



## **The Baseline Scenario 2010-03**

**Updated: 5-4**  
Update this newspaper

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## An Underfunded Program For Greece

**Simon Johnson** | 01 Mar 2010

*By Peter Boone and Simon Johnson*

The EU, led by France and Germany, appears to have some sort of financing package in the works for Greece (probably still without a major role for the IMF). But the main goal seems to be to buy time – hoping for better global outcomes – rather than dealing with the issues at any more fundamental level.

Greece needs 30-35bn euros to cover its funding needs for the rest of this year. But under their current fiscal plan, we are looking at something like 60bn euros in refinancing per year over the next several years – taking their debt level to 150 percent of GDP; hardly a sustainable medium-term fiscal framework.

A fully credible package would need around 200bn euros, to cover three years. But the moral hazard involved in such a deal would be immense – there is no way the German government can sell that to voters (or find that much money through an off-government balance sheet operation).

Alternatively, of course, the Greeks could make much more dramatic cuts to their primary deficit – the government budget balance if you take out interest payments – in order to stabilize their debt-GDP ratio.

But with no significant resurgence of growth in the eurozone coming for a long time, that would really mean moving from last year's 7.7% GDP primary deficit to around a 6% GDP primary surplus (assuming they face a real interest rate of 5%, i.e., below what they are paying today).

The government won't (or can't?) do that. In 2009 Greek wages and pensions rose by 10.5% – an amazing spending spree. In the 2010 budget they are forecast to rise by 0.3%. Where is the austerity? No wonder the prime minister is popular – they aren't really cutting much.

The bailout package is really just an opportunity for European banks to get out of Greek debt. The Greeks can't really collapse until they lose access to funding, so the hope is that this prevents the problems

from spreading – and the prospects of such a “rescue” will keep bond yields down for Portugal, Spain, and others.

Our baseline view is that Greece enters into quite a bad recession this year, their banks and corporates continue to have trouble raising financing – thus causing broader liquidity issues, and it all comes to a head again as we near the time the government needs to take ever harsher measures next year, when there is again no bilateral funding in place.

This is the new Greek cycle.

## Krugman: No Bill Is Better Than a Weak Bill

James Kwak | 01 Mar 2010

*By James Kwak*

Paul Krugman begins [this morning's column](#) this way:

"So here's the situation. We've been through the second-worst financial crisis in the history of the world, and we've barely begun to recover: 29 million Americans either can't find jobs or can't find full-time work. Yet all momentum for serious banking reform has been lost. The question now seems to be whether we'll get a watered-down bill or no bill at all. And I hate to say this, but the second option is starting to look preferable."

Krugman says he would be satisfied with the House bill, but that the need to bring moderate Democrats and at least one Republican on board in the Senate could lead to a severely watered-down bill, in particular one without a Consumer Financial Protection Agency. Instead of accepting such a deal, he says:

"In summary, then, it's time to draw a line in the sand. No reform, coupled with a campaign to name and shame the people responsible, is better than a cosmetic reform that just covers up failure to act."

Krugman recognizes that this is structurally different from what he said about health care reform. In Larissa MacFarquhar's [recent profile](#) of him in *The New Yorker*, discussing health care, he said, "There's a trap I've seen some people fall into — you let your vision of what should be get completely taken over by what appears possible right now — and that's something I'm trying to avoid." Now he's avoiding it.

I generally enjoyed that article. For one thing, I remembered that Krugman and I had a similar perspective on the 2008 Democratic primary (Obama was the most conservative of the major candidates and spouted a lot of "feel-good stuff about hope and dialogue and reconciliation"); both of us supported Edwards, although he switched to Clinton when Edwards dropped out and I switched to Obama.

For another, there's something else we have in common. Explaining why, after the fall of the Berlin Wall, he didn't set out to consult to post-Communist or developing countries, Krugman says, "I know what Jeff

[Sachs] does and I couldn't do it. Taking transport planes, living on yak meat for days — no. But I do write faster than anybody. You've got to figure out what you should be doing."

Anyway, getting back to this morning's column — I'm with Krugman. There are certainly things that would probably make it into a compromise bill that are better than nothing. Resolution authority would be better than nothing, although far from a perfect solution. Systemic risk regulation would be better than nothing — though perhaps not much better, depending on who is in charge of it. But frankly without the CFPB and without a real solution to banks that are too big to fail, it seems to me we will have avoided solving the biggest problems.

If we want change, someone has to be willing to stand up for it. If you want to win a negotiation, you have to be willing to walk away. If you can't do that, you will get rolled on every issue. The Democrats need to force the Republicans to make a public choice on the CFPB, instead of negotiating against themselves and taking the issue off the table. Voters will be upset if Congress does nothing about the financial system, but the Democrats should have the courage to point out why they couldn't pass anything. Taking a stand on consumer protection should not be that hard a position to take.

# Why No International Financial Regulation?

**Simon Johnson** | 02 Mar 2010

*By Simon Johnson*

As we fast approach the unveiling of the Dodd-Corker financial reform proposals for the Senate, it is only fair and reasonable to ask: Does any of this really matter? To be sure, some parts of what the Senate Banking committee (and likely the full Senate) will consider are not inconsequential for relatively small players in the US market. For example, putting consumer protection inside the Fed – which has an awful and embarrassing reputation in terms of protecting users of financial products – would tell you a lot about where we are going.

But our big banks are global and nothing in the current legislation would really rein them in – no wonder they and their allies sneer, in a nasty fashion, at Senator Dodd as a lame duck who “does not matter”.

For example, the resolution authority/modified bankruptcy procedure under discussion would do nothing to make it easier to manage the failure of a financial institution with large cross-border assets and liabilities. For this, you would need a “cross-border resolution authority,” determining who is in charge of winding up what – and using which cash – when a global bank fails.

To be sure, such a cross-border authority could be developed under the auspices of the G20, but there are not even baby steps in that direction. Why?

Part of the answer, of course, is that big cross-border banks know how to play governments off against each other – dropping heavy hints that “international competitiveness” is at stake. These are empty threats – if the US, the UK, and the eurozone cooperated on a resolution regime, this would get serious attention. If they went further and truly integrated their regulations – including communications and practices (and inspections) across regulators/supervisors – this could have major impact.

But national governments like to run their banks in their own way. In part, this may be sensible public policy – who, after all, really wants the US to be in charge of deciding how a bank failure (in another country) is handled? (The US and the UK had a major row in the weeks after Lehman failed). Even within the eurozone, there is a long standing refusal to specify in advance who is responsible for saving what part of which bank – motivated in part by the desire to protect the bureaucratic

turf of national central banks, which ceded power over monetary policy to the European Central Bank.

In part, no doubt, this also reflects varying degrees of “capture” in different places – sometimes by bankers, but sometimes it’s the politicians who do the capturing. As examples, see the work of Asim Khwaja and Atif Mian or Mara Faccio on how political connections really work in and around financial systems.

In any case, hoping that we can constrain banks through some form of international governmental cooperation is a complete illusion. The IMF and the WTO have no mandate on this issue. The Financial Stability Board is a paper tiger – really just a talking shop between regulators (and the same goes for the Bank for International Settlements more generally).

The big global banks know all this – and have known it for years. When Jerry Corrigan – former head of the NY Fed, no less – says Goldman did “nothing inappropriate” in arranging Greek debt swaps, he is in effect saying “catch us if you can”.

You will never stop the international banks at the international level. You need to curtail them at the national level. And you can’t afford to wait for other countries; you have to do it for your own country as a matter of pressing national priority.

Unfortunately, the Dodd-Corker proposals seem most unlikely to move us forward along this dimension.

## The Importance of Donald Kohn\*

James Kwak | 03 Mar 2010

*By James Kwak*

Donald Kohn recently announced that he is resigning as vice chair of the Federal Reserve Board of Governors, after forty years in the Federal Reserve system, most of it in Washington. Articles about Kohn have generally been positive, like this one in *The Wall Street Journal*. The picture you get is of a dedicated, competent civil servant who has been a crucial player, primarily behind the scenes, in the operation of the Fed.

It's a bit interesting that Kohn is generally getting the soft touch given that he was the right-hand man of both Alan Greenspan and Ben Bernanke. Here are some passages from the WSJ article:

"‘Don was my first mentor at the Fed,’ Mr. Greenspan says. Mr. Kohn told Mr. Greenspan how to run his first Federal Open Market Committee meeting, the forum at which the Fed sets interest rates. He became one of Mr. Greenspan’s closest advisers and defender of Mr. Greenspan’s policies.”

"Mr. Kohn has spent the past 18 months helping to remake the central bank on the fly as Chairman Ben Bernanke’s loyal No. 2 and primary troubleshooter.”

"Mr. Kohn has been at Mr. Bernanke’s side for nearly every critical decision during the crisis. He also has been asked to solve some of Mr. Bernanke’s biggest challenges — from finding a way to melt frozen commercial-paper markets to keeping peace among occasionally warring factions inside the Fed.”

Let’s not mince words. Kohn was one of the leading cheerleaders for the Greenspan Doctrine. Here’s one example. In 2005, Raghuram Rajan gave a now-famous paper at the Fed’s Jackson Hole conference warning of the impending financial crisis. Kohn gave a response, which we describe this way in *13 Bankers*:

"Fed vice chair Donald Kohn responded by restating what he called the ‘Greenspan doctrine.’ Kohn argued that self-regulation is preferable to government regulation (“the actions of private parties to protect themselves . . . are generally quite effective. Government regulation risks undermining private regulation and



financial stability"); financial innovation reduces risk ("As a consequence of greater diversification of risks and of sources of funds, problems in the financial sector are less likely to intensify shocks hitting the economy and financial market"); and Greenspan's monetary policy resulted in a safer world ("To the extent that these policy strategies reduce the amplitude of fluctuations in output and prices and contain financial crises, risks are genuinely lower"). Kohn's conclusion reflected the prevailing view of Greenspan at the time: "such policies [recommended by Rajan] would result in less accurate asset pricing, reduce public welfare on balance, and definitely be at odds with *the tradition of policy excellence of the person whose era we are examining at this conference.*"

(Emphasis added.) Now this does not mean that Donald Kohn is a bad person; it just means that he was wrong, along with Alan Greenspan and Ben Bernanke. If recent accounts are to be believed, he, like Bernanke, was relatively quick to shift gears when the crisis exploded and figure out effective responses, for which he deserves credit. (He also oversaw the stress tests, for better or worse.) But from where I'm sitting, the fewer members of the old guard, the better.

So now the question is, who will fill Kohn's seat — and the other two empty seats on the Board of Governors? The Board is supposed to have seven members, and they matter because they have seven of the twelve seats on the Open Market Committee, which sets the fed funds rate. *Business Week* says that the search is being led by Tim Geithner and Larry Summers, and that the likely goal is to find people to back Bernanke.

This confuses me for a few reasons.

First, it's not clear what Bernanke stands for. He was a Greenspan clone for about two years; then he turned into a pragmatic firefighter; and recently he's been avoiding taking positions on issues, except to say that he's against anything that reduces the power of the Fed (like an independent CFPB). So even if you wanted to find three mini-Bens, how would you even identify them? For starters, is he an inflation hawk or a dove?

Second, why is the Democratic establishment uniting behind Bernanke? Bernanke was a Bush appointee to the board, a chair of the Bush Council of Economic Advisers, and then Bush's pick to replace Greenspan. He's a Republican whose main selling point to Obama was

that he was already in the job and accepted by “the markets,” and he was the clear choice of Wall Street this winter. Does this mean that Obama is going to appoint three centrists who follow the (recent) central banking orthodoxy of putting inflation control over economic growth, and who oppose tighter regulation of banks? For anyone who thinks that there is such a thing as a coherent Democratic economic policy, that seems like shooting yourself in the foot.

Finally, and I know I’m in the minority here, why are we trying to increase the power of the Fed chair — especially a Fed chair from the opposite party? Leaving aside policy questions, I think the deification of the Fed chair in the past two decades has been a decidedly bad thing. The sensitivity of the markets to one man’s pronouncements (and, just imagine, his health) is a bad thing; the fact that an unelected person is widely considered the second-most powerful person in the country is a bad thing; and if our economic fate actually depends on one person’s wisdom, that’s also a bad thing. The point of a committee is to have differing views, arguments, and a vote — not to have a bunch of suck-ups and yes men. If we put some real progressives on the board, then that’s what you would have — diversity of opinion and meaningful votes. (Including Bernanke, three of the four current members are Bush appointees, including a former investment banker and a former chair of the ABA.)

I know people will say I don’t understand, and if we had debate on the board the markets would be spooked. I think that effectively amounts to saying that dictatorship is good for the markets, so we should have a dictator.

\* If you’re wondering why I begin so many posts with “The Importance of . . .,” it’s something I picked up from *The French Laundry Cookbook* by Thomas Keller.

## After The Hamilton Project

Simon Johnson | 03 Mar 2010

*By Simon Johnson*

In 2006 Robert Rubin and his allies created the Hamilton Project, housed at the Brookings Institution, to think about what a future Democratic administration would do. (Senator Obama attended the opening.)

From a tactical standpoint, this was a brilliant move. It developed people, including Peter Orszag and Jason Furman (directors of the project), trained a team, and created an agenda.

Unfortunately, financial reform was not – and perhaps still is not – on this agenda. The financial crisis more than blindsided them; it overturned their entire way of thinking about the world. At least in part, this explains their slow, partial, and unsatisfactory response. In any case, it hasn't worked out for them – or for us.

Wednesday morning there is a potential step in another direction. (Alternative link.) There are many questions.

Can would-be reformers agree? This is probably the easy part, at least for now.

Will there be continuity and personnel development, for example in the Institute for New Economic Thinking and the Roosevelt Institute?

Where's the "Geithner wing" of this movement – i.e., the people with practical policy experience inside the regulatory machine, who can be brought in to senior government positions?

And who will provide the political leadership? All eyes are on the Senate – but who exactly will step up and on what basis?

## Dallas Fed President: Break Up Big Banks

James Kwak | 03 Mar 2010

*By James Kwak*

We've cited Thomas Hoenig, president of the Kansas City Fed, a number of times on this blog for his calls to be tougher on rescued banks and to break up banks that are too big to fail. This has been a bit unfair to Richard Fisher, president of the Dallas Fed, who has been equally outspoken on the TBTF issue (although we do cite him a couple of times in our book).

Bloomberg reports that Fisher recently called for an international agreement to break up banks that are too big to fail. Here are some quotations, taken from the Bloomberg article (the full speech is here):

"The disagreeable but sound thing to do" for firms regarded as "too big to fail" would be to "dismantle them over time into institutions that can be prudently managed and regulated across borders."

"Given the danger these institutions pose to spreading debilitating viruses throughout the financial world, my preference is for a more prophylactic approach: an international accord to break up these institutions into ones of more manageable size. If we have to do this unilaterally, we should."

"The existing rules and oversight are not up to the acute regulatory challenge imposed by the biggest banks. Because of their deep and wide connections to other banks and financial institutions, a few really big banks can send tidal waves of troubles through the financial system if they falter."

This is not the first time that Fisher has sounded this alarm. Last fall, he called too-big-to-fail banks a "the blob that ate monetary policy," arguing that they distorted the economy in ways that made it harder for the Fed to fight the economic downturn. This was the core of his conclusion:

"To craft a smart solution to this vexing problem of banks considered too big to fail requires that we deal with the way people and businesses really are. To me this means finding ways *not* to live with 'em and getting on with developing the least

disruptive way to have them divest those parts of the ‘franchise,’ such as proprietary trading, that place the deposit and lending function at risk and otherwise present conflicts of interest.”

The TBTF debate is mainly between people like Fisher and Hoenig (and Paul Volcker and Mervyn King) who think that the problems posed by megabanks (implicit government guarantee, competitive distortion, etc.) cannot be regulated away, and people like Ben Bernanke and Tim Geithner who think that they can. (There are also a few people in free market fantasy land who think that the government can simply promise never to bail out another bank and that market forces will take care of the rest.)

Seen in an abstract light, we can have no assurance that any new regulations will actually work to prevent a financial crisis or defuse one, so the safer option (and isn’t that what regulators should want?) is to break up the big banks. Most of the arguments against this course of action have something to do with international competitiveness (smaller U.S. banks would hurt American companies in the globalized world). I think those arguments are obviously flawed; globalization means that American companies can get their financial services from banks that happen to be headquartered anywhere in the world, not just U.S. banks. But even if we grant them for the sake of argument, the international agreement that Fisher suggests should take care of that issue. And the only way to get such an international agreement is for the U.S. to take the lead.

Politically, breaking up TBTF banks is something that should on paper be able to attract a bipartisan majority. Many progressives are in favor of cutting “Wall Street” down to size; so are some conservatives, on the grounds that TBTF banks enjoy an implicit government subsidy and would require a bailout in the event of a crisis. Thomas Hoenig is generally considered a relatively conservative Fed bank president, at least when it comes to monetary policy. (Of course, such a bipartisan majority would require some Republicans to vote for something that might be popular with the electorate, which might be impossible in the current political climate.)

For whatever reason, the administration and Christopher Dodd seem to be going for the other kind of majority — one that cobbles together a least-common-denominator reform package that leaves the basic financial system intact. Even if they succeed, at best we will have lost our best opportunity for real change in decades.



# Why Exactly Are Big Banks Bad?

Simon Johnson | 04 Mar 2010

*By Simon Johnson*

Just over 100 years ago, as the nineteenth century drew to a close, big business in America was synonymous with productivity, quality, and success. “Economies of scale” meant that big railroads and big oil companies could move cargo and supply energy cheaper than their smaller competitors and, consequently, became even larger.

But there also proved to be a dark side to size and in the first decade of the 20<sup>th</sup> century mainstream opinion turned sharply against big business for three reasons.

First, the economic advantages of bigness were not as great as claimed. In many cases big firms did well because they used unfair tactics to crush their competition. John D. Rockefeller became the poster child for these problems.

Second, even well-run businesses became immensely powerful politically as they grew. J.P. Morgan was without doubt the greatest financier of his day. But when he put together Northern Securities – a vast railroad monopoly – he became a menace to public welfare, and more generally his grip on corporations throughout the land was, by 1910, widely considered excessive.

Third, there was a blatant attempt to use the political power of big banks to shape the financial playing field in ways that would help them (and their close allies) and hurt the remainder of the private sector – including farmers, small business, and everyone else. Senator Nelson Aldrich’s push to create a central bank after 1907 – to be underwritten by the government but controlled by big banks – ultimately backfired. The Federal Reserve, while far from perfect, was created with far more public control and greater safeguards than Wall Street had in mind.

The fact that Nelson Aldrich’s daughter was married to John D. Rockefeller’s son was not lost on anyone.

A hundred years later, we have come full circle – as the mainstream consensus again weighs what to do with today’s overly powerful banks.

There are differences, of course. We no longer fear individuals – it’s the organizations they run that can make us or break us.

And, strangely, it is not the power of big finance to control everything that has us worried – other than in some movies. Rather it’s the ability of

major banks to generate the conditions that make major international financial crises possible – with the incentive to take risks that, when things go well, result in huge upside for bankers and, when things go badly, massive downside for the rest of us.

Even the supporters of our existing financial structure – men like Hank Paulson (in On The Brink), Larry Summers (in his 2000 Ely Lecture), and Jamie Dimon – concede that big crises occur every 5 years or so. What hit us in 2008-09 was not a “once per century” event. Rather it was the latest – and scariest – in a series of regular global crises that goes back to at least the 1970s.

At the heart of this pattern of behavior is a perception of invincibility among the folks who run our biggest banks – and following our most recent crisis they act more assured than ever that the government will provide a backstop.

At the same time, everyone agrees that such “too big to fail” arrangements cannot continue. Even the Federal Reserve, which has fallen on hard and embarrassing times since it was captured by Big Finance during the 1990s, now has its leading officials give speeches to this effect.

We like to think we live in a more professional and technocratic age than a century ago, so the central pretense of current reform efforts is that we can design a “resolution authority” of some kind that would allow the government to take big banks into a form of bankruptcy or liquidation.

But this notion of a resolution authority that can handle massive banks is a complete unicorn – a mythical beast with magical powers that does not really exist. A US resolution authority does nothing to help handle the failure of international banks – there is no cross-border resolution authority, nor will there be one anytime soon. If a Citi or a JP Morgan or a Goldman were to fail, our government would be in exactly the same awkward position as it was in during September-October 2008.

Big banks cannot be reined in through some clever tweaking of the rules. The issue before us is intensely political – just as it was in the first decade of the twentieth century. There is again a confrontation between concentrated financial power and our democracy. One side will win and the other side will lose.

The banks start with a definite edge. The public relations machines of today’s bankers may be even more effective than those of Morgan and



Rockefeller – although the campaign contributions and control of the Senate exercised by those titans was immense.

But it is still early days – the Senate legislation expected this week or next will achieve nothing, except make the stakes clearer and motivations more transparent. If the banks win this round, as seems likely, they will become even larger – and more dangerous. At current scale, our megabanks bring no social benefits and great social risks.

Just as a hundred years ago, the consensus on big banks has to change. In this instance, either we break them up or they will soon break us all.

*An edited version of this post appeared this morning on the NYT's Economix; it is used here with permission. If you would like to reproduce in full, please contact the New York Times.*

## Questions For Mr. Pandit

Simon Johnson | 04 Mar 2010

*By Simon Johnson*

Today, perhaps following our earlier recommendation, Mr. Vikram Pandit – CEO of Citigroup – will appear before the congressional oversight panel for TARP. (Official website, with streamed hearing from 10am).

This is an important opportunity because, if you want to expose the hubris, mismanagement, and executive incompetence – let's face it – Citi is the low hanging fruit.

Citibank (and its successors) has been at the center of every major episode of irresponsible exuberance since the 1970s and essentially failed – i.e., became insolvent by any reasonable definition and had to be saved – at least four times in the past 30 years (1982, 1989-91, 1998, and 2008-09).

In the last iteration, Citi was guided by Robert Rubin - self-styled guru of the markets and sage of Washington, a man who likes to exude "expect the unexpected" mystique – directly onto the iceberg at full speed.

Mr. Pandit was brought in by Mr. Rubin to refloat the wreckage, despite the fact that he had no prior experience managing a major global bank. Mr. Pandit's hedge fund was acquired by Citi and then promptly shut. And Mr. Pandit's big plan for restructuring the most consistently unsuccessful bank – from society's point of view – in the history of global finance: Reduce the headcount from around 375,000 to 300,000.

Here are five questions the FCIC should ask. This line of enquiry may seem a bit personal, but it is time to talk directly about the people, procedures, and philosophy behind such awful enterprises.

1. As far as anyone can judge, Mr. Pandit, you are completely unqualified to restructure and run a disaster prone global bank. Can you please explain in detail how you got the job?
2. Your hedge fund. Old Lane Partners, was closed by Citi in June 2008. Please elaborate on why it was closed, including how much money you lost on what kinds of securities. (Hint: follow the NYT through the sad story.)
3. Please review for us the details of your promised compensation package and how much you have actually received – including

cash, deferred compensation, stocks, and perks (including executive jet travel, valued at market rates); do not forget your chunk of the Old Lane deal. How much taxpayer money has been injected into Citi and on what basis?

4. Of course, as you understand full well, the true cost to society of Citi's misdeeds is vastly more than the direct taxpayer injections of capital. Please tell us – as specifically as you can – what other burdens Citi has generated for the rest of us. (Hint: there is a right answer here, which includes more than 8 million jobs lost since December 2007, a 30-40 percent increase in net government debt held by the private sector, and much higher taxes for everyone in the future.)
5. Mr. Pandit, your proposed restructuring plans simply make no sense; there is nothing you have put on the table that would reduce the risks posed by Citi to the national interests of the United States. Even John Reed, the man who built Citi as a global brand, now says that it should be disbanded. There is no evidence – and I mean absolutely none – for economies of scale in banks over \$100bn in total assets. Richard Fisher, head of the Dallas Fed, calls for immediate action in terms of breaking up large dysfunctional banks such as yours; please explain to us why the Fed should not move immediately to apply his recommendations to Citi – surely, the safety and soundness of our financial system is on the line.

And if Mr. Pandit replies, in response to point 5, “you need Citi because other countries have large banks,” he should be laughed out of court. Just because other countries do things badly and refuse to address their underlying issues has never stopped the United States from fixing its problems. The basis of this republic is our ability and our right to govern ourselves.

We should thank Mr. Pandit and his colleagues at Citi for their service and move immediately to break up their bank – just as our predecessors thanked Mr. Rockefeller and broke up Standard Oil in 1911.

# Monopolies Everywhere

James Kwak | 04 Mar 2010

*By James Kwak*

Thomas Frank has a review in the Wall Street Journal (behind a paywall, but Mark Thoma has an excerpt) of Barry Lynn's new book *Cornered*, which apparently documents the prevalence and power of monopolies and oligopolies in lots and lots of industries, not just finance. (I guess one response would be that we have been too harsh on the banks, since everyone's doing it; but I still think banks are special for all sorts of reasons I won't go into here.)

The problem, as Frank says, is that "the antimonopoly tradition is a museum piece today, and antitrust enforcement has been largely moribund since federal officials during the Reagan Revolution lost interest in this most brutal form of economic intervention." Antitrust enforcement became a question of measuring predicted changes in consumer welfare, which meant that it became the province of models. More importantly, we are now in at least our fifth consecutive administration that sees big, profitable companies as inherently good, without stopping to question how they extract those profits.

The solution is already there to hand — go back to enforcing the existing antitrust laws. And appoint Supreme Court justices who are interested in enforcing them. But that assumes that the administration cares about the issue. Do they?

(For one thing, I applied for an internship in the DOJ's antitrust division for this coming summer . . . and I was turned down.)

# Disastrous Performance By Treasury On Capitol Hill

**Simon Johnson** | 04 Mar 2010

*By Simon Johnson*

The campaign to convince people that Treasury is serious about banking reform – led sometimes by President Obama - suffered a major blow today on Capitol Hill. In testimony to the Congressional Oversight Panel, Assistant Secretary for Financial Stability “and Counselor to the Secretary” Herb Allison said, “There is no too big to fail guarantee on the part of the U.S. government.”

This statement is so extraordinarily at odds with the facts that it takes your breath away.

Should we laugh at the barefaced misrepresentation of what this administration has done (and the Bush team did) – or just dig out “Too Big To Fail” by Andrew Ross Sorkin and go through all the gruesome details again? Should we cry for what this implies about Secretary Geithner’s commitment to real reform – if there is no issue with “too big to fail”, then why do you need any new laws that try to address this issue (e.g., such as the Volcker Rules, sent to Congress this week)?

The temptation is to shrug and ignore repeated such insults to our intelligence and implied injury to our pocketbooks. But this would be a mistake.

I want an answer to this question: Who authorized Mr. Allison to make this statement, and what were they thinking?

If Mr. Allison was free-lancing, we should discuss the consequences. If Mr. Allison was sticking to his talking points, as seems likely, let us find out exactly who is responsible for sharing arrant and self-defeating nonsense with Congress. The disrespect for our legislature and cynicism for mainstream opinion here is beyond what is tolerable or responsible.

The Obama administration has dealt itself another formidable blow.

## **“No One Made People Buy These Cars . . .”**

**James Kwak** | 04 Mar 2010

*By James Kwak*

The Center for Responsible Lending has a great comic strip titled “If Anti-CFPA Folks Ran Toyota Today?” with classic lines like “Fixing these cars will raise the price of cars in the future, and hurt deserving drivers.” I’m pretty sure it was directly inspired by one of my favorite posts, “If Wall Street Ran the Airlines . . .,” but that’s perfectly fine by me. We have to keep saying the same things over and over because they’re true.

## Is Vikram Pandit in Favor of Real Reform?

James Kwak | 04 Mar 2010

Testifying today before the TARP Congressional Oversight Panel, Citigroup CEO Vikram Pandit took pains to strike the right notes. Near the beginning of his prepared testimony, he said, “First, however, I want to thank our Government for providing Citi with TARP funds. For Citi, as for many other institutions, this investment built a bridge over the crisis to a sound footing on the other side, and it came from the American people.” Saying “thank you” may not satisfy many people, but it is a step in the right direction.

More importantly, Pandit said that Citigroup is on the side of the angels — in this case, the side of real financial reform:

“Citi supports prudent and effective reform of the financial regulatory system. America – and our trading partners – need smart, common-sense government regulation to reduce the risk of more bank failures, mortgage foreclosures, lost GDP and taxpayer bailouts. Citi embraces effective, efficient and fair regulation as an essential element in continued economic stability.”

When it comes to the substance, though, I’m not sure how much Pandit had to say that was new, although he took care to say it in the nicest way possible.

Here’s his first major point on regulatory reform:

“With regard to financial institution reform, we at Citi believe that banks should operate as banks, focused completely on serving their clients. Our internal reforms have been totally consistent with these principles, and we have publicly endorsed the general direction of financial regulatory reform under consideration by Congress. A systemic regulator with an overall view of the financial system and the ability to impose enhanced capital requirements and other prudential regulation is critical. I also strongly support the creation of an effective resolution authority that can resolve large, complex institutions in an orderly way.”

(Emphasis added.) Apart from the clause I underlined, the rest would not have been surprising coming out of the mouth of either Jamie Dimon or Lloyd Blankfein. The big banks have been mouthing the words “systemic regulator,” “prudential regulation,” and “effective resolution authority” for months now. They have nothing to fear from them.

Now, the “banks should operate as banks” line seems a tiny bit promising. That sounds like a reference to the “Volcker Rule,” saying that banks should get out of proprietary trading, hedge funds, and private equity. One could be cynical and say that Citi had little to lose, since they weren’t very good at any of those things anyway.

But it’s probably more appropriate to be cynical in a different kind of way, like Felix Salmon, who pointed out that Citi is getting rid of one private equity unit while keeping a different buyout operation and a VC firm. As Salmon said, “Essentially, all this boils down to ‘if you happen to be in Vikram’s good books this week, he’ll want to keep you, otherwise he’ll decide to sell you’. That’s not a strategy, it’s a monarchy.” Seen in that light, Vikram’s claim that “Our internal reforms have been totally consistent with these principles” seems a bit much.

This is Pandit’s second point:

“Regarding market reform, we support regulations that promote transparency, particularly in the derivatives markets, with the use of standardization and clearinghouses. It is also important that regulation is coordinated globally and applied uniformly to all participants in the financial sector. We need a level playing field on which market participants can compete, subject to uniform standards that protect investors and the marketplace as a whole.”

Blah blah blah blah blah. There’s nothing here.

Here’s the third point:

“With regard to consumer market reform, a key lesson of the financial crisis is that what starts as an issue that affects consumers can become an issue for the entire financial system. Recent experience reinforces the truism that what is best for consumers is also best for the financial system and the economy. I strongly believe that consumer protection can and should be strengthened at the federal regulatory level. While a number of architectural frameworks could work to strengthen consumer protection, I believe any consumer authority should be centered



on five principles: (1) There should be enhanced authority in place with a focused responsibility for the well-being of consumers; (2) there should be uniform national standards that apply to all market participants who provide financial products to consumers and a level playing field, irrespective of the entity; (3) there should be transparency in disclosure so that product disclosures are simple, readable, and understandable; (4) there should be a link to the safety and soundness regulator; and (5) issues of market structure and collective action should be examined by the consumer regulator.”

(Numbers (1)-(5) added.) (1) is pure boilerplate. (2) is code for “nonbank lenders need to be regulated so they don’t have a competitive advantage over us regulated banks.” I agree, but Pandit is saying this because it’s in his self-interest. (3) is boilerplate. (4) is disturbing. This sounds like code for “don’t let Elizabeth Warren do anything to my bank without having to get the approval of Ben Bernanke and John Dugan.” (5) . . . I don’t know what (5) means. Is he saying that the consumer protection agency should have antitrust powers? That would be good. Or by saying “market structure and collective action” is he saying that the consumer protection agency should *not* have the power to take action against individual banks? That would be very, very bad. Unfortunately, I suspect he’s saying the latter, since the goal of the banks is to (at most) let the CFPA write rules that are then enforced (or not enforced) by their good old buddies, the prudential regulators.

So to sum up, the answer to the question in the title is: no. At least, there’s not much here to make us believe that Pandit wants real reform. Of course, the real test would be to find out what he’s paying his lobbyists to say behind closed doors. Now that would be interesting.

And this would be consistent with his introduction:

“The errors, mistakes and business practices that precipitated these macroeconomic events have been much discussed: housing policies that led to increased subprime lending in the residential real estate market; an explosion in new subprime mortgage products premised on the assumption of stable and, indeed, ever-increasing residential real estate prices based on decades of precedent; the Federal Reserve’s policy of maintaining historically low interest rates in the post-9/11 period; the growth in demand for securitized and structured credit products by

investors of all types in all sectors with widely varying risk appetites and abilities to absorb risk; the lack of transparency in certain financial markets, including derivatives markets; and a regulatory system that did not keep pace with the ever-increasing sophistication, complexity and interrelatedness of the financial markets, to name just a few.”

So, in Pandit’s view, the crisis and recession were caused by: government housing policies; “subprime mortgage products” that fell out of the sky; the Federal Reserve; investors; “lack of transparency”; and the regulatory system. Do you see *large banks* anywhere on that list? I didn’t think so. At the end of the day, it boils down to this: *it wasn’t my fault*.

I started this post hoping to find something nice to say about Vikram Pandit. I couldn’t find anything.

## Toxic Finance

James Kwak | 05 Mar 2010

*By James Kwak*

The first generation of financial crisis books was largely blow-by-blow, behind-the-scenes accounts, like David Wessel's *In Fed We Trust* and Andrew Ross Sorkin's *Too Big to Fail* — long on characters, events, and dramatic suspense (or at least as much dramatic suspense as you can have when writing about something that unfolded on the front pages of the newspaper), but relatively short on analysis. There were also more analytical books, like Justin Fox's *The Myth of the Rational Market* and John Cassidy's *How Markets Fail*, which seem like books about free market economics that later turned out to be about the crisis. But one thing this crop had in common is that, for the most part, they ended with the near-collapse of the financial system.

The current generation of books is not just about the crisis and what caused it, but also about the response to the crisis, and what went wrong — that is, why the large banks are bigger, more powerful, and more concentrated than ever before and why the unemployment rate is still languishing around 10%. Joseph Stiglitz's *Freefall* (which I haven't finished reading) falls into this category, focusing more on the governmental responses of 2008-2009 than on the causes of the crisis. So does Yves Smith's ECONned, which just came out this week. (I have the early version that the publisher sent to Simon a while back.)

Unsurprisingly for readers of naked capitalism, ECONned stands out for its treatment of the complex securities and especially the trading strategies that helped inflate the bubble and exacerbate the crisis. I've been reading about this stuff for a long time now, and there was still a lot I learned, particularly from Chapter 9, "The Heart of Darkness," which describes how trading in CDOs built out of mortgage-backed securities drove mortgage lending, and not the other way around. In the conventional account, unscrupulous lenders and investment banks were the creators of those toxic assets; in Smith's account, at the peak in 2006, it was traders who were *shorting* the housing market who provided the equity that funded all those subprime mortgages.

But there's another point that Smith makes that I found particularly memorable. She tells the fictional story of XCrop, a new, bioengineered food that is nutritionally complete and cheap to produce — a solution to malnutrition and obesity all in one. But twenty years after becoming

popular, and after having become the mainstay of the food system (replacing today's current staples), XCrop is found to have serious harmful effects on human health. Shifting back to today's foods would be healthier, but it would be difficult and expensive.

Recent financial technology, Smith says, is like XCrop. The point she is making is that our policy objective should not be to get us back to the good old days of cheap mortgages and widespread securitization as quickly as possible so we can return to the outsized consumption of the past decade. We need to have a healthier financial system, and to get there we have to give up the wonder food that turned out to be so harmful to the economy. Instead, however, Smith argues that much of the government has been captured by the financial services industry — the inventors and manufacturers of XCrop. And so, at the end of the day, and despite the central role that free market economic orthodoxy played in producing the crisis, the problem we face is ultimately one of politics.

# Does The Obama Administration Even Want To Win In November?

**Simon Johnson** | 05 Mar 2010

*By Simon Johnson*

Increasingly, senior administration officials shrug when you mention the November mid-term elections. “We did all we could,” and “it’s not our fault” is the line; their point being that if jobs (miraculously at this point) come back quickly, the Democrats have a fighting chance – but not otherwise.

It may be true, at this point, that there is little fiscal policy can do that would have effects fast enough; and monetary policy is out of the administration’s hands.

But ever so quietly, you get the impression the Obama team itself is not so very unhappy – they know the jobs will come back by 2012, they feel that Republican control of the House will just energize the Democratic base, and no one will be able to blame the White House for getting nothing done from 2010 on.

When you push them on this issue, they snap back, “Well, what do you want us to do? What’s the policy proposal that we are not pursuing?” But this is exactly the wrong way to think about the issue.

The point is that the administration has lost control over the narrative. Why have we lost 8 million jobs since December 2007? Why will debt-GDP rise by 40 percentage points relative to what the CBO baseline would have been? Who is responsible for this deep global disaster?

The president has only addressed this head-on once – when he launched the Volcker Rules in January. That was a good moment, grabbing attention and focussing it in a productive direction. But it proved fleeting – Secretary Geithner was spinning it away within 7 hours – and there has been no follow-up in terms of clear political messages.

There’s no story in the culture about what the big banks did and why. There is no attempt from the top to push through the key message for the day – financial reform – and to explain what this can do and how. The administration, in effect, is not even trying.

The inner team apparently thinks that 2012 will go just fine – as long as unemployment is down around 6 percent. And, they reason, the people who lose their seats this November won’t be around to complain.

Really?

If the administration fights hard and loses in November, that is one thing. If it fights on clear issues – forcing the other side to support Too Big To Fail structures – they may still lose, but such a loss will clearly communicate that the political strength of the big banks is now out of control. That is an issue to run on – and win big – in 2012.

And if the administration doesn't even care and hardly tries now, who will come out for them (or send a check) in two years?

The Obama team – both political and economic wings – seems to feel that their base has nowhere else to go, and all they need to do is drift towards the right in a moderately confused fashion to assure re-election for the president.

Jimmy Carter had the same sort of idea.

# Uncontrolled Lending to Consumers Spawned the Financial Crisis

James Kwak | 05 Mar 2010

*This guest post was contributed by Norman I. Silber, a Professor of Law at Hofstra Law School, and Jeff Sovern, a Professor of Law at St. John's University. They were principal drafters of a statement signed by more than eighty-five professors who teach in fields related to banking and consumer law, supporting H. 3126, which would create an independent Consumer Financial Protection Agency. Some of the research on which this essay is based is drawn from an [article by Professor Sovern](#).*

Did under-regulated lending to consumers play a big part in destabilizing the financial system? Many knowledgeable people say yes, but Professor Todd Zywicki disagrees. ("Complex Loans Didn't Cause the Financial Crisis," Wall Street Journal, February 19, 2010). He claims that the present troubles resulted from the "rational behavior of borrowers and lenders responding to misaligned incentives, not fraud or borrower stupidity."

Professor Zywicki's argument enjoys, at least, the modest virtue of technical accuracy, because many objectionable misleading sales practices and agreements that lenders used were, and continue to be, unfortunately, quite legal. Lending practices may have been regularly misleading and confusing and reckless-but fraudulent? Well, no, usually not unlawful by the remarkably low standards of the day. But that in itself is an argument for saying consumer protection laws failed.

Professor Zywicki's case for denying that better consumer protection rules would have mattered quickly becomes technical and rather disingenuous, hinging as it does on the difference between denying that there were inadequate restraints on imprudent lending, on the one hand, and insisting that there were definitely "misaligned incentives," on the other. If the lassitude of the government agencies who were responsible for financial consumer protection is not to blame, then who was responsible for all the euphemistic "misaligning"? Zywicki manages to blame the financial crisis on "extraordinarily foolish loans" that created incentives for borrowers to borrow unwisely, but absolves the regulators who could have prevented those foolish loans from being made.

Zywicki's research leads him to conclude that the onset of the foreclosure crisis "was [initially] a problem of adjustable-rate mortgages, whether prime or subprime." It might have been useful if he recalled

that even if true, it was still the case that inadequate disclosure of the implications of potentially exploding adjustable-rate mortgages was a matter of serious concern to consumer groups. In the second phase, he says, “falling home prices provided incentives for owners . . . to walk away from their houses.” It might have been useful to recall that if the carrying cost of mortgages had been more closely supervised as a matter of consumer protection, the problems would not likely have been as severe.

And so the broad claim that the financial crisis has nothing to do with fraud or consumer protection dissolves in the face of the facts: the crisis can be attributed to failures of consumer protection, including those that enabled lenders to make the loans Zywicki decries. Consider the following examples of consumer protection failures:

First, lenders made loans that virtually invited default. Thus, Countrywide’s manual approved the making of loans that left consumers as little as \$550 a month to live on, or \$1,000 for a family of four. And lenders qualified borrowers for loans based on a temporary low teaser rate even though they knew that borrowers would not be able to make the higher payments required when the teaser rate expired. Of course, when loans became unaffordable, lenders could anticipate that borrowers would refinance, triggering a new round of fees for lenders—but they gave too little attention to the possibility that the loans could not be refinanced. Consumer protection laws failed to prevent this disaster-in-the-making.

Second, the Federal Reserve’s disclosure rules made it impossible for adjustable rate mortgage borrowers—and 80% of the subprime loans were adjustable—to understand the risks they faced. Since the eighties, the Fed has mandated that the disclosures for such loans state figures for monthly payments that are simply wrong. That may have led consumers to believe their loans would be more affordable than they were. One of us recently presided over a survey of mortgage brokers that revealed that many borrowers spent little time reviewing those disclosures and never changed what they did because of them—something that ironically makes sense when the disclosures are misleading. Better consumer protection laws would have enabled borrowers to know when they risked getting in over their heads.

A third consumer protection failure connects to Zywicki’s claim that borrowers “rationally switched to adjustable-rate mortgage when their prices fell relative to fixed-rate mortgages.” The problem is that many



adjustable-rate borrowers did not realize that their loans were adjustable. Thus, a study of borrowers in certain Chicago zip codes found that “the overwhelming majority” of those who received adjustable-rate loans had thought their loans were for fixed rates. The authors explained that “In every case where borrowers were surprised to be told they were receiving an adjustable rate loan, the Loan Originator had told the borrower that the rate was ‘fixed’ but neglected to mention that the terms for which the rate was ‘fixed’ was limited to 12 to 36 months.” It was not until 2008 that the Fed reined in this practice.

These problems could have been forestalled by an agency focused on consumer protection. Why weren’t they? We believe that Zywicki is right to focus on incentives but wrong to ignore the incentives faced by regulators themselves. The economic crisis was caused in part by incentives built into our consumer regulatory structure that encourage regulators not to protect consumers. A CFPA would have different incentives.

For example, in 1994 Congress gave the Federal Reserve the power to bar unfair or deceptive mortgage loan practices and abusive lending practices in connection with mortgage refinancing-powers that would have enabled the Fed to prevent the foolish loans Zywicki complains about, and the practices described above. Yet the Fed did not use that power until 2008, long after the subprime loans had tanked. And it was only last summer that the Fed proposed to change its misleading adjustable-rate mortgage disclosures. Perhaps the reason lies in the fact that the Fed is primarily an agency devoted to monetary policy, where consumer protection is reportedly seen as a backwater. The leaders of the Fed are chosen not because of their expertise in consumer protection, but because of their mastery of economic policy. Thus, the Fed’s incentive is to focus on monetary policy. An agency with protecting consumers as its sole mission would surely not have waited almost twenty years to act while lenders provided borrowers with false and useless disclosures.

A second problem with the current structure of consumer protection regulators stems from the fact that because lenders have some power to choose which agency will regulate them, agencies have an incentive to go easy on consumer protection regulation to avoid chasing lenders to other agencies. For example, four days after the Connecticut Banking Commissioner examined one Connecticut lender, the lender notified the Commissioner that it was becoming a subsidiary of a national bank, thereby excusing it from compliance with Connecticut banking law. The incentive to retain lenders to regulate is especially strong for regulators,

like the OCC, that depend on fees provided by their lenders to finance their operations. That may explain why the OCC took the position that state anti-predatory lending laws did not apply to the lenders within its jurisdiction-laws which might have prevented some of the lending that led to the subprime crisis. But if lenders could not choose their regulator, regulators would lose the incentive to compete to protect lenders from consumer protection laws.

Zywicki is right that we need “simplified and streamlined regulation.” The problem is that the existing structure, with consumer protection split among an alphabet soup of agencies, such as the OCC, OTS, NCUA, FDIC, HUD, FTC, and, of course, the Fed, among others, is not likely to produce simplified and streamlined anything. We share Professor Zywicki’s concern that the Truth In Lending Act needs pruning, for example.

The best way to attain simplified and streamlined regulation is to simplify and streamline the agencies that produce it-by reducing them to one. Doing so would concentrate consumer protection expertise in one place and enable accountability. And, we assert, if it had been done a few years ago, the financial crisis might have been averted.

## More Bank Marketing

James Kwak | 07 Mar 2010

*By James Kwak*

I've already criticized Citigroup CEO Vikram Pandit's testimony before the TARP Congressional Oversight Panel on Thursday, but there's one thing I left out. Citigroup, like other banks not named Goldman Sachs, is attempting to cloak itself in a mantle of goodness. Pandit's testimony included several bullet points discussing all the wonderful things that Citigroup is doing for ordinary Americans. For example: "In 2009, we provided \$439.8 billion of new credit in the U.S., including approximately \$80.5 billion in new mortgages and \$80.1 billion in new credit card lending."

There are two problems with these kinds of numbers. One is that I have no idea what to compare them to. I looked through Citigroup's most recent financial supplement and was unable to find any numbers for "new credit," let alone those numbers in particular. For a credit card, what does "new credit" mean? If I have no balance, and then I lose my job so I run up \$20,000 on my Citi credit card, is that \$20,000 in new credit? Or does new credit only include new cards issued? If so, how does it compare to credit taken away by closing people's accounts or reducing their credit limits?

The second is that whatever Pandit says about "new credit," it's hard to argue that credit didn't *contract* in 2009. For example, total consumer loans (p. 27) fell from \$484 billion at the end of 2008 to \$443 billion at the end of 2009, and total corporate loans fell from \$218 billion to \$177 billion, while money deposited with other banks (including the Federal Reserve) grew by \$100 billion. Now, this is not all Citigroup's fault. For one thing, they were overextended, so de-leveraging made sense from a balance sheet perspective, and for another there may have been a decline in demand for credit. But I'm still troubled by this attempt to pretend that Citi was fueling the economic recovery by stepping up lending.

**Update:** A friend who I believe has plenty of credit and no need for more writes in to say that the credit line on her Citibank credit card was just increased by \$6,000, even though she never used more than one-third of her old credit line. She was wondering why until she realized that the \$6,000 counts as "new credit" to Citi.

## The Deficit Problem Is a Political Problem

James Kwak | 07 Mar 2010

*By James Kwak*

By which I do not mean to say it is not a problem. As Paul Krugman reminds us,

“If bond investors start to lose confidence in a country’s eventual willingness to run even the small primary surpluses needed to service a large debt, they’ll demand higher rates, which requires much larger primary surpluses, and you can go into a death spiral.

“So what determines confidence? The actual level of debt has some influence — but it’s not as if there’s a red line, where you cross 90 or 100 percent of GDP and kablooie . . . Instead, it has a lot to do with the perceived responsibility of the political elite.

“What this means is that if you’re worried about the US fiscal position, you should not be focused on this year’s deficit, let alone the 0.07% of GDP in unemployment benefits Bunning tried to stop. You should, instead, worry about when investors will lose confidence in a country where one party insists both that raising taxes is anathema and that trying to rein in Medicare spending means creating death panels.”

The implication is that our deficits really are a serious problem. But what’s making them a serious problem is not just that they are big and getting bigger; it is that our political system seems incapable of dealing with them. So, ironically, deficit peacocks are right that the deficit is a problem, but only because they refuse to do anything about rising health care costs — since the long-term deficit problem is a health care cost problem.

## Current Financial Conditions and Future Economic Activity

James Kwak | 08 Mar 2010

*By James Kwak*

David Leonhardt (hat tip Brad DeLong) discusses the risk of a double-dip recession. For Leonhardt, the main risks are the pending expiration of the fiscal stimulus and some of the Fed's monetary stimulus measures, as well as continuing de-leveraging by households, which deprives the economy of its usual growth engine.

James Hamilton highlights a new financial conditions index developed by five economists — two from major banks and three from universities. The goal of the index is to estimate the impact of current financial variables on the future trajectory of the economy. For example, the level of *current* interest rates is likely to influence *future* economic outcomes. The paper evaluates several existing financial conditions indexes and finds that most of them show financial conditions returning to neutral in late 2009. It then describes a new index comprised of forty-four variables, which tends to do a better job of predicting economic activity than the existing indexes. (The authors admit that this is in part because they have the benefit of living through the recent financial crisis, which has shown the value of certain variables not included in previous indexes.)

So what?

“Whereas the existing FCIs show the current level of financial conditions to be back at or slightly better than ‘normal’ levels, our index has deteriorated substantially over the past two quarters. Indeed, it has retraced nearly half of the sharp rebound that had occurred earlier in 2009. This setback suggests that financial conditions are somewhat less supportive of growth in real activity than suggested by other FCIs.”

Hamilton already grabbed the key chart:

Why?

“The improvement in financial conditions since the spring of 2009 has been concentrated in indicators that are included in virtually all financial conditions indexes, namely interest rates, credit spreads, and stock prices. In contrast, several components of our FCI that have not been previously included – particularly

quantity indicators related to the performance of the 'shadow banking system' such as ABS issuance and repo loans, as well as total financial market cap – have failed to improve much if at all.”

The shadow banking system became increasingly important to the financial system in the past decade, and so to assess the recovery of the financial system, you need to measure its health as well. The implication is that the financial system is not in good shape to support sustained recovery at the moment, which would be another thing to add to Leonhardt's list of worries.

## Subsidized Housing

James Kwak | 08 Mar 2010

Calculated Risk points out Robert Shiller's article in the New York Times on the subsidization of homeownership in America. Shiller asks why we should subsidize homeownership, beyond short-term expedencies such as the fact that since we have a lot of unemployed construction workers, we could reduce unemployment by subsidizing homeownership (as long as we can subsidize new home construction as opposed to just trading houses). Of course, the reason we have a lot of unemployed construction workers is that we over-subsidized housing for the past decade and a half; hence Shiller's question.

At first, Shiller seems to give this answer:

"While the crisis in the housing market shows that our current approach is far from perfect, there is a certain wisdom behind it, related not only to economic stimulus but also to the preservation of a sense of national identity. . . .

"The best answer isn't found in traditional economics but rather in American culture: a long-standing feeling that owning homes in healthy communities is connected to individual liberties that embody our national identity. . . .

"In his classic 1985 book, 'Crabgrass Frontier,' Kenneth T. Jackson of Columbia University delineated the complex train of thought that over the last two centuries has produced the American belief that homeownership encourages pride and good citizenship and, ultimately, preservation of liberty. These attitudes are enduring."

At this point, I was ready to pounce. Shiller seems to be arguing that we should subsidize homeownership because we share a *belief* that homeownership is good. But he doesn't fall for the trap he seems to be stumbling into. Instead, he says,

"If we choose to keep subsidizing individual homeownership, we must also commit to adding safeguards so that homeowners are less financially vulnerable. Of course, that will require some creative finance.

“But first, we should rethink the idea of renting, which could be a viable option for many more Americans and needn’t endanger the traditional values of individual liberty and good citizenship.”

I’m a little leery of “creative finance,” but I’m all for rethinking renting. The key point, which Shiller makes, is one that I’ve made to many of my friends thinking of buying houses: buying a house is colossally stupid investment according to the investing textbook, because you are taking on a high degree of leverage and putting *more than* your net worth not only into a single asset class, but into a single structure on a single piece of land. What makes it sensible, sometimes, are the mortgage interest tax deduction (an extremely regressive subsidy) and the fact that in many places you may want to live there are few viable rental alternatives, so you have to buy. (That is basically the situation my family was in when we moved to Western Massachusetts nine years ago; our dog eliminated most of the rental options.)

Calculated Risk sums it up this way:

“There are probably advantages to society of a fairly high homeownership rate (as opposed to tax advantages to the individual) – perhaps homeownership creates a stronger bond to the community (more community involvement, awareness of crime, and more), and homeowners tend to keep up their properties (unless they have negative equity!). Shiller argues for other psychological benefits that are harder to quantify.

“There are negatives too; as an example, homeownership reduces geographic mobility, especially right now, and that makes it harder for some homeowners to move for employment reasons.

“And of course withdrawing all of the subsidies for housing would lead to plummeting house prices. So any unwinding of the housing subsidies, like government subsidized mortgage rates, would probably have to be reduced gradually.”

And here’s a short excerpt from 13 Bankers (from the draft manuscript, final version may differ):

“The ideology of homeownership has its roots in two sources. The first is the idea that homeownership is intrinsically good—it encourages individual responsibility, provides financial security, promotes community attachment, encourages people to take care



of property, and so on. . . . There may also be an element of truth to this idea; homeownership is generally thought to create positive externalities, since homeowners are on average more likely to devote effort to improving their communities. After reviewing other empirical studies and doing their own analyses, Edward Glaeser and Jesse Shapiro conclude:

[T]here is a limited body of evidence suggesting that homeownership creates positive spillovers for near neighbors. Homeowners do appear to be more active citizens. They vote more. They take better care of their homes. Houses that are surrounded by homeowners are worth a little more than houses that are surrounded by renters.

However, much of the positive effect of homeownership is due not to ownership itself, but to other factors that differentiate owners and renters. In another paper, Glaeser and Denise DiPasquale found that ‘almost one-half of the effect of homeownership disappeared when we controlled for the time that the person had lived in the home.’ William Rohe and Michael Stegman compared a sample of low-income homebuyers with similar low-income renters over time and found that the homebuyers were less likely to engage in informal neighboring, more likely to participate in block associations, and no more likely to participate in other types of community associations. Alyssa Katz concludes, in *Our Lot*, ‘scholars found that once they set aside the various traits that tend to determine whether someone chooses to own or rent one’s home, homeowners and tenants really aren’t that different.’

Before we rush back into subsidizing homeownership, we should figure out how valuable it really is to society as a whole.

## European Monetary Fund, Arriving Soon

Simon Johnson | 08 Mar 2010

*By Simon Johnson*

American officials are annoyed and deeply skeptical – not thinking that this will amount to anything. But the future has finally arrived – or perhaps its arrival has just been announced – in the form of the European Monetary Fund.

Such an institution would represent a major reshaping of global financial architecture, undermining the traditional basis of power for the United States – which would prefer to keep the International Monetary Fund (IMF) paramount. This is a good thing for the world, but also for the IMF and – believe it or not – for the US.

I laid out the case for regional Monetary Funds in BusinessWeek last year. The main point is that it makes sense to have a two tier system – at the regional level (or for countries grouped in some other way, like “emerging markets”) and at the global level, meaning the IMF.

The regional entities would be like your family doctor; the IMF runs the big hospital. If you go in with chest pains, your friendly physician will try to get you to change your diet, exercise more – and may also provide some relatively harmless pills. If you have a heart attack, however, you need to go to the emergency room – where their bedside manner may be less than ideal, but they can actually save your life.

How much capital would the EMF need in order to be credible? We’re obviously at an early stage, but as a first pass I suggest 250 billion euros in “cash equivalents” as capital and another 500 billion euros in the form of credit lines.

Will the EMF include only euro countries or cover the whole European Union? This probably depends on how involved France and Germany would like to be with Britain’s problems. My guess is that they’ll stay away, at least initially – so the “euro members only” sign will go up.

And, of course, there will be a lot of huffing and puffing on the European stage before the deal gets done. But they’ll get the EMF done, probably sooner than you think.

# They Saved the Big Banks But Kind Of Lost The Economy Doing It

Simon Johnson | 08 Mar 2010

*By Simon Johnson*

It would be easy to take relatively cheap shots at the portrayal of Tim Geithner — “we saved the economy but kind of lost the public doing it” — in the New Yorker, out today.

1. Mr. Geithner is quoted as saying, “Some on the left have fallen into a trap set by the Republicans, allowing voters to mistakenly think that the biggest part of the bank bailout had come under Obama rather Bush.” Mr. Geithner should know – as he spearheaded the saving of banks and other financial institutions under both Bush and Obama. In fact, it’s the continuation of George Bush’s policies by other means that really has erstwhile Obama supporters upset.
2. “I think there are some in the Democratic Party that think Tim and Larry are too conservative for them and that the President is too receptive to our advice.” Probably this is linked to the fact that Tim Geithner is not a Democrat.
3. Geithner also suggests that his critics compare government spending on different kinds of programs under President Obama: “By any measure, the Main Street stuff dwarfs the Wall Street stuff.” This insults our intelligence. Wall Street created a massive crisis and we consequently lost 8 million jobs; any responsible government would have tried hard to offset this level of damage with all available means. This includes fiscal measures that will end up increasing out privately held government debt, as a percent of GDP, by around 40 percentage points. It’s not the fiscal stimulus, broadly defined, that is Mr. Geithner’s problem – it’s the lack of accountability for the bankers and politicians who got us into this mess.

But the Geithner issues reflected here run much deeper. The New Yorker’s John Cassidy alludes to these but he may be too subtle. Here’s the less subtle version.

What exactly was the “Geithner stabilization plan” that frames the article – and is the basis for Secretary Geithner claiming to have saved anything? We are not really talking about the much vaunted but little used toxic asset/loan purchase program (the “PPIP”). “The plan” here

means essentially the stress tests designed by Treasury and run by the Fed – which brought some transparency to banks' balance sheets, but which also used a relatively benign "stress scenario" (watch commercial real estate, residential mortgages, and credit card losses now unfold).

The main feature of the plan, of course, was – following the stress tests – to communicate effectively that there was a government guarantee behind every major bank or quasi-bank in the United States. Of course this works in the short-term – investors like such guarantees. But there's a good reason we usually don't guarantee all financial institutions – or act happy when other countries do the same. Unconditional bailouts lead to trouble, encouraging reckless risk-taking and undermining responsible governance. You can't run any form of reasonable market system when some big players hold "get out of bankruptcy free" cards.

All crises end – this is actually Larry Summers's famous line. We avoided a Great Depression primarily because, compared with 1929-31, we have a government sector that is large relative to the economy – and which does not collapse when credit goes into freefall. What exactly did the Obama administration do in ending the crisis that a Clinton or McCain administration – or even Bush – would not have done? The most plausible answer is: Nothing.

Geithner insists, according to John Cassidy, that the Obama administration has "proposed the biggest regulatory overhaul in seventy-five years." This is the worst conceit. The sad and unfortunate truth is quite the opposite – because Mr. Geithner and his colleagues refused to seize the moment and didn't break the economic and political power of anyone who mattered, they have doomed us to re-run the same horrible credit loop as before. Legislation may tweak the details, but the regulation and control of systemic risk remains just as weak as before.

Is the Secretary of the Treasury completely unaware that our biggest banks have become even bigger? Why does he send out Herb Allison, long-time Merrill Lynch executive, and now an Assistant Secretary to say the US government has "no too big to fail bailout policy," when this is patently not true? Why has he reshaped the details of the "Volcker Rules" so they are now meaningless?

In truth, "too big to fail" is not the worst thing we should fear – our financial institutions are now on their way to becoming "too big to save". In 1929-30, even if the federal government had wanted to put in place a big fiscal stimulus, it could only have mounted something around 1 percent of GDP; the financial shock of that day was much bigger.

Perhaps monetary policy in the early 1930s could have done more, but today we have already pushed “quantitative easing” (meaning that the Federal Reserve buys junk) beyond recorded limits. How much do you want to gamble that, next time, the Fed can do enough to save the day without also creating massive collateral damage?

If we continue to allow banks to grow, as they have over the last 30 years – and did again through the latest boom-bailout-rescue cycle – we head towards a day when Mr. Geithner or his successor will try to save the financial system and will fail.

You might think that is a good thing and for sure it will bring on a big change in creditor attitudes and presumably much stronger regulation. But, just as in the 1930s, first we will have to dig out from under a lot of economic rubble – and we’ll lose a lot more than 8 million jobs.

# Way Too Big To Save

Simon Johnson | 09 Mar 2010

*By Simon Johnson*

Listening to US officials, talking to legal experts, and waiting for an intense Senate debate on financial reform to begin, you can easily form the impression that “too big to fail” adequately describes our most serious future systemic banking problems. It does not.

In September 2008, the large banks and quasi-banks at the heart of our financial system faced failure – and they were saved in the most immediate sense through actions taken by the Federal Reserve, but TARP (passed by Congress and run Treasury) also played a significant supporting role.

The Bush administration threw a small fiscal stimulus into the mix in early 2008, hoping to stave off recession; the Obama administration committed a much larger package at the start of 2009, aiming to prevent anything like a Second Great Depression. This fiscal policy response was in direct reaction to problems caused by the overextension and near failure of the financial system

Do not make the mistake – for example of Secretary Geithner, talking to the New Yorker – of thinking (or implying) that “saving the financial system” did not involve spending a lot of taxpayer money to support the real economy. Remember that if the economy crashes, asset prices fall, and banks’ problems become even more severe.

And try to avoid three further mistakes that are currently common.

1. “Because the government will lose little on its TARP capital injections into banks, the financial rescue ends up not being costly.” The true fiscal cost arising from our recent financial excesses is the increase in net government debt held by the private sector. This will likely amount to around 40 percentage points of GDP (i.e., relative to what the Congressional Budget Office’s baseline would have been otherwise). That’s a huge fiscal cost.
2. “Deficits don’t matter.” Eventually deficits matter – the fiscal costs incurred in saving our financial system mean higher taxes, relative to what would otherwise have been the case, for you and your children. This is not a call for precipitate fiscal austerity; that would be a disaster. But eventually we will get our fiscal house in order – and then don’t send to know for whom the tax bell tolls; it doesn’t doesn’t tinkle for Hank Paulson.

3. “We can save our financial system in the future, if we have the right tools – in the form of an appropriately designed resolution authority.”
  - Such an authority is impossible to achieve, because it would require cooperation between governments (known as a cross-border resolution authority) and that is impossible. (If you don’t know why, [here’s the explanation.](#))
  - Even if you had an authority that worked, e.g., for purely domestic financial entities, it is a leap of faith to assume it would not be compromised by our political process (again, [more background explanation here.](#))

Let’s take that leap of faith and say we use the favorite scheme of Gerald Corrigan from Goldman Sachs – he is widely promoting conservatorship as a transition to wind-down for large complex financial institutions – and let’s say that it “works”. Presumably this would mean something like the situation with AIG since September 2008, run somewhat more effectively –perhaps without the obnoxious bonuses. But would that really lower the fiscal costs of stabilizing the economy in the face of a major financial shock? And could we afford those fiscal costs?

Maybe. But the experience in Europe is definitely not encouraging. The Irish state is in serious trouble because major banks failed and were “saved”; let’s not even talk about Iceland (where banks assets peaked around 11-13 bigger than GDP, i.e., the size of the entire economy). And Switzerland faces serious risks – with banks that had peak assets over 8 times GDP – that the international community apparently just wants to ignore (perhaps because Switzerland is not in the G20 or the even the European Union).

In the UK, one bank (RBS) had assets that were more than GDP (1.25 times, by some estimates). Ask yourself this: if Citigroup, which was around \$2.5 trillion before the crisis (including the off-balance sheet commitments, let’s call that just under 20 percent of GDP) had actually been \$5 trillion, would our problems now be larger or smaller? What if Citigroup – or whoever becomes our biggest bank – reaches \$10 trillion or \$15 trillion in today’s dollars and then fails, how would you feel about that?

The administration proposes – in one part of the Volcker Rules – to cap the size of individual banks relative to total nominal liabilities of the financial system. That makes no sense at all – go talk to the Irish, the

British, the Swiss, or the Icelanders (when they become less furious and are willing to talk).

Big banks have a funding advantage – the implicit government guarantee makes it easier for them to raise capital and cheaper for them to borrow money. They will become larger. There are no economies of scale in banking above \$100 billion in total assets, but this is not about economics. It's the politics of becoming large in order to become even bigger – building your empire, and paying yourself and your people a lot more money (in the good times) and making it more likely your fiefdom survives (in bad times).

The biggest banks in some European countries today are already too big to save. Unless we take immediate and real action to reduce the power – and size – of our largest banks, we are heading in exactly the same direction.

Is the Senate finally ready to address this issue?



## It's Not That Easy

James Kwak | 09 Mar 2010

*By James Kwak*

[Elizabeth Green](#) (hat tip [Ezra Klein](#)) discusses the importance of teaching techniques. Here's one key passage (at least for people like me):

"The testing mandates in No Child Left Behind had generated a sea of data, and researchers were now able to parse student achievement in ways they never had before. A new generation of economists devised statistical methods to measure the 'value added' to a student's performance by almost every factor imaginable: class size versus per-pupil funding versus curriculum. When researchers ran the numbers in dozens of different studies, every factor under a school's control produced just a tiny impact, except for one: which teacher the student had been assigned to."

But who is a good teacher?

As Klein says, "There's a tendency to let the conversation over teachers become a conversation over replacing the current crop of assumed mediocrities with highly-educated professionals. This is particularly prevalent when the conversation is being had by highly-educated, high-achieving media and political professionals who are not actually teachers, but quietly think that if they were teachers, they'd be doing a bang-up job."

But, as Green writes, "Among the factors that do not predict whether a teacher will succeed: a graduate-school degree, a high score on the SAT, an extroverted personality, politeness, confidence, warmth, enthusiasm and having passed the teacher-certification exam on the first try."

This is an important point. When I was a management consultant, I was part of a team that worked with the administration of a city school district in an attempt to improve student performance. That was hubris enough. But to our credit, we didn't think we knew anything about teaching; we worked on issues like recruiting, data analysis (test results came back as a pile of floppy disks that no one ever even stuck into a computer), and setting up internal mentorship programs.

You see, by that point I already knew I wasn't a particularly good teacher. I had taught a music class of junior high school students and

two seminars of Berkeley undergraduates (which is a piece of cake compared to primary or secondary school), and once you do that it becomes obvious pretty quickly that the ability to absorb information, follow directions, work diligently on your own, meet a standardized set of expectations, and generally conform to an existing validation system will not get you far in a classroom. Of course, there are people from Ivy League schools who *also* have the skills necessary to be a good teacher (whatever those are), but that's an accident, not a result.

This should be obvious to anyone who's been to a top university, where most teachers range from the pretty good to the abysmally bad. Would you want them teaching your own kids in elementary school? I didn't think so.

Green's article is mainly about people who have been studying what those skills are and trying to train teachers in those skills, which is an interesting story.

## Banks Paying Customers to Take Overdraft Protection

James Kwak | 09 Mar 2010

*By James Kwak*

I saw a bank ad in the subway yesterday. Basically, it said:

1. If you set up direct deposit the bank will give you \$100.
2. If you set up overdraft protection the bank will give you \$25.
3. If you activate online bill pay the bank will give you \$25.

1 makes sense because (a) it gives the bank more cheap deposits, which are its raw material and (b) it increases your switching costs. 3 makes sense because it increases your switching costs; it may also cause you to give the bank more cheap deposits, since you need money in the account to cover your bills.

2 makes sense because . . . the bank expects to get more than \$25 in fees out of the average customer. A single overdraft fee typically costs more than \$25. Now people will be making an explicit decision: “I want the \$25 now because I don’t think I’ll ever pay an overdraft fee.” (To be fair, they might be thinking, “I already value overdraft protection at \$35 per occurrence, so the \$25 is just a bonus.” But I doubt many people think overdraft protection is worth \$35 per transaction when the typical transaction is a lot less than \$35.

There’s nothing illegal about this, and arguably it’s a smart business decision. It just makes things perfectly clear: the banks want those fees so much they are willing to pay you for them.

## Hank Paulson's Memoir: The Inside Job

Simon Johnson | 10 Mar 2010

*By Simon Johnson*

If you've read, are reading, or plan to read Andrew Ross Sorkin's *Too Big To Fail*, you also need to pick up a copy of Hank Paulson's memoir, *On The Brink*. Sorkin has the bankers' story, in sordid yet compelling detail, of how they received the most generous bailout in the world financial history during fall 2008 – and set us up for great problems to come. Paulson tells us why, when, and how exactly he let them get away with this.

Hank Paulson does not, of course, intend to be candid. As I review in detail on The New Republic's The Book site this morning, *On The Brink* is actually a masterpiece of misdirection and disinformation.

But still, he gives it all away – and if any details remain obscure, check them in Sorkin. Paulson honestly believes that the financial sector as constructed is productive, makes sense, and should continue to operate in roughly its current form.

Whether or not Paulson really understands the functioning of big banks in the US today is an interesting question – for example he never mentions how they treated customers during the boom, and there is not one word about the need for greater consumer protection moving forward. On the other hand, perhaps this omission tells us that he understands the game all too well – and is keen for it to continue.

He certainly did his best to make that happen.

## Good for Bank of America

James Kwak | 10 Mar 2010

I think. BofA is eliminating overdraft protection on debit card purchases. Most stories, like in the Times and the Journal, are headlining the elimination of overdraft fees, but it's not like you're getting overdrafts for free; actually they are eliminating overdrafts on debit card transactions altogether, starting this summer. (You will still be able to opt in to overdraft protection for debit card transactions, but only if you link your checking account to another account, so the money is being transferred from yourself. You will also be able to opt in to overdraft protection, with fees, for checks and automatic bill payments;\* and you will be able to decide on the spot if you want to pay a fee to overdraw your account from an ATM.)

So it sounds like rather than getting as many customers as possible to opt in to overdraft protection, BofA has decided to just kill it. I think this is a good thing. So does the Center for Responsible Lending. Of course, the policy does sort of undermine all the previous rhetoric about how overdraft protection was good for consumers and about customer choice. But let's just blame all that on Ken Lewis and assume that Brian Moynihan made the right choice (although Moynihan was head of consumer banking last year before becoming CEO).

Note also that BofA's stock price is doing just fine today, right in the middle of the pack of big banks. Maybe it's not true that banks have to take advantage of customers in order to make money. Yes, I understand that other fees may go up, or interest on deposits may go down, but if all this is doing is shifting costs from hidden fees to well-understood fees, that's good.

In another attempt to give a little credit, I'm looking at a Morgan Stanley research report from a couple weeks ago projecting tepid job growth during the recovery and recommending comprehensive health care reform, a refundable payroll tax credit, increased job training programs, and protocols for short sales or mortgage principal reduction, with a shout out to a community revitalization project. (Morgan Stanley, too, has a new CEO, former McKinsey director James Gorman.) I doubt Morgan Stanley is putting a lot of lobbying dollars behind these ideas, but still it's something.

\* Which makes sense to me; I wouldn't want my rent check to bounce, especially if my lease has a big fee for returned checks, but if I'm just

buying a cup of coffee I'd rather not get the coffee (or use cash) than pay \$35 for it.

## The Volcker Principles Move Closer To Practice

Simon Johnson | 10 Mar 2010

*By Simon Johnson*

Senators Merkley and Levin, with support from colleagues, are proposing legislation that would apply Paul Volcker's financial reform principles – actually, much more effectively than would the Treasury's specific proposals. ([Link to the bill's text.](#))

Volcker's original idea, as you may recall, is that financial institutions with government guarantees (implicit or explicit) should not be allowed to engage in reckless risk-taking. At least in part, that risk-taking takes the form of big banks committing their own capital in various kinds of gambles – whether or not they call this proprietary trading.

At the Senate Banking Committee hearing on this issue in early February, John Reed – former head of Citi – was adamant that a restriction on proprietary trading not only made sense, but was also long overdue. Gerald Corrigan of Goldman Sachs and Barry Zubrow of JP Morgan Chase expressed strong opposition, which suggests that Paul Volcker is onto something.

Of course, Goldman – among others – may seek to turn in its (recently acquired) banking license and go back to being “just an investment bank”, not subject to Fed regulation. But raising this possibility is a feature, not a bug of the Volcker-Merkley-Levin approach.

Think through this logic – which I argued out with a very senior ex-Goldman person this weekend.

1) If Goldman wants to be saved in the future, it needs to be subject to tough regulation – including this new restriction on proprietary trading.

2) If it doesn't want to be saved, that works for me. But there is no way that Goldman at its current scale – or anything near – could fail without causing enormous collateral damage (literally). Remember that there is no prospect of a “resolution authority” that will work for cross-border financial institutions, like Goldman (in private, top officials and leading bankers are willing to concede this).

3) So if Goldman wants to escape the Volcker Rule, it will have to become much smaller.

4) How small is open to discussion – but I would guess that this would be no larger than Goldman's size in 1998 (around \$270 billion in today's dollars). Given what we've learned about the limitations of everyone's

internal risk models, a sensible regulator would probably want to be even more conservative on size.

5) My assessment is that if Goldman were around \$100 billion in total assets, that would be a reasonable outcome – although we still have to worry about what they (or anyone) does in the “dark markets” of over-the-counter derivatives.

In any case, putting these issues openly on the table for Senate Banking – and on the floor of the entire Senate – is incredibly helpful. The Volcker-Merkley-Levin proposal is concrete and feasible, and a useful part of how we can move forward.



# The Speech For Which We Have Been Waiting

Simon Johnson | 11 Mar 2010

*By Simon Johnson*

For nearly two years now we have waited for a speech. We need a simple speech and a direct speech – most of all a political speech – about what exactly happened to our financial system, and therefore to our economy, and what we must do to make sure it can never happen again.

President George W. Bush apparently did not consider giving such a speech, and Secretary Paulson could never talk in this way. President Obama seemed, at some moments, close to making things clear – when he talked on Wall Street in September and, most notably, when he launched the Volcker Rules in January. But President Obama has always come up short on the prescriptive part – i.e., what we need to do – and his implementation people still move as if there were lead weights in their shoes.

Without a definitive speech, there is no political reference point, there is no convergence in the debate, and there is not even any clarity regarding what we should be arguing about. Without the right kind of speech, there are just many lobbyists working the corridors and a lot of backroom deals that most people do not understand – by design.

Tomorrow, hopefully, we should finally get the speech. Not – sadly – from the White House, not from anyone in the executive branch, and not even from within the Senate Banking Committee (although Senators Merkley and Levin took a big step today), but rather on the floor of the Senate.

On Thursday, Senator Ted Kaufman (D., DE) is due to deliver a strong blow to the overly powerful and unproductively mighty within our financial sector. He will say, according to what is now on his website,

1. Excessive deregulation allowed big finance to get out of control from the 1980s – but particularly during and after the 1990s. This led directly to the economic catastrophe in 2007-08.
2. We need to modernize and apply the same general principles that were behind the Glass-Steagall, i.e., separating “boring” but essential commercial banking (running payments, offering deposits-with-insurance, etc) from “risky” other forms of financial activity
3. We need size caps on the biggest banks in our financial system, preferably as a percent of GDP.

4. We should tighten capital requirements substantially.
5. And we must regulate derivatives more tightly – on this issue, he likes at least some of the steps being pushed by Gary Gensler at the CFTC.

To be sure, a speech is not legislation. And, as yet, this is just one senator's point of view. But because the administration so completely lost the narrative regarding what happened and why, there is now a free, open, and fair competition to explain what we need to do.

The lobbyists will still prevail on this round. But a big debate around the nature of our financial system is exactly what we need.

People who want to defend finance as-is now need come out of the woodwork. Senator Kaufman has set a very high standard. If you wish to oppose this agenda, speak clearly and in public about why we should not pursue exactly what the senator proposes.

If opponents of reform do not come out and argue the merits of their case, people will reasonably and increasingly infer that Senator Kaufman and his allies are right on all the substance.

Reform is blocked by a perverse combination of bankrupt ideology and deep-pocketed corporate interests. The only way to break through is to bring a lot of sunshine into the true affairs of finance – including by speeches like the one we will hear tomorrow.

## Business Economists on the CFPA

James Kwak | 11 Mar 2010

*By James Kwak*

The National Association for Business Economics does a semi-annual Economic Policy Survey of its members, who are primarily private-sector economists. The March 2010 survey isn't up on their site yet, but this is what it has to say about the Consumer Financial Protection Agency:

"A key point of discussion in Congressional deliberations on financial services regulatory reform has been the establishment of an independent agency focused on consumer financial protection. Fifty-four percent of survey respondents feel that creating such an agency would not impair safety and soundness regulation; 25 percent believed it would be detrimental. On a related issue, 43 percent of respondents indicate that a consumer financial protection agency would not impair access to credit while 39 percent believed it would."

The financial sector has been demanding that any new consumer protection agency be made subservient to the traditional safety and soundness regulators, and has also been threatening that greater regulation will make credit harder to come by. Apparently the business community—a group that is pretty skeptical about government, judging by some of the other survey responses—isn't buying it.

# The Coming Greek Debt Bubble

Simon Johnson | 11 Mar 2010

*By Peter Boone and Simon Johnson*

Bubbles are back as a topic of serious discussion, as they were before the financial crisis. The questions are: (1) can you spot bubbles, (2) can policymakers do anything to deflate them gently, and (3) can anyone make money when bubbles get out of control?

Our answers are: Spotting pure equity bubbles may sometimes be hard, but we can always see unsustainable finances supported by cheap credit. But policymakers will not act because all great (and dangerous) bubbles build their own political support; bubbles are invincible, until they collapse. A few investors can do well by betting against such bubbles, but it's harder than you might think because you have to get the timing right – and that's much more about luck than skill.

Bubbles are usually associated with runaway real estate prices (think Japan in the 1980s and the US more recently) or emerging market booms (parts of Asia in the 1990s and, some begin to argue, China today) or just the stock market gone mad (remember [pets.com](http://pets.com)?) But they are a much more general phenomenon – any time the actual market value for any asset diverges from a reasonable estimate of its “fundamental” value.

To think about this more specifically, consider the case of Greece today. It might seem odd to suggest there is a bubble in a country so evidently under financial pressure – and working hard to stave off collapse with the help of its neighbors – but the important thing about bubbles is: Don't listen to the “market color” (otherwise known as ex post rationalization), just look at the numbers.

By the end of 2011 Greece's debt will around 150% of GDP (the numbers here are based on the [2009 IMF Article IV assessment](#); we make some adjustments for the worsening economy and the restating of numbers since that time – for example, the fiscal deficit in 2009 will likely turn out to be about 8 percent, which is double what the IMF expected until recently). About 80 percent of this debt is foreign owned, and a large part of this is thought held by residents of France and Germany. Every 1 percentage point rise in interest rates means Greece needs to send an additional 1.2 percent of GDP abroad to those bondholders.

What if Greek interest rates rise to, say, 10% – a modest premium for a country which has the highest external public debt/GDP ratio in the world, which continues (under the so-called “austerity” program) to

refinance even the interest on that debt without actually paying a centime out of its own pocket, and which is struggling to establish any sustained backing from the rest of Europe? Greece would need to send at total of 12% of GDP abroad per year, once they rollover the existing stock of debt to these new rates (nearly half of Greek debt will roll over within 3 years).

This is simply impossible and unheard of for any long period of history. German reparation payments were 2.4 percent of GNP during 1925-32, and in the years immediately after 1982, the net transfer of resources from Latin America was 3.5 percent of GDP (a fifth of its export earnings). Neither of these were good experiences.

On top of all this Greece's debt, even under the IMF's mild assumptions, is on a non-convergent path even with the perceived "austerity" measures. Bubble math is easy. Hide all the names and just look at the numbers. If debt looks like it will explode as a percent of GDP, then a spectacular collapse is in the cards.

Seen in this comparative perspective, Greece is bankrupt today without a great deal more European assistance or without a much more drastic austerity program. Probably they need both.

Given there's a definite bubble in Greek debt, should we expect European politicians to help deflate this gradually? Definitely not – in fact, it is their misleading statements, supported in recent days (astonishingly) by the head of the International Monetary Fund, that keep the debt bubble going and set us all up for a greater crash later.

The French and Germans are apparently actually encouraging banks, pension funds, and individuals to buy these bonds – despite the fact senior politicians must surely know this is a Ponzi scheme, i.e., people can get out of Greek bonds only to the extent that new investors come in. At best, this does nothing more than postpone the crisis – in the business, it is known as "kicking the can down the road." At worst, it encourages less informed people (including perhaps pension funds) to buy bonds as smarter people (and big banks, surely) take the opportunity to exit.

While the French and German leadership makes a great spectacle of wanting to end speculation, in fact they are instead encouraging it. The hypocrisy is horrifying – Mr. Sarkozy and Ms. Merkel are helping realistic speculators make money on the backs of those who take seriously misleading statements by European politicians. This is irresponsible.

What should be done?

1. The Greeks and the Europeans must decide: do they want to keep the euro, or not.

2. If they want to keep the euro in Greece, the Greeks need to come up with realistic plan to start paying back debt soon. Any Greek plan will not be credible for the first few years, so the Europeans must finance the Greeks fully. This does not mean 20bn euros, it means making available around 180bn euros – i.e., the full amount of refinancing that Greece needs during this period.

3. If they don't want to keep the euro then they should start working now on a plan for Greece's withdrawal. The northern Europeans will need to bail out their own banks, because Greek debt must fall substantially in value – euro denominated debt will need to be written down substantially or converted to drachmas so it will be partially inflated away. The Greeks can convert local contracts, and deposits at banks, into drachma. It will be a very messy, difficult transition, but the more the debt bubble persists, the more attractive this becomes as a "least awful" solution.

Regardless of the decision on whether Greece will keep the drachma or give it up, the IMF should be brought in to conduct the monitoring and burden share. The Europeans' flagrant deception which we now observe – claiming the Greeks have made a big step and encouraging people to buy Greek bonds – proves they do not have the political capacity to be realistic about this situation. Who can now be believed on needs for Greek financial reform and what is truly a credible response? The only credible voice left with the capacity to act is the IMF – and even the Fund risks being compromised by the indiscreet statements of its top leadership as the bubble continues.

If such measures are not taken, we are clearly heading for a train wreck. The European politicians have been tested, and now we know the results: They are not careful, they are reckless.

*An edited version of this post appeared this morning on the NYT's Economix; it is used here with permission. If you would like to reproduce the entire post, please contact the New York Times.*

## Delaying Tactics On Display

**Simon Johnson** | 11 Mar 2010

*By Simon Johnson*

Senator Richard Shelby, ranking Republican on the Senate Banking Committee, today issued the following statement,

“Republicans remain open to finding common ground with Chairman Dodd. If my Democrat colleagues are interested in enacting reforms that protect American taxpayers, promote economic growth, and preserve the competitiveness of our financial markets, there is no reason that we cannot reach an agreement. As long as we remain focused on policy and not politics, an agreement is still very possible. The Republican members of the Committee stand united and ready to work with Chairman Dodd toward that goal.”

This is not a correct or accurate statement with regard to Republican intentions and their work behind the scenes. At this point, leading Senate Republicans are trying hard to prevent any kind of bill from moving forward. Their thinking is that there is not a lot of legislative time remaining in 2010 – a week or two lost now can derail completely opportunity for reform along any dimension.

No doubt we will see an increase in contributions by the financial sector in return for actions and statements that prevent effective consumer protection and that push derivatives regulation towards being even less effective.

# The German Finance Minister Needs To Confront Investment Banks

Simon Johnson | 12 Mar 2010

*By Simon Johnson*

Wolfgang Schauble, German finance minister, has a surprisingly sensible op ed in today's Financial Times. As we suggested yesterday, first the relevant Europeans should decide if they want to keep the euro - more precisely, who stays in and who leaves the currency union - then policy must be adjusted accordingly.

Mr Schauble is obviously correct that existing economic self-policing mechanisms are badly broken; the eurozone can only survive if there are effective monitors and appropriate penalties for fiscal and financial transgression. He is also right to fear that involving the IMF in Greece would necessarily give the Fund greater rights to kibbitz on European Central Bank monetary policy. Given the fear and loathing expressed for the IMF's "4 percent inflation solution" (or is it 6 percent?) in eurozone policy circles, you can see why this gives the Greek prime minister some bargaining power - the Germans will do whatever it takes to keep him away from the IMF in the short-term.

But Schauble misses (or holds back for now) on a potentially important point vis-a-vis investment banks.

He is tough, towards the end of his piece, on countries that "intentionally breached European economic and monetary law." But what about banks that aid and abet countries that are trying to break the rules?

Of course, governments can always massage their statistics unassisted. But when international banks help countries to disguise their true debt levels, through off-balance sheet transactions, what is the difference between that and what Merrill Lynch did for Enron regarding "Nigerian oil barges" (and more)?

Technically, Greece's (and potentially other country's) debt deals may not have broken any laws - because the international space for these transactions is so anarchic.

But Mr Schauble would be well within his rights to call for rogue investment banks - i.e., those that help break European rules in any fashion - to be banned from the highly lucrative market for European government new issues.



Of course, if he is afraid to do this because the banks in question have great market power and a fearsome reputation for sharp elbows and exacting revenge, perhaps Mr. Schauble should consider referring the broader investment banking market (including over-the-counter derivatives) to the relevant anti-monopoly authorities within the European Commission.

## Get Rid of Selection Sunday

James Kwak | 13 Mar 2010

*By James Kwak*

I have a lot to catch up on from this past week, like the Lehman report, but first I have more important business to attend to: the NCAA Division I men's college basketball tournament. Tomorrow is Selection Sunday, the day when sixty-five teams are selected for the tournament. Thirty-one conference champions automatically make the tournament, leaving thirty-four at-large spots handed out by a committee.

Today, the general approach, uncontested by virtually everyone, is that the committee selects what it thinks are the best teams, based on things like record, strength of schedule, and Ratings Percentage Index. Invariably it leads to controversy at the margin. There are also many people who think the system is biased in favor of mediocre teams from major conferences and against good (though not champion) teams from "mid-major" conferences.

I think there are two things wrong with this system. The first is that decisions are arbitrary at the margin, since they are made subjectively by comparing teams that cannot be directly compared. The second is that the process selects for the wrong thing: it selects teams that a committee thinks are good teams, rather than teams that deserve to be there because they win games that matter. To make an analogy, it's as if at the end of the baseball regular season a committee subjectively decided which were the best teams and let them into the playoffs, rather than taking the three division winners and the wild card team from each league. Yes, sometimes a team misses out on the playoffs despite having a better record than a team in the playoffs. But everyone knows what the rules are at the beginning of the year, and the point is to win your division (or the wild card), not simply to be a good team.

Instead, I think we should have the following system. The sixty-five slots should be distributed among the thirty-one conferences at the *beginning* of the season. Each conference has to state how it will allot its slots, also at the beginning of the season. (For example, a conference with three slots might give one to its tournament winner and two to the top two conference regular season teams, not counting the tournament winner.) The benefits are that every team would know exactly what it needs to do to get into the tournament, and there would be none of this annual controversy about who gets in and who doesn't. Regular season

games would be more meaningful, because everyone would know exactly what is at stake. Most importantly, tournament slots would go to teams that deserved them based on predefined, objective criteria, rather than teams that some coaches or a formula think are good.

How would you allot slots among conferences (currently the most controversial part of the whole system)? Each conference's allocation would be based on that conference's teams' performance in the tournament over the past several years, with recent performances weighted more highly. That is, if a conference typically gets three teams in but they do not do well in the tournament, it would risk losing one of its slots; if a conference typically gets three teams in but they do well, it could gain a slot. Over time, this would provide an objective way of determining how many slots each conference deserves, rather than the current arguments.

European soccer fans will realize that this is very similar to how slots in European club tournaments are allotted. Each country's number of slots in the Champions League in year  $x+1$  is determined before the beginning of year  $x$ , based on its teams' performances in European tournaments in prior years ( $x-1$ ,  $x-2$ , ...). Each country then decides how it wants to allocate those slots to its teams (based on performance in the regular season or in the domestic club tournament). So results in year  $x$  determine who plays in the Champions League in year  $x+1$ .

I guess some people might say this is unfair to, say, a great team in a one-slot conference that loses its conference tournament and won't be able to get an at-large bid. But I think my system is more fair, in a different sense — the sense that the requirements are set and known in advance, and not set subjectively after the fact by a committee.

Of course, I realize this has no chance of actually happening. I also think we should get rid of the BCS and simply not have a national football champion (this would restore the importance of conference championships, and leave us with more teams that feel like winners at the end of the season).

## What's Wrong with the Financial System in Eight Minutes

James Kwak | 13 Mar 2010

*By James Kwak*

Yesterday I was at a conference on “New Ideas for Limiting Bank Size,” hosted by the Fordham Law School Corporate Law Center. Simon gave the keynote speech over lunch. It’s actually the first time I’ve seen Simon give a presentation; we’re rarely in the same city at the same time.

I don’t have video of yesterday, but Mike Konczal linked to video of the presentations, including Simon’s, from last week’s all-star conference, “Make Markets Be Markets,” hosted by the Roosevelt Institute. You can see sneak previews of a few charts from 13 Bankers. You can also see eight-minute presentations by other luminaries such as Elizabeth Warren, Frank Partnoy, Joe Stiglitz, Rob Johnson, and Mike Greenberger.

## Underwater Second Liens

James Kwak | 14 Mar 2010

*By James Kwak*

Mike Konczal did some more great work earlier this week in [two posts](#) on the not-so-exciting topic of second liens. I don't have much in the way of new insight or analysis to provide, so let me just summarize.

A second lien is a second mortgage on a house. The second lien is junior to the first mortgage, meaning that if the borrower defaults and the first lender forecloses, the proceeds from the sale go to pay off the first mortgage; the second lien only gets paid back if the sale proceeds exceed the amount due on the first mortgage. You can see where this is heading.

Konczal's [first point](#) was that in the stress tests almost a year ago, the big four banks held \$477 billion of second liens and estimated that these assets were worth 81-87 cents on the dollar, so they would take \$68 billion in losses (under the "more adverse" scenario). Konczal estimated that they were instead worth 40-60 cents on the dollar, implying \$191-286 billion in losses.

After [Ryan Avent](#) questioned whether second liens were really in such bad shape, [Konczal came up with](#) this great chart from Amherst Securities:

Here's how to read it:

"The second to last column is the current loan-to-value, LTV, of the first lien. If it is greater than 100, it is underwater on the first mortgage by itself – the loan is greater than the value of the house. . . . The last column is the current CLTV, or combined-loan-to-value, which is the loan to value on all the debt of the property. . . . These are averages – the data sources aren't more specific."

So, for example, looking at the third line, the borrowers currently owe \$32.1 billion on first liens and \$6.0 billion on second liens. The LTV of the first mortgage is 105%, so the current value of the property is \$30.6 billion. In other words, the first mortgages are underwater, so the second liens are more or less worthless. (In practice, the second liens do have some small value, based on three things: (1) the hope that some borrowers will continue to make payments on second liens, even though

would do better (financially) to walk away; (2) option value, since housing prices could rise enough to make the second liens worth something; and (3) the possibility that the government will start paying off second lienholders to stop blocking short sales.)

So, looking down the chart, the problem seems obvious: the second liens are not worth very much, so the big banks are sitting on major unrealized losses. What's more, these second lienholders are blocking the principal writedowns that would make sense if there were only one lender involved (a single lender would often rather lower the principal and keep the borrower in the house making payments than foreclose), because those writedowns would wipe them out; but they don't want to foreclose, either, because that would also wipe them out. So instead we get "extend and pretend," and possibly servicers pressuring borrowers to pay off their second liens before their first liens.

Now, John Cassidy doubles down on his defense of the stress tests in a [blog post](#) that responds to Konczal. Cassidy says:

1. Banks have to write down loans that are delinquent for six months, and we haven't been seeing this in bulk.
2. "Most second mortgages aren't piggybacked on first mortgages that are underwater. . . . according to one official I spoke to, roughly thirty per cent of second mortgages are in this dire predicament."
3. "About one in five second mortgages aren't really second loans at all. Typically, they are home equity loans taken out by people who have fully paid off their first mortgages. . . . The monthly payments on such loans are usually relatively small—a few hundred dollars—and the likelihood of default is relatively small."

Not surprisingly, I'm not very convinced. As for 1, a lot of this is probably people who are underwater but are still making payments—but might decide to stop. Some of it is probably people who got trial modifications on their first mortgages, so they can still make payments on their second liens. (The servicers who are in charge of those modifications are often the same bank that hold second mortgages.)

As for 2, this seems to directly contradict Konczal's data, which I would trust over "one official I spoke to." Now, Konczal's data are originally from LoanPerformance; I believe they get their data from securitizations, but I don't know if that means that the second liens in their sample were securitized, or just that the first liens were securitized. (My guess is the latter.) It is likely that loans that went into securitizations were more

toxic than those that didn't. So if the banks in question are holding onto whole second liens where the primary mortgage was not securitized, then that could lean in Cassidy's favor. (If on the other hand they are holding onto ABS based on second liens, then that would lean against.)

As for 3, what we care about is not the number of second liens that are underwater, but the dollar amount. If a HELOC is small and hence easy to pay off, by the same token it is relatively insignificant to the question at hand. More importantly, as Konczal says in a comment to his second post, citing Amherst Securities: "many borrowers are not paying their 2nd, but most of those are unpaid 2nds are home equity lines of credit. The unpaid interest is simply added to the balance, and the loan technically remains current." So the default rate on HELOCs is artificially low.

## Are Regulators Trying to Make Bank of America Smaller?

James Kwak | 14 Mar 2010

*By James Kwak*

Last week, Charlie Gasparino reported at [Fox Business](#) that “Executives at Bank of America are coming under increasing pressure to downsize the firm as federal regulators seek to prevent large, cumbersome financial institutions from once again tanking the financial system as they did in the fall of 2008.” Later, he writes, “people close to the bank and government officials say government regulators have made it clear to BofA executives, including its new CEO, Brian Moynihan, that they want the bank to become much smaller.” The article refers to officials at Treasury and the Federal Reserve.

This would be interesting for a couple of reasons. One is that the administration and its allies in Congress are insisting that breaking up large financial institutions is not the answer to the too big to fail problem. If regulators are pressuring BofA to get smaller, that would seem to imply the opposite.

The other question is: why BofA and not, say, JPMorgan Chase, which is roughly the same size and has a similar profile? (I know BofA is bigger in retail and JPMorgan in wholesale, but basically both are big universal banks.) JPMorgan is in better shape right now and has the reputation for having superior management, but even if true those are not things you can rely on staying true indefinitely.

I’m not optimistic that much will come of this, but it’s interesting to think about. The most simple way to make BofA smaller would be to spin Merrill Lynch right back out again, but who (meaning equity investors) would buy it right now?



## Does Meaningful Financial Reform Have Any Chance?

Simon Johnson | 15 Mar 2010

*By Simon Johnson*

Senator Dodd's financial reform bill will be introduced in the Senate Banking Committee today. Unfortunately, on the major issue – too big to fail financial institutions that caused the 2008-09 crisis and that will likely trigger the next meltdown – there is nothing meaningful in the proposed legislation.

The lobbyists did their job a long time ago. Treasury sent up a weak set of proposals – Secretary Geithner apparently felt that to do otherwise would be just to seek “punishment” for past wrongdoings; there is too little concern at the top levels of this administration regarding what comes next. And Senator Dodd was pushed hard by various interests to weaken all potentially sensible proposals – including anything that would bring greater transparency and safety to the derivatives market. The Republicans have also demonstrated their mastery of delaying tactics; by emphasizing “procedural” issues, they have so far managed to conceal their fundamental opposition to real reform.

A few strong voices have emerged on the Democratic side – Senator Jeff Merkley (on the committee) stands out as someone who both understands the issues and can craft the right message. Let's hope he has a good week – if he can bring Senator Sherrod Brown with him, there is a chance that the legislation could move in the right direction. With all 10 Republicans on the 23 member committee steadfastly opposed to anything at all, any two Democratic senators have some negotiating power – as they can potentially hold up a bill.

And there is something pro-reform forces can reasonably work for at this stage.

If the bill that comes to the floor of the Senate actually contains some tough provisions – such as size limits (of any kind) on our largest banks, i.e., any version of the Volcker Rule, or a plausible consumer protection agency for financial products – then there is a broader fight worth having.

The key for Democrats is not just to have a fight, but rather to have a fight on clear principles that make sense to people outside of Capitol Hill. The Republicans want to fight on process – pursuing “biapartisanship” on this issue is a trap of the administration's own

design – and, failing that, they want to paint the Democrats as captives of the financial services industry.

What the Democrats need is something that will compel big banks to come out in force against them – to show their teeth and to pick off votes in an explicit manner.

These powerful forces, once mobilized and out in the open, will almost certainly stop anything from passing the Senate. But the debate will grab people's attention – and the ads, the lobbying, and the outrageous vote buying of Big Finance will help get across the bigger point: Big banks became only more powerful as a result of our most recent boom-bust-bailout sequence.

Reasonable reform has almost no chance of passing the Senate. But a well-crafted debate, drawn up on the right terms – and with the support of the president (although don't hold your breath on that) – could really help shift popular understanding of the issues.

This legislative cycle is almost lost already. But the broader process of moving the mainstream consensus around banking and its dangers has only just begun.

## Are Health Insurers Worth Bashing?

James Kwak | 15 Mar 2010

*This guest post was contributed by Andrzej Kuhl, a colleague of mine from a former life. Andrzej is a management consultant based in Montclair, New Jersey. His company, Kuhl Solutions, helps improve the efficiency and effectiveness of operations in financial sector companies.*

I am getting thoroughly frustrated with a facet of the health care debate – the singular focus on health insurers, with total disregard of other contributors to health care costs. Yes, I am in total agreement with the concept of providing health insurance to folks who currently cannot afford it, or who do not have access at any cost (because of pre-existing conditions). I also believe that the rate of increase of health spending needs to be significantly reduced. But, I do not believe that we can achieve any meaningful health spending reduction just by bashing or financially squeezing the health insurance companies.

Before I go any further, let me state that I do not own stocks or bonds issued by any company in health care, health insurance, or related industry segments. I have no health insurance clients. And none of my relatives or friends work for a health insurer.

Lately, it has become quite fashionable to cite egregious moves of various insurers and imply that if such moves were eliminated, the cost of health insurance (perhaps even health care) would be reduced. President Obama (and others) frequently cites Anthem's 25% rate increase in California. Kathleen Sebelius, the secretary of health and human services, according to a 3/9/10 NYT article (p. A18) has called health insurers' profits "*wildly excessive*". The same NYT article quotes Senator Diane Feinstein: "*I believe, fundamentally, that all medical insurance should be not-for-profit.*" Also in the Times, Robert B. Reich, a former labor secretary and a Professor of Public Policy at the University of California at Berkeley, writes in a 2/24/10 article, "*. . . because big health insurers are making boatloads of money. America's five largest health insurers made a total profit of \$12.2 billion last year [2009].*"

So, let's try to answer two questions:

1. What do we achieve by trimming "*wildly excessive*" profits of health insurers?
2. Are these profits "*wildly excessive*," when compared to other industry segments?

It was actually Professor Reich's article that initially sent me looking for information, as his billions of dollars of health insurance profits were a meaningless factoid unless one placed them in the context of the actual revenues of the five top insurers. In order to have a solid foundation of comparative data, I reached for the 2009 Fortune 500 rankings (based on 2008 financials), easily accessible on the CNN web site. The Fortune numbers are somewhat different from Professor Reich's data, as they represent prior year results, but one also gets an unbiased comparison with other industries.

In 2008, the top 10 health insurers combined had \$264 billion in revenue and profits of \$8 billion. A little bit of arithmetic shows that the combined profit margin for this group was 3.1%. The highest profitability among the top 10 was reported by Aetna: 4.5%.

Thus, even if we regulate all health insurers to eliminate all their profits, as Senator Feinstein would have it, we can only reduce health insurance spending by 3.1%. So much for the boatloads of savings that Professor Reich talks about – the impact on our health insurance costs would be minimal.

Now, one might say that turning the health insurers into true non-profits would also free up the sums currently spent on sales and marketing. While this is mostly true, the sums saved still do not present a panacea for rising health care costs. A spot check of annual reports shows that the cost of sales for top 10 insurers is about 3-4%.

So, let's move to the second question. We cannot make a dent in health insurance spending, but perhaps it's worth bashing health insurers because their 3.1% profits are obscenely high when compared to other industries.

Well, it is not quite so. The same source shows that top 10 pharmaceutical companies reported 18.4% profits in 2008 (\$49 billion profit on \$269 billion revenue). Interestingly, the top pharmaceutical company – Johnson & Johnson – earned (\$13 billion) more than all top 10 health insurers taken together. Other "pharma" players were not far behind. Both #2 (Pfizer) and #4 (Merck) earned \$8 billion each, or as much as the 10 top health insurers taken together. The highest profit was 37.7%, reported by Gilead Sciences.

Similarly, the top 10 companies in the "medical products and equipment" segment had 10% profit (\$6 billion profit on \$64 billion revenue). It actually would have been closer to 15%, if not for the disastrous year experienced by the #3 player, Boston Scientific.

Once you internalize these numbers, it becomes clear that any meaningful reduction of health insurance costs can only be achieved by reducing the underlying health care cost structure. We cannot hold health insurance rates flat if we allow pharmaceutical companies to average 18.4% profits and to grow their revenues. That would be akin to freezing the price of cars while allowing price increases for steel, rubber, etc.

As I was thinking about what health insurance profitability would not be deemed “wildly excessive,” I also looked at other areas of the economy where we spend significant amounts of money without complaining too loudly. Interestingly, the top 10 Computer Software companies reported 23.6% profits on average. The top 10 in Household and Personal Products (ranging from hammers and batteries to toothpaste and lipsticks) averaged 11.2%. Even the regulated Gas & Electric Utilities earned 10.3%.

So, the 3.1% profitability that health insurers reported in 2008 pales in comparison with other industries and, even if totally eliminated, will not make a significant dent in our spending. Any meaningful cost reduction will require a disciplined approach to modify the way we consume and price health services, ranging from doctor and hospital fees to pricing of medications, equipment, and supplies.

## A Few Words on Lehman

James Kwak | 15 Mar 2010

I have a trip coming up at the end of this week, and in the meantime I have two articles to write, and a section of a legal thingy, and I'm sick, and my daughter's sick, so I won't be able to do justice to the Lehman report issued by the bankruptcy examiner on Thursday. So here are just some moderately quick thoughts.

- The report is great reading (I've read some sections of it). You can get the whole thing [here](#), in nine separate PDF files. If you want to get an overview of the report, Volume I has a comprehensive table of contents. Note that the TOC is thirty-eight pages long. Like many legal documents, some of the section heads are written as sentences, so you can sort of "read" the TOC. In particular, you can see from the TOC which parties might be the subject of legal causes of action. (Note that the "Volume" numbers have nothing to do with the logical organization of the report; they only reflect how it was chopped into nine PDFs.)
- The topic that has gotten the most press attention (here's the [main Times story](#), for example) is "Repo 105," which takes up all 300+ pages of Volume III. A repo agreement is a short-term sale of securities (collateral) with a promise to buy it back later at a slightly higher price — in other words, a collateralized loan. With Repo 105, it seems that Lehman would sell the securities before the end of a quarter and promise to buy them back early the next quarter, *and book the transaction as a sale, not a loan*. The effect was to reduce the apparent amount of Lehman's leverage at the end of the quarter — which is when the published balance sheet snapshot is taken. Here's the [Alphaville summary](#) if you want more. In other words, Lehman was cooking the books.
- If this sounds like Nigerian barges (Enron) to you, you're not the only one. The examiner's report itself (section III.A.4(j)(4)(b)) finds that Dick Fuld and his CFOs Chris O'Meara and Erin Callan were "grossly negligent" and that claims for breach of fiduciary duty could be made against all of them. [Peter Henning](#) talks about the potential for criminal charges.
- One theme that has been sounded is that Lehman was an outlier (a "bad apple," a recent president might have said), and there is an internal email in which a Lehman exec says that the other banks were *not* engaging in Repo 105-type transactions. Should we

believe this? naked capitalism has a tip from a reader saying that other banks (or at least one other bank) were using total return swaps to dress up their balance sheets. I find it plausible that some banks were *not* cooking the books because, like Goldman, they had shorted the real estate market enough to protect themselves. But Lehman was not the only bank that was in deep trouble in 2007-2008.

- Frank Partnoy says that alongside the fraud of Volume III, the incompetence of Volume II is perhaps even more troubling. His post has some good examples. Here's Partnoy's conclusion: "The Repo 105 section of the Lehman report shows that Lehman's balance sheet was fiction. That was bad. The Valuation section shows that Lehman's approach to valuing assets and liabilities was seriously flawed. That is worse. For a levered trading firm, to not understand your economic position is to sign your own death warrant."
- Volume IV (Section III.A.5, "Secured Lenders") discusses actions by Lehman's counterparties and whether they are guilty of murdering Lehman. For the most part, the report says that the various banks involved did nothing wrong, or at least nothing wrong that rises to the level of legal action. There is one exception, though. In section III.A.5(f), pages 1220-24, the examiner finds that JPMorgan Chase *may* have violated an implied covenant of good faith and fair dealing by demanding too much collateral from Lehman shortly before its collapse. There is some evidence (p. 1216) that JPMorgan was overcollateralized and knew it was overcollateralized. ("All we need to talk this morning about the calls Leh has been making about having us return a portion of our excess collateral to their holding co. We have taken the position that there is no excess but they have not yet accepted that. We should make sure our statements are consistent since I am sure you will soon get called as well.") But there is also evidence (p. 1217) that JPMorgan was behaving reasonably enough.
- But Yves Smith discusses the most interesting question, which only gets sixty pages in Volume IV (Section III.A.6, "Government"): what was the government doing? The examiner uncovers more evidence that the SEC was not up to the task of monitoring Lehman (similar to the earlier report by the SEC's own inspector general, finding that the SEC did not effectively oversee Bear Stearns). Here's a juicy paragraph that various people have

seized on (pp. 1488-89): “After March 2008 when the SEC and FRBNY began on-site daily monitoring of Lehman, the SEC deferred to the FRBNY to devise more rigorous stress-testing scenarios to test Lehman’s ability to withstand a run or potential run on the bank. The FRBNY developed two new stress scenarios: ‘Bear Stearns’ and ‘Bear Stearns Light.’ Lehman failed both tests. The FRBNY then developed a new set of assumptions for an additional round of stress tests, which Lehman also failed. However, Lehman ran stress tests of its own, modeled on similar assumptions, and passed. It does not appear that any agency required any action of Lehman in response to the results of the stress testing.” The general message is that the SEC did not take any real action to address the problems at Lehman; the Fed and the New York Fed must have been aware of them, but acted primarily as a lender, not as a regulator, deferring to the SEC.

- There is also a discussion on pages 1500-01 of a plan to create a Maiden Lane-type entity to hold \$60 billion of toxic Lehman assets, financed by \$5 billion from Lehman and a \$55 billion non-recourse loan from the Fed. This seems to contradict the line often stated by Bernanke, Geithner, and Paulson that the Fed could not have rescued Lehman in a manner similar to Bear (backstopping enough of the toxic assets to make Lehman a palatable acquisition for someone else). It is possible, however, that the Fed decided that Lehman’s assets were too toxic for such a maneuver; the report doesn’t say why the Fed decided not to go ahead with the plan.

Overall, I’m surprised by how little interest the report has gotten in the media, given its depth and the surprising nature of some of its findings. Of the blogs I read, naked capitalism is giving it the most coverage and discussion.

**Update:** Andrew Ross Sorkin, the prince of the mainstream media when it comes to Wall Street, is getting on the case. In Dealbook, he points out that regulators saw everything that was going on at Lehman during the crucial months:

“There’s a lot riding on the government’s oversight of these accounting shenanigans. If Lehman Brothers executives are sued civilly or prosecuted criminally, they may actually have a powerful defense: a raft of government officials from the S.E.C. and Fed vetted virtually everything they did. . . .



“The problems at Lehman raise even larger questions about the vigilance of the S.E.C. and Fed in overseeing the other Wall Street banks as well.”

To Sorkin’s credit, he also cites Yves Smith for asking the question before he did.

## Senator Kaufman: Fraud Still At The Heart Of Wall Street

Simon Johnson | 15 Mar 2010

*By Simon Johnson*

Last week, Senator Ted Kaufman (D., DE) gave a devastating speech in the Senate on “too big to fail” and all it entails. A long public silence from our political class was broken – and to great effect. Today’s Dodd reform proposals stand in pale comparison to the principles outlined by Senator Kaufman. And yes, DE stands for Delaware – corporate America has finally decided that its largest financial offspring are way out of line and must be reined in.

Today, the Senator has gone one better, putting many private criticisms of the financial sector – the kind you hear whispered with conviction on the Upper East Side and in Midtown – firmly and articulately on the public record in a Senate floor speech to be delivered (this link is to the press release; the speech is in a pdf attached to that – **update: direct link to speech**, which will be given tomorrow). He pulls no punches:

“fraud and potential criminal conduct were at the heart of the financial crisis”

He goes after Lehman – with its infamous Repo 105 – as well as the other entities potentially implicated in those transactions, including Ernst and Young (Lehman’s auditors). This is the low hanging fruit – but have you heard even a squeak from the White House or anyone else in the country’s putative leadership on this issue?

And then he goes for the twin jugulars of Wall Street as it still stands: The idea that we saved something, at great expense in 2008-09, that was actually worth saving; and Goldman Sachs.

“[T]his is not about retribution. This is about addressing the continuum of behavior that took place – some of it fraudulent and illegal – and in the process addressing what Wall Street and the legal and regulatory system underlying its behavior have become.”

Our system has long been imperfect, but it used to work much better:

“When crimes happened in the past (as in the case of Enron, when aided and abetted by, among others, Merrill Lynch, and not prevented by the supposed gatekeepers at Arthur Andersen), there were criminal convictions.”

Here’s the most intriguing bit – he challenges the moral authority of those who think they are doing “God’s work” in finance.

“If we uncover bad behavior that was nonetheless lawful, or that we cannot prove to be unlawful (as may be exemplified by the recent reports of actions by Goldman Sachs with respect to the debt of Greece), then we should review our legal rules in the US and perhaps change them so that certain misleading behavior cannot go unpunished again.”

But that’s not all – he actually lays out the parameters of what should be, if our legal institutions still functioned, a compelling case against Goldman.

“Following these transactions, Goldman Sachs and other investment banks underwrote billions of Euros in bonds for Greece. The questions being raised include whether some of these bond offering documents disclosed the true nature of these swaps to investors, and, if not, whether the failure to do so was material.”

“These bonds were issued under Greek law, and there is nothing necessarily illegal about not disclosing this information to bond investors in Europe. At least some of these bonds, however, were likely sold to American investors, so they may therefore still be subject to applicable U.S. securities law. While “qualified institutional buyers” (QIBs) in the U.S. are able to purchase bonds (like the ones issued by Greece) and other securities not registered with the SEC under Securities Act of 1933, the sale of these bonds would still be governed by other requirements of U.S. law. Specifically, they presumably would be subject to the prohibition against the sale of securities to U.S. investors while deliberately withholding material adverse information.”

This sounds like a potential violation of Rule 10b-5 – you are simply not allowed to sell securities in the United States while withholding

material adverse information, i.e., what any reasonable investor would want to know (like the true indebtedness of a government, when you are being pitched on a sovereign debt issue). In fact, such actions are frequently considered serious fraud – at least when the people involved aren't as powerful as Goldman Sachs.

And after having just spent a considerable amount of time with Hank Paulson's memoir, *On the Brink*, I have to ask: What did Hank Paulson know (as CEO of Goldman at the time), and when did he know it – regarding the potential misleading sale of Greek government securities to US entities? Goldman reportedly netted \$300m from its Greek "swaps" and presumably more from managing subsequent Greek debt issues; this is the same order of magnitude as Mr. Paulson's payout when he left Goldman (around \$500m, tax-free).

Who is Senator Kaufman and what power does he have in this situation? He is not a member of the Senate Banking Committee – and if you think this is a regulatory issue, that reduces the weight of his voice.

But he is a member of the Senate Judiciary Committee and we are discussing here potential crimes – or what should be crimes if the legal system still functioned. He was also a cosponsor of the Fraud Enforcement and Recovery Act (FERA) – which was right on topic – and is an experienced Capitol Hill insider who has studied these issues long and hard. He has also worked closely, over many years, with Vice President Biden.

The tide is turning, but not primarily through the actions of Senator Dodd and his Banking colleagues. Rather the biggest and most unruly players in our financial system have behaved in such an egregious manner that they will be brought down by the law – either that, or they will further bring down the law.

## Enron and Merrill, Greece and Goldman

Simon Johnson | 16 Mar 2010

*By Simon Johnson*

Did big banks break the law during our recent global debt-fuelled boom? The usual answer is: no – they just took advantage of loopholes and captured regulators. The world's biggest banks are widely supposed to be too sophisticated to be tripped up by the legal system.

But is this really true? The new Valukas report on Lehman suggests there are grounds for civil action, i.e., people can sue for damages. News reports give no indication of potential criminal charges, but this may change soon. The hiding of Lehman's true debt levels – through the so-called "Repo 105" structure – is strikingly reminiscent of how Enron's balance sheet was disguised through fake asset "sales" (as Senator Kaufman now points out).

And, of course, the people who ended up facing criminal charges and – in some prominent cases – going to jail, included not only Enron executives, but also responsible bankers from Merrill Lynch (see The Smartest Guys in the Room, Chapter 13). Arthur Andersen, Enron's accountant, was also effectively broken by the scandal. It is a serious crime for professional advisers and financiers to assist in securities fraud.

The failure of Lehman therefore opens a can of worms for close and potentially productive examination in coming weeks. But so does the issue of Greek government debt in April 2002.

According to an offering circular dated 22 April 2002, The Hellenic Republic offered 3.5 billion of bonds, due 22 October 2022, that "will bear interest from, and including, 24 April 2002 at the rate of 5.90 per cent". The joint lead managers include, from the international side, Goldman Sachs, Morgan Stanley, and Deutsche Bank.

Goldman has, of course, admitted it helped manage down reported Greek debt levels through off-balance sheet transactions in 2000 and 2001. Gerald Corrigan, a senior Goldman executive, speaking before the UK Treasury Select Committee recently, said that the reduction in reported Greek debt was "small but significant"; in fact, it was around 1.6 percentage points of GDP, which is not small.

(From the Bloomberg story on Corrigan's testimony: "The transactions reduced the country's deficit by 0.14 percentage points and lowered its debt as a proportion of gross domestic product to 103.7 percent from

105.3 percent, according to Goldman Sachs.” See also the less forthright Goldman Sachs statement on the company’s website.)

The April 2002 offering circular did not disclose the debt swaps. There may have been other documentation available to investors that did reveal true Greek debt numbers – and perhaps these were discussed in the relevant road shows. We are not here taking a position on what was and was not disclosed; this is a matter for a proper official investigation. We also do not know what the other involved banks knew and when they knew it.

If it were the case that Greece’s true debt levels were known and not disclosed by the investment bankers involved, any reasonable investor – or the sovereign debt experts with whom we have discussed this matter – would regard this as withholding adverse material information.

Gerald Corrigan, who is also former head of the New York Fed, argued that Goldman did “nothing inappropriate” – but he was referring to the off-balance transactions of 2000-2001. He has not yet spoken in public about the potential nondisclosure of material information in April 2002 (and perhaps at other dates after the Greece-Goldman swaps).

As Senator Kaufman points out in his latest speech, there is nothing necessarily illegal about any non-disclosure in Europe – these bonds were issued under Greek law. And these bonds were definitely not registered under the US Securities Act of 1933; this is clear in the prospectus.

However, if any of these bonds were sold in the US to “qualified institutional buyers” (QIBs) under rule 144A (an exemption to registration requirements under the 1933 Securities Act), there is a potential legal issue (here I’m just rewording what Senator Kaufman said). Rule 10b-5, under the 1934 Securities Exchange Act, definitely applies to securities sold under 144A – i.e., selling securities to anyone in the United States while deliberately withholding material adverse information is not allowed.

Some people in the market think that around 10 percent of this Greek debt issue was sold under Rule 144A to QIBs; such sales may or may not have been handled by Goldman. Again, this can only be determined by an official investigation – hopefully the Senate Judiciary Committee, on which Senator Kaufman serves, can take this up.

Goldman could be sued by investors who feel they were misled in this fashion – although, realistically, it would only happen if the bonds default; the cost of annoying Goldman otherwise is too high. Most likely

Goldman will reach an amicable agreement with any aggrieved parties. (Merrill's problem was that Enron failed – as with Lehman, this launched an extensive set of enquiries).

Whether the SEC or any attorney general (e.g., in New York) will take any action, civil or criminal, remains to be seen. It is obviously hard – for legal and political reasons – to take on and prevail against one of the world's biggest and most powerful banks. Too big to fail banks are also too big to sue successfully – unless they collapse (which is why we keep coming back to Lehman). (Among other things, in the Greece case there would likely be a big argument about whether the Statute of Limitations applies and to whom.)

In any case, it is time to close the loophole that effectively allows deception regarding securities sold into the United States. Rule 144A should be abolished — US residents (individuals and institutions) should only be allowed to buy securities that are properly registered with the SEC.

If other countries are willing to have their people buy fraudulent securities, that is their problem. This is no longer acceptable in the United States.

## A Whiff of Repo 105

James Kwak | 16 Mar 2010

*The following guest post was contributed by Jennifer S. Taub, a Lecturer and Coordinator of the Business Law Program within the Isenberg School of Management at the University of Massachusetts, Amherst ([SSRN page here](#)). Previously, she was an Associate General Counsel for Fidelity Investments in Boston and Assistant Vice President for the Fidelity Fixed Income Funds.*

To the uninitiated, the term ‘Repo 105’ evokes the name of a basic finance course or perhaps an expensive perfume. However, the broader implication of Lehman’s corrupt accounting strategy is neither simple nor does it pass the smell test.

While hiding \$50 billion off balance sheet is nothing to sneeze at, ‘Repo 105’ may be an unfortunate distraction. We should focus our attention on a far more mainstream and dangerous use of repurchase agreements backed by securitized bonds to *grow* balance sheets. This practice, enabled by a 2005 legal change, directly destabilized the financial sector and led to the ultimate credit crisis of 2008. In other words, the approximately \$7-10 trillion repo financing market created what Gary Gorton and Andrew Metrick call the “run on repo” or what Gerald Epstein describes as a “run on the banking system by the banking system.”

A repurchase agreement or “repo” is a two-part arrangement. The seller (cash borrower) agrees to sell securities at a slight discount to a buyer (cash lender). Under that same agreement, that original seller agrees to buy them back at a future date at a higher price. The securities are known as “collateral.” The discount is known as the margin or a “haircut.” The ratio between the increase in price and the original price is known as the rate.

With ‘Repo 105,’ Lehman, according to volume III of the examiner’s report, acting as a seller (cash borrower), treated \$50 billion in repo transactions as sales instead of financing transactions. Lehman did not reveal to investors that it was doing so. In contrast, standard practice was to record these transactions on balance sheet by increasing both cash (assets on the left side) and collateralized financing (liabilities on the right side). Thus a properly recorded repo transaction results in both a larger balance sheet and also higher leverage ratios.

Not wanting to issue more equity to boost leverage ratios, Lehman instead chose a cosmetic solution. With ‘Repo 105,” near the end of a



reporting period, Lehman treated the transactions as sales and used the cash proceeds to pay down other liabilities. This made the firm appear to have a smaller balance sheet and less leverage than it truly had. The transactions were called 'Repo 105' and 'Repo 108' in reference to the size of the haircut. In other words, for 'Repo 105' transactions, Lehman would provide collateral purportedly worth 105% of the amount of cash it received.

As we blame the bad apples at Lehman, we fail to see how recent legal changes brought about bigger problems in the repo markets and how instead of reversing these missteps, the law may instead amplify it. Indeed, as discussed below, language in the Dodd draft released Monday, March 15<sup>th</sup> suggests we have not learned some basic lessons.

Lehman's 'Repo 105' was blessed under UK law by a perhaps questionable legal opinion from the Linklaters law firm. However, the transformation of the broader repo market, from one backed by largely US Treasury and agency collateral to one backed by securitized bonds, was enabled by US law. As detailed below, changes to the Bankruptcy Code, through BAPCPA in 2005, expanded this vital financing market and made it far more unstable.

Repos have been called the "oil in the industry of Wall Street" largely because, prior to the global financial crisis, investment banks financed up to 50% of their assets in the repo markets. One bank analyst notes that "repo markets are only one channel linking the "shadow banking" sector to the broader economy." Given its size and importance, the repo market is surprisingly obscure.

At its peak in 2007, the repo market in the US was estimated to be between \$7 trillion to \$10 trillion. Outstanding US repos today are estimated to be in the \$3.8 trillion to \$4.27 trillion range. Buyers (cash lenders) in the repo market are typically institutional investors like pension funds and mutual funds who need a liquid but relatively safe place to invest cash for the short term, often overnight. Buyers also include broker-dealers and banks that need securities to cover short positions. Sellers (cash borrowers) in the repo market are often broker-dealers and banks who use these arrangements to finance asset purchases and to leverage. With a matched-book repo, a dealer will act as buyer, bringing in collateral, then will with the same collateral act as a seller with a different counterparty, profiting on the spread.

Gorton observes that "The current panic centered on the repo market, which suffered a run when lenders [whom he likens to depositors during

Depression-era banking runs] required increasing haircuts, due to concerns about the value and liquidity of the collateral should the counterparty 'bank' fail." These repo lenders also refused to rollover existing repos. Both actions created "massive deleveraging . . . resulting in the banking system being insolvent."

To be clear, though, the run did not appear to be on the whole repo market, but rather on repo agreements backed by non-government collateral—in particular, repo backed by securitized bonds. In other words, repo backed by Treasuries did not experience a run. Cash-rich buyers sought out opportunities to loan against US Treasuries. Perhaps the buyers did not trust the valuation of the securitized debt, including mortgage backed securities. Thus, it follows that haircuts got larger for non-government collateral – the amount of collateral posted for a loan escalated. And ultimately, some collateral simply could not be used at all. The average haircut on structured debt, according to Gorton and Metrick went from zero in early 2007, to 10% by March of 2008. In September 2008, the rate shot up from 25% to 45%.

Questions have arisen as to the wisdom in allowing a vast range of collateral to back repos. Some argue that the market needs more than Treasuries and agencies because of the demand for Treasury and agency bonds as collateral for derivatives trades. This, of course invites the question of whether a side-benefit to shrinking the derivatives market would be to make Treasuries more available for repo. For example, approximately 80% of the approximately \$28 trillion credit default swap market (once closer to \$57 trillion) is said to be contracts where the insured party did not own the underlying reference credit. Shrinking the derivatives market might decrease the demand for Treasuries, thus decreasing the reliance on riskier, less secure repo financing that is prone to dry up when asset values decline.

What enabled the tremendous expansion of outstanding repos were amendments to the US Bankruptcy Code in 2005 through BAPCPA. Prior to these amendments, it was clear that if a debtor filed for bankruptcy, a lender who had Treasury collateral, agency, commercial paper and certain bankers acceptances could hold onto that collateral. Unlike most parties with contracts with a debtor that have not been completed, the repo lender would not be subject to the automatic stay.

However, prior to the amendments (notwithstanding another possible provision to rely upon in the Code), it was not clear what would happen to the repo lender who had other types of collateral, in particular

mortgage-related securities. BAPCPA made certain to protect these creditors who took in a new list of collateral types, including mortgage loans and interests in mortgage-related securities. It also was expanded to include foreign sovereign debt. These new types would also be free from the automatic stay. In addition interest paid on the repo would not be clawed back as a preference. This was affirmed in a subsequent court decision in early 2008 in the wake of the subprime crisis. Outstanding repos grew from \$4.9 trillion in 2004 to \$5.6 trillion in 2005 and ultimately to \$7 trillion by first quarter 2009.

Repo contributed heavily to the maturity mismatch and interconnectedness at the center of the crisis. Maturity mismatch was at the heart of crisis as corroborated by investment bank leaders. For example, in the January FCIC hearings, Goldman Sachs CEO, Lloyd Blankfein noted that:

“Certainly, enhanced capital requirements in general will reduce systemic risk. But we should not overlook liquidity. If a significant portion of an institution’s assets are impaired and illiquid and its funding is relying on short-term borrowing, low leverage will not be much comfort.”

Little has been done to address the maturity mismatch associated with the use of short-term (overnight) repo funding by banks to finance longer term assets. Moreover, the recently announced SEC rules affecting mutual funds will only send more cash into repurchase agreements. This will likely increase now that the SEC is requiring taxable money market funds to hold 10% of total assets in instruments which the fund has the right to receive cash with one day’s notice and 30% that give the fund the right to receive cash in five business days.

Finally, language in the Senate financial reform bill, the “Restoring Financial Stability Act of 2010,” (see page 203, beginning on line 12) introduced on March 15 by Senator Dodd, appears to expand even further the rights of repo buyers (lenders) if a financial company is under an FDIC receivership. In the words of President Bush, “Wall Street got drunk.” The bartenders pouring the drinks were repo market buyers (lenders). We should impose some liability on these bartenders for the leverage and liquidity problems to which they contributed. However, instead, it appears we are going in the opposite direction.

## Mario Draghi and Goldman Sachs, Again

Simon Johnson | 17 Mar 2010

*By Simon Johnson*

In its previous response to us, the the Bank of Italy pointed out that Mario Draghi (its current governor) did not join the management of Goldman Sachs until 2002 – hence he was not there when the controversial Greek “debt swaps” were arranged.

We agree that he joined Goldman only in January 2002 (this was in our original post). But the latest revelations regarding the Goldman-Greece relationship (on the Senate floor, no less) clearly indicate that Goldman was a lead manager of Greek debt issues in spring 2002, i.e., when Mr. Draghi was on board.

This raises three entirely reasonable and straightforward questions.

1. Was Mr. Draghi involved in the Goldman-Greece relationship? Sources indicate that this was very much part of his set of responsibilities, but this may be disputed.
2. If Mr. Draghi was involved in marketing Greek debt, did he at that time know the true Greek debt numbers – i.e., was he aware of the “debt swap” arrangement? Perhaps his Goldman colleagues concealed that information from him.
3. And when/if Mr. Draghi became aware of the inherent misrepresentation involved this transaction, did he take steps to fully informed investors (and any relevant regulatory bodies)? Again, it is entirely possible he learned of this matter only recently and from the newspapers.

Keep in mind that Mr. Draghi is still regarded as a leading contender to become president of the European Central Bank – the most important policymaking institution in the eurozone. It will be hard for anyone to advance his candidacy without clear and public answers to these questions.

## We Are All “Yappers Who Don’t Know Anything”

James Kwak | 17 Mar 2010

*By James Kwak*

According to ex-Lehman executives interviewed by [Max Abelson](#) (hat tip [Felix Salmon](#)). To summarize, they say that using borderline-legal transactions to massage your balance sheet at the end of a quarter is completely normal, everyone does it, \$50 billion is no big deal anyway, only “nonprofessionals” would even notice, and the only reason the bankruptcy examiner made so much noise about it was to justify the fee for his work. (Abelson does point out that, according to internal Lehman emails cited in the report, there were Lehman executives at the time who were worried about what they were doing and did not think it was standard practice.)

The unnamed sources may be right about one thing: it may be true that everyone was doing it, or at least something similar for the same purpose. One source said, “If Valukas went into Goldman Sachs, what do you think the report would look like? This would be a fairly tale compared to that.” In other words, Lehman simply had the misfortune to not be bailed out by the U.S. government, leaving its finances open for all the world to see.

But it’s not clear to me how this makes the situation any better. So instead of just Lehman cooking the books, the point is that *everyone* is cooking the books? And they are cooking the books more, so \$50 billion is only chump change? Even if it’s legal, this seems like a problem. (And I don’t think you can resort to the argument that sophisticated money managers knew what was going on and weren’t worried, so therefore the rest of us shouldn’t worry either; if sophisticated money managers were so good, then the collapse of Lehman wouldn’t have had systemic consequences.)

The Lehman report could be interpreted two ways. One is that Lehman was a case of bad apples. If you had asked me before about fraud and the financial crisis, I would have said that there was probably some fraud around the edges, but it was unnecessary—the crisis could have been produced by entirely legal behavior, and probably was. But exposure of accounting fraud (or near-fraud) at Lehman could have the unfortunate effect of causing people to focus on fraud as an explanation of the crisis, implicitly letting all the other banks (and regulators) off the hook.

The other interpretation is that if Lehman was doing it, then probably everyone was, or at least a lot of people were. Maybe Goldman didn't need to because it was shorting the housing market, but any other bank that was about to get blown up by its own toxic assets would have a strong incentive to push the limits of legal accounting as far as it could to buy itself a little more time.

The implication of Abelson's sources is that the latter interpretation is correct.

## Richard Posner Has Another Book?

James Kwak | 18 Mar 2010

*By James Kwak*

Fresh on the heels of *A Failure of Capitalism*, the new title is *A Crisis of Capitalist Democracy*. Maybe the next will be *The Downfall of Everything Good in the World*.

I haven't read it. *BusinessWeek* has a curious review (curiously titled "Slapped by the Invisible Hand" . . . which is the title of Gary Gorton's book). Here's the funny bit:

"Posner, who less than a year ago began his dissection of the crisis of 2008 with *A Failure of Capitalism* (Harvard, May 2009), has enormous credibility when he casts a skeptical eye on Wall Street. As an influential free-market thinker, he helped shape the antiregulatory ideology that inspired so much public policy since 1980. Belatedly he admits error."

Wait a sec. Being *wrong* for decades gives you "enormous credibility"? So if, say, James Inhofe were to admit that he is wrong and that climate change is occurring, then he would suddenly be an important voice on what to do about it? If James Gilleran (former director of the OTS) were to write a book about the problems with lax regulation and what needs to change, would you buy it?

This particular marketing angle is probably not Posner's fault, but he should still be embarrassed by it. Here's what he said in an interview:

"1. The general wisdom is that you switched from a *laissez-faire* approach to one that accepts the role of government regulation to stabilize the economy. What has changed your view of capitalism?

"This has really been only since September 2008—since the crisis, when I took another look at everything. There was erroneous monetary policy and much too low interest rates, which encouraged excessive borrowing. And then there's this very lax regulation of financial institutions, which reflects a failure to recognize that the financial industry is very unstable and requires regulation. It is connected to everything in the economy—consumers and businesses alike depend on it—so when it collapses, you've got real problems. A lot of people failed

to see that. The financial backbone of the economy is a corner of capitalism that requires more intrusive and careful regulations than a lot of economists thought. Because of the centrality of credit in a capitalist economy, a capitalist economy is inherently unstable. This instability can become catastrophic unless you have something in place to mitigate it. Unfortunately no one seems to have very many great ideas on how to do this.”

A lot of people failed to see that? More intrusive and careful regulations than a lot of economists thought? No one seems to have very many great ideas? Posner wants to pretend that this was some deep, dark mystery, like relativity; it’s hard to criticize physicists before Einstein for not figuring out relativity. But it wasn’t. There has been a debate over free market principles and their applicability to the real world (including finance) for decades (see the books by Justin Fox, John Cassidy, or Joseph Stiglitz for more), and Posner was on the wrong side of that debate. He wasn’t a Newtonian physicist who wasn’t quite as smart as Einstein. He was part of the problem, and he made it worse.

Readers may wonder why I have it in for Richard Posner, of all people. The reason is that I am in law school, and as a result I have had to read multiple opinions in which Posner smugly reflects on the production of efficient equilibria through the operation of incentives, without bothering to sully his logic with the faintest scrap of empirical evidence. Posner is also in part responsible for the hegemony of the law-and-economics theory of vast areas of the law, which I described on an exam this way:

“What you end up with is judges who know little about economics making uninformed guesses about economic tradeoffs, and then being upheld by appeals courts who (a) know just as little about economics and (b) wouldn’t find reversible error in any case.”



## Could The US Become Another Ireland?

Simon Johnson | 18 Mar 2010

*By Peter Boone and Simon Johnson*

As Greece acts in an intransigent manner, refusing to act decisively despite deep fiscal difficulties, the financial markets look on Ireland all the more favorably. Ireland is seen as the poster child for prudent fiscal adjustment among the weaker eurozone countries.

The Irish economy is in serious trouble. Irish GDP declined 7.3% as of third quarter 2009 compared with third quarter 2008. Exports were down 9% year-on-year in December. House prices continue to fall. While stuck in the eurozone, Ireland's exchange rate cannot move relative to its major trading partners – it thus cannot improve competitiveness without drastic private sector wage cuts. Yet investors are so pleased with the country that its bond yields imply just a one percent greater annual chance of default than Germany over the next five years.

Ireland's perceived "success" is partly due to its draconian fiscal cuts. The government has cut take home pay of public sector workers by roughly 20% since 2008 through lower wages, higher taxes, and increased pension payments. As the head of the National Treasury Management Agency John Corrigan proudly advised the Greeks (and everyone else): "You have to talk the talk and walk the walk".

So is Ireland truly a model for Greece and other potential problems in Europe and elsewhere? Definitely not – but it does provide a cautionary tale regarding what could go wrong for all of us.

Ireland's difficulties arose because of a massive property boom financed by cheap credit from Irish banks. Ireland's three main banks built up 2.5 times the GDP in loans and investments by 2008; these are big banks (relative to the economy) that pushed the frontier in terms of reckless lending. The banks got the upside and then came the global crash in fall 2008: property prices fell over 50%, construction and development stopped, and people started defaulting on loans. Today roughly 1/3 of the loans on the balance sheets of banks are non-performing or "under surveillance"; that's an astonishing 80 percent of GDP, in terms of potentially bad debts.

The government responded to this with what is now regarded – rather disconcertingly – as "standard" policies. They guaranteed all the liabilities of banks and then began injecting government funds. The government is now starting a new phase – it is planning to buy the most

worthless assets from banks and pay them government bonds in return. Ministers have also promised to recapitalize banks that need more capital. The ultimate result of this exercise is obvious: one way or another, the government will have converted the liabilities of private banks into debts of the sovereign (i.e., Irish taxpayers).

Ireland, until 2009, seemed like a fiscally prudent nation. Successive governments had paid down the national debt to such an extent that total debt to GDP was only 25% at end 2008 – among industrialized countries, this was one of the lowest.

But the Irish state was also carrying a large off-balance sheet liability, in the form of three huge banks that were seriously out of control. When the crash came, the scale and nature of the bank bailouts meant that all this changed. Even with their now famous public wage cuts, the government budget deficit will be an eye-popping 12.5% of GDP in 2010.

The government is gambling that GDP growth will recover to over 4% per year starting 2012 — and they still plan further major expenditure cutting and revenue increasing measures each year until 2013, in order to bring the deficit back to 3% of GDP by that date. The latest round of bank bailouts (swapping bad debts for government bonds) dramatically exacerbates the fiscal problem. The government will in essence be issuing 1/3 of GDP in government debts for distressed bank assets which may have no intrinsic value. The government debt/GDP ratio of Ireland will be over 100% by end 2011 once we include this debt.

Ireland had more prudent choices. They could have avoided taking on private bank debts by forcing the creditors of these banks to share the burden – and this is now what some sensible voices within the main opposition party have called for. However, a strong lobby of real estate developers, the investors who bought the bank bonds, and politicians with links to the failed developments (and their bankers), have managed to ensure that taxpayers rather than creditors will pay. The government plan is – with good reason – highly unpopular, but the coalition of interests in its favor is strong enough to ensure that it will proceed.

Investors may wish to remain pleased today with Ireland, but Ireland's "austerity" – reflecting an unwillingness to make creditors pay for their past mistakes – hardly seems a good lesson for Greece, the eurozone, or anyone else.

Countries – like the US – with large banks that are prone to reckless risk taking should limit the size of those banks relative to the economy

and force them to hold a lot more capital. If you thought the “too big to fail” issues of 2008-09 were bad in the US, wait until our biggest banks become even bigger – today the big six banks in the US have assets over 60 percent of GDP; there is no reason why they won’t increase towards Irish scale.

When Irish-type banks fail, you have a dramatic and unpleasant choice. Either takeover the banks’ debts – and create a very real burden on taxpayers and a drag on growth. Or restructure these debts – forcing creditors to take a hit. If the banks are bigger, more powerful politically, and better connected in the corridors of power, you will find the creditors’ potential losses more fully shifted onto the shoulders of taxpayers.

*An edited version of this post appeared this morning on the NYT’s Economix; it is used here with permission. If you would like to reproduce the entire post, please contact the New York Times.*

## Freefall

James Kwak | 18 Mar 2010

*By James Kwak*

I only recently finished reading *Freefall*,\* Joseph Stiglitz's book, so this review comes about two months late. It took me a while partly because I was busy, but partly because I didn't feel a lot of dramatic tension . . . since I agreed with almost everything he said.

Unlike most crisis books, *Freefall* is relatively short on what caused the financial crisis. The historical background is mainly laid out in Chapter 1, "The Making of a Crisis," although there is discussion of specific problems in later chapters, such as Chapter 4, "The Mortgage Scam." Mainly this book is about the response to the crisis, what was wrong with it, and what needs to change in the future.

Reading the book gave me a familiar feeling. You see, our book (*13 Bankers*) is largely about historical and political background—our Chapter 1 begins with Thomas Jefferson and Alexander Hamilton, although most of the book is about the period since 1980—so there is relatively little topical overlap between the two. But where they do overlap, particularly in the discussion of government responses to the crisis, I had the sensation that we were saying much the same thing.

In Chapter 5, "The Great American Robbery" (by which Stiglitz is referring specifically to the bailouts of 2008-2009), Stiglitz replays the debate of a year ago over *how* to rescue the financial system—a debate that pitted Stiglitz, Paul Krugman, Nouriel Roubini, and others, who favored government takeovers of sick banks, against Tim Geithner, who convinced the rest of the administration that it was better to support the banks in their existing form. Stiglitz is actually considerably more acerbic than Simon and I:

"Almost surely, the failures of the Bush and Obama administrations will rank among the most costly mistakes of any modern democratic government at any time" (p. 110).

"The Bush and Obama administrations had made a simple mistake . . . that the banks' pursuit of their own self-interest was necessarily coincident with what was in the national interest. . . .

"Nor did the deregulators and the politicians who stood behind them want to admit the failure of the economic doctrines that

they had advocated. They wanted to return to the world as it was before 2007” (p. 111).

“Just as Bush used 9/11 and the fears of terrorism to justify so much of what he did, the Treasury under both Bush and Obama used 9/15—the day that Lehman collapsed—and the fears of another meltdown as a tool to extract as much as possible for the banks and the bankers that had brought the world to the brink of economic ruin” (pp. 118-19).

The problem, Stiglitz argues, is that even if the financial system was stabilized, the way it was stabilized has made the recovery “slower and more difficult than need be” (p. 135), and has also helped undermine public confidence in government, exacerbating the dysfunctions of our political system.

When it comes to financial regulation, Stiglitz is also highly critical, although here he aims his guns more at the financial sector than at the administration (the chapter is titled “Avarice Triumphs over Prudence”). Because of the threat of regulatory capture, he favors simple rules: “the regulations have to be simple and transparent, and the regulatory structure has to be designed to prevent excessive influence from the financial markets” (p. 149).

And this is what gave me that comforting feeling. I generally feel insecure about what I write. Having a Nobel Prize winner saying many of the same things makes me feel a little more confident. That doesn’t mean that what we wrote is true (many Nobel Prize winners have said many things that were false), but it reduces the chances that we wrote something that is stupid.

*Freefall* has a considerably wider scope than just finance, however. Stiglitz also discusses other issues such as the role of government in the economy, global imbalances, and the faults of the economics profession. So I would consider it more than just a crisis book; it’s Stiglitz’s blueprint for what needs to change in the world.

\* I got a free copy from the publisher.

## A Little Book News

James Kwak | 18 Mar 2010

*By James Kwak*

So, we have a book that goes on sale a week from Tuesday (although you can pre-order it now). We created another blog for book-specific news, in order to avoid cluttering this blog with too much book stuff. But we are going to provide occasional updates (like this one) here with a few highlights.

In the last week, we got a friendly review by Arnold Kling, we learned that the books do actually exist, and we put up a page with some in-person events in case you're wondering if we look like our photos. We also put up our first factual correction, having to do with the 10 percent cap on deposits. Note that we are interested in correcting errors of *fact* — we put a lot of effort into getting the facts right, including hiring our own professional fact-checkers (that's another blog post for another time). If you think we made an error of interpretation (or an error of theory) . . . well, we're happy to think about it, but don't expect a correction.

## Away Message

**James Kwak** | 19 Mar 2010

*By James Kwak*

I'll be traveling and probably not blogging (hopefully not using a computer at all) until next weekend (March 27 or 28). Simon will be around, though. Bye.

## Metternich With A Blackberry

Simon Johnson | 20 Mar 2010

*By Simon Johnson*

If watching the twists and turns in European politics – “should we bailout Greece?”, “should we bring in the IMF?”, “should the Greeks go directly to the IMF, cutting out the EU?”, etc - has your head spinning and reminds you of overly complicated and opaque episodes from the history books, then you have actually caught the main point. European power structures and alliances webs are being remade before your eyes.

Is this all random – just the collision of disparate national interests with no coherent plans on any side? Or are there some strong, deliberate, and very personal hands at work guiding key pieces into place?

Prince Metternich worked long and hard to manoeuvre countries and people before and after 1815, cynically and cleverly building a system of interlocking interests that suited him – and his employer, the Austrian/Habsburg Emperor. Is there a modern Metternich now at work? Most definitely: Yes.

If you’ve followed the twists and turns of the global dimensions that emerged from the financial crisis of 2008-09, you’ll know that the IMF was transformed from an organization that was being euthanized by the G7 to an important element in the G20’s back-up financing for emerging markets (with the most dramatic turn of events in the run-up to the London summit in April 2009) – and definitely part of what helped stabilize confidence around the world.

This sequence of events created a great opportunity for the IMF’s Managing Director, Dominique Strauss-Kahn (known to friends and foe alike as DSK), to relaunch his political career in France – he previously ran for the presidency but could not secure the socialist nomination, and taking the IMF job seemed to everyone (including President Sarkozy, who lined it up) as akin to being marooned on a desert island. But DSK is – like Metternich – a master of the opportunity, a man who knows when to move and when to stand still, and someone always working a network of long-cultivated European political contacts (including socialists in Greece).

DSK’s objective is to cast himself as the savior of Europe - undoubtedly this would play well with the French electorate – and of course he is greatly aided by the serious underlying problems within the eurozone in general and for Greece in particular ([back story is here](#)). As



he controls the IMF absolutely and completely, he has access to the best global economic intelligence as well as the means to make large loans to countries at low interest rates. He must of course bring others with him, but this is not hard – the White House, for example, could not care less about who ends up running Europe and at what growth rate, as long as it does not blow up.

President Sarkozy's aim at this point is naturally to keep DSK and the IMF as far from the action as possible. But Sarkozy has three problems.

1. The Greeks have learned fast how to play international economic diplomacy – threatening to bring in the IMF in a way that would embarrass the European leadership. Without question, they are being coached by people close to DSK. Watch the masters at work.
2. German voters really do not want to be involved in anything that looks or feels like a bailout. A low interest rate loan to Greece would really upset them. The Germans could do something off-balance sheet (i.e., get their banks to provide cheap credit to Greece), but the German banking system is already so ridden with governance problems and hidden bailouts that this is not appealing to the elite.
3. If you provide financing to Greece at anything other than low interest rates, the numbers simply do not make sense (we take you through this here.) Merrill Lynch pushed back against us this week with a report arguing that if Greece can borrow again at the level of German interest rates, everything would be fine – this is, of course, a legitimate point, but a cursory look at Merrill's relatively sanguine research reports on Greece prior to the crisis (and also at their assessments of global credit markets prior to fall 2008) does not suggest that the "don't worry, be happy" scenario is high probability.

Sarkozy is also an expert tactician and he is not finished yet – entering the weekend, the ball is definitely in his court. Expect further "let's do it without the IMF" options to surface now – in particular, Sarkozy will try to scare the Germans regarding how the European Central Bank (ECB) would be undermined if the IMF enters the arena. Sarkozy can also commit, behind the scenes, to support Axel Weber for the ECB presidency – something top Germans want more than they want almost anything else in the world.

And what if Strauss-Kahn prevails and the IMF makes a loan to Greece, would this save the day? Not necessarily – remember that DSK's

goal is to just to look good until he leaves the Fund to run more openly for the presidency, which is probably no more 12 months from now. His incentive would be to put in place a relatively small program of funding that does not ask Greece to do too much up front; if this explodes later (as seems likely), that would not be his problem.

Sensible program design and dealing with the core underlying issues in a reasonable manner – including confronting the looming issue of “debt restructuring” – is not likely. This is French electoral politics after all.

## Volcker And Bernanke: So Close And Yet So Far

Simon Johnson | 22 Mar 2010

*By Simon Johnson*

In case you were wondering, Paul Volcker is still pressing hard for the Senate (and Congress, at the end of the day) to adopt some version of both “Volcker Rules”. It’s an uphill struggle – the proposed ban on proprietary trading (i.e., excessive risk-taking by government-backed banks) is holding on by its fingernails in the Dodd bill and the prospective cap on bank size is completely missing. But Mr. Volcker does not give up so easily – expect a firm yet polite diplomatic offensive from his side (although the extent of White House support remains unclear), including some hallmark tough public statements. It’s all or nothing now for both Volcker and the rest of us.

But at the same time as the legislative prospects look bleak (although not impossible), we should recognize that Paul Volcker has already won important adherents to his general philosophy on big banks, including – most amazingly of late – Ben Bernanke, at least in part. In a speech Saturday, Bernanke was blunt,

“It is unconscionable that the fate of the world economy should be so closely tied to the fortunes of a relatively small number of giant financial firms. If we achieve nothing else in the wake of the crisis, we must ensure that we never again face such a situation [like fall 2008].”

You may dismiss this as empty rhetoric, but there is a definite shift in emphasis here for Bernanke – months of pressure from the outside, the clear drop in prestige of the Fed on Capitol Hill, and the pressure from Paul Volcker is definitely having an impact.

Bernanke finally understands the “doom loop” – in fact, he provides a nice succinct summary:

“The costs to all of us of having firms deemed too big to fail were stunningly evident during the days in which the financial system teetered near collapse. But the existence of too-big-to-fail firms also imposes heavy costs on our financial system even in more placid times. Perhaps most important, if a firm is publicly perceived as too big, or interconnected, or systemically critical for the authorities to permit its failure, its creditors and

counterparties have less incentive to evaluate the quality of the firm's business model, its management, and its risk-taking behavior. As a result, such firms face limited market discipline, allowing them to obtain funding on better terms than the quality or riskiness of their business would merit and giving them incentives to take on excessive risks."

He also expands on an important, related point – that the presence of "too big to fail" is simply unfair and really should be opposed by all clear thinking businesspeople who don't run massive banks (aside: someone kindly point this out to the Chamber of Commerce – they are undermining their people),

"Having institutions that are too big to fail also creates competitive inequities that may prevent our most productive and innovative firms from prospering. In an environment of fair competition, smaller firms should have a chance to outperform larger companies. By the same token, firms that do not make the grade should exit, freeing up resources for other uses.... In short, to have a competitive, vital, and innovative financial system in which market discipline encourages efficiency and controls risk, including risks to the system as a whole, we have to end the too-big-to-fail problem once and for all."

Bernanke now endorses the first Volcker Rule, "Some proposals have been made to limit the scope and activities of financial institutions, and I think a number of those ideas are worth careful consideration. Certainly, supervisors should be empowered to limit the involvement of firms in inappropriately risky activities."

But he is still hampered by the illusion that there is any evidence we need megabanks in their current form – let alone in their likely, much larger, future form. Let me be blunt here, as the legislative agenda presses itself upon us.

I've discussed this issue – in public where possible and in private when there was no other option – with top finance experts, leading lawyers, preeminent bankers (including from TBTF institutions), and our country's most prominent policymakers. And I have testified on this question before Congress, including to the Joint Economic Committee, the House Financial Services Committee, and – most recently – the

Senate Banking Committee, where leading spokesmen for big banks were also present.

Mr. Bernanke, with all due respect: there is simply no evidence to support the assertion that, “our technologically sophisticated and globalized economy will still need large, complex, and internationally active financial firms to meet the needs of multinational firms, to facilitate international flows of goods and capital, and to take advantage of economies of scale and scope,” at least if this implies – as it appeared to on Saturday – we need banks at or close to their current size.

We can settle this in a simple and professional manner. Ask your staff to contact me with the evidence – or, if you prefer, simply have a Fed governor provide the compelling facts in a speech and/or have a staff member put out the technical details in a working paper.

There is no compelling case for today’s massive banks, yet the downside to having institutions with their current incentives and beliefs is clear and awful. Think hard: what has so far changed for the better in the system that brought us to the brink of global collapse in September 2008? In this context, Mr. Bernanke’s three part proposal for dealing with these huge banks should leave us all quite queasy:

1. He wants tighter regulation. Fine, but what happens next time there is “let it all go free” president again – a Reagan or a Bush? Regulation cannot be the answer; there must be legislation.
2. Improving the clearing and settlement of derivatives is also fine. But why not also make the banks involved smaller – given that a bankruptcy of a future megabank could easily involve millions of open derivative positions? This would also make complete sense as a complementary measure – unless you think society would lose greatly from the absence of megabanks. Again, show us the evidence.
3. A resolution authority is not a bad idea. But everyone involved in rescuing the big banks with unconditional guarantees in spring 2009 insists on one point – if they had run any kind of FDIC-type resolution process, this would have been prohibitively expensive to the taxpayer. You simply cannot have this both ways – either resolution/bankruptcy was a real option in early 2009 (as we argued) or it was not (as Mr. Geithner argues), but in that case the resolution authority (and also living wills, by the way) would change precisely nothing.

Mr. Bernanke needs to face some unpleasant realities. Because of the various actions – some unavoidable and some not – it took in saving Too Big To Fail financial institutions during 2008-09, the Federal Reserve is now looked up with grave suspicion by a growing number of people on Capitol Hill.

The cherished independence of the Fed is now called into question – and losing this could end up being a huge consequence of the irresponsible behavior and effective blackmail exercised by megabanks – who still say, implicitly, “bail us all out, personally and generously, or the world economy will suffer”.

Mr. Volcker sees all this and wants to move preemptively to cap the size of our largest banks. Mr. Bernanke has one last window in which to follow suit (e.g., lobbying Barney Frank could still be effective). In a month it could be too late – the legislative cards are now being dealt.

Mr. Bernanke is a brilliant academic and, at this stage, a most experienced policymaker. What is holding him back?

## Bloomberg Reviews “13 Bankers”

Simon Johnson | 22 Mar 2010

*By Simon Johnson*

Bloomberg’s reviewer, James Pressley, emphasizes our historical parallels between big banks today and big business more generally at the start of the twentieth century. In 1900, the forces supporting the status quo seemed unassailable, yet real reform proved possible – making the economic system both fairer and more productive. We can rein in huge banks today – but only if our political leadership is willing to take the most powerful people on the planet.

“Though **Jamie Dimon** won’t like this (any more than **John D. Rockefeller** did), incremental regulatory changes and populist rhetoric about “banksters” are getting us nowhere. It’s time for practical solutions. This might be a place to start.”

The full review [is here](#).

## The Administration Starts to Fight On Banking, But For What?

Simon Johnson | 23 Mar 2010

*By Simon Johnson*

Speaking to the American Enterprise Institute, Treasury Secretary Tim Geithner had some good lines yesterday,

“The magnitude of the financial shock [in fall 2008] was in some ways greater than that which caused the Great Depression. The damage has been catastrophic, causing more damage to the livelihoods and economic security of Americans and, in particular, the middle class, than any financial crisis in three generations.”

Like Ben Bernanke, Mr. Geithner also finally grasps at least the broad contours of the doom loop,

“For three decades, the American financial system produced a significant financial crisis every three to five years. Each major financial shock forced policy actions mostly by the Fed to lower interest rates and to provide liquidity to contain the resulting damage. The apparent success of those actions in limiting the depth and duration of recessions led to greater confidence and greater risk taking. “

But then he falters.

In part, the Secretary of the Treasury seems hung up on the final cost of TARP

“Reasonably conservative estimates suggest that the direct fiscal costs of this crisis will ultimately be less than 1 percent of GDP, a fraction of the over half a trillion dollars estimated by CBO and OMB just a year ago.”

But everyone agrees that the true fiscal cost of the crisis (and bailout) of 2008-09 is the increase in net government debt held by the private sector – closer to 40 percent of GDP (i.e., nowhere near 1 percent of GDP).



This matters because, by low-balling the true fiscal cost, Treasury plays down the need for the toughest safeguards in the future.

If the cost was one percent of GDP, then perhaps the measures they have in mind would be enough. But if the cost is a doubling of our national debt – pushing us close to the danger level on that dimension – then we should think about what we need quite differently.

We agree completely with the administration's approach – actually, with Elizabeth Warren's approach – to consumer protection. (We make this clear in 13 Bankers.)

But the sticking point is “too big to fail.” Mr. Geithner's Treasury (and Senator Dodd's bill) continue to rely on the complete illusion that a resolution authority (i.e., an augmented bankruptcy process for banks) based on US law will do anything to help manage the failure of a large cross-border financial institution. It simply will not.

I've discussed this specific point with top technical people from G20 countries, as well as with our most experienced international bankers and leading lawyers who specialize on this very issue. They agree that a US resolution authority would be a complete illusion – at least with regard to the big cross-border banks.

Mr. Geithner gave a good speech yesterday. But someone needs to give another speech, walking us through – step-by-step – how exactly this resolution authority would have prevented the cross-border chaos that followed the collapse of Lehman in September 2008. Break it down into pieces and expand on every legal nicety.

Then tell us how the resolution authority will work for Citigroup in 5 or 7 years, when that bank will likely be twice its current size.

And the next speech might also explain why Mr. Geithner no longer mentions the Volcker Rules – there was nothing about proprietary trading and nothing about even prospective caps on bank size. Have they been withdrawn? What exactly happened on the way to the Senate?

Mr. Geithner wanted to sound tough yesterday. But is he really coming out to fight? Or did he and his colleagues already throw in the towel?

## The Brown Amendment: Do the Volcker Rules Live?

Simon Johnson | 24 Mar 2010

The administration may be distancing itself from the Volcker Rules, but the same is not true of all Senators. (Why did President Obama go to the trouble of endorsing Mr. Volcker's approach to limiting risk and size in the banking system, if his key implementers – led by Treasury Secretary Tim Geithner – were going to back down so quickly?)

Among a number of sensible amendments under development in the Senate, Senator Sherrod Brown (D., OH) proposes the following language: (**update: text now attached**)

“LIMIT ON LIABILITIES FOR BANK HOLDING COMPANIES AND FINANCIAL COMPANIES.—No bank holding company may possess non-deposit liabilities exceeding 3 percent of the annual gross domestic product of the United States.”

And a few paragraphs later, an essential point is made clear: this includes derivatives,

“OFF-BALANCE-SHEET LIABILITIES.—The computation of the limit established under subsection (a) shall take into account off-balance-sheet liabilities.”

And there is a strong provision for requiring prompt corrective action if any bank exceeds this hard size cap.

Naturally, the Federal Reserve is pushing back.

The Fed's argument is that any kind of size limitation would be too blunt an instrument – successful regulation requires nuance and subtlety.

Perhaps, but there's a big problem with relying on subtle regulators. Over the past thirty years, almost all our regulators and supervisors have become either sleepy or captured – in a cognitive sense – by the very people they are supposed to be watching over. (Chapters 3 and 4 in 13 Bankers document this in detail; more on that when the book comes out next Tuesday.)

The question of the day can be framed as the classic, “Who will guard the guardians?” Or you can just ask, loudly, “Where the heck were the

people charged with the safety and soundness of the system over the past decade?”

It would be sheer folly to rely on “smart regulation” going forward – yet Larry Summers and Tim Geithner seem to be taking that approach. Just answer this, preferably in public: What happens when another president with the philosophy of a Reagan or a Bush starts to make appointments?

Or just think about this. The New York Fed is run by a senior executive of Goldman Sachs. At the same time, the former head of the New York Fed holds a top position at Goldman – where he is responsible for interacting with regulators around the world. And the practices, if not the explicit rules, of the New York Fed apparently permit its board members to buy stock in companies that the Fed oversees. Please explain exactly how this web of arrangements will help keep regulation strong and effective moving forward.

The Brown amendment is not perfect – in 13 Bankers we recommend a blanket size cap, rather than treating deposit and non-deposit liabilities separately. But this amendment would definitely be a step in the right direction.

Our regulators have failed us, repeatedly. What we need now is some smart legislation.

## Financial Reform: Will We Even Have A Debate?

Simon Johnson | 25 Mar 2010

*By Simon Johnson*

The New York Times reports that financial reform is the next top priority for Democrats. Barney Frank, fresh from meeting with the president, sends a promising signal,

“There are going to be death panels enacted by the Congress this year — but they’re death panels for large financial institutions that can’t make it,” he said. “We’re going to put them to death and we’re not going to do very much for their heirs. We will do the minimum that’s needed to keep this from spiraling into a broader problem.”

But there is another, much less positive interpretation regarding what is now developing in the Senate. The indications are that some version of the Dodd bill will be presented to Democrats and Republicans alike as a *fait accompli* – this is what we are going to do, so are you with us or against us in the final recorded vote? And, whatever you do – they say to the Democrats – don’t rock the boat with any strengthening amendments.

Chris Dodd, master of the parliamentary maneuver, and the White House seem to have in mind curtailing debate and moving directly to decision. Republicans, such as Judd Gregg and Bob Corker, may be getting on board with exactly this.

Prominent Democratic Senators have indicated they would like something different. But it’s not clear whether and how Senators Cantwell, Merkley, Levin, Brown, Feingold, Kaufman, and perhaps others will stop the Dodd juggernaut (or is it a handcart?)

This matters, because there is more than a small problem with the Dodd-White House strategy: the bill makes no sense.

Of course, officials are lining up to solemnly confirm that “too big to fail” will be history once the Dodd bill passes.

But this is simply incorrect. Focus on this: How can any approach based on a US resolution authority end the issues around large complex cross-border financial institutions? It cannot.

The resolution authority, you recall, is the ability of the government to apply a form of FDIC-type intervention (or modified bankruptcy procedure) to all financial institutions, rather than just banks with federally-insured deposits as is the case today. The notion is fine for purely US entities, but there is no cross-border agreement on resolution process and procedure – and no prospect of the same in sight.

This is not a left-wing view or a right-wing view, although there are people from both ends of the political spectrum who agree on this point (look at the endorsements for 13 Bankers). This is simply the technocratic assessment – ask your favorite lawyer, financial markets expert, finance professor, economist, or anyone else who has worked on these issues and does not have skin in this particular legislative game.

Why exactly do you think big banks, such as JP Morgan Chase and Goldman Sachs, have been so outspoken in support of a “resolution authority”? They know it would allow them to continue not just at their current size – but actually to get bigger. Nothing could be better for them than this kind of regulatory smokescreen. This is exactly the kind of game that they have played well over the past 20 years – in fact, it’s from the same playbook that brought them great power and us great danger in the run-up to 2008.

When a major bank fails, in the years after the Dodd bill passes, we will face the exact same potential chaos as after the collapse of Lehman. And we know what our policy elite will do in such a situation – because Messrs. Paulson, Geithner, Bernanke, and Summers swear up and down there was no alternative, and people like them will always be in power. If you must choose between collapse and rescue, US policymakers will choose rescue every time – and probably they feel compelled again to concede most generous terms “to limit the ultimate cost to the taxpayer” (or words to that effect).

The banks know all this and will act accordingly. You do the math.

Once you understand that the resolution authority is an illusion, you begin to understand that the Dodd legislation would achieve nothing on the systemic risk and too big to fail front.

On reflection, perhaps this is exactly why the sponsors of this bill are afraid to have any kind of open and serious debate. The emperor simply has no clothes.

# The Canadian Banking Fallacy

Simon Johnson | 25 Mar 2010

*By Peter Boone and Simon Johnson*

As a serious financial reform debate heats up in the Senate, defenders of the new banking status quo in the United States today – more highly concentrated than before 2008, with six megabanks implicitly deemed “too big to fail” – often lead with the argument, “Canada has only five big banks and there was no crisis.” The implication is clear: We should embrace concentrated megabanks and even go further down the route; if the Canadians can do it safely, so can we.

It is true that during 2008 four of all Canada’s major banks managed to earn a profit, all five were profitable in 2009, and none required an explicit taxpayer bailout. In fact, there were no bank collapses in Canada even during the Great Depression, and in recent years there have only been two small bank failures in the entire country.

Advocates for a Canadian-type banking system argue this success is the outcome of industry structure and strong regulation. The CEOs of Canada’s five banks work literally within a few hundred meters of each other in downtown Toronto. This makes it easy to monitor banks. They also have smart-sounding requirements imposed by the government: if you take out a loan over 80% of a home’s value, then you must take out mortgage insurance. The banks were required to keep at least 7% tier one capital, and they had a leverage restriction so that total assets relative to equity (and capital) was limited.

But is it really true that such constraints necessarily make banks safer, even in Canada?

Despite supposedly tougher regulation and similar leverage limits on paper, Canadian banks were actually significantly more leveraged – and therefore more risky – than well-run American commercial banks. For example JP Morgan was 13 times leveraged at the end of 2008, and Wells Fargo was 11 times leveraged. Canada’s five largest banks averaged 19 times leveraged, with the largest bank, Royal Bank of Canada, 23 times leveraged. It is a similar story for tier one capital (with a higher number being safer): JP Morgan had 10.9% percent at end 2008 while Royal Bank of Canada had just 9% percent. JP Morgan and other US banks also typically had more tangible common equity – another measure of the buffer against losses – than did Canadian Banks.

If Canadian banks were more leveraged and less capitalized, did something else make their assets safer? The answer is yes – guarantees provided by the government of Canada. Today over half of Canadian mortgages are effectively guaranteed by the government, with banks paying a low price to insure the mortgages. Virtually all mortgages where the loan to value ratio is greater than 80% are guaranteed indirectly or directly by the Canadian Mortgage and Housing Corporation (i.e., the government takes the risk of the riskiest assets – nice deal if you can get it). The system works well for banks; they originate mortgages, then pass on the risk to government agencies. The US, of course, had Fannie Mae and Freddie Mac, but lending standards slipped and those agencies could not resist a plunge into assets more risky than prime mortgages. Let's see how long Canada resists that temptation.

The other systemic strength of the Canadian system is camaraderie between the regulators, the Bank of Canada, and the individual banks. This oligopoly means banks can make profits in rough times – they can charge higher prices to customers and can raise funds more cheaply, in part due to the knowledge that no politician would dare bankrupt them. During the height of the crisis in February 2009, the CEO of Toronto Dominion Bank brazenly pitched investors: “Maybe not explicitly, but what are the chances that TD Bank is not going to be bailed out if it did something stupid?” In other words: don't bother looking at how dumb or smart we are, the Canadian government is there to make sure creditors never lose a cent. With such ready access to taxpayer bailouts, Canadian banks need little capital, they naturally make large profit margins, and they can raise money even if they act badly.

Proposing a Canadian-type model to create stability in the U.S. is, to be blunt, nonsense. We would need to merge our banks into even fewer banking giants, and then re-inflate Fannie Mae and Freddie Mac to guarantee some of the riskiest parts of the bank's portfolios. With our handful of new “hyper megabanks”, we'd have to count on our political system to prevent our banks from going wild; Canada may be able to do this (in our view, the jury is still out), but what are the odds this would work in Washington? This would require an enormous leap of faith in our regulatory system immediately after it managed to fail repeatedly and spectacularly over thirty years (see 13 Bankers, out next week, for the awful details). Who can be confident our powerful corporate lobbies, hired politicians, and captured regulators can become so Canadian so soon?

The stakes would be even greater with these mega banks. When such large banks collapse they can take down the finances of entire nations. We don't need to look far to see how "Canadian-type systems" eventually fail. Britain's largest bank, the Royal Bank of Scotland, grew to control assets equal to around 1.7 times British GDP before it spectacularly fell apart and required near complete nationalization in 2008-09. In Ireland the three largest banks' assets combined reached roughly 2.5 times GDP before they collapsed. Today all the major Canadian banks have ambitious international expansion plans – let's see how long their historically safe system survives the new hubris of its managers.

There's no doubt that during the coming months many people will advocate some form of a Canadian banking system in America. Our largest banks and their lobbyists on Capitol Hill will love the idea. For some desperate politicians it may become a miracle drug: a new "safer" system that will lend to homeowners and provide financing to Washington, while permitting politicians and regulators to avoid tough steps. Let's hope this elixir doesn't gain traction; smaller banks with a lot more capital – and able to fail when they act stupid – are what U.S. citizens and taxpayers really need.

*An edited version of this post appeared on the NYT's Economix this morning; it is used here with permission. If you wish to reproduce the entire post, please contact the New York Times.*



## Senator: Which Part Of “Too Big To Fail” Do You Not Understand?

Simon Johnson | 26 Mar 2010

*By Simon Johnson*

When a company wants to fend off a hostile takeover, its board may seek to put in place so-called “poison pill” defenses – i.e., measures that will make the firm less desirable if purchased, but which ideally will not encumber its operations if it stays independent.

Large complex cross-border financial institutions run with exactly such a structure in place, but it has the effect of making it very expensive for the government to takeover or shut down such firms, i.e., to push them into any form of bankruptcy.

To understand this more clearly you can,

1. Look at the situation of Citigroup today, or
2. Read this new speech by Senator Ted Kaufman.

The Citigroup situation is simple. They would like to downsize slightly, and are under some pressure to do so. It is hard to sell assets at a decent price in this environment, so why don't they just spin off companies – e.g., quickly create five companies in which each original shareholder gets a commensurate stake?

The answer is that Citi's debt is generally cross-guaranteed across various parts of the company. US and foreign creditors have a claim on the whole thing, more or less (including the international parts), and you can't break it apart without upsetting them. The cross-border dimensions make everything that much more knotty.

Senator Kaufman explains what this means – essentially the “resolution authority” proposed in the Dodd legislation is meaningless. How would any administration put a huge bank into any kind of “resolution” (a FDIC-type bank closure, scaled up to big banks) when it knows that doing so would trigger default across all the complex pieces of this multinational empire?

You could do it if you are willing to accept the costs – and if you understand there are big drawbacks to providing an unconditional bailout of the 2009 variety. But will a future administration be willing to take that decision? The Obama administration was not – and big finance will only become bigger and more complex as we move forward.

If you look into the eyes of the decision-makers from spring 2009, they honestly believe that taking over Citi or Bank of America would have caused greater financial trouble and a worse recession. You can argue about their true motivation all you want; this is irrelevant. The point is that the structures in place last year remain unchanged today. If a megabank shut-down under pressure was impossible for our policymakers last year, how exactly will the situation change after the Dodd bill passes – remembering that our current policymakers or a close facsimile will run this country for the indefinite future?

Senator Kaufman is strong too what this all means. By all accounts, this Senator is not a person who came to the boom-bust-bailout debate with strong preconceived notions, just someone who has listened carefully to the arguments on all sides. And, unlike most politicians, this Senator does not need to raise money.

Banks that are “too big to fail” are simply too big. Making them smaller may not be sufficient to prevent major crises in the future – Senator Kaufman sensibly also supports a long list of related reforms, including for derivatives markets (see his other speeches on this topic: first, second) – but rolling back our biggest and most dangerous banks certainly is necessary. And there is simply no evidence that banks on today’s modern scale convey any benefits to society.

Massive banks cannot be controlled, at least not in the US context; we are not Canada. “Smart regulation” in this context is an oxymoron. Our regulators have been captured by the ideology of finance for 20 years; the big banks industry are not about to let them out on parole now.

For a long while, the Obama administration insisted that size caps for banks were not on the table. Then, in January, the president himself announced the Volcker Rules – which include a size cap for banks. We’ve argued this cap should be even tighter – big banks can get smaller in an orderly fashion and regulators can help - but still any cap would be a step in the right direction.

Yet there is no size cap in Senator Dodd’s bill.

Given that this White House has shown it can achieve considerable things, when it applies itself, why not pursue the Volcker Rules in full?

The White House is clearly not afraid of the business lobby – Deputy Secretary Neal Wolin took on the Chamber of Commerce this week regarding the Consumer Protection Agency for Financial Products; his tone was strong and his arguments were telling.

Yet the White House, Senator Dodd, and perhaps even Barney Frank are all stuck on one issue – they can't contemplate making our biggest banks smaller (or even limiting their size).

It's as if a very clever political poisoned pill has been put into place. If you act against the big banks they will .... What exactly? Threaten to prolong the recession? Help your opponents get elected? Run ads against everything you believe in?

Whatever the reason, write it down and think about it. How do you feel about a small set of big financial firms having this kind of power? How is that good for the rest of the business community, let alone regular citizens and our democracy?

This administration is perfectly capable of taking on the big banks. All that is missing is a little clarity of thought and a fair amount of political courage. Or they can just call up Senator Kaufman.

## Hard Pressed, Senator Dodd Gives Ground

Simon Johnson | 27 Mar 2010

*By Simon Johnson*

Senator Chris Dodd has good political antennae. He knows that his financial reform bill will come under severe pressure because it has a weak heart – the provisions that deal with “too big to fail” are simply “too weak to make any sense.”

Stung by the hard-hitting critique of Senator Ted Kaufman earlier on Friday and unsure exactly where an increasingly combative White House is heading on the broader strategy vis-à-vis banks, Mr. Dodd took to the Senate floor yesterday afternoon – actually immediately after Senator Kaufman – in an attempt to sustain the momentum behind his approach to “reform”.

Note the prominent and rather defensive mention of Delaware, Senator Kaufman’s state, in what Senator Dodd said (the wording here is from the verbatim recording, not the official transcript):

“A business, as I say respectfully, in Connecticut or Delaware or Colorado, a homeowner in those states shouldn’t have to pay the price because a handful of financial institutions got too greedy, too risky, they were unwilling to examine what they were doing or did, recognizing that the federal government would bail them out if they made a bad choice, which they did.”

Perhaps it was this picture that did it:

Senator Dodd asserts that “never again should a financial problem of a major financial institution put the rest of the country at risk”. But there is no mention of the specific reforms that would prevent this.

Mr. Dodd does express exactly the right general idea,

“First and foremost, never, ever again should a financial institution get so large, so interconnected, produce products that put the rest of us at risk.”

But the cognitive dissonance here is extreme. The only purported mechanism to rein in megabanks in the Dodd bill is the resolution authority, but this by definition cannot work for large complex cross-border financial institution – this is the point insisted upon by Senator Kaufman today.

Dodd recognizes the validity of Kaufman’s argument at some level, but just cannot bring himself to say that he agrees – or to acknowledge

that his legislation does nothing to deal with financial institutions that have already proved themselves to be so large they can damage society.

So we reach an impasse – at least for now. Dodd concedes that too big to fail is the central issue and he implicitly acknowledges that his bill has no way to address the concerns raised by Senator Kaufman (and Paul Volcker and others).

The White House has cleared the way for major progress vs. the financial sector lobby (nice speech by Neal Wolin to the Chamber of Commerce), but does not yet press home its advantage.

Barney Frank knows there is a deep flaw in the current legislation and waits in the wings with a sharp pencil. He previously thought “too big to fail” firms could be taxed down to size; increasingly this seems unrealistic and at odds with the shifting consensus on systemic risk.

Chris Dodd wants to go out in blaze of glory, not with a bill that makes no sense at all on its most critical points.

Ted Kaufman is turning into a relentless critic, Elizabeth Warren is fast becoming a folk hero, and Paul Volcker is poised to make a major speech in Washington on Tuesday. Is Volcker likely to toe the party line and defer to Senator Dodd – or will he lay out in forceful terms what reforms would really mean, i.e., what are the true Volcker principles, who has them, and how would you know?

Financial reform might make for good television after all.

## Who Will Tell The President? Paul Volcker

Simon Johnson | 28 Mar 2010

*By Simon Johnson: [link to NPR radio interview \(and book excerpt\) on how 13 Bankers got their hands on so much political and economic power - and why this spells serious danger for the rest of us.](#)*

Against all the odds, a glimmer of hope for real financial reform begins to shine through. It's not that anything definite has happened – in fact most of the recent Senate details are not encouraging - but rather that the broader political calculus has shifted in the right direction.

Instead of seeing the big banks as inviolable, top people in Obama administration are beginning to see the advantage of taking them on – at least on the issue of consumer protection. Even Tim Geithner derided the banks recently as,

“those who told us all they were the masters of noble financial innovation and sophisticated risk management.”

In part this is window dressing. But in part it recognizes political opportunity – the big banks are unpopular because they remain completely unreformed and unrepentant. And in part it responds to a very real danger – Senator Dodd's bill is so obviously weak on “too big to fail” issues that it will be hard to paint its opponents as friends of big banks.

Senator Richard Shelby knows this and is taking the offensive. The administration can convert an easy win into an own goal if it fails to toughen substantially Senator Dodd's bill.

Fortunately, there is an easy way to address this issue.

Recall the political history of financial reform during the Obama administration. The economic team (Tim Geithner and Larry Summers) felt that no substantive change in the structure and incentives for deeply troubled parts of the financial system was necessary or even possible during the height of crisis. Consequently, they provided unlimited financial support to the country's largest banks – communicated by the “stress tests” – with no conditions, and they also proposed an initial set of legislative changes that was slight.

Quite quickly, however, this strategy ran into trouble – because the largest banks immediately and demonstrably went back to their uncontrolled risk-taking ways, now based on obvious government

guarantees. The lack of careful management within these banks is not an accident – it's very much part of the design, which enables large bonuses to be paid at all levels; the point is not that individuals intentionally engender crisis every year, but the system runs through a loop that implies regular (and, in our view, increasing) government support over time. Too Big To Fail pays well; for the banks it is someone else's problem to fix, and for policymakers the temptation is to kick all available cans down the road.

From summer 2009, leading banks also exuded arrogance – insulting the president and generally carrying on in a high and mighty fashion. The abuse of power by our ever more powerful bankers became increasingly obvious – as did their lobbying (Neal Wolin, Deputy Treasury Secretary, said this week that “big banks and Wall Street financial firms” spend \$1.4 million per day on “lobbying and campaign contributions”; and “there are four financial lobbyists for every member of Congress”; good speech).

With perfect timing during the fall, in stepped Paul Volcker. Not someone ever accused of being a populist – let alone carrying a pitchfork – he pointed out, simply and forcefully (and publicly), that our biggest banks were out of control and must be reined in. With the political side of the White House increasingly anxious about the electoral effects of pandering to an apparent financial oligarchy, Volcker was able to persuade the president to adopt the Volcker Rules: a limit on the risk-taking by big banks and an effective cap on their size.

Unfortunately, the specifics of the Volcker Rules were not well thought through by Treasury and their cause was hardly championed with force. The Capitol Hill lobbying machine took over and mush duly appeared from Senator Dodd's committee on the issue of systemic risk.

But Paul Volcker is not finished, not by a long way. Someone just needs to convince President Obama to call Senator Dodd (or meet again with Dodd and Barney Frank), to ask – politely but firmly – that the Volcker size cap on big banks be legislated, and actually tightened relative to the January proposal. The House already has the Kanjorski amendment, which is a step in the right direction.

On Tuesday, Volcker will go public again. But that's not the most important conversation. His public appearance is just a way to communicate more directly with the political side of the White House.

Volcker's point is simple. Without the Volcker Rules, the administration would be in much more difficulty than it is now; these

proposals really helped to diffuse pressure. Now it's time to make the Rules real – and this requires significantly reducing the size of our largest banks. Phase the rules in, as proposed in January, and there is no reason to think this will constrain our recovery.

Chris Dodd can start this ball rolling and Barney Frank would back him up. The consensus is ready to move. This is such an easy and obvious political win. Treasury and the White House economic team can be brought onside by being allowed to claim this was their idea all along – or they can say something along the lines of “the facts changed, so we changed our opinions”.

But if Paul Volcker doesn't tell the president, who will?



## **“13 Bankers”: National Public Radio Interview**

**Simon Johnson** | 28 Mar 2010

*By Simon Johnson*

On Friday afternoon, NPR’s *All Things Considered* broadcast [Robert Siegel’s interview with me](#) on *13 Bankers* (further down that link there is an excerpt from the very beginning of the book).

We talked, naturally enough, about how the ideas in *13 Bankers* connect with the current policy debate – specifically the financial reform legislation now before the Senate. As anticipated when the book went to press in January, some sensible measures to protect consumers of financial products seem possible – yet this progress just emphasizes how and why we have not yet broken through on Too Big To Fail issues.

But there is a broader point here also. What happened in 2008-09 should not be allowed to happen again. The nature of power in and around the financial sector has become so great – and so distorted – that it harms the rest of us.

I don’t think a majority of Americans understand how much influence financial institutions have in Washington, DC. Banks used to answer to Washington. They were once held accountable for their actions. That is no longer is the case.

We have not previously had such a concentrated banking system in the United States; it’s terrifying how much of our financial future is wrapped up in the big six. We don’t need this level of concentration and we should recognize the dangers that it brings. This view is not anti-finance – but we are very much against the way our biggest banks operate today, and we definitely (and in detail) oppose people who seek in any way to sustain the power of these organizations.

The NPR interview hit many key points but also – in 8 minutes – just scratched the surface. In *13 Bankers*, we take you through the back story – the painful history that brought us here and that now makes it so hard to move forward.

But the book is not pessimistic. We offer American models of reform – instances from our history when elected representatives, with all their limitations and failings, took on concentrated financial power. Luckily for us, despite its massive and seemingly overwhelming advantages, big finance lost in each of the three big confrontations of the past two hundred years.

Each time, most Americans initially did not grasp how the system works, and this proved a major obstacle to reform. But each time political leadership was able to explain what needed to be done – and to persuade the mainstream that this was an important priority.

We can do it again. We must – the consequences otherwise would be too awful. Absent reform, another bailout – indeed a more costly bailout with global consequences, millions of jobs lost, and a ruinous impact on our government budget – is unavoidable.

## What's Next for Health Care?

James Kwak | 29 Mar 2010

*By James Kwak*

I should leave the country more often: I go away and suddenly we have (near-)universal health care coverage! (Well, we'll have to wait a few years for all of the health care reform provisions to kick in, but you know what I mean.) Not only that, but [Ezra Klein](#) reminds me that we even got rid of the pointless subsidy to the banking industry in the student loan program (where the government guaranteed the loans but let private lenders earn profits making the loans, even though the guarantee obviated the need for underwriting).

So what happens now? [Nate Silver](#) points out that passing health care reform has helped the Democrats, though not as much as I would have expected. I'm no expert on electoral politics and public opinion, so my guesses are just that — guesses. Anyway, I think that just as many people see politics as a type of sport, many people like winners; winning on health care would be good for Obama and the Democrats just as losing on it would be bad, regardless of their actual position on the issue. According to Silver, this is a little bit true. Still, I think it could become more true by November (relative to the unknowable counterfactual where health care reform failed), because it largely takes away one major potential criticism of the Democrats: they couldn't get anything done. In Colombia, where I was, they were calling it the largest domestic program of any kind since Medicare, over forty years ago.

In the longer term, will this turn out to be as popular as Medicare? I doubt it, because the reform was so modest in many respects. (Klein has written many times about how this is not only a centrist bill, in many ways it's actually conservative — reliance on market mechanisms, no public option, etc. Here's his [latest version](#).) I worry that, in the transition period, health care costs will continue to grow faster than inflation, companies will cut back on their plans, and people will blame the loss of their coverage on "Obamacare"; when people have their claims denied by their existing insurance plans, they'll blame it on "Obamacare"; and, in general, the debate over the past year has so poisoned public attitudes that about 40 percent of Americans will assume that anything bad that happens to them (like getting sick in the first place) must be Obama's fault. I also worry that, even as the bill "bends the curve" on long-term costs, people will see the fact that costs continue to rise faster than

inflation as proof that the reform didn't work — just like some people point to 10% unemployment as “proof” that the stimulus didn't work.

But I think that near-universal coverage, and a ban on medical underwriting, are un-repealable enough that they will make it through the transition period until we reach the point where Americans assume that they can get decent health insurance at a price that, if not reasonable by international standards, is not completely unaffordable. And that would be a huge step forward.

## I'm Back

James Kwak | 29 Mar 2010

*By James Kwak*

If I were Tyler Cowen or Paul Krugman, I would have original insights from my eight days in Bogota, Colombia. But I'm not. So here are just a few random observations:

- Apparently there was a financial crisis about ten years ago because of faulty mortgage products that led to a high number of defaults. To clean up the financial system, the government nationalized about 70% of the banking industry (by assets), and then sold the assets back into the private sector over the next several years. Colombia now has restrictive banking regulations that prevent capital from subsidiaries from being taken out of the country (except for repatriation of profits). As a result, the Colombian subsidiaries of U.S. banks (Citibank, that is) and Spanish banks seem to be doing better than their overseas parents.
- There was an indoor jungle gym in a mall a few blocks from our hotel that my daughter loved — trampolines, slides, climbing thingies, the works. Not only does the thing exist (we were wishing we had one where we live), but we didn't even have to sign a release first.
- Colombia — or at least the area around our hotel — is able to sustain several times the number of hamburger chains that the United States can sustain. And they look better, too. Maybe Barry Lynn is onto something in *Cornered*. (Or maybe all those chains are really subsidiaries of the same company.)

Most importantly, I did a little first-hand testing of various ways to pay for stuff. The first weekend I was there, the exchange rate was 1,907 Colombian pesos to the dollar. The rate for exchanging dollars on the street was 1850 (well, in the shopping mall — it might have been a little better on the street itself), or about a 3% fee. The net rate for using an American Express card (that is, the price in pesos divided by the number that showed up on my bill) was about 1840 — about 3.5% (although that is partially offset by my 1.25% cash back). But when I used the debit card from my local bank (PeoplesBank), I got a rate of 1906-1907 — that is, no fee whatsoever — whether I stuck it in an ATM to get cash or used it like a credit card to buy something.

I used to use my Bank of America debit card to get cash out of foreign ATMs, and I recall that every time I used it I would see three lines on my bank statement — one for the cash and two for the fees. So that's yet another reason to ditch your big bank.

## Volcker, Warren, and Kaufman: There Must Be New Law

Simon Johnson | 29 Mar 2010

*By Simon Johnson, (13 Bankers, out tomorrow)*

Some people at the top of the administration begin to understand that it makes both economic and political sense to impose binding constraints on our largest banks. But even the clearest thinking among them still has a problem – breaking up banks seems too much at odds with the way they saved these same banks in 2009. At best, this would be most awkward for the individuals involved on all sides.

“We’ll achieve the same general goal by imposing capital requirements that increase with the size of the bank” (not an exact quote) is the administration’s latest whispered idea, and in principle this has some appeal. If done properly, this could level the playing field – and therefore should be supported politically by small banks. By increasing the buffer against future losses, it would put in place greater protection for taxpayers against too big to fail (TBTF) institutions. And it would push TBTF firms to break up if they really have nothing better than cheap funding – based on implicit government subsidies – to support their continued existence.

But this “let’s do it with capital requirements” proposal is deeply flawed and completely unacceptable. From different perspectives, Paul Volcker, Elizabeth Warren, and Ted Kaufman all agree, we cannot rely on our existing regulations (and regulators). We need new law.

Setting capital requirements involves a delegated decision, i.e., Congress indicates some parameters in general terms and the executive branch has to implement. The broad authority is in the hands of top people at the White House/Treasury, while the mind-numbing details fall to the regulators (subject to political pressure). So how do you write the capital requirements legislation that has the “end TBTF” outcome?

The bottom line is that you would have to trust the White House and myriad regulators. But neither have credibility on this front, as Senator Ted Kaufman insists. Given their track record, they might promise to raise capital enough, but once the moment of political attention is over, they’ll likely just roll over for the big banks again.

Accommodating the interests of big firms – if that is what you want to do – is made all the more easy by the complexity of the issues involved. What is the level of capital requirements for the largest banks that would really level the playing field? Would 20 percent get it done? Why not

30% – which is more like the average of pre-1913 capital-asset ratios, i.e., before the era of modern bailouts? No one knows – and a good deal of assertive experimentation would be required.

On top of this, the international part of capital requirements runs through the Basel Committee, which (a) takes a long time, (b) is highly technical, and (c) is murky without any real accountability – i.e., by the time someone writes a front page WSJ article on what went wrong, it's 5 years too late. A key function of international organizations, not subject to disclosure like US public institutions or discovery like US private organizations (facing lawsuits), is to hide all kinds of dubious actions – there is by definition no sunlight. You can shred all the documents you want at an international organization; no one on the outside will ever get you for this.

Any approach that puts heavy emphasis on capital requirements comes down to trusting the Obama administration's economic team to be suitably resilient in the face of heavy pressure from big banks. But when these same people had the choice of being tough or nice to big failed bankers, by their own admission they went overboard on the niceness – no one on the board of directors of Citigroup was even embarrassed by what happened in early 2009. This tells us something about preferences, style and how our top officials see the world– whether you want to call this non-confrontational, highly deferential to the financial sector, or awe of Jamie Dimon.

How can any reasonable person trust the administration to get capital requirements right – i.e., so as to force TBTF banks to make themselves smaller – particularly when the Europeans have serious fiscal-financial problems, will want to paper over their own capital deficiencies, and are much more comfortable using implicit government guarantees to back banks than the US is (or should be)?

There is no substitute for new law here – just as Elizabeth Warren argues (and we discuss further in 13 Bankers). And the only law that will really deal with massive banks is law that effectively constrains their size – the point that Paul Volcker has been making and will likely reiterate tomorrow.



## One Day to Go . . .

**James Kwak** | 29 Mar 2010

*By James Kwak*

Well, officially at least. There have been a bunch of copies on eBay for a while now, and apparently some bookstores have put them on the shelf already. You can now read excerpts from the introduction and the last chapter, courtesy of NPR and the WSJ, respectively. Besides the reviews that Simon has featured on this blog, there's a new one from the Daily Kos. The events page now has some media highlights (Colbert!) in addition to in-person appearances.

And we have a page explaining what the title means.

## The Ballad of GM

James Kwak | 30 Mar 2010

*By James Kwak*

Once again proving that they do in-depth business reporting as well as anyone on the radio, *This American Life* did an episode this past weekend on NUMMI, the auto plant in Fremont, California that is jointly operated by Toyota and GM. Well, since the GM bankruptcy it's been operated by Toyota. And Toyota is closing it this week — the first plant to be closed in the history of the company, according to TAL.

I listened to the episode this morning in my car, a 1999 Chevrolet Prizm that was built at NUMMI and that was the first car my wife and I bought. (It has 111,000 miles and has only required minor repairs, like a power steering pump and a muffler strap.) I've passed by the plant itself many times on 880, driving between the East Bay and the southern end of Silicon Valley. So it was a sad and poignant story for me.

In its basic outlines, the story goes like this. (I'm basing this on the radio show, since I don't have independent knowledge of the facts.) Toyota and GM agreed in the early 1980s to build cars together in what had previously been a particularly low-quality GM factory; GM wanted to learn about the Toyota system, and Toyota wanted to learn about building cars in the United States. NUMMI itself was a near-instant success in terms of efficiency and quality, because the American workforce was trained in and adopted the Japanese production methods. But GM, through a combination of short-sightedness, bureaucracy, and organizational inertia, wasted well over a decade before really implementing what it had learned across its North American operations, and that combined with a number of other strategic errors (reliance on SUVs) and structural problems (fixed and increasing retiree benefits) pushed it into bankruptcy when the financial crisis hit. (Note that the radio show didn't really try to prove that the failure to implement the lessons of NUMMI was more important than those other factors.)

But more valuable than the simple history are some of the basic business lessons to be learned from the story, which were very familiar from my years in the business world: Put quality before volume. Everyone has to care about quality. People need to feel ownership over their work. People want to see other people using their products and services. (One NUMMI employee walked around with postcards addressed to himself and put them on the windshields of cars he saw

that had been built at NUMMI, asking for feedback.) If people are doing work they are proud of, they will care about it more and will be happier. And, as the head of Toyota recently said before Congress, you shouldn't grow faster than the natural capacity of your organization.

**Update:** I forgot to mention that Simon also had a Prizm for ten years, also built at NUMMI.

## Geely Buys Volvo: Goldman Gets The Upside, You Get The Downside

Simon Johnson | 30 Mar 2010

*By Simon Johnson*

Geely Automotive has acquired Volvo from Ford. This is a risky bet that may or may pay off for the Chinese auto maker – after first requiring a great deal of investment.

Goldman Sachs' private equity owns a significant stake in Geely, with the explicit goal of helping that company expand internationally. Remember what Goldman is – or rather what Goldman became when it was saved from collapse by being allowed to transform into a Bank Holding Company in September 2008 (which allowed access to the Federal Reserve's discount window, among other advantages). Goldman's funding is cheaper on all dimensions because it is perceived to be Too Big To Fail, i.e., supported by the US taxpayer; this allows Goldman to provide more support to Geely (and others).

Our Too Big To Fail banks stand today at the heart of global capital flows. People around the world – including from China – park their funds in the biggest US banks because everyone concerned believes these banks cannot fail; they were, after all, saved by the Bush administration and put completely – gently and unconditionally – back on their feet under President Obama. These same banks now spearhead lending to risky projects around the world.

What is the likely outcome?

We know that risk-management at the megabanks breaks down in the face of a boom (remember Chuck Prince of Citigroup in July 2007: “as long as the music is playing, you’ve got to get up and dance. We’re still dancing”). We know there is a growing boom in emerging markets – including through the overseas expansion of would-be multinationals from those countries. This is most notably true of state-backed firms from China, but there is also a more general pattern (think India, Brazil, Russia, and more).

The big global banks, US and European, are charging hard into this space – Citigroup is expanding fast in China and India (areas where they claim great expertise); and the CEO of HSBC has moved to Hong Kong. Many investment advisors are adamant that China will power global growth (never mind that it is less than 10 percent of the world economy),

that renminbi appreciation is around the corner, and that the value of investments in or connected to that country can only go up.

There is a very good reason why, between the 1930s and the 1980s, large US commercial banks were severely constrained in their risk-taking activities. By the 1930s US policymakers had learned the very hard way that we do not want the banks that run our payments system (with the implicit or explicit backing of the government, depending on how you look at it) to be engaged also in high risk equity-type investments – this is really asking for trouble.

The problem is not that all such banking-based risky investments go bad. Far from it – we'll first get an apparently great boom, which will suck in all kinds of financial institutions, our future Chuck Princes. As long as the market goes up, the executives and traders involved will do very well – lauded as geniuses and paid accordingly.

And if some of them fail, so what – failure is essential to a market economy. But here's the key problem with having so much of our economy in the hands of financial firms that are Too Big To Fail. When the next emerging market crash comes, we'll have to make the 2008-2009 decision all over again: should we rescue our big troubled financial institutions, or should we let them fail – and cause great damage to the economy?

In our assessment (*13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*, out today), based on the details of financial deregulation over the past 30 years, the prevailing belief system of top bankers, and the big banks' incentives to take risk, we are all heading for trouble. The "financial reform" legislation currently before Congress and still prevailing pro-banker attitudes at the top of the Obama administration are really not helpful. The country's course was set by a fateful meeting at the White House last March; a resurrected, unreformed, and still crazy system – symbolized by 13 bankers – is in the driving seat now.

At best, this will be another very nasty boom-bust-bailout cycle. At worst, we are heading towards a situation in which our banks are so massive that when they fail, there is no way the government (or anyone else) can offset the damage that causes.

This time our government debt (held by the private sector) will roughly double – increasing by 40 percentage points of GDP – as a direct result of what the banks did. We've lost more than 8 million jobs since December 2008 – for what good reason? Next time could easily be worse.

You can disagree with our analysis – provide your own facts and figures, and we'll have that debate here or elsewhere; the more public, the better from our perspective. And you should certainly want to improve on our policy prescriptions. We put forward some simple ideas that can be implemented and would help – our versions can also be communicated and argued widely: if banks are too big to fail, making them smaller is surely necessary (although likely not sufficient).

But don't ignore the question. Don't assume that this time Goldman and its ilk will avoid getting carried away – they are just doing their jobs, after all, and their job description says “make money”; system stability is someone else's job.

And also don't presume that, just because the big banks and their friends seem to hold all the cards, they will necessarily prevail in the future.

In all previous confrontations between elected authority and concentrated financial power in the United States, the democratic element has prevailed (see chapter 1 in *13 Bankers*; also Monday's WSJ, behind the paywall). This can happen again – but only if you stay engaged, argue this out with everyone you know (including your elected representatives), and help change the mainstream consensus on banking definitively and irrevocably.

# The Ongoing Battle Against Error and Hypocrisy

James Kwak | 30 Mar 2010

*By James Kwak*

With the financial reform bill out of the Senate Banking Committee last week (another good thing that happened while I was away) and fresh off of victory in the health care war, the Obama administration is upping the rhetorical pressure to pass financial reform. This was most obvious in Deputy Treasury Secretary Neal Wolin's speech at the U.S. Chamber of Commerce last week, in which he called out his hosts with fighting words: "the Chamber of Commerce – funded, no doubt, with a good deal of your money – has launched a lavish, aggressive and misleading campaign to defeat the proposed independent agency."

Elizabeth Warren, who has never minced words when it comes to enemies of consumer protection, steps up today with an even more withering attack on the flip-flopping of the American Bankers Association, which was for the separation of consumer protection from prudential regulation before it was against it. As Warren says:

"ABA lobbyists now aggressively insist that separating consumer protection and safety and soundness functions would unravel bank stability. Yet just a few years ago, they heatedly argued the opposite—that the functions *should* be distinct.

"In 2006, the ABA claimed to act on principle as it railed against an interagency guidance designed to exercise some modest control over subprime mortgages. It criticized the proposal for 'combin[ing] safety and soundness guidance with consumer protection guidance, creating confusion that is best addressed by separating them.'"

Huh? To understand the ABA's position in 2006, you need to realize that it was arguing against a proposal by the major regulatory agencies to make consumer suitability (the appropriateness of a mortgage product for a consumer) an element of safety and soundness regulation. And so the ABA argued that consumer issues and safety-and-soundness were two separate things. But this is what it really cared about (from the 2006 ABA comment, page 9):

"In discussing underwriting, the Agencies should be focusing on risk levels of default and loss and creditworthiness of borrowers

rather than ‘appropriateness.’ We are concerned that the Agencies are creating a new ‘appropriateness’ or ‘suitability’ standard that we are very reluctant to see applied in lending, if ‘suitability’ is to mean something other than creditworthiness.”

In other words, the ABA’s bottom line is that it does not want regulators worrying about consumers at all, and it will use whatever argument happens to be handy at the moment. In 2006, it was for separating prudential regulation from consumer protection. Now that the threat is an independent consumer protection agency, it is for unifying consumer protection with prudential regulation (because that would preserve the existing set of regulatory agencies, none of which is primarily responsible for consumer protection).

The ABA’s current argument is that if you split consumer protection from prudential regulation, the consumer protectors will write rules that will make it hard for banks to make money, thereby weakening the banks. While this argument seems to make sense, it has two independently fatal flaws. First, the implication is that if banks can’t survive without screwing their customers, then they should be allowed to screw their customers. Second, it flies in the face of the lessons of the past few years, when, as Warren says, “it was the *lack* of meaningful, independent consumer protection that helped bring down the entire banking system and cause the current crisis”; the banks nearly failed (would have failed without government support) *because* their customers couldn’t pay off their toxic mortgages.\*

Of course, the ABA is a lobbying organization, and some (like a majority of the Supreme Court in *Citizens United*) might say that this is how politics is supposed to work: corporations that have certain interests should be able to give money to lobbying organizations that will do whatever it takes to advance those interests, and being constrained by things like logical consistency or even a sense of shame would be a dereliction of duty for those organizations. So maybe the ABA is just doing its job. But that doesn’t mean that the members of the United States Senate have to fall for it.

(By the way, did you know that Elizabeth Warren also wrote, “If you want to understand how Wall Street captured Washington and how it tenaciously hangs on to that power, read 13 Bankers”?)

\* Yes, I know this is a bit complicated, because many of the toxic mortgages were originated by nonbank mortgage lenders, who then sold



the mortgages to banks, who packaged them into mortgage-backed securities and CDOs and held onto some of the tranches of those CDOs, which were what blew up the banks (in part — Lehman also added a healthy dose of explosive commercial real estate). But the banks were largely responsible for the originations in the first place, both because they provided the demand for the toxic mortgages and because in many cases they provided the funding for the nonbank mortgage lenders.

**Update:** Shahien Nasiripour has more.

## We Were Wrong (About the Supreme Court)

James Kwak | 30 Mar 2010

*By James Kwak*

Last November, we criticized a decision by the Court of Appeals for the Seventh Circuit in *Jones v. Harris Associates* in which Judge Frank Easterbrook wrote that mutual fund companies can charge their mutual funds whatever they can get away with (assuming disclosure and absent fraud), because prices are set by The Market. The case was remarkable because of a dissent by Judge Richard Posner, part of his recent (partial) disavowal of his earlier free market views, arguing that markets could *not* be trusted to set mutual fund fees. However, we predicted that the Supreme Court would pass up the opportunity to strike a blow on behalf of mutual fund investors and against excessive mutual fund fees:

“It can take the easy way out and resolve the case on the sole question of what ‘fiduciary duty’ means. Or it could limit itself to deciding what standard should be used in reviewing mutual fund fees and then tell the 7th Circuit to hear the case again. Most likely it will either sign off on the efficient-markets myth or dodge the question in one of these ways.”

We were partially right; technically speaking, the Court (opinion here) simply clarified the standard to be used when assessing mutual fund fees. Substantively speaking, however, it went a bit further. As Jennifer Taub explains, not only did it strike down Easterbrook’s bit of outdated free market theory, it also held that courts should compare the fees that a mutual fund company charges its captive mutual funds and those it charges institutional clients who can negotiate fees directly. In *Jones v. Harris Associates*, Harris Associates was charging its captive mutual funds fees that were more than double those it charged institutional asset management clients.

It still doesn’t look that great for the plaintiffs—mutual fund investors who claim they were charged excessive fees. The district court that first heard the case found that, under the existing *Gartenberg* standard, the plaintiffs had no case. The Supreme Court in its opinion *said* that it was reaffirming *Gartenberg*, but as Taub and William Birdthistle have pointed out, it really was modifying *Gartenberg* slightly in a pro-plaintiff way. So what happens now is that the case goes back to the Seventh Circuit to deal with the case in a manner consistent with the Supreme Court ruling

(and I think the Seventh Circuit could hand it back to the district court).  
But it's still a small step.

## Paul Volcker: Do The Right Economic Thing

Simon Johnson | 31 Mar 2010

*By Simon Johnson*

A great deal of the popular anger directed at big banks is completely legitimate, as put nicely by John Cassidy at the end of his interview with Treasury Secretary Tim Geithner,

“The hardest part of his job, Geithner often says, is getting people to comprehend the inner logic of a financial-rescue operation, and the unpopular actions it entails. In fact, his problem may be not economic illiteracy but its opposite: Americans understand all too well what has happened. Financial crises have a way of revealing aspects of our economic system that otherwise remain obscured, such as the symbiotic relationship between Wall Street and Washington, the hidden subsidies that financial firms sometimes receive from the Fed and other government agencies, and the fact that the vast profits that firms like JPMorgan Chase and Goldman generate depend in part on an implicit guarantee from the taxpayer. When ordinary Americans are confronted with these realities, they get angry.”

Paul Volcker is also angry.

Of course, Paul Volcker expresses himself in the measured language of a distinguished technocrat. But he is very worried about our current financial structure and where it is heading. Speaking today at the Peterson Institute in Washington DC, Mr. Volcker made two broad points (Marketwatch coverage) – both of which we also emphasize in 13 Bankers.

1. The financial sector does not add anywhere near as much social value as its proponents claim.

“The question that really jumps out for me is, given all that data, whether the enormous gains in the financial sector — in compensation and profits — reflect the relative contributions that sector has made to the growth of human welfare” (from NYT story)

2. Too big to fail banks are alive and well – and this poses a major problem to our future prosperity.

“There is an expectation that very large and complicated financial institutions will not be allowed to fail,” he said. “Unless that conviction is shaken, the natural result is that risk-taking will be encouraged and in fact subsidized beyond reasonable limits.”

The message yesterday and from other statements made by Mr. Volcker is clear. Our biggest banks are out of control and will not be reined in by the measures currently on the table. We need a much stronger approach to big banks – an approach that will strip government-backed banks of their ability to take crazy risks and, most likely, an approach that significantly constrains (and hopefully even reduces) their size.

## **“13 Bankers” In The Media**

**Simon Johnson** | 31 Mar 2010

*By Simon Johnson*

I’ve already discussed the main points of *13 Bankers* with more than a dozen interviewers across a wide range of formats; we’ll post links on the book’s site as they become available.

The Colbert Report and MSNBC aired interviews on Tuesday. Tom Keene talked to both James and me for his Bloomberg radio show – this ran about 40 minutes, so we covered a lot of ground (but I’m not sure if this is on the web). On WNYC I had an extended conversation with Mike Pesca. And here’s the Reuters coverage.

There are more discussions to come, including with Big Think (already taped) and on The Diane Rehm show tomorrow.



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