Who is to Blame for the Financial Crisis?

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> "I have no interest in spending all of our time relitigating the policies of the last eight years.... laying blame.... can distract us from focusing our time, our efforts and our politics on the challenges of the future."

–Barack Obama, speech on national security, delivered at the National Archives, Washington, D.C., May 21st, 2009

It seems President Obama has done as much as humanly possible to avoid prosecution of the many varieties of criminality that flourished in the Bush administration, and the White House has generously extended its indifference to Wall Street, where virtually no one has been held accountable in connection with the ongoing financial crisis. Justice was far more visible even during Ronald Reagan's administration, when almost 2,000 financial officers were prosecuted—500 of the CEOs or other top ranks–and almost 1,100 jailed for their roles in the Savings & Loan scandals of 1987 (1).

Wall Street and the rest of the financial sector has largely maintained a satisfied silence while Obama and Co. have done what they can to stymie investigation into wrongdoing. When spokesmen for the sector have joined the debate on assigning responsibility, they have predictably laid blamed on others, namely: 1) financially undereducated American home buyers (for accepting mortgages on which they would likely default), or 2) the non-regulated mortgage origination companies (2) (companies that developed and promoted all manner of predatory lending practices, thus facilitating a real estate bubble and an eventual crash), or 3) government encouragement of mortgage lending to low-income portions of the population (a criticism in the spirit of the mantra that government is always the problem).

"It's like money falling from the sky!"

Sober scholarship has exposed the feebleness of these interpretations of the crisis. Thus, however irresponsible some home buyers might have been in accepting onerous mortgages, the big banks did all they could to encourage this irresponsibility. They goaded the non-regulated mortgage originators to expand predatory lending practices, flooded them with credit to expand their operations, and then purchased many mortgage-related companies so as to spread the process further (3). They systematically pressured real estate appraisers to inflate property values so as to fuel the bubble (4). They pioneered the pooling and securitization of mortgage-related debt, then suborned the purportedly objective ratings agencies to sanction the repackaged debt as virtually risk-free (5). They spared no effort in distributing mortgage-related financial instruments to institutional investors around the globe, thus effectively exporting 40% or so of the risk they were creating (6). Having perfected the art of shoveling the risk of mortgage debt off to other parties, the big banks shed all decorum in promoting home loans. Headlines from Chase Bank flyers to mortgage loan agents in the field speak volumes (7):

“Even More Borrowers Qualify With Chase!

“Check out our great lineup of no-income verification programs.”

“It’s like money falling from the sky!”

Of course the process did not stop with the systematic, wholesale manufacture of shady mortgage-related debt. The big banks went on to engineer all manner of derivative instruments based on mortgage-related debt (and other assets), which allowed unlimited numbers of speculators to wager bets on the value of these assets, and they prevented the formation of a central exchange for these derivative instruments, which effectively shielded the market in these instruments from regulation and even surveillance (8). The resultant flourishing of derivatives flooded the biggest banks with profits (as much as 40% of their profits were coming from sales of derivatives by 2008 (9)), but also amplified of the shock to the world economy exponentially when the real estate bubble inevitably popped (10). Further still, in 2004 the five biggest banks cajoled Washington (the SEC) into relaxing capital reserve requirements (money they were required to keep kept as a cushion against possible failure of loans or other investments) for the largest firms only—those with $5 billion or more in assets– allowing them dramatically to accelerate all of their machinations across the board (11).

Horrific, Endemic Fraud

The story is grotesque. The pressuring of appraisers alone prompted William Black to charge the big banks with “horrific, endemic fraud” (12). Can we really take seriously the verdict of Martin Wolf, chief economist of Financial Times, and a dean of the financial community, to the effect that the current generation of leaders were simply captivated by the thesis of efficient markets, and that every generation has to relearn the lessons of its grandparents” (13)? This is not a story of an unfortunate ideological bias in favor of free markets. It is a story of greed and regulatory capture, wherein the largest banks–“The Frankenstein Fifteen”, as Kevin Phillips has labeled the new oligarchy (14) –took control of regulatory bodies and made sure they served the banks’ interests, with minimal interest in the costs to society.

In these circumstances, one can to some degree sympathize with the Department of Justice’s predicament. Any contemplated investigation would be formidably complex, given the character of the government’s long-term collusion with Wall Street in facilitating all of the criminality. Democrats as well as Republicans are implicated. Thus, the Clinton administration approved the removal of key restrictions on speculative behavior of big banks. The gutting of the Glass-Steagall Act in 1999 was the most important step, as it gave the banks an implicit guarantee of taxpayer reimbursement should they suffer speculative fiascoes (15). Recall as well that the Carter administration oversaw the lifting of prohibitions against usurious interest rates (16). The top financial officials of Obama’s administration were active facilitators themselves, during the Bush years and Clinton years both (17).

It is tempting to conclude, therefore, that the Washington-Wall St. collusion is Too Big To Prosecute. Worse still, the big banks that were deemed Too Big To Fail in 2008 are now consolidated into a handful of banking giants that are bigger still. “The Frankenstein Fifteen” are already fewer by six, and financial power has never been so closely concentrated as it is now: whereas in 1990 the top 10 financial institutions held 10% of all financial assets in the United States, by 2008 the top 10's holdings hit 50% (18).It is hard to imagine the rise of a populist movement strong enough to prevent the lobbying campaigns of these mammoth companies from neutering any aspect of regulation that would impinge on their habit of lucrative speculative adventurism. Does the rest of the world really expect the US to shed a system that promotes high-risk financial adventurism by bailing out high finance with US taxpayer money whenever it goes badly wrong (19)? To this theme we shall return shortly.

Notes

1. Data from front page of www.banksterusa.org
2. A noteworthy promoter of this accusation is Edward Yingling, head of American Bankers Association. See Joe Nocera, "Subprime and the Banks: Guilty as Charged", New York Times, October 14th, 2009.
3. A concise treatment is Daniel Gross, Dumb Money: How our Greatest Financial Minds Bankrupted the Nation, Simon & Schuster, 2009 (p. 48, e.g.). Merrill Lynch alone bought twelve mortgage-related companies from 2005-2007 (Gretchen Morgenstern, "How the Thundering Herd Faltered and Fell," New York Times, November 9, 2008).
4. In 2003 70% of real estate appraisers reported experiencing pressure to inflate real estate values. By 2007 the number reached 90%. Interview with William Black, former bank regulator at the Federal Savings and Loan Insurance Corporationon, on "Democracy Now!," October 15, 2009 (http://www.democracynow.org/2009/10/15/black).
5. Since the banks pay the ratings agencies for assigning ratings, the latter are naturally reticent to expose unsoundness they may locate in the former's offerings. For damning indictment of the rating agencies' collusion with respect to mortgage-related securities, see Edmund L. Andrews, Busted, W.W.Norton & Co., 2009, pp.141-149.
6. The 40% estimate comes from Bloomberg columnist Mark Pittman, who declared "The bundling of consumer loans and home mortgages into packages of securities... the biggest U.S. export business of the 21st century" (Mark Pittman, "Evil Wall Street Exports Boomed with 'Fools' Born to Buy Debt," Bloomberg.com, October 27th, 2008).
7. Original flyers available at: http://graphics8.nytimes.com/images/blogs/executivesuite/ChaseFlyer.pdf
8. The benchmark discussion of the rise of derivatives is Gillian Tett, Fool's Gold: How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe, Free Press, 2009. For the sector's evasion of regulation, see pp. 34-5, e.g.
9. Estimate of CreditSights Inc., as cited by Kevin Phillips, Bad Money: Reckless Finance, Failed Politics, and the Global Crisis of American Capitalism, Penguin Books, 2009 edition, p.xxv.
10. The opacity of the derivatives markets hamstrung efforts to estimate their size, and the cumulative risk to the financial system. The total value of all contracts appears to have topped $61 trillion, but many of these contracts would cancel each other out. The Bank for International Settlements estimated the net risk to be approximately $14.5 trillion (for elaboration, see Toni Straka, "Coming Soon: The $600 Trillion Emergency Meeting," Seekingalpha.com, Oct. 13, 2008).
11. A good exposure of this is Stephen Labaton, "Agency's '04 Rule Let Banks Pile Up Debt," New York Times, October 2, 2008.
12. Interview with William Black, loc. cit.
13. Interviewed on Bloomberg TV, October 29th, 2009, 4:15pm. Wolf was presumably

concealing his own judgment regarding responsibility.
14. Namely, five huge investment firms (Morgan Stanley, Goldman Sachs, Merrill Lynch, Lehman Brothers, and Bear Stearns), plus five of the largest commercial banks (Citigroup, JP Morgan Chase, Bank of America, Wells Fargo, and Wachovia), plus four mortgage industry giants (FNMA, FRMC, Washington Mutual, and Countrywide), plus insurer American International Group. Phillips, Bad Money, op. cit., p.xli.
15. The Glass-Steagall Act had required the separation of commercial banking—where the FDIC guaranteed the deposits of individual account holders, to a maximum of $100,000 or so–from investment banking. Once unification of the two was permitted, the investment banks were free to deploy masses of capital to speculative ends, with the taxpayer potentially liable for making good much of the damage.
16. See, e.g., Phillips, Bad Money, op. cit., p.xvii.
17. For a concise discussion, see Phillips, Bad Money, op. cit., pp.xxxii-xxxviii.
18. Henry Kaufman, The Road to Financial Reformation: Warnings, Consequences, Reforms, John Wiley & Sons, 2009, p.xii.
19. For a snapshot of US government bailouts of favored financial interests in the last thirty years, see Phillips, Bad Money, op. cit., p. 57.