The Wall Street Leviathan

Jeff Madrick

The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States
PublicAffairs, 545 pp., $14.99 (paper)

Inside Job
a film directed by Charles Ferguson

Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance
edited by Viral V. Acharya, Thomas F. Cooley, Matthew P. Richardson, and Ingo Walter.
Wiley, 573 pp., $49.95

Reforming US Financial Markets: Reflections Before and Beyond Dodd-Frank
by Randall S. Kroszner and Robert J. Shiller, edited and with an introduction by Benjamin M. Friedman.
MIT Press, 152 pp., $19.95

With its revealing accounts of the Wall Street practices that led to the recession of 2008 and 2009, the recent report of the Financial Crisis Inquiry Commission (FCIC) is the most comprehensive indictment of the American financial failure that has yet been made. During two years of investigations, the commission accumulated evidence of many hundreds of irresponsible, self-serving, and unethical practices by Wall Street bankers and systematic tolerance of them by regulators.

Written by the six members appointed by congressional Democrats, the FCIC report concludes, "The crisis was the result of human action and inaction, not of Mother Nature or computer models gone haywire." Many readers would think the conclusion obvious. But Wall Street professionals repeatedly claimed that similar crises occurred frequently in the history of modern capitalism, that they are merely the price paid for a dynamic and innovative economic system, and that individuals were not to blame. They thus minimized their own responsibility for the events and cast doubt on the need for significantly more intense regulation of their activities. The FCIC majority dismisses such arguments.

Can we then infer that future crises may be avoided by intelligent and unbiased financial regulators and a chastened Wall Street? A 2,300-page set of regulations—known as the Dodd-Frank Act after its congressional sponsors, Senator Chris Dodd and Representative Barney Frank—was passed last year to accomplish just that. In a television interview with Charlie Rose this March, Frank said he "got better than 90 percent" of what he wanted. The act has some bite. It proposes ways to deal with many of the practices that contributed to the crisis, including inadequate capital requirements, excessive Wall Street compensation, and damaging conflicts of interest in credit ratings agencies that readily assigned their highest ratings to risky debt. It tries to regulate trading of speculative securities like derivatives, which enabled bankers to wage huge bets with little capital on the movement of securities prices.

Under Dodd-Frank, a new oversight board, composed of members of regulatory agencies led by the Federal Reserve, will now be charged with assessing the level of so-called systemic risk of major financial institutions and imposing stricter capital rules or even shutting institutions down if they are deemed to put the financial system at risk—that is, if their failure might bring down many other institutions with them and endanger the American economy. Now there will be regulation not only of traditional commercial banks, which always fell under the purview of the Federal Reserve, but also investment banks, money market funds, and perhaps even hedge funds, which had been hardly regulated at all.

Former Treasury Secretary Henry Paulson, Federal Reserve Chairman Ben Bernanke, and Treasury Secretary Timothy Geithner; from Charles Ferguson's documentary film Inside Job

Representational Pictures/Sony Pictures Classics

The Consumer Financial Protection Bureau has also been established inside the Federal Reserve to write new requirements for mortgages, consumer loans, and the other consumer credit products that were so badly abused. Of particular concern, people with poor credit and low incomes were sold so-called subprime mortgages that were deceptively cheap at the outset, sometimes requiring no down payments, but whose annual interest charges skyrocketed in later years. The availability of mortgage finance drove housing prices ever higher, and when they collapsed, beginning in roughly 2006, the growing amount of bad debt that resulted caused a collapse of Wall Street and then the global economy.

But the Dodd-Frank Act has largely pushed responsibility for writing and implementing the new rules onto existing regulators, including the Federal Reserve, the Securities and Exchange Commission, the Commodities Futures Trading Commission, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. This will likely prove a damaging flaw. These regulators are by and large the same agencies that tolerated the excessively risky behavior in the first place. Even if they write effective rules they will face pressure from Wall Street lobbyists and mostly Republican legislators to soften restrictions and eliminate some of the critical ones. If the restrictions remain intact, which is likely in view of the Democratic majority in the Senate, the question remains whether the regulators will enforce them vigorously once the economy recovers and the crisis fades in memory. Several agencies have already missed the deadlines to write new rules. Some are worried that the Consumer Financial Protection Bureau will be neutralized by Congress. Wall Street spent $2.7 billion on lobbying between 1999 and 2008 and is lobbying vigorously again.

The Dodd-Frank Act could have been much more effective. It could, from the outset, have set high capital requirements—the amount of money that banks and other financial institutions have to put aside for possible losses. It could have broken up today's enormous banks, which have grown rapidly in size since the crisis. Measured by their profits, the six largest financial institutions in the US now account for 55 percent of all banking assets. It could have divided the banks by function in order to reduce the overlapping of investment activities, which increases the chances of damage to the entire financial system. For example, those banks that accept federally insured deposits from savers could have been restricted to making loans to consumers and businesses. Other institutions that raise money independently of government guarantees could have been allowed to sell more risky stocks or corporate bonds to investors or speculate in securities with their shareholder capital.

The only action proposed by Dodd-Frank along these lines is known as the Volcker Rule, named after former Federal Reserve chairman Paul Volcker. It would prohibit proprietary trading by banks that typically accept the public's deposits—that is, it would limit speculative investments with the institution's own capital. But even the Volcker Rule has not been clearly formulated and applied. The question still not answered is why regulators would perform better in the future than in the past two decades.

The FCIC report will probably not provoke tougher regulation in Washington. Its strength is its accumulation of fact and example. By contrast, Charles Ferguson's popular, Oscar-winning documentary *Inside Job* tells the story of the crisis with directness and clarity, partly because he is willing to make pointed accusations against specific federal regulators and Wall Street bankers. In interviewing some of those he thinks of as culprits, including several prominent economists, he finds that they have hardly anything to say in their defense. Those he did not interview are often shown in revealing congressional testimony. We see Alan Greenspan, the former Federal Reserve chairman, assuring Congress that derivatives, including those guaranteeing subprime mortgage securities, required no federal regulation at all. In fact, unregulated derivatives were a principal source of the risk-taking that brought down the financial system.

Ferguson never adequately explains derivatives but he makes it clear that Wall Street firms borrowed far too much in order to invest in mortgage debt securities that were far too risky, and no one stopped them. The result was soaring housing prices, which led to more risky mortgages. Then the banks and others sold the risky debt to investors around the world as if it had almost no risk at all. Did Wall Street bankers know they had built a house of cards? Ferguson thinks many did, selling bad products without proper warning to their clients; they didn't care, he believes, because they were making too much money. But it takes the FCIC report to prove his point by means of carefully accumulated evidence.

When Ferguson accepted his Oscar in late February, he remarked that no one had yet gone to jail for the worst American financial crisis since the Great Depression. This was a telling observation about the weakness of corporate fraud law as well as the lack of vigor of the US Justice Department. Criminal action against Angelo Mozilo, whose firm Countrywide Financial wrote more subprime mortgages than any other, was dropped this winter. The FCIC report provides many examples of the failure of management to warn shareholders of the risks it was taking—apparent violations of disclosure laws that were never even investigated.

Still, jail sentences may have little effect. By the late 1990s, countless accounting frauds culminated in outrageous behavior by Enron, WorldCom, and others, abetted by such giants as Citigroup and the Arthur Andersen accounting firm. Some Enron executives went to prison and Andersen closed down, but this did not discourage deceptive practices in mortgage securities in the mid-2000s. Wall Street is now creating outsize values for social media companies like Facebook and Twitter, well before these companies have generated serious profits. While federal regulators are debating among themselves and with financial lobbyists about new rules, another bubble is likely forming before our very eyes.

Little had been expected of the FCIC because its subpoena power was weak. It was appointed by Congress in the spring of 2009 with the Democrat Philip

funds, to take big losses when housing collapsed. Citigroup kept many CDOs on their own books or in the off-balance-sheet entities I have mentioned so it could earn the handsome interest they paid, suspiciously higher than the interest on other triple-A-rated securities. Citigroup also often had to buy some of them because it couldn't sell all the CDOs it underwrote to customers.

The Republican minority on the commission, along with other observers, contend that repealing the Glass-Steagall Act was not a factor in the crisis even though the institutions grew unprecedentedly large. But Citigroup used the size of its balance sheet—more than $2 trillion in 2007—to guarantee its ever-growing purchases of mortgage-backed securities and to support other lines of business, including both conventional lending and trading securities. As the Fed put it in 2008, Citigroup's "senior management allowed business lines largely unchallenged access to the balance sheet to pursue revenue growth."

Citigroup along with Merrill Lynch had written more CDOs than anyone else by 2006. Citigroup lost $40 billion in the fourth quarter of 2007, and overall its losses and writedowns came to $130 billion, the largest among commercial banks. Merrill's total losses came to nearly $56 billion, more than any other investment bank. Their CEOs claimed (as did Robert Rubin) that they had no idea the triple-A-rated CDOs were risky. Citigroup received $45 billion in funds from the government's Troubled Asset Relief Program, more than any other bank, and was given guarantees on some assets, but no one was removed from management.

Where was the Fed? The legislation repealing Glass-Steagall, the Gramm-Leach-Bliley Act of 1999, had one other subtle but highly significant consequence, as the FCIC report explains. It diluted the government's regulatory authority over the new financial conglomerates such as Citigroup. Under the legislation, the Fed, the strongest of the regulators when it did its job properly, now oversaw only bank holding companies, the umbrella organizations under which the bank subsidiaries operated. The 1999 act mandated that the Fed rely on the SEC to oversee bank subsidiaries that dealt in securities, and that the Office of the Comptroller of the Currency oversee commercial banks. The practical result was that much of importance thus fell through the cracks of the 1999 bill. The FCIC report refers to this stripped-down authority as "Fed-Lite." The Fed failed to do its job in any case. It made no adequate analysis of the risky CDOs. As far back as 2005, a peer review by other Federal Reserve banks criticized the New York Fed, then under Tim Geithner, for inadequate oversight.

Greenspan, as head of the Fed, comes off worse than anyone else in the FCIC report. In 1999, when the Commodities Futures Trading Commission wanted to regulate derivatives, Greenspan led the attack against it. He wholeheartedly endorsed eliminating the Glass-Steagall restrictions that prevented major banks from engaging in all financial transactions, claiming that competition was the real regulator. As late as 2005, he stated that a housing bubble was unlikely. Most glaring was his refusal to regulate the suspicious mortgages being issued by Countrywide and others, even though the Fed had the authority to do so, and was warned time and again, even by the FBI, that mortgage brokers were writing deceptive and fraudulent mortgages to unsuspecting homeowners. As the report also notes, some 10,500 mortgage salesmen in Florida had criminal records.

The Dodd-Frank Act would now place all financial firms, not just commercial banks that take deposits, under firmer capital restrictions. It calls for useful changes in credit ratings agencies, which had profound conflicts of interest because they supplied ratings to the issuers that paid them. The FCIC report clearly describes the battle for market share by Moody's, one of the largest of them, and its willingness to provide artificially high ratings. But the new proposals still await implementation. Dodd-Frank would also require what has been the secret unregulated trading of derivatives—a source of so much risk-taking—to be done openly by clearinghouses that can also set capital requirements for any trades—that is, margin requirements. But this, too, is a long way from being implemented.

In fairness, some of the regulatory agencies have been undertaking firmer regulation. The SEC is making a broad investigation of insider trading by hedge funds, and the Justice Department is prosecuting several flagrant cases. The FDIC is targeting bank executives for possibly fraudulent behavior in several hundred institutions that have failed. The Dodd-Frank legislation requires that executive compensation, including bonuses, be more openly revealed and shareholders be given a voice in how much executives of financial firms earn. Other agencies are also setting rules to limit compensation. The Obama administration may try to impose fines on particularly irresponsible mortgage servicers like Wells Fargo and Bank of America in order to finance reductions in the principal many homeowners now owe on their mortgages.

But all these reforms may be undermined by pressures from Wall Street and the belligerent Republican majority in the House. The SEC recently proposed banning some bonuses paid by financial firms if they encourage inappropriate risk-taking. The measure was passed only by a three-to-two vote with the three Democratic appointees to the SEC for it and the two Republican appointees against. A new president could easily shift the balance. Republican lawmakers are trying hard to cut back the budgets of the SEC and the Commodity Futures Trading Commission.

One refreshing sign of hope for constructive change is that economists, some of whose theories had much to do with a light regulatory approach toward derivatives and the housing bubble, are increasingly producing research calling for stricter guidelines than Dodd-Frank or the Obama administration. *Regulating Wall Street* presents a wide range of new research supporting stronger regulations than Dodd-Frank recommends, such as the tax proposals I mentioned earlier. In *Reforming US Financial Markets,* Robert Shiller also describes new economic theories that take into account more realistic appraisals of how Wall Street works and demonstrates why more effective regulation is necessary. The old theory of rational markets, which laid the groundwork for light regulation, "is one of the most remarkable errors in the history of thought," Shiller writes. He believes that regulators can and should decide to raise capital requirements during periods of excessive speculation.

In the prologue of *Regulating Wall Street*, the editors, hardly known as progressives, remind financiers how useful strong regulations were in the past:

> Many players on Wall Street and in corporate America in the 1930s hated the new regulatory regime imposed on them.... But in the long run...the new regulatory regime was one of the best things that ever happened for Wall Street and corporate America. Why? Because it created confidence among investors—then and in the decades to follow—that Wall Street finally had become a level playing field.

We would be far better off if the powers on Wall Street would remember this lesson. □

p17