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Seven Deadly Sins of Deregulation and Three Necessary Reforms

di Robert Kuttner

The current carnage on Wall Street, with dire spillover effects on Main Street, is the result of a failed ideology -- the idea that financial markets could regulate themselves. Serial deregulation fed on itself. Deliberate repeal of regulations became entangled with failure to carry out laws still on the books. Corruption mingled with simple incompetence. And though the ideology was largely Republican, it was abetted by Wall Street Democrats.

Why regulate? As we have seen ever since the sub-prime market blew up in the summer of 2007, government cannot stand by when a financial crash threatens to turn into a general depression -- even a government like the Bush administration that fervently believes in free markets. But if government must act to contain wider damage when large banks fail, then it is obliged to act to prevent damage from occurring in the first place. Otherwise, the result is what economists term "moral hazard"-- an invitation to take excessive risks.

Government, under Franklin Roosevelt, got serious about regulating financial markets after the first cycle of financial bubble and economic ruin in the 1920s. Then, as now, the abuses were complex in their detail but very simple in their essence. They included the sale of complex securities packaged in deceptive and misleading ways; far too much borrowing to finance speculative investments; and gross conflicts of interest on the part of insiders who stood to profit from flim-flams. When the speculative bubble burst in 1929, sellers overwhelmed buyers, many investors were wiped out, and the system of credit contracted, choking the rest of the economy.

In the 1930s, the Roosevelt administration acted to prevent a repetition of the ruinous 1920s. Commercial banks were separated from investment banks, so that bankers could not prosper by underwriting bogus securities and foisting them on retail customers. Leverage was limited in order to rein in speculation with borrowed money. Investment banks, stock exchanges, and companies that publicly traded stocks were required to disclose more information to investors. Pyramid schemes and conflicts of interest were limited. The system worked very nicely until the 1970s -- when financial innovators devised end-runs around the regulated system, and regulators stopped keeping up with them.

Seven Deadly Sins

Sin One: Allowing Mortgage Lending to Become a Casino. Until 1969, Fannie Mae was part of the government. Mortgage lenders were tightly regulated. Homeownership rates soared throughout the postwar era, from about 44 percent on the eve of World War II to 64 percent by the mid-1960s. Nobody in the mortgage business got filthy rich, and hardly anyone lost money. Fannie's job was to buy mortgages from banks and thrift institutions, to replenish their money to make mortgages, and along the way to set standards. Fannie financed its operations by selling bonds. In the late 1970s, private Wall Street firms started emulating Fannie. They packaged mortgages, and converted them into bonds. Over time, their standards deteriorated, because they could make more money creating riskier products. In order to avoid losing market share, Fannie emulated some of the same abuses.

Government did not step in to regulate the affair -- which was a time bomb waiting for the creation of the sub-prime mortgage business.

Sin Two: Allowing Unregulated Bond Rating Agencies to Decide What was Safe. Sub-prime is only the best known of a widespread fad known as "securitization." The idea is to turn loans into bonds. Bonds are given ratings by private companies that have official government recognition, such as Moody's and Standard and Poors, but no government regulation. These rating agencies have become thoroughly corrupted by conflicts of interest. If you want to package and sell bonds backed by risky loans, you go to a bond-rating agency and pay it a hefty fee. In return, the agency helps you manipulate the bond so that it qualifies for a triple-A rating, even if the underlying loans include many that are high-risk. Without the collusion of the bond-rating agencies, sub-prime lending never would have gotten off the ground, because it would not have found a mass market. Had regulators looked inside this black box, they would have shut it down. They might have needed new legislation, but they never asked for it. And public-minded regulators might have done a lot under existing law, since banks (which are regulated) were heavily implicated in the financing of sub-prime.

Sin Three: Failing to Police Sub-prime. The core idea of bank regulation is that government inspectors periodically examine the quality of bank assets. If too large a portion of a bank's loan portfolio is behind in its interest payments, the bank is made to raise more capital as a cushion against losses. Problems are nipped in the bud. But complex securities require more sophisticated regulation than simple loans. Regulators basically waived the rule on adequate capital for the new wave of mortgage lenders who created sub-prime. Many mortgage companies were not banks. They made loans only to sell them off to the Wall Street sinners of Deadly Sin No. 1 (see above). So there was no loan portfolio to examine, and no real capital. The Democratic Congress anticipated this problem in 1994, when it passed the Homeownership Opportunity and Equity Protection Act. This prescient law required the Federal Reserve to regulate the loan-origination standards of mortgage companies that were not otherwise government-regulated. But Alan Greenspan, a free-market zealot, never implemented the law. And when Republicans took over Congress in 1995, they never called him on the carpet.

Sin Four: Failure to Stop Excess Leverage. The financial economy is crashing today because so much speculation was done with borrowed money. A typical leverage ratio of a hedge fund or private equity company is 30 to one. That means $30 of debt for $1 of actual capital. If you make one serious miscalculation, you are out of business. And in the case of sub-prime mortgage companies, the leverage ratio was infinite, because they had no capital. The game was entirely based on creating debt. As long as times were good, financial firms could keep borrowing to finance their deals. But once investors looked down, they panicked. Some parts of the system are unregulated, such as hedge funds and private-equity companies. But they all ultimately get a lot of their funding from banks. And regulators do retain the power to look closely at banks' books (see Sin No.3 above). Had they used that power to police the kind of highly risky stuff banks were underwriting, they could have shut it down.

Sin Five: Failure to Police Conflicts of Interest. Remember the accounting scandals of the 1990s? In those scandals, accounting firms were paid once to audit corporate books and then again to help clients cook the books and still pass muster with the audit. That was a sheer conflict of interest. Though accountants were (loosely) regulated, Congress did not crack down until cooked books caused the stock market to crash. A second conflict of interest was the corruption of stock analysts, who were telling customers to buy dubious stocks because their bosses were profiting from underwriting the same stocks. In the aftermath of the dot-com bust, Congress narrowly cracked down on these two abuses with the Sarbanes-Oxley Act but simply ignored others -- such as the role of bond-rating agencies and the habit of basing executive bonuses on stock prices that could easily be manipulated by the same executives.

Sin Six: Failing to Regulate Hedge Funds and Private Equity. When Roosevelt's New Deal acted to rein in the abuses in financial markets, it regulated the major players -- commercial banks, investment banks, stock brokers, holding companies, and stock exchanges. But two of the biggest purveyors of risk today -- hedge funds and private-equity firms -- simply did not exist. Today, private-equity firms and hedge funds do most of the things banks and investment banks do. They basically create credit by making markets in exotic securities. They buy and sell firms. They speculate in financial markets with borrowed money, taking much bigger risks than regulated banks. According to House Banking Committee Chair Barney Frank, more than half the credit created in recent years has been created by essentially unregulated institutions. The people in charge of the government -- conservative Republicans -- took the view that these new-wave financial players offered transactions between consenting adults who needed no special consumer protection. But they were oblivious to the risks to the larger system.

Sin Seven: Repeal of the Glass-Steagall Act. This action, in 1999, was one of two major cases when a cornerstone of New Deal regulation was explicitly repealed. (The other was the repeal of the Public Utility Holding Company Act, and if your utility rates are sky-high, you can thank Congress for that, too.) Glass-Steagall provided that if you wanted to speculate as an investment bank, good luck to you. But commercial banks were part of the banking system. They created credit. They were regulated, supervised, usually enjoyed FDIC insurance, and had access to advances from the Fed in emergencies. So commercial banks and investment banks were two different creatures that should stay out of each other's knitting.

But beginning in the 1980s, regulators who didn't believe in regulation either allowed explicit waivers of some aspects of Glass-Steagall or looked the other way as commercial banks and investment banks became more alike. By 1999, when Citigroup had jumped the gun and assembled a supermarket that included a commercial bank, investment bank, stock brokerage, and insurance company, Glass Steagall was so hollowed out that it was effectively dead. The coup de grace was its official repeal, in the Gramm-Leach-Bliley Act. That's Gramm as in former Sen. Phil Gramm, a deregulation zealot and top adviser to John McCain.

Three Basic Reforms

What all of these sins had in common was that they led financial markets to misprice assets. In plain English, that means buyers were purchasing securities based on bad information, often with borrowed money. When firms started losing money on sub-prime in mid-2007 and other owners decided it was time to get their money out, the whole miracle of leverage went into reverse. And it spilled over into other securities that had been mispriced thanks to all the conflicts of interest tolerated by regulators.

That's why, no matter how much taxpayer money the Federal Reserve and the Treasury keep pumping in, they can't turn dross back into gold. The next administration and the Congress need to return the financial economy to its historic task of supplying capital to the real economy -- of connecting investors to entrepreneurs -- and shut down the purely casino aspects of the system that have only enriched middlemen and passed along huge risks to everyone else.

Reform One: If it Quacks Like a Bank, Regulate it Like a Bank. Barack Obama said it well in his historic speech on the financial emergency last March 27 in New York. "We need to regulate financial institutions for what they do, not what they are." Increasingly, different kinds of financial firms do the same kinds of things, and they are all capable of infusing toxic products into the nation's financial bloodstream. That's why Treasury Secretary Hank Paulson has had to extend the government's financial safety net to all kinds of large financial firms like A.I.G. that have no technical right to the aid and no regulation to keep them from taking outlandish risks. Going forward, all financial firms that buy and sell products in money markets need the same regulation and examination. That will be the essence of the 2009 version of the Glass-Steagall Act.

Reform Two: Limit Leverage. At the very heart of the financial meltdown was extreme speculation with esoteric financial securities, using astronomical rates of leverage. Commercial banks are limited to something like 10 to one, or less, depending on their conditions. These leverage limits need to be extended to all financial players, as part of the same 2009 banking reform.

Reform Three: Police Conflicts of Interest. The conflicts of interest at the core of bond-raising agencies are only one of the conflicts that have been permitted to pervade financial markets. Bond-rating agencies should probably become public institutions. Other conflicts of interest should be made explicitly illegal. Yes, financial markets keep "innovating." But some innovations are good, and some are abusive subterfuges. And if regulators who actually believe in regulation are empowered to examine all financial institutions, they can issue cease-and-desist orders when they encounter dangerous conflicts.

We're talking about a Roosevelt-scale counterrevolution here. But nothing less will prevent the financial collapse from cascading into Great Depression II. And the public should never again forget that this needless collapse was brought to us by free-market extremists.

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