Tremble, Banks, Tremble: The key to Financial Recovery: Restoring the Rule of Law on Wall Street.

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The financial crisis in America isn't over. It's ongoing, it remains unresolved, and it stands in the way of full economic recovery. The cause, at the deepest level, was a breakdown in the rule of law. And it follows that the first step toward prosperity is to restore the rule of law in the financial sector.

First, there was a stand-down of the financial police. The legal framework for this was laid with the repeal of Glass-Steagall in 1999 and the Commodities Futures Modernization Act of 2000. Meanwhile the Basel II process relaxed international bank supervision, especially permitting the use of proprietary models to value complex assets—an open invitation to biased valuations and accounting frauds.

Key acts of de-supervision came under Bush. After 9/11 500 FBI agents assigned to financial fraud were reassigned to counter–terrorism and (what is not understandable) they were never replaced. The Director of the Office of Thrift Supervision appeared at a press conference with a stack of copies of the Code of Federal Regulations and a chainsaw—the message was not subtle. The SEC relaxed limits on leverage for investment banks and abolished the uptick rule limiting short sales to moments following a rise in price. The new order was clear: anything goes.

Second, the response to desupervision was a criminal takeover of the home mortgage industry. Millions of subprime mortgages were made to borrowers with undocumented incomes and bad or non-existent credit records. Appraisers were selected who were willing to inflate the value of the home being sold. This last element was not incidental: surveys showed that practically all appraisers came under pressure to inflate valuations in order to make deals happen. There is no honest reason why a lender would deliberately seek to make an inflated loan.

Mortgages were made with a two-or three-year grace period, with a low, fixed interest rate called a "teaser." These were not real mortgages; they were counterfeits, whose value would collapse when exposed. As with any counterfeit, the profits came early, when the bad paper was first sold. After the grace period, rates would reset, and the lenders knew that the borrowers, who were already stretched by their initial payments, would either refinance or default. If they refinanced, that would mean another mortgage origination fee. And if they defaulted, well … on to step three.

Third, the counterfeit mortgages were laundered so they would look to investors like the real thing. This was the role of the ratings agencies. The core competence of the raters lay in corporate debt, where they evaluate the record and prospects of large business firms.

The value of mortgage bonds depended on the behavior of tens of thousands of individual borrowers, whose individual quality the ratings agencies could never check. So the agencies substituted statistical models for actual inquiry, and turned a blind eye to the fact that the loans were destined to go bad.

Fourth, the laundered goods were taken to market. The investment and commercial banks transformed the bad mortgages into bonds, obtained the AAA ratings, and sold the stinking mess to American pension funds, European banks and anyone else who took the phrase "investment grade" at face value. (Later chumps would include the Federal Reserve.) The European crisis now underway is a direct result, as their banks and investors, stung by losses on American mortgage bonds, are dumping their risky Greek public debt and seeking the safety of U.S. Treasury bills.

When the crisis went public in August 2007, Henry Paulson's Treasury took every step to prevent the final collapse from happening before the 2008 elections, extracting billions from the Federal Housing Authority and from Fannie Mae and Freddie Mac to relieve the pressure on bank balance sheets. It worked until it didn't. In September 2008 the collapse of Lehman triggered the collapse of American International Group (AIG) and the steps that led to the Troubled Assets Relief Program (TARP) and to the effective nationalization of the commercial paper market, meaning that the Federal Reserve has become the primary short-term funder of major American corporations.

Upon taking office, President Obama had a chance to change course and didn't take it. By seizing the largest problem banks, the government could have achieved clean audits, replaced top management, cured destructive compensation practices, shrunk a bloated industry, and cut the banks' lobbying power and therefore their capacity to obstruct financial reform. The way to write-downs of bad mortgage debt and therefore to financial recovery would have been opened.

None of this happened. Instead the Treasury administered fake "stress tests" and relaxed mark-to-market accounting rules for toxic assets which permitted the banks to defer losses and to continue to carry trash on their books at inflated values. This reassured the banks that they would not be permitted to fail—and so back to bonuses-as-usual they went. The banks survived, and the administration today claims this "proves" they didn't need to be taken over. But to what end did they survive? The banks are bigger, more powerful, and moer obstructionist than ever—and largely uninterested in making new commercial, industrial, or residential loans.

Today the former middle class is largely ruined: upside down on its mortgages and unable to add to its debts. With housing prices low and falling, banks are delaying foreclosures because they don't wish to recognize their losses; it is a sick fact that the cash homeowners conserve by non-payment is one source of the anemic recovery so far. But construction remains depressed, state and local budgets continue in a death-spiral of spending cuts and tax increases, the stimulus will soon end, and exports may soon fall victim to international austerity and the rapidly declining euro. Meanwhile the deficit hysterics seem determined to block unemployment insurance and aid to states today, and to cut Social Security and Medicare tomorrow.

In this way, the financial sector remains a fatal drag on the capacity for strong growth. And the financial reform bills about to clear Congress will not cure this. The bill in conference has some useful elements but it is neither sufficient nor necessary to clean up frauds, which have always been illegal. Nor will it clean up private balance sheets and permit lending to restart. Still less will it set a new direction for the financial economy going forward.

What to do?

To restore the rule of law means first a rigorous audit of the banks and of the Federal Reserve. This means investigations—Representative Marcy Kaptur has proposed adding a thousand FBI agents to this task. It means criminal referrals from the Financial Crisis Inquiry Commission, from the regulators, from Congress, and from the new management of troubled banks as they clean house. It means indictments, prosecutions, convictions, and imprisonments. The model must be the clean-up of the Savings and Loans, less than 20 years ago, when a thousand industry insiders went to prison. Bankers must be made to feel the power of the law in their bones.

How will this help the economy? The first step toward health is realism. We must first stop pretending that bad assets can be made good, that bad loans will someday be repaid, and that bad people can run good banks. Debt crises are resolved when debts are written down and gotten rid of, when the institutions that peddled bad debts are restructured and reformed, and when the people who ran the great scams have been removed. Only then will private credit start to come back, but even then the result of bank reform is more prudent banks, by definition more conservative than what we've had.

So yesterday's borrow-like-there's-no-tomorrow America is done for in any event; there will not be another bank-sponsored private credit boom. The housing crisis (and therefore the middle-class insolvency) won't go away soon. There is no cure for falling housing prices except time and patience; debt relief will at best stabilize the middle class. It follows that the private banks and dealers and borrowing by households are not going to be at the center of the next expansion.

We are in the post-financial-crash. We need to do what the U.S. did during the New Deal, and what France, Japan, Korea, and almost every other successful case of post-crash (or postwar) reconstruction did when necessary. That is, we need to create new, policy-focused financial institutions like the Reconstruction Finance Corporation to take over the role that the banks and capital markets have abandoned. Thus, as part of the reconstruction of the system, we need a national infrastructure bank, an energy-and-environment bank, a new Home Owners Loan Corporation, and a Gulf Coast Reconstruction Authority modeled on the Tennessee Valley Authority. To begin with.

A reconstructed financial system should finance the reconstruction of the country. Public infrastructure. Energy security. Prevention and mitigation of climate change, including the retrofitting of millions of buildings. The refinancing of mortgages or conversion to rentals with "right-to-rent" provisions so that people can stay in their homes at reasonable rates. The cleanup and economic renovation of the Gulf Coast. All of this by loans made at low interest rates and for long terms, and supervised appropriately by real bankers prepared to stay on the job for decades.

The entire host of neglected priorities of the past 30 years should be on the agenda now. That is the way—and the effective path—toward prosperity.

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