Wall Street Lost and Found: The Role of the Federal Reserve in De-Regulation, Low Interest Rates, and Lender of Last Resort

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Lightly regulated financial system in the U.S.:

One key cause of financial crisis we are now facing:

The Federal Reserve, especially under Alan Greenspan, was committed to creating a very light regulatory structure.
Regulatory Authority to Restrict Sub-Prime Lending

The Federal Reserve Had Broad Authority to Restrict deceptive lending practices under the 1994 “Home Owners Equity Protection Act”

But it did not do anything to enforce this law.
“Mr. Greenspan says he didn’t get heavily involved in regulatory matters in part because his laissez-faire philosophy was often at odds with the goals of the laws Congress had tasked the Fed with enforcing”
Fast Forward to October, 2008
Greenspan Concedes Error on Regulation
“Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself included, are in a state of shocked disbelief”.
Alan Greenspan, Congressional testimony, 23/10/08, on regulation

“I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms”
Greenspan testimony, II:

Referring to his free-market ideology: “I have found a flaw…. I have been very distressed by that fact
...a flaw in the model that I perceived is the critical functioning structure that defines how the world works.”
“In other words, you found that your view of the world, your ideology, was not right, it was not working,” Mr. Waxman said.

“Absolutely, precisely,” Mr. Greenspan replied. “...that’s precisely the reason I was shocked, because I have been going for 40 years or more with very considerable evidence that it was working exceptionally well.”
Republicans have been trying to blame Fannie Mae and Freddie Mac, government connected agencies for underwriting too many sub-prime loans.
But Greenspan blames the securitization process

“Pressures on lenders to supply more “paper” collapsed subprime underwriting standards from 2005 forward. Uncritical acceptance of credit ratings by purchasers of these toxic assets has led to huge losses.

It was the failure to properly price such risky assets that precipitated the crisis.”
"The world is on the edge of the abyss because of an irresponsible system" – French Prime Minister, Francois Fillon, *Financial Times*, October 3, 2008
Financialized Capitalism:

Locked in A Devastating Dynamic of De-regulation, Financial Innovation, Explosion, and Bail-out
Many Crises, In the Last 35 Years

Source: Laeven and Valencia, 2008
Dynamic of De-Regulation and Bail-out

Leads to excessive expansion of financial sector
TOTAL FINANCIAL ASSETS AS % OF GDP IN US

Source: Flow of Funds Table L5, NIPA Table 1.1.5.
Financial Losses Estimated at 10% of GDP by IMF

Figure 1.13. Comparison of Financial Crises

Sources: World Bank; and IMF staff estimates.
Note: U.S. subprime costs represent staff estimates of losses on banks and other financial institutions from Table 1.1. All costs are in real 2007 dollars. Asia includes Indonesia, Malaysia, Korea, the Philippines, and Thailand.

Source: IMF, October, 2008
Bank of England Estimates of Losses Much Higher

...and increasing uncertainty about future potential losses on lending. For example, estimated mark-to-market losses have more than doubled since the previous Report, and now total some US$2.8 trillion (Box 1, page 14).

AND THIS DOES NOT INCLUDE THE ECONOMIC AND SOCIAL COSTS CREATED BY THE ECONOMIC DOWNTURN THAT FOLLOWS!

This Is the Worst Cycle in Decades

WITHOUT MAJOR POLICY CHANGES, Bernanke, Sarkozy, Paulson, Brown and yes, Barak Obama and Larry Summers will only re-start the and devastating cycle of de-regulation, financial explosion and bail-out.

...At huge cost to the most citizens.
How We Got Into this Mess
Low Interest Rates by Fed the Cause of Crisis?

No.
Federal Funds Rate of Federal Reserve, 1956-2008
(Recession Periods are shaded)
Fed’s Interest Rate Patterns

• Common to lower Interest rates following Recession

• Interest Rates in 2000’s similar to levels in early 1960’s.

• In 1960’s they lead to real economic growth and widespread income gains for American workers.
• In 2000’s led to bubble and crash.

Why the difference?
No Simple Answer, BUT:

1960’s: strong financial regulation to channel credit to more productive uses
   : stronger U.S. real economy to absorb these funds

2000’s: De-regulated financial system so credit channeled fraudulently and to speculative purposes
   : Weaker U.S. real economy, having been hollowed out by financialization and other forces.
De-Regulation of Finance

Key Financial Problem
New Deal Regulation of Finance in U.S.

Separation of commercial and investment Banking (Glass-Steagall)

Segmented Asset Classes and Institutions

Restrictions on Securitization
New Deal System of financial Regulation Eroded in the U.S. in the 1970’s, and 80’s

Largely due to pressure from large banks and their allies in the Fed, Treasury, Congress and the White House
This de-regulation lead to the so-called NEW FINANCIAL ARCHITECTURE (NFA) which led directly to the crisis.
Aspect I: Fraud at Core of Crisis

William Black’s thesis:

“What went wrong is that modern compensation systems did not “align” interests, but rather created perverse incentives to engage in accounting “control fraud,” where the CEO uses an apparently legitimate firm as a “weapon” to defraud creditors and shareholders”*

*William Black, former bank regulator and Professor of Law, University of Missouri, Kansas
This produced an “epidemic” of mortgage fraud, particularly in the unregulated nonprime sector. The FBI began warning in September 2004 about the mortgage fraud “epidemic.” [2] Fraudulent loans cause huge direct losses, but the epidemic also hyper-inflated and extended the housing bubble, and eviscerated trust, causing catastrophic indirect losses. –Bill Black
De-regulation = De-criminalization

When we do not regulate or supervise financial markets we, de facto, decriminalize control fraud. – Bill Black
Modern Compensation schemes:

They encourage control fraud by encouraging fraudulent activities among subordinates.

“The CEO cannot send out a memo urging accounting fraud, but he can safely send the same message through his bonus plan. He does not have to order, or be aware of, the specific frauds—the employees will do whatever is needed to “earn” their top bonus. The CEO simply communicates—by inaction—that he does not care how they meet the target.” Bill Black
Light or no regulation encourages control fraud

“Insured depository institutions must file Suspicious Activity Reports (SARs) when they discover credible information of a crime. Many commercial banks and S&Ls, therefore, often filed SARs about mortgage fraud. Mortgage banking firms were essentially unregulated by the federal government and generally did not file SARs when they found fraud. Investment bankers, in the four years during the peak of the epidemic, filed only 36 SARs.” -- Bill Black
The worst mortgage frauds operated primarily in the unregulated sector. *The New York Times* reported:

43 percent of the cases sampled in the study involved misrepresentation of income, assets or debts. The next-largest category was forged documents, totaling 28 percent of the sampled loans. (Unregulated) Mortgage brokers initiated the loans on 64 percent of the reports involving misrepresentation of income, assets or debt...

-- Bill Black
Conclusion:

“modern finance” has failed the market test. Its policies optimize the environment for control fraud and create perverse dynamics that create recurrent financial crises – Bill Black (quoting Paul Volcker).
Solution: Re-regulate = re-criminalize fraud

Intensive examination of financial institutions to make their books completely transparent.

Need to dramatically expand the resources and personnel of regulatory agencies so as to make financial institutions more transparent.

(Other suggestions below to alter the nature of credit rating agencies will also be important)
But this is only the beginning of the story:

**What were the characteristics of the overall financial system that allowed this fraudulent behavior to spread crisis so widely?**
Aspect II: Structural Flaws In The New Financial Architecture (NFA)

STRUCTURAL FLAWS IN THE NFA POWERED THE BOOM, CAUSED THE CRISIS AND MUST BE FIXED
The New Financial Architecture (NFA)

Originate and Distribute Model of De-Regulated Finance
Four Fatal Flaws of the New Financial Architecture (NFA)

NFA: Flaw 1

Asymmetric and perverse incentives that led virtually all actors to take excessive risk.

For example:
- Bankers made money on way up but didn’t lose on the way down
- Credit Rating agencies – paid to give over-optimistic ratings
NFA: Flaw 2

A regulatory framework that was lax at best and that ignored the “shadow banking system” of hedge funds, private equity funds and the like.
NFA: Flaw 3

Financial innovations that led to assets that were murky and opaque (non-transparent and complex)
A system that was at root pro-cyclical in its dynamics and led to excessive leverage.
1. Massive over-haul of financial system to provide credit for useful investment, not speculation

2. Major re-regulation

3. Deployment of nationalized assets for major employment generation, green-transformation and public infrastructure
Focus Here only on Financial Re-regulation
Nine Point Program For Re-Regulating the U.S. Financial Markets

These nine points are organized according to helping to solve the four fatal flaws of the NFA.

--There is over-lap, redundancy and multiple fire-walls.

It is important to have redundancy because if financial markets find a way around one fire wall, we want another one to be able to catch them.
I. Reduce Asymmetric Incentive Structures and Moral Hazard

1. Transform financial firm incentive structures that induce excessive risk-taking.

Examples:
- implement “clawbacks” through which excessive salaries and bonuses paid during the upturn would have to be repaid in the downturn
  -- through escrow accounts
  -- through tax system

Create Public Rating Agencies
I. Reduce Asymmetric Incentive Structures and Moral Hazard

2. Implement lender-of-last-resort actions with a sting.

Examples:

Rainmakers must be made to pay significantly when their firms are bailed out. (reductions in pay; no golden parachutes)
II. Broaden and Strengthen Regulatory Reach

3. Extend regulatory over-sight to the “shadow banking system.”

- private equity firms
- hedge funds, etc.

Level the playing field, and level it UP not down.
II. Broaden and Strengthen Regulatory Reach

4. **Restrict or eliminate off-balance sheet vehicles.**

- Move all risky investments back on bank balance sheets and require adequate capital to support them. Capital requirements should be sufficient to protect bank solvency even during the liquidity crises that occur from time to time.
II. Broaden and Strengthen Regulatory Reach

5. Implement a financial pre-cautionary principle.

Once the financial regulatory structure is extended to all important financial institutions, it would be possible to implement a regulatory precautionary principle with respect to new products and processes created by financial innovation similar in principle to the one used by the US Food and Drug Administration to determine whether new drugs should be allowed on the market.
Critics will argue this will stifle financial innovation.

**BUT innovation in the financial sector is not like innovation in goods. Has broad “externalities” and links to systemic risk. Often (though not always) linked to increases in systemic risk that are not taken into account by innovators.**
III. Increase Transparency

6. Prohibit the sale of financial securities that are too complex to be sold on exchanges.

That is, insist that all these financial securities be traded on organized markets.

The most complex products, including CDOs, cannot be sufficiently simplified and would disappear from the market.
A general ban on OTC derivative trading has one key advantage over attempts to prohibit specific products such as CDOs. Investment banks can evade regulations banning specific products or services by creating alternative products that are not identical, but perform the same functions. Prohibiting OTC products would eliminate this form of regulatory evasion.
III. Increase Transparency

7. Require due diligence by creators of complex structured financial products.

This task would be difficult and costly if done properly; it could make the most complex securities unprofitable. If this could not be done to regulators' satisfaction, sale of these securities should be prohibited. Make securities creators of MBS’s identify particular mortgages to help with unwinding...again will lead to less complex securities.
IV. Reduce Pro-Cyclicality

8. Restrict the growth of financial assets and excessive leverage through counter-cyclical capital requirements.

A key flaw in current financial markets is it leads to booms and busts. Putting in a system where the ratio of capital requirements goes up in the boom and down in the bust will work as an automatic stabilizer.
IV. Reduce Pro-Cyclicality

9. Create a bailout fund financed by Wall Street.

For example:

- Impose a small financial transaction tax to create a fund to engage in financial bail-outs when necessary.
Reform the Lender of Last Resort and Monetary Policy
4 Trillion Dollars Committed

Lender of last resort

Insurer of last resort

Investor of last resort
Banks hoarding Cash

1930’s

Today

US Bank Reserves – Can deflation “happen here”?

- Spring 1933 - US abandons full Gold Standard
- 1937 - Fed tightening triggers another recession
- 270% y/y as of October
- Sep/Oct 2008 - Fed pursues quantitative easing after the Lehman failure
- October 1931 - Fed tightens policy to defend the Gold Standard

Source: Federal Reserve Bank of St. Louis, SG Equity Research
Data through October
Federal Reserve must:

• Use powers of persuasion to insist on more lending for productive purposes

• As suggested by the British: if necessary, threaten nationalization.
FISCAL POLICY HAS BEEN TRANSFORMED INTO MONETARY POLICY

MONEY INJECTED INTO BANKS HOPING IT WOULD TRICKLE DOWN TO REAL ECONOMY HAS NOT WORKED
Monetary Policy Now: Key job

MUST Support Major Fiscal Policy Initiatives

Monetary Policy:

Buy longer term U.S. treasury debt, to help finance major fiscal expansion:

400 – 600 billion dollar fiscal expansion required.
We will not be able to enact adequate reforms until two fundamental changes take place.

First, the mainstream theory of efficient financial markets that is the foundation of support for the NFA must be replaced by the realistic financial market theories associated with John Maynard Keynes and Hyman Minsky.
Second, there must be a broad political mandate in support of serious financial regulatory reform.

For too long the money from financial institutions have corrupted the political process. Congress and the President have acted in recent decades as if they were paid employees of financial market interests, which many of them were.
The key is to channel popular anger into pressure for a new "New Deal" in government regulation of financial markets.

Until we have regulatory institutions empowered by law to control financial markets and force them to act in the public interest and we populate them with well-trained officials who believe in serious regulation, we will continue down the disastrous path we have been following for the past three decades.
Thank you again for giving me the opportunity to speak to you today.