
Don't Bank on Change: Finance and regulatory reform in the U.S.



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September 2012



United States Program

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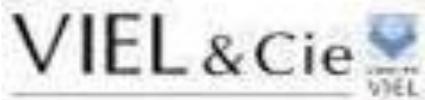
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Laurence Nardon is the editor.

The United States Program is supported by:



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ISBN: 978-2-36567-058-6
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Ce qu'il faut retenir

Au lendemain du crash financier de 1929 et de la Grande Dépression, le système financier américain s'est régulé de façon relativement efficace : la loi Glass-Steagall de 1933 empêchait la fusion des banques commerciales et des banques d'investissement, ainsi que celle des banques et des assurances. Par ailleurs, les sociétés de prêt hypothécaire prenaient en main les instruments financiers de long-terme (crédits immobiliers et plans d'épargne-retraite), loin des prêts à court terme gérés par les banques, évitant ainsi le décalage des échéances entre actifs.

Mais à force de lobbying, les institutions financières américaines ont obtenu la dérégulation du système. La loi Gramm-Leach-Bliley de 1999 supprime la séparation entre banques et assurances. La loi CFMA de 2000 libéralise la plupart des instruments financiers et autorise les banques à acheter des titres de long terme avec de l'argent à court terme. Actifs et produits dérivés se sont multipliés, générant d'immenses profits sur des bases en réalité très précaires. Lorsque les spéculations immobilières ont fini par rencontrer le défaut de paiement, la panique s'est propagée à l'ensemble du secteur financier pour donner la crise de 2007-2008.

La loi Dodd-Frank de 2010 s'efforce de réintroduire une certaine régulation dans le système. La règle Volcker prévoit de séparer à nouveau les institutions financières ; la protection des consommateurs sera mieux assurée, notamment grâce à une plus grande transparence sur les risques encourus ; la loi propose enfin un grand nombre d'excellentes dispositions réglementaires sous l'égide du Conseil de surveillance de la stabilité financière (FSOC).

Cependant, le secteur bancaire américain exerce une grande influence non seulement sur les politiques, aussi bien républicains que démocrates (car il finance leurs campagnes), mais aussi sur le système de la Réserve fédérale et sur la plupart des entreprises privées du pays. La loi Dodd-Frank fait donc face à d'intenses efforts de lobbying pour retarder ou affaiblir ses dispositions. Les perspectives d'une application efficace de ses mesures sont assez faibles. Qui plus est, la réduction, aujourd'hui observée, des décalages entre échéances des produits financiers n'est due qu'à la peur d'une nouvelle crise et cette autorégulation ne devrait pas durer.

Dans une analyse lucide et sans concessions, le professeur Herman Schwartz explique comment le secteur bancaire américain va continuer à desservir l'économie et le système politique du pays.

Executive summary

After the 1929 financial crash that caused the Great Depression, the financial system in America was kept safe through a system of formal and informal regulation: the 1933 Glass-Steagall Act kept commercial banks apart from investment banks, and all banks apart from insurance companies; federal housing corporations handled mortgage loans and channeled them towards pension plans, keeping these long-term assets apart from short-term financial instruments managed by banks, thus avoiding “maturity mismatches”.

Following years of lobbying, financial companies finally achieved global de-regulation: the 1999 Gramm-Leach-Bliley Act removed the firewall between banks and insurance companies. The 2000 CFMA Act deregulated most financial instruments, such as CDS and CDOs, and allowed banks to buy long-term assets with short-term money. Tradable assets multiplied, bringing massive profit to financial institutions based on unsound situations. When risky speculation on housing loans finally met with default, this spread to the entire financial system in a series of bank runs, giving way to the major financial crisis of 2007-2008. The federal government responded by bailing out a number of failed institutions that were “too big to fail”.

The Dodd-Frank Act of 2010 endeavors to re-regulate the system: it plans to re-segregate the different types of financial institutions under the “Volcker rule”; it includes better consumer protection, through for instance better disclosure of financial risks; and proposes many excellent regulation provisions under the authority of the Financial Stability Oversight Council.

The U.S. banking community, however, has influence not only over U.S. politicians both Republican and Democrat (through its ability to fund their campaigns), but also on the Federal Reserve system, as well as on most private businesses in the country. Dodd-Frank is therefore faced with intense lobbying for the watering-down and delaying of its provisions. Prospects for an efficient implementation are at best fragile. Additionally, the current limitation of maturity mismatches seems to be only fear-induced and will in all likelihood not last very long.

In a stern and rather pessimistic appraisal, Professor Herman Schwartz explains how the U.S. banking community will continue to hurt the interests of the American economy and political system.

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Acronyms

CDO:	Collateralized Debt Obligation
CDS:	Credit Default Swaps
CFMA:	Commodity Futures Modernization Act
CFPB:	Consumer Financial Protection Bureau
CFTC:	Commodity Futures Trading Commission
FDIC:	Federal Deposit Insurance Corporation
FED:	Federal Reserve System
FHLMC:	Federal Home Loan Mortgage Corporation, aka "Freddie Mac"
FNMA:	Federal National Mortgage Corporation, aka "Fannie Mae"
FOMC:	Federal Reserve Open Market Committee
FSOC:	Financial Stability Oversight Council
GE:	General Electric
GLB:	Financial Services Modernization Act, aka Gramm- Leach-Bliley Act
HOLC:	Home Owners Loan Corporation
LIBOR:	London Interbank Offering Rate
MBS:	Mortgage Backed Securities
PAC:	Political Action Committee
PAYGO:	Pay as You Go (pension plans)

Introduction: the power of finance

Finance is the gravitational force of American politics these days, invisible, unperceived, yet everywhere essential to understanding everything: the structure of electoral competition, the dynamics of non-electoral politics, policy making outcomes, the dysfunctional economy, and America's relations with the outside world. In the summer before the presidential elections of 2012, the core political arguments orbited around the economic role of the finance industry and its political power, but always at a safe distance. Public opinion data showed that the electorate cared about three things. A consistent majority listed the economy as the top priority, followed at distance by healthcare and the fiscal deficit. Thus jobs figured most strongly in campaign strategies, with both sides justifiably accusing the other of a lack of imagination about how to create more employment. Healthcare, despite a mixed Supreme Court ruling, took second place in the public imagination, but again without a discussion of the role of the insurance industry. Finally, the Very Serious People – as Paul Krugman has called them – continued to highlight the fiscal deficit, yet without making the obvious connection between finance's role in creating the economic crash and falling revenues, and the subsequent deficit. Some moons orbited these gas giants: Mitt Romney's personal finances, immigration, and cultural issues, including and especially whether an aging, rural, Christian white America could tolerate a black president whom they fervently believed was also a Muslim born anywhere but Hawaii. Meanwhile, bankers continued to prey on large and small firms, and large and small investors with the insouciance of 1920s movie mafiosi.

Finance as a mafia?

Indeed, the basic business model for American high finance is just like the old mafia protection rackets. In the old protection racket, gangsters would threaten business owners with broken windows or arson if those owners did not buy 'insurance' or protection from the gangsters. Similarly, financial firms make most of their money selling insurance, in the form of derivatives, to non-financial firms seeking protection from the market volatility that finance itself creates. Financial firms use the great pile of other people's money created by private pensions and widening income inequality in America to speculate, gambling on trivial changes in asset and commodity prices. By speculating, they create volatility in financial and foreign exchange markets. Because non-financial firms are constantly borrowing money to finance on-going operations, because those firms frequently must manage long-term pension and healthcare liabilities, and because many of those firms now sell overseas, they all suffer

from unexpected shifts in interest rates, rates of return and exchange rates. Financial firms then offer to mitigate the very risks that they have created and magnified by selling insurance against that volatility to people, non-financial businesses, and, increasingly, each other. In the act of selling insurance, they create new financial instruments – derivatives – that in turn create new possibilities for gambling with other people's money.

Each new derivative creates the potential for speculation against that derivative, and thus amplifies market volatility. For example, in one egregious incident, Goldman Sachs manufactured and sold derivatives based on mortgage backed securities (MBS) at the behest of a hedge fund that not only wanted to speculate against those same derivatives, but also helped select the securities behind the derivative in order to make sure that it failed. Goldman then created derivatives so the hedge fund could speculate against the original mortgage bonds. Trades like this expanded the size of the 2007-2008 financial crisis. Derivatives themselves can become the collateral that allows the creation of even more derivatives, and thus more opportunities to generate volatility and mayhem in financial markets. The Bank for International Settlements estimates that the global derivatives market was valued at \$650 trillion dollars in December 2011, well above the notional value of the entire global stock of physical or financial (of the regular, non-derivative kind) capital.

The deregulated financial sector profits handsomely from creating and magnifying the very problems it is supposed to solve. The financial sector's share of total U.S. corporate profit more than doubled from 13% in 1965 to 44% in 2002. Despite the on-going financial crisis the finance sector still captures about one-third of all profit. Even if we accept the generous idea that the financial sector on net is value adding to the economy, rather than value subtracting, this is three times what we would expect from the sector's share of value added in GDP.

Finance and politics

Given this, a person might expect that at least one, if not the only major axis of American politics might be finance versus the rest of the society. The financial mafia preys on indebted homeowners, the relatively small part of the public with significant financial assets, government at all levels, and businesses that are unable to self-finance. In short, nearly everyone. The most surprising unanswered question in American politics is why there is no organized opposition to finance's protection racket aside from the tenuously organized Occupy Wall Street.

Bankers' insouciance stems from the fact that the real struggle in American politics is mostly between competing groups of businesses. Businesses outgun the public and finance brings the

biggest guns to intra-business struggles. Voting matters, but businesses enjoy a permanent and untrammelled access to the House and Senate. They thus control the details of legislation; these details are what matter for profitability. Struggles occur over the details, but few businesses have the interest of the average voter at heart. Consumers and small businesses typically lose in any fight that might limit banks' ability to extract rents from the economy. Party competition for voters occurs over a handful of slogans and cultural concerns. At the same time, finance controls both political parties. The major difference between those parties is their concern for the future.

But what does 'future' mean? Imagine the choices facing a group of wolves on a hill, looking down at a flock of sheep. The core issue facing the wolves is the rate at which they eat those sheep. Too high a rate of consumption produces fat times in the present, but risks a catastrophic decline in the wolf population if the sheep cannot breed fast enough to make up their own losses. A prudent wolf might want to limit today's consumption to a level that permitted modest growth in the number of sheep, and thus the number of wolves, over time. Just so, the dilemma facing gangsters preying on a limited set of non-financial businesses. Too much predation can drive all the businesses into the ground. The difference between the Republicans and the Democrats is that the parts of finance backing the Republicans propose policies tantamount to eating all the sheep today. The Republican Party wants to remove nearly all prudential and substantive regulation limiting financial firms' ability to prey on the economy and each other. Those backing the Democrats want to husband some sheep for the future. They propose some limitations on financial firms' ability to speculate with other peoples' money, and to limit the implicit taxpayer subsidy to this speculation. Neither party imagines a world in which the wolves are penned away from the sheep. These two different visions define the parameters of the regulatory reforms that have already occurred or are proposed.

Finance, campaign finance, and political influence

The finance mafia's leverage over both parties comes from a simple fact about American elections: winning elections requires money, and finance is the single biggest source of legal and quasi-legal campaign funds. Candidates who cannot win the money primary cannot win the voting primary. In the 2010 election, over 24% of all campaign contributions came not just from the top 1% of contributors, but actually from the top 1% of that 1% (i.e. the top 0.1%), according to

the Sunlight Foundation, an open government advocacy group.¹ For thirty-four senators, those donors provided more than half of campaign contributions. In the critical 2008 campaign, financial firms contributed nearly \$500 million to both parties. A bare majority of this went to the Democrats, reversing businesses' traditional tilt towards the Republicans. This money assured access to the new Obama administration. In the 2012 election, as of June 2012, fewer than 200 people accounted for over 80% of the money given to SuperPACs (PACs - Political Action Committees), which are advocacy organizations outside the official campaigns that now spend much more than those official campaigns.²

Finance does not have to give contributions everywhere, to everyone in order to have a second veto on regulation that might impede their predatory behavior. The structure of the U.S. Senate gives individual senators enormous power. One senator can block legislation using the 'filibuster,' unless 60 other senators vote to override that delaying tactic. Furthermore, the Senate's committee system traditionally gave committee chairs enormous power to shape, move or delay legislation. Targeted campaign contributions to individual senators thus yielded control over the critical committees regulating finance. Conflicts of interest thus were and are rife. Phil Gramm, a Texas Senator, was a main author of the 2000 Commodity Futures Modernization Act, which prohibited regulation of derivatives, and the 1999 Gramm-Leach-Bliley Bill which removed barriers to amalgamating financial firms. His wife, Wendy Gramm, had been a member of the Commodity Futures Trading Commission, which regulated the simpler derivatives on offer in the early 1990s. CFTC was the primary regulator of firms like Enron, an energy firm that transformed itself into a financial firm. Wendy Gramm left the CFTC and joined the board of directors of Enron shortly after the CFTC ruled that Enron was exempt from regulation. Enron subsequently went bankrupt in 2001 because of mis-timed speculative bets in energy markets. Over half of Phil Gramm's campaign contributions from 1997 to 2002 came from bank employees or PACs organized by banks.

Republicans are not the only offenders. Obama appointed Gary Gensler, a former Goldman Sachs employee, to head the Commodity Futures Trading Commission in 2009, and Democratic Senators Christopher Dodd (D-CT) and Charles Schumer (D-NY) also protected the investment banks and hedge funds that populate New York and its Connecticut suburbs. Financial and insurance firms' PACs and employees contributed \$6.6 million of the \$8.9 million

¹ <http://sunlightfoundation.com/blog/2011/12/13/the-political-one-percent-of-the-one-percent/>

² <http://www.theatlantic.com/politics/archive/2012/07/big-campaign-spending-government-by-the-1/259599/>

Dodd raised from 2003 to 2008.³ Over his career to date, Schumer raised \$13.1 million from financial and insurance firms; investment and commercial bank employees and PACs comprise his top ten donors.⁴ Finally, 25% of Barney Frank's lifetime campaign contributions came from finance, insurance and real estate sources.⁵ Dodd and Frank were the authors of the eponymous Dodd-Frank bill that attempted to re-regulate finance after the crisis, and whose general lack of impact I will discuss below.

The institutional power of finance

Corporate capture of the legislative branch goes beyond what is necessary for finance to prevent regulatory outcomes that harm its interests. But even if the parties were more responsive to voters and it was possible to pass new and effective regulations, the financial sector controls a crucial institutional arena in the U.S. state that affects how regulation is implemented: the Federal Reserve System, or FED, the basis for the U.S. central bank. The legislation creating the U.S. FED initially created twelve regional banks, so that monetary policy could respond to different regional needs. Of these twelve, the New York Federal Reserve Bank traditionally had regulatory oversight of the investment banks centered on Wall Street. But all of these regional Federal Reserve banks are captured by the banking community. The local banking community elects the three groups of directors of the regional FEDs. Banks directly select 'Class A' directors, generally from among the banking community. Banks also select Class B directors to represent the broader public, but these invariably come from local non-financial firms. Together, Class A and B directors elect the Class C directors who actually govern the regional bank. While the governors of the various Federal Reserve banks cannot be direct shareholders in financial firms, their sympathy towards banks' interests is visible in crucial regulatory decisions the FED made in the 1990s. For example, the FED ruled that commercial banks' sales of corporate bonds or the merger of banking giant Citibank with the Travelers Insurance company did not violate the Glass-Steagall Act, which until 1999 prohibited commercial banks from engaging in investment bank-type activity, and prohibited firms that mixed banking and insurance activities. Finally, the legal owners of the corporations that constitute the regional reserve banks are those local banks. All together, these institutional features give the banking community considerable power over the day-to-day operation of the

³ <http://www.opensecrets.org/politicians/summary.php?cycle=2008&type=I&cid=n000581&newMem=N>

⁴ <http://www.opensecrets.org/politicians/industries.php?cycle=Career&type=I&cid=N0001093&newMem=N&recs=20>

⁵ <http://www.opensecrets.org/politicians/summary.php?cycle=Career&type=I&cid=N0000275&newMem=N>

regional Federal Reserve banks that are supposed to regulate the banking community.

Equally important, the regional banks supply part of the membership of the Federal Reserve Open Market Committee, or FOMC. The FOMC is the institution that actually sets U.S. monetary policy. Seven of the twelve members of the FOMC are presidential appointees, with staggered 14 year terms. But the remaining five always include the head of the New York Federal Reserve Bank and, on a rotating basis, four of the other 11 regional heads. This gives the commercial and investment banks direct access to monetary and regulatory policy. They are never more than one vote away from a blocking minority, and two votes away from a majority. The FED is thus arguably independent of the political authorities by virtue of its long terms of office. But it is hardly independent of the banking community.

Here too, the potential for conflict of interest is obvious.⁶ And real. Take two recent examples from the ongoing financial crisis. Jamie Dimon, the CEO of banking giant JP Morgan Chase, is also a Class A director of the New York Federal Reserve Bank. When bad bets on mortgage-backed securities brought investment bank Bear Stearns to the edge of bankruptcy in March 2008, the New York FED arranged an emergency buyout of Bear Stearns with JP Morgan. In effect, Dimon was overseeing the Federal Reserve staff negotiating with his bank. The New York FED also had direct regulatory oversight of JP Morgan Chase during the so-called London Whale fiasco that cost Chase \$5.8 billion in 2012. This fiasco would have been illegal under the Volcker Rule contained in the 2010 Dodd-Frank law regulating finance. That rule prohibits banks that accept federally insured deposits from using that money to speculate on their own behalf; this proprietary trading is a major source of bank profits. The Volcker Rule was originally scheduled to take effect in July 2012, but it has been delayed until Fall 2012.

Similarly, the chairman of the board of the New York FED during the acute phase of the financial crisis was Stephen Friedman, a Class C director of the New York FED and a former chairman of Goldman Sachs. Theoretically Class C directors cannot be direct shareholders in a financial institution. Yet Friedman was an active participant in a private equity fund that owned banks during his chairmanship, and he also bought \$3 million worth of Goldman Sachs stock at the same time that he was arranging what was in effect a bailout of Goldman Sachs in early 2008.

⁶ Simon Johnson at <http://baselinescenario.com/2012/06/14/an-institutional-flaw-at-the-heart-of-the-federal-reserve/>, and <http://baselinescenario.com/2012/06/30/three-more-governance-questions-for-the-new-york-fed/>.

Finance and corporate America

Thus the broad mass of the population has little ability to generate or enforce the outcome of political fights over regulation. They simply cannot give enough money to and focus enough attention on individual senators and regulators to move them in a consumer-friendly direction. But what about businesses? Businesses also are on the losing end of predatory behavior by the financial sector. Why don't they react? Put simply, most of the large firms in the U.S. fall into one of two categories. Either they themselves have substantial financial operations, or their profitability is a function of their own ability to lobby Congress. The first group means that there simply are not enough large manufacturing firms to constitute a counter lobby to finance. The second group has little incentive to close the lobbying door to finance.

Consider General Electric (GE), the eighth largest American firm by capitalization in 2012, and the largest firm by capitalization at different times in the last decade. GE is a diversified manufacturer of consumer and producer capital goods: home appliances, medical imaging equipment, car parts, railroad locomotives, electric turbines, and wind turbines. All of these are goods that would sell in larger volumes with consequently higher production efficiencies if markets were more stable. Predictable and steady growth makes production more efficient and encourages firms and households to buy capital goods. Yet GE is also a financial powerhouse. Its GE Capital subsidiary accounted for one-third of GE's corporate revenue in the first quarter of 2012, but nearly 55% of GE's profits. These proportions have been consistent over the past decade. GE has little interest in tighter regulation over its financial activities.

Or consider Apple, the top U.S. firm by market capitalization in 2012. Its cash holdings exceeded \$100 million in early 2012, liberating it from external financial markets. Apple's major problem was not market volatility, but rather the management of the portfolio of patents and innovations that generate its profits. Apple's major fights are with other patent powerhouses like Samsung, Google, and Microsoft. Fighting with the financial sector is secondary to Apple's core concerns. So firms like Apple have no incentive to solve the problem, and firms like GE are part of the problem.

These conditions made it possible for what former IMF chief economist and current MIT professor Simon Johnson has called financial oligarchs to mount a "quiet coup."⁷ When the financial crisis unfolded in 2007 and 2008, politically connected firms not only survived, but profited handsomely from bailouts. They correctly gambled that they were "too big to fail" – that if their financial bets generated crippling losses, the state would come in and bail them out.

⁷ Simon Johnson, "The Quiet Coup," *Atlantic Monthly*, May 2009.

Losses would be socialized, while gains would fall into private hands as bonuses. Less well-connected firms like Lehman Brothers and Bear Stearns went bankrupt. This situation has not changed. Indeed, it is now worse, as concentration in the banking sector has increased, and many investment banks now also hold government insured consumer deposits. The total assets of the five Too Big To Fail banks – JP Morgan Chase, Citibank, Bank of America, Wells Fargo and Goldman Sachs – went from 26% of U.S. GDP in 1992 to 56% in 2011.

What brought American politics to this point? What hope is there for meaningful regulation of finance? Can the political system restrain the power of what is demonstrably not just a financial oligarchy but also something close to a system of organized crime? The next sections walk through each issue.

From regulated finance to predatory finance

Finance's political power and its ability to disrupt the entire economy is a novel phenomenon. After World War II, America had a well-regulated financial system. This system not only protected consumers from finance, but also protected finance from itself. That is, it limited the number of sheep the wolves could eat, and by doing so it prevented the wolves from destroying their own food supply. This latter point is worth emphasizing. Regulation was not just about protecting sheep from the misbehavior of wolves. It was also about protecting the collectivity of wolves from the misbehavior of individual wolves or small groups of wolves. The regulatory system that emerged from the Great Depression and New Deal limited the damage that rogue wolves could do to the entire pack of wolves. This regulatory system had both formal and informal aspects.

The formal or legal system of regulation separated different parts of the financial system. Simultaneously an informal – in the sense that it was never legislated but rather emerged from administrative practice – system of regulation helped prevent the emergence of serious maturity mismatches. Put differently, formal regulation prevented problems in one part of the financial system from spreading to other parts – they created a firewall. Informal regulation prevented small problems inside a given sector from becoming a bigger problem – they made sure combustible materials were not stored near sources of flame. Deregulation in the 1990s removed the firewall, and deregulation in the 2000s piled oil-soaked rags near the furnace. This produced the conflagration of 2007-2008.

Formal regulation of finance

The most famous and formal regulation separating different parts of the American financial system was the 1933 Glass-Steagall Act. Glass-Steagall segmented the financial system by prohibiting banks from owning insurance companies, and by splitting commercial banks, whose deposits were insured by the Federal government, from investment banks, whose clients' money was all at risk. As George Soros has argued, Glass-Steagall created a system like watertight compartments in a ship. While the system of regulation was never perfectly watertight, problems in one compartment could not easily spread to other compartments. Equally important, financial firms could not mobilize all of the liquidity in the system and concentrate that liquidity on one risky bet; they could not risk everyone's savings in a financial bubble. Other regulations controlled pricing and market

entry, but Glass-Steagall protected banks from themselves and from each other.

If one part of the financial system misbehaved, its troubles did not automatically flow to other sectors. Thus the normal jobs of the financial system – intermediating between savers and borrowers and intermediating between those who wished to consume now and those who wished to consume in the future – could continue unabated if a crisis erupted in one sector. Small problems could become medium sized problems, but they could not bring the entire economy to a screeching halt. For example, deregulation of the savings and loan banks (akin to German *Sparkassen*, Spanish *Cajas*, or British Building societies and trustee savings banks) created a financial crisis in the 1980s, but this produced only a minor recession.

Savings and loan banks traditionally accepted consumer deposits and recycled them as local mortgages and commercial lending. When the Reagan administration deregulated interest rates on deposits and loans in the early 1980s, the savings and loan banks suddenly faced competition from larger banks that could afford to pay consumers higher interest rates on deposits. Before deregulation, regulations limited commercial bank's ability to pay interest to depositors but compensated commercial banks with a monopoly on checking (chequeing) accounts. To keep profits stable in the face of this competition, savings and loan banks began lending to increasingly more speculative real estate developers. And, predictably, some banks engaged in outright fraud, lending money – insured consumer deposits – to related borrowers who had no hope of repaying. These banks understood that the Federal Deposit Insurance Company would make consumers whole in the event that the bank's speculative loans went bad. And many of these loans did go bad when commercial and home real estate prices fell at the end of the 1980s.

Failing loans meant failing banks. The number of savings and loan banks fell by roughly 50%, and their share of the total mortgage market fell from over 50% in the 1970s to about 30% by 1990. Yet this crisis did not cause a systemic financial crisis in the United States. Insurance companies, investment banks, and commercial banks went about their normal business, unaffected by insolvent savings banks. While the 1980s real estate bust helped create a recession in 1990-1991, this recession was mild and shallow compared to the catastrophic recession of 2008-2009. Total financial losses to the government agency that bailed out the savings banks were limited to about \$90 billion. This is a large number. But the orderly liquidation of foreclosed property and the unaffected banking sectors' ability to continue lending meant that losses did not snowball into the trillions, as they did in 2007-2008. Glass-Steagall's segmentation of the financial system into relatively discrete savings, insurance, commercial and investment boxes prevented the savings and loan debacle from damaging the other sectors.

Informal regulation of finance and the matching of maturities

The second and informal barrier was much less visible, but no less critical than Glass-Steagall. This barrier was a system of public finance, and in particular housing finance that removed maturity mismatch from large parts of the financial system. Maturity mismatches occur when an organization borrows in credit markets on a short-term basis and then reinvests the proceeds into less liquid, longer-term assets. Maturity refers to length of time before a given debt must be repaid. A loan or bond with a one-year maturity must be repaid after one year; a loan or bond with a ten-year maturity after ten years. Mismatched maturities are dangerous for a financial system. If the short term lender calls in her loan from the actor who has borrowed short term in order to lend or invest long term, that long term investor may not be able to generate enough cash to repay the short term loan. Debtors are forced into a panicked liquidation of their long-term asset at a loss, producing default on their short-term liability to the bank. These fire sale prices magnify the problem, because the flood of distressed property into the market drives down prices for all property, for all assets, making it impossible for all debtors to repay banks, and for all banks to repay depositors.

Banks are the ground zero of mismatched maturities in most economies. Indeed, banks exist precisely in order to turn short term liabilities (depositor's money) into long term assets (loans to homebuyers and industrial firms), which is why banks are vulnerable to bank runs. The central regulatory problem after the 1930s was finding ways to prevent bank runs.

One way to prevent a run was to reassure depositors so they would not panic at the first sign that a bank was financially weak. Most countries did this by offering public deposit insurance. Deposit insurance was valium for anxious depositors. Deposit insurance made it less likely that a bank would have to sell off its long-term assets – its loan portfolio – at fire sale prices in order to pay back the money it borrowed short-term from depositors. But deposit insurance did not solve the maturity mismatch problem. Instead, it just limited the potential dangers. The real solution lay in the structure of publicly controlled long-term finance that emerged after the New Deal. This solution prevented problems on the other side of the bank run, namely forced liquidation of long-term investments. It accomplished this by removing long-term assets from banks' balance sheets and moving those assets to the balance sheet of an entity that had long-term liabilities rather than short-term liabilities on the other side of its balance sheet.

Put simply, all assets on a balance sheet must have a corresponding liability on the other side of the balance sheet. For example, mortgages are liabilities to the person who borrows money to buy a home; the house itself is an asset offsetting the liability,

which is why it is used as collateral. At the same time, the mortgage is also an asset for the bank. Consumer deposits accepted by the bank are the offsetting liability for the bank. In principle, this matching of assets and liabilities should net out. Yet, as we saw with bank runs, mismatched maturities could force a liquidation of long-term assets at prices too low to repay the depositors. But if long-term assets could be moved off banks' balance sheets and onto the balance sheet of institutions that had long-term liabilities, then the maturity mismatch would disappear. Short-term assets (like commercial loans) would match short-term liabilities (deposits), and long-term assets would be matched by long-term liabilities. But where?

Maturity matching via housing debt and pensions

The natural holders of medium and long-term assets are private pension plans, funded public pensions, and public sector entities financing infrastructure. In particular – and this matters for understanding the current financial crisis – the natural home for large volumes of long-term mortgage debt is large (and typically private) pension plans. At a social level, young families entering the housing market commit to a long-term transfer of funds to older households exiting wage labor and home ownership for smaller, rented housing. At an economic level, mortgage debt is typically the single largest component of the private long-term debt market. In 2002, before the big run up in housing prices and debt, mortgage debt already accounted for more than 50% of the private bond market in 12 of the 19 rich OECD countries, exceeded gross public debt in 10 of 19, and was larger than the equity market in nine of nineteen.⁸ If mortgage debt can't be stabilized, the entire system of private debt is unstable (or, conversely, mortgages will be expensive and have short maturities).

Matching maturities removes a potential source of instability from both banking and pension systems. Before the Great Depression, the absence of state intervention in mortgage markets in most countries limited residential mortgage finance. After the Great Depression, states in nearly all Northern Atlantic countries developed housing finance systems that contained this safer maturity match. They also had state-imposed credit rationing coupled with interest rate regulation. This reduced the opportunities for taking risk on the borrowing side and provided few incentives for doing so on the lending side. This informal regulation of finance in general and housing in particular was not only part and parcel of the more general

⁸ See Table 1 in Herman Schwartz, "Housing, the Welfare State and the Global Financial Crisis: What is the Connection?" *Politics and Society* 40:1, March 2012, pp. 33-56.

regulation of finance, but also, given the growing scale of housing finance, its most important aspect. As the United States financial system started the financial crisis, and housing finance was ground zero for that crisis, some details on maturity matching in the United States are in order.

Before the 1940s, U.S. banks tried to limit their maturity mismatch by structuring mortgages as loans that had to be repaid in full within three to five years – so-called balloon loans. Even so, the 1930s saw a vicious cycle of bank runs, property liquidation and falling prices for banks' assets. The U.S. state responded to this by moving illiquid and undervalued assets – mortgages – off banks' balance sheets and onto the balance sheet of a state institution with a longer time horizon, the Home Owners Loan Corporation (HOLC).⁹

The HOLC, and its children, Fannie Mae (Federal National Mortgage Corporation – FNMA) and Freddie Mac (Federal Home Loan Mortgage Corporation – FHLMC), replaced short-term mortgages with what is now the standard 30-year mortgage in U.S. home finance. A longer term meant lower monthly payments for debtors, and thus allowed them to get back in good standing. By getting back in good standing, they restored value to the assets (the mortgages) now held by HOLC and its successors. And by restoring value to these assets, they helped restore value to the assets remaining in banks' hands, enabling them to resume lending.

But how could HOLC, and later Fannie and Freddie, fund their purchases of mortgages? Unlike banks, they could not and did not want to accept consumer deposits. Instead, they turned to capital markets, and borrowed from pension and insurance funds. Pension and insurance firms had a natural interest in acquiring a long-term asset. Pension funds needed some place to invest the steady and predictable stream of payments into insurance and pension accounts. And on the liability side of their balance sheet they had a commitment to fund 10, 20, or 30 years of annuitized pension or life insurance payments to their clients. To fund these liabilities, pension and insurance funds needed assets that generated a stable and predictable cash flow.

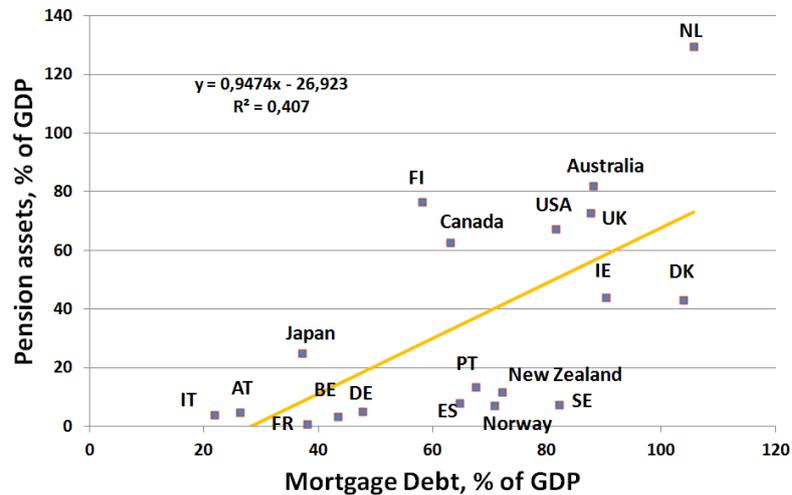
Directly or indirectly, mortgages provided that stable and predictable cash flow. Pension and insurance funds created a long-term asset for themselves by lending money on a long-term basis to the federal housing corporations, and thus indirectly connected

⁹ As Kenneth Snowden, "Long-Run Impacts of Responses to the Mortgage Crisis of the 1930s in the U.S.," presented at 'Never Waste a Good Crisis': The Social Policy Dimension of Regulatory Crisis Management in the EU & the U.S., Social Science Research Center Berlin, 19-20 November, 2010 p. 11 notes, banks themselves had already begun agitating in the 1920s for some Federal agency to help move mortgages off banks' books. See also Sarah Quinn, "Government Policy, Housing, and the Origins of Securitization, 1780 – 1968" (PhD Dissertation, University of California, Berkeley, 2010).

pension funds to mortgage markets. The housing corporations used money from the pension funds to buy mortgages from the banks that had made the initial loan. This removed long-term assets from the banks' books. In turn, the federal housing corporations used the cash flow from those mortgages to pay back their debts to the pension funds. In the 1980s, this began to change, as Fannie Mae and Freddie Mac began to package mortgage debt together and sell the income from those mortgages directly to investors as mortgage backed securities (MBS). They transformed individual mortgages into a kind of corporate bond, replacing the need for Fannie Mae to actually hold mortgages on its books (as assets) and debts to its funders (as liabilities). Fannie, and later Freddie, thus eventually created a new class of liquid, long-term asset that pension funds could buy, removing mismatched maturities from banks' balance sheets. Those of you who have patiently read through the last 1000 words can now start to see the connection to the 2007-2008 financial crisis – this is where the MBS at the heart of the crisis come from. Your patience is rewarded, but the picture needs a few more lines to be complete.

Mortgages are not the only way to get stability, but they nevertheless account for a large proportion of pension assets everywhere. Figure 1 maps the size of mortgage debt and private pension assets relative to GDP in the 19 rich OECD countries in 2009. It shows a striking correlation despite the growing share of equities in pension plans. While equities became an ever-larger share of pension assets after the 1970s, Gary Burtless has shown that their volatility makes them less suitable for annuitization.¹⁰ Moreover, in the first post-war decades, equity markets were too small to be more than a supplement to mortgage markets in most countries. Finally, while government debt is also stable, it is also low yielding.

¹⁰ Gary Burtless, "Can Improved Financial Market Access Offer a Reasonable Substitute for Public Pensions? Lessons from the Economic Crisis," *Politics and Society* 40:1, March 2012.

Figure 1: Mortgage debt vs. private pension assets, % of GDP

Source: Author calculations from OECD and European Mortgage Foundation data.

Public- and private-funded pensions are thus naturally matched by widespread private indebted homeownership in a given society. Think: the typical Anglo-American examples, but also Netherlands and Denmark. Public, tax-financed Pay As You Go (PAYGO) pensions are naturally matched by widespread rental housing and private homeownership that is not debt financed. Think: much of continental Europe, but in particular Italy and Austria.

Each of these is a solution to the maturity mismatch problem. The mortgage-private pension solution removes long term assets from banks' books, allowing them to have a balance sheet dominated by short-term liabilities and short-term assets. The rental-public PAYGO pension solution means banks avoid accumulating large long-term assets in the first place. (Note that the function of *Pfandbriefe* – covered bonds – in Germany is precisely to segregate large accumulations of long-term assets from the banks' main balance sheet.) Maturity matching stabilizes the financial system.

Deregulation and the return of financial panics

Here come the remaining lines: This system of formal and informal regulation began to break down in the late 1990s, re-introducing the possibility of large-scale bank panics and a systemic crisis. Put simply, financial firms used their political power in the United States to remove the firewalls separating different segments of the financial system, and to reintroduce large-scale maturity mismatches. These changes allowed financial firms to increase their profits, but at the cost of greater risk to the entire financial system and thus to society at large. But the last remaining big barrier to bank runs – deposit insurance – meant that those risks would fall on taxpayers and not on

banks if banks' speculative gambles failed. If banks gambled with depositors' money and lost, the deposit insurance system would bail them out. Deregulation thus made the 2007-2008 crisis possible. The essence of that is financial: banks gambled with derivatives built from mortgage backed securities that in turn were built from subprime mortgages; they gambled in ways that connected all parts of the financial system; they gambled in ways that magnified any losses they might take on those gambles. When the subprime mortgages blew up, the derivatives blew up; when the derivatives blew up they took down not just the investment banks, but also the commercial banks, big parts of the insurance industry, and the money market funds that finance regular commercial activity. Unlike the savings and loan collapse, this crisis damaged all parts of the financial system.

Repeal of Glass-Steagall

I've already mentioned the major pieces of legislation that undid the formal and informal systems of regulation protecting finance from itself, and society from finance. The 1999 Gramm-Leach-Bliley Act (officially: The Financial Services Modernization Act of 1999) undid the Glass-Steagall Act of 1933. It permitted commercial banks to enter the insurance and investment banking business. The impetus for GLB was the illegal merger of the giant bank Citicorp with the insurance firm Travelers Group in 1998. This created a corporation engaging in commercial banking (as Citibank), investment banking (as Smith Barney and, to a lesser extent, Primerica), insurance (as Primerica and as Travelers until 2002). It thus reconnected parts of the financial system that Glass-Steagall had severed. Citibank justified the merger by claiming it would attain economies of scale in providing individual and corporate consumers with comprehensive financial services tailored to their needs. But what it actually did was give Citibank the ability to use funds in its federally insured deposit base to speculate on its own account. It similarly connected the huge pile of savings in the individually owned secondary (wage-related) pensions scheme known as 401(k) accounts to Citi's speculative arm.

Banks had already chipped away at the Glass-Steagall restrictions during the 1970s and 1980s. Banks sponsored 12 attempts to repeal Glass-Steagall, usually through the more responsive Senate. But the House of Representatives – at that time still influenced by thousands of small local banks – typically killed these bills. Instead, aggressive lobbying of the FED and Treasury bought the ability to underwrite municipal bonds for a small number of large commercial banks, like Citi, JP Morgan, and Bankers Trust. This was weakened further in 1996, when Alan Greenspan, then chairman of the FED, issued a ruling that banks could own investment bank subsidiaries whose activities amounted to 25% of total bank revenue. De facto, this gutted Glass-Steagall. But the 25% limit was still a considerable obstacle limiting commercial banks' investment activities, and, on the other side, preventing investment banks from getting access to billions of consumer deposits. The GLB Act

retroactively blessed the Citicorp-Travelers merger and removed the 25% limit. Even that was not enough for the banks: in 2004 the U.S. stock market regulator, the Securities and Exchange Commission, waived leverage rules for the five biggest investment firms (those with more than \$5 billion in market capitalization), Bear Stearns, Merrill Lynch, Lehman Brothers, Goldman Sachs, and Morgan Stanley. Banks could then bet as much as 30 times their equity.

Shortly after the Clinton Administration announced that it would sign GLB into law, its Treasury Secretary, Robert Rubin, announced he was resigning to take a \$15 million per year job at Citibank. Rubin reoriented Citi towards the subprime market and also towards the financing of speculative firms like Enron. In 2008, Citibank's stock price fell 70% under his leadership and the bank survived bankruptcy only by virtue of a \$45 billion government bailout. Citi and Rubin are thus poster children not just for the entire financial crisis, but also for the faction of short-sighted wolves. They represent the effects of financial capture and moral hazard at the highest political levels, producing risky bets, the looting of financial institutions and their clients, and public bailouts.

The end of Glass-Steagall led to a frenzy of mergers and the emergence of the "too big to fail" banks at the national level as big banks rolled the thousands of small local banks into their own operations. JP Morgan Chase, Citibank, Wells Fargo, Bank of America (née Nationsbank), and Wachovia (later merged into Wells Fargo) emerged as the five largest commercial banks in the U.S. Bringing the different parts of the financial system back together was dangerous but not necessarily catastrophic. After all, many European banks were and are also large universal banks, dealing in banking services, insurance and underwriting. What made the emergence of universal banks in the United States problematic was the subsequent deregulation of derivatives, or more precisely refusal to regulate derivatives in the 2000 Commodity Futures Modernization Act (CFMA).

The Commodity Futures Modernization Act of 2000

The CFMA basically put all derivatives outside of regulatory control. Derivatives that were contracted between "sophisticated parties" – i.e. banks – were not subject to oversight. While the government could still exercise some regulatory oversight over the banks, CFMA limited this to supervision of the bank as a whole and not of specific derivatives. This created a huge hole in the law. Derivatives sold over the counter to non-financial firms remained regulated. But new derivatives that mimicked older regulated derivatives could also be sold, without regulation, even though they were functionally identical to existing, regulated derivatives. For example, insurance products are regulated. But the new credit default swaps (CDS), which are in essence a form of insurance, were not. Raw politics created this loophole. The chair of the Commodity Futures Trading Commission in 1998 and 1999, Brooksley Born, argued for a functional form of

regulation in which derivatives would be regulated based on what they did, and in which few waivers would be granted for new derivatives. CDS would thus be regulated as insurance and be subject to capital adequacy requirements. This would drastically lower their profitability. Borns was purged and replaced by William Rainer, who had written a report arguing for complete deregulation.

This regulatory void allowed the financial sector to generate trillions of dollars of derivatives, by building derivatives on top of other derivatives. In this maze of financial instruments, nothing of substance ever existed. The vast expansion of CDS shows how this occurred, and the inherent dangers in the lack of regulation. CDS started out in the early 1990s as a simple way for banks to insure themselves against default by one of their borrowers. For a monthly fee, an insurance company would agree to buy a loan in default at face value from the lending bank. If there were no default the insurance company would keep the fee, while the bank would continue to earn interest from the borrower. Banks clearly had an interest in this product – they stood to lose money if a borrower defaulted – and the firms issuing CDS could assess the probability of a discrete firm going bankrupt using normal insurance principles. In principle, this was nothing more complicated than a life insurance policy for an indebted firm.

In practice, CDS soon deviated from normal insurance in very dangerous ways. The most important of these was the sale of ‘naked CDS.’ In normal insurance markets, parties without an insurable interest cannot buy insurance, because the ability to buy insurance without having an interest creates an incentive to make the insured event occur (moral hazard is the term of art here). For example, my neighbor can buy insurance on herself and her house, because she stands to lose something if she dies or the house burns down. Her incentives to avoid dying or starting a fire are obvious. But I generally cannot buy life insurance on my neighbor or fire insurance on my neighbor’s house, because I have nothing to lose and everything to gain if she slips on the banana peels I leave on her doorstep or if the pile of oily rags I leave near her house catch fire. The incentives for me to behave badly are enormous. In the CDS market, a speculator can buy insurance without having an insurable interest. A naked CDS allows a third party – neither the lender nor the borrower – to bet that the borrower will default. They thus have an interest in seeing the borrower default. The potential for mischief here is evident.

Naked CDS also created a second problem. In normal insurance markets, the insurer’s potential losses are limited to the value of the object at risk, a single life or a single house. But with naked CDS, a single firm or a group of firms could offer many times the value of the actual insured object (in this case a borrower’s debt). In the event of a default, the insurers’ losses could be many times the actual loss of the insured debt. Very small defaults could trigger very large losses for financial firms that had offered naked CDS. And in fact, in the 2007-2008 crisis, relatively small losses on subprime

mortgage bonds triggered extremely large losses for insurance companies and banks that had written naked CDS on those mortgage bonds. This is what bankrupted insurance giant AIG.

Finally, as we now know, the very foundation for the value of these derivatives, LIBOR, the London Interbank Offering Rate, was itself subject to manipulation. LIBOR is theoretically the interest rate at which banks lend to other, solvent banks. Like the interest rate on U.S. or German government debt, LIBOR serves as the baseline for interest rates on all other financial instruments, including the trillions of dollars of outstanding derivatives. LIBOR theoretically represents a market rate, set via a quasi-auction process where banks report the interest rate they would pay if they were in the market to borrow funds. But in July 2012, British bank Barclay's admitted to rigging this market in cooperation with other big banks. Return to our organized crime metaphor for a moment. Until the LIBOR rigging disclosures, mafias could tell merchants that the price of the protection the mafia sold was 'set by the market' and apparently objective. The market price for insurance was thus 'fair.' Indeed, they could pretend that competition among competing mafias would drive down the price of insurance to a socially efficient level! But in fact, the mafias were colluding to set the price of insurance at levels favorable to the mafias, not their clients. This market rigging also extended to the nearly \$3 trillion municipal bond market in the United States (thus, about one-third the size of the mortgage bond market).¹¹ In both the United States and Britain, public authorities knew about the LIBOR rigging. U.S. Treasury Secretary Timothy Geithner was told about the LIBOR rigging in early 2008, while he was president of the New York Federal Reserve Bank. And the Bank of England also knew about LIBOR rigging as early as autumn 2008. Yet in 2008, both were rather more concerned about a total collapse of the financial system – the wolves eating not only all the sheep but each other – than they were about the wolves eating a few too many spring lambs.

Deregulation and the mechanics of the financial crisis

I can now lay out the structural contours of that financial crisis, and thus of the tasks of any new effort at regulation. After removing the regulatory firewalls separating different parts of the financial system, what were now "too big to fail" banks reconstructed the maturity mismatch that informal policy had removed from housing finance. How? First, banks began issuing billions of dollars of subprime

¹¹ Matt Taibbi, "The Scam Wall Street Learned From the Mafia: How America's biggest banks took part in a nationwide bid-rigging conspiracy - until they were caught on tape," *Rolling Stone* June 2012, <http://www.rollingstone.com/politics/news/the-scam-wall-street-learned-from-the-mafia-20120620>.

mortgages. Subprime mortgages had always existed in the U.S. housing market, but as a small part of the market targeted at the self-employed and at those with bad credit records. Between 5% and 10% of U.S. mortgages issued in the 1990s were subprime. Banks tended to keep these mortgages on their own books, and thus were exposed to any losses that might occur. This understandably made them cautious. Like regular, 'prime' mortgages, subprime mortgages theoretically could be securitized. But practically, Fannie and Freddie were barred from buying such mortgages in large numbers, and pension plans likewise could not legally buy a bond with a junk credit rating.

But deregulation of the derivatives market made it possible to construct a new form of bond, the collateralized debt obligation (CDO), from subprime mortgages. Financial engineering could make an AAA-rated bond out of C- and D-rated mortgages by assigning primary legal right to the income from those mortgages to the holder of the AAA-rated bond. This prior legal right reduced the risk that the bond might default, which is why credit rating agencies were willing to rate the bond AAA. The share of subprime mortgages that were securitized doubled from 1995 to 2003. By enlarging the demand side of the market for subprime, the investment banks created a huge incentive for commercial banks – or their own internal mortgage units – to expand the supply side as well. The more subprime mortgages banks issued, the more income they earned from the fees associated with those mortgages; the more CDOs that could be constructed from those mortgages, the more fees investment banks could earn selling CDOs; and, as we will see, the more CDOs there were, the more money insurance firms could make selling CDS to insure them. But all of that is just normal predation. The self-destructive impulse emerged from banks' willingness to deliberately recreate the maturity mismatch post-war regulation had largely prevented by speculating on CDOs with their own money.

Banks noticed an opportunity to arbitrage between interest rates in the short-term money market and the long-term mortgage market. Subprime mortgages paid out interest at roughly 8 to 10%. But in the short-term market, U.S. money market funds were offering to lend money for only 3-4% interest. The money market is the primary supplier of short-term credit for commercial purposes – companies borrowing to pay workers or buy supplies.¹² So banks created subsidiaries with a very thin capital base to take advantage of this interest-rate disparity. Their subsidiaries bought subprime mortgage using money borrowed from the money market. That is, they deliberately mismatched maturities, borrowing short-term money to buy long-term assets. Money market funds were willing to lend this

¹² Money market funds, including those run by the investment banks, are the core of the so-called shadow banking system. They are funded by consumer deposits, but, aside from those in commercial banks, these deposits are not insured by deposit insurance. MMFs are thus extremely vulnerable to a run on their deposit base.

money because they thought that the bank subsidiaries had adequate collateral in the form of the actual mortgages. Bank subsidiaries were willing to borrow 20 to 30 times their equity because they thought housing prices could not fall nationwide. And if they did fall, the bank subsidiaries were not worried. After all, they had bought insurance against default in the form of CDS. Meanwhile, the combination of extreme leverage and short-term versus long-term leverage created huge profits.

Banks thus recreated the conditions that had prevailed before the post-war regulatory system. The mismatch of maturities meant that any panicked sale of some assets to pay off depositors could lead to a fire sale of all collateral assets, making one bank's problems everyone's problem. They created the conditions for a new bank run, this time by money market funds rather than by individual depositors. This also magnified the possibility of a crash, because the money market funds were lending to many banks, and could withdraw loans to all of them on short notice. Individual depositors still had to get in line at a bank counter. By connecting commercial lenders (the money market funds) and the insurance companies to their speculative deals, the banks assured that any crisis would bring down all parts of the financial system simultaneously. As it did. In the 2007-2008 crisis the wolves not only ate all the sheep, but started eating each other.

Confronting falling housing prices and rising food and oil prices in 2007, many subprime borrowers understandably chose to eat and drive to work rather than pay their mortgages. As subprime borrowers began to default, the CDOs bought by banks' subsidiaries and built on those mortgages lost value. As those mortgages lost value, money market fund managers began to worry about the collateral held by the bank subsidiaries to whom they had loaned money, and so they began to call in their loans. In essence, money market funds started a bank run. As that bank run accelerated, more and more CDOs had to be liquidated, driving down their value, and bankrupting the bank subsidiaries. When those subsidiaries tried to cash in their CDS insurance policies, they discovered that insurance firms had issued far too many to make good on all CDS. By 2008, banks, money markets and insurance companies were effectively all bankrupt.

The government response to this crisis was not to fire the people responsible or call for sweeping regulatory change. For one thing, the 'government' here meant the Treasury and FED, both of which were full of people who had worked for the firms in crisis. Instead, they opened up the money spigot and poured trillions of dollars into failed financial firms. Thus the U.S. government seized AIG, and made good on its CDS obligations to Goldman Sachs and other investment banks. It sponsored emergency mergers of failing firms into somewhat stronger firms, as with Bank of America's acquisitions of Countrywide Mortgage (a huge mortgage lender and servicer) and Merrill Lynch. It offered an unlimited line of credit to money market funds. And it allowed investment banks like Goldman

to become commercial banks, which meant that its depositors were eligible for deposit insurance and thus less likely to pull out all of their money. To return to our mafia metaphor, this is like the government hiring mafia arsonists to put out a fire the mafia itself had started, and paying them overtime and bonuses for doing so.

The post-crisis regulatory response

Now that we understand the core elements of the system of regulation and how they were removed, we can assess the core elements of current efforts at reregulation. The discussion above emphasized that the old system of regulation kept different parts of the financial system separate, and had a mechanism for removing mismatched maturities. The old system de facto kept financial institutions small – rather than too big to fail – by preventing them from branching across state lines. The old system protected consumers (albeit in a clumsy, one-size-fits-all fashion) by setting minimum and maximum interest rates on deposits and loans. The Dodd-Frank Act (technically, the Wall Street Reform and Consumer Protection Act of 2010) tries to recreate some, but not all elements of this old system.

I will not get into the minutiae of the Act. For one thing, the regulatory agencies tasked with implementing the Act – which already runs to almost 1000 pages – will probably generate 30 times that number of pages as they turn general principles into specific regulations. Even where these correctly anticipate bank efforts to innovate around and thus avoid the regulation, the specific rules will certainly be litigated and weakened as time goes on. Second, the regulatory agencies tasked with generating actual regulations have missed two-thirds of the bill's original deadlines as of July 2012.¹³ And finally, if Mitt Romney wins the 2012 presidential election, he and the Republican Party are committed to repealing Dodd-Frank. Right-wing think-tanks like the American Enterprise Institute and the Heritage Foundation are already waging an intellectual campaign against the Act. As with their proposals to repeal the new healthcare Act and the Enron-inspired Sarbanes-Oxley reporting requirements on firms, they have not proposed any detailed substitute legislation. So a focus on minutiae is pointless.

Instead, I will focus on how Dodd-Frank addresses each of the main issues above: segmentation of the financial market, maturity mismatching, consumer protection, and comprehensive regulatory oversight. In short, I will ask whether Dodd-Frank can successfully keep the financial sector from destroying itself, and the economy, again.

¹³ <http://www.davispolk.com/dodd-frank-rulemaking-progress-report/>

Segregating different parts of the financial system

Dodd-Frank does nothing to re-segregate different parts of the financial system. The closest it comes to this is the Volcker rule. The Volcker rule prohibits banks that take insured consumer deposits from making speculative investments on their own account (that is, no proprietary trading). At present, banks can speculate in hopes of making big profits. But even if they gamble badly, and lose more than their capital, depositors' money is still protected by the public deposit insurance system, the Federal Deposit Insurance Corporation (FDIC). The moral hazard here is enormous and is the same as before the crisis. Good bets mean big profits and big bonuses for bankers. Bad bets means a taxpayer-financed bailout. While other provisions of the bill limit the government's liability to the value of assets that can be recovered from a failed bank, it is difficult to believe that the FED and Treasury would allow losses to cascade through counterparties to the failing bank. The Volcker rule is supposed to limit the potential for moral hazard.

Under Volcker, banks can buy and sell derivatives on behalf of their clients. In principle, this presents no risks to banks. They can buy and sell derivatives where those activities are necessary to hedge the bank's own liabilities that are not deposits. They can buy and sell derivatives related to U.S. Treasury debt, debt from Fannie Mae and Freddie Mac, and municipal bonds; as of 2012, about three-fourths of outstanding bonds in the United States were government or quasi-government bonds like Fannie and Freddie debt. And banks can still invest in hedge funds and private equity funds, again, if these investment amount to less than 3% of their Tier 1 capital base. These loopholes – which cover the vast majority of transactions – explain why banks do not think the Volcker rule will seriously erode profits. Moreover, as noted above, the Volcker rule has not yet come into effect, and when it does, it will be phased in over a five year period.

Maturity mismatching

As with post-war regulation, there is no explicit system to prevent maturity mismatches. Instead, the old system of informal regulation is beginning to re-emerge, supplemented by some aspects of the consumer protection laws. The crisis dramatically shrank the market's appetite for subprime mortgages by eliminating the demand for MBS and CDOs built on subprime mortgages. For most of the four years after the crisis, the vast majority of new funding for home purchases came from the re-nationalized mortgage giants, Fannie Mae and Freddie Mac. These firms returned to their core business, namely removing long duration debt from banks' balance sheets and selling it to firms that wanted a long duration asset. So for the time being, this

problem is less acute. However as banks recover, they will be tempted to play the same arbitrage game with long and short-term rates in some other area. The only limit on banks' ability to arbitrage is that banks that package loans together as asset backed securities – like, for example, mortgage backed securities (MBS) – must retain at least a 5% ownership stake in that security. Making banks 'eat what they cook' should induce greater caution in the origination of loans and the repackaging of those loans. Here too a huge exception exists: if banks build an MBS using mortgages with at least a 20% down payment, they do not have to retain 5% of the new bond.

Consumer protection

Consumer protection matters for two reasons. First, obviously, strong consumer protection might help prevent the financial sector from abusing its clients and stripping their assets. Equally important, though, it prevents the financial system from poisoning itself with debts that can never be repaid; it has a strong bearing on the collective health of the financial system. Many of the consumer protection components of the original bill were watered down via lobbying. And as with any regulation, the disposition of the regulators matters, which is why banks fought ferociously and successfully to prevent Elizabeth Warren from becoming the first head of the new Consumer Financial Protection Bureau (CFPB), and ferociously but unsuccessfully to give the FED control over the CFPB. The CFPB is housed inside the FED, but theoretically as an independent agency.

That said, the Dodd-Frank bill did create a whole new range of consumer protections around mortgages and other major forms of consumer debt. The most important of these are better disclosure of the terms and risks of different kinds of financial products and a clear fiduciary duty for the sellers of financial products.

“Too big to fail”

The changes above aim at reducing moral hazard by banks and at reducing the consequences of bad behavior. Even so, if major banks are so large that their failure would threaten the entire financial system, then the FED and Treasury would still have to bail them out. Dodd-Frank has several provisions to limit the size of banks, and to try to enforce collective discipline on banks. It remains to be seen if any of those provisions will be enforced. The FED, after all, was supposed to watch out for the collective interests of the banks before the crisis, and failed miserably.

Dodd-Frank aims to pre-empt a future financial crisis two ways. First, it establishes a new oversight body with an explicit mandate to stabilize the financial system. This is the Financial

Stability Oversight Council (FSOC). Second, it has a variety of provisions that try to make any failure orderly and less catastrophic.

The new FSOC brings together all of the federal regulatory bodies and some of their state-level counterparts. But it is chaired by the Treasury Secretary, and between them, the Treasury and FED wield enough authority and expertise to control the other members. That said, the FSOC is supposed to watch out for the health of the entire system. It has the ability to bring non-bank financial institutions under the supervision of bank regulators if those non-bank financials are a threat to systemic stability. Similarly, banks must now present accounts that consolidate all of their subsidiaries and also account for all of their liabilities via CDOs and CDS, making it harder to hide the kinds of dangerous exposures that magnified the 2007-2008 crisis. The FSOC can limit bank leverage to a 15 to 1 ratio. It can impose increasing stronger liquidity and capital adequacy provisions as banks grow. And as a last resort it can require large banks to divest themselves of subsidiaries if their size is problematic.

Second, Dodd-Frank also has provisions that aim to mitigate the consequences of any bank failure. It requires banks to pre-plan their bankruptcies, so that liquidation can be orderly. It exposes management and shareholders to losses in the event of bankruptcy; this should motivate management to avoid gambling too much. Despite these efforts to rein in too big to fail, the U.S. banking sector is much more concentrated today than it was before the crisis, and the largest banks have fingers in almost every aspect of the financial system. The big four commercial banks (Citi, JP Morgan Chase, Bank of America, Wells Fargo), and the big two investment banks (Goldman Sachs, Morgan Stanley) all still implicitly retain the expectation of a government bailout if they fail. And the four big commercial banks now all contain a former securities broker-dealer, enhancing their ability and incentive to speculate. It was precisely these incentives that led JP Morgan Chase to lose – it claims – \$5.8 billion in its London Whale fiasco in 2012.

In summary, then, Dodd-Frank is a relatively weak effort to overcome the collective action problems that plague finance, including the multiplication of derivatives, the zero sum nature of speculation, and the perverse incentives facing management and traders. Its most important rules have yet to come into effect. And the election may nullify the entire effort. Meanwhile each month seems to bring some new scandal to light: LIBOR, London Whale, MF Global (where \$1.6 billion of customer money simply 'disappeared'), Peregrine (\$200 million of client money), signing of false affidavits in foreclosure proceedings, etc.

Where are we?

The current state of play in U.S. financial regulation does not offer much hope of attaining stability, let alone some reduction of the political power of the financial sector. No major party is calling for serious regulation of the financial sector. By serious, I mean regulation that is capable of restraining finance's share of profits to a level consistent with more rapid growth in the real economy, and capable of restraining finance from serving mostly as a casino in which only the house's management wins. Serious re-regulation would restore finance to its function as an intermediary between savers and firms, the present and the future, rather than its current function as a generator of instability in the economy and bonuses for bankers. This regulation would have to deal with the core issues laid out above: the elimination of sustained maturity mismatches and the segregation of different parts of the financial system. The Obama campaign, so far, merely points to the creation of the Consumer Financial Protection Bureau as its signature financial sector reform, and proposes nothing more. And the Romney campaign, as noted above, proposes to undo both the CFPB and the rest of Dodd-Frank.

Neither of these positions should be surprising. Contributions from employees of financial firms to campaigns and by financial firms to the SuperPACs give them considerable influence over the political apparatus. Reform of finance would have to also encompass campaign finance reform to really be effective. It would also require reducing banks' influence over the FED and its component regional banks. The chances of either of these happening are somewhat smaller than the odds of a lasting Mid-East peace. Neither parties nor major corporations have any obvious interest in pursuing substantive reform.

What of the masses then? The most surprising political event of 2011 was the eruption of Occupy Wall Street (OWS). While OWS attracted considerable media attention in Europe, the corporately-owned media in the United States went out of its way to ignore or smear OWS. Six giant firms (GE, Viacom, Newscorp – i.e. Murdoch/Fox News – Disney, TimeWarner and CBS) control 90% of U.S. print, radio and TV media. GE's financial interests militate against any hard line against finance; Newscorp/Fox News is essentially the propaganda arm of the Republican Party. Google Trends shows a clear OWS peak in 2011 that was none-the-less lower than the corresponding peak for the most surprising mass movement of 2009-2010, the Tea Party. And OWS shows fewer searches than Tea Party over its entire history. Similarly, media coverage of Tea Party rallies had little to say about the highly visible (and in America legal) presence of handguns and assault rifles, but

much to say about the lack of showers or the proliferation of casual sex at OWS encampments.

In contrast to the Tea Party, OWS has been unable to move the center of American politics. Unlike the Tea Party movement, OWS lacked sympathetic billionaires willing to pay for an organizing infrastructure and a network willing to act as its propaganda arm. Where the Tea Party has visibly unseated powerful Republican politicians, OWS does not run candidates and was invisible in the Democratic political primaries. The Tea Party movements are feared on the right; OWS is a curiosity on the left. Its signature achievement is to bring “the 99%” into American political discourse. But OWS has been unable to translate this into pressure on politicians. Finally OWS has been the subject of considerable and nationally coordinated police harassment and suppression. Whether OWS will have staying power in this kind of hostile environment is an open question.

The upcoming election thus will not be won on the basis of any overt consideration of the role of finance in the U.S. economy and polity, finance’s central role in economic stagnation, rising income inequality, and the erosion of representative democracy. Nor will either campaign talk much about regulation of finance. The real power of finance remains largely invisible to the mass public. Finance should be invisible, in the same way that electricity is invisible. It should be a quiet business oriented toward supplying consumers and companies with a vital input. It should not be driving the economy. But regulation of finance is not on America’s political agenda in the 2012 elections.

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