What the 2007 Financial Crisis Taught Us About Corrupt Bankers

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"Of all the ways we have to run a banking system, the one we have today is the worst" (Mervyn King, former Governor of the Bank of England)

Prior to 2007, financial companies had come to dominate the economies of many countries. For example, in the US 40% of corporate profits were in banking.(1) In 2007 many countries experienced what has come to be known as the Global Financial Crisis. This was caused by a complex range of connected factors, some of which will be discussed in this post.(2)

Setting the Scene

From the 1980s onwards, governments and their corporate lobbyists had gradually re-structured the economies of advanced nations towards the extreme form of capitalism known as neoliberalism. This system is dominated by a belief in de-regulation or 'light touch' regulation, which effectively means that the role of financial regulators is to enable banks to carry out their activities, rather than to police them. This enabled banks to carry out a range of activities that were profitable for them, but caused serious problems for everyone else.

A Series of Interconnected Frauds

Banks are always trying to come up with schemes to make bigger profits. This led to them lending money to people who could not repay it, mostly as mortgages. The banks used contracts that customers did not understand, with interest rates that started low and rose sharply. These were called liar's loans(3) or sub-prime mortgages. Salesmen were paid commissions to persuade customers to take out these loans.

The banks then sold these loans to other investors in a process known as securitisation, without explaining that the loans were unlikely to be paid back. Some of these securities became so complex and opaque that hardly anyone could understand exactly what each one was. One of the world's leading experts on the subject, Bill Black, has explained that the only way to make money from these securities was to deceive the people who were buying them.(4)

The risk of the mortgages not being repaid had been passed on to someone else, so banks had no reason to ensure that they made sensible loans. The more bad loans they could make, the more profit they could make, but the more risk was created for everyone else.(5)

Organisations known as Credit Ratings Agencies are supposed to tell investors how safe or risky an investment is, but they failed to rate these securities correctly, suggesting that they were safer than was actually the case.(6)

Some banks, such as Goldman Sachs, then created ways to make even more money, by betting that these loans would not be repaid.(7) The banks made money three times over, by creating mortgages, then advising the investors, then betting against their own investors. Many senior executives claimed that they did not know what was actually going on, but this was part of a deliberate strategy to make their operations as opaque as possible.

The fraudulent mortgages led to a spiral of ever-upward house prices, which enabled borrowers to borrow even more, pushing up house prices. This is known as a house-price bubble. Eventually the bubble bursts, when people are no longer able to pay for such expensive homes. House prices in many places dropped rapidly, so many people had mortgages that were greater than the value of their properties (negative equity). Some banks suffered losses so great that they were effectively bankrupt. Banks stopped lending, even to each other. Many people were removed from their homes, and others were unable to move house. Businesses could not borrow to finance their activities. Many businesses went bust, and many jobs were lost.(8)

Former bank employees have admitted that what they did before the crisis was to steal other people's money. A former Goldman Sachs trader, Greg Smith, admitted that his bosses described clients as "muppets" to be "ripped off".(9) Bill Black has explained that all regulatory agencies were complicit in failing to properly regulate the banks.(10) They knew about the different frauds and how to stop them, but chose not to do so.

The frauds described above are just the tip of the iceberg. Since the crisis, the banks have been involved in a wide array of criminal and unethical behaviour. They repeatedly commit fraud on an industry-wide scale.(11) They have sold numerous products that were unsuitable for their clients, and they regularly try to manipulate markets, using all manner of complex schemes, such as placing fake orders. In 2014 British and US banks were fined £2.6 billion for rigging money-markets.(12) US banks have been fined billions of dollars for breaking rules related to terrorism, tax evasion and accounting fraud.(13) These fines sound large, but they are not sufficient to deter criminal behaviour. In 2020, the total amount of fines related to money-laundering was $10 billion.(14) The individuals who run these institutions are hardly ever prosecuted.

Complexity, Contagion and Systemic Risk

The banks employ armies of lawyers and accountants to re-structure their businesses and their accounts.(15) This is sometimes called legal and financial engineering. The scale and complexity of their operations is so great that no individual has any idea of the overall situation, and no one understands how precarious their financial position is. During the crisis, it turned out that the whole financial system was so complex and interconnected that it created a form of contagion. When some banks went bust, others were technically bankrupt too. What had started as a problem with sub-prime mortgages rippled around the world, de-stabilising the economies of many countries.

Too Big To Fail: Profits for the few, losses for the many

Many of the biggest financial companies in Britain and the US, such as Bear Stearns, Lehman Brothers, and Northern Rock, were involved in these activities. These banks are considered to be so important to the economy, or 'too big to fail', that governments believe they have to rescue them when things go wrong. This is known as a bailout. The bailout was much larger than most people realize. In November 2011, secret information became available showing that the total size of the US bailout was at least $7.7trillion.(16) The banks and the regulators repeatedly lied to cover up how unstable the situation had become. The bailout money has not been used to reduce the debts of ordinary people or to finance activity in the real economy. It was given to the banks, and it has ended up increasing the wealth of the super-rich.

Since the crisis, the biggest banks have become even bigger. Numerous commentators have pointed out that the current global banks are not only too big to fail, they are now too big and too complex to regulate or to manage. Matt Taibbi summarised the bailout as follows:

> "what we actually ended up doing was…committing American taxpayers to permanent blind support of an ungovernable, unregulated, hyperconcentrated new financial system that exacerbates the greed and inequality that caused the crash…America's six largest banks now have a total of 14,420 subsidiaries, making them so big as to be effectively beyond regulation. A recent study found that it would take 70,000 examiners to inspect such trillion-dollar banks with the same level of attention normally given to a community bank."(17)

The banking system is structured in a way that is guaranteed to cause problems. Banks advise clients, but they are also allowed to trade for themselves. This creates what is known as a conflict of interest, where Goldman Sachs can bet against its own clients, or engage in other forms of corrupt trading. Without fundamental reform, these problems are likely to continue. There will be another financial crisis in the future, and no one knows how bad it will be.(18)

This Has All Happened Before

The fraudulent nature of bankers has been recognized for many years. A former Governor of the Bank of England once said:

> "If we closed down a bank every time we found an incidence of fraud, we would have rather fewer banks than we do at the moment".

The 2007 crisis is not the first catastrophic failure of the financial system. In 1929, the world experienced the great depression, and thousands of US banks failed. There are strong parallels between recent events and those that led up to the 1929 crisis. In both cases, banks had been given more and more freedom to manipulate the system for their own benefit.

After the problems in 1929, the remedies included the complete separation of different types of banks in the US.(19) Banks that do basic lending to homeowners and small businesses were separated from those that focus on gambling on stockmarkets. This worked well and provided a stable financial system for decades afterwards. However, lobbyists persuaded policymakers to gradually reverse these safeguards. Separation is no longer required, and financial crises have become much more commonplace around the world.

The evidence that emerged about the criminality of the banks in the run-up to the 2007 crisis shocked most people, and there were great expectations that new regulations would be introduced. Discussions about the banks became a regular feature of mainstream conversation. A number of solutions were put forward, but in the end, none of the really big problems were fixed, and some have been made even worse.

Executive Pay

I have talked in previous posts about rentiers – companies and people who receive huge amounts of unearned income, or increases in wealth, because the economy is rigged. The financial system is probably the most extreme example of this. During and after the crisis, executives at the biggest banks kept taking huge salaries despite the chaos they caused. For example, two US firms, known as Fannie Mae and Freddie Mac:

> "paid out more than $200 million in bonuses between 2008 and 2010, even though they lost more than $100 billion in 2008 alone, and required nearly $400 billion in federal assistance during the bailout period."

Similarly, the giant insurance company, AIG:

> "paid more than $1 million each to 73 employees of AIG Financial Products, the tiny unit widely blamed for having destroyed the insurance giant (and perhaps even triggered the whole crisis)"(20)

Self-evidently, executive pay has become a means for powerful people with government connections to extract almost unlimited wealth from the system, with no justification.

Propaganda About Banking Permeates Our Societies

The media presentation of finance gives the impression that it is about rich people investing to make a better economy and a better society, but this is not currently true. Banks are no longer doing what most people believe banks do. Many of their loans are actually for unproductive purposes.(21) They devote vast resources to finding ever more complex ways to extract more wealth from everyone else. The US Federal Reserve Chairman, Paul Volcker, suggested that the ATM was the only financial innovation that has benefitted society in recent years.(22)

The media celebrate the big profits of banks. However, if the financial system is working properly, profits should be small. Big profits, and great wealth for a few people, are signs of a system that is not working properly.

The Future

The financial crisis triggered serious recessions in many countries. Governments have implemented 'austerity measures', which means decreasing government spending, so healthcare, education and social services are under-funded. At the same time, the wealth of the richest 1,000 people in Britain doubled in the five years after the crisis.(23)We have a system where the banks take all the profits when things go well, but taxpayers take the losses when things go wrong. This puts banks in a situation where they know they cannot lose, which encourages them to take even more risks.

Suggesting fundamental changes to the financial system might sound like the impossible dreams of an idealist, but the financial system has often been changed. In 1999, parts of Europe replaced their national currencies with a European currency called the Euro. In 1986, Britain carried out the 'Big Bang' where the system was changed dramatically.(24) Before 1971, the US dollar could be converted into gold, but the rules were changed in 1971 so that was no longer possible. In 1944, at a conference that created the World Bank and the IMF, there were in-depth discussions about how the financial system should be structured in the future.

Re-structuring banking, using rules similar to the ones that were introduced after the great depression, is not difficult. The different aspects of banking can be separated, so that gambling does not de-stabilise the rest of the system. Big banks can be broken up so that they can be regulated properly. The biggest obstacle is lack of political will.

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Notes

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