Consumer Federation of America
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# REFORM OF FINANCIAL MARKETS

## THE COLLAPSE OF MARKET FUNDAMENTALISM AND THE FIRST STEPS TO REVITALIZE THE ECONOMY

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CONTENTS

**ISSUE BRIEF** 1

THE CONTEXT OF THE CURRENT CRISIS
THE RISE AND FALL OF MARKET FUNDAMENTALISM
THE FLAWS IN MARKET FUNDAMENTALISM
RESTORING PRUDENTIAL OVERSIGHT OVER FINANCIAL MARKETS
CONCLUSION

**I. THE LOOMING BATTLE OVER REGULATORY REFORM IN FINANCIAL MARKET** 15

THE CONTEXT OF THE CURRENT CRISIS
THE RISE AND FALL OF MARKET FUNDAMENTALISM
REFRAMING THE DEBATE OVER ECONOMIC POLICY
PURPOSE AND OUTLINE OF THE PAPER

**II. THE FAILURE OF FINANCIAL MARKETS** 30

THE FLAWS IN MARKET FUNDAMENTALISM
SIX CRITICAL CHALLENGES
Moral Hazard
Transparency and Asymmetric Information
Perverse Incentives
Agency
Conflicts of Interest
Unfairness/Inequality

**III. THE ROLE OF PUBLIC POLICY IN THE FINANCIAL CRISIS** 49

POLICY CHOICES MAGNIFIED THE FLAWS IN MARKET FUNDAMENTALISM
RESPONSIBILITY FOR DISMANTLING THE INSTITUTIONS OF PRUDENTIAL REGULATION

**IV. PRUDENTIAL REGULATION** 67

RESTORING PRUDENTIAL OVERSIGHT OVER FINANCIAL MARKETS
MORAL HAZARD
INFORMATION
PERVERSE INCENTIVES
AGENCY
CONFLICTS OF INTEREST
UNFAIRNESS/INEQUALITY

IV. GETTING REGULATORY REFORM RIGHT 84

AN EXAMPLE OF EFFECTIVE PRUDENTIAL REGULATION
TIMIDITY IN THE FACE OF CRISIS CAN LEAD TO AN INADEQUATE RESPONSE

V. CONCLUSION 98

APPENDIX A: OBSERVATIONS ON THE NEW DEAL ECONOMIC PARADIGM AND THE DISTINCTION BETWEEN THE FINANCIAL SECTOR AND THE REAL ECONOMY 101

APPENDIX B: SIDE-BY-SIDE POLICY RECOMMENDATIONS 104

## LIST OF TABLES

TABLE ES-1: DETAILED CONGRESSIONAL OVERSIGHT PANEL RECOMMENDATIONS 2

TABLET ES-2: DETAILED GROUP OF THIRTY RECOMMENDATIONS 3

TABLE ES-3: INITIAL PROPOSALS OF THE OBAMA ADMINISTRATION 6

TABLE I-1: THE GROUP OF THIRTY RECOMMENDATIONS AS SOLUTIONS TO PROBLEMS IN DEREGULATED FINANCIAL MARKETS 17

TABLET I-2: THE CONGRESSIONAL OVERSIGHT PANEL RECOMMENDATIONS AS SOLUTIONS TO PROBLEMS IN DEREGULATED FINANCIAL MARKETS 18

TABLE I-3: INITIAL PROPOSALS OF THE OBAMA ADMINISTRATION 20

TABLE II-1: CONDITIONS FOR ASSET BUBBLES 37

TABLE III-1: AREAS OF CONCERN IN THE 1998 CFTC CONCEPT RELEASE ON DERIVATIVES 58

TABLE III-2: MAJOR LEGISLATIVE AND REGULATORY FAILURES IN THE PAST DECADE 60

TABLE III-3: REQUEST FOR COMMENT IN THE 1998 CFTC CONCEPT RELEASE ON DERIVATIVES 62

TABLE IV-1: DETAILED CONGRESSIONAL OVERSIGHT PANEL RECOMMENDATIONS 68

TABLE IV-2: DETAILED GROUP OF THIRTY RECOMMENDATIONS 69

TABLE V-1: POLICY RECOMMENDATIONS OF LITAN/BAILY 97

LIST OF FIGURES

FIGURE ES-1: HISTORY OF MAJOR DOMESTIC FINANCIAL CRISES 7

FIGURE I-1: HISTORY OF MAJOR DOMESTIC FINANCIAL CRISES 22

FIGURE II-1: INSTITUTIONAL WEAKNESS AND BEHAVIORAL FLAWS IN DEREGULATED FINANCIAL MARKETS 33

FIGURE V-1: REAL HOUSEHOLD NETWORK WORTH, COMPOUND ANNUAL GROWTH RATES 90

FIGURE V-2: INDICATORS OF REAL ECONOMY PERFORMANCE, 1945-2000 V. 2001-2008 91

FIGURE V-3: THE BREAKDOWN OF SECURITIZATION IN THE LITAN/BAILY ANALYSIS 93

FIGURE A-1: STRUCTURE-CONDUCT-PERFORMANCE (SCP) PARADIGM OF INDUSTRIAL ORGANIZATION 102

FIGURE A-2: ADJUSTING THE SCP PARADIGM IN RESPONSE TO THE IMPORTANCE OF BEHAVIORAL ECONOMICS IN THE FINANCIAL SECTOR 104

FIGURE B-1: SYSTEMIC RISK 105

FIGURE B-2: INFORMATION/ACCOUNTING 106

FIGURE B-3: INCENTIVES 107

FIGURE B-4: AGENCY/CONFLICTS OF INTEREST 108

FIGURE B-5: UNFAIRNESS/PREPARE FOR FUTURE 109

# REFORM OF FINANCIAL MARKETS

## THE COLLAPSE OF MARKET FUNDAMENTALISM AND THE FIRST STEPS IN REVITALIZING THE ECONOMY

# Issue Brief

### The Context of the Current Crisis

Over the course of the past year, the nation has experienced a collapse of its financial markets that has plunged the real economy into a deep recession. As a subprime mortgage crisis has morphed into a global financial catastrophe, it has become increasingly clear that nothing in recent history comes close to the current situation other than the Great Depression of the 1930s. The crisis is so severe and its onset so (apparently) sudden that almost all analysts have realized this is not a routine downturn in the business cycle, and business as usual responses will be insufficient to solve it. The search for more aggressive policy responses has triggered both a hunt for the root causes of the crisis and growing calls for sweeping reforms of our system of financial regulation.

This paper examines how "market fundamentalism" – the dominant regulatory philosophy of the past three decades – led to the current crisis. The purpose of the paper is to provide a general explanation of the key factors that have caused the failure of market fundamentalism and, based on that analysis, to identify the principles that must be embodied in proposals to repair, reform and rebuild the economy. We organize that analysis around the recommendations of high-profile regulatory reform proposals released in recent months by the Group of Thirty and the Congressional Oversight Panel. While neither proposal is likely to be seen as a perfect embodiment of all public interest group priorities for reform, both recognize the failure to impose effective prudential regulation on financial institutions and products as a root cause of the crisis and both make a strong and compelling case for a dramatic increase in oversight of financial markets. The Group of Thirty report frames the challenge starkly: "How can we restore strong, competitive, innovative financial markets to support global economic growth without once again risking a breakdown in market functioning so severe as to put the world economies at risk" (Group of Thirty, *Financial Reform: A Framework for Financial Stability* (Washington, D.C. January 15, 2009), p. 4.).

This is, in our view, the correct question for policymakers to ask, but it needs to be answered in a comprehensive and rigorous fashion. This paper places the recommendations of the Group of Thirty and the COP in the context of six fundamental flaws that afflict market fundamentalism, as described in Tables ES-1 and ES-2. The overarching conclusion we reach, based on our analysis, is that we do not need a new, New Deal. Nor do we need to resort to some radical, untried experiment to solve our financial problems. Market fundamentalism was the radical experiment that pushed deregulation much too far in the financial sector. To cure its excesses, we need to rediscover the pragmatic, progressive values of the original New Deal. We need to return to the principles and restore the institutions of New Deal prudential regulation.

*Table ES--1: Detailed Congressional Oversight Panel Recommendations*

**Moral Hazard**

- 1. Identify and Regulate Financial Institutions that Pose Systemic Risk
  - Systemic Risk Regulator
    - Authority
    - Tools
    - Reporting
  - Heightened Regulation
    - Countercyclical Capital
    - Insurance
    - Strict Leverage Ratios
    - Strict Capital Ratios
    - Limits on Contingent Liability
    - Limits on Off-Balance Sheet
    - Caps on Short-Term Debt
    - Caps on Taxpayer Exposure
    - Receivership and Liquidation Process
- 8. Prepare for Next Crisis
  - Financial Risk Council
  - Dedicated to Task
  - Diverse Points of View
  - Broad Perspective
  - Multiple Specialized Analytic Tools
  - Formal Reporting

**Information/Accounting**

- 3. Shadow Banks
  - Public Reporting
    - Positions
    - Transaction
- 6. Reform Credit Rating
  - Implement Overnight Authority
    - Registration
    - Recordkeeping
    - Reporting
  - Re-evaluate Models
    - Assumptions
    - Embedded Structuring

**Incentives**

- 2. Limit Excessive Leverage
  - Objectives Based Capital
  - Leverage rqts
  - Counter Cyclical Capital
  - Liquidity Rqts
- 3. Supervise Shadow System
  - Safety Reg.
  - Regulate Activity/Products
  - OTC
    - Clearing House
      - Margins
      - Mark-to-Market
    - Guaranty Funds
  - Exchange Traded Derivs.
    - CEA Contract Rules
    - Registration
    - Reporting
    - Capital Rqts
- 7. Global Regulatory Floor
  - Establish Regulatory Floors & Harmonize
  - Coordinate Surveillance
  - Strengthen Communications & Cooperation
  - Target Systemic Institutions

**Agency**

- 5. Reform Executive Pay
  - Tax Incentives
  - Asymmetric Pay
    - Options
    - Severance
  - Claw Back
  - Corporate Governance
    - Strengthen Bd.
    - Long-Term Focus
- 6. Reform Credit Rating
  - Eliminate or Scale back NRSRO designation
  - Credit Rating Rev. Brd.
    - ex ante review
    - ex post auditing

**Conflicts of Interest**

- 6. Reform Credit Rating
  - Close Revolving Door
  - Change Fee System
  - Promote Competition
  - Impose Liability

**Unfairness/Inequality**

- 4. New System for Mortgage and Consumer Credit
  - Allow States to Enforce Laws on National Banks
  - Create a Single Federal Consumer Credit Regulator

**Source: Congressional Oversight Panel, *Special Report on Regulatory Reform,* January 29, 2009.**

## *Tablet ES-2: Detailed Group of Thirty Recommendations*

| | Problems | | | | | | |
|---|---|---|---|---|---|---|---|
| | Moral Hazard | Information/Accounting | Incentives | Agency | Conflicts of Interest | Agency | Unfairness |
| Solutions | | | | | | | |
| Filling Gaps | 1a - "Too Big to Fail" Banks | 4a -Registration and Reporting | 1b - Capital & Margin Rqts | 1b -Ownership Interest | 1b - Ban/Control of Comingling | 1b -Ownership Interest | |
| | Single Regulator | | | | | | |
| | Size Based Scrutiny | 4b - Reporting Rqts | 2a - Consolidate Regulation | | | | |
| | National Limits | | | | | | |
| | | 4b - Disclosure Stds | 2b - Non-banks | | | | |
| | 1c - Separation of Banks/Nonbanks | | | | | | |
| | | | 3a - Bank-like Mutual Funds | | | | |
| | 3b - Mutual Funds | | | | | | |
| | Reorganize | 4a - Public Disclosure for Private Pools | 4a - Register Private Pools | | | | |
| | Differentiate | | | | | | |
| | Conservative Investment | | 4c - Regulate Lg Private Pools | | | | |
| | | | Capital | | | | |
| | 5a - GSEs | | Liquidity | | | | |
| | Separation | | Risk mgmt | | | | |
| | Public Delimitation | | | | | | |
| | | | 4d - Off Shoring | | | | |
| | | | Regulation at Business Location | | | | |
| | | | 6a - Fix regulation | | | | |
| | | | Gaps | | | | |
| | | | Overlaps | | | | |
| | | | Complexity | | | | |
| | | | Remove opportunity for arbitrage | | | | |
| Prudential | 7c- Access to Liquidity | 8a - International Information Sharing | 7a - Central Bank Role in Stability | | | | |
| Regulation | | | Crisis and Expansion | | | | |
| | 7d - Emergency Lending Authority | 8b - Gather Information on Leverage | Participation in Governance | | | | |
| | | | Input into key regulations | | | | |
| | 7e - Limitations on Liquidity Actions | | Supervisory role in | | | | |
| | | | lg firms, payment and clearing | | | | |
| | | | 8a - Offshoring | | | | |
| | | | Delineation of Responsibilities | | | | |
| | | | Close Gaps | | | | |
| | | | Raise Standards | | | | |
| | | | Intl Standards | | | | |
| | | | 8b Define Leverage | | | | |
| | | | 8c - Formal Regional Mechanisms | | | | |

| | Problems | | | | | | |
|---|---|---|---|---|---|---|---|
| | Moral Hazard | Information/Accounting | Regulation of Incentives | Agency | Conflicts of Interest | Agency | Unfairness |
| | Problems | | | | | | |
| | Moral Hazard | Information/Accounting | Incentives | Agency | Conflicts of Interest | Agency | |
| Solutions | | | | | | | |
| Standards | | | Tolerance | Compensation | Indep. Board Members | Compensation | |
| | | 11c - Liquidity Disclosure Stds | Profile | Risk Mgmt Policies | | Risk Mgmt Policies | |
| | | | | | 9c - Independence | | |
| | | 12a - Reevaluate Fair Value | 9e - Periodic Review of Profiles | | Auditing | | |
| | | | | | Risk Mgmt | | |
| | | 12c- Credit Loss Reserves Principles | 9f - Assessment of Counterparies | | | | |
| | | | | | 12b - Accounting Stds | | |
| | | 12c - Transparency of Reserve Determination | 9g - Accept CRMPG and IIF | | Reevaluate Fair Value | | |
| | | | 10a - Raise Capitalization Stds | | | | |
| | | | 10b - Upper End of Guidance | | | | |
| | | | 10c- Reevaluate Definition of Capital | | | | |
| | | | 11a - Diversified Mix & | | | | |
| | | | Cushion of Liquidity | | | | |
| | | | 11b - Liquidity Stds | | | | |
| Transparency | 16a - Closing of Regulated Banks | 13a -Securitized & Structured Assets | 13a -Securitized/Structures' Assets | 13b - Securitization | 14a - Indep. Internal Risk Rating | 13b - Securitization | |
| | | Disclosure = Securities | Regulatory Stds = Securities | Retain Credit Risk | | Retain Credit Risk | |
| | 16a - Non-Depository Insts | | | | 14c - Payment to Align Incentives | | |
| | Resolution of Failed | 13c - Off Balance Sheet Vehicles | 14b - Rating Agencies | | | | |
| | Regulated only | | Accountability for Quality | | | | |
| | Establish Regulator as Receiver | 15b - Share Information on CS=DS and OTC | More Robust Valuation | | | | |
| | | 17a - Asset Backed Products | 15a - Regulate OTC Derivatives | | | | |
| | 16d- Special Treatment of Contract | Determine Disclosure Info | | | | | |
| | | | 17b - Structured Product | | | | |
| | | 18 - Evaluate Higher Level of Transparency | Regulated Disclosure | | | | |

**Source: Group of Thirty, *Financial Reform: A Framework for Financial Stability* (Washington, D.C. January 15, 2009)**

The administration has begun to articulate its proposal for regulatory reform of financial markets, and the initial signs are encouraging. They have adopted an appropriately broad view of the crisis. In congressional testimony to introduce the first elements of the plan, Treasury Secretary Timothy Geithner said, for example, that "our system failed in basic fundamental ways." (Testimony of U.S. Secretary of Treasury Timothy F. Geithner before the Committee on Financial Services, U.S. House of Representatives, March 26, 2009.) In describing that failure, he cited many of the individual problems we analyze in this report:

> The system proved too unstable and fragile, subject to significant crises every few years … Innovation and complexity overwhelmed the checks and balances in the system. Compensation practices rewarded short-term profits over long-term return … The huge apparent returns to financial activity attracted fraud on a dramatic scale. Large amounts of leverage and risk were created both within and outside the regulated part of the financial system.

"To address this will require comprehensive reform. Not modest repairs at the margin, but new rules of the game," he added.

Ultimately, Geithner said, the administration's regulatory reform plan will cover four broad areas: systemic risk, consumer and investor protection, eliminating gaps in our regulatory structure, and international coordination. This list of priorities indicates a willingness to define the solution broadly. Although the administration has pledged to move on its broader agenda in the near future, its initial recommendations cover the area of systemic risk and this is reflected in the detail provided in Table ES-3.

## The Rise and Fall of Market Fundamentalism

Market fundamentalism had its symbolic birth when former President Ronald Reagan famously declared in his first inaugural address that, "Government is not the solution to our problems. Government is the problem." The term market fundamentalism, which has previously been used by Nobel Laureate economist Joseph Stiglitz, refers to an ideology that places an almost religious faith in the workings of the free market. The cornerstone of this philosophy is the efficient market hypothesis. This is the belief that the pursuit of private interest through unregulated markets is all we need to promote the public good, because markets inevitably create efficiency, growth and stability. The efficient market hypothesis has proven to be a fallacy, as have two other tenets of market fundamentalism – the "trickle down" economics hypothesis, which claimed that inequality does not matter, and the " less government the better hypothesis," that claimed that anything that government did was worse than doing nothing.

As long as the institutional structures and prevailing philosophy of the New Deal

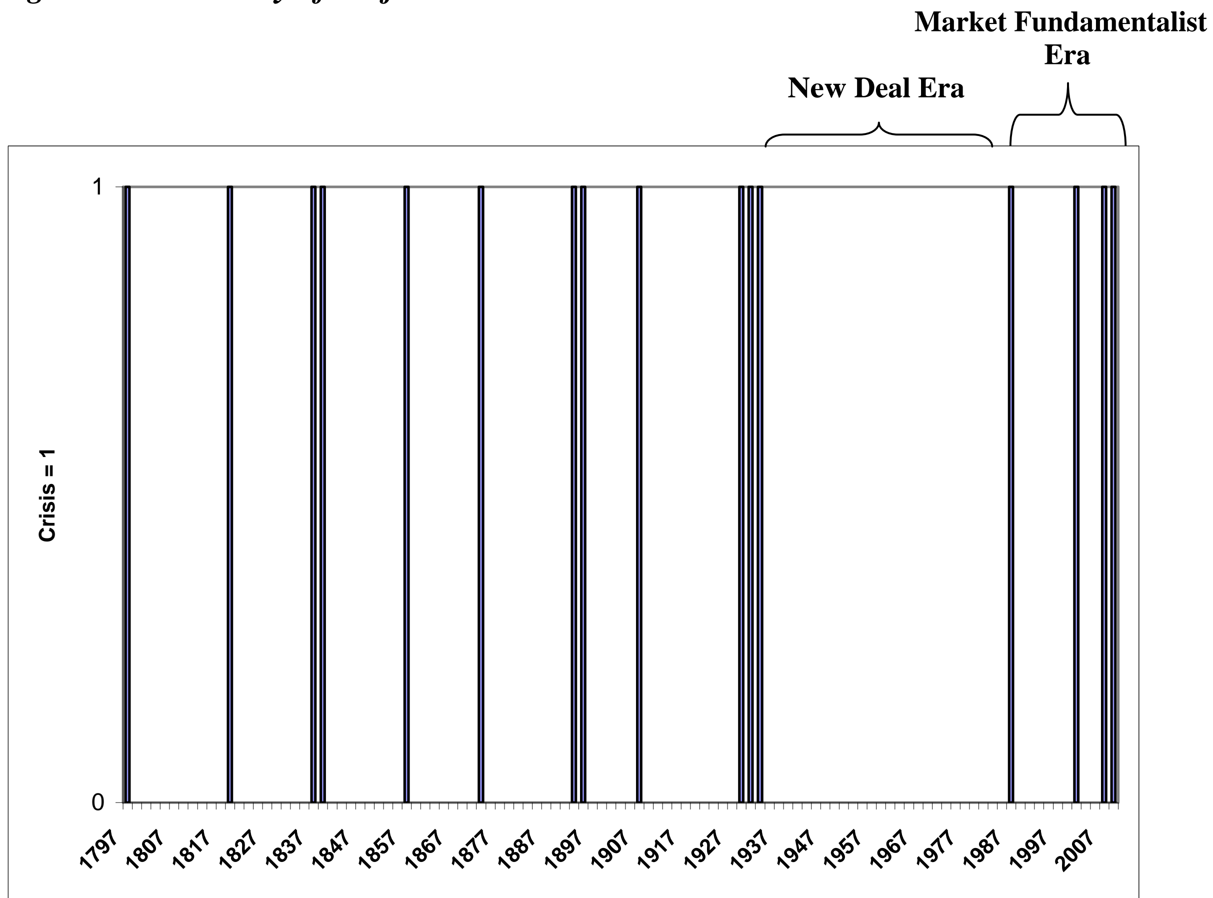
### *Table ES--3: Initial Proposals of the Obama Administration*

| Moral Hazard | Information/Accounting | Regulation of Incentives | Agency | Conflicts of Interest | Unfairness/Inequality |
|---|---|---|---|---|---|
| | | | | | |
| Not Just Institutions, but he System | SEC Disclosure for Registered | Leveraged Private Investment | Executive Compensation | | Strengthen Consumer and Investor |
| | Hedge Funds | Register with SEC | Improved risk Mgmt. | | Protection |
| Single Entity | | | Long term focus | | |
| | | Do Not Ban Products | | | Federal Product Safety Bd? |
| Risk Sensitive Prudential Reg. | | | | | |
| Counter Cyclical Rqts. | | Money Market Funds | | | |
| Size/Risk sensitive | | SEC reduce risk of rapid | | | |
| capital | | withdrawal | | | |
| reserves | | | | | |
| liquidity | | Hedge Funds and Private Pools | | | |
| | | Close gaps | | | |
| Conservative Capital | | Register at SEC if big | | | |
| Further into the tails of outcomes | | Report to asses threat | | | |
| Liquidity constraints | | shared with regulator | | | |
| Aggregate counterparty risk | | | | | |
| | | CDS and OTC Derivatives | | | |
| SIF Defined | | Supervise SIF scale firms | | | |
| Size | | Standardized through clearing | | | |
| Interdependence | | Supervise clearing | | | |
| Leverage (include off balance sheet) | | Greater use of exchanges | | | |
| Reliance on short term funding | | Nonstandardized | | | |
| Importance as source of credit | | Document | | | |
| | | Confirm trades, netting, | | | |
| Resolution Mechanism | | collateral margin, & | | | |
| FDIC Process for New Institutions | | close-out practices | | | |
| Institution covered include | | | | | |
| Banks and Thrift Holding Cos | | Intl. Coordination | | | |
| Insurance Cos | | Prudential Supervision | | | |
| Futures Merchants | | Address Tax Havens & Money | | | |
| Any other SIF | | Laundering | | | |

**Source: Testimony of U.S. Secretary of Treasury Timothy F. Geithner before the Committee on Financial Services, U.S. House of Representatives, March 26, 2009**

remained in place in the financial sector, financial crises remained manageable, and the country experienced a prolonged period of economic growth and financial stability. (See Figure ES-1) In contrast, during the past 30 years in which the market fundamentalist philosophy has prevailed, we have witnessed a series of domestic economic crises and financial meltdowns. Beginning with the S&L crisis of the 1980s, these have included the derivatives crisis of 1994, the collapse of a famous hedge fund, Long Term Capital Management, the tech stock bubble, the Enron fiasco and accompanying accounting scandals, the energy speculation bubble, and the housing bubble. There have also been three recessions and a series of foreign financial and economic crises. In short, barely a year went by in which one could not find a major market failure that should have raised loud alarms about the economic structure that we were building in the world. This time, things are much worse, and policymakers are forced to pay attention.

***Figure ES-1: History of Major Domestic Financial Crises***




**Sources: Congressional Oversight Panel, *Special Report on Regulatory Reform,* January 29, 2009.**

If President Reagan's inauguration marked the symbolic ascendance of market fundamentalism, ironically, its collapse was symbolically announced last October by former

Federal Reserve Chairman Alan Greenspan, one of the leading architects and advocates of deregulation of financial markets. In congressional testimony, Greenspan, admitted to a major flaw in the theory.

> Those of us who looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets state of balance…
>
> If it fails, as occurred this year, market stability is undermined…
> I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms (U.S. House of Representatives, Committee on Oversight and Government Reform, October 23, 2008)

Public interest advocates have long held that the pursuit of private profits is not synonymous with the public good. The constant stream of crises and meltdowns during the ascendance of market fundamentalism provided more than adequate fuel to sustain this belief. In his remarkable admission, Greenspan went one step further and acknowledged, in blunter and clearer language than has been his practice, that the pursuit of private profit is not necessarily synonymous with the private good.

**The Flaws in Market Fundamentalism**

Left to its own devices, the market suffers from inherent or endemic flaws as a result of which it fails to consistently achieve its primary function of efficiently allocating resources to uses. These flaws are highly inter-connected, so one could draw the lines and distinctions between problems in various ways. The important lesson is that there is a nexus of problems that plagues market fundamentalism in the financial sector and leads to its failure to execute its proper function in the economy.

Moral Hazard: In the finance sector, there has long been a tendency to shift costs and risks onto the backs of taxpayers, where the government guarantees the ultimate soundness of financial institutions, either directly through insurance, or indirectly, by conceding that some institutions are "too big to fail." The shift of risk is highly visible where the government acts as insurer, and the counterbalance to that risk was supposed to be vigorous government regulation to constrain risky behavior. But market fundamentalism led to weak government oversight even at insured institutions. Financial institutions outside the insurance system were even less constrained in the risks they could assume. As a result, the government has been driven to bail out not only banks and the government sponsored enterprises, Fannie Mae and Freddie Mac, but also investment banks and insurer AIG. What was once an abstract threat – that financial institutions would take irresponsible risks in the confidence that the government would bail them out – has become a pressing reality.

Transparency and Asymmetric Information: The second flaw that receives a great deal of attention in discussions of the current financial crisis is information transparency. The availability of information is central to the operation of efficient markets. Lack of transparency makes it difficult to evaluate risk and achieve efficient outcomes, while asymmetry of information between management, stockholders and the public provides an open invitation for mischief. These problems have been manifest in the current crisis in a host of ways, including collateralized debt obligations so complex as to be completely opaque even to many who bought and sold them; financial institutions who used accounting maneuvers to move risky assets off their balance sheet in ways that were supposed to be outlawed after the Enron scandal; and intricate inter-connections of institutions through over-the-counter derivatives transactions that left participants in the dark about the nature and scope of counter-party risk to which they were exposed.

Key players who had critical roles in the information chain had massive conflicts of interest that either blinded them to risks or made them reluctant to convey that information to other market participants. As a result, the quality of information was abysmal. This includes credit rating agencies, whose AAA ratings were essential to creating a market for mortgage-backed securities. Paid by issuers, the ratings agencies' profitability depended on their ability to win market share in the highly lucrative business of rating structured finance deals, and their ability to win that business too often depended on the "flexibility" of their ratings. Investment bankers, meanwhile, were responsible both for ensuring that credit rating agencies received complete and accurate information regarding the securities they were to rate and that investors received full and fair disclosure regarding the deal. But the massive fees they earned underwriting the securities left them with little incentive other than the public interest to fulfill their information responsibilities diligently.

Perverse Incentives: Market fundamentalism has a pervasive incentive problem that creates an engine of instability in the structure/conduct heart of the unregulated financial market. This was evident in the current crisis, where a daisy chain of conflict-ridden market participants spread the risks from unsound mortgage loans into every corner of the global financial markets. As fees from making deals became a major source of income, the quality of the deals mattered less and less. After all, the deals could always be sold by conflict-ridden brokers, supported by loans from conflict-ridden banks, securitized by conflict-ridden investment banks, rated by conflict-ridden credit rating agencies, and moved off the balance sheets so that more deals could be made and more fees earned. As long as more money could be pulled in, the day of reckoning could be pushed off. The structure of income and compensation created a perverse incentive to pump up fees and bonuses, with little regard to the quality of the underlying assets and loans.

Agency: The separation of ownership and control has long been recognized as a social problem for the capitalist economy, but the incentive structures of market fundamentalism make it urgent. Stiglitz has described a powerful interaction between

information, agency, incentive structures and conflicts of interest. Because of imperfect information, it is often difficult to make sure that an agent does what he is supposed to do. Because of the failure to align incentives, it is often the case that he does not.

The problems of agency and perverse incentives intersect in a highly visible issue in the current context – executive compensation. Compensation packages for financial industry executives not only increased dramatically in recent years, but also took on a structure that introduced short-term bias in business decision-making. Hedge fund manager David Einhorn described this phenomenon in a recent speech on "Private Profit and Socialized Risk." Noting that investment banks pay out 50 percent of revenues as compensation, he said, "the management of the investment banks did exactly what they were incentivized to do: maximize employee compensation … So, more leverage means more revenues, which means more compensation. In the good times, once they pay out the compensation, overhead and taxes, only a fraction of the incremental revenues fall to the bottom line for shareholders." In the bad times, as we have recently seen, the results for shareholders are cataclysmic.

Conflicts of Interest: Conflicts of interest pervade the financial system. We have already mentioned the key role that conflicts at credit rating agencies and investment banks played in bringing about the current crisis through its impact on information. However, conflicts of interest can and do take many other forms as well. When, for example, a single entity owns both an insured business (e.g. a commercial bank) and an uninsured business (an investment bank), or both regulated and unregulated subsidiaries that deal with each other, there is a powerful conflict of interest. Profit can be increased by having the insured (regulated) entity, which is not supposed to get into risky lines of business, subsidize the uninsured (unregulated) ventures that do get into riskier businesses, with imprudent loans. Or unregulated entities (such as off-balance sheet investment vehicles) can be used to hide risks assumed by the regulated entity (bank) in order to evade capital requirements designed to protect against risks to taxpayers.

At the extreme, where agents not only pursue their interests at the expense of shareholders and the public, but also do so illegally, conflicts of interest become fraud. Fraud is not unique to market fundamentalism, but the institutional structure creates a fertile field for an endemic fraud problem. High stakes, lax oversight, creative accounting and a short-term perspective are conducive to fraud. In an environment that emphasizes short-term stock market returns and allows risk takers to take out earnings quickly, practices degenerate. As the bad actors get their short-term rewards, the good actors become desperate to keep up. In fact, given the structural conduciveness to fraud and the structurally induced race to the bottom in ethics, it is fair to argue that market fundamentalism has a uniquely endemic fraud/abuse problem.

Unfairness/Inequality: The five flaws described above have all been recognized as creating a potential for market failures in unregulated markets. In its report on financial regulatory reform, the Congressional Oversight Panel adds a sixth – unfairness. Unfairness

in transactions, the COP argues, can starve the system of resources, raising costs and restricting activity. It describes two categories of problems, outright deception and fraud on the one hand and a more subtle problem that exists when parties to a transaction are unfairly matched. In addition to threatening the flow of resources into the system, unfairness in transactions can result in misallocation of resources, as lenders take advantage of overmatched borrowers, for example.

This broader conceptualization of the importance of unfairness/inequality as a supply-side issue fits the current crisis in another sense, which is a demand side problem. The severe increase in inequality of income and resources that took place during the reign of market fundamentalism resulted in a failure of incomes to keep up with the rapid expansion of the production capacity of the economy. The rising cost of necessities – housing, education, health care, and energy – put severe stress on household budgets, causing them to plunge into debt to maintain their standard of living. Savings are too low, and concentrated wealth creates rampant speculation rather than productive investment in the real economy.

**Restoring Prudential Oversight over Financial Markets**

In recent months, two high profile reports have been issued that reflect the immense scope of regulatory reform that is needed to address the collapse of market fundamentalism in the financial sector. In January, the Group of Thirty, a prestigious group of international financial and economic experts, issued a report calling for a dramatic increase in regulatory oversight of financial markets, including more than four dozen specific principles intended to achieve four core recommendations: 1) eliminating gaps and weaknesses in coverage of prudential regulation and supervision so that all systemically significant financial institutions are subject to appropriate oversight; 2) improving the quality and effectiveness of prudential regulation and supervision; 3) strengthening institutional policies and standards, particularly with regard to corporate governance, risk management, capital, and liquidity; and 4) making financial markets more transparent, with better aligned risk and prudential incentives.

Two weeks later, the Congressional Oversight Panel, established by Congress to oversee the Troubled Asset Relief Program, issued its own report with a similar thrust. The COP Report organized its recommendations into eight broad categories covering much the same ground as the Group of Thirty: 1) identify and regulate financial institutions that pose systemic risk; 2) limit excessive leverage in American financial institutions; 3) increase supervision of the shadow financial system; 4) create a new system for federal and state regulation of mortgages and other consumer credit; 5) create executive pay structures that discourage excessive risk-taking; 6) reform the credit rating system; 7) make establishing a global financial regulatory floor a U.S. diplomatic priority; and 8) plan for the next crisis.

This report analyzes those recommendations in light of how they address the flaws previously identified with market fundamentalism.

**Moral Hazard:** The COP makes two broad recommendations on moral hazard. First, it calls for a systemic risk regulator with adequate authority and tools to identify and regulate systemic risk. It then identifies numerous specific policies that are intended to reduce systemic risk. The Group of Thirty recommendations on moral hazard identify the products and institutions that put the taxpayer at risk and propose a variety of mechanisms to reduce the exposure to risk through federal backing of institutions. In some cases, it advocates banning relationships that create the moral hazard. In others, it would place limits on the extent of exposure by regulating the product or the institution. Interestingly, it also contemplates limiting the size of institutions that are insured and advocates a sliding scale of reserves to reduce the exposure of the public. One of the interesting new wrinkles in thinking about dealing with systemic risk in both sets of recommendations is the recognition that more attention needs to be devoted to setting up procedures for liquidation of loans (and institutions) in default.

Both also declare a need to prepare for the next crisis. The COP proposes to do so by creating a new entity dedicated to the task of assessing systemic risks to the financial system. It recommends that this entity be made up of diverse points of view, take a broad perspective on potential threats, use multiple, sophisticated modeling techniques, and report to the Congress on its findings. In contrast, the Group of Thirty recommends formalizing and circumscribing the new role for the central bank in ensuring stability. This issue of where that responsibility should reside could prove controversial, with some arguing as the Group of Thirty does that the Fed should play this role and others arguing just as vigorously that the Fed is ill-suited to this function. Despite the brewing debate on this question of jurisdiction, the concept of enhanced systemic risk regulation has broad support, and the need for better preparation for future crises is an important area of agreement.

**Information:** The COP report offers policy recommendations to improve information in two areas – shadow banking and credit rating agencies. For shadow banking, public reporting of positions and transactions is recommended. Since credit rating provides such a vital function, the COP recommends an oversight authority and a re-evaluation of their models. The Group of Thirty also calls for greater transparency and higher quality of information and accounting, including by making information disclosure a requirement to offer products both to the public and in the currently unregulated private markets.

**Perverse Incentives:** The COP report identifies three areas of policy to address perverse incentives – excessive leverage, shadow banking and international regulation. The report recommends four policies to limit leverage, and it proposes to extend regulation to over-the-counter markets and pull derivatives into exchanges, where traditional tools of prudential regulation would apply. The Group of Thirty recommends that the full range of classic instruments of prudential regulation of financial institutions be strengthened. This includes defining capital and setting strong capital and margin requirements as well as enhanced monitoring of the status of institutions with a new view of risk, leverage and liquidity. It is similarly comprehensive and detailed in its call to extend regulation to the

shadow banks and bank-like institutions that have come to play such a large role in financial markets.

The perverse incentive in the international arena is forum shopping for the least regulated haven, which creates a race to the bottom for regulation. The COP proposes to negotiate a regulatory floor, harmonize regulation across nations, and improve communications, cooperation and surveillance, focusing on systemic risks. The Group of Thirty has a similar call for international cooperation, with less detail.

**Agency**: The COP report identifies two problems of agency that afflicted the financial system as configured in recent years: executive compensation and the role of credit rating agencies. It suggests that the agency problem that afflicts credit rating agencies could be addressed by creating a public entity that would have to sign off on any rating before it took on regulatory significance. The COP calls for reform of executive compensation to better align executive incentives and actions with the long-term interests of shareholders, and it identifies tax incentives, asymmetric pay and clawback of pay as areas for policy improvement. Both the COP and the Group of Thirty also identify corporate governance as an area for institutional improvements, particularly with regard to executive compensation and risk management. In addition, the Group of Thirty recommends that originators of loans be required to retain substantial ownership interest in those assets.

**Conflicts of Interest:** The COP report focuses its conflict of interest recommendations on the credit rating agencies, advocating that the revolving door between the industry and the agencies should be closed, the payment system altered and liability imposed. It also suggests policies to increase competition. While the perverse incentives of conflicted rating agencies are given explicit attention in the Group of Thirty Report, it discusses a broader range of policy responses. Reducing conflicts of interest is handled in the Group of Thirty Report much like the reduction of moral hazard, with a mix of bans and regulatory oversight intended to reduce the problem. Comingling of regulated and unregulated business is discouraged. Conflict of interest is also addressed by creation of independent internal and external governance and evaluation of risk.

**Unfairness and Inequality:** The COP recommendations focus on the endemic problem of unfairness and inequality in two major areas – mortgage and consumer credit. Here the mismatch is severe, and the report lists a variety of conditions and exploitative practices that were common in the mortgage market. In response, the COP proposes to increase regulation by allowing state consumer protection laws to apply to national banks and by creating a single federal regulator for consumer credit covering both mortgage and consumer credit.

## Conclusion

Effective reform must challenge the market fundamentalist ideology or it will fall far short of accomplishing what is needed to repair the system. While each has its flaws, both

the COP report and the Group of Thirty recommendations pass that test, proposing a set of reforms designed to restore meaningful prudential regulation across the financial markets. As early reaction to these proposals has made clear, however, the supporters of market fundamentalism will not easily accept defeat. Already they are attempting to fight by distracting from the real causes of the crisis and mischaracterizing the reforms proposed as socialism. The coming policy debate is not a debate between capitalism and socialism, however, but between a pragmatic, progressive approach to capitalism that was followed in the United States for half a century beginning with the New Deal and the radical market fundamentalist approach to capitalism pursued for the past 30 years, which has collapsed in an economic meltdown of historic proportions.

The debate will be shaped by two tendencies. One is the tendency to defend the failing system and to blame its failure on things other than its fundamental flaws in order to limit the extent of change. This approach has already emerged in some policy proposals of financial sector lobbyists and is clearly articulated in the additional views expressed by the two Republican members of the COP. The second tendency, also already on display across the ideological spectrum, is the desire to affix blame. Blame is cathartic, but not very productive. Anger about the problem does not immediately translate into sound thinking about solutions. At this point, it does not matter who gets the blame; the important thing is that we properly identify what to blame them for. After thirty years of a dominant ideology, thinking clearly and changing direction towards more and better regulation is a challenge for the whole society, but the direction in which the nation must go is clear.

It is time for us to abandon the market fundamentalist view that sees regulation as the *ex post* clean up after the occasional market failure, and to return to the New Deal view which understood that regulation is the *ex ante* prophylaxis to prevent market failure. We must restore the function and effectiveness of institutions of prudential regulation along the lines of the successful structure that the New Deal constructed.

Because of the nature of the current crisis, there is a natural tendency to move from the emergency repair of the system to focus on how to resolve or cushion the collapse of financial markets. Ultimately, however, the threat of collapse of a systemically significant financial institution is not the only problem that afflicts financial markets. The comprehensive view of systemic risk taken by the administration must be applied to the other areas where regulatory reform is needs. Reforming the financial system to ensure it plays its proper role in our economy will not be complete or effective until the Congress adopts and the administration implements policies to prevent excessive risk taking, perverse compensation schemes, and conflicts of interest more broadly and to provide much greater transparency and fairness for investors, consumers and regulators in the financial markets. The Administration has promised to move on to these issues in the weeks and months ahead.

This paper provides the analytic framework for understanding why a comprehensive solution is necessary to repair the financial system in the United States.

# I. THE LOOMING BATTLE OVER REGULATORY REFORM IN FINANCIAL MARKETS

## THE CONTEXT OF THE CURRENT CRISIS

It is both ironic and symbolic that on the same day that the second round of financing for the $700 billion bank bailout was approved in the Senate[1] and the House Democrats unveiled their $825 billion stimulus package,[2] the Group of Thirty, a prestigious group of international financial and economic experts including three of President Obama's top advisors, issued a report entitled *Financial Reform: A Framework for Financial Stability.*[3] The report frames the challenge starkly:

> The key issue posed by the present crisis is crystal clear: How can we restore strong, competitive, innovative financial markets to support global economic growth without once again risking a breakdown in market functioning so severe as to put the world economies at risk?[4]

The recommendations of the Group of Thirty called for a dramatic increase in regulatory oversight of financial markets with more than four-dozen specific principles intended to achieve four core recommendations:

> Gaps and weaknesses in the coverage of prudential regulation and supervision must be eliminated. All systemically significant financial institutions, regardless of type, must be subject to an appropriate degree of prudential oversight.
>
> The quality and effectiveness of prudential regulation and supervision must be improved. This will require better-resourced prudential regulators and central banks operating within structures that afford much higher levels of national and international policy coordination.
>
> Institutional policies and standards must be strengthened, with particular emphasis on standards for governance, risk management, capital, and liquidity. Regulatory policies and accounting standards must also guard against procyclical effects and be consistent with maintaining prudent business practices.

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[1] Lori Montgomery and Paul Kane, "Senate Votes to Release Bailout Funds to Obama," *Washington Post,* January 16, 2009, p. A1.

[2] Naftali Becdavid, Elizabeth Williamson and Sudeep Reddy, "Stimulus Package Unveiled," *Wall Street Journal,* January 16, 2009, p. A1.

[3] Group of Thirty, *Financial Reform: A Framework for Financial Stability* (Washington, D.C. January 15, 2009)

[4] Group of Thirty, p. 4.

> Financial markets and products must be made more transparent, with better-aligned risk and prudential incentives. The infrastructure supporting such markets must be made much more robust and resistant to potential failures of even large financial institutions.[5]

Two weeks later the Congressional Oversight Panel (COP) issued a *Special Report on Regulatory Reform* that had a similar thrust.

> After fifty years without a financial crisis – the longest stretch in the nation's history – financial firms and policy makers began to see regulation as a barrier to the efficient functioning of the capital markets rather than a necessary precondition for success…
>
> The United States now faces its worst financial crisis since the Great Depression. It is critical that the lessons of that crisis be studied to restore a proper balance between free markets and the regulatory framework necessary to ensure the operation of those markets to protect the economy, honest market participants and the public.[6]

The COP Report used eight broad categories to organize its recommendations:

1. Identify and regulate financial institutions that pose systemic risk.
2. Limit excessive leverage in American financial institutions.
3. Increase supervision of the shadow financial system.
4. Create a new system for federal and state regulation of mortgages and other consumer credit.
5. Create executive pay structures that discourage excessive risk taking.
6. Reform the credit rating system.
7. Make establishing a global financial regulatory floor a U.S. diplomatic priority.
8. Plan for the next crisis.[7]

Both the Group of Thirty and the COP organized their recommendations as solutions. The Group of Thirty used four categories – closing gaps, strengthening regulation, raising standards and promoting transparency. The CPO used three categories – manage risk, require sufficient transparency, ensure fair dealing. This paper organizes the recommendations of these two groups as solutions to specific problems in financial markets. Table I-1 shows the detailed recommendations of the Group of Thirty in our framework. Table I-2 shows the recommendations of the COP in the same framework.

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[5] Group of Thirty, pp. 8, 10, 12, 14.
[6] Congressional Oversight Panel issued a *Special Report on Regulatory Reform,* Washington, D.C., January 29, 2009, p. 2.
[7] COP Report, p. 4.

*Table I-1: The Group of Thirty Recommendations as Solutions to Problems in Deregulated Financial Markets*

| | Problems | | | | | |
|---|---|---|---|---|---|---|
| | | | | | | |
| | Moral Hazard | Information | Incentives | Agency | Conflicts of Interest | Inequalty |
| Solutions | | | | | | |
| | | | | | | |
| Filling Gaps | 1a - "Too Big to Fail" Banks | 4a -Registration and Reporting | 1b - Capital & Margin Rqts | 1b -Ownership Interest | 1b - Ban/Control of Comingling | |
| | | 4b - Reporting Rqts | 2a - Consolidate Regulation | | | |
| | | 4b - Disclosure Stds | 2b - Non-banks | | | |
| | 1c - Separation of Banks/Nonbanks | | | | | |
| | 3b - Mutual Funds | | | | | |
| | | 4a - Public Disclosure for Private Pools | 4a - Register Private Pools | | | |
| | 5a - GSEs | | 4c - Regulate Lg Private Pools | | | |
| | | | 4d - Off Shoring | | | |
| | | | 6a - Fix regulation | | | |
| | | | | | | |
| Prudential | 7c- Access to Liquidity | 8a - International Information Sharing | 7a - Central Bank Role in Stability | | | |
| Regulation | 7d - Emergency Lending Authority | | | | | |
| | 7e - Limitations on Liquidity Actions | 8b - Gather Information on Leverage | | | | |
| | | | 8a - Offshoring | | | |
| | | | Delineation of Responsibilities | | | |
| | | | 8b Define Leverage | | | |
| | | | 8c - Formal Regional Mechanisms | | | |
| | | | | | | |
| International | | 10d - Capital and Risk Disclosure Stds | 9c - Setting Parameters of Risk | 9b - Governance & Risk Mgmt | 9a - Governance & Risk Mgmt | |
| Standards | | | 9e - Periodic Review of Profiles | | Indep. Board Members | |
| | | 11c - Liquidity Disclosure Stds | 9f - Assessment of Counterparies | | 9c - Independence | |
| | | 12a - Reevaluate Fair Value | 9g - Accept CRMPG and IIF | | 12b - Accounting Stds | |
| | | 12c- Credit Loss Reserves Principles | 10a - Raise Capitalization Stds | | | |
| | | 12c - Transparency of Reserve Determination | 10c- Reevaluate Definition of Capital | | | |
| | | | 11a - Diversified Mix & | | | |
| | | 12c - Transparency of Reserve Determination | Cushion of Liquidity | | | |
| | | | 11b - Liquidity Stds | | | |
| | | | Cushion of Liquidity | | | |
| | | | 11b - Liquidity Stds | | | |
| | | | | | | |
| Transparency | 16a - Closing of Regulated Banks | 13a -Securitized & Structured Assets | 13a -Securitized/Structures' Assets | 13b - Securitization | 14a - Indep. Internal Risk Rating | |
| | 16a - Non-Depository Insts | 13c - Off Balance Sheet Vehicles | Regulatory Stds = Securities | Retain Credit Risk | 14c - Payment to Align Incentives | |
| | 16d - Special Treatment of Contract | 15b - Share Information on CS=DS and OTC | 14b - Rating Agencies | | | |
| | | 13c - Off Balance Sheet Vehicles | Accountability for Quality | | | |
| | | 17a - Asset Backed Products | More Robust Valuation | | | |
| | | 15b - Share Information on CS=DS and OTC | 15a - Regulate OTC Derivatives | | | |
| | | 18 - Evaluate Higher Level of Transparency | 17b - Structured Product | | | |
| | | 17a - Asset Backed Products | Regulated Disclosure | | | |

**Source: Group of Thirty, *Financial Reform: A Framework for Financial Stability* (Washington, D.C. January 15, 2009)**

*Table I-2: The Congressional Oversight Panel Recommendations as Solutions to Problems in Deregulated Financial Markets*

| Moral Hazard | Information | Incentive | Agency | Conflicts | Unfairness / | |
|---|---|---|---|---|---|---|
| | asymmetry | | | of Interest | Inequality | |
| | | | | | | |
| Manage | Coordinate | Reform | Reform fee | Measures to | | |
| Risk | globally | executive | structures for | identify and | | |
| | | pay | rating agencies | Regulate | | |
| | | | | systemic risk | | |
| | | Regulate | | | | |
| | | shadow | | | | |
| | | system | | | | |
| | | | | | | |
| | | Limit | | | | |
| | | leverage | | | | |
| | | | | | | |
| Require | Public | Public | Better | Better | | |
| Transparency | reporting | reporting | information | information | | |
| | | | | | | |
| | Reform | | | | | |
| | credit | | | | | |
| | rating | | | | | |
| Ensure fair | | | | | Manage consumer | |
| Dealing | | | | | & mortgage credit | |
| | | | | | | |
| | | | | | Disclosure rqts. | |

**Source: Congressional Oversight Panel, *Special Report on Regulatory Reform,* January 29, 2009.**

While the Group of Thirty devotes all of its attention to detailed recommendations, the COP report provides background on the causes of the current crisis. This paper combines the two, relying on and expanding COP's analysis of the causes of the problem to link to the detailed recommendations for solutions.

The administration has begun to articulate its proposal for regulatory reform of financial markets, and the initial signs are encouraging. They have adopted an appropriately broad view of the crisis. In congressional testimony to introduce the first elements of the plan, Treasury Secretary Timothy Geithner said, for example, that "our system failed in basic

fundamental ways."[8] In describing that failure, he cited many of the individual problems we analyze in this report:

> The system proved too unstable and fragile, subject to significant crises every few years … Innovation and complexity overwhelmed the checks and balances in the system. Compensation practices rewarded short-term profits over long-term return … The huge apparent returns to financial activity attracted fraud on a dramatic scale. Large amounts of leverage and risk were created both within and outside the regulated part of the financial system.

"To address this will require comprehensive reform. Not modest repairs at the margin, but new rules of the game," he added.

Ultimately, Geithner said, the administration's regulatory reform plan will cover four broad areas: systemic risk, consumer and investor protection, eliminating gaps in our regulatory structure, and international coordination. This list of priorities indicates a willingness to define the solution broadly. Although the administration has pledged to move on its broader agenda in the near future, its initial recommendations cover the area of systemic risk. In this category, the administration includes creating tools to identify and mitigate systemic risks and to protect the financial system from the failure of systemically important financial institutions (as described in Table I-3).

### THE RISE AND FALL OF MARKET FUNDAMENTALISM

The framing of the challenge in grave terms and the call for a dramatic change in policy seem commensurate with the severity of the economic situation. It has become painfully clear that the financial sector is melting down, and the real economy has plunged into a deep recession. We have had financial crises and economic recessions before, but they have generally not occurred simultaneously, and they have not been this severe. Individually, each of the current crises has evoked a series of "as bad as" comparisons that stretch back decades. Taken together, it is quite clear that there is nothing in recent history that comes close to the current situation, other than the Great Depression of the 1930s.[9] The pain of this bust phase is so severe and (apparently) so sudden that it is clear to almost all analysts that this is not a routine downturn in the business cycle, and business as usual responses will be insufficient to solve this problem. The search for more aggressive policy responses has triggered a hunt for an explanation of the root causes.

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[8] Testimony of U.S. Secretary of Treasury Timothy F. Geithner before the Committee on Financial Services, U.S. House of Representatives, March 26, 2009.

[9] Bob Willis, "Surging U.S. Unemployment Rate Puts Pressure on Obama (Update 2)," *Bloomberg.com,* "The jobless rate rose to 8.1 percent in February as employers reduced payrolls by 651,000, the Labor Department said yesterday in Washington. Losses have now exceeded 600,000 for three straight months, the first time that's happened since collection of the data began in 1939.

*Table I--3: Initial Proposals of the Obama Administration*

| Moral Hazard | Information/Accounting | Regulation of Incentives | Agency | Conflicts of Interest | Unfairness/Inequality |
|---|---|---|---|---|---|
| | | | | | |
| Not Just Institutions, but he System | SEC Disclosure for Registered | Leveraged Private Investment | Executive Compensation | | Strengthen Consumer and Investor |
| | Hedge Funds | Register with SEC | Improved risk Mgmt. | | Protection |
| Single Entity | | | Long term focus | | |
| | | Do Not Ban Products | | | Federal Product Safety Bd? |
| Risk Sensitive Prudential Reg. | | | | | |
| Counter Cyclical Rqts. | | Money Market Funds | | | |
| Size/Risk sensitive | | SEC reduce risk of rapid | | | |
| capital | | withdrawal | | | |
| reserves | | | | | |
| liquidity | | Hedge Funds and Private Pools | | | |
| | | Close gaps | | | |
| Conservative Capital | | Register at SEC if big | | | |
| Further into the tails of outcomes | | Report to asses threat | | | |
| Liquidity constraints | | shared with regulator | | | |
| Aggregate counterparty risk | | | | | |
| | | CDS and OTC Derivatives | | | |
| SIF Defined | | Supervise SIF scale firms | | | |
| Size | | Standardized through clearing | | | |
| Interdependence | | Supervise clearing | | | |
| Leverage (include off balance sheet) | | Greater use of exchanges | | | |
| Reliance on short term funding | | Nonstandardized | | | |
| Importance as source of credit | | Document | | | |
| | | Confirm trades, netting, | | | |
| Resolution Mechanism | | collateral margin, & | | | |
| FDIC Process for New Institutions | | close-out practices | | | |
| Institution covered include | | | | | |
| Banks and Thrift Holding Cos | | Intl. Coordination | | | |
| Insurance Cos | | Prudential Supervision | | | |
| Futures Merchants | | Address Tax Havens & Money | | | |
| Any other SIF | | Laundering | | | |

**Source: Testimony of U.S. Secretary of Treasury Timothy F. Geithner before the Committee on Financial Services, U.S. House of Representatives, March 26, 2009**

We have used the word "apparently" to describe the suddenness of the onset of the current crisis because there were prior episodes that were clear signals that there were severe problems in financial markets and loud warnings offered by leading economists – American Nobel laureates among them[10] – that this could happen.[11]

Over the past 30 years, there have been a series of domestic economic crises and financial meltdowns. The S&L crisis of the 1980s, the derivatives crisis of the 1994, the collapse of a famous hedge fund, Long Term Capital Management in 1998, the California electricity meltdown, the tech stock bubble of 1999-2000, the Enron fiasco of 2000-2002, the housing bubble of 2005-2007, and the energy speculation bubble of 2006-2008.[12] There have also been three recessions and a series of foreign financial and economic crises – the Japanese malaise of the 1990s, currency crises in Mexico (1994-1995), Thailand (1996-1997), South Korea and Brazil (1998-1999), and Argentina (2002).[13] In short, barely a year went by in which one could not find a major market failure that should have raised loud alarms about the economic structure that we were building in the world. This time things are much worse, and policymakers are forced to pay attention.

The recurrence of crises in recent years and the gravity of the current crisis suggest severe problems in the functioning of the financial sector. In Congressional testimony in October 2008 Alan Greenspan, one of the leading architects and advocates of deregulation of financial markets, admitted to a major flaw in the theory.

> Those of us who looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief… I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms."[14]

The COP report puts this recent period of financial turmoil in perspective by noting that the half-century prior to the 1980s was remarkably free of financial crises, as depicted in Figure I-1. For almost a century and a half before the Great Depression, every 20 years or so there was a crisis. For the fifty years after the creation of the New

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[10] Joseph E. Stiglitz, *The Roaring Nineties: A New History of the World's Most Prosperous Decade* (New York: W.W. Norton, 2003); Paul Krugman, *The Return of Depression Economics* (New York: W.W. Norton, 1999).

[11] The bursting of the tech stock bubble triggered hard looks at the dangers. In addition to Stiglitz, see Robert J. Shiller, *Irrational Exuberance* (New York: Random House, 2000, 2005) and Robert Pollin, *Contours of Descent: U.S. Economic Fractures and the Landscape of Global Austerity* New York: Verson, 2003, 2005).

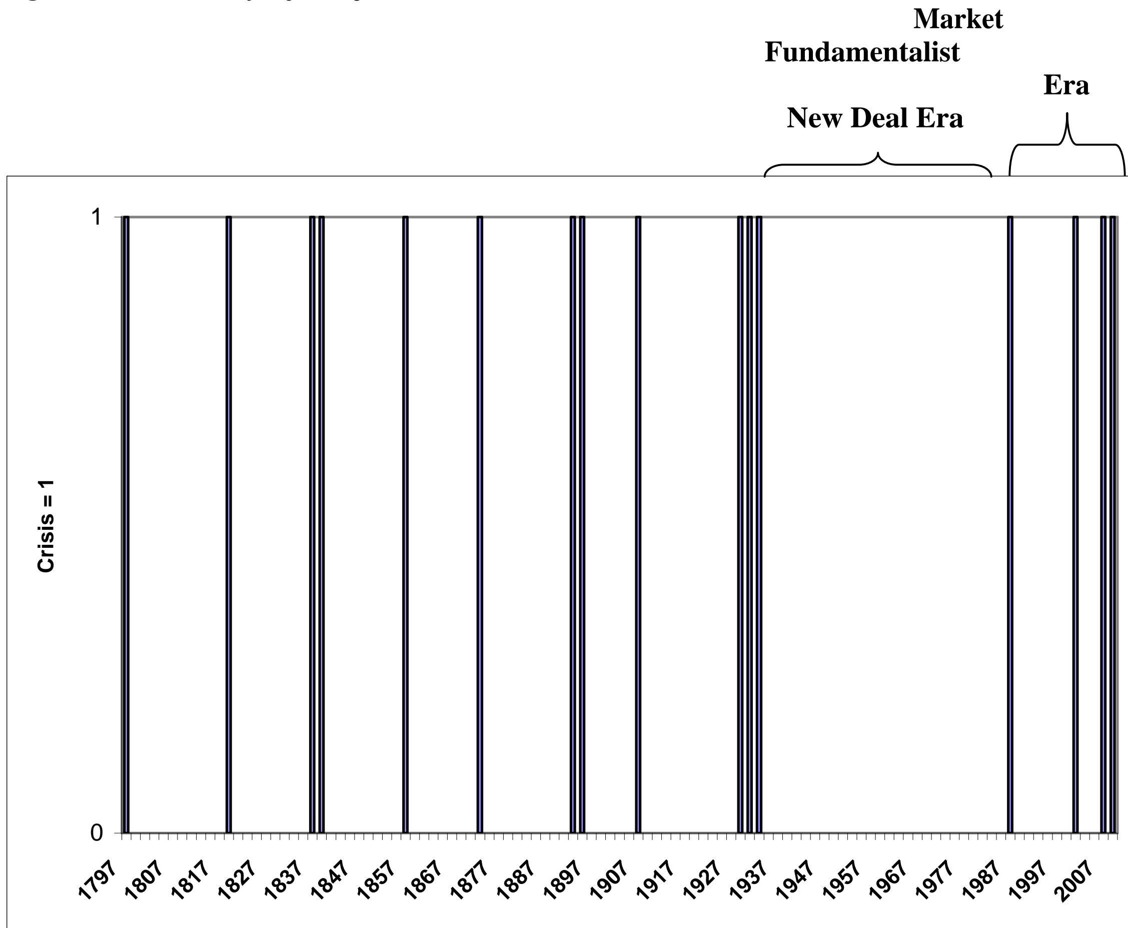
[12] Stiglitz, Roaring Nineties, discusses several of these crises.

[13] Paul Krugman, *The Return of Depression Economics and the Crisis of 2008* (New York: W.W. Norton, 2009, provides discussion of these crises.

[14] "The Financial Crisis and the Role of Federal Regulators," Committee on Oversight and Government Reform, U.S. House of Representative, October 23, 2008.

Deal institutions of prudential regulation, there were no such crises. This very stark record of financial crises challenges the claim that it was the antiquated New Deal institutions that were the cause of the problems in the financial sector. To the contrary, it suggests that a lack of regulation and repeal of remarkably successful New Deal legislation is the problem.

***Figure I-1: History of Major Domestic Financial Crises***




**Sources: Congressional Oversight Panel, *Special Report on Regulatory Reform,* January 29, 2009.**

Understanding the problems caused by the repeal and abandonment of the New Deal institutions for prudential regulation of the financial sector is essential to any effort to repair the damage. What we are witnessing is the beginning of a profound debate over the fundamental institutional structure of the financial sector and the economy. Notwithstanding the steady stream of crises and the severity of the current crisis, after thirty years in which deregulation was the dominant economic mantra, any proposal for

reregulation is certain to be met with immediate resistance, because the dominant economic frame of reference in the past thirty years has been market fundamentalism.

We use the term market fundamentalism to describe an ideology that rests on several basic principles and assumptions. The cornerstone is the efficient market hypothesis. [15]

- The pursuit of private interest through unregulated markets is all we need to promote the public good, because markets inevitably create efficiency, growth and stability.[16]
- The efficient market hypothesis is the main pillar of market fundamentalism, but there are two other tenets that immediately and inevitably follow from that first premise.
- The inequality that inevitably results from the working of the unregulated market is not considered to be a problem. Indeed, it is deemed a necessity by some.[17]
- Idolizing the market, market fundamentalism must denigrate government. The less government the better is the mantra. [18]

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[15] Robert Pollin, *Contours of Descent* (New York: Verso, 2005), pp. 12-13 points out the contradictory outcomes of market fundamentalism, noting that under the neoliberal market system "two simple market forces, self-interest and competition, are wellsprings for the prodigious of effort and material abundance that are so evident in the United States and other advanced capitalist countries. However, if free market capitalism is a powerful mechanism for creating wealth... a neoliberal policy approach… also produces severe difficulties in terms of inequality and financial instability, which in turn diminishes the market mechanism's ability to even promote economic growth. "

[16] Pollin, Contours (p. 13), identifies "three fundamental problems that result form a free market system," which correspond roughly to the three market fundamentalist hypotheses. The efficient market hypothesis is closest to what he calls the Keynes problem, which identifies both the problem of the business cycle and the problem of speculation: "In a free market economy, investment spending by business is the main driving force that produces economic growth, innovation and jobs. But… spending by business is likely to fluctuate… when financial market convert long-term assets into short-term commitments for investors, this also fosters a speculative mentality in the markets. What becomes central for the investor is not whether a company's products will produce profits over the long-terms, but rather whether the short-term financial market investors *thing* a company's fortunes will be strong enough in the present and immediate future to drive the stock price up. Because of this, the financial market is highly susceptible to rumors, fads and all sorts of deceptive account practices, since all of these can help drive the stork price up in the present, regardless of what they accomplish in the longer term.

[17] Greg IP and John D. McKinnon, "Bush Reorients Rhetoric, Acknowledges Income Gap," *Wall Street Journal,* March s26, 2007, "top White House economic officials still don't consider today's inequality – the growing share of income going to those at the top – an inherently bad thing; they believe it simply reflects the rising rewards accruing to society's most skilled and productive members." IN contrast to the view that inequality does not matter, Pollin, Contours, identified a second problem in market economies (p. 13) which involved the fact that " in a free market economy generally, workers have less power than employers in this bargaining process because workers cannot fall back on other means of staying alive if they fail to get hired in a job… unless some non-market forces in the economy, such as government regulations or effective labor unions, are able to counteract these market processes, workers will continue to experience weakening bargaining strength and eroding living standard (Pollin, *Contours,* pp. 13…14.

A variety of terms have been applied to the system that has been in place for the last thirty years "Casino Capitalism,"[19] "Speculative Management,"[20] "wild west capitalism[21] but the term market fundamentalism has recently been used by both Joseph Stiglitz,[22] a Nobel laureate economist at Columbia University and a former head of the Council of Economic Advisors under President Clinton, and George Soros,[23] a prominent hedge fund manager. We think this is an apt description of the economic ideology that has governed the last thirty years, not only because it captures the content of the economic principles on which the economic system rested, but also because it conveys the sense of a religious belief based on faith rather than fact, which is very much the way advocates and apologists for market fundamentalism act.

Whatever we call it, the key point is that as long as the institutional structures of the New Deal remained in place in the financial sector, financial crises remained manageable.[24] It was the major financial deregulatory policies and laws of the 1990s that let "Casino Capitalism" run wild.[25] Financial market deregulation was the last of a series of deregulation decisions driven by market fundamentalist ideology that led to disaster. Just as the deregulation of electricity quickly led to the California meltdown, the deregulation of commodity markets led to the Enron debacle, and the deregulation of telecommunications in 1996 played a key part in the technology stock bubble, the passage of the Financial Services Modernization Act in 1999,which repealed the Glass Steagall Act, and the passage of the Commodity Futures Modernization Act in 2000, which prevented the regulation of over-the-counter derivatives, undermined prudential

[18] A third fundamental problem identified by Pollin, Contours, p. 16-17, is "that for market economies to function with some modicum of fairness, they must be embedded in social norms and institutions that effectively promote broadly accepted notions of the common good… [which] argued in favor of government interventions to achieve three basic ends: stabilizing overall demand in the economy at a level that will provide for full employment; crating a financial market that is stable and conducive to the effective allocation of investment funds; and distributing equitably the rewards fro high employment and a stable investment process.

[19] Susan Strange, *Casino Capitalism, 1986*.

[20] Dan Krier, *Speculative Management* (State University of New York Press: New York, 2005)*;* Robert Shiller, The Taming of "Speculative Capitalism," *Japan Times,* April 2007.

[21] Roubini: Anglo-Saxon model has failed," *FT.com,* February39, 2009. http://www.ft.com/cms/s/0/89829f7a-f1d1-11dd-9678-0000779fd2ac.html

[22] Stiglitz, *The Roaring Nineties* (New York: Norton, 2003).

[23] George Soros, *The New Paradigm for Financial Market* (New York: Public Affairs Press, 2008).

[24] Tim Shaffer, "Paul Krugman's Depression Economics," *Reuters,* December 8, 2008, quoting Krugman, "Well, we have about 60 years of financial stability, basically because we had an effectively regulated banking system. Then we fell prey to a combination of excessive optimism and excessive literalism. We started believing that financial markets always work, and we also believed that everything was OK as long as things we call banks were guaranteed, not realizing that lots of things we don't call banks are nonetheless subject to bank runs.

[25] "Roubini: Anglo-Saxon model has failed," *FT.com,* February39, 2009. http://www.ft.com/cms/s/0/89829f7a-f1d1-11dd-9678-0000779fd2ac.html

regulation of financial and commodities markets, intensified the financial crises, and laid the groundwork for the economy-wide meltdown.[26]

Because market fundamentalism was religiously applied across the economy, and because there are differences in economic structure across the sectors, the manifestations of the problem differ across the sectors, but they share common themes. In the financial sector the core cause of the failure of unregulated markets is a nexus of endemic problems including asymmetric information, perverse incentives, agency, conflicts of interest, moral hazard and unfairness. In the real economy the core causes of the failure of unregulated markets lies in basic market conditions and persistent flaws in market structure – low elasticities of supply and demand, high barriers to entry, economies of scale and scope, vertical economies and network effects, among other factors – that undermine competition and result in the abuse of market power.[27] Left to its own devices the market fails to consistently achieve its primary function of efficiently allocating resources to uses. Economic theory could envision a more efficient outcome without regulation only by ignoring or downplaying the flaws in the market, but reality could not produce the theoretical outcome because the flaws inevitably assert themselves.

Left to its own devices, the market suffers from inherent or endemic flaws as a result of which it fails to consistently achieve its primary function of efficiently allocating resources to uses. The implementation of market fundamentalism in policies undermined the regulatory institutions that were intended to address these flaws – removing or reducing their power where the institutions existed or preventing the creation of new regulatory institutions where they were needed. Economic theory could envision a more efficient outcome without regulation only by ignoring or downplaying the flaws in the market, but reality could not produce the theoretical outcome because the flaws inevitably assert themselves.

The financial sector deserves to be top of mind at the moment for reasons that go beyond the severity of the current meltdown. First, finance is infrastructural in the sense that the firms in this sector have "very great influence, as suppliers of essential inputs to other industries, on the size and growth of the entire economy… [and are] uniquely prerequisite to economic development… [T]hey condition the possibilities of growth."[28] When the financial sector is broken, everyone suffers. Second, the financial sector is one area of the economy where the market should work best because it is just "paper." Basic conditions that might impede market functioning, like the nature of physical units, durability, value/weight, seasonality, storability, etc. are minimal here.[29] If market

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[26] Stiglitz, Roaring Nineties.
[27] Appendix A offers some observations on the implications for the New Deal economic paradigm of the distinction between the causes of market failure in the financial sector and the real economy.
[28] Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions* (Cambridge: MIT Press) p. 11.
[29] George Cooper, *The Origin of Financial Crises: Central Banks, Credit Bubbles and the Efficient Market Fallacy* (New York, Vintage), p. 101, argues that financial markets are more prone to instability because of feedback loops and internal process that autonomously affect demand. The basic conditions

fundamentalism cannot work in this sector, where inherent basic conditions and structural impediments should be minimal, its chances of working in other sectors, where market forces are inherently weaker, are even smaller.

That deregulation posed a threat across many sectors, including financial markets, was known in advance, but ignored.

> We knew that there was a need for regulation—most regulations had been put in place for a good reason. We knew too that while markets fail, so do governments, and thus, one had to have careful and limited regulation. Precisely because markets and governments so often fail, it is even more important for them to work in partnership. But, although some in the Clinton administration understood this, in too many instances – in electricity, telecom, and banking – we succumbed to the deregulation mantra, rather than asking what was the *right* regulatory structure.[30]

Over the course of less than a decade, four sectors were devastated by deregulation: electricity, when the Energy Policy Act of 1992 amended the Federal Power Act of 1935; telecommunications, when the Telecommunications Act of 1996 amended the Communications Act of 1934; banking, when the Financial Services Modernization Act of 1999 (Graham, Leach, Bliley) repealed the Glass-Steagall Act of 1933; commodity markets specifically and financial markets generally, when the Commodity Futures Modernization Act of 2000 amended the Commodities Exchange Act of 1936. Arguably, these were the four most massive changes in economic legislation since the New Deal. In each of these sectors, it became quickly apparent that abandoning the pragmatic, progressive principles that had governed the economy for well over half a century in the name of regulatory reform has proven disastrous.

## REFRAMING THE DEBATE OVER ECONOMIC POLICY

Thus, the debate is not between capitalism and socialism, as it was recently portrayed in the election campaign[31] and in a recent hearing in the Congress, but between a pragmatic, progressive approach to capitalism that was followed in the United States for half a century beginning with the New Deal and the radical market fundamentalist approach to capitalism that has been pursued for the past 30 years.

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I refer to are associated with the exercise of market power in real economy markets. The Enron scandal, California meltdown and oil price bubble suggest that trading in instruments designated in real economy commodities is just as prone to instability as broader financial markets.

[30] Stiglitz, Roaring Nineties, p. 112.

[31] James Pethokoukis, 'Obama and the Socialist 'Thing,''' *U.S. News,* July 29, 2008; Josh Patashnik, "Taking Liberties: Why the 'Most Liberal' Ranking are a Crock," *the New Republic,* July 28, 2008, points to John McCain's statement that "he cannot guarantee that Obama is *not* a socialist."

The debate will be shaped by two tendencies. One is the tendency to defend the failing system and to blame failure on things, other than the fundamental flaws, to limit the extent of change. As a financial sector lobbyist put it:

> "You want to apply the appropriate amount of regulation to address the concern that this kind of situation never happens again," said Scott Talbott, senior vice president of governmental affairs for Financial Services Roundtable, which represents the largest financial institutions in the United States. "But at the same time, you don't want to stifle innovation, creativity or the allocation of resource or to take appropriate risks."[32]

The additional views of two Republican members of the COP also reflect this counter argument.

> Those that believe that regulation is the only answer, however, ignore the significant ways in which government intervention magnified our existing problems … Before embracing more government regulation as the only answer, such advocates should consider the many ways in which government regulation itself can be part of the problem. The history of financial regulation is replete with such examples as either regulators or regulation have simply failed or made matters worse."[33]

While the Republican members of the COP conceded that regulation may be part of the answer, some go farther, denying that deregulation was part of the problem. For example, Senator John Ensign, Chairman of the Republican National Senatorial Committee, went on *Face the Nation* and said of the economic meltdown: "Unfortunately, it was allowed to be portrayed that this was a result of deregulation, when in fact it was a result of overregulation."[34]

In a sense, the fierce battle that occurred over the bailout of financial institutions is only a precursor to the more profound struggle over regulatory reform that is looming, one that will be framed as a battle over the most basic principles and fundamental values. "Gov. Mark Sanford… told Joe Scarborough he was against bailing out the auto industry because it would threaten the very market-based system that has created the wealth that this country has enjoyed."[35]

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[32] Anthony Faiola, "Obama Advisor Urges More Rigorous Global Financial Regulation," *Washington Post,* January 16, 2009, p. D6.

[33] COP, Report, p. 56

[34] Cited in Arianna Huffington, "The Right Wing Economics That Got Us into This Mess Should Go the Way of Soviet Communism," Huffington *Post,* December 26, 2008.

[35] Cited in Arianna Huffington, "The Right Wing Economics That Got Us into This Mess Should Go the Way of Soviet Communism," Huffington *Post,* December 26, 2008.

Framing the issue as a struggle over basic assumptions is not only expedient for those who want to resist change and maintain the current system without major reform, it is critically important for those who want to implement change, because the problems that need to be addressed are at the core of the "market fundamentalist" system that has been in place for thirty years. Deregulated financial institutions have failed at their primary function – assessing and allocating risk – and they have shifted the burden of that failure to the public not only through the $700 billion bailout, but also through the extension of trillions of dollars of credit by the Federal Reserve system and seizures of failed banks by federal insurance institutions.

Effective reform must be launched from a proper understanding of the nature and magnitude of the underlying problem, and it must challenge the market fundamentalist ideology, or it will fall far short of doing what is needed to repair the system. The fact that defenders of market fundamentalism want to define the debate in this way reinforces the need to put forward a set of grand principles.

Thus, the framing of the policy debate needs to be changed. Given the intense political atmosphere, the reports of the Group of Thirty and the Congressional Oversight Panel are a good place to start the debate for reform. While the Group of Thirty report in particular preserves the rhetoric of competitive markets, it accepts, as does the COP report, the proposition that the market has failed because of fundamental flaws in financial institutions that have been allowed to harm the economy because of inadequate prudential regulation. In these reports, the current crisis is not viewed as the result of too much regulation, but too little, not the result of a few bad decisions or bad actors, but a systemic failure of institutions, caused by lack of transparency, perverse incentives, conflicts of interest and other problems that create inefficiency, instability and crisis, if they are not subject to effective prudential oversight and regulation.

The second tendency at times like these, when things have gone so badly, is to want to affix blame. Blame is cathartic, but not very productive. Anger about the problem does not immediately translate into sound thinking about solutions.

In the political arena, Ronald Reagan and Bill Clinton both abandoned the pragmatic, progressive economic model of the New Deal and embraced market fundamentalism. George W. Bush was a true believer at the end of a long period of extreme deregulation, disinclined to admit there was a problem and unable and unwilling to respond effectively to the crisis. Alan Greenspan, the leading apostle of market fundamentalism in the financial sector, spanned all three administrations as Chairman of the Federal Reserve. The industry lobbied for deregulation aggressively and relentlessly, and the Congress, whether led by Republicans or Democrats, passed the laws that opened the door to the meltdown.

Thus, no matter where one is on the political spectrum, one can find someone to blame for the crisis. At this point, it does not matter who gets the blame; the important

thing is that we properly identify what to blame them for. After thirty years of a dominant ideology, thinking clearly and changing direction towards more and better regulation is a challenge for the whole society.

## PURPOSE AND OUTLINE OF THE PAPER

This paper seeks to provide an intellectual underpinning for financial reform on the scale and magnitude suggested by the Group of Thirty and Congressional Oversight Panel by engaging the debate over market fundamentalism head on. The goal is to respond forcefully and analytically to the heated political rhetoric that will be hurled at regulatory reform. The former and current officials in the Group of Thirty will not be inclined to do so (although some of the economists may be), preferring institutionally and temperamentally to take a more pragmatic tack. Members of Congress will quickly become immersed in the details as they try to craft legislation to deal with a dramatically and rapidly deteriorating economic situation. As a result, the broader public policy debate risks becoming skewed – high rhetoric and "traditional values" on one side opposed to change, versus pragmatism on the other. This paper shows not only that high rhetoric and traditional values can be marshaled in support of regulatory reform, but also that the empirical evidence demonstrates the need for pervasive reform.

The purpose of this paper is to provide a middle level, general explanation that identifies the key factors that have caused the failure of market fundamentalism and the principles for repairing, reforming and rebuilding the economy. We believe a broad and analytic perspective is helpful because it reinforces the need to make fundamental changes across many sectors. The analytic framework strives to give coherence to a series of events that must be explained and policy changes that must be made in different industries that might otherwise appear to be random or haphazard. This paper deals with the most important sector, and the one that appears to be teed up for immediate legislative action.[36]

The purpose of the paper is also to make it clear that we do not have to resort to some radical, untried experiment; we need to return to tried and true traditional values. Market fundamentalism was the radical experiment that pushed deregulation much too far in the financial sector. The central theme is simple; we do not need a new, New Deal, we need to rediscover the pragmatic, progressive values and principles of the original New Deal.

Section II examines the structure and conduct of deregulated markets that lead to their failure, focusing on financial markets. Broadly speaking, we find that the basic assumptions that market fundamentalism makes about markets and stable economic growth are flawed – the efficient market fallacy, the inequality fallacy and the less

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[36] A similar framework has been applied to telecommunications, electricity, and commodity markets.

government fallacy. We identify six processes and patterns of conduct that are promoted and accentuated by market fundamentalist policies that lead to market failure.

- Shifting of risk onto public institutions, moral hazard,
- Asymmetric and imperfect information, frequently associated with problems of lack of transparency,
- Perverse incentives,
- The separation of ownership and control, a problem of "agency," and
- Conflicts of interest/Fraud,
- Unfairness/Inequality.

Section III briefly reviews specific macro economic policies that compounded and magnified the problems in the financial sector and the history of regulatory mistakes that opened the door to the current crisis. Excessive deregulation has been the core policy across sectors, but other policies advocated by market fundamentalists have magnified the market imperfections. Policy makers placed too much faith in the marketplace and underestimated the market imperfections and failures that could and did occur.

Section IV reviews the policy recommendations of the Group of Thirty and Congressional Oversight Panel, as well as the initial proposals of the Obama Administration. It examines these policy recommendations in terms of the market imperfections identified in Section II.

Section V attempts to shed light on how far regulatory reform should go. It begins with a case study of a financial sector that avoided the meltdown because it eschewed the irrational exuberance for deregulation and the irresponsible policies of market fundamentalism. It concludes with a review of a recent recommendation for regulatory reform that is much less aggressive than the COP or the Group of Thirty and appears to be far too timid in light of the severity of the collapse of market fundamentalism.[37]

Appendix A presents some thoughts on the implications of the current crisis for the economic paradigm that guided the New Deal.

Appendix B presents the policy recommendation reviewed in this paper on a side-by-side basis.

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[37] Robert E. Litan and Martin N. Baily, *Fixing Finance: A Roadmap for Reform,* February 17, 2009.

## II. THE FAILURE OF FINANCIAL MARKETS

### THE FLAWS IN MARKET FUNDAMENTALISM

Public interest advocates have long held that the pursuit of private profits is not synonymous with the public good. The constant stream of crises and meltdowns during the ascendance of market fundamentalism provided more than adequate fuel to sustain this belief, but the broad collapse of market fundamentalism takes the debate to a whole new level. Ironically, Alan Greenspan, the chief apostle of deregulation in the financial sector, went one step further than the public interest advocates when he admitted that there is a fundamental flaw in the efficient market hypothesis. As noted above, in more blunt and clearer language than has been his practice, he declared in essence that the pursuit of private profit is not necessarily synonymous with the *private* good.

The enormity of Greenspan's admission of failure did not sink in immediately. For example, when the Troubled Asset Relief Program (TARP) was rolled out, the Federal Reserve and three bank regulatory agencies issued a naïve plea to the banks: "The agencies expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers."[38]

In a few months, with $350 billion spent and no strings attached,[39] it became obvious that the beneficiaries of this largesse would not do the right thing for the economy. It turns out that when loans start to go bad, bankers do whatever they can to repair their balance sheets. They lend less, hoard cash and squeeze the good loans as hard as they can.[40]

Individually, each bank has to do what is in its narrow self-interest during the bust phase, tightening credit in an effort to be the last man or woman standing when the carnage is over. They did the opposite during the boom phase, each bank writing more and more risky loans in an effort to be the king of the hill as the mountain of debt grew. The pattern was similar during the S&L crisis two decades ago.[41] It is not that banks do

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[38] Board of Governors, *Interagency Statement on Meeting the Needs of Creditworthy Borrowers,"* November 12, 2008.

[39] Matt Apusso, "Where'd the Bailout Money Go? Shhhh, It's a Secret," *ABC News,* December 30, 2008.

[40] Michael Lewis and David Einhorn, "The End of the Financial World as We Know it, *New York Times,* January 4, 2009; "How to Repair and Broken Financial World," *New York Times,* January 4, 2009**.** Joseph Stiglitz, Is the Entire Bailout Strategy Flawed? Let's Rethink this Before It's Too Late," *Alternet,* February 2, 2009: "Many a bank may decide that the better strategy is a conservative one: Hoard one's cash, wait until things settle down, hope that you are among the few surviving banks and then start lending. Of course if all the banks reason so, the recession will be longer and deeper than it otherwise would be."

[41] Stiglitz, Roaring Nineties, p. 103: "The S&L debacle showed that when incentives go awry, as they do with bad accounting and poorly designed deregulation, dire consequences can follow. Markets, rather than steadily creating wealth, may undertake excessively risky ventures. Without regulation, weak banks worried about their survival, took large risks, and gambled on huge gains, knowing that others would pick up the pieces if the gamble paid off. The S&Ls also illustrated the thin line that sometimes exists

not learn from their past mistakes, it is that they cannot. Left to their own devices, they expand credit irresponsibly on the up cycle and contract it anti-socially on the down cycle. They swing wildly from irrational exuberance to extreme pessimism.[42]

While the Group of Thirty goes directly to solutions, the COP report starts with an analysis of the problem. We use the COP Report as the initial point of departure and add depth by referring to Stiglitz's account of the impact of the implementation of market fundamentalism in the 1990s.[43]

The launch point for the COP analysis is the identification of the critical role that the financial sector plays in society. "A well-regulated financial system serves a key public purpose: if it has the power and if its leaders have the will to use the power, it channels savings and investment into economic activity… A healthy financial system, one that allows for the efficient allocation of capital and risk, is indispensable to any successful economy."[44]

For the financial system to play its proper role in society, the COP report argues, there are three key functions it should provide. "Manage risk, facilitate transparency and promote fairness among market actors."[45] Failure to properly execute these functions results in inefficiency and can lead to severe problems that the COP report identifies as financial panics, manipulation, swindles and fraud.[46]

## SIX CRITICAL CHALLENGES

There are six interconnected patterns of harmful conduct that stem from the configuration of the incentive structure that market fundamentalism fosters in the financial sector. Asymmetric information and agency problems are exploited by individuals to promote private interests at the expense of the public good. Conflicts of interest, which are allowed in the name of deregulation, overwhelm the system. The financial sector suffers a moral hazard problem made worse by market fundamentalism. Where risks can be shifted to third parties, they will be, to raise profits. Perverse

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between ethical and unethical behavior, and that when payoffs are large enough, there are many within the business community who find ways of overcoming moral compunctions" at best the law is skirted; at worst it is ignored. Whether from excessive risk taking or straightforward looting, the bankers gained and the American taxpayer lost.

[42] Cooper, p. 84 n 47. Typically in an economic downturn the banks become more concerned over rising defaults, leading them to demand higher interest rates to compensate for the higher risks. Occasionally the banks will choose to ration credit, refusing to lend to some borrowers on any terms. This cycle has been very much evident in the recent housing market bubble where credit conditions were eased in the economic expansion – when easier credit was not needed – and is now being tightened in the contraction – when easier credit is needed. **This process alone is sufficient to undermine the Efficient Market Hypothesis.**

[43] Stiglitz. Roaring Nineties.

[44] COP Report, pp. 2…4.

[45] COP Report, p. 11.

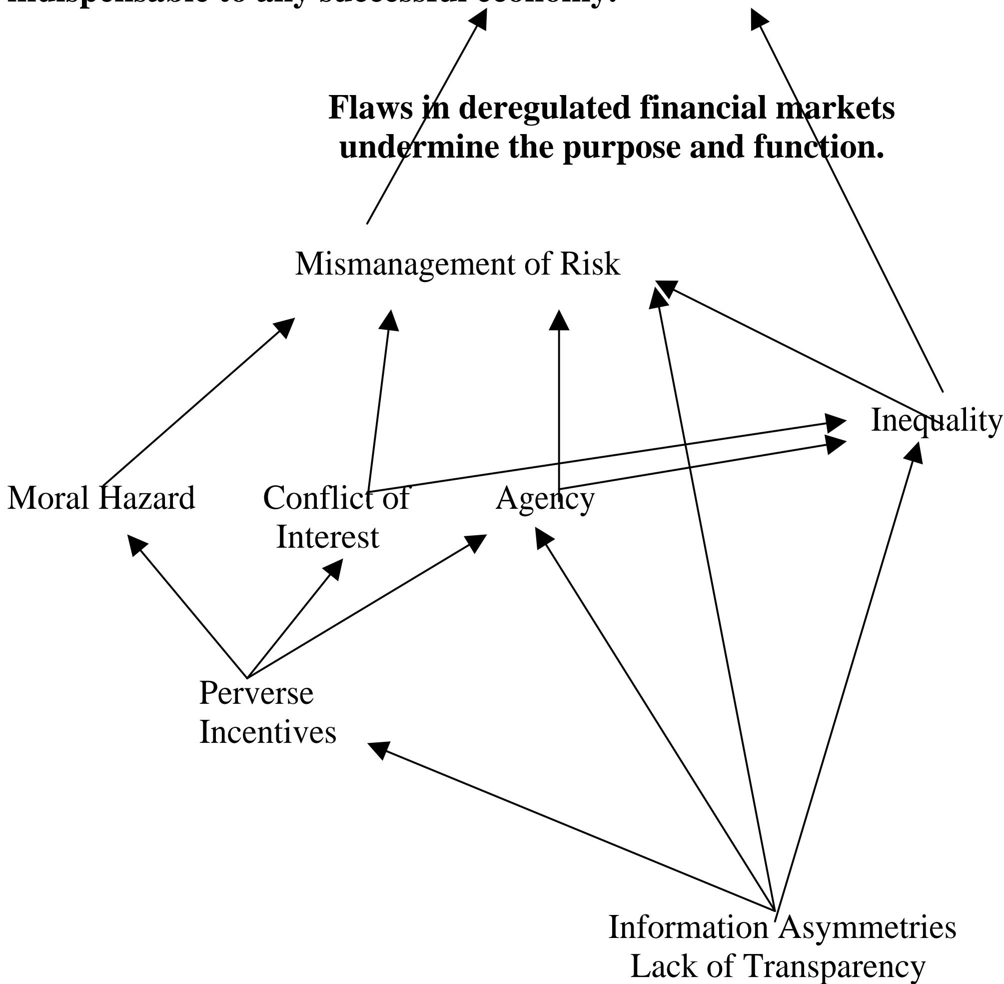
[46] COP Report, p. 8.

incentives and lax oversight misallocate resources and create an endemic fraud problem. The pervasive pattern of unfairness and inequality creates inefficiency and starves the real economy of resources.

The six problems are interconnected and, in a sense, hierarchical as shown in Figure II-1). More fundamental problems contribute and compound the other problems.

***Figure II-1: Institutional Weakness and Behavioral Flaws in Deregulated Financial Markets***

**The purpose and function of a healthy financial system is to channel savings and investment into economic activity; efficiently allocating capital and risk is indispensable to any successful economy.**



In many cases, as the discussion below shows, these flaws are highly interconnected, so one could draw the lines and distinctions between problems in various ways, but the important lesson is that there is a nexus of problems that plagues market fundamentalism in the financial sector and leads to its failure to execute its proper function in the economy. As Nouriel Roubini, a long-time critic of the unregulated financial sector and professor of economics at New York University put it:

> So while this crisis does not imply the end of market economy capitalism it has shown the failure of a particular model of capitalism: the laissez faire unregulated (or aggressively deregulated) wild-west model of free market capitalism with lack of prudential regulation and supervision of financial markets and with the lack of proper provision of public goods by governments.
>
> It is the failure of ideas such as the "efficient market hypothesis" that deluded itself about the absence of market failures such as asset bubbles; the "rational expectations" paradigm that clashes with the insights of behavioral economics and finance; the "self-regulation of markets and institutions" that clashes with the classical agency problems in corporate governance that are themselves exacerbated in financial companies by the greater degree of asymmetric information – how can a chief executive or a board monitor the risk-taking of thousands of separate profit-and-loss accounts? Then there are the distortions of compensation paid to bankers and traders.
>
> This crisis also shows the failure of ideas such as the one that securitization reduces systemic risk rather than actually increases it; that risk can be properly priced when the opacity and lack of transparency of financial firms and new instruments leads to unpriceable uncertainty rather than priceable risk.[47]

## Moral Hazard

Traditionally, moral hazard has been the focal point of concern in the financial sector, but the current crisis demonstrates a much broader set of problems and concerns. "The failure of large institutions can have systemic consequences, potentially triggering a cascade of losses, which means that risk taking by the firm can impose costs far beyond its own shareholders, creditors, and counterparties."[48] In the finance sector there is a tendency to shift costs and risks onto the backs of taxpayers, where the government guarantees the ultimate soundness of financial institutions, either directly through

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[47] "Roubini: Anglo-Saxon model has failed," *FT.com,* February39, 2009. http://www.ft.com/cms/s/0/89829f7a-f1d1-11dd-9678-0000779fd2ac.html

[48] COP Report, p. 10.

insurance, or indirectly by conceding that some institutions are "too big to fail." Profit driven entities will inevitably take advantage of this guarantee to increase their profits by taking rewards for risks they can shift to taxpayers and ultimately profiting from risky loans that the taxpayer bails out. "If creditors, employees, and even shareholders of major financial institutions conclude that the federal government is likely to step in again in case of trouble (because of the systemic risk of their institutions), they may become even more lax about monitoring risk, leading to even greater excesses in the future."[49]

The technical definition of moral hazard – "The effect of certain types of insurance systems in causing a divergence between the private *marginal cost* of some action and the marginal *social cost* of that action thus resulting in an allocation of resources which is not optiimal"[50] – does not fully convey the implications of this problem in the current financial mess, so let me put a finer point on it. Capitalism without bankruptcy is like Catholicism without hell; it lacks a sufficiently strong motivational mechanism to ensure good behavior.

The financial system should never have allowed to become exposed to the plague of banks that are "too big to fail." Moreover, size is not the only cause of systemic risk. We have also discovered that some products are so complex and can spread like virus through the financial system that they pose a threat of systemic risk because they afflict so many institutions and they are nearly impossible to unwind when they fail. In other words, we must prevent products and institutions from becoming "too big or too complicated to fail."

## Transparency and Asymmetric Information

The second flaw that receives a great deal of attention in discussions of the current financial crisis is information transparency. [51] Transparency is a central problem, and the

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[49] COP Report, p. 12.

[50] David W. Pearce, *The Dictionary of Modern Economics* (Cambridge, MIT Press, 1984), p. 298. The Wikipedia definition is as follows: **Moral hazard** is the prospect that a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk. Moral hazard arises because an individual or institution does not bear the full consequences of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to bear some responsibility for the consequences of those actions… Financial bail-outs of lending institutions by governments, central banks or other institutions can encourage risky lending in the future, if those that take the risks come to believe that they will not have to carry the full burden of losses. Lending institutions need to take risks by making loans, and usually the most risky loans have the potential for making the highest return. A moral hazard arises if lending institutions believe that they can make risky loans that will pay handsomely if the investment turns out well but they will not have to fully pay for losses if the investment turns out badly.

[51] The Wikipedia definition of moral hazard also points out that several of the other flaws in the financial markets can be seen as different types of moral hazard:" Moral hazard is related to information asymmetry, a situation in which one party in a transaction has more information than another. The party that is insulated from risk generally has more information about its actions and intentions than the party paying for the negative consequences of the risk. More broadly, moral hazard occurs when the party with more information about its actions or intentions has a tendency or incentive to behave

availability of timely and relevant information is seen as a critical factor to achieving efficient outcomes, since lack of transparency makes it difficult to evaluate risk and achieve efficient outcomes. "After all, the fundamental risk/reward corollary depends on the ability of market participants to have confidence in their ability to accurately judge risk."[52] The availability of information is central to the operation of efficient markets, but left to its own devices the market will underproduce information because it is a public good.[53] Asymmetric information wreaks havoc with market functioning. It is for this observation that Stiglitz won his Nobel Prize.[54]

Cooper, identifies the crucial role of information as follows:

> Therefore, according to efficient market theory asset price bubbles are prevented by investor's appetite to buy assets on the cheap and sell them when too expensive. It follows that an asset price bubble can only be formed if investors are willing to buy assets when they are already overpriced, implying that asset bubbles require investors to behave irrationally. This line of reasoning leads to the irrational investor defense of the Efficient Market Hypothesis: to disprove market efficiency it is necessary to prove that investors behave irrationally…Buried deep within the Efficient Market Hypothesis is the unstated assumption that investors always have to hand the necessary information with which to calculate the correct price of an asset. If this assumption turns out to be false and investors are sometimes denied the necessary information to make informed judgments about asset prices, or worse still if they are given misleading information, then it becomes possible for asset price bubbles to form without investors behaving irrationally. [55]

inappropriately from the perspective of the party with less information….A special case of moral hazard is called a principal-agent problem, where one party, called an agent, acts on behalf of another party, called the principal. The agent usually has more information about his or her actions or intentions than the principal does, because the principal usually cannot perfectly monitor the agent. The agent may have an incentive to act inappropriately (from the viewpoint of the principal) if the interests of the agent and the principal are not aligned.

[52] COP Report, p. 3.

[53] COP Report, p. 13.

[54] The important role of the imperfect information occurs in several of Stiglitz's arguments: "For the stock market to function well, there needs to be accurate information about what a company is worth so that investors can pay the right price for its shares. By obfuscating the problems inherent in many of the companies they brought to the market or for which they helped raise capital by issuing shares, the banks contributed to the erosion of the quality of information. They were supposed to provide information to investors, to reduce the disparity between informed insiders and outsiders. Instead, asymmetries of information maintained or increased; in many cases, bankers and analysts knew the real state of affairs about the companies they worked with but the public did not. Confidence in the markets declined, and when the correct information came out, share prices declined sharply.

[55] Cooper, p. 112 .

This observation suggests a simple typology of conditions for asset bubbles based on the distribution of information and the tendency of investors to gain in rational action (see Table II-1).

***Table II-1: Conditions for Asset Bubbles***

| | | Distribution of Information | |
|---|---|---|---|
| | | Perfect | Imperfect |
| Investor Behavior | Perfect | Bubble not Possible | Bubble Possible |
| | Bounded Rational or Irrational | Bubble Possible | Bubble Possible |

It seems that the set of conditions where bubbles are not possible is small, if not null.

Asymmetry of information between management, stockholders and the public provides an open invitation for mischief. When auditors and rating agencies, who are the certifiers of information, have conflicts of interest between their reporting functions and their financial relations to clients, there is an obvious problem. While auditor conflicts were at the heart of the Enron crisis, a more central conflict of interest in the current crisis was in the issuer-paid credit rating agency system. Credit rating agencies' profitability depended on their ability to win market share in rating structured finance deals, and their ability to win that business too often depended on the "flexibility" of their ratings.[56] Investment banks had their own conflicts. Although they were responsible for both ensuring that credit rating agencies received complete and accurate information regarding the securities they were to rate and that investors received full and fair disclosure regarding the deal, the massive fees they earned underwriting the securities left them with little incentive to fulfill their information responsibilities diligently.

[56] Roger Lowenstein, "Triple A Failure," *The New York Times Magazine,* April 27, 2008. See also, Gretchen Morgenson, "Debt Watchdogs, Caught Napping: Riding on Housing Boom, Credit-Rating Firms Led Investors Astray," *The New York Times*, December 7, 2008; U.S. Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission's Staff Examinations of Select Credit Rating Agencies,* July 2008; Jesse Westbrook, "SEC Ratings Probe Reveals Conflicts in Grading Debt," *Bloomberg,* July 8, 2008; Neil Baron, "Viewpoint: Put the Focus Back on Ratings Accuracy," *American Banker,* January 9, 2009.

At the end, financial institutions claimed not to have accurate information about the quality of the assets they owned, but if true, this was a self-inflicted wound in a number of ways. Examining how Wall Street analysts and economists could have failed to foresee the surge in subprime foreclosures in 2007 and 2008, a group of four Federal Reserve economists found that the risk models used by the firms correctly predicted that a 10 to 20 percent drop in real estate prices would imperil the market for subprime mortgage-backed securities, but the Wall Street analysts downplayed the likelihood of that happening.[57]

Others had been warning about risks in this market for some time. In a paper presented in February 2007 to the Hudson Institute, for example, economists Joseph R. Mason[58] and Joshua Rosner[59] noted that changes in the market for mortgage-backed securities and a relaxation of lending standards may have "created an environment of understated risk to investors." They concluded that "even investment grade rated CDOs will experience significant losses if home prices depreciate."[60] Hedge fund manager John Paulson, who has made billions for his investors in 2007 and again last year betting against mortgage-backed securities and the financial institutions that owned them,[61] told members of the House Oversight and Government Reform Committee last November that his firm's concerns "about weak credit underwriting standards, excessive leverage among financial institutions and a fundamental mis-pricing of credit risk" dated back to 2005.[62] His firm determined where to invest, he has said, by looking past the credit ratings and instead examining the data on the loans underlying the securities[63] – something that the financial institutions could also have done, particularly when, like Citigroup and others, they were making the loans in one affiliate and underwriting them in another. Perhaps they just did not look because they were making too much money on the underwriting and origination fees and because they were running with the herd.[64]

Financial institutions have a more compelling case when they argue that they lacked essential information about the creditworthiness of the counterparties to their deals. These institutions now hold tens of trillions of dollars in credit default swap contracts, but until recently, they "haven't had to provide even cursory disclosure of

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[57] Steve Lohr, "In Modeling Risk, the Human Factor was Left Out," *The New York Times,* November 5, 2008, citing "Making Sense of the Subprime Crisis."

[58] Associate Professor of Finance and LeBow Research Fellow, Drexel University LeBow College of Business, Senior Fellow at the Wharton School, and Visiting Scholar, Federal Deposit Insurance Corporation.

[59] Managing Director, Graham Fisher & Co.

[60] Joseph R. Mason and Joshua Rosner, *How Resilient are Mortgage-backed Securities to Collateralized Debt Obligation Market Disruptions?,* paper presented at he Hudson Institute, February 15, 2007.

[61] Gary Weiss, "The Man Who Made Too Much," *Condé Nast Portfolio.com,* February 2009.

[62] Testimony of John Paulson, President and Founder of Paulson & Company, Inc. before the Committee on Oversight and Government Reform, U.S House of Representatives, November 13, 2008.

[63] Anthony Effinger, "Paulson Housing Bets Make $2.7 Billion, Beat Citadel," *Bloomberg,* November 29, 2007.

[64] Eric Dash and Julie Creswell, "Citigroup Saw No Red Flags Even as it Made Bolder Bets," *The New York Times*, November 23, 2008.

credit-default swaps in their financial statements."[65] As the Yale School of Management professor who wrote AIG's computerized risk models has said: "You have this very, very complicated chain of the movement of the risk, which made it very opaque about where the risk finally resided. And it ended up residing in many places. So the whole infrastructure of the financial market became kind of infected, because nobody knew exactly where the risk was."[66]

That was the painful lesson regulators learned when they allowed Lehman Brothers to fail, and it was the reason they determined that AIG could not be allowed to follow in Lehman's footsteps. As the COP Report notes, the problem of lack of transparency in this and other areas has become acute. "In recent years, it appears that even many of the most sophisticated investors – and perhaps even the credit rating agencies themselves – had trouble assessing the risks associated with a wide array of new and complex financial instruments. Complexity itself may therefore have contributed to the binge of risk taking that overtook the Unites States Financial System in recent years."[67]

> Financial engineering involved the creation of increasingly sophisticated instruments, or derivatives, for leveraging credit and "managing" risk in order to increase potential profit. An alphabet soup of synthetic financial instruments was concocted: CDOs, CDO squareds, CDSs. ABXs, CMBXs, etc. This engineering reached such heights of complexity that the regulators could no longer calculate the risks and came to rely on the risk management models of the financial institutions themselves. The rating companies followed a similar path in rating synthetic financial instruments, deriving considerable additional revenues from their proliferation. The esoteric financial instruments and techniques for risk management were based on the false premise that, in the behavior of the market, deviations from the mean occur in a random fashion. But the increased use of financial engineering set in motion a process of boom and bust. So eventually there was hell to pay.[68]

The proliferation of complex products was accompanied by the growth of "opaque" institutions and entities that "face almost no registration and reporting requirements. The problem was not only complex products… that are the polar opposite of open and transparent exchange."[69]

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[65] Lewis and Einhorn, "How to Repair a Broken Financial World."

[66] Carrick Mollenkamp, Serena Ng, Liam Pleven and Randall Smith, "Behind AIG's Fall, Risk Models Failed to Pass Real-World Test," *The Wall Street Journal*, DATE?

[67] CPO Report, p. 11.

[68] George Soros, "The Crisis and What to Do About it, *New York Review of Books,* December r4, 2008.

[69] CPO Report, p. 14.

> The conclusions of the rational expectations theorists – most important, those relating to the efficiency of markets – fall apart if different people know or believe different things, as they plainly do. Markets are supposed to lead the economy to efficiency *as if by an invisible hand.* In the aftermath of the Roaring Nineties, it appears that the invisible hand wasn't working very well, and the theories of asymmetric information helped provide the explanation. Unfettered markets, rampant with conflicts of interest, can lead to inefficiency. We can never eliminate the problems; we can, however, mitigate them. In the nineties, we made them worse.[70]

**Perverse Incentives**

The failure to properly manage risk undermines the functioning of the system and, in the extreme, causes it to collapse. Management of risk is framed by the COP report both in terms of several narrow and well-known challenges, such as moral hazard and systemic risk, but also a broader concern about the efficiency with which risk is evaluated.

Market fundamentalism has a pervasive incentive problem. There is an engine of instability in the structure/conduct heart of the unregulated financial market. Fees from making deals became a huge source of income and the quality of the deals mattered less and less.[71] The deals can be sold by conflict-ridden brokers and supported by loans from conflict-ridden banks or securitized by conflict-ridden investment banks and rated by conflict-ridden credit ratings agencies and moved off the balance sheets so that more deals can be made and more fees earned. The broad breakdown results from "devoting relatively little attention to risk assessment," exhibiting "a willingness to issue extraordinarily risky loans."[72] These risky loans were attractive as a result of a perverse set of incentives affecting financial institutions that "could sell them quickly in secondary markets while earning large fees from bundling them. Credit rating agencies (who were paid by the issuers) awarded their triple-A seal of approval because they failed to properly evaluate the risk of securitized instruments."[73]

As long as more money could be pulled in, the day of reckoning could be pushed off. Easy credit and shaky accounting practices create an upward spiral,[74] and tax policy makes it all the more rewarding. Easy money and regressive tax policy accelerate the upward spiral. Bad practices tend to drive out good. Bursting bubbles reveal blatant fraud that was hidden beneath the froth – Enron, Worldcom, Madoff.

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[70] Stiglitz, Roaring Nineties, p. 152.
[71] Stiglitz, Roaring Nineties, p. 149, Investment houses became marketers. They did what it took to sell what they could sell.
[72] COP Report, p. 9.
[73] COP Report, p. 9.
[74] Cooper, p. 105, "The combination of debt-financing and mark-to-market accounting conspire to give price movements in the asset markets a fundamentally unstable positive feedback characteristic."

In an environment that emphasizes short-term stock market returns and allows risk takers to take out earning quickly, practices degenerate.[75] As the bad actors get their short-term rewards, the good actors become desperate to keep up. The process affects lending,[76] accounting,[77] executive compensation,[78] underwriting[79] and home mortgages.[80] As the former CEO of Citibank put it: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance."[81]

> Our financial catastrophe, Like Bernard Madoff's pyramid scheme, requires all sorts of important, plugged in people to sacrifice our collective long-term interests for short-term gain. The pressure to do this in today's financial markets is immense. Obviously the greater the market pressure to excel in the short-term, the greater the need for pressure from outside the market to consider the longer term. But that's the problem: there is no longer any serious pressure form outside the market. The tyranny of the short-term has extended itself with frightening ease into the entities that were meant to, one way or another, discipline Wall Street, and force it to consider its enlightened self-interest.[82]

> Firms made short-term underwriting fees for packaging mortgage-backed securities that have since become known as "toxic assets." Traders booked short-term profits trading them (or simply marking them up). Executives pushed their subordinates to take more risk because they would yield more profits, and bigger bonuses. Nobody had any incentive to worry about whether those securities would "blow up. Too much bonus money was at stake."[83]

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[75] Stiglitz, Roaring Nineties, p. 143, "Deregulation enhanced the scope for conflicts of interest. It also had the advertised effect of increasing competition. In normal circumstances, increased competition is a good thing. But in the nineties, the banks became so eager for short-term profit that here was a race to the bottom. Each bank knew that its competitors were engaging in similar practices, and if it did not compete, it would be left behind; and each banking officer knew what that meant; small bonuses, perhaps even being fired.

There is good economic research that shows a direct tie between options compensation and an increase in accounting fraud.

[76] George Cooper, *The Origin of Financial Crises: Central Banks, Credit Bubbles and the Efficient Market Fallacy* (New York: Vintage), p. 60.

[77] Stiglitz, Roaring Nineties, p. 100.

[78] Stiglitz, Roaring Nineties p. 125.

[79] Stiglitz, Roaring Nineties p. 146-148.

[80] Krugman, Return, p. 149.

[81] Cited in Soros, p. 84.

[82] Michael Lewis and David Einhorn, "The End of the Financial World as We Know It," *New York Times,* January 4, 2009.

[83] Joe Nocera, "First, Let's Fix the Bonuses," *New York Times,* February 21, 2009, p. b8.

It is interesting to note that some trace the problem to an underlying change in ownership structure that started in the 1970s when the corporate form of ownership replaced the partnership in investment banking. By changing the incentive structure and shifting risk, the pattern of behavior was dramatically altered.

> John Gutfreund did violence to the Wall Street social order – and got himself dubbed the King of Wall Street – when he turned Salomon Brothers from a private partnership into Wall Street's first public corporation… He and the other partners not only made a killing; they transferred the ultimate financial risk from themselves to their shareholders…
>
> No investment bank owned by its employees would have levered itself 35 to 1 or bought and held $50 billion in mezzanine C.D.O.'s. I doubt any partnership would have sought to game the rating agencies or leap into bed with loan sharks or even allow mezzanine C.D.O.'s to be sold to its customers. The hoped-for short-term gain would not have justified the long-term hit.[84]

While some call for a return to partnerships to ensure that bankers have skin in the game,[85] the broader message is that corporate governance did not replace the discipline that partners imposed on one another.

> Today's bonus system is a warped legacy of those old partnerships. Starting in the 1970s Wall Street firms began going public, which meant that the partners' capital was replaced by shareholder equity. But the firms never abandoned the idea that salary was only a small part of employee pay – and that the big payoff came at the end of the year at bonus time. In addition, trading began to overshadow advising as an investment bank's primary way of making money. [86]

Viewed in this broader perspective, reform of executive compensation is not punishment for being greedy, it is a vital step necessary to repair the perverse incentives of the financial sector built up over the past thee decades.

## Agency

The separation of ownership and control has long been recognized as a social problem for the capitalist economy, but the incentive structures of market

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[84] Michael Lewis, "The End," *Portfolio,* December 2008,

[85] James K. Glassman and William T. Nolan, "Bankers Need More Skin in the Game," *Wall Street Journal,* February 25, 2009, A15.

[86] Joe Nocera, "First Let's Fix the Bonuses," *New York Times,* February 21, 2009, p. B8,

fundamentalism make it more or less urgent. "Financial actors do not always bear the full consequences of their decision and therefore are liable to take (or impose) more risk than would otherwise seem reasonable. For example, financial institutions generally invest other people's money and often enjoy asymmetric compensation incentives, which reward them for gains without penalizing them for losses." [87] Stiglitz sees a powerful interaction between information, agency, incentive structures and conflicts of interest. Because of imperfect information, it is often difficult to make sure that an agent does what he is supposed to do. Because of the failure to align incentives, it is often the case that he does not.

The problems of agency and perverse incentives intersect in a highly visible issue in the current context – executive compensation. The COP report notes the themes of inequality and a disconnect between compensation and performance, but emphasizes the implications of a faulty compensation system for the central function of the financial sector. The compensation packages not only increased dramatically, but took on a structure that "introduced short-term bias in business decision making," particularly stock market performance. The result is "unnecessary risk that many compensation schemes introduce into the financial sector. Altering the incentives that encourage this risk through the tax code, regulation, and corporate governance reform will help mitigate systemic risk in future crises."[88]

The huge compensation packages of Wall Street executives have garnered loud headlines, as has the astronomical growth in the inequality that it represents. The problem of excessive executive compensation is economy wide however. CEO pay is estimated to have stood at just over 40 times average worker wages in 1970. By 2008, CEOs earned 500 times as much as the average worker. But analysts and reformers focus on the agency problem that has been created by the dramatic change in the compensation structure. CEOs earn at the expense of shareholders, and this problem is particularly pronounced in the finance sector where "the management of the investment banks did exactly what they were incentivized to do: maximize employee compensation. Investment banks pay out 50% of revenues as compensation."[89] The consequence of the agency problem is a perverse incentive.

> So, more leverage means more revenues, which means more compensation. In good times, once they pay out the compensation, overhead and taxes, only a fraction of the incremental revenues fall to the bottom line for shareholders. Shareholders get enough so that the returns are decent. Considering the franchise value, the non-risk fee generating capabilities of the banks, and the levered investment results, in good times the returns on

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[87] COP Report, p. 10.
[88] COP Report, p. 37.
[89] David Eiinhorn, "Private Profit and Socialized Risk," *Grant's Spring Investment Conference,* April 8, 2008, p. 1.

> equity should not be decent, they should be extraordinary. But they are not, because so much of the revenue goes to compensation… Nobody talks about the investment banks' 50% structures, which have no high water mark and actually are exceeded in difficult times in order to retain talent.
>
> The CEOs and other executives of corporations are *supposed* to act in the best interests of the corporations, its shareholders and workers; but in the nineties, incentives got badly misaligned. In acting in their own interests, CEOs often did not serve well those on whose behalf they were supposed to be working. The irony was that the changes in pay structure which were at the root of much of the problem were defended as improving incentives."[90]

**Conflicts of Interest**

Conflicts of interest pervade the financial system. We have already mentioned, in the information discussion above, the critical problem that conflicts of interests involving credit rating agencies and investment banks played in the current financial crisis. But conflicts of interest can take many other forms as well.

When a single entity owns both an insured business (e.g. a commercial bank) and an uninsured business (an investment bank), or both regulated and unregulated subsidiaries that deal with each other, there is a powerful conflict of interest. Profit can be increased with imprudent loans by having the insured (regulated) entity, which is not supposed to get into risky lines of business, subsidize the uninsured (unregulated) ventures that do get into riskier businesses. Where management can enrich itself at the expense of stockholders, with gimmicks, such improperly accounted stock options, there is a pervasive conflict of interest.

The most prominent change in attitude toward potential conflict of interest was the decision to repeal the ban on comingling investment activities and commercial banking. In recounting the early market fundamentalism efforts to eliminate the ban instituted by the Glass Steagall Act, a PBS documentary recounted a 1987 debate.

> Thomas Theobald, then vice chairman of Citicorp, argues that three "outside checks" on corporate misbehavior had emerged since 1933: "a very effective" SEC; knowledgeable investors, and "very sophisticated" rating agencies. Volcker is unconvinced, and expresses his fear that lenders will recklessly lower loan standards in pursuit of lucrative securities offerings and market bad loans to the public. For many critics, it boiled down to the issue of two different cultures – a culture of risk which was the

[90] Stiglitz, p. 14.

> securities business, and a culture of protection of deposits which was the culture of banking.[91]

A little over a decade latter, the repeal of Glass-Steagall led the advocates of repeal to "hail the change as the long-overdue demise of a Depression-era relic."[92] The irony is that in less than a decade all three of "the checks on corporate behavior" failed. Two of them – "knowledgeable investors" and "very sophisticated rating agencies" were based in the market and the third failed when the SEC decided to abdicate its oversight to the private sector.

At the extreme, where agents not only pursue their interests at the expense of shareholders and the public, but also do so illegally, conflicts of interest become fraud. Fraud is not unique to market fundamentalism, but the institutional structure creates a fertile field for an endemic fraud problem. High stakes, lax oversight, creative accounting and a short-term perspective are conducive to fraud. The line between the illegal, immoral and ill-advised becomes blurred in this hothouse environment.

Given the structural conduciveness to fraud and the structurally induced race to the bottom in accounting and ethics, it is fair to argue that market fundamentalism has a uniquely endemic fraud/abuse problem. That said, it is important to recognize that the problem will not be solved just by attacking the illegal fraud. That must be done through enforcement, but public policy must address the underlying structures that give rise to and permit the fraudulent activity to become so pronounced. The catharsis of just throwing the criminals in jail and declaring victory will not suffice. It becomes a strategy to sidestep or avoid the more meaningful and fundamental reforms of market structure.

The story of Citigroup, Citibank's parent company, could be the poster child for the financial chicanery that market fundamentalism invites. The marriage of commercial and investment banking was consummated in violation of the law, but in anticipation of its repeal. Repeal was vigorously supported by Robert Rubin, President Clinton's Secretary of the Treasury, who would later become chairman of Citigroup's executive committee. Citigroup was deeply involved in the Enron fiasco and the Worldcom bankruptcy. Citgroup's investment arms were underwriting stock offerings and IPOs for both Worldcom and its CEO Bernie Ebbers, while its commercial banks and insurance companies were making loans to prop up wobbly enterprises. At the same time, its analysts were touting the enterprises to the public. The two entities that eventually went bankrupt (Enron and Worldcom) were inflated by accounting practices that misrepresented the underlying value of the assets (goodwill in the case of Worldcom, off-balance sheet entities that hid debt and accounting gimmicks that inflated income in the case of Enron), but the banks did not care because of all the fees they were collecting on other transactions. Of course, there was blatant fraud here, too, for which the CEOs of

[91] Frontline, "The Long Demise of Glass-Steagall," PBS.org, May 8, 2008.
[92] Frontline, "The Long Demise of Glass-Steagall," PBS.org, May 8, 2008.

both Enron and Worldcom were eventually convicted, but there was a lot more than fraud at work, there was a systemic failure of prudential oversight.

And the Citigroup saga did not end with Enron and Worldcom. In the current crisis, Citigroup has once again been called to account, this time by the Federal Reserve, for its poor oversight and risk controls.[93] Engaged in a high-risk growth strategy, the firm began underwriting billions in mortgage-backed securities, using "accounting maneuvers to move billions of dollars of the troubled assets off its books, freeing capital so the bank could grow even larger."[94] As a recent account described:

> From 2003 to 2005, Citigroup more than tripled its issuing of C.D.O.'s, to more than $20 billion from $6.28 billion, and Mr. Maheras, Mr. Barker and others on the C.D.O. team helped transform Citigroup into one of the industry's biggest players. Firms issuing the C.D.O.'s generated fees of 0.4 percent to 2.5 percent of the amount sold — meaning Citigroup made up to $500 million in fees from the business in 2005 alone.
>
> Even as Citigroup's C.D.O. stake was expanding, its top executives wanted more profits from that business. Yet they were not running a bank that was up to all the challenges it faced, including properly overseeing billions of dollars' worth of exotic products, according to Citigroup insiders and regulators who later criticized the bank …
>
> … While the sheer size of Citigroup's C.D.O. position caused concern among some around the trading desk, most say they kept their concerns to themselves.
>
> "I just think senior managers got addicted to the revenues and arrogant about the risks they were running," said one person who worked in the C.D.O. group. "As long as you could grow revenues, you could keep your bonus growing."
>
> To make matters worse, Citigroup's risk models never accounted for the possibility of a national housing downturn, this person said, and the prospect that millions of homeowners could default on their mortgages. Such a downturn did come, of course, with disastrous consequences for Citigroup and its rivals on Wall Street.[95]

So far, the consequence for taxpayers has been a federal bailout of about $350 billion, and shareholders have seen the company's market value drop to less than one-tenth of what it was at its peak two years ago. As a *Times* article noted: "Citigroup's woes are emblematic of the haphazard management and rush to riches that enveloped all of Wall Street. All

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[93] Dash and Creswell, "Citigroup Saw No Red Flags."
[94] Ibid.
[95] Ibid.

across the banking business, easy profits and a booming housing market led many prominent financiers to overlook the dangers they courted."[96]

**Unfairness/Inequality**

The five flaws in unregulated financial markets discussed above have been recognized as creating the potential for market failure in unregulated markets. The COP adds a sixth problem – unfairness, which it argues also contributes to the malfunctioning of the system. Unfairness in transactions, it argues, can starve the system of resources, raising costs and restricting activity. Unfairness involves two categories of problems.

> Unfair dealings can be blatant, such as outright deception or fraud, but unfairness can also be much more subtle, as when parties are unfairly matched… If one party to a transaction has significantly more resources, time, sophistication, or experience, other parties are at a fundamental disadvantage… Unfair dealings affect not only the specific transaction participants, but extend across entire markets, neighborhoods, socioeconomic groups, and whole industries…As those consequences spread, the entire financial system can be affected as well… Unfairness… causes a loss of confidence in the marketplace. [97]

Unfairness in transactions not only threatens the flow of resources into the system, but it results in the misallocation of resources, as lenders take advantage of overmatched borrowers. The wrong people get loans at the wrong prices from the point of view economic efficiency. This conceptualization expands on the treatment of unfairness as an outcome of the market – inequality – i.e. we frequently see inequality as inequity; here we see it as inefficiency.

This broader conceptualization of the importance of unfairness/inequality as a supply-side issue fits the current crisis in another sense, which is a demand side problem. The severe increase in inequality of income and resources that took place during the reign of market fundamentalism resulted in a failure of incomes to keep up with the rapid expansion of the production capacity of the economy and the rising cost of necessities – housing, education, health care, and energy – put severe stress on household budgets.[98]

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[96] Ibid.

[97] COP Report, p. 3.

[98] Ip and McKinnon, "The typical worker's pay have grown only) .3%, adjusted for inflation, since the expansion began at the end of 2001 while the economy has grown by 16%. The share of total income going to the richest 1% of Americans rose to a postwar record of 17.4% in 2005… Even before Republican's November defeat at the polls, some administration allies were warning that economic insecurity was eroding Republican support. A business coalition hired pollster David Winston to figure our why voters remained so dissatisfied with the economy. His focus groups of middle-income voters in Cincinnati and Pittsburgh found voters going deeper into debt to keep up with rising costs of health care and energy. Executive compensation "is getting to the point where it's obscene, said on focus group participant… But Republican strategists largely ignored the findings. Michael Lewis, "The End," cites

They plunge into debt to maintain their living standard.[99] Savings are too low, and concentrated wealth creates rampant speculation rather than productive investment in the real economy.[100] The tide may rise, but it does not lift all boats. Instead, the rip currents of inequality are so strong that the middle class is capsized and drowns in an ocean of debt. The supply-side and the demand-side of excessive inequality intersect in an inadequate national savings rate.

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the ratio of median home price to income" as " a measure of sanity in housing prices." Noting that it had increased from 3-to-1 to 4-to-1 and was as high as 10-to- in the hot markets. Various aspect of household deficit spending are dealt with in a series of reports from the Levy Institute, see Edward N. Wolff, *Recent Trends in Household Wealth in the United States: Rising Debt and the Middle-Class Squeeze, June 2007;* Robert W. Parenteau, *U. S. Household Deficit Spending: A Rendezvous with Reality,* The Levy Economics Institute, 2007; Dimitri B. Papadimtriou, Edward Chilcote, and Gennare Zezza, *Are Housing Prices, Household Debt, and Growth Sustainable?,"* the Levy Institute, January 2006.

[99] Robert K. Frank, "Why Wait to Repeal Tax Cuts for the Rich?", *New York Times,* December 7, 2008, p. 5, "A robust finding in behavioral research is that people are extremely reluctant to accept cutbacks in their standard of living."

[100] Joseph Stiglitz, "Capitalist Fools," *Vanity Fair,* January 2009, " The president and his advisers see\med to believe that tax cuts, especially for upper-income Americans and corporations, were a cure-all for any economic disease… The tax cuts played a pivotal role in shaping the background conditions of the current crisis. Because they did very little to stimulate the economy, real stimulation was left to the Fed, which took up the task with unprecedented low-interest rates and liquidity… The flood of liquidity made money readily available in mortgage markets, even to those who would normally not be able to borrow. And, yes, this succeeded in forestalling an economic downturn; America's household savings rate plummeted to zero. But it should have been clear that we were living on borrowed money and borrowed time. The cut in the tax rate on capital gains contributed to the crisis in another way. It was a decision that turned on values: those who speculated (read: gambled) and won were taxed more lightly than wage earners who simply worked hard. But more than that, the decision encouraged leveraging, because interest was tax deductible.

## III. THE ROLE OF PUBLIC POLICY IN THE FINANCIAL CRISIS

The Additional Views of the Republicans on the COP argues that it was not only a failure to properly regulate that caused the crisis; "other" policies contributed.[101] That is certainly the case, but their effort to ignore the fundamental flaws in market fundamentalism or blame it on a narrow set of problems misrepresents the nature of the current crisis and points policy makers in the wrong direction.[102] Inadequate regulation flows from the core values of market fundamentalism – the assumption that markets work well and that government is the problem. Solving secondary problems without addressing the primary problems will not produce the result we want. Moreover, the "other" policies that are blamed for the crisis are actually part and parcel of market fundamentalism. They are the logical conclusions that flow from the faulty assumptions of market fundamentalism.

### POLICY CHOICES MAGNIFIED THE FLAWS IN MARKET FUNDAMENTALISM

Market fundamentalism drove a public policy that exposed its structural flaws. In spite of the repeated crises, meltdowns and market failures, market fundamentalism provided the intellectual rationale for markets to run wild. Unregulated markets expanded rapidly, called shadow banking in the finance sector and the grey market in commodities. They were not regulated because market fundamentalism believed that they should not be regulated so they could work their magic. The fact that they have cratered reflects the inefficient, antisocial behaviors that unregulated markets promote.

Before the market meltdown in late 2008, for example, the notional value of over-the-counter credit default swap market was estimated at $62 trillion.[103] In 2006, the SEC estimated that hedge funds, which are largely unregulated,[104] accounted for 5 percent of

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[101] COP Report, pg. 61-76.

[102] Stephen Mihm, "Dr. Doom" *New York times,* August 17, 2008, quotes Nouriel Roubini as follows: "For months Roubini has been arguing that the true cost of the housing crisis will not be a mere $300 billion – the amount allowed for by the housing legislation sponsored by Representative Barney Frank and Senator Christopher Dodd – but something between a trillion and a trillion and a trillion and a half dollars. But most important, in Roubini's opinion, is to realize that the problem is deeper than the housing crisis. 'Reckless people have deluded themselves that this is a subprime crisis,' 'But we have problems with credit-card dept, student-loan debt, auto loans, commercial real estate loans, home-equity loans, corporate debt and loans that financed leveraged buyouts. All of these forms of debt, he argues, suffer from some or all of the same traits that first surfaced in the housing market: shoddy underwriting, securitization, negligence on the part of credit-rating agencies and lax government oversight. 'We have a subprime financial system,' he said, 'not a subprime mortgage market.'"

[103] Eric Dinallo, Superintendent of the New York State Insurance Department, "The Causes and Effects of the AIG Bailout," testimony before the Committee on Oversight and Government Reform, U.S. House of Representatives, Oct. 7, 2008.

[104] The Securities and Exchange Commission attempted to regulate hedge funds under the Investment Advisers Act in 2005, but that rule was overturned by the D.C. Circuit Court of Appeals in 2006. Some hedge fund managers who had registered as investment advisers under that rule have chosen to retain their registration.

assets under management and 30 percent of trading on equity markets.[105] More recent estimates peg the number of hedge funds at roughly 10,000 and their assets under management at $1.8 trillion, even after they suffered losses over the past year of more than $1 trillion.[106] Underwriters of CDOs have also found a way to work outside the regulated system, by conducting many of their transactions through unregulated private sales to "sophisticated" investors.[107]

> With these deals, known as collateralized debt obligations, the world glimpsed the raw power of unchecked financial markets operating full-throttle to the point of self-destruction. The cascading losses on CDO bonds have undermined the solvency of several large banks and obliterated the trust that is the bedrock of all functioning markets.[108]

Over-the-Counter markets in commodities served as a similar avenue for traders to avoid oversight and as a haven for manipulation and excessive speculation.[109]

While unregulated markets, particularly over-the-counter derivatives markets, played a major role in the current crisis, much damage also occurred within the regulated financial sector as the result of decisions by regulators not to exercise the authority available to them. The deregulatory legislation adopted over the past several decades generally required regulators to set the parameters of market freedom and had contingency powers that regulators could have exercised to place restraints on markets.[110] Unfortunately, they generally chose not to, because the market fundamentalist ideology indicated it was not necessary. The Fed's failure to use its authority under the Home Ownership Equity Protection Act to rein in unsound mortgage lending has, for example, been cited as a root cause of the current crisis.[111] Another contributing cause was the 2004 decision by the SEC to replace its net capital rules for the largest investment banks and their holding companies with a voluntary system in which regulators would defer to the company's risk management practices and models.[112] The theory was that financial institutions did not want to fail, so they would be rigorous in guarding against risks.[113]

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[105] Floor Statement of Sen. Carl Levin, introducing The Hedge Fund Transparency Act of 2009, in the U.S. Senate, January 29, 2009.
[106] Ibid.
[107] Jill Drew, "Frenzy," *The Washington Post,* December 16, 2008. See also Mark Whitehouse and Serena Ng, "Insurance Deals Spread Pain of U.S. Defaults Worldwide," *The Wall Street Journal,* December 23, 2008.
[108] Drew, "Frenzy."
[109] Permanent Subcommittee on Investigations, United States Senate, *Excessive Speculation in the Natural Gas Market,* June 25, 2007.
[110] The Commodities Futures Modernization Act, which has played such a devastating role in the current crisis, was the glaring exception in that it completely precluded regulation, providing regulators with no contingency powers.
[111] Peter S. Goodman, "Taking Hard New Look at a Greenspan Legacy," *The New York Times,* October 8, 2008.
[112] Lee A. Pickard, "Viewpoint: SEC's Old Capital Approach Was Tried – and True," *American Banker,* August 8, 2008.
[113] Stephen Labaton, "Agency's '04 Rule Let Banks Pile Up New Debt," *The New York Times*, October 3, 2008.

That turned out not to be the case,[114] and the firms that relied on these capital standards have all now either folded (Lehman Brothers), been merged into other entities (Bear Stearns, Merrill Lynch), or converted to bank holding companies (Goldman Sachs, Morgan Stanley).

With finance liberated at the core of market fundamentalism, public policy was pushed to further the interests of market participants and allow the finance sector to dominate the economy. The assumption is that more freedom for private sector actors to do their thing is good for the economy. Proponents of market fundamentalism pushed tax, regulatory and accounting policies to create incentives that rewarded financial returns, short-term perspectives and speculation before the needs of the real economy. Market fundamentalism catered to the desires of Wall Street and the wealthy, who could and can afford to gamble for high risk, quick return investment. Stock market performance was all that mattered, while the balance sheet results were ignored.[115]

Easy money fueled asset bubbles that contributed to the crisis. But those who place the blame primarily on easy money as evidence of misguided regulation fail to recognize that easy money did not by itself create unmanageably complex products, opaque institutions and transactions, or dramatically over-levered financial institutions. Moreover, they ignore the deregulatory source of easy money. Easy money comes about as a result of financial deregulation in a variety of ways – low interest rates, lenient lending practices, low capital and margin requirements, relaxed rating standards, and tax cuts for the wealthy and corporations.

> The capital gains tax cut reinforced CEO's proclivity to focus on short-run market value rather than long-run performance. When investors were "locked in" to their shares, they cared less about the market value of the shares today or even tomorrow. They wanted to know about how a firm would fare in the long term. Cutting the capital gains tax helped focus investor's attention on the here and now. This in turn fed the frenzy,

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[114] David Einhorn, *Private Profits and Socialized Risk*, speech at Grants Spring Investment Conference, April 8, 2008. See also James G. Rickards, "A Mountain, Overlooked," *The Washington Post,* October 2, 2008.

[115] Robert Pollin, "Tools for a New Economy," *Boston Review,* points out that excessive financialization does not contribute to the proper functioning of the real economy: "Financial markets do provide an essential service by simplifying the conversion of investment into money. But this benefit must be weighed against the fact that trading has almost nothing to do with raising funds for investment. As of 2007, players in the market traded roughly $300 worth of stocks and bonds for every dollar that nonfinancial corporations raise for new investments in plant and equipment. This ratio is about three times what it was only a decade ago, at the peak of the dot-com bubble." Thomas I. Palley, "Financialization: What It Is and Why It Matters?," *The Levy Economics Institute,* goes a step further and argues that financialization harms the economy: " Its principal impacts are to (1) elevate the significance of the financial sector relative to the real sector, (2) transfer income from the real sector to the financial sector, and (3) increase income inequality and contribute to wage stagnation. Additionally, these are reasons to believe that financialization may put the economy at risk of debt deflation and prolonged recession. Financialization operates through three different conduits: changes in the structure and operation of financial markets, changes in the behavior of nonfinancial corporations and prolonged recession.

> exacerbating the bubble, while at the same time setting in motion forces that would make the downturn greater, when the bubble burst. … But now, with the capital gains tax cut when those who worried that their particular stock might be overpriced, and therefore cashed in, it left them with far more money to reinvest into the stock market, thereby feeding the frenzy all the more. Similarly, the tax cuts made the incentives for giving stock options to CEOS all the greater and it made the (after tax) return from providing distorted account information … all the more powerful.[116]

The failure of top-heavy tax cuts and a finance and speculation driven economy to produce broad based and vigorous growth in the real economy created a need for easy money.

> You still hear some... argue that the administration's tax cuts were meant to stimulate the economy, but this was never true. The bang for the buck – the amount of stimulus per dollar of deficit – was astonishingly low. Therefore, the job of economic stimulation fell to the Federal Reserve Board, which stepped on the accelerator in a historically unprecedented way, driving interest rates down to 1 percent… The predictable result was a consumer spending spree. Looked at another way, Bush's own fiscal irresponsibility fostered irresponsibility in everyone else. Credit was shoveled out the door, and subprime mortgages were made available to anyone this side of life support. Credit-card debt mounted.[117]

Accounting practices were initially relaxed and gimmicks used to pump up the value of assets or avoid revealing the real value of assets. This led directly to the rash of major accounting scandals at public companies, most notably at Enron and Worldcom. After the Enron scandal, efforts were made to reverse that process, in part by providing the Financial Accounting Standards Board with an independent and secured source of funding and in part by directing the board to adopt tougher accounting standards to deal with off-balance sheet liabilities. Unfortunately, those efforts were only partially successful. FASB has still found itself subject to extensive political pressure, as the recent debate over mark-to-market accounting has made clear.[118] And the "strengthened" accounting standards on off-balance sheet transactions adopted post-Enron still allowed

[116] Stiglitz, pp. 175-176,

[117] Joseph E. Stiglitz, "The Economic Consequences of Mr. Bush," *Vanity Fair,* December 2007.

[118] Although they failed to win the suspension of mark-to-market that they sought, banking and mortgage industry representatives did succeed in getting language added to the Emergency Economic Stabilization Act of 2008 calling for an SEC study of the issue.

financial institutions to move risky assets off-balance sheet based on an ultimately false assumption that the assets did not pose a risk to the financial institutions.[119]

Tax and accounting policy allowed balance sheets to be artificially inflated by misrepresenting assets (e.g. good will), obligations (stock options), or costs (accelerated depreciation for long lived assets). In an effort to allow greater leverage, balance sheets were distorted with good will and mark-to-market accounting (when it resulted in inflated asset values) and market-to-model accounting (when asset values dropped). The asymmetric treatment of mark-to-market accounting epitomizes the distortion. During the boom phase, the market price is used to mark the value of the asset, no matter how exuberant it may be. Market fundamentalists insist that the market price is always the right price. But during the bust phase, we hear a different story. We are told that assets are being undervalued and they should not be marked to market. What a difference a declining market makes to the market fundamentalist.

Debt ridden IPOs and LBOs flourished, since they yielded quick returns, but were unsustainable. While accounting practices overvalued private assets, they undervalued public assets

The micro-level indicators of the flaws in market fundamentalism were revealed early in the Citigroup/Enron/Worldcom examples that occurred soon after deregulation. The warning signs were not heeded, and the incidents that may have been downplayed as aberrations have become endemic. Contagion, herd effects and the race to the bottom ensure that the worst practices spread throughout the industry.

There are a variety of macro-level indicators that suggest the efficient market and trickle down hypotheses are wrong – asset bubbles, the extreme financializtion of the economy, over levered households, etc**.** The cumulative effect of three decades of economic policy have taken a heavy toll and ultimately led to the collapse of the system. An examination of the magnitude of the economic meltdown is beyond the scope of this paper, but hard to miss or overestimate.

> For the last 30 years the US has been growing fast only during periods of asset bubbles that eventually burst with significant economic and financial costs.
>
> The 1980s real estate bubble went bust in the late part of that decade leading to a severe banking crisis for the Savings and Loan banks, a credit crunch and a severe recession in 1990-91; next the 1990s tech/internet bubble went bust in 2000 leading to the 2001 recession; massive monetary

[119] Government Accountability Office, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System,* January 2009, Pg. 32-35 and Figure 5, pg. 34.

> and credit easing – as well as lax supervision/regulation of mortgages and credit – led to another housing and credit bubble that has now gone bust creating a severe financial crisis and recession.
>
> The current monetary easing may lead to another bubble but we are somehow running out of bubbles to create. Housing, credit, equities, commodities, hedge funds, private equity bubbles: they have all gone bust now. We need to create an economic system that is less prone to bubbles and more likely to lead to sustainable stable growth.
>
> For the last few years the US has overinvested in the most unproductive form of capital – residential housing stock that increase utility but not labor productivity – and not enough into physical capital that increases the productivity of labor.
>
> Also we overinvested in the financial sector, a corollary of the housing boom: when the S&P500 market capitalization of financial firms was 25 per cent of the market and when over a third of the profits or earnings of S&P500 constituents came from financial companies, that was an excess of finance.
>
> And having a country where there are more financial engineers than computer engineers or mechanical engineers means a misallocation of human capital as well.
>
> So we need to create a growth model relying less on housing/real estate, less on finance and less on having the brightest minds of the country going into financial services rather than into the production and innovation of new and improved goods and services.[120]

These micro level flaws in market fundamentalism undermine and demolish the basic and understandably flawed assumptions of market fundamentalism

**The efficient market hypothesis is wrong.** Unregulated markets do not automatically create a stable, growing economy. In each of the sectors, there is a critical market failure that prevents the sector from doing what it is supposed to do, efficiently allocating resource to uses. Because the nature of the economic activity varies from sector to sector, the precise form of the market failure will vary, but there are repeated patterns.

[120] Roubini, Anglo Saxon.

In the finance sector we now know that self-interest is not enough to ensure prudential behavior.[121] Even the most sophisticated financiers fail to assess risk when financial instruments become too complex and the financial incentives to ignore risks become too strong.[122] The inability to assess and indifference to the risk of default and the difficulty of resolving assets in default undermines the central function of financial markets. The ascendance of finance undermined and drained resources from the real economy.[123]

**The income inequality hypothesis is wrong.** Trickle down economics does not produce a stable growing economy. Inequality is not a necessary condition for economic progress. To the contrary, inequality is a sufficient condition for economic meltdown. Inequality created by regressive tax cuts for corporations and the wealthy does not provide savings and investment to fuel real economic expansion. A narrow distribution of wealth does not create a stable base for economic growth, because wealth is not sufficiently spread to support demand.

**The "less government the better" hypothesis is wrong.** The public sector is not inherently inept, and the private sector is not inherently skillful.[124] The charges of public sector ineptitude pale in comparison to the ineptitude, fraudulent accounting, irrational lending and underwriting, and conflict-of-interest-driven abuse in the unregulated and under-regulated markets created by market fundamentalism.[125] Stable economic growth is not the outcome of small government for two reasons. First, it undermines effective oversight of the economy, which plays a key role in establishing the conditions for meltdown. Second, when the efficient market and inequality fallacies start to push the economy off the tracks, the "less government fallacy" prevents public policy from taking the measures necessary to prevent the wreck or put the economy back on track quickly.

## Responsibility for Dismantling the Institutions of Prudential Regulation

The effort to exonerate market fundamentalism by blaming regulators and other policies, like monetary policy, is not very convincing, to say the least. Market

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[121] George Cooper, *The Origin of Financial Crises: Central Banks, Credit Bubbles and the Efficient Market Fallacy* (New York: Vintage, 2008).

[122] Michael Lewis, "The End," *Portfolio Magazine*, December 2008.

[123] Andy Kessler, "The Demise of a Giant Hedge Fund," *The Weekly Standard,* October 13, 2008.

[124] Soros, Super Bubble, p. 77. Market fundamentalists blame market failures on the fallibility of the regulators, and they are half right: Both markets and regulators are fallible. Where market fundamentalists are totally wrong is in claiming that regulators ought to be abolished on account of their fallibility… The fact that regulators are fallible does not prove that markets are perfect. It merely justifies reexamining and improving the regulatory environment.

[125] Stiglitz, Roaring Nineties, p. 167, "The offenses of Enron and Worldcom – and of Citigroup and Merrill Lynch – put most acts of political crookedness to shame. The typical corrupt government official pockets a measly few thousand dollars – at most a few million. The scale of theft achieved by the ransacking of Enron, Worldcom, and other corporations in the nineties was in the billions of dollars – greater than the GDP of some nations.

fundamentalists created the environment they wanted. It took great effort to dismantle the institutions of prudential regulation. The industry lobbied hard for deregulation, and policy makers acquiesced willingly. Regulators and policy makers did, or did not do, what market fundamentalism demanded.

Over the course of several decades legislation repealed, relaxed or prevented regulation of key institutions and behaviors that, left to their own devices, performed badly. Regulators did not enforce the laws that were left on the books, because they were hard pressed not to do so, and the predominant ideology told that it was unnecessary. Self-regulation, guided by self-interest, was supposed to be sufficient. The combination of deregulation, lax enforcement and self-regulation created the Wild West atmosphere in financial markets. There were too many hard fought battles and clear warning signs to suggest that the outcome was an unintended consequence of a system that was otherwise healthy.

The conscious removal of regulation on a number of products and institutions that have "blown up" underscores the purposeful nature of the environment that market fundamentalism created. Ending the separation of commercial and investment banking – i.e. the repeal of Glass-Steagall – had long been an objective of the financial sector, and that became a central goal of the market fundamentalist deregulators.

> The most important consequence of the repeal of Glass-Steagall was indirect – it lay in the way repeal changed the entire culture. Commercial banks were not supposed to be high-risk ventures; they were supposed to manage other people's money very conservatively. It is with this understanding that the government agrees to pick up the tab should they fail. Investment banks, on the other hand, have traditionally managed rich people' money – people who can take bigger risks in order to get bigger returns. When repeal of Glass-Steagall brought investment and commercial banks together, the investment-bank culture came out on top. There was a demand for the kind of high returns that could be obtained only through high leverage and big risk taking.[126]

The ugly fight over non-regulation of derivatives is another bellwether indicator of the intentionality of the policy. When the CFTC threatened to regulate these instruments, famously called "weapons of mass financial destruction" by Warren Buffet, the executive branch and independent agencies teamed up to prevent it, and Congress eventually outlawed it. (Discussed in more detail below.) Moreover, when prudential regulation threatened to infringe on the rapidly expanding business in these unregulated products, by triggering capital and reserve requirements that would limit their growth, the regulators were told that they could safely get out of the way.

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[126] Joseph E. Stiglitz, Capitalist Fool," *Vanity Fair,* January 2009.

Having witnessed the intensity with which a Chairwoman of the Commodities Futures Trading Commission was dispatched for threatening to stand in the way of innovation and growth, it is easy to see why the SEC might choose not to stand in the way, even though it meant abdicating its most fundamental opportunity. By 2004 the SEC was in hands of people who had gorged themselves on the Kool-Aid of market fundamentalism. Self-regulation was all the rage across a number of vital areas of the financial sector, so why not allow it in risk taking? Stiglitz and many others see the decision to abdicate responsibility for capital standards and allow self-regulation as critical.

> There we other important steps down the deregulatory path. One was the decision in April 2004 by the Securities and Exchange Commission, at a meeting attended by virtually no one and largely overlooked at the time, to allow big investment banks to increase their debt-to-capital ratio (from 12:1 to 30:1, or higher) so that they could buy more mortgage-backed securities, inflating the housing bubble in the process. In agreeing to this measure, the S.E.C. argued for the virtues of self-regulation: the peculiar notion that banks can effectively police themselves. Self-regulation is preposterous, as even Alan Greenspan now concedes, and as a practical matter it can't, in any case, identify systemic risks – the kinds of risks that arise when, for instance, the models used by each of the banks to manage their portfolios tell all the banks to sell some security all at once.[127]

The violent reaction of the market fundamentalists to the suggestion that policy makers should consider extending regulation to the derivatives market and subsequent developments underscores the extent to which the outcome of the ill-advised deregulation of financial services was predictable and the cause of market failure knowable. In 1998, the rapid growth of derivatives alarmed the newly appointed chairwoman of the CFTC, and she suggested that the agency should consider regulating these products under its general authority. The market fundamentalists at the Treasury and the Federal Reserve objected vigorously, but the CFTC, exercising the independent authority of an independent agency, had issue a "Concept Release" that raised questions about a broad range of issues that the unregulated sale of derivatives posed (see Table III-1).

Continuing pressure from the industry and the executive branch and the Federal Reserve to prevent the CFTC from even asking the critical questions continued, and Alan Greenspan testified that "Regulation of derivative transactions that are privately negotiated by professionals is unnecessary. Regulation that serves no useful purpose hinders the efficiency of markets to enlarge standards of living."[128] In the midst of the dispute, Long Term Capital Management, the famous hedge fund founded by two Nobel laureates, collapsed, but this did not dissuade the market fundamentalists.

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[127] Stiglitz, "Capitalist Fools."

[128] Hearing of Senate Agriculture, Nutrition and Forestry Committee, July 30, 1998, cited in Essential Information "Sold Out."

*__Table III-1: Areas of Concern in the 1998 CFTC Concept Release on Derivatives__*

Potential Changes to Current Exemptions
1. Eligible Transactions
    Swaps
    Hybrid Instruments
2. Eligible Participants
    Swaps
    Hybrid Instruments
3. Clearing
    Functions
    Products Clears
    Admission Standards
    Risk Management Tools
    Other Considerations
4. Transaction Execution Facilities
5. Registration
6. Capital
7. Internal Controls
8. Sales Practices
    Disclosure
    Customer Information
    Other
9. Recordkeeping
10. Reporting
11. Self-Regulation

**Source: Commodity Futures Trading Commission, Over-the-Counter Derivatives: Concept Release, May 7, 1998.**

Shortly thereafter, the President's Working Group on Financial Markets produced a report entitled *Over-the-Counter Derivatives Markets and the Commodity Exchange Act.* Notwithstanding the fact that the Concept Release averred only its desire to gather information, the report of the President's Working Group claimed "a cloud of uncertainty has hung over the OTC derivatives market" and cited the CFTC concept paper a number of times. Needless to say, concluding that regulation was unnecessary and that even the threat of regulation was inhibiting innovation, it rejected the CFTC proposal. The first sentence of the recommendations section and the final paragraph offer an erroneous argument we have heard before, that sophisticated traders, risk management tools and existing regulation are adequate to control these products.

> The members of the Working Group agree that there is no compelling evidence of problems involving bilateral swap agreements that would warrant regulation under the CEA; accordingly, many types of swap agreement should be excluded from the CEA. The sophisticated counterparties that use OTC derivatives simply do not require the same protection under the CEA as those required by retail investors. In addition, most of the dealers in the swaps market are either affiliated with broker-dealers or FCMs that are regulated by the SEC or the CFTC or are financial institutions that are subject to supervision by bank regulatory agencies. Accordingly, the activities of most derivatives dealers are already subject to direct or indirect federal oversight…
>
> In general, private counterparty credit risk management has been employed effectively by both regulated and unregulated dealers of OTC derivatives, and the tools required by federal regulators already exist.[129]

The Financial Service Modernization Act was signed by the President one week after the report on derivatives. A year later, the Commodity Futures Modernization Act was passed and the dismantling of much of the institutional structure of prudential regulation created by the New Deal was complete. However, the rollback of regulation continued apace. For not only did Congress pass major pieces of legislation to accomplish deregulation, there were a host of other lesser acts that reduced oversight (see Table III-2).

Three broad categories of action deregulated the financial product space, with numerous examples in each (see Table III-2).

- legislative repeal and relaxation of regulation and the failure to authorize regulation (e.g. comingling, FSMA, derivatives, credit rating agencies, assigned liability and preemption of state consumer protection authority),

- lax enforcement of existing regulations (derivatives, predatory lending, credit rating conflicts of interest, mergers), and

- ineffective self regulation (FASB, exchanges, voluntary capital standards for derivatives and the Basel accords).

Derivatives appear in all three categories for good reason. The $600 trillion of unregulated paper,[130] much of which proved to be "toxic," was the centerpiece and the

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[129] President's Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act,* November 1999, pp. 16… 34.

[130] The Prudent Investor, "The $600 Trillion Derivatives… Emergency Meeting," October 13, 2008, citing the Statistical Annex of the Bank of International Settlement notes According to figures released in the

masterpiece of market fundamentalism in the financial sector, and it took deregulation, lax regulation and ineffective self-regulation of the most extreme form to create it. Comingling of commercial and investment banking activity, which resulted in repeal of Glass-Steagall, is also listed twice, and listed first because it had a pervasive impact on the incentive structure of the financial sector, as Stiglitz has argued.

***Table III-2: Major Legislative and Regulatory Failures in the Past Decade***

Legislated Repeal and Restriction of Prudential Regulation
- Comingling of Commercial and Investment Banking
- Derivatives
- Credit Rating Agency Conflicts
- Preemption of State Protections
- Narrow Assignee Liability

Lax Exercise of Regulatory Authority
- Comingling of Commercial and Investment Banking
- Derivatives
- SEC Failure to Oversee Voluntary Self-Regulation of Risk
- SEC Treatment of SIVs and QSPEs
- Fannie and Freddie move into Subprime
- Predatory Lending

Failure of Self-Regulation
- Voluntary Risk Regulation
- FASB Rule on Off Balance Sheet Accounting
- Failure of Risk Modeling
- Basel I & II Capital Reserves

**Source: Essential Information, Consumer Education Foundation, *Sold Out: How Wall Street and Washington Betrayed America,* March 2008.**

Ten years and three weeks after Alan Greenspan signed the President's Working Group report on "Over-the-Counter Derivatives," with the financial sector collapsing and the economy plunging, he admitted "shocked disbelief" that there was a flaw in his theory. The *Smartest Guys in the Room* [131] had a simple answer to all questions "the market

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quarterly review of the BIS (pp A103) in September the total notional amount of outstanding derivatives in all categories rose 15% to a mindboggling *$596 TRILLION as of December 2007"*

[131] The term was first applied Enron in a book by Bethany McLean and Peter Eklind (Penguin, 2003) and then a movie directed by Alex Gibney. It has been extended to the subprime crisis "Subprime Lending's

will take care of it." They were wrong. Table III-3 lists the 75 questions that the CFTC was prevented from asking about derivatives. As policy makers contemplate rebuilding the institution of prudential regulation, they should ask these types of questions about every financial institution and every financial product that has been involved in the collapse of the financial system and answer those question by building institutions whose primary purpose is to promote the public interest and return the financial sector to its proper role in a capitalist society as outlined by the COP.

> "A well-regulated financial system serves a key public purpose: if it has the power and if its leaders have the will to use the power, it channels savings and investment into economic activity… A healthy financial system, one that allows for the efficient allocation of capital and risk, is indispensable to any successful economy."[132]

As the recommendations of the Group of Thirty and the COP and the initial proposals of the Obama Administration reviewed in the Section III show, some in the policy arena are willing to take on this critical task, but as the discussion in Section IV also shows, there are others who cling to the belief that the market can be trusted to do a large part of the job, and that innovation is more important than sound prudential regulation.

Notwithstanding the magnitude of the financial collapse, the harm it is doing to the real economy, and the obvious causes of the market failure, the market fundamentalist ideology is tenacious. Like Martin Luther's *95 Theses* nailed to the Castle Church in Wittenberg, Germany to call to account an entrenched ideology that had corrupted and abandoned basic values, Brooksley Born's 75 questions should be nailed to the door of the Fed, Treasury, CFTC and SEC, the citadels of market fundamentalist ideology that had corrupted and abandoned the basic values of prudential regulation. The American people should demand that the questions are answered carefully and completely from the public interest point of view in the reformation of the institutions of prudential regulation in America.

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Smartest Guys in the Room," *Mother Jones,* March/April 2008. The term fits perfectly the meeting at which the SEC decided that the risk models of the big banks were so smart that regulatory oversight of capital ratios was no longer necessary.

[132] COP Report, pp. 2…4.

## *Table III-3: Request for Comment in the 1998 CFTC Concept Release on Derivatives*

**1. Eligible Transactions**
**(a) Swaps**

1. In what ways has the swap market changed since the Commission adopted Part 35. Please address:
   (a) the nature of the products;
   (b) the nature of the participants, both dealers and end-users;
   (c) the location of transactions;
   (d) the business structure of participants (*e.g.*, the use of affiliates for transacting OTC derivatives);
   (e) the nature of counterparty relationships;
   f) the mechanics of execution;
   (g) the methods for securing obligations; and
   (h) the impact of the current regulatory structure on any of the foregoing.
2. What are the mechanisms for disseminating the prices for swap transactions?
3. Does the swap market serve as a vehicle for price discovery in underlying cash markets? If so, how? Please describe.
4. To what extent is the swap market used for hedging? To what extent is it used for speculation? Please provide details.
5. Is there a potential for transactions in the swap market to be used to manipulate commodity prices? Please explain.
6. To what degree is the swap market intermediated, *i.e.,* to what extent do entities
   (a) act as brokers bringing end-users together?
   (b) act as dealers making markets in products?

   Please describe the intermediaries in the market and the extent and nature of their activities.
7. To what extent do swap market participants act in more than one capacity (*e.g.*, as principal in some transactions and broker in others)?
8. In light of current market conditions, do the existing Part 35 requirements provide reasonable, objective criteria for determining whether particular swaps transactions are exempted under the CEA? Should the meaning of terms such as "fungible," "material economic terms," or "material consideration" be clarified or modified in any way? If so, how?
9. What steps can the Commission take to promote greater legal certainty in the swap market?
10. What types of documentation are relevant in determining whether a particular transaction falls within the swaps exemption and/or the Policy Statement? Should the Commission set standards in this regard?
11. If the current restrictions set forth in the Part 35 requirements negatively affect or potentially limit the OTC market or its development in the United States, what changes would alleviate the negative effects? Should the exemption in Part 35 be broadened in any manner?
12. What steps, if any, can the Commission take to promote greater efficiency in the swap market, such as for example, by facilitating netting?
13. Are any changes in regulation relating to the design or execution of exempted swap transactions needed to protect the interests of end-users in the swap market? Are there changes in regulation that would attract new end-users to the market or lead existing end-users to increase their participation?
14. Should distinctions be made between swaps that are cash-settled and swaps that provide for physical delivery? Please explain.
15. Should transactions in fungible instruments be permitted under the swaps exemption?

16. To what extent should the creditworthiness of a counterparty continue to be required to be a material consideration under the swaps exemption? Please explain.

**(b) Hybrid Instruments**

17. In what ways has the hybrid instrument market changed since the Commission adopted Part 34? Please address:
    (a) the nature of the products;
    (b) the nature of the participants, both dealers and end-users;
    (c) the location of transactions;
    (d) the nature of the counterparty relationships;
    (e) the mechanics of execution;
    (f) the methods for securing obligations; and
    (g) the impact of the current regulatory structure on any of the foregoing.
18. What are the mechanisms for disseminating prices for hybrid instrument transactions?
19. Does the hybrid instrument market serve as a vehicle for price discovery in underlying commodities? If so, how? Please describe.
20. To what extent is the hybrid instrument market used for hedging? To what extent is it used for speculation? Please provide details.
21. Is there a potential for transactions in the hybrid instrument market to be used to manipulate commodity prices? Please explain.
22. To what degree is the hybrid instrument market intermediated, *i.e.,* to what extent do entities
    (a) act as brokers bringing end-users together?
    (b) act as dealers making markets in products?

    Please describe the intermediaries in the market and the extent and nature of their activities and the extent to which transactions in these instruments are subject to other regulatory regimes.
23. To what extent do hybrid instrument market participants act in more than one capacity (*e.g.*, as a principal in some transactions and broker in others)?
24. In light of current market conditions, do the existing Part 34 requirements provide reasonable, objective criteria for determining whether a particular hybrid instrument performs the functions of a futures or option or those of a security or depository instrument? Are the criteria easily understood and applied by participants in the market? Do they properly distinguish types of instruments? If not, should they be changed? How?
25. What steps, if any, can the Commission take to promote greater legal certainty in the hybrid instrument market? Please explain.
26. Should Part 34 be amended to reflect more accurately or more simply whether commodity-dependent components predominate over commodity-independent components?
27. Are changes in regulation relating to the design or execution of transactions in exempted hybrid instruments needed to protect the interests of end-users in the hybrid instrument market? Are there changes in regulation that would attract new end-users to the market or lead existing end-users to increase their participation?
28. Should the Commission exercise its authority to exempt any hybrid instruments with a predominant commodity component subject to specified terms and conditions? Please explain.

**2. Eligible Participants**
**(a) Swaps**
**(b) Hybrid Instruments**

29. Should the current list of eligible swap participants be expanded in any way? Should it be contracted in any way? If so, how and why?

30. Are there currently eligible swap participants who would benefit from additional protections? Are there potential swap participants who are not currently eligible but would be appropriate subject to additional protections? In either case, please describe the types of persons and the types of protections.
31. Should the Commission establish a class of eligible participants for the trading of hybrid instruments with a predominant commodity-dependent component? If so, please describe.
32. Is it advisable to use a single definition of sophisticated investor whenever that concept arises under the Commission's regulations? If so, what definition should apply?

**3. Clearing**
**(a) Functions**
**(b) Products Cleared**
**(c) Admission Standards**
**(d) Risk Management Tools**
**(e) Other Considerations**

33. Are any swaps currently subject to any type of clearing function, either in the U.S. or abroad? If so, please provide details.
34. Would permitting swap clearing facilities promote market growth and assist U.S. participants in remaining competitive? If so, please describe the appropriate elements of a program for the oversight of swap clearing organizations.
35. Should there be a limit on the clearing functions permitted for swaps?
36. Should there be a limit on the range of products that may be cleared through a swap clearing facility?
37. Should there be standards for admission as a clearing participant?
38. What types of risk management tools should a clearing facility employ?
39. To what degree would cleared swaps be similar to exchange traded products? How best can the Commission promote fair competition and even-handed regulation in this context?
40. How should the Commission address OTC derivative clearing facilities that are subject to another regulatory authority by virtue of conducting activities subject to that regulator's jurisdiction?

**4. Transaction Execution Facilities**

41. Should the definition of MTEF be changed in any way to provide more clarity?
42. Are MTEFs or other types of execution facilities currently being used for swap trading, either in the U.S. or abroad? If so, please provide details.
43. What terms and conditions, if any, should be applied to execution facilities? Please address potential competitive effects on current exchange trading and the degree to which similar requirements should be made applicable. Please also address the strengths and weaknesses of current Part 36 for this purpose.

**5. Registration**

44. What benefits might arise from requiring registration of dealers, intermediaries, advisors, or others involved in OTC derivative transactions? Should any requirement be in the form of a notice filing or full registration?
45. What criteria should be used in determining the types of transactions and the types of market participants subject to registration requirements?
46. Should regulation by other federal agencies be a factor in permitting an exemption from registration or notice filing?
47. What role should membership in a designated self-regulatory organization play?

**6. Capital**

48. Are any capital requirements for OTC derivatives dealers needed? Why? What benefits would they provide to the market? What burdens would they impose?
49. Should any reporting or disclosure requirements be established for dealers as an alternative to capital requirements in order to permit counterparties to evaluate their creditworthiness adequately? Please explain.
50. Do ratings by nationally recognized statistical rating organizations fulfill the function of assuring end-user counterparties of the creditworthiness of OTC derivatives dealers?

**7. Internal Controls**

51. Would OTC derivatives market participants benefit from internal control guidelines? If so, what market participants should be covered?
52. What provisions should be included in internal control requirements, if any?
53. How should compliance with any internal control requirements be monitored (*e.g.*, regular audits, periodic spot checks, required reports)?
54. Who should be responsible for monitoring compliance with any internal control requirements (*e.g.*, regulatory agencies, SROs, independent auditors)?
55. Could and should internal control standards serve as a substitute for regulatory capital requirements?

**8. Sales Practices**

56. Since Part 35 was adopted, has the swap market experienced significant problems concerning fraud or sales practice abuses? Since Part 34 was adopted, has the hybrid instrument market experienced significant problems concerning fraud or sales practice abuses? If so, please describe.
57. Is there a need for any sales practice rules in the OTC derivatives market? If so, what should the rules provide, and to whom and under what circumstances should they be applicable?
58. Is there a need for risk disclosures by OTC derivatives dealers to end-users? If so, what risks should be disclosed?
59. Should OTC derivatives dealers be required to supplement any required generic risk disclosure statement with additional firm- or transaction-specific disclosures? If so, what should such disclosures cover?
60. What kind of disclosures, if any, should dealers make to end-users clarifying the nature of the relationship between the parties? Should there be rules establishing duties of the OTC derivatives dealer to its customers, and if so, what should they require?
61. What kind of disclosures, if any, should dealers make concerning the material terms of OTC derivatives contracts, including methods for calculating price, value, profit and loss, as well as the amount of commissions, fees and other costs involved?
62. What other kinds of disclosures, if any, might be appropriate concerning, for example, potential conflicts of interest, the dealer's policies on helping end-users to unwind transactions and matters such as the dealer's financial soundness, experience, or track record?
63. Should dealers be required to make periodic status reports to end-users concerning the status of their OTC derivatives positions (*e.g.*, value, profits and losses)? If so, what kind of reports should be required, and how often should such reports be made?
64. Should dealers be required to collect information concerning their end-user customers? If so, what kind of information? Should dealers be required to retain documentation in their files concerning such information, and if so, what kind of documentation (*e.g.*, confirming that particular information has been collected and reviewed by management to assure transactions are in conformity with the end-user's investment goals and policies)?

65. What sales practice rules, if any, should apply to transactions where a dealer is acting as an agent or broker to facilitate a principal-to-principal transaction between two end-users? Similarly, what sales practice rules, if any, should apply to dealer-to-dealer transactions where both dealers are trading for their own proprietary accounts?
66. Should dealers have to comply with different sales practice standards in dealing with end-users having different levels of sophistication, based, for example, on portfolio size, investment experience, or some other measure? If so, please elaborate.
67. Should dealers be required to follow any supervision requirements in connection with the activities of sales personnel and other employees responsible for handling the accounts of end-user customers? Should complex or highly leveraged transactions require prior approval by senior management of the dealer?
68. What is the appropriate regime for formulating and overseeing the implementation and enforcement of possible sales practices rules, including the appropriate roles of the Commission, other financial regulators and industry self-regulatory bodies?

**9. Recordkeeping**

69. Are recordkeeping requirements for participants in the OTC derivatives markets needed? If so, what records should be required? Who should be required to keep them?

**10. Reporting**

70. Should the Commission establish reporting requirements for participants in the OTC derivatives markets? If so, what information should be reported? By whom?

**C. Self-Regulation**

71. How effective are current self-regulatory efforts? What are their strengths and weaknesses?
72. Are there particular areas among those discussed above where self-regulation could obviate the need for government regulation?
73. Please discuss the costs and benefits of existing voluntary versus potential mandatory self-regulatory regimes.
74. If a self-regulatory regime were adopted, what mechanism would best assure effective oversight by the Commission?
75. How best can the Commission achieve effective coordination with other regulators in connection with the oversight of the OTC derivatives market?

**Source: Commodity Futures Trading Commission*, Over-the-Counter Derivatives: Concept Release*, May 7, 1998.**

# IV. PRUDENTIAL REGULATION

## RESTORING PRUDENTIAL OVERSIGHT OVER FINANCIAL MARKETS

In briefly reviewing the detailed recommendations of the COP and the Group of Thirty and the initial proposals of the Obama Administration with respect to systemic risk, which is the area in which it has brought forward details of its view and approach to regulatory reform, our purpose is not to pick and choose every specific policy that should be implemented. Rather it is to convey the immense scope of regulatory reform that is needed to address the collapse of market fundamentalism in the financial sector. Both groups point out that their analyses are part of a broader analytic effort that is necessary and only beginning. The Group of Thirty, for example, recognizes that its recommendations are only part of what is necessary to repair the financial system.

> [T]he focus of this Report is on the safety and soundness aspects of financial regulation. There are many other important aspects of financial regulation that are touched upon here only to the extent that they bear on financial stability, including competition policies, customer and investor protection, market practices oversight, and financial fraud and crime prevention. Also, to the extent distinctions are drawn between regulation and supervision, the former encompasses the setting of policies, principles, rules, and standards, while the latter encompasses the judgmental application of those policies and standards to particular institutions.[133]

Because we have used the COP discussion of the causes of the problem to frame our analysis, we use the COP discussion of solutions as the outline for this policy discussion (see Table Iv-1). The discussion will be driven by the COP recommendations in the sense that the examination of each area begins with the COP recommendations. Only where the recommendations of the Group of Thirty go beyond the COP analysis will we discuss those additions (see Table Iv-2). Table I-3 above presented the detail of the Obama administration. Appendix B presents the policy recommendations of these three organizations, as well as those of Litan and Baily (discussed in Section IV) on a side-by-side basis organized by problem area addressed.

There is a great deal of overlap between the two sets of recommendations and no contradiction. Where one set of recommendations goes farther than the other, we have no way of knowing whether the "omission" is significant (i.e. we do not know whether one group would argue that the other has gone too far). Since our purpose here is to outline the broad scope of the problem, presenting the comprehensive set of recommendation is the appropriate approach. Ultimately, as both sets of recommendations realize, there will be numerous devils in the details.

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[133] Group of Thirty, p. 4.

*Table IV-1: Detailed Congressional Oversight Panel Recommendations*

| Moral Hazard | Information/Accounting | Incentives | Agency | Conflicts of Interest | Unfairness/Inequality |
|---|---|---|---|---|---|
| 1. Identify and Regulate Financial | 3. Shadow Banks | 2. Limit Excessive Leverage | 5. Reform Executive Pay | 6. Reform Credit Rating | 4. New System for Mortgage |
| Institutions that Pose Systemic | Public Reporting | Objectives Based Capital | Tax Incentives | Close Revolving Door | and Consumer Credit |
| Risk | Positions | Leverage rqts | Asymmetric Pay | Change Fee System | Allow States to Enforce Laws |
| Systemic Risk Regulator | Transaction | Counter Cyclical Capital | Options | Promote Competition | on National Banks |
| Authority | | Liquidity Rqts | Severance | Impose Liability | Create a Single Federal |
| Tools | 6. Reform Credit Rating | | Claw Back | | Consumer Credit Regulator |
| Reporting | Implement Overnight Authority | 3. Supervise Shadow System | Corporate Governance | | |
| Heightened Regulation | Registration | Safety Reg. | Strengthen Bd. | | |
| Countercyclical Capital | Recordkeeping | Regulate Activity/Products | Long-Term Focus | | |
| Insurance | Reporting | OTC | | | |
| Strict Leverage Ratios | Re-evaluate Models | Clearing House | 6. Reform Credit Rating | | |
| Strict Capital Ratios | Assumptions | Margins | Eliminate or Scale | | |
| Limits on Contingent Liability | Embedded Structuring | Mark-to-Market | back NRSRO | | |
| Limits on Off-Balance Sheet | | Guaranty Funds | designation | | |
| Caps on Short-Term Debt | | Exchange Traded Derivs. | Credit Rating Rev. Brd. | | |
| Caps on Taxpayer Exposure | | CEA Contract Rules | ex ante review | | |
| Receivership and Liquidation | | Registration | ex post auditing | | |
| Process | | Reporting | | | |
| | | Capital Rqts | | | |
| 8. Prepare for Next Crisis | | | | | |
| Financial Risk Council | | 7. Global Regulatory Floor | | | |
| Dedicated to Task | | Establish Regulatory | | | |
| Diverse Points of View | | Floors & Harmonize | | | |
| Broad Perspective | | Coordinate Surveillance | | | |
| Multiple Specialized | | Strengthen Communications | | | |
| Analytic Tools | | & Cooperation | | | |
| Formal Reporting | | Target Systemic | | | |
| | | Institutions | | | |

**Source: Congressional Oversight Panel, *Special Report on Regulatory Reform,* January 29, 2009.**

## *Table IV-2: Detailed Group of Thirty Recommendations*

| | Problems | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| | Moral Hazard | Information/Accounting | Incentives | Agency | Conflicts of Interest | Agency | Unfairness |
| Solutions | | | | | | | |
| | | | | | | | |
| Filling Gaps | 1a - "Too Big to Fail" Banks | 4a -Registration and Reporting | 1b - Capital & Margin Rqts | 1b -Ownership Interest | 1b - Ban/Control of Comingling | 1b -Ownership Interest | |
| | Single Regulator | | | | | | |
| | Size Based Scrutiny | 4b - Reporting Rqts | 2a - Consolidate Regulation | | | | |
| | National Limits | | | | | | |
| | | 4b - Disclosure Stds | 2b - Non-banks | | | | |
| | 1c - Separation of Banks/Nonbanks | | | | | | |
| | | | 3a - Bank-like Mutual Funds | | | | |
| | 3b - Mutual Funds | | | | | | |
| | Reorganize | 4a - Public Disclosure for Private Pools | 4a - Register Private Pools | | | | |
| | Differentiate | | | | | | |
| | Conservative Investment | | 4c - Regulate Lg Private Pools | | | | |
| | | | Capital | | | | |
| | 5a - GSEs | | Liquidity | | | | |
| | Separation | | Risk mgmt | | | | |
| | Public Delimitation | | | | | | |
| | | | 4d - Off Shoring | | | | |
| | | | Regulation at Business Location | | | | |
| | | | | | | | |
| | | | 6a - Fix regulation | | | | |
| | | | Gaps | | | | |
| | | | Overlaps | | | | |
| | | | Complexity | | | | |
| | | | Remove opportunity for arbitrage | | | | |
| | | | | | | | |
| Prudential | 7c- Access to Liquidity | 8a - International Information Sharing | 7a - Central Bank Role in Stability | | | | |
| Regulation | | | Crisis and Expansion | | | | |
| | 7d - Emergency Lending Authority | 8b - Gather Information on Leverage | Participation in Governance | | | | |
| | | | Input into key regulations | | | | |
| | 7e - Limitations on Liquidity Actions | | Supervisory role in | | | | |
| | | | lg firms, payment and clearing | | | | |
| | | | | | | | |
| | | | 8a - Offshoring | | | | |
| | | | Delineation of Responsibilities | | | | |
| | | | Close Gaps | | | | |
| | | | Raise Standards | | | | |
| | | | Intl Standards | | | | |
| | | | | | | | |
| | | | 8b Define Leverage | | | | |
| | | | | | | | |
| | | | 8c - Formal Regional Mechanisms | | | | |
| | | | | | | | |

| | Problems | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| | Moral Hazard | Information/Accounting | Incentives | Agency | Conflicts of Interest | Agency | Unfairness |
| Solutions | | | | | | | |
| | | | | | | | |
| Standards | | | Tolerance | Compensation | Indep. Board Members | Compensation | |
| | | 11c - Liquidity Disclosure Stds | Profile | Risk Mgmt Policies | | Risk Mgmt Policies | |
| | | | | | 9c - Independence | | |
| | | 12a - Reevaluate Fair Value | 9e - Periodic Review of Profiles | | Auditing | | |
| | | | | | Risk Mgmt | | |
| | | 12c- Credit Loss Reserves Principles | 9f - Assessment of Counterparies | | | | |
| | | | | | 12b - Accounting Stds | | |
| | | 12c - Transparency of Reserve Determination | 9g - Accept CRMPG and IIF | | Reevaluate Fair Value | | |
| | | | | | | | |
| | | | 10a - Raise Capitalization Stds | | | | |
| | | | | | | | |
| | | | 10b - Upper End of Guidance | | | | |
| | | | | | | | |
| | | | 10c- Reevaluate Definition of Capital | | | | |
| | | | | | | | |
| | | | 11a - Diversified Mix & | | | | |
| | | | Cushion of Liquidity | | | | |
| | | | 11b - Liquidity Stds | | | | |
| | | | | | | | |
| Transparency | 16a - Closing of Regulated Banks | 13a -Securitized & Structured Assets | 13a -Securitized/Structures' Assets | 13b - Securitization | 14a - Indep. Internal Risk Rating | 13b - Securitization | |
| | | Disclosure = Securities | Regulatory Stds = Securities | Retain Credit Risk | | Retain Credit Risk | |
| | 16a - Non-Depository Insts | | | | 14c - Payment to Align Incentives | | |
| | Resolution of Failed | 13c - Off Balance Sheet Vehicles | 14b - Rating Agencies | | | | |
| | Regulated only | | Accountability for Quality | | | | |
| | Establish Regulator as Receiver | 15b - Share Information on CS=DS and OTC | More Robust Valuation | | | | |
| | | | | | | | |
| | | 17a - Asset Backed Products | 15a - Regulate OTC Derivatives | | | | |
| | 16d- Special Treatment of Contract | Determine Disclosure Info | | | | | |
| | | | 17b - Structured Product | | | | |
| | | 18 - Evaluate Higher Level of Transparency | Regulated Disclosure | | | | |

**Source: Group of Thirty, *Financial Reform: A Framework for Financial Stability* (Washington, D.C. January 15, 2009)**

The eight broad categories of recommendations used by the COP map fairly well onto the six fundamental flaws in unregulated markets that we have identified. It is interesting to note that, in this approach, policies to reform credit rating occur in three of the problem areas and policies to address shadow banking occur in two. This is commensurate with the amount of attention these issues are receiving. The recommendations are sharpest in the moral hazard area, which is also consistent with the sense of crisis and systemic risk.

## MORAL HAZARD

Moral hazard is the area where the Obama administration has begun to define the framework for regulatory reform it will propose so we begin the discussion with their policy recommendations. . In this category, the administration includes creating tools to identify and mitigate systemic risks and to protect the financial system from the failure of systemically important financial institutions.

Secretary Geithner's testimony identified six steps the administration is proposing to accomplish this goal:

- establishing a single entity with responsibility for systemic stability, with authority both over the major institutions and over critical payment and settlement systems and activities, and with extensive authority to require corrective actions;

- establishing and enforcing "substantially more conservative" capital requirements on institutions that pose potential risk to the financial system, incorporating mechanisms to dampen financial cycles;

- requiring large and leveraged private investment funds to register with the Securities and Exchange Commission;

- establishing a comprehensive framework of oversight, protections and disclosure for the over-the-counter derivatives market, moving the standardized parts of those markets to a central clearinghouse, and encouraging further use of exchange-traded instruments;

- adopting requirements for money market funds to reduce the risk of rapid withdrawals of funds; and

- establishing a stronger resolution mechanism, modeled on the FDIC's authority with regard to banks, that provides the government needed tools to protect the financial system and the broader economy from the potential failure of large complex financial institutions.

The administration has left some of the details of its plans vague – including who should act as systemic risk regulator – and has pledged to work with Congress to fill in the details. How that is accomplished will determine the plan's effectiveness.

The COP makes two broad recommendations on moral hazard. First, it calls for a systemic risk regulator with adequate authority and tools to identify and regulate systemic risk.[134] It then identifies numerous specific policies that are intended to reduce systemic risk.[135] These are well-known principles of prudential regulation. One of the interesting new wrinkles in thinking about dealing with systemic risk in both sets of recommendations is the recognition that more attention needs to be devoted to setting up procedures for liquidation of loans (and institutions) in default.

The Group of Thirty recommendations on moral hazard identify the products and institutions that put the taxpayer at risk and propose a variety of mechanisms to reduce the exposure to risk through federal backing of institutions.[136] In some cases, it advocates banning relationships that create the moral hazard.[137] In others it would place limits on the extent of exposure by regulating the product or the institution.[138] Interestingly, it also

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[134] COP Report, p. 22. 1. Identify and Regulate Financial Institutions that Pose Systemic Risk A much better approach would be to identify the degree of systemic risk posed by financial institutions, products, and markets in advance—that is, in normal times—and to regulate them accordingly. Providing proper oversight of such institutions would help to prevent a crisis from striking in the first place, and it would put public officials in a much better position to deal with the consequences should a crisis occur.

[135] COPO Report, pp. 23-24: Action item: Impose heightened regulatory requirements for systemically significant institutions to reduce the risk of financial crisis. Such regulation might include relatively stringent capital and liquidity requirements, most likely on a countercyclical basis; an overall maximum leverage ratio (on the whole institution and potentially also on individual subsidiaries); well-defined limits on contingent liabilities and off-balance-sheet activity; and perhaps also caps on the proportion of short-term debt on the institution's balance sheet. The systemic regulator should consider the desirability of capping any taxpayer guarantee and whether to require systemically significant firms to purchase federal capital insurance under which the bank, in return for a premium payment, would receive a certain amount of capital in specified situations.

[136] 1a. In all countries, the activities of government-insured deposit-taking institutions should be subject to prudential regulation and supervision by a single regulator (that is, consolidated supervision). The largest and most complex banking organizations should be subject to particularly close regulation and supervision, meeting high and common international standards.

[137] 1c. In general, government-insured deposit-taking institutions should not be owned and controlled by unregulated non-financial organizations, and strict limits should be imposed on dealings among such banking institutions and partial non-bank owners.

[138] 3b. The vehicles should be clearly differentiated from federally insured instruments offered by banks, such as money market deposit funds, with no explicit or implicit assurances to investors that funds can be withdrawn on demand at a stable NAV.

16a. In countries where this is not already the case, a legal regime should be established to provide regulators with authority to require early warning, prompt corrective actions, and orderly closings of regulated banking organizations, and other systemically significant regulated financial institutions. In the United States, legislation should establish a process for managing the resolution of failed non-depository financial institutions (including non-bank affiliates within a bank holding company structure) comparable to the process for depository institutions.

16b. The regime for non-depository financial institutions should apply only to those few organizations whose failure might reasonably be considered to pose a threat to the financial system and therefore subject to official regulation.

contemplates limiting the size of institutions that are insured[139] and advocates a sliding scale of reserves to reduce the exposure of the public.[140] If "too big to fail" is going to be such a problem, them limiting the size and requiring larger institutions to have more capital reserves are reasonable approaches to reducing the threat. A key step is to limit the exposure through non-banking institutions and to abandon the hybrid model for Government Sponsored Enterprises.[141]

Both sets of recommendations declare a need to prepare for the next crisis. The COP report proposes a new entity dedicated to the task of assessing systemic risks to the financial system made up of diverse points of view that takes a broad perspective on potential threats and uses multiple, sophisticated modeling techniques and reports to the Congress.[142] The proposal is designed to respond to both the difficulty of assessing systemic risk in the highly complex, global financial system that has merged in the 21st century and the tendency for existing financial institutions to take a homogeneous view and follow each other in herds.

The Group of Thirty recommends a different approach. Given the manner in which the current crisis has played out, the Group of Thirty concludes that access to central banks takes on a role in backstopping the financial structure. It advocates formalizing and circumscribing the new role for the central bank in ensuring stability.[143] Although the COP

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16c. A regulatory body having powers comparable to those available for the resolution of banking institutions should be empowered to act as a receiver or conservator of a failed non-depository organization and to place the organization in liquidation or take action to restore it to a sound and solvent condition.

16d. The special treatment accorded to various forms of financial contracts under current U.S. law should be examined in light of recent experience, with a view toward resolving claims under these contracts in a manner least disruptive to the financial system.

[139] 1d. To guard against excessive concentration in national banking systems, with implications for effective official oversight, management control, and effective competition, nationwide limits on deposit concentration should be considered at a level appropriate to individual countries.

[140] 1b. Large proprietary trading be limited by strict capital and liquidity requirements.

[141] 5a. For the United States, the policy resolution of the appropriate role of GSEs in mortgage finance should be based on a clear separation of the functions of private sector mortgage finance risk intermediation from government sector guarantees or insurance of mortgage credit risk.

5b. Governmental entities providing support for the mortgage market by means of market purchases should have explicit statutory backing and financial support. Hybrids of private ownership with government sponsorship should be avoided. In time, existing GSE mortgage purchasing and portfolio activities should be spun off to private sector entities, with the government, if it desires, maintaining a capacity to intervene in the market through a wholly owned public institution.

[142] COP Report, p. 48. "A Financial Risk Council composed of strong, divergent voices should avoid overly optimistic consensus and conventional wisdom, keeping Congress appropriately concerned and energized about known and unknown risks in a complex, highly interactive environment…. The council would be required to publish regular reports to Congress and to select among various techniques for identifying threats. These approaches might include: 1. Wargaming; 2. Strategic scenario analysis: 3. Nonlinear modeling/"black swan" sensitivity analysis."

[143] 7c. A sharp distinction should be maintained between those regulated banking organizations with normal access to central bank liquidity facilities and other types of financial institutions whose access, if any, should be limited to extreme emergency situations of critical systemic importance.

report identifies the possibility of using an existing institution as the systemic system regulator and mentions the Federal Reserve as a possibility, this recommendation may spur controversy, as some analysts question the Fed's suitability to play this role. Sen. Christopher Dodd, who chairs the Senate Banking Committee, recently cautioned, for example, that if the Federal Reserve is to perform this function, "we must be mindful of ensuring the independence and integrity of the Fed's monetary policy function," and he added that "some have expressed a concern about overextending the Fed when they haven't properly managed their existing authority."[144] Many, particularly among conservatives, have blamed the Fed's decision to keep interest rates so low for so long for igniting the housing bubble, suggesting that the Fed's monetary policy can at times create systemic risk that it is ill-suited to regulate.[145] Others have been more pointed in their criticism.

> Only in the weird world of Washington are mistakes rewarded with major new responsibilities. After mismanaging both housing loans and the dot-com mess, the Federal Reserve may now become responsible for supervising investment banks. [...]
>
> History shows that the Federal Reserve is a poor supervisor and regulator. The Fed's Board ignored warnings about the risky housing loans that banks were keeping off their balance sheets. This costly mistake is only the most recent of many supervisory failures.[146]

And Brookings scholar Martin Mayer, who has written extensively about financial regulatory issues over the years, has disputed the claim that the Fed lacked authority to prevent the current crisis. The real problem, Mayer argues, is that the Fed lacked the will to regulate.

> The Fed could easily have prevented this ruinous expansion of OTC credit-default swaps by requiring banks to keep extra reserves against such holdings, larger than the margin requirements of the exchanges where derivatives were traded, cleared in a clearinghouse, properly settled and extinguished. Instead, the Fed promoted the false idea that the banks in their own interest would police the gambling of the mortgage

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7d. Central bank emergency lending authority for highly unusual and exigent circumstances should be preserved, but should include, by law or practice, support by appropriate political authorities for the use of such authority in extending such credit to non-bank institutions.

7e. Central bank liquidity support operations should be limited to forms that do not entail lending against or the outright purchase of high-risk assets, or other forms of long-term direct or indirect capital support. In principle, those forms of support are more appropriately provided by directly accountable government entities. In practice, to the extent the central bank is the only entity with the resources and authority to act quickly to provide this form of systemic support, there should be subsequent approval of an appropriate governmental entity with the consequent risk transfer to that entity.

[144] Benton Ives, "Dodd Says Federal Reserve Might Not Be Ideal for Role of Super-Regulator," *CQ Today,* February 4, 2009.

[145] COP Report, Additional Views of Republican Members, pg. 62-64. E.g., "Economists have consistently identified the Federal Reserve's accommodative monetary policy as one cause of the current financial crisis." Pg. 63.

[146] Allan H. Meltzer, "Keep the Federal Reserve Away from Investment Banks, *The Wall Street Journal,* July 16, 2008.

> bankers and the credit-gobbling quantitative traders and the leveraged-buyout fakirs – and that the hidden trading of non-standard, bilaterally settled, opaque derivative instruments would improve the stability of markets. […]
>
> The truth is that the Fed had plenty of authority to take the steps that would have avoided today's dangers and its own embarrassments. The problem was that the Fed lacked the will to supervise. Before we can restore the self-confidence of the market, we will need to create a Federal Reserve that believes in its own regulatory mission more than it believes in prudence at the banks.[147]

Despite the brewing debate over the question of where that responsibility should reside, the concept of enhanced systemic risk regulation has broad support, and the need for better preparation for future crises is an important area of agreement.

**INFORMATION**

The COP report offers policy recommendations to improve information in two areas – shadow banks and credit rating agencies. For shadow banking, public reporting of positions and transactions is recommended.[148] Since credit rating provides such a vital function, the COP recommends an oversight authority[149] and a re-evaluation of their models.[150]

That the Group of Thirty recommendations call for greater transparency[151] and higher quality of information and accounting [152] is hardly surprising, nor is the call for

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[147] Martin Mayer, "The Fed Has Power, but No Will," *Barrons*, April 14, 2008.

[148] COP Report, p. 30: Public reporting requirements. (1) public reports of OTC transactions to improve transparency and pricing, and (2) reporting to the SEC derivatives positions that affect public securities…. Other options would include additional disclosure requirements or prohibitions on rating agencies' use of nonpublic information.

[149] COP Report, p. 44: Another, substantially different, option for the design of such a Credit Rating Review Board would be to model the board in part on the Public Company Accounting Oversight Board (PCAOB),

[150] COP Report, p. 41: Many of the models involved excessively rosy assumptions about the quality of the underlying mortgages, ignoring the fact that these mortgages (especially subprime mortgages) were far riskier than ever before and were in fact becoming steadily riskier year by year.88 Credit rating agency modeling of mortgage-related securities may also have involved mistaken assumptions about the independence of the underlying mortgages—including the assumption that defaults would not be highly correlated across a broad bundle of mortgages or mortgage-related securities.

[151] 4b. The prudential regulator of such managers should have authority to require periodic regulatory reports and public disclosures of appropriate information regarding the size, investment style, borrowing, and performance of the funds under management. Since introduction of even a modest system of registration and regulation can create a false impression of lower investment risk, disclosure, and suitability standards will have to be reevaluated.

10d. Capital and risk disclosure standards should be reevaluated to provide a higher degree of transparency of a firm's risk appetite, its estimated needs for and allocation of economic capital, and its valuation practices.

11c. Liquidity disclosure standards, building on the suggested practices in the Basel Committee Principles, should complement the suggested improved disclosure practices for capital and risk profile information.

[152] 12a. Fair value accounting principles and standards should be reevaluated with a view to developing more realistic guidelines for dealing with less liquid instruments and distressed markets.

standards to mirror those applied in securities markets.[153] This is the motherhood and apple pie heart of reform. More surprising is the call by the Group of Thirty to make information disclosure a requirement to offer products to the public and in the currently unregulated private markets.[154]

## PERVERSE INCENTIVES

The COP report identifies three areas of policy to address perverse incentives – excessive leverage, shadow banking and international regulation. The report recommends four policies to limit leverage[155] and proposes to extend regulation to over-the-counter

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12c. Accounting principles should also be made more flexible in regard to the prudential need for regulated institutions to maintain adequate credit loss reserves sufficient to cover expected losses across their portfolios over the life of assets in those portfolios. There should be full transparency of the manner in which reserves are determined and allocated.

12d. As emphasized in the third report of the CRMPG, under any and all standards of accounting and under any and all market conditions, individual financial institutions must ensure that wholly adequate resources, insulated by fail-safe independent decision-making authority, are at the center of the valuation and price verification process.

13c. Off-Balance-Sheet Vehicles: Pending accounting rule changes for the consolidation of many types of off-balance-sheet vehicles represent a positive and needed improvement. It is important, before they are fully implemented, that careful consideration be given to how these rules are likely to impact efforts to restore the viability of securitized credit markets.

[153] 13a. Market Supervision: Extensive innovation in the capital markets and the rapid growth of securitization make it imperative that securitized and other structured product and derivatives markets be held to regulatory, disclosure, and transparency standards at least comparable to those that have historically been applied to the public securities markets. This may require that a broader range of markets be monitored, that there be adequate transparency as to transaction volumes and holdings across all products, and that both credit and leverage elements of each product be thoroughly understood and monitored.

[154] 17a. The disclosure and dissemination regime for asset-backed and other structured fixed income financial products (including securities and other financial products) in the public and private markets should be enhanced.

17c. The appropriate national regulator should condition transactions in the private and wholesale markets on satisfaction of appropriate information disclosure standards.

18. Efforts to restore investor confidence in the workings of these markets suggest a need to revisit evaluations of the costs and benefits of infrastructure investments that would facilitate a much higher level of transparency around activity levels, traded prices, and related valuations. Part of the costs of such changes is the impact on firm-specific concerns regarding the private nature of their market activity. These concerns, and direct investment costs, need to be weighed against the potential benefits of higher levels of market transparency.

[155] COP Report, p. 27: A number of valuable ideas have been proposed as ways to strengthen capital and curtail excessive leverage, including the following: Objectives-based capital requirements. Under this approach, capital requirements should be applied not simply according to the type of institution (commercial bank, broker-dealer, hedge fund, etc.) but on the basis of regulatory objectives (for example, guard against systemic risk, etc.). Leverage requirements. Beyond risk-based capital requirements, there is also a strong argument for unweighted capital requirements, to control overall leverage. Countercyclical capital requirements. To help financial institutions prepare for the proverbial rainy day and manage effectively in a downturn, it has been proposed that capital (and provisioning) requirements be made countercyclical—that is, more stringent when asset prices are rising and less stringent when they are falling. Since the procyclicality of financial institution leverage likely intensifies the ups and downs in asset markets, countercyclical capital requirements could serve as a valuable automatic stabilizer, effectively leaning against the wind. One approach could involve a framework that raises capital adequacy requirements by a ratio linked to the growth of the value of bank's assets in order to tighten lending and build up reserves when times are good. To further address the problem of financial firms being forced to sell illiquid assets

markets and pull derivatives into exchanges, where traditional tools of prudential regulation would apply.[156]

The Group of Thirty recommends that the full range of classic instruments of prudential regulation of financial institutions be strengthened.[157] This includes defining capital[158] and setting strong capital and margin requirements[159] and enhanced monitoring of the status of institutions[160] with a new view of risk,[161] leverage[162] and liquidity.[163] The Group

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into a falling market, some commentators have proposed that regulators could impose liquidity requirements in addition to capital requirements.

[156] COP Report, pp. 29-20: Ensure consistency of regulation for instruments currently operating in the shadow financial system. Extending the reach of financial regulation to cover the shadow financial system is necessary in order to accurately measure and manage risk across the markets. A consistent regulatory regime will also reduce the ability of market players to escape regulation by using complex financial instruments and to secure higher yields by masking risk through information asymmetries. Increase transparency in OTC derivatives markets. The Panel also recommends implementing new measures to improve transparency in the shadow financial system. Lack of transparency in the shadow financial system contributed to failures of risk management and difficulty in pricing assets and assessing the health of financial institutions. Transparency can be enhanced in several ways; several options are presented below: Regulated clearinghouses… Exchange-traded derivatives. As an alternative to clearinghouses, regulators can require that all standardized—and standardizable—OTC derivatives contracts be traded on regulated derivatives markets. These markets would be governed by the same standards that guide designated contract markets under the Commodity Exchange Act (CEA). CEA-governed exchanges must fully disclose the terms of the contracts traded and rules governing trading, and must also publicly report prices, volumes and open interest.

[157] 2. Gaps and weaknesses in the coverage of prudential regulation and supervision must be eliminated. All systemically significant financial institutions, regardless of type, must be subject to an appropriate degree of prudential oversight.

2a. For those countries lacking such arrangements, a framework for national-level consolidated prudential regulation and supervision over large internationally active insurance companies should be established.

6a. Countries should reevaluate their regulatory structures with a view to eliminating unnecessary overlaps and gaps in coverage and complexity, removing the potential for regulatory arbitrage, and improving regulatory coordination.

6b. In all cases, countries should explicitly reaffirm the insulation of national regulatory authorities from political and market pressures and reassess the need for improving the quality and adequacy of resources available to such authorities.

8c. To the extent new international regulatory organizations are ultimately needed, the initial focus should be on developing more formal regional mechanisms, such as in the European Union, but with continued attentiveness to the global dimension of most significant financial markets.

[158] 10c. The existing international definitions of capital should be reevaluated, looking toward close alignment on national definitions.

[159] 1b. large proprietary trading should be limited by strict capital and liquidity requirements.

[160] 9e. Conducting periodic reviews of a firm's potential vulnerability to risk arising from credit concentrations, excessive maturity mismatches, excessive leverage, or undue reliance on asset market liquidity;

9f. Ensuring that all large firms have the capacity to continuously monitor, within a matter of hours, their largest counterparty credit exposures on an enterprisewide basis and to make that information available, as appropriate, to its senior management, its board, and its prudential regulator and central bank;

9g. Ensuring industrywide acceptance of and action on the many specific risk management practice improvements contained in the reports of the Counterparty Risk Management Policy Group (CRMPG) and the Institute of International Finance.

[161] 10a. International regulatory capital standards should be enhanced to address tendencies toward procyclicality. Benchmarks for being well capitalized should be raised, given the demonstrable limitations of even the most advanced tools for estimating firmwide risk.

of Thirty is detailed in the call to extend regulation to the shadow banks and bank-like institutions that have come to play such a large role in financial markets. This includes regulating all relevant markets, such as over-the-counter derivatives trading,[164] institutions, such as non-banks,[165] money market mutual funds,[166] hedge funds,[167] and rating agencies,[168] and practices, such as forum shopping,[169] and off-shoring,[170] as well products, such as

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10b. These benchmarks should be expressed as a broad range within which capital ratios should be managed, with the expectation that, as part of supervisory guidance, firms will operate at the upper end of such a range in periods when markets are exuberant and tendencies for underestimating and underpricing risk are great.

[162] 8b. Given the recurring importance of excessive leverage as a contributing factor to financial disruptions, and the increasingly complex ways in which leverage can be employed on and off balance sheets, prudential regulators and central banks should collaborate with international agencies in an effort to define leverage and then collect and report data on the degree of leverage and maturity and liquidity mismatches in various national systems and markets.

[163] 11a. Base-level liquidity standards should incorporate norms for maintaining a sizable diversified mix of long-term funding and an available cushion of highly liquid unencumbered assets. Once such standards are developed, consideration should be given to what is the preferred mix of senior and subordinated debt in bank capital structures.

11b. Supervisory guidance for liquidity standards should be based on a more refined analysis of a firm's capacity to maintain ample liquidity under stress conditions, including evaluation of the quality and effectiveness of its liquidity management policies and contingency funding plan.

[164] 15a. Much-needed planned improvements to the infrastructure supporting the OTC derivatives markets should be further supported by legislation to establish a formal system of regulation and oversight of such markets.

[165] 2b. An appropriate prudential regulator should be designated for those large investment banks and broker-dealers that are not organized as bank holding companies.

[166] 3a. Money market mutual funds wishing to continue to offer bank-like services, such as transaction account services, withdrawals on demand at par, and assurances of maintaining a stable net asset value (NAV) at par should be required to reorganize as special-purpose banks, with appropriate prudential regulation and supervision, government insurance, and access to central bank lender-of-last-resort facilities.

3b. Those institutions remaining as money market mutual funds should only offer a conservative investment option with modest upside potential at relatively low risk.

3b. Money market mutual funds should not be permitted to use amortized cost pricing, with the implication that they carry a fluctuating NAV rather than one that is pegged at US$1.00 per share.

[167] 4a. Managers of private pools of capital that employ substantial borrowed funds should be required to register with an appropriate national prudential regulator. There should be some minimum size and venture capital exemptions from such registration requirement.

4c. For funds above a size judged to be potentially systemically significant, the prudential regulator should have authority to establish appropriate standards for capital, liquidity, and risk management.

[168] 14b. Risk ratings issued by the NRSROs should be made more robust, to reflect the risk of potential valuation losses arising not just from default probabilities and loss in the event of default, but also from the full range of potential risk factors (including liquidity and price volatility).

[169] 4d. For these purposes, the jurisdiction of the appropriate prudential regulator should be based on the primary business location of the manager of such funds, regardless of the legal domicile of the funds themselves. Given the global nature of the markets in which such managers and funds operate, it is imperative that a regulatory framework be applied on an internationally consistent basis.

[170] 8a. National regulatory authorities and finance ministers are strongly encouraged to adapt and enhance existing mechanisms for international regulatory and supervisory coordination. The focus of needed enhancements should be to: (i) better coordinate oversight of the largest international banking organizations, with more timely and open information sharing, and greater clarity on home and host responsibilities, including in crisis management; (ii) move beyond coordinated rule making and standard setting to the identification and modification of material national differences in the application and enforcement of such standards; (iii) close regulatory gaps and raise standards, where needed, with respect to offshore banking centers; and (iv) develop the means for joint consideration of systemic risk concerns and the cyclicality implications of

securitized assets.[171] With the enlarged role of the central bank in ensuring stability, the Group of Thirty recommends that the central bank also become involved in developing regulatory oversight.[172]

The perverse incentive in the international arena is forum shopping for the least regulated haven, which creates a race to the bottom for regulation. The COP proposes to negotiate a regulatory floor and harmonize regulation across nations and improve communications, cooperation and surveillance, focusing on systemic institutions. The Group of Thirty has a similar call for international cooperation, with less detail.[173]

A similar issue exists with regard to the potential for forum shopping by financial institutions within the United States. Financial institutions are free to choose between a federal and a state charter and, at the federal level, between a bank or thrift charter. Regulatory agencies that depend on the financial institutions for their funding compete to attract regulated entities, and too often do so by lowering consumer protection standards.[174] In contrast to securities, where state regulators retain extensive authority to enforce state law, states have been preempted from enforcing consumer protection laws against national banks. As a result, states have not been able to fill the gap of weak federal banking oversight in the same way they have been able to do on the securities front, most prominently in the investigations of former New York Attorney General Eliot Spitzer into analyst conflicts of interest and mutual fund trading scandals and more recently in actions by current New York Attorney General Andrew Cuomo and Massachusetts Secretary of the Commonwealth William Galvin on auction rate securities and other issues related to the current crisis. The

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regulatory and supervisory policies. The appropriate agencies should strengthen their actions in member countries to promote implementation and enforcement of international standards.

15b. Given the global nature of the market, it is essential that there be a consistent regulatory framework on an international scale, and national regulators should share information and enter into appropriate cooperative arrangements with authorities of other countries responsible for overseeing activities.

[171] 17b. The appropriate national regulator should, in conjunction with investors, determine what information is material to investors in these products and should consider enhancing existing rules or adopt new rules that ensure disclosure of that information, for both asset-backed and synthetic structured products.

[172] 7a. Where not already the case, central banks should accept a role in promoting and maintaining financial stability. The expectation should be that concerns for financial stability are relevant not just in times of financial crisis, but also in times of rapid credit expansion and increased use of leverage that may lead to crises.

7b. In countries where the central bank is not the prudential regulator, the central bank should have: (i) a strong role on the governing body of the prudential and markets regulator(s); (ii) a formal review role with respect to proposed changes in key prudential policies, especially capital and liquidity policies and margin arrangements; and (iii) a supervisory role in regard to the largest systemically significant firms, and critical payment and clearing systems.

[173] COP Report, p. 44-46: 7. Make Establishing a Global Financial Regulatory Floor a U.S. Diplomatic Priority… Build alliances with foreign partners to create a global financial regulatory floor. Actively participate in international organizations that are designed to strengthen communication and cooperation among national regulators.

[174] Barbara Roper, Travis Plunkett, Allen Fishbein, J. Robert Hunter, and Jean Ann Fox, *Comments of the Consumer Federation of America Regarding Review by the Treasury Department of the Regulatory Structure Associated with Financial Institutions (Treasury-DO-2007-0018),* November 21, 2007.

COP Report treats this issue within the context of credit regulation (see footnotes 146 and 147 below) by proposing to allow states to apply consumer protection laws against national banks and by creating a new federal consumer credit safety agency. The issue has implications beyond simply credit issues, however, which deserve to be considered as part of a broader debate on regulatory reform.

The Obama administration has begun to articulate its position on regulation of incentives. It prefers to regulate products that have caused problems, rather than ban them and to extend regulation to institutions in the shadow banking system that have posed systemic risk. Thus, it advocates greater use of clearing and exchanges for standardized credit default swaps and OTC derivatives and documentation of non-standardized products. It also advocates registration and reporting for hedge funds and private pools of capital if they are large. It recommends that the SEC develop policies to reduce the risk of runs on money market funds. Finally, it will pursue international cooperation to prevent forum shopping and deal with tax havens and money laundering. .

**AGENCY**

The COP report identifies two problems of agency that afflicted the financial system as configured in recent years – executive compensation and the role of credit rating agencies. It calls for reform of executive compensation to better align executive incentives and actions with the long-term interests of shareholders.[175] It identifies tax incentives, asymmetric pay and clawback of pay as areas for policy improvement.[176] It identifies corporate governance as an area for institutional improvement.[177] It suggests that the agency problem that afflicts credit rating agencies can be addressed by changing their status.[178]

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[175] COP Report, p. 40. Encourage corporate governance structure with stronger board and long-term investor oversight of pay packages. encouraging executive practices that align executives' interests with the long-term performance of the business they manage.

[176] COP Report, pp. 38-39: Create tax incentives to encourage long-term–oriented pay packages. Encourage financial regulators to guard against asymmetric pay packages in financial institutions, such as options combined with large severance packages. Asymmetric links between compensation and risk create incentives for executives to pursue potentially systemically threatening high-risk–high-reward strategies without sufficient regard for the downside potential. Encouraging regulators to spot and discourage compensation packages that excessively insulate executives from losses will help resolve this asymmetry and promote stability. Stock options create incentives that are tied to stock price, but the overall compensation package's asymmetric link to stock price actually helps encourage more dramatic risk taking. As the price of the underlying stock declines, the option holder become less sensitive to further declines in value of the underlying stock, and more interested in the possibility of achieving dramatic gains, regardless of the risk of further losses. A number of common features of executive pay practice that further protect executives against downside risk exacerbate this asymmetry problem. Among these features are the prevalence of option repricing when the underlying company stock falls below the option strike price for sustained periods of time and large severance packages paid to failed executives.

[177] COP Report, p. 39: Regulators should consider requiring executive pay contracts to provide for clawbacks of bonus compensation for executives of failing institutions. Financial system regulators should consider revoking bonus compensation for executives of failing institutions that require federal intervention. Whether the federal government promises to support the institution before a crisis develops, as with Fannie

The Group of Thirty shares the recommendation for better corporate governance over executive compensation[179] and better oversight over risk management.[180] It offers additional areas for policy. The Group of Thirty report recommends that originators of loans be required to retain substantial ownership interest in those assets.[181]

## CONFLICTS OF INTEREST

The COP report focuses its conflict of interest recommendations on the credit rating agencies, advocating that the revolving door between the industry and the agencies should be closed, the payment system altered and liability imposed.[182] It also suggests policies to increase competition.[183] The credit rating agencies are arguably Exhibit A in the current crisis for the disastrous consequences that can result from conflicts of interest, but the issue is much broader and will need a broader regulatory response.

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Mae and Freddie Mac, or after, as with TARP recipients, the prospect of losing bonus compensation could deter risky practices that make the federal rescue more probable.

[178] COP Report, p. 44: Reform the quasi-public role of NRSRO's and consider creating a Credit Rating Review Board. Perhaps the most pressing issue of all from a regulatory standpoint is the NRSRO designation itself. Particularly given all of the concerns that have been raised about the credit rating agencies and their poor performance leading up to the current crisis, state and federal policymakers will need to reassess whether they can continue to rely on these private ratings as a pillar of public financial regulation. In fact, it may be time to consider the possibility of eliminating, or at least dramatically scaling back, the NRSRO designation and replacing it with something else. One option would be to create a public entity—a Credit Rating Review Board—that would have to sign off on any rating before it took on regulatory significance. Even if an asset was rated as investment grade by a credit rating agency, it could still not be added to a bank or pension fund portfolio, for example, unless the rating was also approved by the review board. Ideally, the board would be given direction by lawmakers to favor simpler (plain vanilla) instruments with relatively long track records. New and untested instruments might not make the cut.

[179] 9b. Coordinating board oversight of compensation and risk management policies, with the aim of balancing risk taking with prudence and the long-run interests of and returns to shareholders;

[180] 9. Regulatory standards for governance and risk management should be raised.

[181] 1b. Participation in packaging and sale of collective debt instruments should require the retention of a meaningful part of the credit risk.

13 b. Credit Underwriting Standards: The healthy redevelopment of securitized credit markets requires a restoration of market confidence in the adequacy and sustainability of credit underwriting standards. To help achieve this, regulators should require regulated financial institutions to retain a meaningful portion of the credit risk they are packaging into securitized and other structured credit products.

[182] COP Report, pp. 41…43: Regarding conflicts of interests, worrisome is the rating agencies' practice of charging issuers for their ratings…. To address conflicts of interest, the SEC or a new regulatory body could impose limits on the proportion of revenues of rating agencies that are derived from issuers... Alternatively, for each rating, issuers could be required to pay into a pool, from which a rating agency would be chosen at random… One could also imagine the introduction of grace periods in which credit rating analysts could not take jobs with their clients…Since rating agencies currently face little if any legal liability for malfeasance in the production of ratings, a number of experts have proposed strategies for imposing liability on credit rating agencies to ensure appropriate accountability.

[183] COP Report, p. 43: To improve incentives, the SEC or some other regulatory body should further encourage additional competition by progressively expanding the ranks of the NRSROs.

While the perverse incentives of conflicted rating agencies are given explicit attention in the Group of Thirty Report,[184] it discusses a broader range of policy responses. Reducing conflicts of interest is handled in the Group of Thirty Report much like the reduction of moral hazard, with a mix of bans and regulatory oversight intended to reduce the problem.[185] Comingling of regulated and unregulated business is discouraged.[186] Conflict of interest is also addressed by creation of independent internal and external mechanisms to govern[187] and evaluate risk.[188]

### UNFAIRNESS/INEQUALITY

It is certainly possible to identify a range of situations in which there is a mismatch between parties to transactions because of the existence of entities of very different sizes with very different endowments of information and skills. The endemic problem that the COP recommendations focus on involves two major areas – mortgage and consumer credit. Here the mismatch is severe, and the report lists a variety of conditions and exploitative practices that were common in the mortgage market.[189] The COP proposes to increase regulation by allowing state consumer protection laws to apply to national banks[190] and by

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[184] 14c. Regulators should encourage the development of payment models that improve the alignment of incentives among the providers of risk ratings and their clients and users, and permit users to hold NRSROs accountable for the quality of their work product.

12b. The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business model of these institutions, apply appropriate rigor to valuation and evaluation of intent, and require improved disclosure and transparency. These standards should also be reviewed by, and coordinated with, prudential regulators to ensure application in a fashion consistent with safe and sound operation of such institutions.

[185] 1b. Large, systemically important banking institutions should be restricted in undertaking proprietary activities that present particularly high risks and serious conflicts of interest.

[186] 1b. Sponsorship and management of commingled private pools of capital (that is, hedge and private equity funds in which the banking institutions own capital is commingled with client funds) should ordinarily be prohibited

[187] 9a. Strengthening boards of directors with greater engagement of independent members having financial industry and risk management expertise;

9c. Ensuring systematic board-level reviews and exercises aimed at establishing the most important parameters for setting the firm's risk tolerance and evaluating its risk profile relative to those parameters;

14. Regulatory policies with regard to Nationally Recognized Securities Rating Organizations (NRSROs) and the use of ratings should be revised, preferably on an internationally coordinated basis.

14a. Users of risk ratings, most importantly regulated users, should be encouraged to restore or acquire the capacity for independent evaluations of the risk of credit products in which they are investing.

[188] 9d. Ensuring the risk management and auditing functions are fully independent and adequately resourced areas of the firm. The risk management function should report directly to the chief executive officer rather than through the head of another functional area;

[189] The conditions include uniformed buyers confronted with complex products subject to lax standards. The exploitative practices include teaser rates, sharp selling and delayed or incomplete disclosure.

[190] Cop Report, p. 34: Eliminate federal pre-emption of application of state consumer protection laws to national banks. Preemption affects states' consumer protection initiatives in three main respects: 1. Standards: The ability of states to set consumer protection laws and the scope of coverage for those laws. 2. Visitation: The ability of states to examine financial institutions for compliance with consumer protection laws. 3. Enforcement: The ability of states to impose penalties for violations of consumer protection laws.

creating a single federal regulator for consumer credit covering both mortgage and consumer credit.[191]

[191] COP Report, p. 34. Create a single federal regulator for consumer credit products. The need for a uniform federal law to create a meaningful baseline of protections is clear. It is essential that one regulatory agency have the responsibility and accountability for drafting, implementing, and overseeing effective consumer credit product protection rules. Without a uniform set of minimum standards, regulatory arbitrage among state— and federal—regulators will continue. and no regulator or agency will have the authority and responsibility to protect consumers.

## V. GETTING REGULATORY REFORM RIGHT

### AN EXAMPLE OF EFFECTIVE PRUDENTIAL REGULATION

Much of our argument centers on what worked in America before the onslaught of market fundamentalism, and the Group of Thirty and COP both appear to believe that a return to much stricter regulation is needed to address the problem. Can regulation really work?

A description of what is happening – actually not happening – in India provides strong support for the proposition that prudential regulation can be effective.[192] India enjoyed phenomenal economic growth over the past decade amid the various bubbles, but its banking system has avoided even the hint of a meltdown because it applied a very traditional model of prudential regulation. A *New York Times* article provides a breathtaking counterpoint to the pandemonium in financial markets in America and elsewhere around the globe.

The article recognizes that there are cultural differences between the two countries because, "Indians are simply not as comfortable with credit as Americans," but it points out that Indian bankers would have been glad to get in on the frenzied lending activity if they had been allowed to. They bristled under the heavy hand of prudential regulation.

The Indian approach that saved the day was based on the premise that financial institutions would not restrain themselves. The incentives to engage in risky behavior would be too strong.

> But there was also another factor, perhaps the most important of all. India had a bank regulator who was the anti-Greenspan. His name was Dr. V. Y. Reddy, and he was the governor of the Reserve Bank of India. Seventy percent of the banking system in India is nationalized, so a strong regulator is critical, since any banking scandal amounts to a national political scandal as well. And in the irascible Mr. Reddy, who took office in 2003 and stepped down this past September, it had exactly the right man in the right job at the right time.
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> "He basically believed that if bankers were given the opportunity to sin, they would sin," said one banker who asked not to be named because, well, there's not much percentage in getting on the wrong side of the Reserve Bank of India. For all the bankers' talk about their higher lending standards, the truth is that Mr. Reddy made them even more stringent during the bubble.

The regulator also worried about the balance sheets of the banks and did not let them get over levered or wrapped up in exotic instruments.

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[192] Joe Nocera, "How India Avoided a Crisis," *New York Times,* December 20, 2008.

> "Indian banks are not levered like American banks. Capital ratios are 12 and 13 percent, instead of 7 or 8 percent. All those exotic structures like C.D.O. and securitizations are a very tiny part of our banking system. So a lot of the temptations didn't exist."
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> Seeing inflation on the horizon, Mr. Reddy pushed interest rates up to more than 20 percent, which of course dampened the housing frenzy. He increased risk weightings on commercial buildings and shopping mall construction, doubling the amount of capital banks were required to hold in reserve in case things went awry. He made banks put aside extra capital for every loan they made. In effect, Mr. Reddy was creating liquidity even before there was a global liquidity crisis.

The moral hazard problem was identified and addressed. The regulator banned products and practices that conflicted with the basic purpose of the commercial banks.

> One of the first moves he made was to ban the use of bank loans for the purchase of raw land, which was skyrocketing. Only when the developer was about to commence building could the bank get involved — and then only to make construction loans. (Guess who wound up financing the land purchases? United States private equity and hedge funds, of course!)

Ironically, there was a real estate bubble in India, but it was not Indian banks that fueled it; it was American shadow banks.  Fools rush in where angels dare not tread.

> Yet two years ago, the Indian real estate market — commercial and residential alike — was every bit as frothy as the American market. High-rises were being slapped up on spec. Housing developments were sprouting up everywhere. And there was plenty of money flowing into India, mainly from private equity and hedge funds, to fuel the commercial real estate bubble in particular. Goldman Sachs, Carlyle, Blackstone, and Citibank — they were all here, throwing money at developers…
>
> As the credit crisis has spread these past months, no Indian bank has come close to failing the way so many United States and European financial institutions have. None have required the kind of emergency injections of capital that Western banks have needed. None have had the huge write-downs that were par for the course in the West. As the bubble has burst, which lenders have taken the hit? Why, the private equity and hedge fund lenders who had been so eager to finance land development. Us, in others words, rather than them. Why is that not a surprise?

The agency problem was addressed as well. The regulator understood that the purpose of banking was not just to make the most loans you could, but also to make the right loans – loans that were sound.

> On the one hand, this meant they made fewer loans than their American counterparts because they couldn't sell off the loans to Wall Street in securitizations. On the other hand, it meant they still had the incentive — as American banks did not — to see those loans paid back.
>
> Ms. Kochhar said that the underlying risks of having "a majority of loans not owned by the people who originated them" was not apparent during the bubble. Now that those risks have been made painfully clear, every banker in India realizes that Mr. Reddy did the right thing by limiting securitizations. "At times like this, you tend to appreciate what he did more than we did at the time," said Mr. Kapoor. "He saved us," added Mr. Parekh.
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> Then, as securitizations and derivatives gained increasing prominence in the world's financial system, the Reserve Bank of India sharply curtailed their use in the country. When Mr. Reddy saw American banks setting up off-balance-sheet vehicles to hide debt, he essentially banned them in India. As a result, banks in India wound up holding onto the loans they made to customers.

The key to the problem and the solution is not the greed of the bankers. Greed is a given. The key is the strength of the regulator to resist the excesses of greed and direct the financial sector to socially productive outcomes.

> When I asked Mr. Kapoor for his take on what had happened in the United States, he replied: "We recognize it as a problem of plenty. It was perpetuated by greedy bankers, whether investment bankers or commercial bankers. The greed to make money is the impression it has made here. Anytime they wanted a loan, people just dipped into their home A.T.M. It was like money was on call."
>
> So it was. And our regulators, unlike theirs, just stood by and let it happen. The next time we're moving into bubble territory, perhaps we can take a page from Mr. Reddy's book — sometimes it's better to apply the brakes too early than too late. Or, as was the case with Mr. Greenspan, not at all.

Thus, the critique of market fundamentalism is not a case of twenty-twenty hindsight. There were plenty of analysts in the U.S. who saw the problem coming and warned against it. There were regulators abroad who understood the problem and stuck to the basic principles that had worked so well for so long to avoid the pitfalls of market fundamentalism.

The key point is that, as reform moves forward, we will hear the same complaints that the bankers raised in India: there are deals we can't do under these onerous rules.

> "Did the Indian bankers stand up to applaud… these moves? Of course not. They were naturally furious, just as American bankers would have been if Mr. Greenspan had been more active. Their regulator was holding them back, constraining their growth! Mr. Parekh told me that while he had been saying for some time that Indian real estate was in bubble territory, he was still unhappy with the rules imposed by Mr. Reddy. "We were critical of the central bank," he said. "We thought these were harsh measures." "For a while we were wondering if we were missing out on something," said Ms. Kochhar of Icici. Banks in the United States seemed to have come up with some magical new formula for making money: make loans that required no down payment and little in the way of verification — and post instant, short-term, profits. As Luis Miranda, who runs a private equity firm devoted to developing India's infrastructure, put it: "We kept wondering if they had figured out something that we were too dense to figure out. It looked like they were smart and we were stupid." Instead, India was the smart one, and we were the stupid ones.

The response is simple; if the deal cannot pass the test of a traditional prudential standard, it is not worth doing. If the standards are lowered or eliminated, the bad deals will overwhelm the system. This is the reason we believe that policy should start with regulation and set the parameters within which the market is allowed to work.

As the financial crisis has unfolded, the importance of adherence to tenets of prudential practice and the important role of regulation has become more apparent. Less than two months after the column describing Indian banks, *New York Times* ran an opinion piece commenting on the first proposal of Treasury Secretary Geitner to apply a stress test to troubled banks, making the point essential point:

> Private investors are not going to be willing to put money into an institution whose business model is broken and whose profit power is limited. Investors in the stock market have already run their own stress tests on the banks and have found many of them lacking – hence the free fall in the share prices of many banks.
>
> On the bright side, lots of small banks that focused on good, old-fashioned lending are considerably better off than their big formerly powerful brethren created in the merger mania of the last decade…
>
> There is no silver bullet to end this crisis, and Mr. Geitner was correct when he said it was going to take time to work our way out of it.

> But it will also require transparent, rigorous analysis: candor with the public and investors; and a recognition that lots of debt heaped upon a pile of dubious assets has created a financial nightmare – it's no more complicated than that.
>
> Worst of all, none of this had to happen. Regulators should have been more vigilant.[193]

**Timidity in the Face of Crisis Can Lead to an Inadequate Response**

We have framed this analysis in terms of a debate with those who do not want to admit the problem in the market, arguing instead that the problem was not inadequate regulation but too much regulation. The Indian example supports the proposition that strict prudential regulation can work to prevent a meltdown. However, there will be a second debate with those who argue for only modest reforms. How far we should go in regulatory reform is going to be a major point of debate. While the goal of this analysis is to set the broad terms of the debate, rather than offer detailed prescriptions, it is important to understand why the framing may matter so much. The recent analysis by Litan and Baily serves as a case in point.

Litan and Baily continue to cling to the "clean-up"[194] model of regulation. Market failure is a "side-effect"[195] that occurs in the "crevices"[196] of the market. They grudgingly accept that regulation needs to do a better job of preventing market failure,[197] but their primary purpose is to preserve the paramount role of the market in promoting innovation.[198]

The most obvious example of why this matters is in their insistence that regulators not be allowed to require approval of products before they go to market.[199] Instead, regulators are to monitor market participants more closely and only intervene after the fact if the products create more harm than good. Ignoring both the difficulty regulators have

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[193] Gretchen Morgenson, "The Worst Misstep: Geitner Added to the Doubt," *New York Times,* February 15, 2009.

[194] Robert E. Litan and Martin N. Baily, *Fixing Finance: A Roadmap for Reform,* February 17, 2009, p. 23, Much financial history could be written as the story of a continuing game between market actors and those who police them (industry bodies or governments), with the former generally outpacing the latter, and the latter typically cleaning up the mess left by the former.

[195]Litan and Baily, Regulators failed to police this activity while both lawmakers and regulator failed to adapt financial rules to prevent the untoward die-effects of rapid and increasingly complex financial innovations in mortgage markets specifically and financial markets more generally (p. 10).

[196] Litan and Baily, Financial institutions, their executives and shareholders, exploited crevices in the financial regulatory system without regard to the cumulative damage they would eventually cause to the financial system (p. 10).

[197] Litan and Baily, The constant challenge for policy makers is thus to design rules of the road that adapt to, and ideally anticipate, these untoward developments. When this does not occur, as recent events clearly illustrate, policy makers must change the policy framework in a way that prevent future abuses without at the same time chilling socially responsible innovation and risk-taking. That is a tall order (p. 15).

[198] Litan and Baily, Although the impulse for policymakers after a crisis "to do something" is a powerful one, government policies can easily over-react and stifle change and innovation (p. 13).

[199] Litan and Baily, p. 23

experienced in responding quickly to a rapidly evolving crisis and the enormous cost that this regulatory approach has entailed, they continue to relegate regulators to the role of cleaning up the mess after the fact. There is no real appreciation of the huge hole that has been blown in the market fundamentalist arguments.

The Litan/Baily argument is unconvincing for four reasons. First, the benefits of innovation they claim are not persuasive. The huge disruption and cost of the boom and bust cycle that was launched immediately with the "modernization" of the financial system (Financial Services Modernization Act of 1999 and the Commodity Futures Modernization Act of 2000) is under appreciated. The dollar value of the financial instruments that Litan and Baily admit have gone astray is, by historical standards, astronomical. In less than a decade after the "modernization" Acts were passed, these instruments grew from about $1 trillion to about $65 trillion in value.[200] The growth in the value of these instruments is several times larger than the growth in the reserves of depository institutions, mortgage debt, bank credit, and consumer credit combined; yet Litan and Baily admit that these instruments had little redeeming social value.

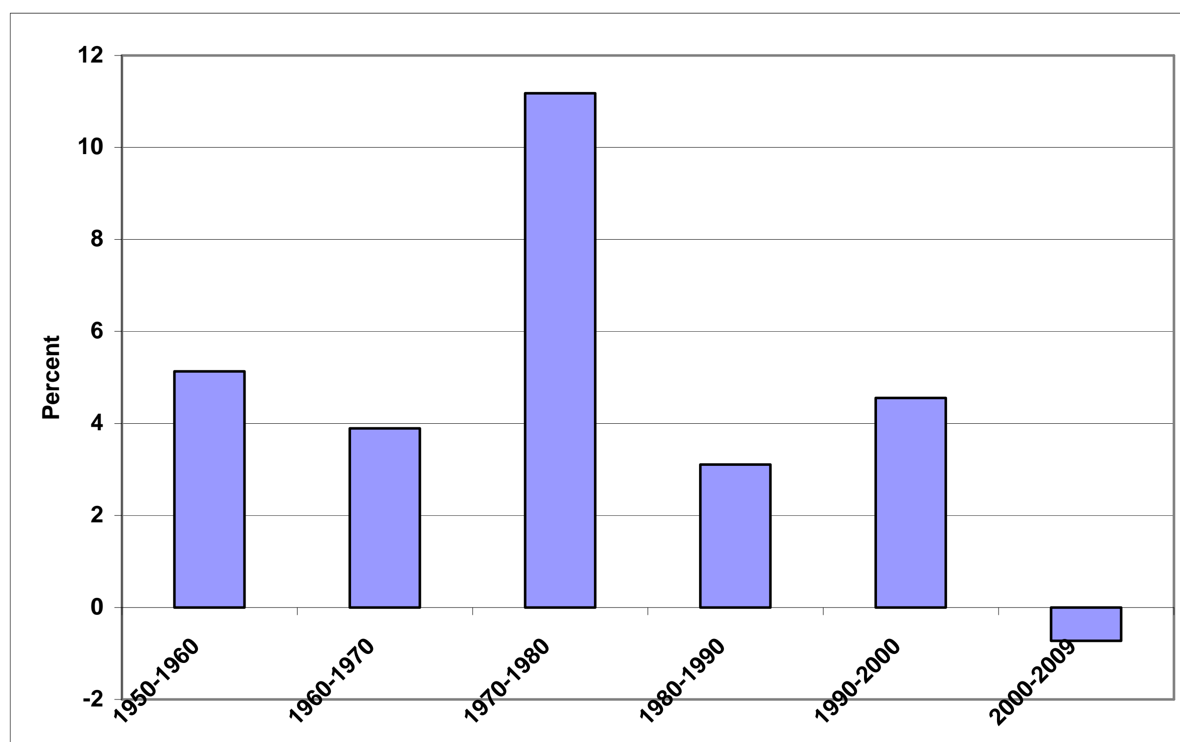
> To be sure, this crisis has all too clearly demonstrated that some recent "innovations" have little redeeming merit or mixed effects at best, while some "innovations" were really not innovative at all. For example, as they were structured and essentially approved by the rating agencies, CDOs turned out to be dangerous devices for securitizing subprime mortgages. Likewise, there was no discernable social benefit to the off-balance sheet SIVs banks created to circumvent bank capital regulations. In the area of derivatives, the failure of AIG pointed to problems in the market for CDS…. Derivatives trading in general provided a way to avoid the capital and regulatory requirements in place for traditional insurance products.[201]

The growth of derivatives to over $600 trillion of dubious value and the holding of much of this in off balance sheet vehicles magnifies the potential harm, without showing a commensurate benefit. If CDOs, SIVs and CDSs have little redeeming social value and provided mechanisms for escaping from prudential oversight, it is hard to see why such instruments should be let into the world without scrutiny.

The disruption to wealth formation in the United States is stunning. Litan and Baily point out that a $19 billion boom in household wealth (2000-2007) was followed by a bust of $12.6 billion, but they do not explore the implications of this for the public policy choices before them. Stock prices and housing values continue to decline, so the increase in household net worth is through 2009 is likely to be less than $6 billion. In real terms, household net worth has actually declined over the first nine years of this decade, something that has not happened in sixty years (see Figure V-1). In weighing the harm of market

[200] Felix Salmon, "The Secret Formula that Destroyed Wall Street," *Wired,* March, 2009, p. 79.
[201] Litan and Baily, pp. 22-23.

*Figure V-1: Real Household Network Worth, Compound Annual Growth Rates*




**Source: Federal Reserve, Flow of Funds, Bureau of the Census, *Historical Abstract of the United States.***

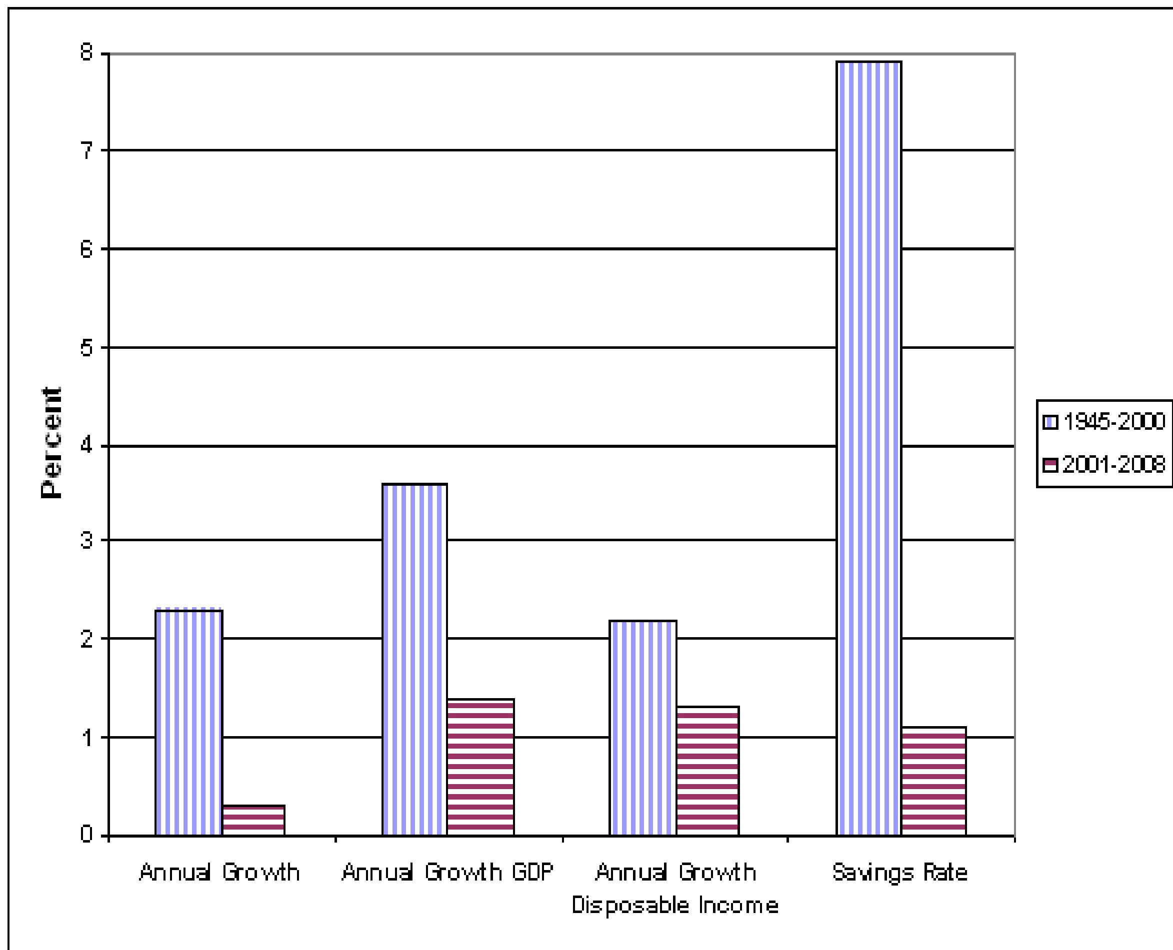
failure against the benefit of market innovation, it seems that Litan and Baily have tilted the scales in the wrong direction.[202]

Moreover, while the potential harm of letting unregulated products into the market is so great, it is not clear that the innovations Litan and Baily identify could not take place in a world where prudential regulation sets standards for products to meet before the fact. There was, in fact, plenty of productive innovation under the New Deal institutions of prudential regulation. The financial sector grew rapidly and in proportion to the real economy for fifty years. Deregulation was pushed not because of market failure, but in the hope, now dashed, that deregulated markets would work better.

The economic failure of market fundamentalism is not limited to a measure of performance like net worth, which is tied closely to the financial sector, it is evident in the major indicators of the real economy. Compared to the previous half century, the past eight years have been the weakest in the economy since the Great Depression (see Figure V-2)

[202] Floyd Norris, "A 10-Year Stretch That's Worse than it Looks," *New York Times,* February 7, 2009, concludes that the decade ending in January 2009 is the worst since the Great Depression.

*Figure V-2: Indicators of Real Economy Performance, 1945-2000 v. 2001-2008*




**Source: Neil Irwin and Dan Eggan, "Economy Made Few Gains in Bush Years," *Washington Post,* January 12, 2009 for jobs, GDP and Disposable Income. *Economic Report of the President,* 2008, Table b30, Bureau of Economic Analysis. Comparison of Personal Savings in the National and Product Accounts, and Bureau of the Census, *Historical Abstract of the United States,* p. 978, for savings rate.**

The second reason that their argument is unconvincing is that they dismiss the string of past crises, which occurred during the period of market fundamentalism. The previous crises were managed by papering them over, with at best modest tweaks to the financial system. The lessons were not learned, and the deregulation bull rushed ahead. We cannot help but wonder whether their reaction is just another inadequate response. There is a hint of this in their argument, when they admit that, even though the market has moved to discipline itself by punishing bad actors and actions, markets have "short memories"[203] and criminal prosecutions and civil lawsuits are "in light of past experience obviously not

[203]Litan and Baily, p. 14.

sufficient."[204] Reform is necessary to institutionalize the new norms of behavior. Timidity in the face of crisis has a price; it invites bigger blow-ups down the road.

The third and most important reason that their argument is unpersuasive is that their description of what went wrong in the securitization process suggests a much more profound problem than the argument admits. Their description of how the market failure came about demonstrates a pervasive failure across a wide range of institutions that is driven by the fundamental flaws in unregulated market behavior that we have identified – lack of transparency, agency, conflicts of interest, information inequality, and perverse incentives (see Figure V-3).

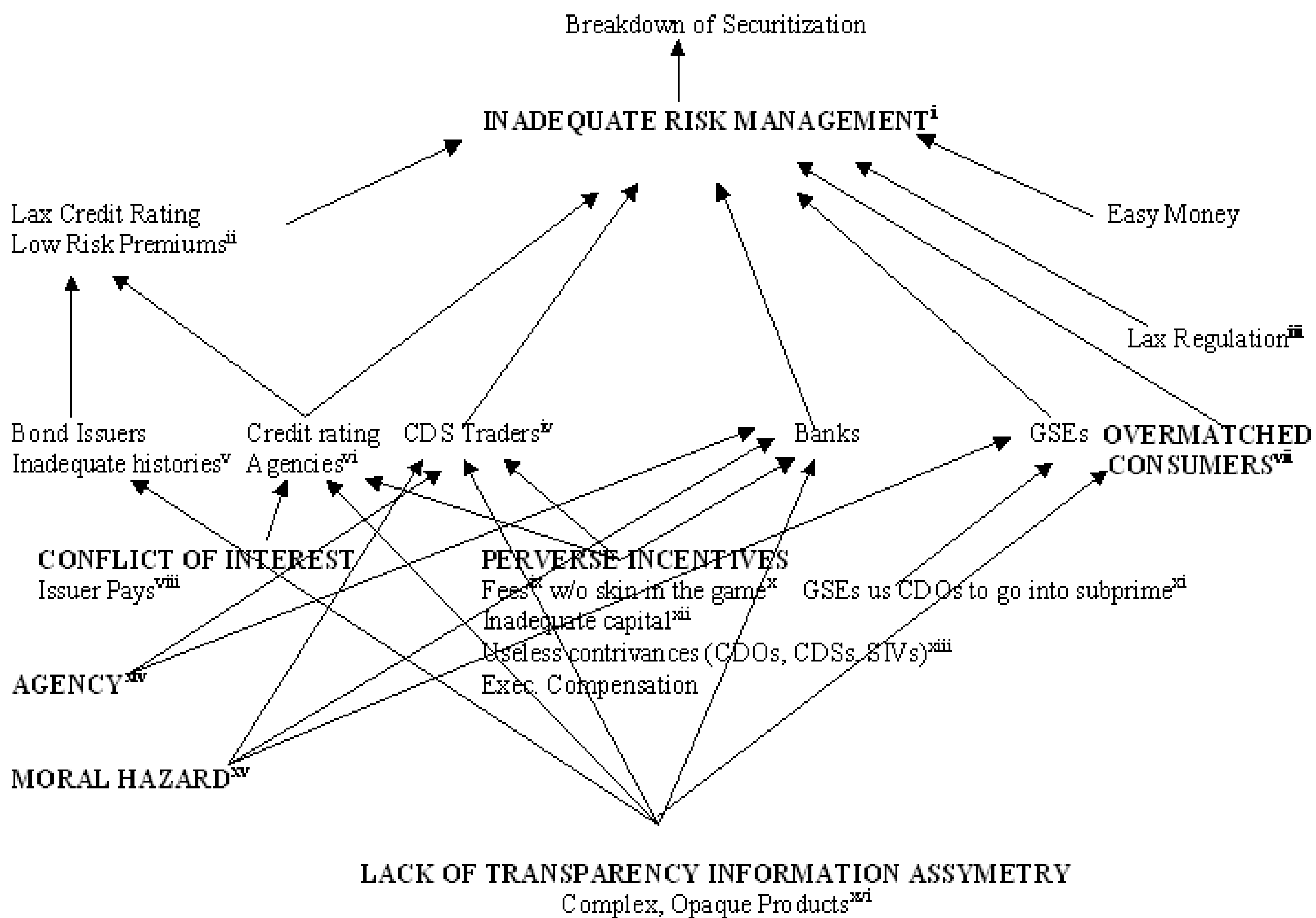
Since we have described these market imperfections in the earlier discussion, the Figure simply includes the citations to the Litan/Baily discussion of the issues. Even though they identify only a subset of the complex market imperfections we discussed above, it is clear that the problem is severe, more severe, in our opinion, than their rhetoric and recommendations reflect. Simply put, reading through the description of what the private sector actors did, one gets the impression that, without strict rules and close regulatory oversight, "all hell breaks loose," which is pretty much what happened in less than a decade after the "modernization" of the financial system.

Given the pervasiveness and the potency of the flaws in the financial markets, their premise that regulation is secondary will likely lead to inadequate reform. For them, regulatory reform is largely a matter of accelerating market responses[205] and preventing regulatory reform from going too far.[206] The inclination to advocate inadequate regulatory remedies is reinforced by a distorted view of regulation.

Litan and Baily take a very narrow view of regulation, assuming that the framework from the recent past must continue into the future. "With rare exceptions – notably, where regulatory approval is required before certain types of derivative contracts may be traded on exchanges – U. S. financial regulatory policy historically has not embraced the precautionary principle or the logic behind it."[207] If history includes the period before the financial "modernization" acts were passed, the precautionary principle is not all that rare, particularly for major issues. Thus, important conflicts of interest were prevented by an outright ban on comingling investment and commercial banking, a problem that was allowed back into the financial sector in a big way by the Financial Services Modernization Act. The Commodity Futures Modernization Act created specific loopholes that banned regulation of key products precisely because the market fundamentalists feared regulators would exercise authority over those products.

[204] Litan and Baily, p. 14.
[205] Litan and Baily, p. 15.
[206] Litan and Baily, p. 13.
[207] Litan and Baily, p. 23.

*Figure V-3: The Breakdown of Securitization in the Litan/Baily Analysis*




**Source: Robert E. Litan and Martin N. Baily,** ***Fixing Finance: A Roadmap for Reform,*** **February 17, 2009,**

i At the height of the financial boom, investors seeking high returns seemed willing almost to ignore the risks of loss or default in the assets they were buying – the risk premium fell well below its normal historical level (p. 9). Bank capital standards for our largest banks have proven inadequate, by themselves, to provide sufficient market discipline to encourage prudent risk-taking by those institutions

ii. It is possible that financial institutions will develop much less complex securities, those without multiple tranches, which are backed by subprime mortgages. Such new securitized instruments would carry higher interest rates to reflect their higher risk and would be more transparent (p. 17).

iii. Securities regulators permitted the formerly independent investment banks during the run-up to the subprime mortgage crisis to operate with substantially greater leverage than they had before (p. 18)

iv. The credit default swaps market, even after clearinghouses are established is still not adequately regulated (p. 14).

v. Yet, the largest bond issuers made the same mistakes as the credit rating agencies: both misjudged the risks of subprime debt primarily by relying on a limited historical record of these newer mortgage instruments.

vi. The regulatory framework governing credit rating agencies obviously has failed to encourage appropriate risk ratings (p. 14).

vii. Some homebuyers with little financial sophistication also surely were duped by “predatory lenders” into taking on mortgages they could not afford (p. 16).

viii. There is an even more important reason, however, why the market failed to discipline the rating agencies: because the agencies are by the issuers, the mores securities the agencies rated, the more money they made. This inherent conflict of interest would not exist if the agencies were able to charge investors rather than issuers (p. 17).

ix. Mortgage lenders and brokers were only too happy to oblige, reaping fees on all the subprime mortgages they could originate, without bearing the risk that the mortgages would default (except during a temporary “put back” period if borrowers violated the mortgage’s “representations and warrantees… This, of course, was a fatal flaw in the originate-to-distribute model of mortgage finance, which gave lenders and brokers with no skin in the game few incentive to monitor the credit-worthiness of borrowers (p. 17)

x. It is critical to recognize that financial markets work – allocating scarce funds to their best uses or activities that promise the highest risk-adjusted returns – only when the parties to transactions have money at risk, or “skin in the game.” (p. 16).

xi. The GSEs were prevented by rule from buying subprime mortgages directly and did not lead the charging into this segment of the mortgage fiasco… Fannie and Freddie purchased CDAs backed heavily by subprime and less-than-prime (Alt A) mortgages (p. 18).

xii. Indeed, the fact that commercial bank originators of CDOs were able to form and use SIVs is another indication of how the banks evaded prevailing capital standards and thus undermined market discipline (p. 18).

xiii. The absence of effective market discipline, abetted by misdirected financial innovation, also clearly was an important factor (p. 16). To be sure, this crisis has all too clearly demonstrated that some recent “innovations” has little redeeming merit or mixed effects at best, while some “innovations” were really not innovative at all (p. 22).

xiv. Too many market participants benefitted by taking risks with other people’s money. The market incentive pillar needs strengthening as well as the regulator pillar (p. 15).

xv. With less shareholder money at risk for each dollar of assets invested, the largest commercial and investment banks that believed the federal government would never permit their creditors to suffer loss… were less constrained by market forces than would have been the case had more stringent capital (and thus leverage) rules applied (p. 18).

xvi. Lawmakers and regulators failed to adapt financial rules to prevent the untoward side-effects of rapid and increasingly complex financial innovations (p. 10).

In arguing for restraint in regulatory reform, Litan and Baily confuse the recession with the financial meltdown. Because the economy has dealt with recession without major institutional reform, the suggestion is that the reaction to the financial meltdown need not entail major institutional reform.

> Third, the unprecedented size and nature of the bailouts suggests that these measures are likely to be very infrequent. After all the nation has had numerous recessions since the Depression and in no other instance has the government done anything quite like what it has done this time to shore up the financial system in this crisis. This suggests that creditors of financial institutions, and the institutions themselves, should not blithely assume that their future mistakes always will be bailed out by some government agency. To the contrary, our post-Depression history suggests that the general rule is that firms and their creditors do not get bailed out as a matter of course, which leaves plenty of room for the market to discipline actors in a wide variety of circumstances in the future.[208]

The absence of financial meltdowns since the Depression suggests that the market failure in the financial sector is not part of the business cycle. The primary lesson that should be taken from the post-Depression history seems to be that sound prudential regulation is the first line of defense against financial market failure.

In a remarkable example of tunnel vision, Litan and Baily offer the FDA as a model since "[j]ust as the FDA monitors pharmaceuticals for adverse side-effects *after they are introduced into the marketplace*, financial regulators should do the same for financial innovations, or for that matter, any kind of financial activity that *displays rapid growth.*[209] They seem to forget that the FDA runs a large and, when it is in the hands of people who believe in its mission, vigorous program of product testing and approval, which screens products before they get to the marketplace. Rather than being a testament to the *ex post* "clean-up" model, the FDA is a example of the model that protects the public by having both an *ex ante* prophylaxis component and an *ex post* "clean-up" component.

In spite of the overwhelming importance of market failure in causing the financial meltdown, Litan and Baily emphasize the regulatory failure and argue against a meaningless straw man – an approach that puts "all of the weight" on regulation.

> While clearly there is a place for regulation and supervision – which we argue shortly, is still true even in the wake of regulatory and supervisory failures in the run-up to the subprime crisis – it would be a mistake in our view to put all of the weight of our financial policy on this one tool.[210]

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[208] Litan and Baily, p. 26.
[209] Litan and Baily, p. 24.
[210] Litan and Baily, 26.

Litan and Baily have set up a false dichotomy. The choice is not an either or proposition between reliance on regulation or markets, but rather is a question how regulation can address market imperfections to reduce the chances and costs of market failure.

Tale V-1 presents our categorization of their recommendations in the analytic framework we have outlined in this paper. Reflecting their defense of the market, they have proposed a small subset of the measures proposed by the Group of Thirty and the Congressional Oversight Panel. Reflecting their narrow view of the role of regulation, Litan and Baily break no new ground.

Litan and Baily place a great deal of faith in the ability of the market to correct itself. Their primary goal is to speed the correction with modest regulatory reforms. Ironically, Alan Greenspan has weighed in again on this part of the debate in two ways. First, he has joined the growing chorus of voices that suggests the most drastic of measures – temporary nationalization of the banks—may be necessary to reboot the banking system.[211] This argues for much bolder action than Litan and Baily seem willing to countenance. Second, he is utterly pessimistic about the long-term ability of the free market system to rid itself of crises. He is far more pessimistic about the working of the market than Litan and Baily.

As the architect of a failed system, he has swung from irrational exuberance to irrational pessimism. Because he did not believe in pragmatic, progressive capitalism, he does not see the way out of the mess. He appears to have learned the lesson of the thirty-year failure of market fundamentalism, but not the lesson of the fifty-year success of the New Deal institutions of prudential regulation. The speed with which market fundamentalism goes wrong – generally a half a decade between repeal of regulation and severe meltdown – and the long period in which the New Deal institutions of prudential regulation controlled financial crises provide strong evidence that there is a balanced middle path. We need to act quickly and decisively to repair the damage to the economy and rebuild the institutional structure of prudential regulation that prevents the worst of human nature from doing its worst to the economy.

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[211] Henry Blodget, "Greenspan: Nationalize the Banks," *Business Insider.*

*Table V-1: Policy Recommendations of Litan/Baily*

| Moral Hazard | Information/Accounting | Regulation of Incentives | Agency | Conflicts of Interest | Unfairness/Inequality |
|---|---|---|---|---|---|
| | | | | | |
| Primiary Regulator for Systemically | Clearing House for Derivatives | Incentivize Prudency | Executive Compnesation | Uniform Credit Rating | More Rules for Disclosrue to |
| Important Finanacial Institutions (SIFI) | | Origninators - Fed Stds | Reward Long-Term | Compensation | Unspohisticated |
| End Constructive Ambiguity | Enhanced Disclosure | Scuritizers - Ratain Risk | Risk Management | | |
| | | Credit Raters | | | Counseling |
| Define SIFI carefully | Scorecrd for RatingAgencies | Accountable to Market | | | |
| Banks, Insurers, Conglomerates | | | | | Single Agency |
| Hedge Funds, Insurers by | More precise & Detailed Ratings | New Derivative Issuers | | | Opt out |
| size, leverage, interconnection | | Capital Rqts | | | Default Mortgage |
| infrastrcuture orle | | Colalteral Rqts | | | |
| | | Clearing Houses | | | |
| Special Rules for SIFI | | | | | |
| Long-term Subordinated, Convertible | | No Pre-aproval of Products | | | |
| Debt | | | | | |
| Capital & coillateral Rqts for | | Regulation by Function | | | |
| non-Stadardized Dirivatives | | Solvency | | | |
| Liqudiity/Solvency Stds. | | Consumer Protection | | | |
| Countercyclical Capital Stds | | | | | |
| | | Risak Retention | | | |
| Oversight of Derivatives | | | | | |
| Capital and Liqudity | | Intl Cooperation, Not Regulation | | | |
| Clearing Houses | | Close Havens | | | |
| Cutomized | | | | | |
| | | | | | |
| Early Prompt Resolution | | | | | |
| | | | | | |
| GSEs | | | | | |
| Direct Govt or Utility Model | | | | | |
| Sunset in 5-10 years | | | | | |
| Shift to on-budget subsidies for | | | | | |
| for Assistance | | | | | |
| Sunset in 5-10 years | | | | | |
| Shift to on-budget subsidies for | | | | | |
| for Assistance | | | | | |
| Down-payment Match | | | | | |
| | | | | | |
| Anticipating Future Crises | | | | | |
| Report to Congress | | | | | |
| Warn of Asset Bubbles | | | | | |

**Source: Robert E. Litan and Martin N. Baily, *Fixing Finance: A Roadmap for Reform,* February 17, 2009,**

## VI. CONCLUSION

The era of market fundamentalism was launched, symbolically, with Ronald Reagan's first inaugural address, when he declared: "Government is not the solution to our problems. Government is the problem." It turns out that government isn't the problem, unregulated markets are, and government *is* the solution, or at least a very large part of it. The era of market fundamentalism should have ended, symbolically, when Alan Greenspan admitted that there was a fundamental flaw in his theory. Properly functioning financial markets are critical to the health of the economy, but a series of spectacular crises, meltdowns and boom and bust cycles indicate that market fundamentalism is not only fatally flawed as an economic theory, but its application in the real world clearly demonstrates that it cannot create markets that provide this basic function.

The claim that markets are the superior institutional form for organizing transactions is an empirical claim and, at most, a rebuttable presumption. As an empirical science, economics ought to accept the proposition that alternative forms of organization might be superior for achieving the desired outcome depending on the nature of the sector. The test should be practical, not theoretical; not theoretically perfect markets compared to imperfect regulation, but the real world of imperfect markets and imperfect regulation. If we make the real world comparison, we conclude that market fundamentalism has performed poorly, and a return to pragmatic progressive principles is needed to repair, reform and rebuild the economy.

We hear a lot of talk about writing 21st century regulation for a 21st century economy, but that misses a basic point – the principles of effective prudential oversight and stable growth do not change. Roosevelt's New Deal got it right. It did so in two fundamental ways. It stopped private enterprise from doing things that hurt the public and did things that are good for the public that private enterprise would not. In the financial sector, the Glass-Steagall Act separated commercial and investment banking and established the FDIC, while the Securities Exchange Act created the SEC to regulate stock markets. The Commodities Exchange Act did much the same for commodity exchanges. These laws and institutions accomplished the first task of protecting the public, while the FDIC and FHA filled the gap where markets did not provide services. Even the moderate members of the Group of Thirty recognize the need for a thorough and pervasive re-regulation of financial markets.

The central message is harsh, as Roubini points out, but the direction of change that is needed is clearly back toward stronger prudential regulation.

> It is clear that the Anglo-Saxon model of supervision and regulation of the financial system has failed.
>
> It relied on self-regulation that, in effect, meant no regulation; on market discipline that does not exist when there is euphoria and irrational exuberance; on internal risk management models that fail because – as a former chief

executive of Citi put it – when the music is playing you gotta stand up and dance.

Furthermore, the self-regulation approach created rating agencies that had massive conflicts of interest and a supervisory system dependent on principles rather than rules. This light-touch regulation in effect became regulation of the softest-touch.

Thus, all the pillars of Basel II have already failed even before being implemented.

Since the pendulum had swung too much in the direction of self-regulation and the principles-based approach, we now need more binding rules on liquidity, capital, leverage, transparency, compensation and so on...

Roubini's concern is that regulatory reform will fail to impose effective oversight, not so much in the details of regulation, but in ensuring against broader processes that tend to undermine oversight – arbitrage, forum shopping and capture.

But the design of the new system should be robust enough to counter three types of problems with rules:

A tendency toward 'regulatory arbitrage' should be bourne in mind, as bankers can find creative ways to bypass rules faster than regulators can improve them.

Then there is 'jurisdictional arbitrage' as financial activity may move to more lax jurisdictions.

And finally, 'regulatory capture' as regulators and supervisors are often captured - via revolving doors and other mechanisms - by the financial industry.

So the new rules will have to be incentive compatible, i.e. robust enough to overcome these regulatory failures.

The resistance to this vitally needed program of reform will be substantial, not only from the industry, which has the incentive to weaken or find ways to escape regulation, but also from the politicians, who see regulatory reform as a clash of ideologies. An op-ed piece in the *Washington Post* entitled "Post-Partisan? Not Really" by Robert Ehrlich, a four term Republican member of the House of Representatives and the governor of Maryland from 2003-2007, offered the call to arms for those who would resist. Ehrlich recognizes that "part of the moderate, post-partisan, post-ideological Obama did indeed come through,"[212]

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[212] Robert L. Ehrlich, "Post-Partisan? Not Really," *Washington Post,* January 22, 2009, p. A17.

but he sees the bulk of the economic agenda as an ideological struggle that cannot be avoided.

Ehrlich questions the belief, expressed by Obama, that government policy can or should endeavor to direct the economy.

> But there was also the assurance the federal government will “create new jobs” and “lay a new foundation for growth.”
>
> And this dangerous observation:
>
> “The question we ask today is not whether our government is too big or too small, but whether it works.” (As though Americans should not focus on whether their government is too big or not big enough).

Ehrlich essentially defended the income inequality hypothesis, horrified by Obama’s statement that, “The nation cannot prosper long when it favors only the prosperous.” Ehrlich declared that market capitalism was at stake: “The stakes are extraordinarily high – market capitalism, free speech, the war against terrorism, marginal tax burdens, workplace freedom. Let the great debate begin anew![213]

President Obama’s pragmatic, progressive reframing of the issues recasts the debate exactly as it should. The mere contemplation that government can work is dangerous in Ehrlich’s view, but an empirical, pragmatic view of the thirty years of market fundamentalism leads to the unavoidable conclusion that the market cannot work without effective government oversight. The job of public policy is to build structures that restrain the antisocial tendencies of capitalism and channel its powerful forces in socially productive directions. Prudential regulation and public interest obligations should come first, not be tacked onto markets to clean up the mess that inevitably occurs when deregulation allows them to run wild.

“Let the great debate begin anew!” Indeed.

[213] Ehrlich, p. A17.

## APPENDIX A;

## OBSERVATIONS ON THE NEW DEAL ECONOMIC PARADIGM AND THE DISTINCTION BETWEEN THE FINANCIAL SECTOR AND THE REAL ECONOMY

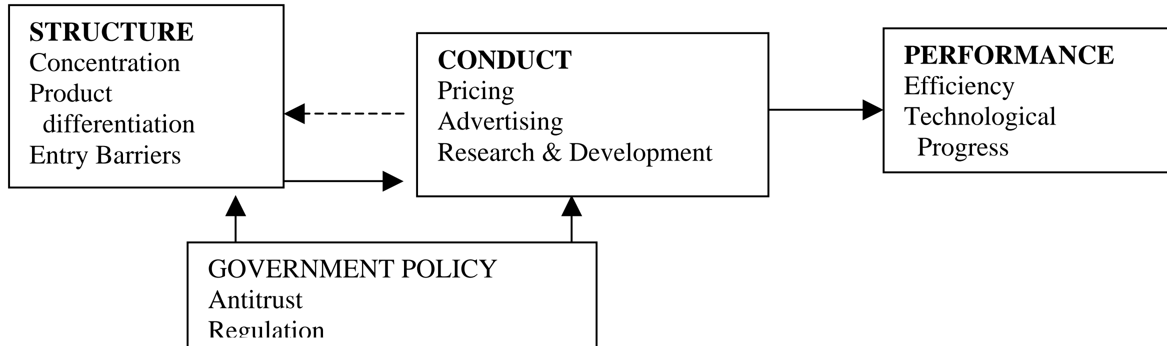
The economic paradigm that guided the construction of new deal institutions was the Structure Conduct Performance paradigm in its early days. This paradigm remained dominant for about forty years until the Chicago School provided the intellectual underpinnings for market fundamentalism.[214] The structure, conduct, performance paradigm identifies the factors that affect market performance. Figure A-1 shows three graphic representations of the paradigm from well-known texts. These formulations identify different sets of "conditions" or "determinants" that affect structure and behavior indirectly, but they do not see direct relationships between determinants or basic conditions and behavior. Conduct is primarily the result of structure. The paradigm was primarily structural and oriented toward the real economy. Indeed, in Shepherd's identification of industries, he depicts Financial Markets, Banking and Securities as floating above the industries of the real economy.

The clear distinction between the real economy and the financial sector and the growing recognition of behavioral economics suggests that the paradigm needs to give more weight to behavior and its determinants as autonomous causes of market performance (as in the final panel of Figure A-1). This distinction fits the current crisis well, since the market imperfections identified as afflicting the financial sector tend to be behavioral, while the imperfections that afflict the real economy tend to be structural. This is not to say that behavioral problems cannot afflict the real economy and structural problems cannot afflict the financial sector. To the extent that the SCP paradigm was significantly concerned with the conditions that caused markets to deviate from the theoretically efficient outcome and behavioral economics is concerned with deviations from presumed rational behavior and the resulting market inefficiencies, the union of the two should not be problematic. Thus, we might talk of the behavioral, structure, conduct, performance paradigm (BSCP).

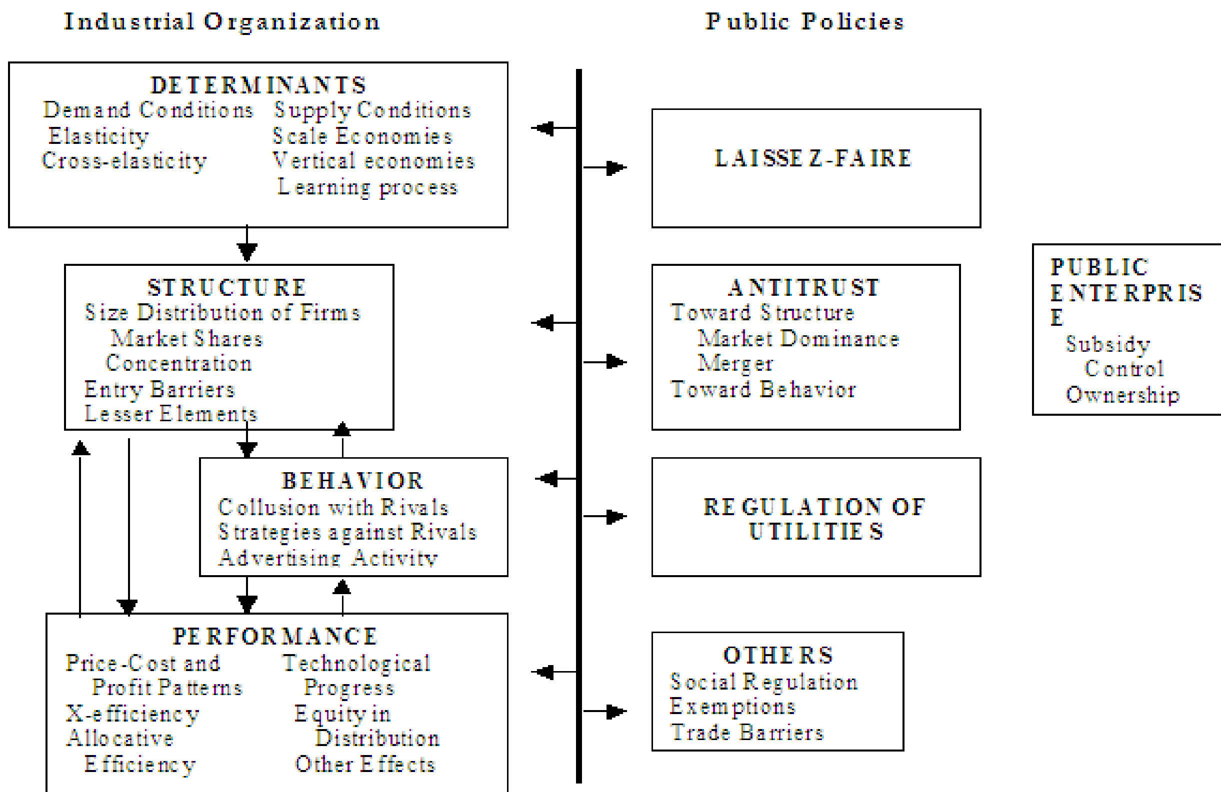
[214] Robert Pitofsky (Ed.), *How the Chicago School Overshot the Mark: The Effect of Conservative Economic Analysis on U. S. Antitrust* (New York: Oxford University Press, 2008).

*Figure A-1: Structure-Conduct-Performance Paradigm of Industrial Organization*

**Viscusi, Kip, W. John M. Vernon and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust* (Cambridge: MIT Press, 2001), p. 62.**




**William G. Shepherd, *The Economics of Industrial Organization* (Englewood Cliffs: Prentice Hall) p. 5.**



**F. M Scherer and David Ross, *Industrial Market Structure and Economic Performance* (Houghton Miflin: Boston, 1990) (hereafter Scherer and Ross), p. 5.**

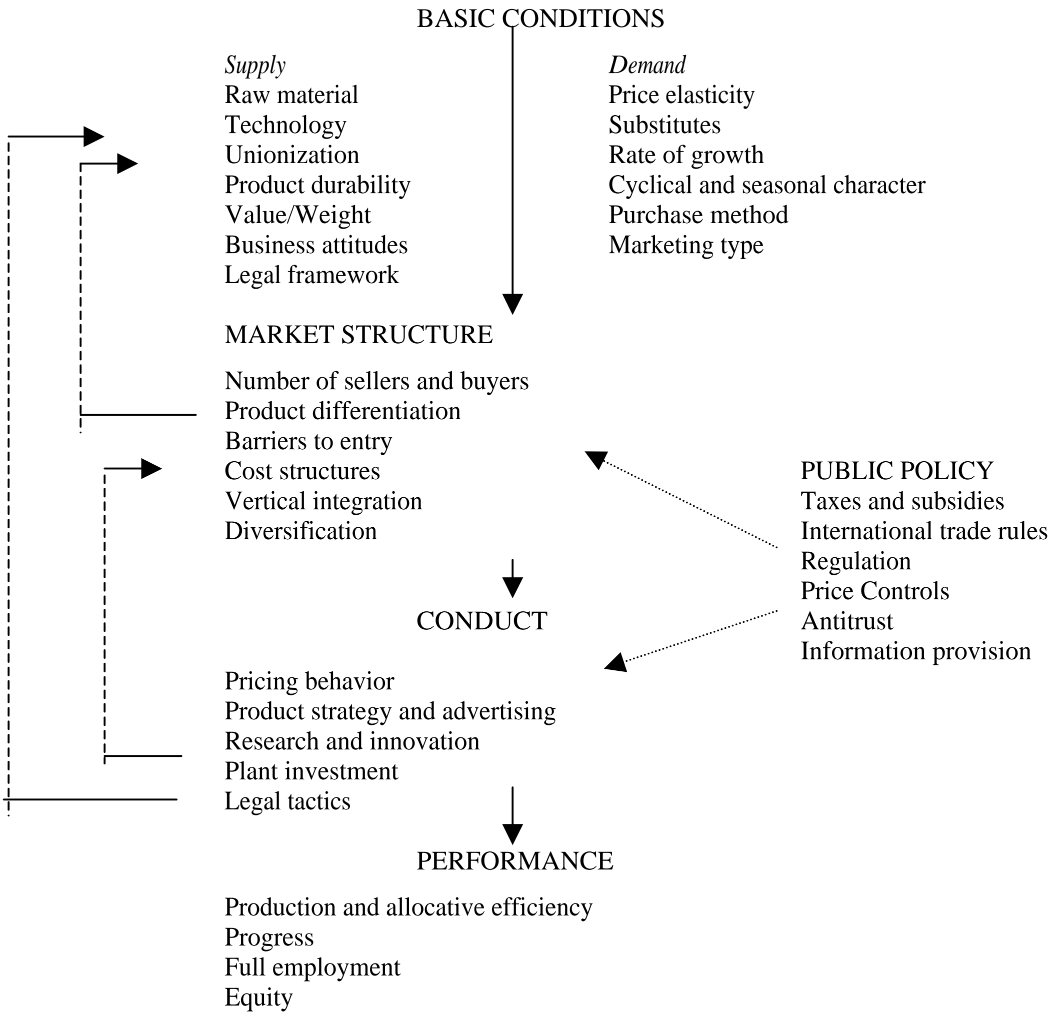
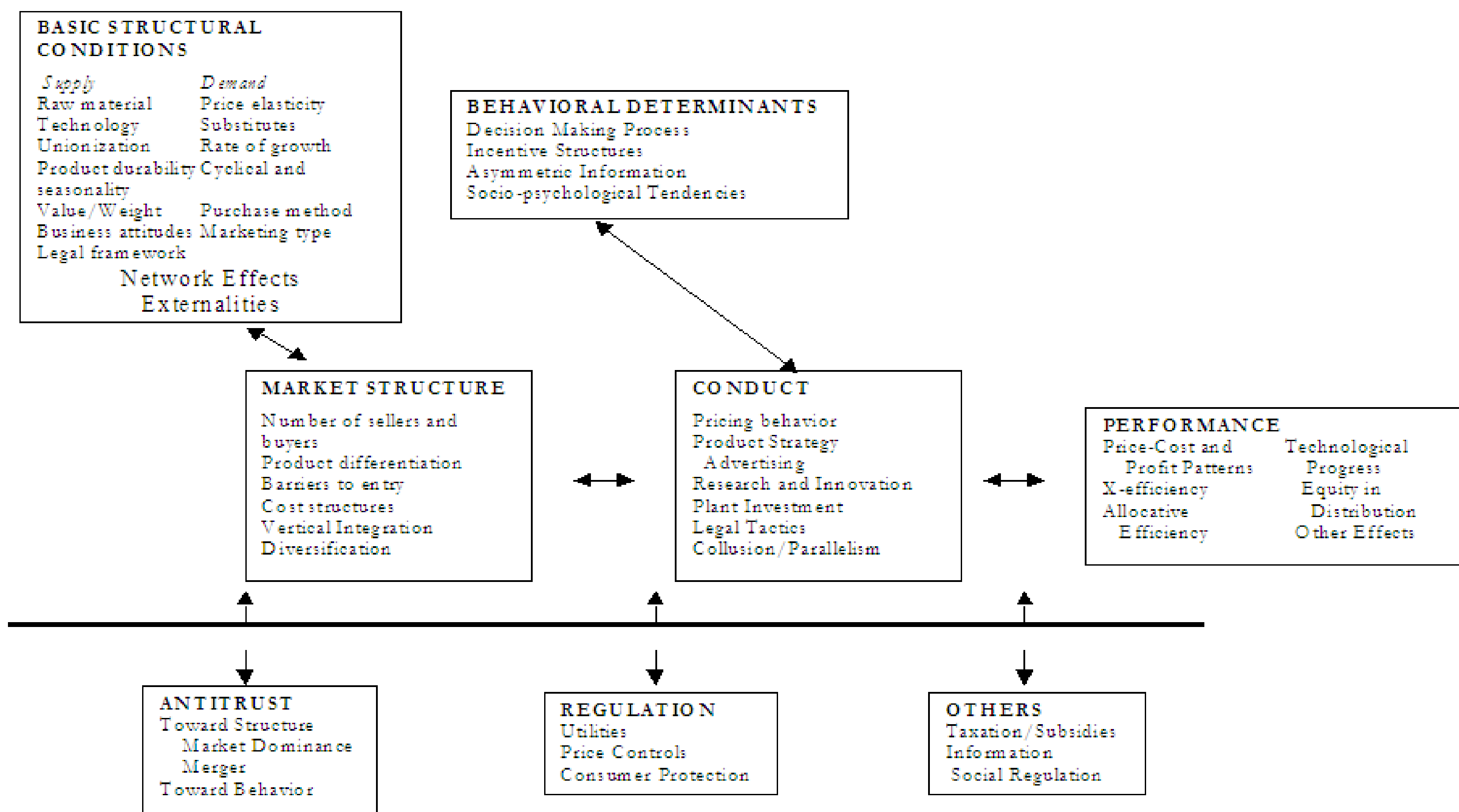


*Figure A-2: Adjusting the SCP Paradigm in Response to the Importance of Behavioral Economics in the Financial Sector*



# APPENDIX B:
# Side-by-Side Policy Recommendations

*Figure B-1: Systemic Risk*

| Congressional Oversight Panel | Group of Thirty | Litan and Baily | Obama Administration |
|---|---|---|---|
| | | | |
| 1. Identify and Regulate Financial | 1a - "Too Big to Fail" Banks | Primiary Regulator for Systemically | Not Just Institutions, but he System |
| Institutions that Pose Systemic | Single Regulator | Important Finanacial Institutions (SIFI) | |
| Risk | Size Based Scrutiny | End Constructive Ambiguity | Single Entity |
| Systemic Risk Regulator | National Limits | | |
| Authority | | Define SIFI carefully | Risk Sensitive Prudential Reg. |
| Tools | 1c - Separation of Banks/Nonbanks | Banks, Insurers, Conglomerates | Counter Cyclical Rqts. |
| Reporting | | Hedge Funds, Insurers by | Size/Risk sensitive |
| Heightened Regulation | 3b - Mutual Funds | size, leverage, interconnection | capital |
| Countercyclical Capital | Reorganize | infrastructure role | reserves |
| Insurance | Differentiate | | liquidity |
| Strict Leverage Ratios | Conservative Investment | Special Rules for SIFI | |
| Strict Capital Ratios | | Long-term Subordinated, Convertible | Conservative Capital |
| Limits on Contingent Liability | 7c- Access to Liquidity | Debt | Further into the tails of outcomes |
| Limits on Off-Balance Sheet | | Capital & collateral Rqts for | Liquidity constraints |
| Caps on Short-Term Debt | 7d - Emergency Lending Authority | non-Standardized Derivatives | Aggregate counterparty risk |
| Caps on Taxpayer Exposure | | Liquidity/Solvency Stds. | |
| Receivership and Liquidation | 7e - Limitations on Liquidity Actions | Countercyclical Capital Stds | SIF Defined |
| Process | | | Size |
| | 16a - Closing of Regulated Banks | Oversight of Derivatives | Interdependence |
| | 16a - Non-Depository Insts | Capital and Liquidity | Leverage (include off balance she |
| | Resolution of Failed | Clearing Houses | Reliance on short term funding |
| | Regulated only | Customized | Importance as source of credit |
| | Establish Regulator as Receiver | | |
| | | Early Prompt Resolution | Resolution Mechanism |
| | 16d- Special Treatment of Contract | | FDIC Process for New Institutions |
| | | | Institution covered include |
| | 5a - GSEs | GSEs | Banks and Thrift Holding Cos |
| | Separation | Direct Govt or Utility Model | Insurance Cos |
| | Public Delimitation | Sunset in 5-10 years | Futures Merchants |
| | | Shift to on-budget subsidies for | Any other SIF |
| | | for Assistance | |
| | | Sunset in 5-10 years | |
| | | Shift to on-budget subsidies for | |
| | | for Assistance | |
| | | Down-payment Match | |

*Figure B-2: Information/Accounting*

| Congressional Oversight Panel | Group of Thirty | Litan/Baily |
|---|---|---|
| 3. Shadow Banks | 4a -Registration and Reporting | Clearing House for Derivatives |
| Public Reporting | 4a - Public Disclosure for Private Pools | |
| Positions | | Enhanced Disclosure |
| Transaction | 4b - Reporting Rqts | |
| | 4b - Disclosure Stds | Scorecard for Rating Agencies |
| 6. Reform Credit Rating | | |
| Implement Overnight Authority | 8a - International Information Sharing | More precise & Detailed Ratings |
| Registration | | |
| Recordkeeping | 8b - Gather Information on Leverage | |
| Reporting | | |
| Re-evaluate Models | 11c - Liquidity Disclosure Stds | |
| Assumptions | | |
| Embedded Structuring | 12a - Reevaluate Fair Value | |
| | 12c- Credit Loss Reserves Principles | |
| | 12c - Transparency of Reserve Determination | |
| | 13a -Securitized & Structured Assets Disclosure = Securities | |
| | 13c - Off Balance Sheet Vehicles | |
| | 15b - Share Information on CS=DS and OTC | |
| | 17a - Asset Backed Products Determine Disclosure Info | |
| | 18 - Evaluate Higher Level of Transparency | |

*Figure B-3: Incentives*

| Congressional Oversight Panel | Group of Thirty | Litan/Baily | Obama Administration |
|---|---|---|---|
| | | | |
| 2. Limit Excessive Leverage | 6a - Fix regulation | Incentivize Prudency | Leveraged Private Investment |
| Objectives Based Capital | Gaps | Originators - Fed Stds | Register with SEC |
| Leverage rqts | Overlaps | Securitizers - Retain Risk | |
| Counter Cyclical Capital | Complexity | Credit Raters | Obama Administration |
| | | | |
| Liquidity Rqts | Remove opportunity for arbitrage | Accountable to Market | Do Not Ban Products |
| | | | |
| 3. Supervise Shadow System | 7a - Central Bank Role in Stability | New Derivative Issuers | Money Market Funds |
| Safety Reg. | Crisis and Expansion | Capital Rqts | SEC reduce risk of rapid |
| Regulate Activity/Products | Participation in Governance | Collateral Rqts | withdrawal |
| OTC | Input into key regulations | Clearing Houses | |
| Clearing House | Supervisory role in | | Hedge Funds and Private Pools |
| Margins | lg firms, payment and clearing | No Pre-approval of Products | Close gaps |
| Mark-to-Market | | | Register at SEC if big |
| Guaranty Funds | 8a - Offshoring | Regulation by Function | Report to asses threat |
| Exchange Traded Derivs. | Delineation of Responsibilities | Solvency | shared with regulator |
| CEA Contract Rules | Close Gaps | Consumer Protection | |
| Registration | Raise Standards | | CDS and OTC Derivatives |
| Reporting | Intl Standards | Risk Retention | Supervise SIF scale firms |
| Capital Rqts | 8b Define Leverage | | Standardized through clearing |
| | 8b Define Leverage | Intl Cooperation, Not Regulation | Supervise clearing |
| 7. Global Regulatory Floor | 8c - Formal Regional Mechanisms | Close Havens | Greater use of exchanges |
| Establish Regulatory | 8c - Formal Regional Mechanisms | | Nonstandardized |
| Floors & Harmonize | Tolerance | | Document |
| Coordinate Surveillance | Profile | | Confirm trades, netting, |
| Strengthen Communications | | | collateral margin, & |
| & Cooperation | 9e - Periodic Review of Profiles | | close-out practices |
| Target Systemic | 9f - Assessment of Counterparies | | |
| Institutions | 9g - Accept CRMPG and IIF | | Intl. Coordination |
| | | | Prudential Supervision |
| | 10a - Raise Capitalization Stds | | Address Tax Havens & Money |
| | 10b - Upper End of Guidance | | Laundering |
| | 10c- Reevaluate Definition of Capital | | |
| | | | |
| | 11a - Diversified Mix & | | |
| | Cushion of Liquidity | | |
| | 11b - Liquidity Stds | | |
| | | | |
| | 13a -Securitized/Structures' Assets | | |
| | Regulatory Stds = Securities | | |
| | | | |
| | 14b - Rating Agencies | | |
| | Accountability for Quality | | |
| | More Robust Valuation | | |
| | | | |
| | 15a - Regulate OTC Derivatives | | |
| | | | |
| | 17b - Structured Product | | |
| | Regulated Disclosure | | |

*Figure B-4: Agency/Conflicts of Interest*

| | Congressional Oversight Panel | Group of Thirty | Litan/Baily |
|---|---|---|---|
| Agency | | | |
| | | | |
| | 5. Reform Executive Pay | 1b -Ownership Interest | Executive Compensation |
| | Tax Incentives | | Reward Long-Term |
| | Asymmetric Pay | Compensation | Risk Management |
| | Options | Risk Mgmt Policies | |
| | Severance | | |
| | Claw Back | 13b - Securitization | |
| | Corporate Governance | Retain Credit Risk | |
| | Strengthen Bd. | | |
| | Long-Term Focus | | |
| | | | |
| | 6. Reform Credit Rating | | |
| | Eliminate or Scale | | |
| | back NRSRO | | |
| | designation | | |
| | Credit Rating Rev. Brd. | | |
| | ex ante review | | |
| | ex post auditing | | |
| | | | |
| Conflicts | | | |
| of Interest | | | |
| | 6. Reform Credit Rating | 1b - Ban/Control of Comingling | Uniform Credit Rating |
| | Close Revolving Door | | Compensation |
| | Change Fee System | Indep. Board Members | |
| | Promote Competition | | |
| | Impose Liability | 9c - Independence | |
| | | Auditing | |
| | | Risk Mgmt | |
| | | | |
| | | 12b - Accounting Stds | |
| | | Reevaluate Fair Value | |
| | | | |
| | | 14a - Indep. Internal Risk Rating | |
| | | | |
| | | 14c - Payment to Align Incentives | |

*Figure B-5: Unfairness/Prepare for Future*

| | Congressional Oversight Panel | Group of Thirty | Litan/Baily |
|---|---|---|---|
| Unfairness | 4. New System for Mortgage and Consumer Credit<br>Allow States to Enforce Laws on National Banks<br>Create a Single Federal Consumer Credit Regulator | | More Rules for Disclosure to Unsophisticated<br>Counseling<br>Single Agency<br>Opt out<br>Default Mortgage |
| Prepare | 8. Prepare for Next Crisis<br>Financial Risk Council<br>Dedicated to Task<br>Diverse Points of View<br>Broad Perspective<br>Multiple Specialized Analytic Tools<br>Formal Reporting | | Anticipating Future Crises<br>Report to Congress<br>Warn of Asset Bubbles |