Dēmos

EFFECTIVE REGULATION FOR THE 21ST CENTURY
REPORT SERIES

# FINANCIAL REGULATION AFTER THE FALL

ROBERT KUTTNER

## ABOUT DĒMOS

Dēmos is a non-partisan public policy research and advocacy organization. Headquartered in New York City, Dēmos works with advocates and policymakers around the country in pursuit of four overarching goals: a more equitable economy; a vibrant and inclusive democracy; an empowered public sector that works for the common good; and responsible U.S. engagement in an interdependent world.

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Robert Kuttner is co-founder and co-editor of *The American Prospect* magazine, as well as a Distinguished Senior Fellow at Dēmos, where he is leading a new project on the future on regulation. He was a longtime columnist for *BusinessWeek*, and continues to write columns in the *Boston Globe*. His newest book, his eighth, is the *New York Times* best-seller, *Obama's Challenge*. The book addresses the economic crisis that President Obama faces, and the need for him to be a transformative president and to embrace radical reform. His previous book, *The Squandering of America* (2007), explored the political roots of America's narrowing prosperity and warned of an impending crash. The book won the Sidney Hillman award.

Bob's best-known earlier book is *Everything for Sale: the Virtues and Limits of Markets* (1997). The book received a page one review in the *New York Times Book Review*. Of it, the late economist Robert Heilbroner wrote, "I have never seen the market system better described, more intelligently appreciated, or more trenchantly criticized than in *Everything for Sale*." Bob's previous books on economics and politics include: *The End of Laissez-Faire* (1991); *The Life of the Party* (1987); *The Economic Illusion* (1984); and *Revolt of the Haves* (1980). His magazine writing has appeared in *The New York Times Magazine* and *Book Review*, *The Atlantic*, *The New Republic*, *The New Yorker*, *Foreign Affairs*, *Dissent*, *Columbia Journalism Review*, and *Harvard Business Review*. He has contributed major articles to *The New England Journal of Medicine* as a national policy correspondent. His other positions have included national staff writer of *The Washington Post*, chief investigator of the U.S. Senate Banking Committee, and economics editor of *The New Republic*.

Robert Kuttner was educated at Oberlin, The London School of Economics, and the University of California at Berkeley. He has taught at Brandeis, Boston University, the University of Massachusetts, and Harvard's Institute of Politics. For four decades, Bob's intellectual and political project has been to revive the politics and economics of harnessing capitalism to serve a broad public interest. He has pursued this ideal as a writer, editor, teacher, lecturer, commentator and public official.

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The four most dangerous words in the English language are: "This Time it's Different."
—David Dodd

## I. INTRODUCTION

America's financial system has undergone a severe shock that is still cascading throughout the real economy. As financial institutions, their investors and homeowners have lost several trillion dollars, the combination of a contraction in asset values, declining consumer and business demand, and a weakened credit system have pushed the economy into a classic downward spiral. In the absence of heroic government measures, the financial crisis will lead to a serious general depression. Yet very substantial public spending and recapitalization of the nation's financial system, though necessary, are not sufficient. These measures must be combined with comprehensive regulation. If we fail to achieve that, the cycles of speculative excess, followed by financial crash and then public bailout, will only persist.

**The core abuses that led to the crash of 2007-08 had precise parallels in the Crash of 1929.**

The current crisis, the most severe since the Great Depression, has its roots in a policy of extreme deregulation, which goes back to the 1970s. Financial deregulation has taken multiple forms. Part of the process was the weakening or dismantling of many of the instruments for policing financial markets that were first devised during the New Deal. Another part was the willful failure to create new regulatory measures to keep up with financial innovations and related abuses, such as derivatives and hedge funds, that were not anticipated during the Great Depression. It was widely argued that a 21st century economy had outgrown regulatory concepts devised in the 1930s, or that something fundamental had changed about the economy so that financial markets no longer required much regulation at all.

Rather than modernizing the regulatory system, Congress, the Federal Reserve, and four administrations dating to Ronald Reagan largely abandoned financial regulation. But the fundamental vulnerabilities of financial markets had not changed at all. In fact, the core abuses that led to the crash of 2007-08 had precise parallels in the Crash of 1929. The parallels included a lack of transparency, insider conflicts of interest, and dangerously high levels of leverage—all of which were given a free pass by regulators then and now. Investment banking firms and other credit intermediaries systematically understated risks, and regulators failed to provide necessary checks and balances.

The hazardous effects of deregulation were compounded by a monetary policy of very low interest rates. At the center of both policies was the Federal Reserve. Absent regulation, financial engineers succumbed to the temptation to use the cheap credit environment to speculate with borrowed money. Since falling interest rates tend to stimulate increases in asset values, financial speculators and ordinary investors gambled that rising asset values (homes, common stocks, exotic securities) would allow them to realize gains on thinly capitalized investments.

The whole logic of the bubble economy could continue only as long as investors believed that asset values would continue to rise. The damage and potential for catastrophic collapse was compounded as the Federal Reserve kept resorting to very low interest rates and weak regulation to rescue the casualties of earlier bouts of speculative excess.

As early as December 5, 1996, then Federal Reserve Chairman Alan Greenspan expressed concern that inflated share prices reflected "irrational exuberance." At the time Greenspan spoke, the Dow Jones Industrial Average was just 6,437. But Greenspan declined to use either monetary or regulatory policy to temper what he already understood as an alarming stock market bubble. On the contrary, as speculation in Asian currencies produced serious losses in financial markets, Greenspan loosened monetary policy in 1997 and 1998, stimulating further increases in the value of financial assets. After the dot-com crash of 2000-01, Greenspan resorted to very low interest rates coupled with minimal regulation yet again. The sub-prime collapse, which finally caused the bubble to pop and exposed the overleveraging of the entire system, was the final straw but reflected only one abuse among many.

## II. THE CRASH OF AN IDEOLOGY

With the unraveling of this entire financial system, beginning with the first wave of sub-prime defaults in the summer of 2007, a whole set of assumptions about the financial economy has now come crashing down along with the overheated financial markets. In the recent past, virtually all innovations in financial markets were presumed virtuous, both in the prevailing ideology and in public policy. The market, by definition, was said to be efficient. If the market invented something, it must have value; otherwise it would not fetch buyers. And any such innovation was said to enhance economic efficiency and hence economic growth.

Financial markets were said to be fully capable of policing themselves. Government intervention was held to be an unwelcome intrusion that only retarded the innovative genius of markets. Even if some degree of government supervision was indicated, defenders of deregulation contended that private financial actors would always innovate around regulation. It was futile even to try. The technology itself was said to make the regulatory enterprise a fool's errand.

Governments, and agencies within government, were deterred from adequate regulation by the knowledge that regulated entities could shop for more lenient regulators either at home or offshore, a process known as "regulatory arbitrage." And many proponents of further deregulation such as the U.S. Chamber of Commerce, George W. Bush's Treasury Henry Paulson and a supporting cast of academic experts, contended that the competitive position of the New York money market required a regulatory environment at least as lenient as that of London or Frankfurt.[1]

In 2006, the last year before the collapse, there was an outpouring of industry-sponsored studies and government white papers, reinforced by hundreds of op-ed pieces, warning that New York was losing market share because of the burdens of the Sarbanes-Oxley Act requiring accurate corporate accounting, the sole piece of reform legislation of the entire era. The costs attributed to compliance with Sarbanes-Oxley were of course dwarfed by the much larger costs of the system's failure to regulate other abuses.

In the end, the deregulated financial economy failed its own most fundamental test—efficiency. The accounting frauds of the 1990s misled investors into putting scarce capital into ventures whose only real 'value' was the hope that other investors would bid the share price even higher. The securitization mania of the current decade misallocated even more capital, away from productive uses that might have stimulated durable growth, and into pure speculative bubbles. Financial engineers, unconstrained by public regulation, cost investors and the real economy many trillions of dollars and will now cost us many years of higher growth. A modicum of regulation would have produced a far more efficient allocation of capital.

The crisis has confirmed several verities about the behavior of financial markets that never should have been doubted. Financial markets, left merely to the discipline of supply and demand, are not competent to detect frauds; are not capable of discouraging dangerously high levels of leverage; or squeezing out excess insider compensation; or detecting even flagrant conflicts of interest; or accurately pricing complex financial instruments. Even disclosure requirements, though salutary, are no substitute for direct regulation of standards. The terms of sub-prime mortgages were ostensibly disclosed to borrowers, but it was child's play for pitchmen to misrepresent risks.

"The market," after all, is an abstraction. It is comprised of human beings, some of whom have more information and market power than others. When a bubble psychology takes hold, the prospect of getting rich overwhelms common sense. There is no substitute for public regulation to protect financial markets, investors, and the whole economy from the tendency of financial engineers to take excessive risks with other people's money. Once a competitive race for market share begins, even prudent bankers tend to drop their standards lest they lose out. As Charles Prince, then the CEO of Citigroup, famously put it, "As long as the music is playing, you've got to get up and dance."

And obviously, if markets were indeed efficient and self-regulating, the financial system would not now be seeking large scale relief from government. No serious person now argues that we don't need regulation—the question is what and how. In practice, "the market" often turned out to be personified by 26-year-old apprentice financial engineers who really had little understanding of what they were creating. They only understood that if fees were to be had and risks could be passed to someone else, the innovations were worth pursuing. The financial writer Michael Lewis, in a retrospective on the entire era,[2] recently quoted one insider, who became very rich shuffling the kind of paper that eventually took down the entire system: "*This is allowed?*" he asked, incredulously, speaking of his own (entirely legal) behavior.

That is the question we need to address: What should be allowed, and why? And the political question going forward is whether the Congress and the new administration will deliver serious remedies, so that financial markets again serve the appropriate role of financing the real economy rather than enriching insiders for promoting speculation and rearranging assets.

The now-discredited views about the genius of self-regulating financial markets were held by most financial economists, by the Federal Reserve and the Treasury, and by leading economic policymakers of both parties. But it would be a mistake to conclude that excess deregulation was mainly the consequence of flawed economic theory. It also reflected deep corruption in both the private sector and the public. The academic theory of perfect markets was convenient cover for reckless business behavior that failed to pass the most elementary tests of common sense. Free-market theory provided a useful alibi for the political allies of Wall Street abuses whenever they needed to limit regulatory constraints. There were those who warned that these policies would end in disaster. But as long as vast sums of money were being made, the voices of alarm were drowned out by those who benefited from the deregulated bubble economy.

With the practical failure of the dogma of deregulation, it would be comforting to believe that Congress and the Obama Administration will now have a clear field to restore a well-regulated financial system, fully accountable to consumers and investors—one in which the financial economy is servant of the real economy rather than master. But this challenge is a deeply political enterprise, not a bloodless technical one. Even at the hour of their disgrace, the same forces advocating as little regulation as possible are still present and still powerful. The new administration faces the same undertow of bad advice. It would be naïve to expect that every single necessary reform will not be bitterly contested by those who benefit from weak rules. This was also Franklin Roosevelt's experience in the New Deal.[3]

While the regulatory response to the excesses that caused the current financial crisis will include many forms of greater transparency, some outright prohibitions will be needed as well.

It is also worth noting that although the New Deal regulatory schema was primarily one of disclosure, it also explicitly prohibited many practices. It limited the use of margin, regulated payment of interest on bank accounts, prohibited commercial banks from performing the functions of investment banks, and a great deal more. While the regulatory response to the excesses that caused the current financial crisis will include many forms of greater transparency, some outright prohibitions will be needed as well.

This paper is an effort to catalogue abuses and suggest ways to think about regulatory remedies. Because of the continuing undertow of the market-fundamentalist ideology and the continuing political power of the very people and institutions that brought us this catastrophe, some of the most robust remedies will seem at the margins of mainstream debate. But, in order to move them to center stage where they can gain a proper hearing, it is necessary to at least inject these ideas into discussion,

## III. ABUSES AND REMEDIES

There are several broad public policy challenges. The first is to rebuild a viable banking and credit system. The Paulson approach of pumping money into wounded banks with few questions asked has prevented an even worse crisis. Having accepted the capital, however, banks have not taken the next step of resuming ordinary lending. Plainly, we need to devise a better strategy to recapitalize the financial system and to get something close to normal credit flowing again.

A second and related challenge is to accurately value and dispose of toxic assets that are now clogging the system. Secretary Paulson initially attempted to have the Treasury purchase up to $700 billion of these assets. This approach proved unworkable. A variety of proposals are under discussion, from the use of auctions to determine the market value of these securities to the creation of a public body modeled on the Resolution Trust Corporation of the 1980s, which disposed of assets after the first savings and loan collapse. However, it will be impossible contain the losses to mortgage-backed bonds without also braking the collapse in housing prices.

Thus, a third basic need is to stabilize the nation's system of housing and home finance. With the wave of foreclosures resulting from sub-prime lending, housing values have dropped more than 20 percent from their peak and continue to fall. This will intensify the pattern of foreclosures and falling asset values. The remedies offered to date have been primarily voluntary and indirect. Government aid has flowed to lenders, in the hope that they would voluntarily refinance at-risk loans. For the most part, this approach has failed. To brake the wave of foreclosures and the collapse in housing prices, government may well need to refinance millions of mortgages directly.

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The fourth, and broadest, imperative is to redesign a simpler and more transparent financial system (one that is far less vulnerable to speculative abuse and systemic risk), and a reliable policing mechanism in order to restore the financial markets to their proper role as facilitators of the real economy. A core principle of both these efforts must be that any institution that creates credit and hence risk needs to be subjected to prudential regulation. It doesn't matter whether the institution calls itself a commercial bank, an investment bank, a mortgage broker, a hedge fund or a private equity firm. There must be no category of institution that escapes supervision. As Barack Obama astutely put it in an important campaign speech on March 27, 2008, at Cooper Union in New York: "We need to regulate institutions for what they do, not for what they are."[4]

In resolving to restore a functioning credit system that is transparent to investors and consumers and free of swindles, it is necessary to take stock of the abuses that led to the recent financial crash. A secondary issue to be addressed below is which government agencies should regulate what kinds of financial institutions and products. Just as in the 1930s, we will need extensive investigations into how abuses operated, in order to devise the best remedies. This process will be the work of the next Congress and Administration, but here is a preliminary catalogue.

## Credit Rating Agencies

Private bond-rating agencies have immense powers over the credit market. They very substantially determine the credit costs to borrowers and returns to investors for different categories of securities, by assigning risk classifications that in turn determine interest rates. An analogy is that central banks influence the short term cost of credit via monetary policy. This function of pricing credit is in many respects a public good. Yet the credit rating agencies are private institutions, largely unregulated and accountable to no one but their clients and shareholders. Another analogy is the role of commercial banks, which also appraise risk and price credit whenever they make a loan. But commercial banks are subject to periodic examinations and explicit reserve requirements. By contrast, credit rating agencies have generally been trusted to develop their own risk models, with no meaningful supervision or regulation. Yet they themselves are effectively part of the regulatory system, since "investment grade" securities are considered prudent investments for a variety of fiduciary purposes. They even have power over entire nations, when they evaluate and assign ratings to sovereign debt

In the recent crisis, the rating agencies were thoroughly corrupted by conflicts of interest. They were paid by financial clients to design risky securities that could somehow justify the triple-A ratings bestowed by the same rating agencies. Basically, clients paid the agencies to show the same clients how to game the system, and then colluded in lowering rating standards. The competition for business among the agencies created a race to the bottom. Without this corruption of the rating agencies, the crisis would have been far less severe. If sub-prime and other securities based on high risk loans had been properly rated as junk bonds, they would have found far fewer buyers, and the sales volume and systemic risks would have been much diminished as well.

Credit rating agencies were also far too lax in their failure to downgrade the bonds of investment banking companies and other financial firms such as Fannie Mae and Freddie Mac whose own balance sheets deteriorated as they took excessive risks. Rather than alert investors to risk, the rating agencies systematically helped issuers camouflage risk. If the executives running these financial companies had been on notice that risky practices led to a probable downgrading of their bonds, they would have been more prudent.

What is the remedy to these abuses? What is the best way for the rating process to be done in a transparent and competent manner? The current SEC has proposed a very weak set of disclosure and reporting requirements. Others have urged an entirely different compensation system, with credit rating agencies are paid by investors and not by those with a financial interest in the ratings. However, the central role of these agencies, the degree of abuse and its dire consequences, may well call for an even more drastic remedy. There is a strong case that the credit rating agencies could be turned into public institutions or non-profits accountable directly to the SEC, on the premise that they carry out a public function that is too important to the economic efficiency of credit markets and too easily corrupted to be left in private hands.

## Securitization of Credit

Securitization of credit is the conversion of a loan into a bond. It is widely (and mistakenly) held to be a fairly recent innovation. Material distributed by The Securitization Forum, the industry trade association, claims it dates to the 1970s. In fact, securitization is at least a century old. One of the core abuses of the 1920s was the conversion of high-risk loans by banks such as Morgan into securities that were then sold to their retail banking customers, with the prestige of the House of Morgan certifying their supposed soundness. The conflict of interest in this brand of abuse was one of the prime rationales for the 1933 Glass-Steagall Act, which separated commercial banking from investment banking.

**I could find no evidence that private mortgage-backed securities made mortgages more readily available or cheaper to qualified consumers. Mainly, they produced a new source of fee income for investment bankers and credit rating agencies.**

A benign form of government-controlled securitization arose in the period between the 1930s and the 1970s. The original FNMA, the Federal National Mortgage Association, was created as a government agency to replenish local bank deposits used for mortgage loans. FNMA bought and sometimes sold mortgages. This "secondary market" in mortgages was invented by the government; it was a public monopoly limited to the activities of the FNMA, which was then a government agency and not subject to speculative abuse. The bonds that FNMA sold were not tied to specific pools of mortgages, but were general obligations of a public agency. There was no slicing of them into different tranches based on supposed degree or risk, as has been the case with privately created collateralized debt obligations, or CDOs. Unlike recent mortgage-based securities, which relieved mortgage originators of the responsibility to use prudent underwriting standards while generating profits for the mortgage 'packagers," the invention of the New Deal secondary mortgage market had a purely public purpose—enhancing the lending capacity of retail banks.

As private investment banks got into the business of creating mortgage-backed securities in the 1970s, the bonds became more complex and exotic, during a period when regulators lost interest in tracking new forms of risk. In studying the first generation of private mortgage-backed securities, I tracked the spreads between 30-year mortgages and comparable Treasury securities in the twenty years before and after private mortgage backed securities were invented. If these innovations truly increased liquidity and availability of credit to borrowers, the spreads should have narrowed. In fact, the spreads bounced around but there was no trend. I could find no evidence that private mortgage-backed securities made mortgages more readily available or cheaper to qualified consumers.[5] Mainly, they produced a new source of fee income for investment bankers and credit rating agencies.

Mortgage-backed securities grew exponentially during the liquidity crunch of the early 1980s, but this was a unique circumstance that did not necessitate a large and permanent mortgage-backed securities sector.

The process of privatizing FNMA into Fannie Mae, which began in 1969, has now come nearly full circle—but not quite. The government has pumped $100 billion into Fannie Mae and its sister institution, Freddy Mac (nee the Federal Home Loan Mortgage Corporation). The government has placed these quasi-private entities into government "conservatorship." But this is a halfway measure. It is time to turn Fannie and Freddie back into fully public institutions, and perhaps merge them as well. If the secondary mortgage market were a public monopoly, as it was between 1935 and 1968, there would be no profit in gaming the system, and no competitive race to the bottom. The government could restore strict underwriting standards and drastically simplify the entire affair.

There is even a case for prohibiting the securitization of mortgages by private institutions, or, at any rate, for prohibiting the slicing of mortgage-backed securities into so-called tranches with different degrees of risk and yield. "Tranching" has not been limited to mortgage-backed bonds. It has become a pervasive practice with no clear benefit to economic efficiency. At the very least, there needs to be a full investigation of the costs, benefits, and risks of tranching. How, if at all, does this practice truly enhance the ability of entrepreneurs to find investors, or the ability of investors to fine-tune their portfolio strategies? Is tranching mainly a convenience for middlemen? Does the complexity and opacity overwhelm the arguable benefits? What would the system suffer if tranching were, in fact, disallowed?

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## Home Finance and Housing Policy

As the sub-prime collapse revealed, the entire system of mortgage finance has been corrupted. In principle, home finance is a very straightforward enterprise. There are well established formulas on prudent loan-to-value ratios, and on ratios of income to monthly payment capacity. In the years before the 1970s, we had such a system and it worked like a fine watch. The homeownership rate rose from about 40 percent on the eve of World War II to about 64 percent by the mid-1960s. During this well-regulated period, defaults were rare, the FDIC and Federal Savings and Loan Insurance Corporation seldom had to pay out claims, and banks and thrift institutions seldom went broke. During that era, most mortgage institutions were mutually owned nonprofits, and exorbitant executive compensation was unknown. It would be hard to argue that this regulated system constrained the nation's need for credit, since it coincided with the longest and broadest economic boom and the most rapid rise in the rate of homeownership on record.

One of the great frauds in recent years was the claim that the sub-prime lending business was a socially-motivated effort to make the blessings of homeownership more widely available to low- and moderate-income Americans. In fact, sub-prime lending was created mainly as a way to increase fee income for loan originators and packagers, and to offer higher yields to investors willing to take a higher risk. A loan made to a less credit-worthy borrower naturally came with a higher interest rate, because it had a higher risk of default. But through the magic of securitization, investors came to believe that the bonds backed by pools of these loans were basically as safe as conventional mortgages.

**Sub-prime lending was created mainly as a way to increase fee income for loan originators and packagers, and to offer higher yields to investors willing to take a higher risk.**

Every link in the sub-prime chain was unregulated. The mortgage loan originator could waive ordinary underwriting standards and no regulator objected. The bond-rating agency that turned high-risk loans into triple-A bonds had no regulator questioning the alchemy. The role of the investment bank that financed the loan originator and packaged the bonds, and in some cases even bought the bonds through an off-balance-sheet affiliate, was essentially unregulated, too.

Going forward, there are three interconnected policy challenges. First, we need to restore a "plain vanilla" system of mortgage finance, in which well supervised banks and thrift institutions take in deposits and make mortgage loans. No mortgage banker or broker without capital reserves should be permitted into the business. No mortgage product or originator should be outside the system of government-approved underwriting standards. The secondary mortgage market, as noted, should also be carefully regulated and perhaps limited to public institutions such as FNMA which themselves need far more hands-on supervision. The monumental mess of sorting out owners of these mortgage-backed, "tranched" bonds in order to refinance distressed mortgages suggests that this innovation creates far more trouble than value.

The second challenge is to make housing truly affordable to moderate income people. It should have been obvious from the outset that charging marginally qualified prospective homeowners above-market interest rates was perverse as a supposed strategy for expanding homeownership. But this was never the true intent, only the rationalization offered by the industry. Mortgage products that began with "teaser" rates and quickly escalated to exorbitant rates (in order to produce the higher yield for investors) guaranteed a very high rate of default and foreclosure. In fact, millions of people who got high-cost sub-prime loans actually qualified for conventional mortgages, but were steered into riskier products that were more costly to the borrower and more lucrative to the lender.

**Every link in the sub-prime chain was unregulated.**

Government does need a better affordable-housing policy. If we want to make homeownership available to marginally qualified buyers, such a policy requires both subsidy of first-time homeownership and disinterested credit counseling. Sub-prime lenders, by contrast charged above-market rates, misrepresented the costs and risks, and pretended that marketing was counseling. Because they made their fees on loan origination, many lenders scarcely cared whether a loan was repaid or not. (The imperative of homeownership at all costs would be less urgent if government also had policies to promote affordable rental housing.)

The defenders of sub-prime have tried to paint moderate income homebuyers as the wrongdoers, when in most cases they were the victims. In fact, there are good examples of proven programs that help increase homeownership among moderate income people. Neighborhood Housing Services, a federally sponsored community program now in its fourth decade, combines credit counseling with practical assistance in the rehabilitation of houses. NHS has helped hundreds of thousands of Americans become secure homeowners. The Self-Help Loan Pool, a program begun in North Carolina, works with people whose credit ratings are not 'scored' highly enough to qualify under prevailing banking standards, but who have a credit history and job security sufficient to make monthly payments. This program offers subsidies as high as $20,000 and interest rates as low as zero. ShoreBank of Chicago has a long history of helping moderate-income families become homeowners, without resorting to sub-prime loans. These respected homeownership programs, and others, helped borrowers avoid predatory lenders, and continue to have low default rates. Ironically, legitimate programs were harmed by the rise of sub-prime, which diverted customers.

**By early in the current decade, it had become possible for investment bankers to create securities that were bets on bets on bets.**

The third problem is the worsening wave of defaults and foreclosures. The most straightforward way to deal with the backlog of at-risk sub-prime loans is to have government, through a new version of Roosevelt's Home Owners Loan Corporation, refinance mortgages at very low interest rates and in some cases write down the principal as well. This could be done by purchasing mortgages from lenders at a discounted rate. Loans would be taken off the books of private lenders at some ratio at well below 100 cents on the dollar, but well above the zero value at which some of the mortgage-backed bonds trade. This will require legislation that also gives courts the authority to require alterations of terms and holds mortgage-servicers harmless from litigation by bondholders if they cooperate with a refinancing program.

## Derivatives and Shadow Banks

By early in the current decade, it had become possible for investment bankers to create securities that were bets on bets on bets. A banker could invent a security that was a contract betting that a particular tranche of a particular issue of collateralized debt obligation would default. Someone else, perhaps a hedge fund, would take the other side of the bet. Still another player might create a tertiary derivative security insuring the secondary derivative against default. This was not an economically useful form of hedging; it was simply a form of gambling that generated fee income, and with multiples of leverage that in theory could be infinite. In effect, it was also the creation of credit backed by no reserves. No regulatory entity supervised the process.

This set of practices violates all the norms of a banking system based on what is known as "fractional reserve banking." This principle allows banks to "create" money by generating credit, but requires that capital reserves be held against the risk of loan loss since, otherwise, a bank could create an infinite amount of money by borrowing in money markets and re-lending. Under fractional reserve banking, government monitors and strictly limits the ratio of capital to loan assets. If bank examinations reveal a deterioration in asset quality (for example, when examiners find an increase in the percentage of non-performing loans), the bank is made to increase its capital reserves or reduce its lending. This discipline is needed both to police lending practices and bank safety and soundness, and also as a tool of monetary policy. For if regulatory agencies relax these standards, it amounts to a de facto loosening of credit. Investment banks, traditionally, were not subject to this discipline, because they enjoyed no government inspection or seal of approval and were presumed to be putting only their own capital at risk.

**They enjoyed no government inspection or seal of approval and were presumed to be putting only their own capital at risk.**

In normal times, this form of basic bank regulation worked well. But since the 1970s, with standards getting looser and regulators paying less attention to increasingly speculative business strategies, the government has repeatedly been called upon to contain systemic costs after the fact. In periods of recovery from speculative excess, such as the aftermath of the Latin American debt crisis of the early 1980s, regulators temporarily relaxed their accounting of non-performing loans lest banks be revealed to be insolvent. In that case, the workout and digestion of losses under the government's 1989 Brady Plan took the better part of a decade. The Brady Plan, named for then-Treasury Secretary Nicholas Brady, negotiated bank refinancing and write-offs of a portion of the debt for several Latin nations. Although banks had to scramble for additional capital, the system held. But the renegotiation of third-world debt was not coupled with more prudent regulation, so abuses were repeated and intensified.

**With the blurring lines between commercial and investment banks and the regulatory toleration of unregulated shadow banks such as hedge funds and mortgage brokers, the discipline of fractional reserve banking is badly compromised. Unlike a bank, a shadow bank is not required to keep reserves and is subjected to no examination.**

With the blurring lines between commercial and investment banks and the regulatory toleration of unregulated shadow banks such as hedge funds and mortgage brokers, the discipline of fractional reserve banking is badly compromised. Unlike a bank, a shadow bank is not required to keep reserves and is subjected to no examination. Unlike a portfolio of commercial loans, a portfolio of exotic derivative securities is much harder to value. Its market value can drop from its nominal worth to hardly anything, almost overnight. No reserves are held against the creation of these bonds. There are further complications in the form of affiliated off-balance sheet entities created to hold such securities—nominally independent but actually liabilities of the bank. So the bank's nominal balance sheet does not reflect its true risks.

Much of the supposed phenomenon of the world being "awash in liquidity" in the middle part of this decade—which was supposed to be a good thing--had less to do with high savings rates in the third world and more to do with the erosion of regulatory standards at home. This was tantamount to a loosening of monetary policy because it relaxed standards for credit creation (and in the event it went hand in hand with a deliberate lowering of interest rates as well.) The relationship of regulatory policy to monetary policy is worth further thought and exploration. Something is seriously wrong when monetary policy has to be used to compensate for the failure of regulatory policy, or when weak regulation becomes a de facto loosening of monetary policy. The two functions should be kept separate.

The task ahead, moreover, is not only to more effectively regulate the risks, but to determine whether our economy would be better off if certain kinds of exotic securities were either prohibited outright, or assigned reserve requirements that made them effectively unprofitable to create. One worthwhile research project would be to explore what different classes of securitized financial products actually do for the real economy, rather than accepting the assumption that they virtuously "add liquidity" or "spread risk." In devising better regulatory strategies for the future, we need to understand just where regulation has failed in the recent past.

It was credit default swaps and other so-called over-the-counter (OTC) derivatives that created the serious problems of excessive speculation, dangerously high leverage, and eventual collapse.

Some regulatory strategies going forward might include: much more stringent examination of the asset portfolios and business strategies of bank holding companies; a requirement that the liabilities of any "off balance sheet" entity that poses risk to the mother institution be added to its consolidated balance sheet; much more comprehensive reserve requirements for all entities that create credit; registration and advance regulatory approval requirements for all newly created derivative securities; cease-and-desist powers for regulators to halt dangerous or deceptive behavior; and outright prohibitions of inherently hazardous products.

Events have overtaken the old premise that little regulatory scrutiny is required for private transactions between high-net-worth consenting adults. These are the very transactions that carried huge systemic risks and contributed to a systemic crash and the need for taxpayer bailouts. No significant financial transactions should escape regulatory scrutiny.

## Non-Exchange Traded Derivatives

The closely related question of how to regulate derivatives also commands our attention. For the most part, it was credit default swaps and other so-called over-the-counter (OTC) derivatives that created the serious problems of excessive speculation, dangerously high leverage, and eventual collapse. These OTC derivatives are private contracts that are neither registered, nor traded on exchanges, nor subjected to any form of regulation. By contrast, derivatives traded on exchanges, such as traditional options and futures, have been relatively well behaved in the current crisis. In theory, requiring all derivatives to be registered and traded on exchanges would permit "price discovery" to take place, in the same fashion that continuous trading of stocks and bonds allows gradual adjustments in price without abrupt discontinuities. There would be no over-the-counter derivatives which were nothing more than contracts between buyer and seller.

But is the remedy realistic and sufficient? Much of the abuse is in the origination, not the trading, of third and fourth order derivatives that are nothing more than side bets with high degrees of leverage. In practice, what would happen if a particular credit default swap (which allowed bets on the risk of default of a BBB tranche of a particular bond backed by a particular basket of loans) were required to be listed on an exchange? How would that change the behavior of the originator? In general, the more obscure the security and the shallower the trading market, the greater and more abrupt the swings in price. We have seen the results of concerted selling of publicly traded securities by short sellers and hedge funds, resulting in very abrupt price swings of even broadly traded common stocks and bonds. It is inconceivable that a highly obscure derivative security would ever have a broad trading market. Once unfavorable information was revealed, it could crash just as abruptly as an unlisted derivative. Critics of the Commodity Futures Trading Commission have also contended that its disclosure and enforcement requirements for exchange-traded securities are too weak. So if we are to rely on listing and exchange-trading as a remedy, we may also need to strengthen the CFTC criteria at the same time.

One of the problems with derivatives until now has been that no regulatory authority knows who owns then.

Because of all these potential problems, requiring all derivatives to be exchange-traded, while desirable, is no panacea. Derivatives would also need to be registered as securities and their ownership disclosed to the regulatory authorities. One of the problems with derivatives until now has been that no regulatory authority knows who owns then. As a consequence, the government does not have a clear picture of just how much more potential damage is still to be felt. Besides registration and exchange trading, we need much more stringent examination and reserve requirements directed at the issuer. If everyone who wrote such contracts had to keep reserves against the risk of default, the whole sector would shrink, and that would be salutary for the economy. There should also be flat prohibitions of some practices. One conceptual challenge is to determine where to draw the line between legitimate forms of bond insurance, such as first order insurance of municipal bonds, and pure gambling that amounts to credit creation with no capital requirements.

The reason outright prohibitions should be on the list of possible remedies is that in the absence of clear definitions of what is permitted, financial engineers can play an endless cat-and-mouse game with regulators. Suppose, for example, that only "first-order" derivatives were permitted—options, futures, and perhaps simpler forms of securitized loans. The problem with the present system of tranching and "spreading risk" via exotic securitization is that it creates perverse incentives for the originator to pay too little attention to the true risk as long as someone else is assuming it. One astonishing gap in the present regime of bank examination is that examiners do not review underwriting standards of loans that are immediately securitized, on the grounds that they do not stay in the bank's portfolio and therefore are somebody else's problem. But the systemic danger is that they are precisely nobody's problem.

**In the era of strict financial regulation, which ended in the 1970s, there was no covert innovation around regulation, because certain activities were flatly and categorically prohibited.**

Many authorities have insisted—indeed, some still insist—that regulation of financial engineering is a hopeless endeavor, because the engineers will always be able to innovate around the regulators. But the recent financial collapse suggests that the stakes are just too high to take that claim at face value; in fact, it is disproved by history. In the era of strict financial regulation, which ended in the 1970s, there was no covert innovation around regulation, because certain activities were flatly and categorically prohibited. S&L's could only make certain kinds of loans. Banks could not pay interest on demand deposits. Commercial banks could not perform the functions of investment banks. There was no interstate branching. There were usury ceilings. As innovators attempted to breach these constraints, it took explicit political and regulatory complicity to permit the breaches. These may have been good or bad policy changes, but the claim that it is institutionally impossible to evaluate and constrain potentially hazardous innovations is nothing but a convenient myth.

## Credit Default Swaps

**The more serious problem arises when, through credit default swaps, insurance contracts themselves become vehicles for speculation.**

The insurance of bonds against default is a well established line of business, partly legitimate and efficiency-enhancing. If an obscure municipality can get its bonds rated and then insured, it can sell them in national capital markets at fair and accurate interest costs relative to the risk, and often at lower interest costs than would otherwise be the case. In theory, the bond insurer fine-tunes the process and provides an additional layer of security for the buyer who relies primarily on the rating agency. Even before the collapse of the CDS market, however, there was criticism of how the business was practiced. For example, critics have pointed to the low default rate of municipal bonds but anomalously high costs of insuring them as a convenient arrangement between bond rating agencies and insurers to inflate middlemen fees.

The more serious problem arises when, through credit default swaps, insurance contracts themselves become vehicles for speculation. As firms such as A.I.G. got into the game, collecting huge fees by insuring ever more exotic derivatives. The business became less one of providing insurance against default of actual bonds than one of highly-leveraged speculation. Although the mythology holds that these bets are zero-sum games with no wider systemic costs, once you have a giant entity such as A.I.G. making large bad bets, the systemic risk is extreme because the ripple effects of failure are huge. That's why government had to bail A.I.G. out.

Although A.I.G. is an insurance conglomerate, it was performing the function of an investment bank. It is an American-based company, but the unit proliferating credit default swaps that incurred losses that could run well into the hundreds of billions was based in London. No regulatory agency in either country kept up with this process; it simply fell through the cracks.

**If ordinary insurance regulation had been extended to A.I.G's credit default swaps business, the application of standard insurance principles would have revealed that the risk was far greater than ordinary insurance risks.**

With the benefit of hindsight, how might public policy have prevented the A.I.G. disaster and kindred CDS land mines that have yet to detonate? Is this really an area of activity for insurance regulators to monitor? What about the problem of losses in affiliates compromising the supposedly segregated reserves of ordinary forms of insurance? At one point, as the A.I.G. crisis was unfolding, the New York State Insurance Commissioner was prepared to permit A.I.G. to divert $20 billion in its other reserves against insurance losses to restore market confidence in the company. That would have been terrible policy. What kinds of walls are needed between very different lines of business with very different degrees of risk? In normal insurance underwriting, actuarial risk is calibrated very precisely. The risk of loss from writing credit default swaps is far less knowable. Are much more stringent reserve requirements an appropriate remedy? If regulators' risk models had taken into account that the possibility of a drop in housing prices could lead to a chain of events capable of wiping out A.I.G's capital, reserve requirements might have been imposed that would have drastically limited the entire line of business.

Basically, if ordinary insurance regulation had been extended to A.I.G's credit default swaps business, the application of standard insurance principles would have revealed that the risk was far greater than ordinary insurance risks; the risk was literally unknowable and hence infinite. The ordinary remedy would have been reserve requirements in proportion to the risk. Two intriguing questions to sort out are: why did no regulator noticed this? and who should be charged with detecting such problems in the future? An even more fundamental question is why this whole business should not be organized as straightforward insurance, rather than as exotic swaps?

At the end of the day, we may need strict limitations on the creation of derivatives, based on the degree of separation from the actual, real-world transaction. Writing insurance contracts against default of ordinary corporate and government bonds is straightforward and efficiency enhancing. But in the case of insurance contracts on the risk of other derivatives defaulting, the systemic risk, perverse incentives, and moral hazard may far outweigh the putative gains to "efficiency;" these supposed gains, in any case, need to be defined rather than merely hypothesized. To put the proposition another way, how is the world worse off and the economy less efficient if entire categories of derivatives simply do not exist?

The just retired governor of India's central bank, Dr. Yaga Reddy, recently addressed a conference on the financial crisis held at the United Nations. He explained that India's financial system had escaped largely unscathed, because regulatory authorities essentially prohibit complex securitized products either directly or by requiring prohibitively high reserves against them. "As a developing country, we don't really understand these securities," Dr. Reddy observed wryly, "so we leave them to the more advanced economies."[6] India, with a simpler and more transparent banking system, has been growing at rates in excess of eight percent. Where is the gain to efficiency that India is missing?

## Hedge Funds and Private Equity

As lines between commercial banks and investment banks have blurred, private equity firms and hedge funds have also increasingly done much of what used to be the business of regulated credit intermediaries. But private equity companies and hedge funds are largely unregulated. Many observers, cognizant of the deeper perils revealed in the collapse of Long Term Capital Management in 1998, thought that the next crisis would be triggered by a crisis in the hedge fund industry.

Hedge funds and private equity funds escape regulation through a loophole in the Investment Company Act of 1940. The premise of the entire New Deal schema of securities regulation is that entities that sell securities to the public should be regulated largely in order to protect investors, and that the mechanism of that regulation is largely via disclosure. Commercial banks, meanwhile, are held to somewhat higher standards via direct examination and supervision, reserve requirements and other explicit regulatory constraints. The system was not designed to deal with the abuses and risks of creatures such as hedge funds and private equity companies, which do not sell shares to the public on regulated exchanges, and hence escape regulation entirely.

Unregulated hedge funds pose a systemic problem in several respects. First, since multiple funds often pursue similar strategies, they tend to intensify speculative trends and make the system more volatile. And they can all guess wrong at once, spelling big trouble for the funds—and for the rest of us. Even when they guess right, they can be destabilizing. When there were runs on bank stocks in the summer and fall of 2008, short-selling by hedge funds was heavily implicated. Second, hedge funds are often the "counter-parties" that trade in dubious, highly-leveraged and lightly regulated products such as credit default swaps. Since hedge funds are outside the regulated system, regulators literally do not know what hedge funds own, or their degree of leverage, or the systemic risks that they pose.

> **As lines between commercial banks and investment banks have blurred, private equity firms and hedge funds have also increasingly done much of what used to be the business of regulated credit intermediaries.**

Third, hedge funds can be swamps of conflicts of interest. Hedge fund managers often act on tips that represent otherwise privileged information. Insider trading is prohibited; but tipping off a friend and offering a favor that can be called in later is a gray area where enforcement is impossible if the entity is unregulated to begin with. In November and December 2008, as details of the Madoff scandal emerged, it became clear that several hedge funds functioned as "feeders" of client investments into Madoff's Ponzi scheme. The hedge fund managers received lucrative kickbacks for channeling this money. But because they were unregulated, there were no limits on this flagrant conflict of interest.

## LBOs & MBOs

A related issue is whether we need changes in the tax code to discourage highly leveraged buyouts (LBOs). Much of the profit in acquiring a target company using mostly borrowed money derives from the fact that the interest on the loan is tax-deductible. This gets to a whole other set of questions involving corporate governance and superior forms of accountability to the so called market for corporate control. The claim of private equity companies has been that their LBO and management buyout (MBO) activities serve to hold management more accountable and virtuously take advantage of market mis-pricing. In the standard story, private equity firms perceive opportunities to extract hidden value by taking over underperforming firms and improving their management. There are firms that do exactly that. But critics have contended that many firms make most of their money on tax subsidies for leverage, abuse of insider information, asset stripping, and stock price manipulation in advance of the LBO. The supposed virtue and privileged position of private equity firms raises one set of regulatory questions about how best to hold management accountable—is it really necessary to turn the target company inside out, for example? Their capacity to corrupt markets and increase systemic risk poses another set of questions.

Private equity firms, which claim that their business strategies are trade secrets, should be required to disclose more information to regulators if not to the public. Although they are not exchange-traded, many do invite investments from the public. One of America's great investment successes, Warren Buffett's Berkshire-Hathaway, amounts to a private equity business, yet is publicly listed and complies with all the required public disclosures. That fact suggests that honorable private equity firms may have nothing to fear from registration and disclosure.

To the extent that hedge funds or private equity companies perform many of the functions of regulated financial institutions, how should they be regulated? There is a strong case that all financial institutions with the capacity to create credit and risk be required to have essentially the same degree of disclosure to regulators, as well as reserve requirements and limits on leverage. The once independent and privately held investment banks have now converted to bank holding companies, in part to qualify for government aid. As such, they should be subjected to bank-style examinations and reserve requirements. The examinations should go further, to assure that their strategies do not depend on potentially illegal manipulations of markets, trading on privileged information, or creation of excessive systemic risks.

## Short Selling

The practice of short selling, especially by hedge funds, has worsened market volatility and been especially savage in its effect on bank capital. A short seller, anticipating that the price of a stock will fall, arranges to borrow shares of the stock from a broker to deliver to a purchaser, sell a comparable number of shares, then subsequently buys the shares back on the open market at a lower price, returns them to the broker, and pockets the difference. Concerted short selling can create a self fulfilling prophesy, driving down share prices of a target stock. (Defenders of short selling contends that it corrects market mis-valuations. But with effective regulation and corporate accounting, such bubbles would not occur in the first place.)

**The practice of short selling, especially by hedge funds, has worsened market volatility and been especially savage in its effect on bank capital.**

Through a bizarre symbiosis, in that the availability of short sellers allowed creators of derivatives to construct ever more abstract financial houses of cards. In order to create the securities on a large scale, they needed a market that included short-sellers on the other side of the transaction. Regulatory policy on short selling has been schizophrenic, acting to aggressively constrain it only during periods of extreme crisis after most of the damage has been done. The SEC's behavior has been especially inconsistent, ordinarily defending this practice only to ban it at sensitive moments last year, in a futile effort to contain runs on bank stocks.

Critics of excessive short selling have sought either to prohibit or drastically constrain it since as long ago as 1928. In the sorting out of the causes of the Crash of 1929, scholars have assigned some of the blame to organized "bear raids" on stocks, as they were known in the 1920s.[7] This literature is largely forgotten, but it has a very contemporary ring and is rather persuasive.

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Most financial economists assume that short selling "improves efficiency" by allowing investors to go either long or short. This supposedly creates more "accurate" pricing of shares. Yet short selling has also exaggerated volatility. Is it true that short-selling enhances price-setting, and what exactly does that mean? We need to explore the counter-factual: what would the economic world be like if there were no short selling? There would be fewer opportunities for purely financial gains, often windfall ones with negative real-world consequences. But what would be the effect on the ability of real enterprises to attract and retain capital investment? Standard basic textbooks describe financial markets as places where intermediaries help to connect savers and investors with entrepreneurs. Short sellers are not part of this story, which begs the question: Is the standard story wrong? Perhaps, then, if we don't prohibit short selling outright, we need to further investigate the abuses and develop strategies to contain them—which is necessary in order to truly understand their impact on market volatility.

## TARP, Yardstick Competition and Public Ownership

The emergency $700 billion public aid to the banking system, known as the Troubled Assets Relief Program (TARP), has succeeded only in preventing the collapse of major money center banks. It has not managed to restore accurate valuation of bank assets and liabilities, to clean up bank balance sheets by disposing of toxic securities, or to restore normal credit flows. Under Secretary Paulson, the government maintained a hands-off approach, asking for little accounting of what the banks were doing with the money, and declining to become actively involved in the management of the banks. As far as can be known from his testimony, Paulson has required neither revised business plans nor better operational controls as a condition of aid. Nor has he been clear about the program's goals.

On the question of the cause and cure of the toxic assets problem, the Congressional Oversight Panel, created as part of the TARP legislation, put the concern well in its first report, dated December 10:

> Treasury needs to explain its understanding of the role played by each of the following factors and by their interaction: (1) capital inadequacy in financial institutions; (2) lack of reliable information in credit markets with respect to counterparty risk; (3) temporary liquidity shortfalls in particular financial markets; (4) falling real estate prices and rising foreclosure rates; (5) stagnant family incomes and rising unemployment; (6) changes in consumer borrowing capacity; (7) business and financial focus on short-term gains to the detriment of long-term growth; (8) effectiveness of regulatory oversight; (9) CPP participants' involvement in and exposure to off balance sheet vehicles and unregulated markets; and (10) broader long-term macroeconomic imbalances.[8]

Treasury has also been less than clear in its goals for the rescue of large institutions. For example, at this writing Citigroup has now been the beneficiary of two infusions of capital, totaling $45 billion, first under the general authority of TARP and then under the blanket systemic risk authority. This sum far exceeds the current market valuation of Citigroup shares. For all intents and purposes, the government has bought it. In addition, the Treasury and Fed have guaranteed another $306 billion of Citi's most risky securities. The wide expectation is that Citi will soon be back for even more help. By any normal metric, the company is insolvent. Yet the government has asked for remarkably little in exchange for these infusions of taxpayers' dollars and assumption of risks. Citi is precluded from paying dividends for a period, and its executive compensation plans must be submitted for review and approval. But the government gets no seats on its board; no executives are replaced; and there is no assurance that Citi will resume normal lending, which was presumably the whole point of the exercise.

**The Treasury should keep a closer watch over where the money is going, and be far clearer about the purpose of the program.**

At the very least, the Treasury should keep a closer watch over where the money is going, and be far clearer about the purpose of the program. For some banks, the objective is to strengthen the bank's balance sheet but not to facilitate expansion. For others, the goal is expanded lending. For still others, the financial aid is intended to put the bank in a sufficiently solid position so that it can be acquired. This degree of government aid is unprecedented, and requires far more active intervention and reporting. It remains to be seen whether the TARP approach, even if managed more coherently, will be sufficient.

The contrast with the auto rescue is striking. Government is giving the auto industry far less money and demanding far more in return. Arguably, the insolvency of Citi could be acknowledged; it could be broken up and its healthy pieces sold to other banks; and there would be far less consequence for the real economy than the collapse, say, of General Motors.

This raises some intriguing policy questions. Should government take over at least one bank, not only to clean it up and improve its management, but to be a role model of resumed lending and prudent practice? Sweden, after a similar collapse, used such a technique in the 1980s; the entire banking system was temporarily nationalized, and then, after its balance sheets had been cleaned up, mostly sold back to the private sector, but with more effective controls. In the current British version of the crisis, the U.K. has gone much further in this direction than the U.S.

This idea is not as far fetched as it may seem, since temporary nationalization is effectively what the FDIC does when it takes over a failed bank such as Indy Mac. For the time being, the failed bank becomes a government-owned entity, with hundreds of competent civil servants actually serving as senior managers of the bank. FDIC policy is to work out a merger if possible, as in the case of Washington Mutual, and take the failed institution over as a last resort—and then sell it off when it has been cleaned up.

**Should government take over at least one bank, not only to clean it up and improve its management, but to be a role model of resumed lending and prudent practice?**

The FDIC does not have the staff or the mandate to take over and operate an institution the size of Citi, which is approximately 20 times bigger than Indy Mac. But even less does the Treasury have the capacity to operate a bank, or even to supervise the operations of a bank that receives public financial aid. Under Paulson, the inclination has been to contract out the process to other investment banks, creating new conflicts of interest. Part of the challenge is to rebuild, or build, new public capacity.

**It may well be necessary to create a whole new institution, which could evoke something both of the Reconstruction Finance Corporation of the 1930s, and of the Resolution Trust Corporation of the 1980s.**

It may well be necessary to create a whole new institution, which could evoke something both of the Reconstruction Finance Corporation of the 1930s, and of the Resolution Trust Corporation of the 1980s, with the capacity to (a) closely monitor banks receiving public financial aid; (b) help sort out and dispose of toxic assets; and (c) in the extreme case take over and run a bank and/or supervise and orchestrate the break-up and sale of a bank. Until now, this sort of thing has been done on the fly, over frantic weekends. It needs to be done far more systematically.

During the New Deal, a popular concept in reform circles was "yardstick competition." President Roosevelt explicitly supported the idea when he sponsored public electrical power. If at least one publicly owned electrical utility operated in every market, the idea was, regulators could determine true costs and reasonable outlays for maintenance, marketing, construction of new capacity and pricing, and thereby have a yardstick to determine rates, performance standards, and reasonable levels of return for private competitors. In present circumstances, it would be salutary to have at least one commercial bank be a publicly owned institution, in the spirit of Roosevelt's Yardstick Competition.

## IV. THE REGULATORY ARCHITECTURE

One of the core questions going forward is who should regulate what. The current system is a patchwork, made up of more than 100 bank and insurance regulators at the state level, four major Federal bank regulatory agencies (the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision) as well as several minor ones; two different securities regulators (the Securities and Exchange Commission and the Commodity Future Trading Commission), as well as industry "self-regulatory organizations" that operate with authority delegated by the SEC.

One of the core questions going forward is who should regulate what. The current system is a patchwork...

In the recent collapse, few of these agencies distinguished themselves. The Office of Thrift Supervision and the SEC under Christopher Cox have been particular failures. Many of the most flagrant sub-prime abuses went on under the nose of the OTS, whose supervised savings institutions included Indy Mac and Washington Mutual. For good measure, the OTS was the lead supervisory agency of the financial activities of A.I.G, whose collapse has so far cost taxpayers upwards of $125 billion. The SEC somehow managed to miss the Madoff swindle.

One notable exception to this dismal pattern has been the Federal Deposit Insurance Corporation, which has maintained its professionalism and regulatory diligence. Another intermittently vigilant agency was the SEC during the periods when Arthur Levittt (1993-2001) and William Donaldson (2003-2005) chaired it.

Were we designing a regulatory architecture from scratch, nobody would devise such a fragmented system (other than self-interested client industries that want as weak and divided a system as possible). But it is not yet clear how best to consolidate jurisdiction; and at this stage of the reform project, being clear about the principles of regulation is more impaortant than rearranging the regulatory institutions. Ideally, there would be one agency in charge of all commercial bank examination. That agency would look a lot like a better- resourced FDIC.

In the recent collapse, few of these agencies distinguished themselves.

## Securities Regulation and Self-Regulation

In our system, the role of assuring honest capital markets for investors falls to the Securities and Exchange Commission. At times in its history the SEC has performed that role well. A political scientist might argue that the constituency for strong regulation (investors and corporate executives who appreciated transparent capital markets) roughly balanced the constituency for weak regulation (investment bankers, broker-dealers, issuers of sketchy securities). But in recent years, many corporate executives colluded with investment bankers; and many investors were either naïve, poorly organized, or gulled by the bubble economy. The pervasive ideology of deregulation has seriously weakened a once strong SEC. Some of this has been the result of industry-oriented chairmen, such as Christopher Cox and Harvey Pitt. Some of it occurred under chairmen, including Levitt and Donaldson, who were more investor- and consumer-oriented but often had their hands tied by Congress and hostile courts. The SEC's enforcement efforts have also been woefully underfunded during a period when abuse proliferated. They have been further weakened by a well worn career path in which senior SEC enforcement officials look forward to careers on Wall Street and seek to ingratiate themselves with prospective employers.

**Were we designing a regulatory architecture from scratch, nobody would devise such a fragmented system.**

Among the areas requiring more effective SEC regulation are: executive compensation; proxy reform (to enable shareholders to vote directly on competing board candidates); restoration of effective private right of action in cases of investment frauds not detected by the SEC (which has been weakened by both Congressional action and court rulings); more transparency and comprehensive disclosure of fees and commissions by mutual funds; better enforcement of the filing and adequacy of disclosures made by publicly traded corporations; registration and regulation of hedge funds; and a crackdown on abuses associated with stock options. We also need a much longer interval before former SEC enforcement officials can take jobs with regulated companies.

A tricky issue going forward is the relative jurisdiction of the SEC and the Commodity Futures Trading Commission. Increasingly, commodities futures are used less for price hedging by producers of consumers of primary products, and more for speculation. The market in financial futures and in derivatives is essentially part of the securities market. The development of speculative bubbles in oil and other products suggests that CFTC oversight is too weak. One option is to merge the CFTC into the SEC. If this is done, care should be taken to preserve court rulings predicated on the existing SEC allowing private right of action. Another option is much tighter coordination between the two agencies. A third is to transfer jurisdiction over financial derivatives to the SEC.

In practice, some of the most important regulatory functions have been delegated by the SEC to so-called self-regulatory organizations, or SROs. These bodies have been industry dominated, and notoriously weak regulators. For example, supervision of the accounting profession had been entrusted to the accountants' own professional association and lobby, The American Institute of Certified Public Accountants. AICPA was consistently an advocate before the SEC for the weakest possible regulatory standards. It totally missed the accounting scandals of the 1990s, in which credulous or corrupted audits enabled the frauds committed by Enron, WorldCom, and kindred large corporations that cooked their books at investor expense. As a result of the AICPA's default, Congress in the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board, an independent nonprofit accountable to the SEC to monitor audit standards.

The enforcement of standards and rules for stock exchanges and their broker dealers, as well as investment banking companies, has also been delegated to the industry. Traditionally, the New York Stock Exchange and NASDAQ had their own in-house regulatory arms. They failed to notice the corporate and accounting scandals of the 1990s, focusing instead on marginal and small-scale abuses such as penny-stock swindles and boiler-room stock promotion schemes. They have also been loath to take action against large firms or crack down on systemic conflicts of interest. When the New York State Attorney General's office prosecuted New York's largest investment banks, including Goldman Sachs, Morgan-Stanley and Merrill Lynch, extracting a settlement of $1.4 billion for gross misrepresentations by stock analysts, it was doing what would have been the work of the Exchange's system of self-regulation, had that body been more than window dressing.

In 2006, the New York Stock Exchange converted itself from a mutually owned non-profit into a for profit company. As a result, its delegated regulatory functions had to be spun off into a separate entity, since even the Bush-era SEC was unwilling to anoint a for-profit entity as a regulator. In 2007, the regulatory functions of NASDAQ and the New York stock exchange were merged into a new industry-dominated "self-regulatory" organization called the Financial Industry Regulatory Authority, or FINRA. Its primary responsibility is to police more than 5,000 broker dealers. It somehow missed the problems and disastrously speculative business strategies at Merrill Lynch and Lehman Brothers.

**There is a good argument that the whole self-regulation model has failed, and that something as fundamental to the integrity of the nation's capital markets as the conduct of stock exchanges, broker-dealers, and investment bankers should revert to the SEC itself.**

There is a good argument that the whole self-regulation model has failed, and that something as fundamental to the integrity of the nation's capital markets as the conduct of stock exchanges, broker-dealers, and investment bankers should revert to the SEC itself; or at the very least to an independent nonprofit responsible to the SEC rather than to the regulated industry, such as PCAOB in the case of accountants. President Obama recently appointed Mary Schapiro, chief executive of Finra, to chair the SEC. This will either be a case of someone who knows the weaknesses of self-regulation all too well bringing her insider knowledge to a strengthened SEC and rising to the occasion; or it just will be another disappointingly weak appointment reflecting the still pervasive industry influence.

## The Question of a Super-Regulator

Secretary Paulson has proposed that the Federal Reserve be explicitly empowered to function as a kind of super regulator, with the power to range across the entire financial system in search of systemic risks, regardless of the kind of financial institution posing it.[9] In effect, the Fed has been doing just this since the summer of 2007, without explicit authorization or guidelines beyond the emergency authority added in the 1930s.

There are two problems with this approach. First, the Federal Reserve is not a true public agency. This has been a politically contentious issue since the Fed's founding a century ago, and the banking industry has always resisted steps to make the Fed more accountable to the public. Even Roosevelt was unable to go more than partway down this path. The Fed's Board of Governors in Washington, D.C. is appointed by the president and subject to Senate confirmation. But its regional reserve banks, which have primary supervisory responsibility over some 5,000 bank holding companies, are owned by member private banks and governed by boards and presidents that are accountable to those banks. Its policy-setting open market committee is a blend of public members of the Board of Governors and non-public presidents of its regional reserve banks. If the Fed is to be given additional regulatory powers, it is time to revisit the issue of its hybrid status, which leaves it far too accountable to commercial banks rather than to Congress, the executive branch and the public.

Second, in practice, the Federal Reserve has been a feeble regulator, especially when it comes to the non-bank affiliates of bank holding companies, which have been the source of so many recent problems. It has also refused to aggressively implement a number of regulatory mandates that it currently has. Under Chairman Greenspan, the Fed refused to issue regulations to carry out the Home Ownership Equity Protection Act of 1994, even after being directed to do so by Congress. That act required all mortgage originators to use prudent underwriting standards. Had it been enforced, we might have been spared much of the sub-prime collapse.

**In practice, the Federal Reserve has been a feeble regulator.**

Emergency systemic-risk authority addresses problems after the damage has been done. It is no substitute for ongoing prudential regulation, of such entities as rating agencies, hedge funds, private equity companies; and such instruments as credit default swaps and sundry forms of securitization. The Fed has been among the weakest of prudential regulators. Most of its examiners are housed in the regional reserve banks, which are not public institutions. It is also questionable whether one institution, especially one not fully public, should be given so much concentrated power. The Fed has not yet earned that, and its failings are partly a function of its structure.

It is generally agreed that there is some line to be drawn between "investor protection," via an enhanced SEC, and improved "prudential regulation," to be carried out by some combination of the other bank regulatory agencies and the Federal Reserve. But the two functions partly overlap. If hedge funds, for example, are to be subjected to serious regulation, supervision, and examination analogous to what we expect of traditional bank examiners, that is prudential regulation. But it is also a form of investor protection. Before even considering an expanded role for the Fed, Congress should conduct a full investigation of its regulatory performance to date. Given the Fed's dismal performance as a bank and bank-holding-company supervisor and its traditional coziness with the banking industry, one should be wary of proposals to make the Fed into an uber-regulator, absent radical reform of the Fed itself, and perhaps not even then.

The prudential regulation (and hence investor protection) of financial exchanges, broker-dealers, investment offerings, mutual funds, hedge funds, private equity, credit-rating agencies, accounting standards, and of corporate finance, is best entrusted to a much strengthened SEC. The Federal Reserve's supervisory capacity needs to be dramatically upgraded before it can be fully relied upon as a prudential regulator of universal banks and their holding company affiliates.

## Regulatory Havens and International Regulatory Harmonization.

**The Federal Reserve's supervisory capacity needs to be dramatically upgraded before it can be fully relied upon.**

Effective supervision and prudential regulation is made much more difficult when regulated companies get to play off one regulator against another in search of the weakest jurisdiction (a practice known as regulatory arbitrage.) There have been sporadic efforts to address this problem, and most have failed. For example, in the 1990s, the OECD was making good progress towards an international agreement that would have shut down most offshore tax havens (which are also regulatory havens). Nations whose locally domiciled corporations or banks did any business with OECD countries would have been required to collect and share tax information with the taxing authorities of OECD countries, as these countries currently do with each other. This initiative was killed during the first month of the Bush administration. A comparable regulatory program, suggested by former German Chancellor Helmut Schmidt, would require any bank that has an account with the European Central Bank (which is to say any bank that does business in Europe) to follow common reporting rules regardless of its domicile. Tolerating hedge funds and private equity companies registered in offshore havens of non-regulation makes effective domestic regulation and private litigation far more difficult if not impossible.

With regard to bank regulation, a botched effort to impose a common regulatory regime via capital standards was attempted in the two Basel Accords (the recommendations on banking laws and regulations issued by the international Basel Committee on Banking Supervision between 1988 and 2004). These were international agreements codified in domestic law that attempted to create common worldwide standards of capital adequacy for all large banks operating globally. The problem, in practice, was that the capital standards and different classes of risk ("risk buckets") relied too heavily on the banks' own risk models and on now discredited assessments by credit-rating agencies. In practice, the Basel norms had the effect of reducing capital standards in many cases; and they created the perverse incentive of encouraging banks to creatively invent off-balance-sheet affiliates not subject to capital standards. In addition, the sole reliance on capital standards left regulators without any other form of regulatory harmonization or other strategies of prudential regulation. Capital adequacy was seen as an all-purpose risk metric; Basel provided no international regulation of financial *products.*

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In the event, all the cumulative abuses that led to the financial collapse were utterly missed by the Basel standards. Procedurally, the work of creating these standards was non-transparent, and largely unwelcoming of public comment. It took place under the auspices of the Basel Committee (an opaque and largely unaccountable body of experts created in 1974), relying on intensely engaged industry lobbyists and representatives of national regulatory authorities and central banks at a time when regulation itself was highly out of fashion, even among regulators. The Basel process was widely understood more as an effort to create a competitive level playing field for international banks domiciled in nations with divergent regulatory standards than as an exercise in prudential regulation.

The Basel Accords, whose capital adequacy standards have now been incorporated into national and European Union banking law, do suggest that banking regulation at the international level is at least possible. But just about everything else about the Accords, from their conceptual underpinnings, to the non-transparent way they were devised, to the overly deferential approach to the industry, to what they left out, has been a failure.[10]

## Historic Memory, Genies and Bottles

Why did we forget the lessons of 1929 and repeat the experience of a financial crash seeded by excessive speculation? The roots of the answer are to be found three decades ago, in a rendezvous of an accidental event with an ideological counter-revolution. The accidental event was an outbreak of hyper-inflation, resulting from the interaction of the economic stimulus of the Vietnam War, the OPEC oil price shocks, and the collapse of the Bretton Woods system of fixed-exchange rates. The decade of the 1970s turned into a difficult period for banks and thrift institutions, largely because of the way the inflation of that era destabilized both traditional business models and the existing system of prudential regulation.

One of the core pieces of New Deal regulation was limitation on the interest rates that banks could pay depositors. The architects of that regulation wisely understood that if banks began using interest rates to compete for deposits, they would be tempted to relax their lending standards in order to fetch the higher yields needed to make higher interest rates on savings accounts profitable.

But in an era of high inflation, the interest that banks were permitted to pay fell short of the rate of inflation. Depositors began deserting banks for newly invented money market mutual funds, whose ability to pass along market interest rates was unregulated. Some banks invented quasi-checking accounts known as "Negotiated Orders of Withdrawal" or NOW accounts, which were checking accounts in everything but name; unlike checking accounts, though, they paid interest. Regulators permitted these breaches in the New Deal system of prudential regulation, fearing that if they objected, banks would continue to lose funds to non-bank competitors, and the entire monetary system would be endangered.

Meanwhile, on the lending side of the ledger, banks were losing some of their bread and butter loan business to the newly burgeoning commercial paper market. Large corporations no longer needed banks for many loan transactions; they could simply sell IOUs directly in money markets, with the help of investment bankers. Banks bitterly protested to Congress that the investment banks enjoyed high returns and little regulation, while commercial banks were still shackled with Depression-era regulations that had been overtaken by events. Gradually, the regulatory agencies allowed commercial banks to do some of the things investment banks did, a process that ultimately culminated in the repeal of the Glass Steagall Act. Lost in the shuffle was historic memory of why regulation had been needed in the first place.

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By the late 1970s, both banks and thrift institutions were experiencing squeezes on their bottom lines. At a time of rising inflation and increasing interest rates, they found themselves with the precarious business strategy of borrowing short-term funds and making long-term loans, often at fixed rates. Banks and thrifts came under pressure to find new lines of business and new ways of replenishing profits. In the case of thrifts, this desire for higher earnings led to the speculative lending behavior that ended in the savings and loan collapse of the 1980s. In the case of commercial banks, it led to third world lending that also produced massive losses and the first of several government rescues in the early 1980s. Meanwhile, in the world of investment banking, new and highly lucrative strategies such as leveraged buyouts and the invention of new kinds of securities such as mortgage-backed bonds overturned a stable and secure way of life anchored in a system of prudential regulation.

By the 1980s, with the advent of the Reagan administration, piecemeal regulatory acquiescence in risky innovations, which at first had reluctantly been accepted as necessary accommodations to the inflationary environment, became pervasive and dogmatic. Ad hoc deregulation became an ideological counter-revolution. In the new climate of regulatory laxity, financial engineers took advantage to invent ever more exotic and opaque products. Middleman fees skyrocketed. The financial economy became ever further removed from the real economy.

Once it reached this tipping point, deregulation spawned more deregulation. Still-regulated entities chronically complained about being forced to compete with new players who faced none of the same constraints. With regulators generally morbidly incurious about innovations, investment bankers, bank holding companies, and their new unregulated affiliates had an easy time creating unsupervised counterparts to regulated competitors. In the 1980s and 1990s, the effort to clean up the casualties of deregulation also produced more deregulation, as regulators periodically waived rules requiring banks to mark securities down to their reduced market value, and went along with highly risky products and strategies in order to help damaged banks rebuild earnings.

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A version of this dynamic still operates as regulators try to sort out and clean up the consequences of the collapse. Today the credit system is frozen, partly because traumatized lenders are now overly reluctant to take on ordinary risks such as that of making a small business loan. Yet, at the same time, there are needed efforts in public policy to make sure that creditors shun potentially toxic risks. Some may argue: this is no time to crack down on credit standards and practices, since we want lenders to start taking risks again. But properly understood, this paradox is no contradiction. Creditors need to return to their task of supplying credit to legitimate enterprises and to the business of accurately assessing risk—that is the core function of a credit intermediary. To the extent that they are precluded from exotic gambles and the lure of easy money, they will be better able to play their proper role.

Conversely, to the extent that regulators indulge gambling behavior, they face a morning-after of having to loosen or suspend rules in order to keep the system from collapse. To generate private capital for banks, regulators find themselves pressured to waive accounting standards and to ease rules on ownership of banks by private equity firms and hedge funds, which may just be inviting new conflicts of interest.

After three decades of deregulation, it is fashionable to argue that the genie cannot be put back into the bottle. We no longer have separate categories of financial institutions. Financial transactions are global. Investors have a bewildering array of choices. Yet the speculative genie was emphatically put back in the bottle during the New Deal, and the system that followed served the real economy well for forty years. Indeed, it was a system of strict financial regulation that allowed the low interest rates of the 1940s, 1950s and early 1960s to serve the real economy rather than be squandered in wasteful speculation.

The fact is that the standard regulatory instruments are timeless, and have not been overtaken either by globalization or technology. These instruments include registration and disclosure; transparency; prudential examination to assure that standards are being followed; explicit prohibition of insider conflicts of interest; capital-adequacy and reserve requirements; accurate accounting standards; convergent global regulatory standards couples with international crackdowns on tax- and regulatory havens; effective private right of action to further deter fraud; and outright prohibition of behavior that adds more to systemic risk than to economic efficiency. Sorting out the details of the crisis will take time. But make no mistake: the challenge of putting genies back into bottles is political, not technical.

## The Case for Drastic Simplification

The purpose of the financial economy is to serve the real economy. Over the past three decades, the financial economy has departed farther and farther from that role. It has become an entity unto itself, concerned mainly with generating fee income and trading profits for insiders. There is a very strong case to be made for the drastic simplification of the American financial system. Some of the world's most rapidly growing economies such as India and China do not use the exotic financial instruments that have become pervasive in the Anglo-Saxon countries. Rather, banks supply capital to enterprises. Some of these loans may be ill advised, especially in the case of China. But that hasn't prevented the Chinese economy from growing at rates of ten percent for two decades now. If there were something to the story that financial engineering significantly adds to economic efficiency, we should have seen it in higher domestic growth. In fact, much of what we took for growth was just a financial bubble.

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In a more rudimentary banking system whose function was to serve the real economy, banks would accept deposits and make loans. Investment bankers and venture capitalists would raise funds for enterprises. But there would be far less in the way of second-, third-, and fourth-order financially engineered "products." All credit-intermediaries would be well regulated. The whole system would be more transparent to consumers, investors, and regulators.

In the recent past, the burden of proof was on those who sought to constrain newly invented financial instruments. But now that all this innovation has produced the most serious crash since the Great Depression, it is time to shift that burden and make it acceptable to ask: *what do these innovative instruments and financial techniques really add to economic efficiency*? Do they add to the supply of credit and "spread risk" in a wholesome and efficiency-enhancing way? Or are they primarily devices to generate fees for middlemen and pass risk along to someone else, adding nothing of value to the real economy, undermining rather than enhancing efficient pricing—and increasing systemic risk?

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This raises another question. In a drastically simplified system, how will banks earn normal profits? And how much profit do they really need in order to play their intermediary role of connecting savers or investors with borrowers and entrepreneurs? As noted, much of the financial engineering of recent decades was merely an effort to increase middleman earnings, not to improve "financial services." In this decade, a wildly disproportionate percentage of total corporate earnings came from the financial services industry. Now, much of that profitability has been revealed as illusory or unsustainable. It was built either on outright fraud or on unsavory practices that either will no longer fetch buyers or that need to be constrained for the health of the larger economy. It is hard to escape the conclusion that a financial sector with more modest aspirations, pretensions, fees and earnings is just what the real economy needs—a sector more like a public utility.

These are frankly radical ideas—radical in the sense of challenging both entrenched financial interests and conventional views of governments and markets. They were radical eight decades ago when Franklin Roosevelt succeeded in bringing financial markets under a degree of regulation in the public interest. They are just as radical today, because financial entrepreneurs and their political allies still resist constraints on their ability to profit.

Despite the disgrace of Wall Street and the collapse of the ideology of deregulation, we have not yet rebuilt a broadly shared philosophy of necessary regulation. For the most part, the financial industry and its allies in government continue to lobby fiercely for policies to pump the bubble economy back up, and against policies that would prevent abuses and protect us against future bubbles and bailouts. On multiple fronts, the Obama administration faces the most serious economic challenges since the 1930s. And the task of harnessing financial markets to serve a broad economic interest will be the most politically arduous of all.

# ENDNOTES


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