The Wall Street Leviathan

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Inside Job

a film directed by Charles Ferguson

Regulating Wall Street


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 systemic toleration 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 and institutions should therefore minimize their own responsibility for the events and cast doubt on the need for greater regulation of their activities. The FCIC majority dismisses such arguments.

Can we plan to avoid new crises if these crises may be avoided by intelligent and unbiased financial regulators and a chastened Wall Street? A 2,000-page act 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 not more 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 rating agencies. It also finally 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 agency, the Consumer Financial Protection Bureau, will be charged with addressing the 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.

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 rates skyrocketed in later years. The availability of mortgage finance drove housing prices even 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 Commodity Futures Trading Commission, 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 rewrite certain exemptions 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 53 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 shareholders' 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 experts, 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 crisis. Even the New York Fed, brought down by the financial system, Ferguson never adequately explained derivatives, yet clear that Wall Street firms borrowed far too much in order to invest in mortgage 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 given up on mortgage securities as yet another, was not moved by history. 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, the consequences may have little effect. By the late-1990s, countless accounting frauds culminated in outrage by the behavior of Enron, WorldCom, and others, brought about 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 outrage values for social media companies like Facebook and Twitter, well before these companies have generated serious profits. While federal regulators are debating how to police 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
The Republican minority on the House Banking Committee, led by Representative Jim Baird, wrote in a recent letter to regulators: "We are concerned about the potential for misconduct and abuse in the new regulations. Our administration believes that the Glass-Steagall Act was a prudent measure to protect consumers and the financial system. We urge you to consider the potential consequences of such regulations and how they might impact our economy." The letter was signed by several other Republican representatives, including Adam Kinzinger, who is chairman of the Oversight and Investigations Subcommittee.

The American Bankers Association (ABA) echoed the sentiments of the Republican lawmakers, calling the new regulations "overreaching and unnecessary." ABA President and CEO Ceci Harms said: "We believe that the new regulations will create uncertainty and confusion for lenders and consumers. We are concerned that the new regulations will drive up the cost of credit and reduce availability for small businesses."