they qualified, which are loaded with risky features.

In addition, given the long-standing political dispute over the very existence of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), it is not surprising that these government-sponsored enterprises (GSEs) are often blamed for the crisis. Those blaming the GSEs point to their decision to purchase subprime securities from Wall Street.

The fact is, while we agree that Fannie Mae and Freddie Mac should not have purchased subprime mortgage-backed securities (MBS), their role in purchasing and securitizing problem loans was small in comparison with that of private industry. All subprime mortgage-backed securities were created by Wall Street. Fannie Mae and Freddie Mac did not securitize any of these loans because the loans did not meet their standards. When they finally began to purchase the MBS, they were relative late-comers to a market that had been created by private-sector firms and they purchased the least risky and most easily sellable of the securities.

In fact, the GSEs' role in the overall mortgage market diminished substantially as subprime lending rose. As of 2001, Fannie Mae and Freddie Mac funded almost two-thirds of home mortgage loans across the United States. These were loans that Fannie Mae and Freddie Mac purchased directly from originators who met the GSE guidelines and either held on their balance sheets or securitized and sold to investors. Subprime loans accounted for just 7 percent of the market.

Around 2003, private issuers began to introduce new, riskier loan products into the market and began to displace the GSEs. In early 2004, private-issue MBS surpassed the GSE issuances of all loans and by early 2006, Fannie and Freddie's market share of new issuances had dropped to one-third of the total. As the role of the GSEs was declining, the percentage of subprime loans in the mortgage market almost tripled.

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Republican opposition to the measure remains strong, however. "I think it ought to be repealed," said House Minority Leader John Boehner, R-Ohio. "I think it is going to make credit harder for the American people to get." [49] The new law:

- Gives regulators authority to assess whether a bank poses a risk to the economy and to break apart or close such banks;
- Limits some derivatives trading;
- Tightens capital standards;
- Sets up a consumer-credit watchdog agency in the Federal Reserve; and
- Allows Congress to seek audits of the Federal Reserve. (*See sidebar, p. 634.*)

"We shouldn't put in place a regulatory regime that overly reacts and, as a result, significantly dampens our capacity to have the most vibrant capital and credit markets in the world," said Sen. Judd Gregg, R-N.H. [50]

Some Republicans did seek tough rules, however. In May, for example, the Senate approved an amendment from Collins requiring banks with more than $250 billion in assets to meet slightly stricter capital requirements than in the past, and the plan made it into the final package. Collins' amendment would prevent the biggest banks, which make many high-risk trades, from trading with too much borrowed money. [51]

Democrats including the Obama administration are all over the map in their views, hotly debating nearly every proposed provision. The Obama administration actually opposed Collins' amendment, for example. [52]

In both the current and recent administrations, Treasury Department leaders mainly come from the financial industry and the Federal Reserve, a fact that likely drives White House wariness of some rule tightening, many observers say. "Isn't it interesting that the White House is opposing" an amendment to require the Federal Reserve to undergo stringent independent auditing, given that Treasury Secretary Timothy Geithner "is a former head of the New York Fed," says Texas' Auerbach.

Some Democrats have fought for very strict regulation. Sens. Sherrod Brown (Ohio) and Ted Kaufman (Delaware) proposed forbidding any single bank from holding more than 10 percent of the country's deposits, and Sen. Al Franken (Minnesota) wanted an independent board to assign financial firms a credit ratings agency for each project, rather than letting banks "shop" for agencies as they do now. Neither measure made it into the law. [53]

But many Democrats also have fought to soften bill provisions. For example, Sen. Tom Harkin (Iowa) and Rep. Greg Meeks (New York) successfully pushed to keep the SEC from regulating so-called equity-indexed annuities — products often fraudulently sold to seniors as ultra-safe, fixed-income investments, even though their value depends on stock prices, and both the SEC and the courts have ruled that the SEC should regulate them. [54]

Its architects praise the law. "This is going to be a very strong bill, and stronger than almost everybody predicted it could be," said House Financial Services Committee Chairman Barney Frank, D-Mass. [55]

But many analysts say the legislation will do little to limit banking risk.

"Lobbying in the gazillions predictably stopped the needed major structural reforms . . . revealed by the scope and scale of the financial crisis," said Robert Johnson, director for global finance at the Roosevelt Institute, a liberal think tank in New York City. "We still have many practices that are not transparent and many off-balance-sheet problems that disguise the conditions of our financial firms." [56]

Fraud Enforcement

In the end, laws make no difference unless they're enforced, and financial-sector enforcement has been chancy at best over the years, partly because of the industry's vast influence, many observers say.

Nevertheless, no matter how lightly an industry is regulated, the ability to crack down on at least the most abusive behavior always exists, says Texas' Galbraith. "You can't decriminalize fraud. Good accounting, good auditing and appropriate criminal referrals are what we need" from regulators, he says. "My sense is that once the wheels [of civil and criminal investigations] start turning, the effects are pretty powerful," including making other industry players "think twice" about their behavior. At present "it's hard to judge" how much enforcement activity is bubbling, but there are encouraging signs, Galbraith says.

On April 16, for example, the SEC filed a civil lawsuit charging Goldman Sachs with fraud for selling mortgage-backed securities the bank knew were intended to fail. The so-called Abacus securities were designed by a hedge-fund manager, John Paulson, who did not buy any of the securities but designed them to fail so that he could profit by betting against them using derivatives, under the legal permission granted by the 2000 Commodity Futures Exchange Act. [57] In mid-July, Goldman agreed to pay $550 million to settle the case, an amount the SEC notes is "the largest-ever penalty paid by a Wall Street firm." In the settlement, the bank neither admitted nor denied the SEC's allegation that it had committed fraud, however. [58]

Some analysts say that the fine is far too small to deter bad behavior by the high-rolling financial industry.

For one thing, the fine amounts to only about two weeks' worth of profits for Goldman Sachs, according to the independent, foundation-funded investigative journalism organization ProPublica. [59]

"It's the largest fine in SEC history, and that's the bad news . . . because it shows how ineffective the SEC has been for decades now," said the University of Missouri's Black. While "losses caused by securities fraud have grown into the multibillion dollars" over the past few decades, "the SEC not only didn't bite, but it forgot that it had teeth." The Goldman Sachs fine "is very, very weak; it's not going to have any significant deterrent effect," said Black. Furthermore, civil lawsuits against the bank will be extremely difficult to pursue, since the SEC did not exact an admission of intentional deception from the bank, he said. [60] Goldman, in fact, reportedly expected to have to pay a $1 billion fine. [61]

Meanwhile, states, especially in the West, are said to be pursuing numerous fraud cases involving the mortgage industry, and some in Congress also have shown interest, Galbraith notes. Last November, for example, Rep. Marcy Kaptur, D-Ohio, introduced legislation to hire up to 1,000 new FBI agents to pursue cases of suspected corporate, securities, and mortgage fraud. [62]

White-collar enforcement, especially in finance, has always faced severe challenges, at least partly because regulators mostly come from the regulated industries, says Baker of the Center for Economic and Policy Research. "It's as if [big pharmaceutical manufacturers] Pfizer and Merck appointed members to the Food and Drug Administration," Baker says. "This remains an enormous problem not addressed by" legislation.

In the Federal Reserve system, for example, which is charged with overseeing banks, "you've got the New York banks electing" the very officials who will oversee them, says Texas' Auerbach, author of the 2008 book *Deception and Abuse at the Fed: Henry B. Gonzalez Battles Alan Greenspan's Bank.*

"There was massively too much leverage" — the use of large amounts of debt, rather than actual assets or capital, to purchase investments — "in the financial system" before the last crash, noted Richard Breeden, who chaired the Securities and Exchange Commission from 1989 to 1993. "Regulators had the authority to control that and eliminate it" but didn't. "We can keep passing laws, but if the regulators don't have the backbone to enforce the rules and to be realistic, then that's a different problem." [63]

Currently, for example, pro-regulation, liberal advocates are pressing the administration to appoint Elizabeth Warren, a Harvard Law professor and head of Congress' oversight committee for the financial-industry bailout, as chief of the new consumer-protection agency created by the reform law. "Professor Warren has a proven track record as a smart and tough consumer advocate" and in fact was the first person to propose that there be such an office, said Sen. Bernie Sanders, I-Vt., in a letter to President Obama urging Warren's appointment. [64]

However, with the banking industry believed to strongly oppose Warren's nomination, Senate Republicans would likely filibuster it, and even with all Democrats and Independents voting "yes," Senate Democratic leaders would still have to win over at least one Republican vote to get the 60 votes needed to end a filibuster and approve her nomination. [65] If Obama "nominates a zealot or an activist, I think it will bring to life our greatest fears about this consumer protection agency," said Sen. Bob Corker, R-Tenn. [66] Meanwhile, Wall Street activities continue much as they did pre-crash, observers say.

For example, "many big banks have not modified their [employee compensation] practices from what they were before the crisis," paying executives in ways that incentivize "excessive risk-taking," said Federal Reserve Chairman Ben S. Bernanke in June. [67]

"Despite all those dramatic congressional hearings, average compensation of Wall Street bankers rose by 27 percent in 2009," said Nomi Prins, a senior fellow at the liberal New York City-based think tank Demos. Meanwhile, "banks posted their lowest lending rates since 1942, despite all the subsidies and cheap money they received from, well, us" as a supposed incentive to help the economy by making business loans, she said. [68] ■

OUTLOOK

New Crash Ahead?

Most analysts don't see an end to extreme boom-and-bust cycles in financial markets.

The new financial industry overhaul legislation "will have relatively little impact" on slowing growth of speculative "bubbles," like the vastly inflated stock prices for fledgling Internet companies in the so-called dot.com bubble of the 1990s and the soaring house prices of the early 2000s, says Baker of the Center for Economic and Policy Research.

"I believe that nothing in the [new legislation] will prevent another crisis," said Richard Marston, a professor of finance at the University of Pennsylvania's Wharton School. The basic problem is that "securitization" — conversion of pools of loans, like mortgages and credit-card debt, into packages to be sold as investments — "has changed banking in a fundamental way," he says. "It ties all financial institutions and investors together," so that risky investment activities can't easily be walled off from the rest of the system, and risk spreads easily throughout the economy. [69]

Congress didn't even pretend to address the real causes of the crash, some analysts say.

No legislation to reform the financial industry could "address the underlying problems" that really triggered the economic meltdown, said Wharton finance professor Franklin Allen. Low interest rates and "global imbalances" of wealth, such as large reserves of currency in Asia, led to over-borrowing, visible in the proliferation of high-risk mortgages, and the law's provisions "do nothing" to address these. [70]

"A number of . . . provisions in the bill . . . run far afield from Wall Street reform and will ultimately harm Main

Street," said American Bankers Association President Edward L. Yingling. "This bill will, in the end, add well over a thousand pages of new regulations for even the smallest bank," with the result that "the capability of traditional banks to provide the credit needed to move the economy forward has been undermined." [71]

Some analysts say it's unlikely lawmakers can ever effectively address the problem of "wealth bubbles," whose rapid deflation triggers financial and economic meltdowns.

"I don't think the problem of bubbles is an economic problem. It's a political problem," says Cato's Calabria. "The public loves a bubble" because people rejoice when their house values or stock portfolios make them feel wealthy, he says. That being the case, neither lawmakers nor regulators nor banks will ever get much support for deliberately trying to pop wealth bubbles or slow their development, he suggests.

"Based on what's in the bills, in 10 to 15 years there will be another crash," Calabria predicts. ■

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FOR MORE INFORMATION

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