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Lloyd Blankfein: Time Man Of The Year

Simon Johnson | 01 Apr 2010

By Simon Johnson, co-author of 13 Bankers: The Wall Street Takeover and the Next Financial Meltdown

In a surprise announcement earlier this morning, Time Magazine brought forward its annual “Man of the Year” award – and conferred this honor on Lloyd Blankfein, CEO of Goldman Sachs. April 1st apparently is at least 7 months earlier than anyone else has ever won this award, since it began in 1927.

As the award has previously been conferred on controversial figures (including Joseph Stalin in 1942 and Mrs. Simpson in 1936), Time also saw fit to issue a statement clarifying Mr. Blankfein’s merits,

“[Goldman is] very important. [They] help companies to grow by helping them to raise capital. Companies that grow create wealth. This, in turn, allows people to have jobs that create more growth and more wealth. It’s a virtuous cycle. [They] have a social purpose.”

A spokesperson for Goldman responded quickly,

“It was always clear to us that had [Lloyd not won], it would have been quite disruptive to the world’s financial markets. We would have had to spend money, other people would have had to replace transactions as well. Generally for us, volatility is good for our trading business, however it would not have been good for the financial markets as a whole, so it would not have been good for our business...We would not have been affected directly by our exposure to [him], but the world’s financial system would have been affected...there would have been no losses vis a vis our credit exposure.”

Now it seems the Nobel Peace Prize Committee feels pressed to follow suit. Their statement just released in Oslo begins,

“The Norwegian Nobel Committee has decided that the Nobel Peace Prize for [2010] is to be awarded to President [Lloyd Blankfein] for his extraordinary efforts to strengthen international diplomacy and cooperation between peoples. The Committee has attached special importance to [Blankfein]’s vision of and work for a world without [credit derivatives].”

There may be more to this story. According to the website Market News Video, “Goldman recently upgraded Norway-based oil and gas company Statoil (STO) from neutral to buy, and even put the stock it on its conviction buy list”. And Goldman has long predicted that oil prices would hit \$200 per barrel – a forecast that has greatly helped buoy Norway’s public finances and restrain pressures to join the eurozone.

In a conference call, David Viniar (Goldman’s CFO) scoffed at the idea of a connection between the firm’s market activities and Mr. Blankfein’s recent slew of prizes,

“We had no material exposure to [Norway].”

Mr.Viniar further remarked, somewhat enigmatically,

“We also have taxpayer money at GS and it’s our responsibility not to lose it.”

He did not, however, clarify to which country’s taxpayers he was referring – nor how exactly Goldman got its hands on their money.

Meanwhile, there are persistent unconfirmed rumors that Mr. Blankfein is the front-runner to win the Pillsbury Bake-Off.

This would be controversial, as we are still 10 days away from the competition itself and Mr. Blankfein is not one of the named finalists.

Still, Mr. Blankfein did recently win the Financial Times 2009 Person of the Year award – despite also being at the same time “a keen judge for the Financial Times and Goldman Sachs Business Book of the Year Award.”

In fall 2009 Mr. Blankfein had seemed to commit to stop fixing the results of various kinds of competitions that are widely believed to be free and fair – like the stock market:

“We participated in things that were clearly wrong and have reason to regret. We apologize.”

But there may be divergent views within Mr. Blankfein’s own senior management team. David Viniar, for one, is holding to a harder line. With regard to what happened in the basketball gold medal game at the Vancouver Olympics, he was quite firm:

“There’s no guilt whatsoever.”

Capital Requirements Are Not Enough

Simon Johnson | 01 Apr 2010

By Simon Johnson and James Kwak, authors of 13 Bankers: The Wall Street Takeover and the Next Financial Meltdown (Pantheon, 2010).

The number of important people expressing serious concern about financial institutions that are too big or too complex to fail continues to increase. Since last fall, many leading central bankers including Mervyn King, Paul Volcker, Richard Fisher, and Thomas Hoenig have come out in favor of either breaking up large banks or constraining their activities in ways that reduce taxpayers' exposure to potential failures. Senators Bernie Sanders and Ted Kaufman have also called for cutting large banks down to a size where they no longer pose a systemic threat to the financial system and the economy.

To its credit, the Obama administration recognizes the problem; according to Treasury Department officials, addressing "too big to fail" is one of the central pillars of financial reform, along with derivatives and consumer protection. However, the administration is placing its faith in technical regulatory fixes. And, as Andrew Ross Sorkin emphasizes in his recent Dealbook column, they see increased capital requirements as the principal weapon in their arsenal: "[Treasury Secretary Tim] Geithner insists that if there is one change that needs to be made to the banking system to protect it against another high-stakes bank run like the one that claimed the life of Lehman Brothers, increasing capital requirements is it."

(Brief primer: Capital is money contributed by a bank's owners—conceptually, their initial capital contributions plus reinvested profits—that does not have to be paid back. Therefore, it acts as a buffer to protect a financial institution from defaulting on its obligations as the value of its assets falls. The more capital, the less likely a bank is to fail. The more capital, however, the lower the institution's leverage, and hence the lower its profits per dollar of capital invested—which is why banks always want lower capital requirements.)

Don't get us wrong: we think that increased capital requirements are an important and valuable step toward ensuring a safer financial system. We just don't think they are enough. Nor are they the central issue.

One problem is the question of where to set the capital requirements. The administration has proposed increasing capital requirements for the largest firms; because they are too big to fail, it is especially important

that they be safe. But this requires knowing how much capital would be needed to withstand what used to be regarded as a relatively financial storm—a “tail event”—which is something that no economist should feel comfortable estimating today, given that such storms may have become more frequent. We believe it would be simpler to have a standard capital requirement for all banks, and make sure that none of those banks are too big to fail.

Another problem is how they will be set and enforced. The Treasury Department says that bank regulators already have the power to increase capital requirements, but they will do so as part of an international agreement that they hope to reach by the end of this year. (Current capital requirements are generally based on an existing international accord.) But because capital requirements are enforced by regulatory agencies, which have the power to overlook shortfalls on a case-by-case basis (called “regulatory forbearance”), they can be an unreliable instrument during an economic boom, when regulators are infected by enthusiasm wafting in from the financial markets, if not by the more sinister problem of regulatory capture.

Third, there is the problem that capital requirements, like all complex calculations, can be gamed. Lehman Brothers, for example, was more than adequately capitalized on paper—Tier 1 capital of 11.6 percent—shortly before it went bankrupt in September 2008. Thanks to the literally voluminous report by the Lehman bankruptcy examiner, we now know this was in part due to aggressive and misleading accounting. More generally, rampant use of regulatory arbitrage—techniques to artificially increase bank capital ratios—was a factor in the failure of AIG (much of whose business was enabling European banks essentially to evade capital requirements) and the near-failure of Citigroup (which was almost capsized by the structured investment vehicles it created to evade capital requirements).

Capital requirements alone are not a reliable tool for preventing the collapse of systemically important financial institutions. Like other regulatory refinements, they depend on the ability and motivation of regulators to rein in financial institutions that have clear incentives to evade them at every opportunity. They also fundamentally reflect the belief that we are smart enough to prevent large financial institutions from collapsing in future financial crises. And the critical underlying assumption is that we will never again have a president in the United States who seeks to deregulate everything in sight; such an assumption would be unrealistic and dangerous.

We think the better solution is the “dumber” one: avoid having banks that are too big (or too complex) to fail in the first place. In our book, 13 Bankers, we propose strict asset caps (as a percent of GDP, i.e., relative to the size of our overall economy) on financial institutions that are adjusted for the types of assets and obligations held by those institutions – if they want to take more risk, they need to be smaller. We cannot predict what kind of trouble the next generation of bankers will be able to concoct for themselves. But we can try to make sure that when it does happen, we can let them fail without having to bail them out with taxpayer money.

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

Barney Frank Does the Right Thing

James Kwak | 01 Apr 2010

By James Kwak

The revolving door between business and government is something that Simon and I have criticized, most recently in a book you may have heard us mention once or twice. Ryan Grim of the Huffington Post reports that Barney Frank, chair of the House Financial Services Committee, has sent a message that he is serious about blocking the revolving door.

Peter Roberson was a lobbyist for the Bond Market Association (now part of SIFMA, a big securities industry lobbying organization) from 2000 to 2006 before becoming a staff member for Frank's committee, where he was recently working on derivatives legislation. When Frank found out he was in discussions with ICE (presumably, the exchange), it sounds like Frank fired him and blocked him from lobbying the committee so long as he is chair:

"Several people have expressed criticism of the move by Peter Roberson from the staff of the Financial Services Committee to ICE, after he worked on the legislation relevant to derivatives. I completely agree with that criticism. When Mr. Roberson was hired, it never occurred to me that he would jump so quickly from the Committee staff to an industry that was being affected by the Committee's legislation. When he called me to tell me that he was in conversations with them, I told him that I was disappointed and that I insisted that he take no further action as a member of the Committee staff. I then called the Staff Director and instructed her to remove him from the payroll and provide him only such compensation as is already owed."

Now, it is well understood that one of the main reasons to work for a committee like Financial Services is precisely because it enables you to get better paying jobs in industry later. So I don't know if it's possible to block the revolving door completely. But this seems like a step in the right direction.

“Break Up the Banks” – in the National Review

James Kwak | 02 Apr 2010

By James Kwak

“Big banks are bad for free markets,” economist Arnold Kling (who usually blogs at [EconLog](#)) begins in the conservative flagship *National Review*, and it only gets better from there. “There is a free-market case for breaking up large financial institutions: that our big banks are the product, not of economics, but of politics.”

Like other conservative economists, Kling uses Fannie Mae and Freddie Mac as an example of financial institutions that grew too large through a combination of lobbying expertise and government guarantees . . . and frankly I agree with him. But he is equally unsparing of other large banks that were supposedly “pure” private actors but turned out to have their own government guarantees.

Kling points to various government policies that have favored the growth of large banks. But rather than simply saying that this means that government should stay out of the markets, Kling says that the problem is one of political economy:

“In recent decades, the blend of politics and banking created a Washington–Wall Street financial complex in the mortgage market. . . . During this period, Wall Street firms were able to shape the basic beliefs of political figures and regulators, a phenomenon that Brookings Institution scholar Daniel Kaufmann has dubbed ‘cognitive capture.’ Andrew Ross Sorkin’s *Too Big to Fail*, which describes the response of the Federal Reserve and Treasury to the financial crisis, leaves the distinct impression that senior bankers had much more access to and influence over Washington’s decision makers than did career bureaucrats.”

Kling’s answer: make the banks smaller. I agree.

[Jonathan Chait](#) has an interesting take on Kling:

“I agree with Kling that the ideal solution would be to simply limit the size of the banks. The second-best solution, which is currently being pursued by Democrats in Congress, is to regulate the banks to prevent them from engaging in risky behavior, and/

or tax the large ones to reduce the advantage they gain over small institutions that aren't too big too fail. . . .

"[The large banks] *already have* so much political power that breaking them up has zero political feasibility. So we're in a second-best world where it's regulate, and hope regulation works, or do nothing. My skepticism of Kling's argument is that, like some principled right-wing arguments that acknowledge climate change, it argues for an ideal solution that lacks any chance of happening, while favoring the status quo over a second-best solution."

Chait's point makes sense, but insofar as I have to take sides, I'll take Kling's. First, as a general point, I think that it's not quite fair to hold economists or policy commentators up to a rigorous standard of political feasibility. It's not like Kling is proposing a legislative strategy for the Democratic majority; he's just saying what he thinks policy should be, and his proposed policy isn't impossibly infeasible like "everyone should just be nice to each other." I'm sure we could have an endless debate in the blogosphere about the relative merits of the ideal and the achievable, so I'll stop there.

Second, I'm not sure that Kling says he would favor the status quo over more regulation of the sort proposed by the administration. In any case, I certainly would not, and when I criticize the administration for not going far enough, I generally try to remember to say that they are going in the right direction. Simon and I also take pains to say that simply breaking up big banks is not enough and other changes such as higher capital requirements (and a CFPA, which we write about to the point of boring our readers) are also necessary.

Finally, Kling's goal may not be achievable in this session of Congress, but it may be achievable in the next decade. It takes time to shift public opinion away from the idea that big banks are inherently good. But it's still the good fight.

Update: Tom Keene asked us how we managed to get book endorsements from both Dean Baker and Jim Bunning. I said that this just shows how opposition to big banks is not a simply partisan issue. Kling's article spells out why many supporters of free markets—the economic "right"—are opposed to big banks.

Contradicting Secretary Geithner

Simon Johnson | 02 Apr 2010

By Simon Johnson

Speaking Thursday morning on the Today show, Treasury Secretary Tim Geithner insisted on two points:

1. If the bank rescue of 2008-09 had been handled in any other way – for example, being tougher on bankers – the costs to the real economy would have been substantially higher.

“again, what was the choice the president had to make? He had to decide whether he was gonna act to fix [the banking system] or stand back because it might be more popular not to have to do that kind of stuff, and that would have been calamitous for the American economy, much, much worse than what we went through already.”

2. The reform legislation currently before Congress would end all concerns regarding Too Big To Fail in the future.

“The president’s not gonna sign a bill that doesn’t have strong enough teeth.”

In 13 Bankers, we disagree strongly with point #1 (see this excerpt) and find point #2 so at odds with reality that it is scary. Friday morning, also on the Today Show, I have a brief opportunity to suggest a different narrative.

First and foremost, it is impossible to believe that the government could not have been tougher on banks and bankers in spring 2009. The idea that every failed top banker needed to keep his job – and that every director of a failed bank needed to stay in place – is simply preposterous.

Of course, the people who ran our biggest banks onto the rocks think they are indispensable, but as Charles de Gaulle reportedly said, ““The cemeteries of the world are full of indispensable men.”

This is not about being vindictive. This is about holding people accountable. We argue in 13 Bankers that the government could have taken over big insolvent banks – and applied a FDIC-type resolution process. At the very least, top management and boards of directors at

failed banks – i.e., all those rescued by the government – should have been fired.

Not only that – but all those people should have had their contracts broken and their bonuses clawed back to the full extent possible. Losing personal money is the only thing that modern American financial executives ultimately understand. And if that was breach of contract – let them sue and good luck to them in court; just think of the extra evidence for wrongdoing that would uncover.

The costs of this excessively nice approach are enormous. “[I]t is certain that a healthy financial system cannot be built on the expectation of bailouts” – that’s what Larry Summers said in his 2000 Ely Lecture to the American Economic Association, and it’s true (see the *American Economic Review*, Vol. 90, No. 2; no free weblink available). Now we have a system where the biggest banks expect to be saved, come what may – and the credit markets share that view. This is monstrously unfair and extremely dangerous.

In fact, it’s exactly the kind of financial structure that Larry Summers railed against in 2000 – that lecture was mostly about “emerging markets” and how they get into repeated financial crises. This is where the US is now heading.

As for the financial reform bill now before Congress, Secretary Geithner is completely wrong if he thinks it “has teeth”. There is simply nothing there that will rein in our largest financial institutions – and you can see this in the financial markets. Even as some sort of legislation moves closer to passing, massive banks retain their funding advantage – and continue to look for ways to get larger (see Jamie Dimon’s [letter to his shareholders this week](#)).

And as a symptom of these continuing problems, see the latest round on executive pay at banks – we’re back to [cash and other short-term oriented payouts](#). This administration recognizes that such incentives are dangerous – particularly when combined with implicit government guarantees. But they can do nothing – and will do nothing – about this or about the deeper underlying issues.

The biggest and most dangerous elements of Wall Street have taken over Washington.

The Most Dangerous Man in America: Jamie Dimon

Simon Johnson | 03 Apr 2010

By Simon Johnson

There are two kinds of bankers to fear. The first is incompetent and runs a big bank. This includes such people as Chuck Prince (formerly of Citigroup) and Ken Lewis (Bank of America). These people run their banks onto the rocks – and end up costing the taxpayer a great deal of money. But, on the other hand, you can see them coming and, if we ever get the politics of bank regulation straightened out again, work hard to contain the problems they present.

The second type of banker is much more dangerous. This person understands how to control risk within a massive organization, manage political relationships across the political spectrum, and generate the right kind of public relations. When all is said and done, this banker runs a big bank and – here's the danger – makes it even bigger.

Jamie Dimon is by far the most dangerous American banker of this or any other recent generation.

Not only did Mr. Dimon keep JP Morgan Chase from taking on as much risk its competitors, he also navigated through the shoals of 2008-09 with acuity, ending up with the ultimate accolade of “savvy businessman” from the president himself. His letter to shareholders, which appeared this week, is a tour de force – if Machiavelli were a banker alive today, he could not have done better. (You can access the full letter through the link at the end of the fourth paragraph in this [WSJ blog post](#); for another assessment, see [Zach Carter's piece](#).)

Dimon fully understands – although he can't concede in public – the private advantages (i.e., to him and his colleagues) of a big bank getting bigger. Being too big to fail – and having cheaper access to funding as a result – may seem unfair, unreasonable, and dangerous to you and me. But to Jamie Dimon, it's a business model – and he is only doing his job, which is to make money for his shareholders (and for himself and his colleagues).

Dimon represents the heavy political firepower and intellectual heft of the banking system. He runs some of the most effective – and tough – lobbyists on Capitol Hill. He has the very best relationships with Treasury and the White House. And he is determined to scale up.

The only problem he faces is that there is no case at all for banking of the size and form he proposes. Consider the logic he presents on p.36 of his letter.

He starts with a reasonable point: Large global nonfinancial companies are an integral and sensible part of the American economic landscape. But then he adds three more steps:

1. Big companies need big banks, operating across borders, with large balance sheets and the ability to execute a wide variety of transactions. This is simply not true – if we are discussing banking at the current and future proposed scale of JP Morgan Chase. We go through this in detail in 13 Bankers – in fact, refuting this point in detail, with all the evidence on the table, was a major motivation for writing the book. There is simply no evidence – and I mean absolutely none – that society gains from banks having a balance sheet larger than \$100 billion. (JP Morgan Chase is roughly a \$2 trillion bank, on its way to \$3 trillion.)
2. The US banking system is not particularly concentrated relative to other OECD countries. This is true – although the degree of concentration in the US has increased dramatically over the past 15 years (again, details in 13 Bankers) and in key products, such as credit cards and mortgages, it is now high. But in any case, the comparison with other countries doesn't help Mr. Dimon at all – because most other countries are struggling with the consequences of banks that became too large relative to their economies (e.g., in Europe; see Ireland as just one illustrative example).
3. Canada did fine during 2008-09 despite having a relatively concentrated financial system. Mr. Dimon would obviously like to move in the Canadian direction – and top people in the White House are also very much tempted. This is frightening. Not only does it represent a complete misunderstanding of the government guarantees behind banking in Canada (which we have clarified here recently), but this proposal – at its heart – would allow, in the US context, even more complete state capture than what we have observed under the stewardship of Hank Paulson and Tim Geithner. Place this question in the context of American history (as we do in Chapter 1 of 13 Bankers): If the US had just five banks left standing, would their political power and ideological sway be greater or less than it is today?

For a long time, our leading bankers hid behind their lobbyists and political friends. It is most encouraging to see Mr. Dimon come out from behind those layers of protection, to engage in the intellectual fray.

It is entirely appropriate – and most welcome – to see him make the strongest case possible for keeping banks at their current size and, in fact, for making them bigger. We should encourage such engagement in public discourse, but we should also examine carefully the substance of his arguments.

As we point out in the Washington Post Outlook section this week, Theodore Roosevelt carefully weighed the views of J.P. Morgan and other leading financiers in the early twentieth century – when they pushed back against his attempts to rein in their massive railroad and industrial trusts. Roosevelt was not at that time against big business per se, but he insisted that big was not necessarily beautiful and that we also need to weigh the negative social impact of monopoly power in all its economic and political forms.

If we don't find our way to a modern version of Teddy Roosevelt, Jamie Dimon – and his successors – will lead us into great harm. It's true that, after another crash or in the midst of a Second Great Depression, we can reasonably hope to find another Roosevelt – FDR – approach. But why should we wait when such a disaster is completely preventable?

Krugman on Financial Regulation

James Kwak | 03 Apr 2010

By James Kwak

Several people have asked us to comment on Paul Krugman's op-ed yesterday (both by email and in our bookstore event yesterday), in which he contrasts the Paul Volcker school ("limiting the size and scope of the biggest banks") with the other school ("the important thing is to regulate what banks do, not how big they get"). Krugman says he is in the latter group. But Mike Konczal* beat me to it:

"For me, it's not an either/or but a both/and question. I think we should do both (a) and (b), impose a hard size cap of \$400 billion to \$500 billion and then expand regulation over all the broken-up shadow banks. If you look at the conclusion of 13 Bankers, I think Simon Johnson and James Kwak are in a similar boat."

The short answer is what Mike said. We don't think limiting size and scope is a sufficient solution. This is what we say on page 216 of the book:

"To be clear, size limits should not replace existing financial regulations. A world with only small banks, but small banks with minimal capital requirements and no effective oversight, would not be dangerous in the same way as today's world of megabanks, but it would be dangerous nonetheless; it was the collapse of thousands of small banks that helped bring on the Great Depression. . . . Therefore, enhanced capital requirements and closer prudential regulation, as proposed by the Obama administration, are also necessary."

We don't spend a lot of time on the smarter/better regulations because we think they are relatively uncontroversial, and the administration is already pushing for them. We emphasize the size constraints precisely because those are more controversial and the administration is not pushing for them (unless you count the 10 percent limit on bank liabilities, which currently would affect exactly no one, according to the Treasury Department).

We've written several times about why smarter/better regulations alone are not enough, but I think the most basic point is simply that

regulation always fails — companies always find a way around it — and the costs of failure will be lower in a world with smaller banks than in a world with bigger banks. Yes, it is possible that several smaller banks could act in a way that is highly correlated and essentially mimic one larger bank; but it is not a foregone conclusion that this would happen, among other reasons because the more actors you have, the more likely they are to take differing positions on the market. (I believe the system was safer because Goldman and JPMorgan Chase became skeptical about the housing market around 2006-2007; imagine if there were just one gigantic investment bank, and it behaved like Bear, Lehman, or Merrill.)

So I actually don't think there's much of a debate here. Or, more precisely, there is a debate about whether to have size and scope constraints, but you don't have to pick between size and scope constraints on the one hand and closer prudential regulation and resolution authority on the other hand.

* Yes, that is Mike of Rortybomb fame, although it's on Ezra Klein's blog. Mike is guest-blogging for Ezra. I'd like to point out that I was one of the first, though not the first, to recognize Mike's blogging brilliance; he guest-blogged here last August when we were on vacation.

Now We Are “Ill-Informed and Under-Educated”

James Kwak | 05 Apr 2010

By James Kwak

A couple of weeks ago, Max Abelson got some investment bankers who used to work at Lehman to say what they really think about ordinary people:

“[Lehman]’s just not that big of an event. But that’s not what people want it to be, so they’ll make it not that way if they can. They just want to be mad and don’t know what they’re talking about and want to be outraged.”

“When I read this, I giggle a little bit. Because \$50 billion is a s—load of money, but in the grand scheme of things, \$50 billion is a drop in the ocean.”

“Yappers who don’t know anything.”

Well, the commercial bankers are not taking this lying down. They are out trying to prove that they can be just as offensive.

Speaking of the proposed Consumer Financial Protection Agency, bank president Robert Braswell had this to say, according to the News & Record of Greensboro:

“The consequences to the consumer will be equal or worse than what they’re trying to legislate away,” said Robert Braswell, president of Greensboro-based Carolina Bank. . . .

Banks, he said, will pass on added costs to consumers or stop offering some services, such as free checking. Braswell said when he has been on lobbying trips to Washington on behalf of bankers groups, congressmen and congressional staffers did not seem receptive to points made by those in the industry.

“There is no consideration to (whether it’s duplicative); there’s no consideration as to cost,” he said. “Those who are behind this legislation are absolutely ill-informed and under-educated . . . They refuse to consult with anyone who does possess the requisite knowledge.”

This isn’t even worth a point-by-point rebuttal. Insofar as the CFPA is duplicative, it duplicates powers that existing regulators didn’t use; and

it also extends consumer protection to the nonbanks, which were not regulated at all. If free checking only exists because banks are gouging other customers, then free checking shouldn't exist. Oh, and Tim Geithner, Michael Barr, and Elizabeth Warren are "under-educated"? I guess I am, too.

I would be encouraged by Braswell's claim that congressmen and their staffers are not receptive to points made by the industry . . . except that it's not true. Anyone who knows what is going on in Washington knows that the bank lobbyists have been punching holes in the legislation successfully for the past seven months. Maybe they're not receptive to Braswell, but there are plenty of industry spokespeople doing a much better job — and not talking about it in public.

By the way, on the subject of Lehman and yappers, John Hempton has some good evidence that, yes, other banks were doing it, too. The main evidence is that Bank of America's end-of-period assets were consistently lower than their average assets, which implies that they were doing something at the end of every quarter to massage the size of their balance sheet down. (Hempton also found matching imbalances in a specific counterparty's balance sheet.) We had a brief exchange about whether there might be some business reason for this consistent imbalance (for example, in high-ticket sales businesses, most of the sales are clumped at the end of each quarter — but that's an income statement thing, not a balance sheet thing), and he is pretty certain that there is no other explanation.

Larry Summers: “Senator Kaufman is exactly right”

Simon Johnson | 05 Apr 2010

By Simon Johnson, co-author of 13 Bankers: The Wall Street Takeover and The Next Financial Meltdown

Senator Ted Kaufman (D., DE) has given three blistering speeches recently, individually and collectively cutting to the heart of the financial reform matter: the deregulation of finance has gone too far and big banks now need to be reined in; the continued prevalence of fraud among Wall Street’s biggest bankers; and why the administration’s proposed “resolution authority” would do nothing at all to end the problems associated with Too Big To Fail financial institutions.

You might think no one listens to Senate floor speeches, but you’d be wrong. Yesterday, on “This Week” (ABC), Jake Tapper asked Larry Summers – head of the White House National Economic Council and key strategist on financial reform – point blank about one of Senator Kaufman’s most important points.

Summers started this part of the interview with a fiery anti-finance industry moment, citing their lobbying spending against financial reform (“\$1 million per congressman”) and arguing that the legislation currently before Congress will provide basic consumer protection, more effective regulation, and the ability to handle the failure of large financial firms. “How can anyone take the position ... that we don’t need comprehensive financial reform?”

To which, Jake Tapper responded,

“TAPPER: Some Democrats say it doesn’t go far enough. Here’s Delaware Democrat Ted Kaufman talking about the Dodd bill.”

(BEGIN VIDEO CLIP: in this version, the question is asked around the 1:50 mark; note, the transcript below includes a few important sentences at the end that are not in the clip)

“KAUFMAN: Unless Congress breaks up the mega-banks that are too big to fail, the American taxpayer will remain the ultimate guarantor of an almost certain to repeat itself cycle of boom, bust and bailout.”

(END VIDEO CLIP)

"TAPPER: Senator Kaufman is saying that there isn't being — enough being done about too big to fail. In 2000, you said, quote, "It is certain that a healthy financial system cannot be built on the expectation of bailouts." Can you honestly say that the Dodd bill changes that?"

"SUMMERS: Yes, I can. It changes — it reduces the expectation of bailouts by insisting that institutions have much more capital so they won't need to be bailed out. It eliminates the prospect of bailout by creating a framework in which a failure can be managed with creditors taking responsibility."

"It restricts — and this was the important point that former Fed Chairman Paul Volcker has stressed — it restricts the so-called proprietary trading activities, some of the most risky activities of these institutions. So, yes, this bill is a direct attack on too large to fail by making failure a possibility, as it has to be in a market system, and by making these institutions much safer and much sounder. Senator Kaufman is exactly right."

Larry Summers is incorrect on three important dimensions of the Dodd legislation: it doesn't "insist institutions have much more" capital requirements, it doesn't "restrict proprietary trading activities" in any meaningful fashion, and it doesn't "eliminate the prospect" of a bailout. For the details on all these issues, review the three Kaufman speeches linked above – these are now essential reading for anyone who wants to grasp what really needs to happen.

The White House rhetoric on financial reform is moving in the right direction. But there is growing dissonance between what the White House says it is supporting and what is really in the legislation.

Mr. Summers and other leading representatives of the administration should move to recognize and correct this dissonance. Either they should work hard to strengthen the legal provisions, along the lines stressed by Senator Kaufman, or they should be more honest – i.e., they do not think that "too big to fail" is really such an important problem, or they are afraid that big banks would react by contracting credit (this is essentially what Jamie Dimon threatens at the end of his letter to shareholders last week).

If the White House continues down the path of endorsing reform while not really pushing for meaningful change, the financial reform conversation will become increasingly uncomfortable for them.

Passing a bill that contains mostly mush is not a good idea – it would only further the perception (and the reality) that this administration is far too close to certain “savvy businessmen” on Wall Street.

The coming legislative debate will clearly divide people into “for” and “against” our massive global banks that have so manifestly gone bad. For the last time: Which side does the president really want to be on?

Note: Jake Tapper was quoting from Larry Summers’s 2000 Ely Lecture to the American Economic Association is available to buy through JSTOR – or you can ask your favorite library to obtain this. See my review of Summers’ thinking from the 1990s on crises and financial reform here – we also cover this in more detail in chapter 2 of 13 Bankers. While some specific actions of Treasury during the 1990s were controversial and even regrettable, Summers’ Ely Lecture was right on target. The administration, however, has not found itself able to apply the principles outlined in Summers’ Lecture – 13 Bankers, in part, explains why.

The Fourteenth Banker

James Kwak | 05 Apr 2010

By James Kwak

I wanted to bring your attention to a new blog that could turn out to be very important. It's called The Fourteenth Banker ([here's why](#)) and it's hosted and written by a current banker who wants to see real change in the industry. This is from the About page:

"Despite being with a big bank, I support reform legislation ending TBTF, separation of Commercial and Investment banking, an independent consumer protection agency and other meaningful reforms. Why? I have seen first hand the perversions that happen because of some who believe that the an institution exists for them and the stockholders primarily. Countless others have been hypnotized by this illusion as well. Free market idealism is conveniently permissive of unbridled self interest. I believe in the free market. In fact, this blog is a free market of ideas and is meant to lead to a free market in banking where institutions self police as a matter of competitiveness. I have hopes of a free market where being in community in a responsible and consistent way is the path to prosperity, a free market where we recognize that if we take care of the community, the community will take care of us. It takes a sort of faith. Or does it? Is not all successful business enterprise based on providing more value than is consumed?

"That is why we are here. I invite other bankers to engage in discussion about issues and excesses in our industry and possible solutions."

The goal of the blog is to provide a forum for people within the industry who are dissatisfied with both its behavior over the past decade and its stubborn refusal to change its ways in the wake of the financial crisis. Posts include coverage of misdeeds by the financial sector, as well as an inside perspective on issues such as breaking up banks.

Banks are very large organizations that include many different people with different political, moral, and business ideas. I am sure there are many bankers who are upset with the way their companies have taken advantage of customers, investors, creditors, and taxpayers, and who

want the industry to change. However, many banks have attempted to suppress any attempt at real dialogue by issuing blanket gag orders for their employees. The Fourteenth Banker could help make it possible for bankers to engage in that debate.

Financial Regulation and Fools

James Kwak | 05 Apr 2010

By James Kwak

Last week I disagreed with Paul Krugman's dichotomy between limiting banks' scale and scope and restricting banks' risky behavior. Today Krugman has another op-ed, this time criticizing the current Senate bill for not being sufficiently "fool-resistant." This time, I basically agree with him.

The problem with the Dodd bill, in Krugman's words, is that "everything is left at the discretion of the Financial Stability Oversight Council, a sort of interagency task force including the chairman of the Federal Reserve, the Treasury secretary, the comptroller of the currency and the heads of five other federal agencies." Citing Mike Konczal,* Krugman points out, "just consider who would have been on that council in 2005, which was probably the peak year for irresponsible lending" — Alan Greenspan, John Snow, and John Dugan. (If you're following the logic of Krugman's argument, those would be "fools.")

The better alternative is to have hard-coded restrictions in the bill itself, to *reduce* agency discretion. I agree with that, and that's why I think size caps should be in legislation — not just the power for regulators to set size caps.

Here's how Krugman concludes:

"I know that getting such things into the bill would be hard politically: as financial reform legislation moves to the floor of the Senate, there will be pressure to make it weaker, not stronger, in the hope of attracting Republican votes. But I would urge Senate leaders and the Obama administration not to settle for a weak bill, just so that they can claim to have passed financial reform. We need reform with a fighting chance of actually working."

But I'm not hopeful. First of all, this isn't just about politics; as far as I can tell, Treasury Secretary Tim Geithner actually disagrees with Krugman and thinks that it's *better* to leave things to the discretion of regulators. Here are Mike Konczal and Felix Salmon discussing Geithner's position.

Second, it's largely about politics. Bear in mind, I'm not a political consultant. But if I *only* cared about the politics of financial reform, not

the substance, this is what I would do. The Obama administration doesn't want to lose, say, 52-48 (that's 52 in favor of the cloture motion, 48 against), because that's a political liability; then they failed to reform the financial system, and they were blocked by a bipartisan coalition (41 Republicans and 7 "Democrats"), and the Republicans will say it's because they were being too extreme. So I think they will do everything they can to get all 59 Democrats on board. Then they can say to Mitch McConnell: "Either you let us pass this bill, or you block it on a strict party line vote, which will prove to the country that you, the Republicans — not us Democrats — are in bed with Wall Street." That's a win-win situation; either they get their bill and declare victory, or they have a real issue to use in November.

But the cost of keeping 59 Democrats on board is a very, very weak bill — on TBTF, on derivatives, and on consumer protection. And that's where I think this is heading.

Now, the administration could say, "This is a weak bill, but it's the best we could get given the opposition, and we're going to keep fighting in the future." But I don't think they'll say that, because politically you want to have accomplishments, and calling your own bill a weak bill is like shooting yourself in the foot. So I think they will take the weak bill and declare victory.

* Can I point out again that Mike Konczal was our guest blogger before he was Ezra Klein's? Krugman says that Mike's blog is "essential reading for anyone interested in financial reform." Mike, when you're all famous, don't forget us little people.

Greece And The Fatal Flaw In An IMF Rescue

By Peter Boone and Simon Johnson. This is a long post, about 3,500 words.

In 2003 the International Monetary Fund published yet another internal review with an impressively dull title “The IMF and Argentina, 1991-2001”. But hidden in that text is explosive language and great clarity of thought – in essence, the IMF staff belatedly recognized that their decision to repeatedly bailout Argentina from the mid-1990s through 2002 was wrong:

“The IMF should refrain from entering or maintaining a program relationship with a member country when there is no immediate balance of payments need and there are serious political obstacles to needed policy adjustment or structural reform” (p.7, recommendation 4).

If Mr. Trichet (head of the European Central Bank), Ms. Merkel (German Chancellor), and Mr. Sarkozy (French President) have not reviewed this document yet, they should skim it immediately. Because one day soon Greece will be calling on the IMF for a loan, and it seems mostly likely that the mistakes made in Argentina will be repeated.

There are disconcerting parallels between Argentina’s catastrophic decade, 1991-2001, which ended in massive default, and Greece’s recent and impending difficulties. The main difference being that Greece is far more indebted, is much less competitive in global markets, and needs a commensurately greater fiscal and wage adjustment.

At the end of 2001, Argentina’s public debt GDP ratio was 62%, while at end 2009 Greece’s was 114%. Argentina’s public deficit reached 6.4% GDP in 2001, while Greece’s was 12.7% GDP (or 16% on a cash basis) in 2009. Both countries locked themselves into currency regimes which made it extremely painful to exit: Greece has the euro, while Argentina created a variant of a currency board system tied to the US dollar. And both countries had seen their competitiveness, as measured by the “real exchange rate” (which reflects differential inflation relative to competitors) worsen by 20% over the previous decade, helping price themselves out of export markets – and boosting their consumption of imports. In 2009 Greece had a current account deficit equal to 11.2% of GDP, while Argentina’s 2002 current account deficit was a much smaller 1.7% GDP.

The solution to such crises is rarely gradual. Once financial market confidence is lost, yields on government debt soar, private capital flees, and sharp recessions occur. The IMF ended up drawing tough conclusions from its Argentine experience – the Fund should have walked away from weak government policy programs earlier in the 1990s. Most importantly, IMF experts argued that from the start the IMF should have prepared a Plan B, which included restructuring of debts and termination of the currency board regime, since they needed a backstop in case the whole program failed. By providing more funds, the IMF just kicked the can a short distance down the road, and likely made Argentina's final collapse even more traumatic than it would otherwise have been.

Sadly, the Greeks are today in a similar situation: the government's macroeconomic program is not nearly enough to calm markets, or put Greece's debt on a sustainable path. By 2012 we estimate Greece's debt/GDP ratio will rise from 114% of GDP to over 150%. The interest payments alone on this would amount to 9% of Greek's incomes at current rates, and almost all those funds are transferred to the German, French, and Swiss debt holders.

Greece's 2010 "austerity" program is striking only for its lack of credibility. Under that program Greece, even in 2010, does not pay the interest on its debt – instead the government plans to raise 52bn euros in credit markets to refinance all its interest while at the same time it borrows 4% of GDP more. A country's "primary budget" position measures the budget without interest expenses — at the very least, the Greeks need to move from a 4% of GDP primary budget deficit to a 9% of GDP primary surplus – totalling 13% of GDP further fiscal adjustment, in the midst of what will be a massive recession, just to have enough funds to pay annual interest on their 2012 debt. This is under the rather conservative assumption that interest rates would settle near 6% per year, where they stand today. The message from these calculations is simple: Greece needs to be far more bold if its austerity program is to have a serious chance of success.

How did Greece manage to get into such a terrible situation? Local politics that lead to profligate spending is one answer. But remember that someone needs to supply the money that allows such profligacy. In this case it was the European Central Bank that handed Greece the keys to the safe.

The reason Mr. Trichet wants Europe to stand tough against Greece

This may not be obvious, but, creating money in a currency union is no simple task. In any single country, central banks usually restrict themselves to buying government bonds, and making loans to regulated commercial banks. Net purchases of these securities by central banks creates what is called “high-powered money”; this feeds into the financial system and results in the creation of what we all use to make payments and store value, i.e., money, plain and simple.

However in the European Monetary Union there are now 17 nations and a plethora of banks. So, to put it crudely, there is sure to be a fight to decide who gets the newly printed funds. The ECB resolved this by what seemed like a fair rule: All commercial banks can borrow from the ECB if they provide collateral, in the form of highly rated government and other securities, to the ECB. So, for example, a Greek bank can gain liquidity by depositing Greek government bonds with the ECB – as long as those bonds are “investment grade”, i.e., highly rated.

This simple and seemingly reasonable rule created great dangers for the eurozone, which have come back to haunt Mr. Trichet. The commercial banks in the zone are able to buy government bonds, which “paid” 3-6% long term interest rates (for all the sovereign bonds of members) over the last decade, and then deposit them at the ECB. They could then borrow from the ECB at the ECB financing rate, which today is 1%, against this collateral so pocketing a profit — and then buy more sovereign bonds with the funds. Mr. Trichet recognized this system had inherent dangers of turning into a new Ponzi game: if nations spent too much, and built up too much debt, eventually the system would collapse. So at the foundation of the eurozone, Mr. Trichet led a contingent within the EU that demanded all nations live by a “Growth and Stability Pact”, whereby each nation could only run deficits of 3% of GDP, and they had to keep their debt/GDP ratio below 60% of GDP.

Of course, politics trumped Mr. Trichet – as it always must – and the Greeks, along with the Portuguese, used their new found cheap lending system to run large deficits and build up debt. The cheap access to money also helped feed the real estate booms in Ireland and Spain.

Today, Mr. Trichet and Ms. Merkel are desperate for harsh changes to ECB lending rules that will stop this ponzi game. They want to penalize profligate spenders. They also want profligate nations to pay more interest. Soon, due to its poor credit rating, Greek debt will be treated like poor collateral, so banks will no longer be able to borrow as much with Greek debt as collateral. When these changes at the ECB come into

effect in 2011, the days of Greece being able to borrow easily at low interest rates in the euro zone will close once and for all.

As protector of the euro zone, the ECB does not want to see large bailouts to nations that abused the system. Marco Kranjec, an ECB council member, recently made the ECB view clear: "Membership in the Euro region dictates a special discipline....only non-euro region EU members, such as Hungary, Latvia and Romania, are eligible for financial aid". The non-euro members get aid because they do not have access to the ECB lending window, but, if you abuse that window, you will not get extra help.

If Greece needs to pay more for its debt, the debt dynamics become ever more unsustainable. What interest rate should markets charge for a nation that has 120-150% public debt/GDP ratio, a large budget deficit, a recessionary uncompetitive economy, and a bloated public sector that stages frequent and often violent strikes? The answer is probably around what Argentina paid in the late nineties: 10% per year. But as Greece's Prime Minister is fully aware when he calls for lower interest rates, Greece cannot afford these rates – their budget would simply collapse.

If they are permitted to be candid, what choices would the IMF staff present to Greece?

So when the Greeks soon turn up at the IMF, what will the IMF say? If politics did not circumvent rational economics, the choices are clear:

Choice 1: True Fiscal Austerity – 10% of GDP, with further measures soon

To gain confidence in markets, the Greeks need to demonstrate that they are prepared to actually stop the rapid rise of their debt relative to income. This means running a primary surplus in short order.

For Greece to achieve this, the numbers required are, simply put, staggering. Lower public spending and higher taxes will lead to a sharp contraction in demand, and it will have repercussions as businesses in Greece see less follow on spending. Ultimately, every \$1 of fiscal tightening may generate \$1.50-2.00 in lost domestic demand. Fiscal tightening only works if the new unemployment leads to wages and prices falling, so making a nation more competitive. The jury is out whether Greek unions would permit such large wage reductions, but the whole process will surely take several years. So, in the first year or two, we could expect Greek GDP to fall sharply with a strong austerity program.

This is where the problems set in – and the risk of a vicious downward cycle. Lower GDP means lower tax revenues, and higher unemployment benefits, and all these things worsen the budget. Under reasonable assumptions, if the Greeks took an initial 10% of GDP in further fiscal measures, they would still run a budget deficit in 2011 of approximately 5% of GDP. This deficit would fall as the economy recovered later, and if unemployment fell, but that could take a long time.

We doubt such an austere program could work, and even if it did, someone needs to finance Greece's budget deficit, and roll over their debt, for 3 or more years. Markets would undoubtedly be concerned by sharp output declines and ongoing strikes. The only solution would be for the EU and IMF to step up, and effectively guarantee three years of financing needs, or \$150bn in total. That is seven times the whisper numbers that the European Union is currently considering providing to Greece.

Choice 2: Sovereign default but keep the euro

The second choice means admitting that the fiscal situation is just too painful to solve: Greece would default on its debt and call a stop to all interest and principal for, say, two years.

The default on debt would have major ramifications. The government would need to take actions to avoid a run on all the Greek banks – this would need to be coordinated with the ECB to ensure there was liquidity support. Private creditors would pull loans wherever possible from Greek entities. In short: Greece would suffer a large financial and economic collapse, and GDP would decline substantially.

This financial collapse would mean Greek debt would need to be written down substantially. We would guess that a 65% write down of face value, bringing total Greek debt to around 50-60% of a lower new GDP, would be reasonable. Such write downs roughly match the terms that Argentina received after its debt restructuring.

This draconian cut to government debt would not solve Greece's problems. It would still need to cut budget spending in order to lower the deficit – and in the aftermath of defaults, there are generally few sympathizers. Greece could save on interest (which to data it never paid in any case), but it would not be a panacea for the budget or economy.

Choice 3: The IMF's Plan B – Debt default and exit the eurozone

Faced with a collapsing banking system that comes with default on sovereign debt, there is good reason to call for Greece to, at least temporarily, give up the euro. The advantage of moving to a different currency would be that Greece could generate a rapid increase in competitiveness, and so speed up its transition. The government could offer to restructure debt into this new currency, or into Euros at a much larger haircut. The bloated costs of the public sector could be eroded through inflation in the new currency. This should make it possible to quickly move to a budget surplus and an external surplus.

In Argentina, the government partially indexed deposits at banks, but they forced the deposits to be converted to pesos from dollars. They similarly required all domestic debt be converted, and they negotiated a sharp reduction in external debt while offering those debt holders the ability to convert debt into pesos.

Argentina's economic collapse ended roughly six months after they defaulted and ended their peg. While it was painful, the economic recovery started rapidly; nine months after default and devaluation, GDP began growing rapidly. This is a trend that continues even today. The same lesson, that large devaluations and default can result in rapid recoveries, was observed in Russia in 1999, and in the aftermath of the asian crises.

Greece's recovery would take longer, because they have not yet had many of the adjustments that are needed, but they could probably expect a recovery to decent growth starting H2 2011.

The IMF leadership will want to muddle through, but will Merkel and Trichet play ball?

Will the IMF prepare a program with drastic fiscal cuts, sticking to the lesson it learned from Argentina, in order to bring the nation back into solvency? Will they turn to the EU and be blunt: either you need to be prepared to provide Greece 150bn euros of loans over three years as credit lines, at low interest rates so they can afford it, or the program will be underfunded. Will they walk away from any program if the EU does not promise large enough funding, and the Greeks do not promise drastic enough cuts? And, would they dare to discuss a "Plan B" for Greece, as their own internal review suggested would have been best for Argentina back in the nineties?

The answer to all this seems very clear. The IMF will agree to another program that is very likely to fail, just like they did in Argentina. There are some obvious reasons why this is likely. One reason is that it is easy

to hide behind a veil of probabilities. Of course there is some chance that Greece might make it out with little change, so why not wait and see if it works? The trouble is the odds, for Greece, are slim. It is impossible to say exactly what the odds are, but suffice it to say, Greece's external debt and current fiscal difficulties, while tied into a fixed exchange rate regime, mean that nation needs far harsher adjustments than any of the sovereign major defaulters of the last 50 years. We cannot think of one comparable example of success. The social and political divisions in Greece, along with the penchant for debilitating strikes, also reduce the odds for success.

(Some people suggest Ireland is an example – however Ireland started with much lower debt levels, and despite large fiscal cuts they are still running a deficit over 10% of GDP that requires annual financing and a rapid build-up of sovereign debt. Greece could not get these funds in markets, and they will have trouble repaying that new debt just like the old.)

Meanwhile, the longer we wait for real fiscal adjustments, the more Greece builds up debts and so needs an ever larger adjustment later. Such an end could be enormously disruptive: imagine nationwide strikes, violence, and chaotic default. Consider the burden on others: while Greece marches on building up debt and sinking ever deeper into problems, how can we expect creditors to feel comfortable lending to Portugal, Ireland or Spain? The whole euro zone will suffer if Greece defaults, and, they will suffer if Greece does not default. The IMF concluded that Argentina had a window, in the late nineties when they could possibly have escaped their burdensome debt and currency peg in a planned move – but they missed it. The euro zone arguably has a chance now to deal resolutely, one way or another, with this problem before the chronic pain impacts others.

There are also powerful personal interests that will guide these decisions. Dominique Strauss-Kahn, current head of the IMF, is primarily focused on becoming the next President of France. It will not look good – to the French electorate – if the IMF is seen forcing a Greek default, nor if it demands that the Europeans provide over a hundred billion euros of long term financing. So, he surely wants to offer a lax short term program, which is backed up by promises for “greater austerity in the future if needed”. Greece will march on, mired in recession, with its debt stock growing as the IMF and EU fund them. The private sector, as in the case of Argentina, will simply not want to touch their debt. Dominique Strauss-Kahn can then declare his candidacy in

early 2011, resign from the Fund, and let his successor force the true austerity – at which time Greece will suffer ever more under any solution.

It is also in the interests of most other members of the euro zone to just “kick the can down the road”. The other debt laden periphery nations are naturally terrified of a Greek collapse that will spill over to their nations. They will now lobby hard for the IMF to be generous, and they will be satisfied with partial steps. Perhaps this will give them time to prepare, but more likely, they will just kick the can down the road themselves – as the Portuguese seem to be doing with their lax fiscal budget announced for 2010. These nations surely underestimate how much worse this may get, and they continue to suckle on the cheap credit window which the ECB has, until now, kept open to them.

The fight begins: Will Europe’s “euro visionaries” and the austere Germans force hard decisions today?

However, there are two groups in the euro zone who may still not play this game. Ms. Merkel knows German taxpayers would loathe any kind of Greek bailout, and Germans inherently care more about the long term stability of the euro than any other nation.

It is, undoubtedly, in the ECB’s and Germany’s long term interest to force Greece to take tough medicine now, or, to default on their sovereign debts and leave the euro zone. Having one member be forced out of the eurozone will send a clear message to others.

There are many nations now waiting on the sidelines: How can Mr. Trichet and the Germans feel comfortable that new entrants will not copy the Greek Ponzi game once they gain access to ECB’s funding windows if the new entrants see Greece get a new large loan package at subsidized interest rates? The ECB should be rightly concerned that such actions would only make fiscal probity, and therefore monetary policy, far harder to control in the euro zone.

Where next for Greece?

Mr. Trichet understands that Greece’s problems reflect a dangerous flaw in the euro zone system, and the solution will set the tone for behaviour of other members for years to come. He’ll want his pound of flesh before this is done. The IMF staff surely understands that Greece’s economic problems are critical, and require drastic actions, but the IMF’s managing director just wants to survive to be elected a new President of France in 2012.

The German population detests providing bailouts to periphery nations, while the debtors of the Euro zone would like the same game to continue a little bit longer. Meanwhile, the Greeks continue to drag their feet on serious reform while claiming to be “courageous”– presumably they are hoping, magically, that markets will start to want to lend to them again at very low rates in the midst of a fiscal program with little hope for long term success. It all seems horribly reminiscent to those early days when Argentina slid towards a cruel collapse.

Book News

James Kwak | 07 Apr 2010

By James Kwak

(This is an occasional update on this blog. For more frequent news and reviews, see the [13 Bankers](#) site.)

Since the last update here, we've gotten several more reviews: [The Daily Beast](#), [Fortune](#), [The Aleph Blog](#), and [Rortybomb](#), to name a few. Links to many reviews are [here](#). (If you wrote a review and want us to link to it, send me an email at [baselinescenario at gmail dot com](mailto:baselinescenario@gmail.com).)

I've also updated the list of [past media appearances](#) that you can view online, so you can see Simon's suit from many different angles. In particular, I'd like to flag the [Firedoglake Book Salon](#) from this past weekend, where Bill Black hosted an in-depth, online discussion with Simon. I've also updated the list of [upcoming events](#) (in-person and media). For those in Rhode Island, there's a last-minute addition: I'll be talking at Brown this Sunday.

Some people have asked how the book is selling. I know little about the publishing industry, but I believe the accurate answer is always, "I don't know." Our Amazon book ranking is in the 40s, which we are grateful for. (Michael Lewis was #1 for a couple of weeks until he was completely blown out of the water by Stephenie Meyer's next vampire novel, which isn't even shipping until June.) But as for bookstore sales (which are still several times Amazon sales), you really don't know, because bookstores can return unsold copies. So it's too early to tell.

Update: Simon's entire event (over one hour) at the World Affairs Council of Washington is available on [C-SPAN](#).

Greenspan: Love Him, Hate Him

James Kwak | 07 Apr 2010

By James Kwak

Alan Greenspan is just as maddening in his retirement as he was during his nineteen-year reign over the global economy. Today in his appearance before the Financial Crisis Inquiry Commission (extensive coverage by [Shahien Nasiripour](#) and [Ryan McCarthy](#) here), Greenspan seems primarily concerned with passing the buck and preserving the remaining shreds of his legacy, a pathetic quest epitomized in his “I was right 70 percent of the time” remark. At the same time, however, he does make some very blunt statements about the financial industry and financial regulation that policymakers should ignore at their peril. (I’m not saying that because Greenspan was wrong before, he must be right now; I’m saying that when the most ardent defender of free financial markets reverses course, that should increase your skepticism toward free financial markets.)

Greenspan’s prepared testimony begins with a massive attempt to pass the buck. The first two pages of his account of the financial crisis have to do with rapid economic development overseas and the accumulation of the fabled global glut of savings. But he reaches even farther back to . . . the fall of the Berlin Wall and the discrediting of communism.

Greenspan also repeats the tired old argument that Fannie and Freddie were to blame (pages 3-4), focusing on their purchases of private mortgage-backed securities. This is something that, following Alyssa Katz, we also criticized Fannie and Freddie (and the government behind them) for. But tellingly, Greenspan’s data only go up to 2003-2004 — because from this point the GSEs’ share of the subprime market *declined*, as they were pushed out of the way by private sector players.

But the more interesting part of the testimony begins on page 7, where Greenspan discusses the challenges of regulating the modern financial system. The problems he points to include:

- systematic underestimation of risk
- “the virtually indecipherable complexity of a broad spectrum of financial products and markets”
- a failure of the regulatory system

With this in mind, Greenspan favors rules that “would kick in automatically, without relying on the ability of a fallible human

regulator to predict a coming crisis,” including increases in capital and collateral requirements. This runs largely counter to the Obama administration’s preference for leaving specific limits to regulators.*

Here, though, I think Greenspan is still too optimistic. “I presume, for example,” he says, “that with 15% tangible equity capital, neither Bear Sterns nor Lehman Brothers would have been in trouble.” That is a huge increase over the current requirement of 4% (8% Tier 1 capital, but only half of that has to be tangible equity). But still, is it enough? As Steve Randy Waldman pointed out, Lehman turned out to be worth between \$50 and \$160 billion less than its books said it was worth just before its collapse. At about \$640 billion in assets, that’s a “mistake” of 8 to 25 percentage points. If, as Greenspan acknowledges, the products themselves are extremely complex and we can’t count on anyone to evaluate them, how do we know that 15% capital is enough?

When it comes to “too big to fail,” Greenspan makes the same point, in similar terms, that we do in *13 Bankers*: “The productive employment of the nation’s scarce saving is being threatened by financial firms at the edge of failure, supported with taxpayer funds, designated as systemically important institutions,” and “The existence of systemically threatening institutions is among the major regulatory problems for which there are no good solutions.” But then Greenspan proposes solutions: namely, contingent capital (an idea I’ve criticized here, citing Gillian Tett) and resolution authority. He proposes breaking up TBTF institutions . . . but only after they fail.

Nasiripour and McCarthy have additional statements by Greenspan from his responses to questions. One key point he was making was that regulators simply cannot keep up with the megabanks.

Regulators can’t keep up with today’s megabanks, he said. They’re too complex. Regulators, in short, don’t have a chance.

Greenspan, appearing before the panel convened to investigate the roots of the financial crisis, said that the “ideal way” to supervise banks would be to go through its individual loan documents — the way supervisors used to police banks and financial firms before they grew so large.

But unfortunately, he lamented, that’s no longer possible because firms are so complex.

“We are reaching far beyond our capacities,” Greenspan told the Financial Crisis Inquiry Commission. “It’s not a simple issue of ‘Let’s regulate better,’” he said. “It’s a different world.”

“The complexity is awesome,” he noted.

It’s nice that, in his retirement, Greenspan has finally become humble about the prospects for regulation. I wish the current batch of government officials would share the same humility. Not because I’m against regulation — I’m definitely in the more/stricter/better camp when it comes to regulation. But because I think you have to be prepared for it to fail. So either we need to change banking so that it is simple enough to regulate again (which isn’t going to happen). Or we need to reduce the size of banks so that when they do fail, they don’t take the financial system with them.

* In their defense, the administration might argue that those limits should be set by regulators but should *then* kick in automatically — although I’m not sure that’s what they are saying.

Standing At Thermopylae

Simon Johnson | 08 Apr 2010

By Peter Boone and Simon Johnson

No one in official Washington is seriously worried about Greece. It's far away, relatively small, and – anyway – “we already sent the IMF”. Under current circumstances, this is very much like saying 2,500 years ago: We sent 300 Spartans to stand against a horde of Persians, so what's the problem?

The Greek economic situation is worsening fast – with government bond yields rising rapidly today (currently the 10-year rate is around 7.5 percent). Unless there is rapid action by the international community, this has the potential to get out of control.

There are three scenarios to consider: the nightmare, the “savior”, and the decision.

Nightmare scenario: No one makes a quick decision, and bond spreads for other relatively weak eurozone countries take off. “Core Europe”, such as Belgium and France, are also hit by higher bond yields. At that point, the EU does something small for Greece, but that does not really address the worsening problems elsewhere. Real interest rates remain differentiated across Europe, with Germany very low and the periphery very high. This causes very different growth rates, feeds into strikes, and budget deficits worsen. European banks take capital losses so (again) need to recapitalize. The periphery banks need their recapitalization to be funded by the state, which increases national debt. At some point soon a European country defaults. Then there is a wave of defaults.

“Savior” scenario: Phone Larry Summers, and he will help arrange another round of unconditional bailouts for all creditors everywhere – perhaps on scale that makes the 13 bankers episode look small. The strategy will be to welcome all the moral hazard back into the system so people feel the risk of state (and private) bankruptcy is zero. Each day we delay now, Mr. Summers and his colleagues will have to provide more largesse - and more distortion – when they finally come in. For example, they could do a new round of “stress tests” and decide that each European nation has a good enough plan to reduce its budget deficit. Perhaps the eurozone nations agree to a common tax or fiscal mechanism to help each other through transfers. They then open the European Central Bank (ECB) lending windows to all those countries.

Investors realize they are safe because the ECB shows it has no backbone – maybe Mr. Trichet resigns but probably not, so the spreads come in, etc. The moral hazard issues are mind-boggling, and it would very hard to get any teeth into the system after that. The financial markets would, of course, in the short term stand up and applaud – until they thought through and began to understand all the consequences for government balance sheets.

Decision scenario: As we laid out at length on Tuesday, Greece faces only hard decisions involving some combination of: much more fiscal austerity than is currently in the cards, debt restructuring (also known as default), and leaving the eurozone. Given all the players involved on the European side, it is hard to see how they take any of these decisions soon. This is why “prompt correction action” is never prompt and rarely truly corrective – politicians in this situation (and regulators more generally) have an incentive to delay taking hard decisions that will encounter serious pushback; they would rather wait for events – either they will get lucky or, more likely, they will be forced in a particular direction. But this is exactly how you get forced to a decision point where the only options really are “global collapse or overly generous rescue that creates major problems down the road”.

The US needs to step forward with some clear leadership on these issues. The situation would still be difficult, given the attitudes and fractious nature of Europe. But Washington will not even try – the White House still doesn’t understand what it has helped create and the dangers that this poses.

What Would Really End “Too Big To Fail”?

Simon Johnson | 08 Apr 2010

By Simon Johnson, co-author of 13 Bankers: The Wall Street Takeover and The Next Financial Meltdown

As we move closer to a Senate – and presumably national – debate on financial reform, the central technical and political question is: What would prevent any bank or similar institution from being regarded – ultimately by the government – as so big that it would not be allowed to fail. If you are “too big to fail” (TBTF), credit markets see you as lower risk and as more attractive investment – enabling you to obtain more funding on cheaper terms, and thus become even larger.

Everyone agrees, in principle, this is a bad arrangement. It’s an unfair distortion of markets – giving huge banks the opportunity to grow bigger, because they have implicit government guarantees. It is also manifestly unsafe, because it encourages reckless risk-taking: If things go well, the TBTF bank gets the upside; if there is mismanagement of risk, or just bad luck, the downside falls to the taxpayer and to society more broadly. These costs can be huge: 8 million jobs lost since December 2007.

But there remains sharp disagreement on what exactly would end too big to fail. The main views fall primarily into three camps.

The view of Senator Dodd, Democratic congressional leadership more broadly, and the White House – and actually the big banks themselves (e.g., Jamie Dimon in Wednesday’s Wall Street Journal) – is that the creation of a “resolution authority” would, at a stroke, effectively remove the perception and the reality that some banks are too big to fail. The basic idea here – as elaborated on by Sheila Bair this week – is that the Federal Deposit Insurance Corporation (or potentially another agency) would expand the powers it currently has to “resolve” – i.e., takeover and liquidate in an orderly manner – banks with federally insured deposits; in the future, it could do this for any financial institution.

The view of leading Republicans is that the Dodd-Dimon approach would just formalize the existence of TBTF banks. Peter Wallison and David Skeel, for example, argue strongly that the FDIC has no competence in winding down large complex financial institutions – and they are certainly correct that this task would be quite different from closing small or medium-sized banks while protecting depositors. But

their proposal – which seems to also have the support of Senator Richard Shelby (ranking Republican on the Senate Finance Committee) is that we should just allow big financial firms to fail outright, i.e., to run through the usual bankruptcy procedures.

At a rhetorical level, “let ‘em fail” has some appeal. But as a practical matter, it is a complete nonstarter. Remember that when Treasury Secretary Hank Paulson decided to let Lehman fail in September 2008, credit markets immediately choked and the global economy teetered on the brink of a Second Great Depression.

When another mega-bank starts to meltdown, any future president – no matter how libertarian or interventionist by inclination – will face the same horrible moment of decision: Let the financial system collapse or provide an expensive rescue. It is striking in this context that Mr. Wallison and others from the right used to be outspoken proponents of downsizing financial institutions that had become so large that they were assessed (correctly, as it turns out) Too Big To Fail – but that was when the debate was about Fannie Mae and Freddie Mac.

The third approach, articulated most clearly so far within the Senate by Ted Kaufman (D., DE) is much simpler and more direct: Break up these mega-banks. As even Alan Greenspan said in October 2009, “If they’re too big to fail, they’re too big” (see Chapter 9 of *13 Bankers*).

There is no evidence for economies of scale or scope – or other social benefits – from banks with assets above \$100 bn. Yet our largest banks have balance sheets around \$2 trillion and Mr. Dimon defiantly affirmed last week – in his letter to shareholders – that JP Morgan Chase should be allowed to grow bigger, if it so pleases. But any such growth would not be outcome of any fair or normal market process. Rather it would reflect the Too Big To Fail implicit subsidy on which Mr. Dimon can now draw, manifest in the form of lower funding costs.

Mr. Dimon may or may not be a good manager of risk, but he will not run JP Morgan Chase for all time. Sooner or later, one or more of our biggest banks will run into serious trouble.

And at that moment, it will matter a great deal whether “biggest bank” means assets of 2-4 percent of GDP (as we propose) or 20 percent of GDP (roughly our current situation) or over 100 percent of GDP (the problem of RBS, the largest UK bank, which essentially failed in 2008).

Making our largest banks smaller is not sufficient to ensure financial stability. As we review in *13 Bankers*, there are many other complementary measures that make sense – including higher capital

requirements, more transparency for derivatives, and generally more effective regulation. But reducing the size of our largest banks is absolutely necessary if we are to reduce the odds of another major financial catastrophe.

Make our largest banks small enough to fail. There is simply no other way to really end the problem of Too Big To Fail.

This piece previously appeared, in an edited version, on the NYT's Economix this morning – and it is used here with permission. If you would like to reproduce the entire post, please contact the New York Times.

The Repo 18: It's Not the Collateral, It's the Cover-Up

James Kwak | 09 Apr 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.

Since reading portions of the report issued by Anton Valukas, the examiner in the Lehman bankruptcy and writing about the firm's accounting tricks in "A Whiff of Repo 105," I've been thinking about footnote 69.

Perhaps 'obsessing' is a better description of my state of mind. Consider that I possess a printed copy of the nine-volume, 2,200 page report. However, that obsession seemed justified, very early this morning, when the Wall Street Journal broke the story, Big Banks Mask Risk Levels, revealing the early results of the SEC's probe of repurchase agreement accounting practices at major firms.

According to the WSJ, based on data from the Federal Reserve Bank of New York, eighteen banks "understated the debt levels used to fund securities trades by lowering them an average of 42% at the end of each of the past five quarterly periods." These banks include Goldman Sachs, Morgan Stanley, JP Morgan Chase, Bank of America and Citigroup.

According to the story, these practices are perfectly legal. However, the full investigation is not yet complete. There remains still the possibility that this may be the "Watergate" of the financial crisis. If manipulation of balance sheets rises to the level of fraud, there may be convictions to follow. Thus far, leveraging up, binging on toxic assets and threatening the global economy have been protected within the bounds of simply bad business judgment. However, as we learned from Nixon, the cover up is a whole different narrative.

Upon spotting the WSJ story this morning, I remembered that fascinating footnote from the examiner's report. It appears on page 19 and reads as follows:

"⁶⁹ Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 8 (Kelly told the Examiner that **Lehman was the last of the CSE firms to continue using Repo 105-type transactions to manage its balance sheet by late 2007); Examiner's Interview of Marie**

Stewart, Sept. 2, 2009, at p. 4 (Stewart believed that Lehman was the **last of its peer group** using Repo 105 transactions by December 2007)." (Emphasis added)

These revelations by Martin Kelly, Lehman's controller, and Marie Stewart, the global head of accounting policy, invited many questions.

First, how reliable are they? Recall that Kelly is the first addressee listed on the May 2008 letter from Lehman whistleblower, Matthew Lee. Second, how could they know what the practices were at the competitor CSEs (CSE was the regulatory designation from 2004 – 2008 of the five large independent investment banks – Bear, Lehman, Merrill, Morgan Stanley and Goldman)? Third, if there was no legal change at that time, what was the magic of 2007? In other words, if the examiner, Anton Valukas, is correct in suggesting the "repo 105" practice was actionable, are these other investment banks vulnerable to litigation for pre-2007 practices? Fourth, was it possible that the other investment banks had been hiding billions of dollars of debt off balance sheet? Fifth, what was the connection between these practices and the financial crisis? Sixth, was this still going on at the firms?

Prior to finding the answers to these questions, I noticed that the SEC had posted a sample letter that it sent to "certain public companies requesting information about repurchase agreements, securities lending transactions, or other transactions involving the transfer of financial assets with an obligation to repurchase the transferred assets." The illustrative letter was signed by the Senior Assistant Chief Accountant. Pleased that the SEC was on the job, I turned my attention to other matters, until this morning.

It is hard to predict what will happen next. However, it is quite possible, that the Valukas Report will be the global financial crisis analog to the Pecora Hearings, helping to energize robust regulatory reform. At the very least, this reinforces the need that all debt and all transactions that have the economic effect of debt or leverage must be on balance sheet. Only time will tell.

Note from James: This behavior by the banks seems similar to what John Hempton pointed out: if you compare some banks' end-of-period balance sheets to their average balance sheets, you see a difference. The WSJ report deals with repo, while Hempton was looking at the total balance sheet, but the story is basically the same.

A Failure of Corporate Governance

James Kwak | 09 Apr 2010

By James Kwak

(I've gotten several great articles forwarded to me via email by readers. It may take a few days to do them justice. Here's one.)

In the great consensus of the past twenty years, government regulation was unnecessary because the free market provided better tools for constraining private companies. One force was the market, idealized by Alan Greenspan, who believed that counterparties could even police effectively against fraud. The other force was shareholders, who would punish managers for acting contrary to their interests. The market would prevent companies from abusing their customers, while corporate governance would prevent them from abusing their shareholders.

For those who still believe in the latter, McClatchy has a good (though infuriating) article on what went wrong on Moody's, the bond rating agency that, we previously learned, responded to warnings about the toxic assets it was rating by . . . firing the people making the warnings. In the words of an executive on a Moody's risk committee:

"My question the whole time has been, 'Where the hell has the board been?' I would have expected, sitting where I was, that I would have got a lot more calls from the board. I got none of that."

Another Moody's executive added, "There was no (corporate) governance at the firm whatsoever. I met the board, I presented to them, and it was just baffling that these guys were there. They were just so out of touch."

The story that Kevin Hall tells about Moody's has been told many times before. Board members often serve at the pleasure of the CEO, who controls who receives the perks of board membership. The result is often, but not always, boards that rubber-stamp the decisions of the CEO and his or her inner circle. Court precedents make it difficult to hold board members personally liable for anything, and companies buy liability insurance for their board members just in case. As Lynn Turner, former chief accountant of the SEC, said to McClatchy, "I personally think until law enforcement agencies start holding these boards accountable, . . . you're probably not going to get a lot of change."

This is why I am skeptical of proposals to, for example, increase the number of independent board members. There's nothing wrong with it, but I think it betrays a certain amount of naivete over what independent board members actually do.

Another Great TAL Episode on the Financial Crisis

James Kwak | 09 Apr 2010

By James Kwak

ProPublica has a long and detailed story of Magnetar, the hedge fund that helped fuel the subprime bubble by providing the equity for new subprime collateralized debt obligations — precisely so that it could then go and short the higher-rated tranches. In other words, Magnetar wanted to short some really, really toxic CDOs. But either there weren't enough toxic CDOs to short, or they weren't toxic enough. So they provided the equity necessary to manufacture more toxic CDOs. Then they shorted them. Yes, the math works out.

Yves Smith told the story of Magnetar in her book ECONned. The ProPublica story adds a bunch of details. But the best part is that This American Life is doing a story on Magnetar in this weekend's radio show, which I'm sure will be great.

The Oracle of Kansas City

James Kwak | 09 Apr 2010

By James Kwak

Many of you have probably already seen Shahien Nasiripour's interview with Thomas Hoenig, president of the Federal Reserve Bank of Kansas City and the most prominent advocate of simply breaking up big banks. (Paul Volcker is more prominent, but his views are more nuanced; the famous Volcker limit on bank size, it turns out, would not affect any existing banks, at least as interpreted by the Treasury Department.) It largely elaborates on Hoenig's positions that we've previously applauded in this blog, so I'll just jump to the direct quotations:

On megabanks:

"I think they should be broken up. . . . We've provided this support and allowed Too Big To Fail and that subsidy, so that they've become larger than I think they otherwise would. I think by breaking them up, the market itself would begin to help tell you what the right size was over time."

On whether the United States needs megabanks to compete globally:

"That is a fantasy — I don't know how else to describe it. Our strengths will be from having a strong industrial economy. We will have financial institutions that are large enough to give us influence in the markets but not so large that they're too big to fail. . . .

"The United States became a financial center not because we had large institutions but because we had a strong industrial economy with a good working financial system across the United States — not just highly-concentrated in one market area."

On the Dodd bill and regulatory discretion:

"There's still this desire to leave discretion in the hands of the Secretary of the Treasury, and while I understand that desire — because you never know what the circumstance is going to be —

the problem is in those circumstances you always take the path of least resistance because of the nature of the crisis.

“You don’t want to be the person responsible for the meltdown, so you take the exception and you move it through.

“But if you had a good firm rule of law, and the markets knew. . . there were no exceptions . . . you would be in the long run much better off.”

There was one thing I didn’t agree with. Hoenig seems to say that if you break up the big banks, the market will determine what size they should be. I think that if you broke up the big banks and left them to their own devices, they would reaggregate into new megabanks — precisely because of the funding advantages that you get from being too big to fail. So I think there needs to be a size limit that is actively policed by the government.

Fix The Dodd Bill – Use The Kanjorski Amendment

Simon Johnson | 10 Apr 2010

By Simon Johnson

At the heart of the currently proposed legislation on financial reform (e.g., the Dodd bill and what we are expecting on derivatives from the Senate Agriculture committee), there is a simple premise: Key decisions about exact rules going forward must be made by regulators, not Congress. This is obviously the approach being pushed for capital requirements, but it is also the White House's strong preference for any implementation of the Volcker Rule – first it must be studied by the systemic risk council (or similar body) and only then (potentially) applied.

Treasury insists that Congress is not capable of writing the detailed rules necessary for a complex financial system – only the regulators can do this. This is either a mistake of breathtaking proportions, or an indication that the ideology of unfettered finance continues to reign supreme.

The regulators who got us into our current mess include Ben Bernanke (a Republican from the Greenspan tradition of financial regulation), John Dugan (also a Republican, who makes Bernanke look progressive), and of course Alan Greenspan himself.

If legislation can only empower regulators then, given regulators are only as strong a newly elected president wants them to be, the approach in the Dodd bill simply will not work.

There is still a feasible alternative, based on a different approach – that proposed by Representative Paul Kanjorski (chairman of the Capital Market Subcommittee of the House Financial Services Committee) and adopted as an amendment in the House bill.

This amendment will allow federal regulators to preemptively break up large financial institutions that – for any reason – pose a threat to financial or economic stability in the United States. (Yes, there is a weak version of this idea currently in the Dodd draft, but it is very weak – allowing regulators to act “only as a last resort”; see p.3 of the official bill summary.)

Representative Kanjorski has exactly the right idea, but we need to go a step further – because we cannot at this point reasonably expect regulators to implement properly. Remember, in the Catch-22 type

nature of these issues, the regulators can easily say: Implicit in Congress's decision not to mandate a break-up, will infer a congressional intent that no institutions currently meet the criteria.

The reality is this. As documented in 13 Bankers (see Chapter 7), six banks currently fit the Kanjorski criteria – they are, by any definition, “too big to fail.” Congress should mandate their break-up rather than leaving this to the judgment of regulators.

We can discuss the best language and exact terms but the broader point is that we need change by statute, not “after further study.”

Even if you trust and believe in the new-found regulatory zeal of our current regulators, Senator Dodd and all other Democrats should be concerned that the next president may be a free market Republican who will appoint regulators captured by Wall Street.

The Dodd legacy should be to break the doom loop for future generations. It would be unwise to let that legacy depend on the judgment of regulators to be named later.

Thank You

James Kwak | 11 Apr 2010

By James Kwak

13 Bankers is #11 on the New York Times hardcover nonfiction bestseller list.^{*} I'm certain that could not have happened without the readers of this blog. (Actually, the book would not have existed in the first place without this blog, and the blog wouldn't exist without readers.) It's also #4 on the Wall Street Journal hardcover business list and #14 on the Indiebound hardcover nonfiction list.

In other major news, the book is Arianna Huffington's pick for April, which means that there will be a month of blog posts by us and by other bloggers at the Huffington Post. Our first post in the series, arguing against the "banana peel" theory of the financial crisis, is already up. We've lined up a wide range of commentators, several of whom we expect to disagree with us rather strongly.

We also have some full-length video of presentations by Simon. Over the next week, I'll be in Providence and Simon will be in Chicago and Los Angeles (schedule here). Simon has a bunch of interviews; I'll be on Sense on Cents tomorrow evening.

^{*} The list is for the week ending April 3. It goes on the Web on April 9 but doesn't go into the print edition until April 18, by which point it is two weeks out of date. (One friend thinks the lag is to give bookstores enough time to stock their shelves.)

Taxation and Prohibition

James Kwak | 11 Apr 2010

By James Kwak

Andrew Haldane (of "doom loop" fame) has another provocative paper, "The \$100 Billion Question," delivered in Hong Kong last week. A central theme of the paper is what Haldane sets up as a debate between taxation and prohibition as approaches to solving the problem of "banking pollution" — the systemic risk externality created by the banking industry. Taxation is higher capital and liquidity requirements; prohibition is structural reforms that limit the size or scope of financial institutions. Drawing on work by Weitzman and Merton, Haldane discusses when one approach would be superior to the other.

The advantages of prohibition include modularity (ability of a system to withstand a collapse of one component), robustness (likelihood that regulations will work when needed), and better incentives (since tail risk is a function of banker behavior — not weather patterns — the risk-seeking nature of banking means that no capital level will necessarily be high enough).

Here's Haldane on robustness:

"There is a literature on how best to regulate systems in the face of such Knightian uncertainty.

It suggests some guideposts for regulation of financial systems. First, keep it simple. Complex control of a complex system is a recipe for confusion at best, catastrophe at worst. . . .

"Second, faced with uncertainty, the best approach is often to choose a strategy which avoids the extreme tails of the distribution. Technically, economists call this a "minimax" strategy — minimising the likelihood of the worst outcome. Paranoia can sometimes be an optimal strategy.

"Third, simple, loss-minimising strategies are often best achieved through what economists call 'mechanism design' and what non-economists call 'structural reform'. . . . In the words of economist John Kay, it is about regulating structure not behaviour.

“Taken together, these three features define a ‘robust’ regulatory regime – robust to uncertainties from within and outside the system. Using these robustness criteria, it is possible to assess whether restrictions might be preferable to taxation in tackling banking pollution.”

The disadvantages include lost economies of scale and scope — but, as Haldane discusses, these don’t exist in banking beyond a moderate size threshold.

In the United States, it seems pretty certain that the administration and Congress have chosen the taxation route. But Haldane thinks the debate is not over in the long term:

“We are at the start of a great debate on the future structure of finance, not the end. Some fear that momentum for radical financial reform will be lost. But financial crises leave a scar. This time’s sovereign scar should act as a lasting reminder of the criticality of reform. . . .

“The history of banking is that risk expands to exhaust available resources. Tail risk is bigger in banking because it is created, not endowed. For that reason, it is possible that no amount of capital or liquidity may ever be quite enough. Profit incentives may place risk one step beyond regulation. That means banking reform may need to look beyond regulation to the underlying structure of finance if we are not to risk another sparrow toppling the dominos.

“Today’s financial structure is dense and complex, like a tropical rainforest. Like the rainforests, when it works well it is a source of richness. Yet it is, as events have shown, at the same time fragile. Simpler financial eco-systems offer the promise of greater robustness, at some cost in richness. In the light of a costly financial crisis, both eco-systems should be explored in seeking answers to the \$100 billion question.”

It's pretty clear which side he's on.

Greece Saved For Now – Is Portugal Next?

Simon Johnson | 12 Apr 2010

By Peter Boone and Simon Johnson

The Europeans announced Sunday they would provide 30 billion euros of assistance to Greece, amid informed rumors that the IMF will offer another 10-15 billion. With a total of say 40-45 billion euros in the bag – more than the market was expecting — the Greeks have time to make changes.

The Greek government, helped by the market threat of a near term collapse, appear to have strong armed the other eurozone countries into a generous package without making efforts to change seriously their (Greek) fiscal policy. This is good for near term calm, but it does not solve any of the inherent problems now manifest in the eurozone.

Often assistance packages of this nature just help “smart money” to get out ahead of a default. This could be the case here; 40-45 billion euros total money could last roughly one year. Both Russia and Argentina got large packages in the late 1990s but never regained access to private markets, so eventually everything fell apart.

Sunday’s package should make it possible for Greece to borrow short-term but it takes courage to lend for 5 or 10 years to the Greeks unless there is much more fundamental change.

There are two key things to watch for:

- 1) Is the global recovery so strong that Greek’s economy picks up fast and their budget deficit comes down sharply?
- 2) Will the IMF and Greeks now come up with a real austerity program that sharply cuts the deficit so that a year from now, when the official bailout money could run out, the market is receptive to Greek debt?

The danger for private debt holders is clear: Sovereign loans invariably treated better in a restructuring than private debt. So the European aid in some sense squeezes private debt holders. They will be pleased there is no near term default, but it means their recovery value has gone down if things get bad again. Greek long term yields will probably stay high. The key market reaction to watch over the next 6-12 months is long term yields, and whether these come down to levels that imply low risk of default.

And there is still definite risk of contagion. The actions of the EU show they are willing to intervene when yields get up to 7-8% on long term debt and markets close off to a nation.

What does this really mean for Portugal or Ireland? People holding Greek debt lost a lot of money in the last few months. That will not come back soon, as markets will for a long time be wary of buying their debt – especially when Fitch just took the Greek rating to BBB minus, i.e., at the floor where the ECB now lets banks borrow against (“repo”) government debt.

The Portuguese therefore are not at all out of the woods. If they do not start making serious moves towards cutting their deficit, they are next for a test.

Surely the eurozone will bail Portugal out also – but where would it stop after that? The stronger Europeans, by coming to Greece’s rescue at this time with little conditionality, are effectively showing all the weaker nations that they too can get a package. This will undoubtedly reduce the resolve for needed fiscal reforms across the European periphery.

We are still lurching from crisis to crisis in Europe.

The Cover-Up

James Kwak | 13 Apr 2010

By James Kwak

Wall Street is engaged in a cover-up. Not a criminal cover-up, but an intellectual cover-up.

The key issue is whether the financial crisis was the product of conscious, intentional behavior — or whether it was an unforeseen and unforeseeable natural disaster. We've previously described the "banana peel" theory of the financial crisis — the idea it was the result of a complicated series of unfortunate mistakes, a giant accident. This past week, a parade of financial sector luminaries appeared before the Financial Crisis Inquiry Commission. Their mantra: "No one saw this coming." The goal is to convince all of us that the crisis was a natural disaster — a "hundred-year flood," to use Tim Geithner's metaphor.

I find this incredibly frustrating. First of all, plenty of people saw the crisis coming. In late 2009, people like Nouriel Roubini and Peter Schiff were all over the airwaves for having predicted the crisis. Since then, there have been multiple books written about people who not only predicted the crisis but bet on it, making hundreds of millions or billions of dollars for themselves. Second, Simon and I just wrote a book arguing that the crisis was no accident: it was the result of the financial sector's ability to use its political power to engineer a favorable regulatory environment for itself. Since, probabilistically speaking, most people will not read the book, it's fortunate that Ira Glass has stepped in to help fill the gap.

This past weekend's episode of This American Life includes a long story on a particular trade put on Magnetar (ProPublica story here), a hedge fund that I first read about in Yves Smith's ECONned. The main point of the story is to show how one group of people not only anticipated the collapse, and not only bet on it, but in doing so prolonged the bubble and made the ultimate collapse even worse. But it also raises some key issues about Wall Street and its behavior over the past decade.

This will require a brief description of what exactly Magnetar was doing. (If you know already, you can skip the next two paragraphs.) It's now a cliché that a CDO is a set of securities that "slices and dices" a different set of securities. But it's slightly more complicated than that. First there is a pile of mortgage-backed securities (or other bond-like

securities) that are collected by an investment bank. The CDO itself is a new legal entity (a company) that buys these MBS from the bank; that's the asset side of its balance sheet. Its liability side, like that of any company, includes debt and equity. There's a small amount of equity bought by one investor and a lot of debt, issued in tranches that get paid off in a specific order, bought by other investors. The investment bank not only sells MBS to the CDO, but it also places the CDO's bonds with other investors. Whoever buys the equity is like the "shareholder" of this company. There is also a CDO manager, whose job is to run the CDO — deciding which MBS it buys in the first place, and then (theoretically) selling MBS that go bad and replacing them by buying new ones. The CDO itself is like an investment fund, and the CDO manager is like the fund manager.

According to the story, in 2006, when the subprime-backed CDO market was starting to slow down, Magnetar started buying the equity layer — the riskiest part — of new CDOs. Since they were buying the equity, they were the CDOs' sponsor, and they pressured the CDO managers to put especially risky MBS into the CDOs — making them more likely to fail. Then Magnetar bought credit default swaps on the debt issued by the CDOs. If the CDOs collapsed, as many did, their equity would become worthless, but their credit default swaps on the debt would repay them many, many times over.

The key is that Magnetar was exploiting the flaws in Wall Street's process for manufacturing CDOs. Because the banks made up-front fees for creating CDOs, the actual human beings making the decisions did not particularly care if the CDOs collapsed — they just wanted Magnetar's money to make the CDOs possible. (No one to buy the highly risky equity, no CDO.) Because the ratings agencies' models did not particularly discriminate between the contents that went into the CDOs (see pages 169-71 of *The Big Short*, for example), Magnetar and the banks could stuff them with the most toxic inputs possible to make them more likely to fail.

Now, one question you should be asking yourself is, how is this even arithmetically possible? How is it possible that a CDO can have so little equity that you can buy credit default swaps on the debt at a low enough price to make a killing when the thing collapses? You would think that: (a) in order to sell the bonds at all, there would have to be more equity to protect the debt; and (b) the credit default swaps would have been expensive enough to eat up the profits on the deal. Remember, this is

2006, when several hedge funds were shorting CDOs and many investment banks were looking for protection for their CDO portfolios.

The answer is that nothing was being priced efficiently. The CDO debt was being priced according to the rating agencies' models, which weren't even looking at sufficiently detailed data. And the credit default swaps were underpriced because they allowed banks to create new synthetic CDOs, which were another source of profits. So here's the first lesson: the idea that markets result in efficient prices was, in this case, hogwash.

By taking advantage of these inefficiencies, Magnetar made the Wall Street banks look like chumps. This American Life talks about one deal where Magnetar put up \$10 million in equity and then shorted \$1 billion of AAA-rated bonds issued by the CDO. It turned out that in this deal, JPMorgan Chase, the investment bank, actually held onto those AAA-rated bonds and eventually took a loss of \$880 million. This was in exchange for about \$20 million in up-front fees it earned.

But who's the chump? Sure, JPMorgan Chase *the bank* lost \$880 million. But of that \$20 million in fees, about \$10 million was paid out in compensation (investment banks pay out about half of their net revenues as compensation), much of it to the bankers who did the deal. JPMorgan's *bankers* did just fine, despite having placed a ticking time bomb on their own bank's balance sheet. Here's the second lesson: the idea that bankers' pay is based on their performance is also hogwash. (The idea that their pay is based on their net contribution to society is even more absurd.)

So who's to blame? The first instinct is to get mad at Magnetar. But this overlooks a Wall Street maxim cited by TAL: you can't blame the predator for eating the prey. Magnetar was out to make money for its limited partners; if it had bet wrong and lost money, no one would have bailed it out. Although I probably wouldn't have behaved the same way under the circumstances, I have no problem with Magnetar.

I do have a problem with the Wall Street bankers in this story, however. Because losing \$880 million of your own company's money to make a quick buck for yourself is either incompetent or just wrong. And allowing Magnetar to create CDOs that are as toxic as possible — and then actively selling their debt to investors (that's where the banks differ from Magnetar, in my opinion) — is either incompetent or just wrong. But even so, I don't think the frontline bankers are ultimately at fault. Maybe they were simply incompetent. Or maybe, they were

knowingly exploiting the system to maximize their earnings — only in this case the system they were exploiting was their own banks' screwed-up compensation policies, risk management "systems," and ethical guidelines.

In which case the real blame belongs to those who created that system and made it possible. And that would be the bank executives who failed at managing compensation, risk, or ethics, endangering or killing their companies in the process. And that would be the regulators and politicians who allowed these no-money down no-doc negative-amortization loans to be made in the first place; who allowed investment banks to sell whatever they wanted to investors, with no requirements or duties whatsoever; who allowed banks to outsource their capital requirements to rating agencies, giving them an incentive to hold mis-rated securities; who declined to regulate the credit default swaps that Magnetar used to amass its short positions; who allowed banks like Citigroup and JPMorgan Chase to get into this game with federally insured money; and who failed at monitoring the safety and soundness of the banks playing the game.

The lessons of Magnetar are the basic lessons of the financial crisis. Unregulated financial markets do not necessarily provide efficient prices or the optimal allocation of capital. The winners are not necessarily those who provide the most benefit to their clients or to society, but those who figure out how to exploit the rules of the game to their advantage. The crisis happened because the banks wanted unregulated financial markets and went out and got them — only it turned out they were not as smart as they thought they were and blew themselves up. It was not an innocent accident.

Greek Bailout, Lehman Deceit, And Tim Geithner

Simon Johnson | 13 Apr 2010

By Simon Johnson

We live in an age of unprecedented bailouts. The Greek package of support from the eurozone this weekend marks a high tide for the principle that complete, unconditional, and fundamentally dangerous protection must be extended to creditors whenever something “big” gets into trouble.

The Greek bailout appears on the scene just as the US Treasury is busy attempting to trumpet the success of TARP – and, by implication, the idea that massive banks should be saved through capital injections and other emergency measures. Officials come close to echoing what the Lex column of the Financial Times already argued, with some arrogance, in fall 2009: the financial crisis wasn’t so bad – no depression resulted and bonuses stayed high, so why do we need to change anything at all?

But think more closely about the Greek situation and draw some comparisons with what we continue to learn about how Lehman Brothers operated (e.g., in today’s New York Times).

The sharp decline in market confidence last week – marked by the jump in Greek yields – scared the main European banks, and also showed there could be a real run on Greek banks; other Europeans are trying to stop it all from getting out of hand. But there is no new program that would bring order to Greece’s troubled public finances.

It’s money for nothing – with no change in the incentive and belief system that brought Greece to this point, very much like the way big banks were saved in the US last year.

If anything, incentives are worse after these bailouts – Greece and other weaker European countries on the one hand, and big US banks on the other hand, know now for sure that in their respective contexts they are too big to fail.

This is “moral hazard” – put simply, it is clear a country/big bank can get a package of support if needed, and this gives less incentive to be careful. Fiscal management for countries will not improve; and risk management for banks will remain prone to weakening when asset prices rise.

If a country hits a problem, the incentive is to wait and see if things get better – perhaps the world economy will improve and Greece can grow

out of its difficulties. If such delay means that the problems actually worsen, Greece can just ask Germany for a bigger bailout.

Similarly, if a too-big-to-fail bank hits trouble, the incentive is to hide problems, hoping that financial conditions will improve. Essentially the management finds ways to “prop up” the bank; on modern Wall Street this is done with undisclosed accounting manipulation (in some other countries, it is done with cash). If this means the ultimate collapse is that much more damaging, it’s not the bank executives’ problem any way – their downside is limited, if it exists at all.

The Greeks will now:

1. Lobby for a large multi-year program from the IMF. They’ll want a path for fiscal policy that is easy in the first year and then gets tougher.
2. When they reach the tough stage, can’t deliver on the budget, and are about to default, the Greek government will call for another rapid agreement under pressure – with future promises of reform. The eurozone will again accept because it feels the spillovers otherwise would be too negative.
3. The Greek hope is that the global economy recovers enough to get out, but more realistically, they will start revealing a set of negative “surprises” that mean they miss targets. If the surprises add to the feeling of crisis and further potential bad consequences, that just helps to get a bailout.
4. The Greek authorities will add a ground game against the European Central Bank, saying things like: “the ECB is too tight, so we need more funds”. We’ll see how that divides the eurozone.

In their space, big US banks will continue to load up on risk as the cycle turns – while hiding that fact. Serious problems will never be revealed in good time – and the authorities will again have good reason (from their perspective) to agree to the hiding of issues until they get out of control, just as the Federal Reserve did for Lehman Brothers. Moral hazard not only ruins incentives, it also massively distorts the available and disclosed information.

As for Mr. Geithner, head of the New York Fed in 2008 and Secretary of the Treasury in 2009: Those who cannot remember the bailout are condemned to repeat it.

Pack of Fools

James Kwak | 14 Apr 2010

By James Kwak

“I thought that I was writing a period piece about the 1980s in America, when a great nation lost its financial mind. I expected readers of the future would be appalled that, back in 1986, the CEO of Salomon Brothers, John Gutfreund, was paid \$3.1 *million* as he ran the business into the ground. . . . I expected them to be shocked that, once upon a time on Wall Street, the CEOs had only the vaguest idea of the complicated risks their bond traders were running.

“And that’s pretty much how I imagined it; what I never imagined is that the future reader might look back on any of this, or on my own peculiar experience, and say, ‘How quaint.’”

That’s Michael Lewis in *The Big Short* (p. xiv), looking back on *Liar’s Poker*.

“Looking back, however, Salomon seems so . . . small. When the *Business Week* story was written, it had \$68 billion in assets and \$2.8 billion in shareholders’ equity. It expected to earn \$1.1 billion in operating profits for all of 1985. The next year, Gutfreund earned \$3.2 million. At the time, those numbers seemed extravagant. Today? Not so much.”

That’s the third paragraph of Chapter 3 of *13 Bankers*. (This was a complete coincidence; I didn’t see *The Big Short* until it came out, and I have no reason to think that Lewis saw a draft of our book.)

I actually did not rush out to buy *The Big Short*, even though Michael Lewis is a great storyteller. I figured I knew the story already; Gregory Zuckerman’s *The Greatest Trade Ever* covered some of the same ground and some of the same characters, and I already knew plenty about CDOs, credit default swaps, and synthetic CDOs. But I’m very glad I read it, and not just because it’s a fun read.

Lewis’s central theme is the question of why some people were able to see a financial disaster that, in retrospect, seems so obvious, while almost everyone else — including even the people who concocted the machine

that broke down so spectacularly — were so blind. This is the point of his epigraph, by Tolstoy:

“The most difficult subjects can be explained to the most slow-witted man if he has not formed any idea of them already; but the simplest thing cannot be made clear to the most intelligent man if he is firmly persuaded that he knows already, without a shadow of a doubt, what is laid before him.”

But I enjoyed it most for its portrait of what was going on behind the scenes on Wall Street. The picture is not pretty.

Lewis’s book focuses on a group of people (mainly at hedge funds) who figured out that subprime-backed CDOs were going to collapse and set out to make money from that collapse. To do so, they bought credit default swaps on bonds issued by those CDOs. They had to buy these credit default swaps from their brokers — the big investment banks. These swaps had collateral requirements: as the price of the swap fell (or the price of the underlying bonds rose), they had to give collateral (cash or Treasuries) to the banks; as the price of the swap rose, the banks had to give collateral to them.

The problem was that the banks, as the swap dealers, got to decide what the swaps were worth. So, for example, Charlie Ledley bought an illiquid CDS on a particular CDO from Morgan Stanley. Five days later, in February 2007, the banks started trading an index of CDOs that promptly lost half its value. But, as Lewis writes, “With one hand the Wall Street firms were selling low interest rate-bearing double-A-rated CDOs at par, or 100; with the other they were trading this index composed of those very same bonds for 49 cents on the dollar” (p. 162).^{*} That is, the market price of the already-issued CDOs didn’t affect the sale price of new CDOs. And what’s more, Ledley’s broker insisted that the price of *his* CDS (which should have soared as the index of CDOs fell) had not changed. Here you see the banks simultaneously ignoring a market price in two separate ways: once so they can continue selling new assets that are extremely similar — worse, if anything — to assets that they are trading as garbage; and again so they can avoid sending collateral to their hedge fund client.

In June 2007, the subprime-backed CDO market began to collapse for good. And, again, the banks suddenly couldn’t figure out how much their clients’ CDS were worth, so they could avoid sending them collateral. “Goldman was newly unable, or unwilling, to determine the

value of those positions, and so could not say how much collateral should be shifted back and forth” (p. 195). Between June 15 and June 20, Michael Burry could not get ahold of his Goldman Sachs salesperson, who finally claimed that Goldman had had a “systems failure” — which was what Morgan Stanley and Bank of America also claimed. According to Burry, the only reason why the banks finally started marking his positions accurately was that they were getting in on the same trade.

This also happened between the dealers. At one point Greg Lippmann at Deutsche Bank, who had shorted the market, said to his counterpart at Morgan Stanley, who insisted that subprime CDOs were still worth 95 cents on the dollar: “I’ll make you a market. They are 70-77. You have three choices. You can sell them back to me at 70. You can buy some more at 77. Or you can give me my f—ing \$1.2 billion” (the collateral owed) (p. 213). But even though Morgan Stanley claimed the securities were worth 95, they refused to buy more at 77 — even though that would have represented instant profits according to their “model.”

What’s the point here? It’s the same as yesterday. Free financial markets are supposed to create efficient prices. Every argument about the benefits of financial markets (optimal allocation of capital, liquidity, etc.) depends on this one point. But the prices in this market were being set based on *the dealers’ own interests*. Think about that.

Then there is the story of Howie Hubler (Chapter 9). Hubler was smart enough to buy credit default swaps on \$2 billion of BBB-rated CDOs. But to pay the premiums on those CDS, he then went and *sold* credit default swaps on \$16 billion of AAA-rated CDOs. In other words, he was betting that the housing collapse would wipe out the BBB tranches of the CDOs, but not the AAA tranches. At the time, CDS prices reflected a belief that the AAA tranches were only one-tenth as likely to default as the BBB tranches. So to be more precise about it, he was actually betting that the AAA tranches were *less than* one-tenth as likely to default as the BBB tranches.

So some trader misjudges the correlation between mortgage-backed securities (which determines the correlation of the AAA and BBB tranches) and makes a trade that turns out badly. So what? The problem is what we learn about the system.

First, we learn this: “The \$16 billion in subprime risk Hubler had taken on showed up in Morgan Stanley’s risk reports inside a bucket marked ‘triple A’ — which is to say, they might as well have been U.S. Treasury bonds” (p. 207). (The VaR calculation for this position also showed

virtually no risk, since it was based on historical volatility data.) So Morgan Stanley had no idea what it was holding onto.

This is incompetence. But is it innocent incompetence or willful ignorance? I doubt that anyone on the management team said, "Let's design a stupid way of categorizing our positions so that our traders can make risky bets, hide them from us, and blow up the bank." But think about this: this type of error *only goes one way*. Steve Randy Waldman has already made this point about capital: "For large complex financials, capital cannot be measured precisely enough to distinguish conservatively solvent from insolvent banks, and capital positions are always optimistically padded." The same is true about risk, which will always be underestimated. If a bank has a system that overestimates risk, the traders who understand the positions will (correctly) argue that real risk levels are lower; if the system underestimates risk, they will keep their mouths shut. Higher risk measures mean more capital means lower returns; all the internal pressures are to underestimate risk. The incentives of the system breed incompetence, and everyone benefits in the short term.

Eventually, Morgan Stanley lost \$9 billion on the trade. In December 2007, CEO John Mack tried to explain the loss on an investor call. "The hedges didn't perform adequately in extraordinary market condition of late October and November," he said (p. 217). This wasn't a hedge; it was a long-short bet. But on Wall Street, it's second nature to call everything a hedge. When pressed by an analyst (from Goldman), Mack punted ("I am very happy to get back to you on that when we have been out of this, because I can't answer that at the moment"). As Lewis said, "The meaningless flow of words might have left the audience with the sense that it was incapable of parsing the deep complexity of Morgan Stanley's bond trading business. What the words actually revealed was that the CEO himself didn't really understand the situation."

This is a classic example of something that goes far beyond Wall Street: the CEO who has no idea what is going on inside his business. And, as Lewis says, Mack was generally considered one of the more competent ones. CEOs of large corporations exist on such a high level of abstraction relative to what actually happens that all they know is what their subordinates tell them, and their subordinates barely know what is going on as well. (I believe there is now a reality show based on this gap.) Mack probably really thought that Howie Hubler was putting on a hedge, because that's probably what someone told him before he went on the call. And when CEOs show up before the Financial Crisis Inquiry

Commission and say something like “we put the interests of our clients first in everything we do,” they may actually believe it — because they don’t know any better. (Which is very convenient, because ignorance allows you to say things that are not true without actually lying.)

So what kind of picture of Wall Street does *The Big Short* paint? Banks manipulating the prices of custom derivatives. Traders making stupid bets and taking home eight-figure bonuses. Painfully inadequate risk management systems. Management teams that have no idea what is going on. A toxic combination of cutthroat greed on the part of individual bankers and broken incentive systems on the part of banks.

This is not a finely-tuned machine for allocating capital and fueling the real economy. It’s a system whose rules have been twisted to allow the few smart people to get rich by screwing their customers or their employers. “That Wall Street has gone down because of this is *justice*,” says Steve Eisman at the end of the book (p. 251). But as we now know, it didn’t go down.

* I believe they were not the “very same bonds,” since the newly issued bonds were 2007 vintage and the ones in the index were earlier vintages; but if anything, that meant that the 2007 bonds, which were sold at par, were even worse.

Update: I forgot to mention that I bought my copy of *The Big Short*. Actually, I bought mine and then I traded it for Christopher Lydon’s copy, because Lydon got Michael Lewis to autograph his copy for me. But net, I paid for it.

Senator McConnell Is Completely Wrong On Financial Reform

Simon Johnson | 14 Apr 2010

By Simon Johnson

At one level, it is good to see the Republican Senate leadership finally express clear positions on the financial industry and what we need in order to make it safer. At another level, what they are proposing is downright scary.

In a Senate floor speech yesterday, Senator Mitch McConnell (Senate Republican leader) said,

"The way to solve this problem is to let the people who make the mistakes pay for them. We won't solve this problem until the biggest banks are allowed to fail."

Do not be misled by this statement. Senator McConnell's preferred approach is not to break up big banks; it's to change nothing now and simply promise to let them fail in the future.

This proposal is dangerous, irresponsible, and makes no sense. The bankruptcy process simply cannot handle the failure of large complex global financial institutions – without causing the kind of worldwide panic that followed the collapse of Lehman and the rescue/resolution of AIG. This is exactly the lesson of September 2008.

If a huge financial institution were to reach the brink of bankruptcy, the choice again would be: collapse (for the world economy) or rescue (of the very bankers and creditors who are responsible for the mess). The point of the reforms now before us is to remove that choice, as far as possible, from the immediate future.

There is only one plausible way to ensure banks that are currently "too big to fail" can actually fail: Make them substantially smaller. This is necessary but not sufficient for financial stability – a point we make most forcefully in 13 Bankers, where we support a whole range of complementary measures (including more capital, very tight regulation of derivatives, and tough consumer protection), as well as a broader approach to breaking the political power of these banks.

And, at some level, the size point has already been taken on board by the administration. The second Volcker Rule, as announced in January, reads,

“Limit the Size- The President also announced a new proposal to limit the consolidation of our financial sector. The President’s proposal will place broader limits on the excessive growth of the market share of liabilities at the largest financial firms, to supplement existing caps on the market share of deposits.”

The hard size cap proposed – although somewhat vaguely specified – in this part of the Volcker Rule should be applied and tightened considerably in the Dodd bill now approaching the Senate floor.

You can do this with the Brown amendment, a version of which we should expect to see on the Senate floor. Or you may prefer the approach of the Kanjorski amendment, which is already included in the House legislation. Our position is that the Democrats should propose – and the White House should support the strongest versions possible, with low and hard size caps on banks. Force the Republicans to defend explicitly our biggest banks and how they operate – as Senator McConnell now appears willing to do. Take that to the polls in November.

You cannot responsibly propose what Senator McConnell is now putting forward: Do nothing and later on we will be tough – despite the fact that, at the key moment of decision, the consequences of being tough on a failed global megabank (and its creditors) would be catastrophic. This is the true road to disaster.

“The Derivatives Dealers’ Club”

James Kwak | 14 Apr 2010

By James Kwak

Robert Litan of Brookings wrote a [paper on the derivatives dealers’ club](#) — the small group of large banks that control most of the market for certain types of derivatives, notably credit default swaps. It’s a blunt analysis of how these banks can and will impede derivatives reform in order to maintain their dominant market position and the rents that flow from it.

I haven’t had time to do it justice, so I recommend Mike Konczal’s analysis in parts [one](#) and [two](#) (but particularly one). As Konczal says, “In case you weren’t sure if you’ve heard anyone directly lay out the case on how the market and political concentration in the United States banking sector hurts consumers and increases systemic risk through both political pressures and anticompetitive levels of control of the institutions of the market, now you have.”

And note that Litan is no bomb-thrower; most recently he mounted a [defense of most financial innovation](#) ([my comments here](#)).

Senator McConnell Is Wrong, Senator Kaufman Is Right. Any Questions?

Simon Johnson | 15 Apr 2010

By Simon Johnson, co-author of 13 Bankers: The Wall Street Takeover and The Next Financial Meltdown

Senator Mitch McConnell continues to insist that the Dodd bill creates permanent bailouts – and that it would be definitely better to do nothing. Apparently, he has indicated a willingness to make a Senate floor statement to that effect every day.

Senator McConnell is completely wrong on this issue – and, if he gets any traction, we will feel the need to point this out every day. His remarks today and yesterday go far beyond any reasonable level of partisanship. This is about playing games with the financial stability of this country and the world; it should stop.

Don't take my word for it – Senator Ted Kaufman is a strident critic of our current financial system and a tough voice for greatly strengthening the Dodd bill. But today he was as clear and as forceful as you can be on the floor of the Senate: Senator McConnell's proposed approach is "dangerous and irresponsible."

Senator Kaufman continues, bluntly:

"If we do nothing, and wait for another crisis, future presidents – whether Republican or Democrat – will face the same choices as President Bush: whether to let spiraling, interconnected too-big-to-fail institutions, like AIG, Citigroup and others, collapse in a contagion, sending the economy into a depression, or step in ahead of bankruptcy and save them with taxpayer money. If that happens, the choice of allowing bankruptcy will mean tremendous economic pain for Main Street America."

If you think bankruptcy for megabanks is the solution, you need to get over this.

"If bankruptcy was a cure in Lehman Brothers, it was one that almost killed the patient – the U.S. economy. When former Treasury Secretary Hank Paulson decided to let Lehman Brothers go into bankruptcy, our global credit markets froze and creditors and counterparties panicked and headed for the hills."

“Instead of imposing market discipline, it only prompted more bailouts and almost brought down our entire financial system.”

“It ultimately took 18 months to close out the case on Lehman Brothers, an eternity for financial institutions that mark to market and fund their balance sheets on an interday basis. Bankruptcy is an even more unattractive option when one considers that Lehman was an investment bank, while today’s megabanks operate under the bank holding company umbrella.”

We’re all in favor of effective regulation, more capital, and greater controls on derivatives trading. And passing a resolution authority, as proposed in the Dodd bill, would be a step in the right direction for purely domestic financial entities.

But Senator Kaufman is exactly right to press for more. The resolution authority will not end “too big to fail” for large complex cross-border financial institutions. It simply will not – if you think differently, just go talk to our G20 counterparts, as I have done. There is no cross-border resolution mechanism, there is no international process to negotiate one, and there is no chance you will see such a process in the next 20 years.

Breaking up big banks is not sufficient for financial stability – no one would suggest that. But it is necessary. Again, Senator Kaufman nails this:

“Given the consequences of failing to do enough to prevent another financial crisis, the safest thing to do today is for Congress to put an end to too big to fail. If you believe these mega-banks are too big, if you reject the choice of bankruptcy that will lead to a recession or depression, then breaking them up is the logical answer. That’s the only way that greatly diminishes the future probability of financial disaster. The Great Depression of the 1930s must be avoided at all costs. “

The Other Battle

James Kwak | 15 Apr 2010

By James Kwak

One battle in Washington — the one that has been in the news this week — is over resolution authority and the supposed “bailout fund” attacked by Mitch McConnell. Another battle will be over the Consumer Financial Protection Agency, which Republicans are likely to try to cripple behind the scenes. While most of the reviewers of *13 Bankers* have seized on the call to break up big banks, few have discussed the first part of that chapter, which argues for strong consumer protection. Simon and I wrote an op-ed in *The Hill* to reiterate the point and warn against some of the tactics opponents may use.

The Next Global Problem: Portugal

Simon Johnson | 15 Apr 2010

By Peter Boone and Simon Johnson

The bailout of Greece, while still not fully consummated, has brought an eerie calm in European financial markets. It is, for sure, a massive bailout by historical standards. With the planned addition of IMF money, the Greeks will receive 18% of their GDP in one year at preferential interest rates. This equals 4,000 euros per person, and will be spent in roughly 11 months.

Despite this eye-popping sum, the bailout does nothing to resolve the many problems that persist. Indeed, it probably makes the euro zone a much more dangerous place for the next few years.

Next on the radar will be Portugal. This nation has largely missed the spotlight, if only because Greece spiralled downwards. But both are economically on the verge of bankruptcy, and they each look far more risky than Argentina did back in 2001 when it succumbed to default.

The main problem that Portugal faces, like Greece, Ireland and Spain, is that it is stuck with a highly overvalued exchange rate when it is in need of massive fiscal adjustment. Portugal spent too much over the last several years, building its debt up to 78% of GDP at end 2009 (compared to Greece's 114% of GDP and Argentina's 62% of GDP at default). The debt has been largely financed by foreigners, and as with Greece, the country has not paid interest outright, but instead refinances its interest payments each year by issuing new debt. By 2012 Portugal's debt-GDP ratio should reach 108% of GDP if they meet their planned budget deficit targets. At some point financial markets will simply refuse to finance this Ponzi game.

To resolve its problems, Portugal needs major fiscal tightening. For example, just to keep its debt stock constant and pay annual interest on debt at an optimistic 5% interest rate, the country would need to run a 5.4% of GDP primary surplus by 2012. With a 5.2% GDP planned primary deficit this year, they need roughly 10% of GDP in fiscal tightening. It is nearly impossible to do this in a fixed exchange rate regime – i.e., the eurozone – without massive unemployment. The government can only expect several years of high unemployment and tough politics, even if they are to extract themselves from this mess.

Neither the Greek nor Portuguese political leaders are prepared to make the needed cuts. The Greeks have announced minor budget

changes, and are now holding out for their 45bn euro package while implicitly threatening a messy default on the rest of Europe if they do not get what they want – and when they want it. The Portuguese are not even discussing serious cuts. In their 2010 budget they plan a budget deficit of 8.3% of GDP, roughly equal to the 2009 budget deficit (9.4%). They are waiting and hoping that they may grow out of this mess – but such growth could only come from an amazing global economic boom.

While these nations delay, the EU with its bailout programs – assisted by Mr. Trichet's European Central Bank – provides financing. The governments issue bonds, European commercial banks buy them and then deposit these at the ECB as collateral for freshly printed money. The ECB has become the silent facilitator of profligate spending in the euro zone.

Last week the ECB had a chance to dismantle this doom machine when the board of governors announced new rules for determining what debts could be used as collateral at the ECB. Some observers anticipated the ECB might plan to tighten the rules gradually, so preventing the Greek government from issuing too many new bonds that could be financed at the ECB. But the ECB did not do that. In fact, the ECB's board of Governors did the opposite: they made it even easier for Greece, Portugal, and any other nation to borrow in 2011 and beyond. Indeed, under the new lax rules you only need to convince one rating agency (and we all know how easy that is) that your debt is not junk in order to get financing from the ECB. Today, despite the clear dangers and massive debts, all three rating agencies are surely scared to take the politically charged step of declaring Greek debt is junk. They are similarly afraid to touch Portugal.

So what next for Portugal? Pity the serious Portuguese politician who argues that fiscal probity calls for early belt tightening. The EU, the ECB, and the Greeks have all proven that the euro zone nations have no threshold for pain, and EU money will be there for anyone who wants it. The Portuguese politicians can do nothing but wait for the situation to get worse, and then demand their bailout package too. No doubt Greece will be back next year for more. And, the nations that "foolishly" already started their austerity, such as Ireland and Italy, must surely be wondering whether they too should take the less austere path.

There seems to be no logic in the system, but perhaps there is a logical outcome. Europe will eventually grow tired of bailing out its weaker countries. The Germans will probably pull that plug first. The longer we

wait to see fiscal probity established, at the ECB and the EU, and within each nation, the more debt will be built up, and the more dangerous the situation will get. When the plug is finally pulled, at least one nation will end up in a painful default; unfortunately, the way we are heading, the problems could be even more widespread.

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The Few: Sensible Republican Senators On Financial Reform

Simon Johnson | 16 Apr 2010

By Simon Johnson

There are three kinds of Republicans in the Senate today. First, there are those willing to follow the lead of Senator Mitch McConnell – whose approach to financial sector reform apparently amounts to little more than, “Don’t worry, be happy”. If Senator McConnell has a reform plan he would like to lay out for review, now would be a good time to put some credible details on the table.

Based on what we have seen so far, Senator McConnell proposes to do nothing regarding the systemic risks posed by today’s megabanks and just “let ‘em fail” when necessary. This is a dangerous and irresponsible position, and it should be opposed tooth-and-nail by anyone who actually cares whether or not we run ourselves into a Second Great Depression.

The second group has remained silent so far, waiting to see which way popular opinion and their leadership will go. Most likely, almost all will cast their lot in with Senator McConnell.

And if Senator McConnell brings 40 Senators with him, they will defeat the Dodd bill – and then smash themselves into the rocks of November 2010 as the “too big to fail” party. Perhaps we should welcome that.

But there is also a third group, not yet numerous, that is more inclined to be sensible or – as Senator Corker aptly put it – to “act like adults.”

These Senators (so far I have a list with precisely three names; tell me if you have more) begin to understand that allowing our megabanks to continue in their current form makes no sense. The power of this idea is starting to get through (also at BusinessWeek).

Saying we should do nothing about these megabanks makes no sense. And trying to turn the argument on its head to claim that, “a greater number of smaller banks would pose an even bigger risk of taxpayer bailouts” is truly not a powerful idea.

So what are the prospects for Senator Dodd’s financial reform bill, which is expected on the floor soon?

Could it even be strengthened, for example in the direction that key Democratic Senators are already pushing?

The prospects for this are not as bleak as you might think. There are three elements that make this a potentially productive moment:

1. The American people are legitimately and completely outraged by how big banks continue to behave. In such circumstances, you may think you have a backroom deal, but when it surfaces and people begin to do the math, the backlash can move things in an unpredictable direction.
2. Senate Democrats are only now beginning to understand what the bill-as-drafted would and would not do.
3. Almost all Senate Republicans are likely against the bill, but that “almost” may matter.

In short, anything can happen.

So it's a good time to call your elected representative. Or just email them this link: <http://13Bankers.com> (this is why we wrote the book).

Michael Lewis on Wall Street

James Kwak | 16 Apr 2010

By James Kwak

The Big Short is a good story and provides some illuminating lessons about Wall Street. Lewis doesn't really come out and say what he thinks about Wall Street; he lets his characters do that for him. But in his recent [interview with Christopher Lydon](#), he really lets loose. Here are some direct quotations.

Lewis: "The people who were responsible for orchestrating the crisis, because they're on top and they're in the middle of it, they're the only ones who are sort of fluent in the language of it. I mean, who's to question Tim Geithner, the secretary of the treasury, about this or that, because he's the only with the information . . . even though he is clearly culpable in what happened."

Lydon: "Not to mention Larry Summers and Bob Rubin and all the other architects of the deregulation. They're still calling the shots in a new administration after a change of party management. It's unreal."

Lewis: "It is unreal, because basically all of the people you mentioned all swallowed a general view of Wall Street, which was that it was a useful and worthy master class, that these people basically knew what they were doing and should be left to do whatever they wanted to do. And they were totally wrong about that. Not only did they not know what they were doing, but the consequences of not knowing what they were doing were catastrophic for the rest of us. It was not just not useful; it was destructive. We live in a society where the people who have squandered the most wealth have been paying themselves the most, and failure has been rewarded in the most spectacular ways, and instead of saying we really should just wipe out the system and start fresh in some way, there is a sort of instinct to just tinker with what exists and not fiddle with the structure. And I don't know if that's going to work. When you look at what Alan Greenspan did, or what Larry Summers did, or what Bob Rubin did, there are individual mistakes they made, like for example not regulating the credit default swap market, preventing that from happening. But the broader problem is just the air they breathe. The broader problem is just the sense they all seem to have that what's good for Goldman Sachs is good for America."

Lewis: “The question is how does Washington move away from those institutions and make decisions that are in the public interest without regard for the welfare of these institutions. It’s a hard question because . . . this is the problem. Essentially the public and their representatives have been buffaloed into thinking that this subject — financial regulation, structure of Wall Street — is too complicated for amateurs. That the only people who are qualified to pronounce on this are people who are in it. And there are very very few people who aren’t in it in some way who have the nerve to stand up and fight it. . . .

“The elected representatives look at the financial system, I’m sure, and they think, it’s too complicated for me to understand, I’m going to be quickly exposed as a know-nothing if I take the lead on regulation, and in the bargain I’m going to miss out on all these campaign contributions from the financial industry because I’ll alienate them.”

Lewis, on Barack Obama: “He’s been captured by his banker, just like the ordinary American’s captured by their stockbroker. He’s been buffaloed by the complexity of it all, he doesn’t have time to sort it out for himself, and he has to trust the people who seem to know. The alternative is for him to set off on his own in a quixotic quest to reform the financial system without having any experience of the system. It’s sort of like the presidential version of regulatory capture, that he is at the mercy of the people who really don’t have probably his long-term best interests at heart but who seem to know what they’re talking about.”

TV Doubleheader

James Kwak | 16 Apr 2010

Simon and I are both on Bill Moyers (first half) tonight. Then Simon is on Real Time with Bill Maher. Enjoy.

We're Big . . . and We're Connected

James Kwak | 16 Apr 2010

By James Kwak

MBIA, the big bond insurer, is actually headquartered in Armonk, New York, about forty miles from Wall Street, and it's not quite one of the swaggering elite. But it plays its own crucial role in the financial system, insuring municipal bonds as part of a tight oligopoly. Then it recently expanded into writing credit default swaps on mortgage-backed securities and collateralized debt obligations, raking in profits during the boom while loading up on exposures that would almost kill it during the financial crisis.

But when it comes to attitude, MBIA wanted to be every bit the financial oligarch. Bloomberg has an [excerpt](#) from Christine Richard's upcoming *Confidence Game*, which tells the story of hedge fund manager Bill Ackman's short position on MBIA. (Here's a [previous Bloomberg story](#) on the topic.) There isn't much in the excerpt, but there is this choice quote from MBIA CEO Jay Brown, as recalled by Ackman:

"You're a young guy, early in your career. You should think long and hard before issuing the report. We are the largest guarantor of New York state and New York city bonds. In fact, we're the largest guarantor of municipal debt in the country. Let's put it this way: We have friends in high places."

(The next year, New York attorney general Eliot Spitzer began investigating Ackman for market manipulation, but Ackman was never charged with anything.) It doesn't get much more clear than that.

(Disclosure: I knew Bill Ackman a long, long time ago. We took calculus together in high school; I was a sophomore and he was a senior. And I vaguely recall helping him with it. Nice guy. Yes, he had gray hair in high school.)

SEC Charges Goldman with Fraud

James Kwak | 16 Apr 2010

By James Kwak

[Press release here](#). [Complaint here](#). The allegation is that Goldman failed to disclose the role that John Paulson's hedge fund played in selecting residential mortgage-backed securities that went into a CDO created by Goldman. Here's paragraph 3 of the complaint:

"In sum, GS&Co arranged a transaction at Paulson's request in which Paulson heavily influenced the selection of the portfolio to suit its economic interests, but failed to disclose to investors, as part of the description of the portfolio selection process contained in the marketing materials used to promote the transaction, Paulson's role in the portfolio selection process or its adverse economic interests."

The problem is that the marketing documents claimed that the securities were selected by ACA Management, a third-party CDO manager, when in fact the selection decisions were influenced by Paulson's fund. Goldman had a duty to disclose that influence, especially since Paulson was simultaneously shorting the CDO. (According to paragraph 2 of the complaint, he bought the credit default swaps from Goldman itself. I used to wonder about this; if he bought the CDS from another bank, then Goldman could claim it didn't know he was shorting the CDO, implausible as that claim might be. But in this case Goldman must have known.)

It seems like the key will be proving that Paulson influenced the selection of securities enough that it should have been in the marketing documents. Paragraphs 25-35 include quotations from emails showing that Paulson was effectively negotiating with ACA over the composition of the CDO, so it's pretty clear he had influence. The defense will presumably be that ACA had final signoff on the securities, and Paulson was just providing advice, so Paulson's role did not need to be disclosed. (I don't know what kind of standard will be applied here.)

The complaint also alleges that Goldman misled ACA into thinking that Paulson had a long position in the CDO via the equity tranche, while in fact Goldman knew all along that he would short the debt tranches. It seems pretty clear that that's what ACA believed. The

implication is that had ACA realized that Paulson was shorting the CDO, they would not have gone along with the deal.

One of the things I say now and then that most annoys people is that the financial crisis was not caused by criminal behavior. (Note: The “Prayer for the Relief” at the end of the complaint only asks for civil penalties, but I suppose this does not preclude a criminal action — someone who’s a real lawyer could answer that.) My general line is that I’m sure there was some bad behavior that rose to the level of criminal liability — like lying in disclosure documents — but that it wasn’t necessary for the crisis, and we could have had the crisis without any criminal activity at all. (For example, since most investors weren’t even reading the disclosure documents, Goldman could have said that Paulson was involved in the security selection, and then everything would have been hunky-dory.) For the most part, the ideological takeover and the resulting non-regulatory environment that we discuss in *13 Bankers* were enough to do the job.

And I don’t think this action contradicts my general point. I would love it if the SEC could nail banks for some of the CDOs they created, but I’m still betting that the vast majority will not create legal liability for them.

The type of transaction involved — in which a hedge fund makes a CDO as toxic as possible in order to then short it — is similar to the Magnetar trade, which I discussed earlier. One thing we learn from paragraph 5 is that Paulson sure knew how to pick ‘em:

“The deal closed on April 26, 2007. Paulson paid GS&Co approximately \$15 million for structuring and marketing ABACUS 2007-AC1. By October 24, 2007, 83% of the RMBS in the ABACUS 2007-AC1 portfolio had been downgraded and 17% were on negative watch. By January 29, 2008, 99% of the portfolio had been downgraded. As a result, investors in the ABACUS 2007-AC1 CDO lost over \$1 billion. Paulson’s opposite CDS positions yielded a profit of approximately \$1 billion for Paulson.”

And once again, no doubt to the annoyance of many, I don’t blame Paulson. It’s Goldman that had the duty to its investors, not Paulson.

Fabrice Tourre of Goldman, however, who is named as a defendant? Well, he will forever be identified by the email quoted in paragraph 18, whatever it means:

“At the same time, GS&Co recognized that market conditions were presenting challenges to the successful marketing of CDO transactions backed by mortgage-related securities. For example, portions of an email in French and English sent by Tourre to a friend on January 23, 2007 stated, in English translation where applicable: ‘More and more leverage in the system, The whole building is about to collapse anytime now...Only potential survivor, the fabulous Fab[rice Tourre]...standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstrosities!!!’ Similarly, an email on February 11, 2007 to Tourre from the head of the GS&Co structured product correlation trading desk stated in part, ‘the cdo biz is dead we don’t have a lot of time left.’”

According to the SEC’s complaint, the deal closed on April 26, 2007, and Paulson & Co. paid Goldman Sachs approximately \$15 million for structuring and marketing ABACUS. By Oct. 24, 2007, 83 percent of the RMBS in the ABACUS portfolio had been downgraded and 17 percent were on negative watch. By Jan. 29, 2008, 99 percent of the portfolio had been downgraded.

Our Pecora Moment

Simon Johnson | 17 Apr 2010

By Simon Johnson

We have waited long and patiently for our Ferdinand Pecora moment – a modern equivalent of the episode when a tough prosecutor from New York seized the imagination of the country in the early 1930s and, over a series of congressional hearings: laid bare the wrong-doings of Wall Street in simple and vivid terms that everyone could understand, and created the groundswell of public support necessary for comprehensive reregulation. On Friday, that moment finally arrived.

There is fraud at the heart of Wall Street, according to the Securities and Exchange Commission. Pecora took on National City Bank and J.P. Morgan (the younger); these were the supposedly untouchable titans of their day. The SEC is taking on Goldman Sachs; no firm is more powerful.

Pecora exposed the ways in which leading banks mistreated their customers – typically, retail investors. The SEC alleges, with credible detail, that Goldman essentially set up some trusting clients and deliberately misled them – to the tune of effectively transferring \$1 billion from them to a particular unscrupulous investor.

Pecora had the drama of the congressional hearing room and used his skills as an interrogator to batter the bastions of Wall Street, day-after-day, with gruesome and convincing detail. We don't know where and when, but the SEC action points in one direction only: Lloyd Blankfein (CEO of Goldman) in the witness box, while John Paulson (unindicted co-conspirator) waits in the on-deck circle.

Either Blankfein knew what was going on – and is therefore liable before the law – or he was clueless and therefore incompetent. Either way, the much vaunted risk management and control systems of Goldman, i.e., what is supposed to prevent this kind of thing from happening, are exposed to be what we have long here claimed: bunk (as I argued with Gerry Corrigan, former head of the NY Fed and long-time Goldman executive, before the Senate Banking Committee when we both testified on the Volcker Rules in February).

“Too big and complex to manage” is actually the best defense for Goldman's executives and they should offer to break up the firm into smaller and more transparent pieces as a way to settle the firm's liability with the SEC. The current management of Goldman – along with the

team that ran the firm under Hank Paulson – have destroyed the value of an illustrious franchise. Goldman used to stand for something that customers felt they could trust; now it is just a sophisticated way of ripping them off.

John Paulson obviously knew what he was doing in helping to create the “designed to fail” securities – and the consequences this would have. If he cannot be convicted of conspiracy to commit fraud, then the law in this regard needs to be tightened significantly. The Financial Crisis Inquiry Commission, chaired by Phil Angelides, is probably already planning to grill John Paulson about his taxes – the point Pecora made in this regard with J.P. Morgan junior was most telling and gripped the nation; it turned out that Morgan hardly paid any tax. I would respectfully suggest that the Angelides Commission also pull in Hank Paulson and pursue a similar line of questioning with him – when it focuses on how much money Hank Paulson made, and how little tax he paid, while building and overseeing an extortion scheme of grand proportions, America will scream.

We have something today that Pecora did not have – the pattern of behavior is already established, if not yet widely comprehended. Senator Levin’s recent grilling of WaMu revealed another layer of deliberate mistreatment of consumers within the mortgage industry. The Valukas report on the failure of Lehman exposed exactly how investors are misled by balance sheet manipulation in its most modern and insidious form. And we have learned more than enough about Goldman misleading investors over Greek debt levels.

Brooksley Born was right, a very long time ago, to fear the “dark markets” of over-the-counter derivatives and what those would bring.

Senator Ted Kaufman was right. Just a few weeks ago, he argued strongly from the Senate floor that there is fraud at the heart of Wall Street. Even some people who are generally sympathetic to his critique of modern financial practices thought perhaps that this specific notion was pushing the frontier. But now they get it – and today Ted Kaufman is more than mainstream; he is the public figure who made everything crystal clear.

When you deliberately withhold adverse material information from customers, that is fraud. When you do this on a grand scale, the full weight of the law will come down on you and the people who supposedly supervised you. And if the weight of that law is no longer sufficient to deal with – and to prevent going forward – the latest forms

of very old and reprehensible crimes, then it is again time to change the law.

John Paulson Needs A Good Lawyer

Simon Johnson | 18 Apr 2010

By Simon Johnson, co-author of 13 Bankers: The Wall Street Takeover and The Next Financial Meltdown

Of all the reactions so far to various dimensions of Goldman fraudulent securities “Fab” scandal, one stands out. On Bill Maher’s show, Friday night, I argued that John Paulson – the investor who helped design the CDO at the heart of the affair – should face serious legal consequences.

On the show, David Remnick of the New Yorker pointed out that Paulson has not been indicted. And since then numerous people have argued that Paulson did nothing wrong – rather that the fault purely lies with Goldman for not disclosing fully to investors who had designed the CDO.

But this is to mistake the nature of the crime here – and also to misread the legal strategy of the SEC.

The obvious targets are Goldman’s top executives, whom we know were deeply engaged with the housing side of their business in early 2007 – because it was an important part of their book and they were well aware that the market was in general going bad.

Either Goldman’s executives were well aware of the “Fab” and its implications – in which case they face serious potential criminal and civil penalties – or they did not have effective control over transactions that posed significant operational and financial risk to their organization.

They will undoubtedly pursue the “we did not know” defense – which of course debunks entirely the position taken by Gerry Corrigan (of Goldman and formerly head of the NY Fed) when I pressed him before the Senate Banking Committee in February. Corrigan claimed that Goldman’s risk management system is the best in the business and simply superb; the former may be true, but the latter claim will be blown up by Lloyd Blankfein’s own lawyers – they must, in order to keep him out of jail. (Aside to Mr. Blankfein’s lawyers: the people you are up against have already read 13 Bankers and may put it to good use; you might want to get a copy.)

And don’t be misled by the purely civil nature of the charges so far – and the fact that the announced target is only one transaction. This is a good strategy to uncover more information – for broader charges on

related dimensions – and it allows congressional enquiries to pile on more freely.

As for John Paulson, the issue will of course be the “paper trail” – including emails and phone conversations. A great deal of pressure will be brought to bear on the people who have worked with him, many of whom now faced permanently broken careers in any case.

Here’s the legal theory to keep in mind. Mr. Paulson only stood to gain on a massive scale (or at all) if the securities in question were mispriced, i.e., because their true nature (that they had been picked by Mr. Paulson) was not disclosed. In other words, the Paulson transactions at this stage of the game only made sense if they involved fraud. The principals involved (Paulson and top Goldman people) are all super smart, with unmatched practical experience in this area; they get this totally.

John Paulson was not the trigger man – it was Goldman and its executives who withheld adverse material information from their customers. But if the entire scheme was Mr. Paulson’s idea – if he was in any legal sense the mastermind (obviously he was, but can you prove it beyond a reasonable doubt?) – then we are looking at potential conspiracy to commit fraud. And if he had conversations of any kind and at any time during this period with top Goldman executives, this will become even more interesting - so of course all relevant phone records will now be subpoenaed.

Mr. Paulson should be banned from securities markets for life. If that is not possible under current rules and regulations, those should be changed so they can apply. If that change requires an Act of Congress, so be it.

There is fraud at the heart of Wall Street. It is time to end that.

Goldman Sachs: Too Big To Obey The Law

Simon Johnson | 19 Apr 2010

By Simon Johnson, co-author of 13 Bankers.

On a short-term tactical basis, Goldman Sachs clearly has little to fear. It has relatively deep pockets and will fight the securities “Fab” allegations tooth and nail; resolving that case, through all the appeals stages, will take many years. Friday’s announcement had a significant negative impact on the market perception of Goldman’s franchise value – partly because what they are accused of doing to unsuspecting customers is so disgusting. But, as a Bank of America analyst (Guy Mozkowski) points out this morning, the dollar amount of this specific allegation is small relative to Goldman’s overall business and – frankly – Goldman’s market position is so strong that most customers feel a lack of plausible alternatives.

The main action, obviously, is in the potential widening of the investigation (good articles in the WSJ today, but behind their paywall). This is likely to include more Goldman deals as well as other major banks, most of which are generally presumed to have engaged in at least roughly parallel activities – although the precise degree of nondisclosure for adverse material information presumably varied. Two congressmen have reasonably already drawn the link to the AIG bailout (how much of that was made necessary by fundamentally fraudulent transactions?), Gordon Brown is piling on (a regulatory sheep trying to squeeze into wolf’s clothing for election day on May 6), and the German government would dearly love to blame the governance problems in its own banks (e.g., IKB) on someone else.

But as the White House surveys the battlefield this morning and considers how best to press home the advantage, one major fact dominates. Any pursuit of Goldman and others through our legal system increases uncertainty and could even cause a political run on the bank – through politicians and class action lawsuits piling on.

And, as no doubt Jamie Dimon (the articulate and very well connected head of JP Morgan Chase) already told Treasury Secretary Tim Geithner over the weekend, if we “demonize” our big banks in this fashion, it will undermine our economic recovery and could weaken financial stability around the world.

Dimon's points are valid, given our financial structure – this is exactly what makes him so very dangerous. Our biggest banks, in effect, have become too big to be held accountable before the law.

On a more positive note, the administration continues to wake from its deep slumber on banking matters, at least at some level. As Michael Barr said recently to the New York Times,

“The intensity, ferocity and the ugliness of the lobbying in the financial sector — it's gotten worse. It's more intense.”

This is exactly in line with what we say in 13 Bankers – just take a look at the introduction (free), and you'll see why our concerns about “The Wall Street Takeover and the Next Financial Meltdown” have grabbed attention in Mr. Barr's part of official Washington.

But at the very top of the White House there is still a remaining illusion – or there was in the middle of last week – that big banks are not overly powerful politically. “Savvy businessmen” is President Obama's most unfortunate recent phrase – he was talking about Dimon and Lloyd Blankfein (head of Goldman). After all, some reason, auto dealers are at least as powerful as auto makers – so if we break up our largest banks, the resulting financial lobby could be even stronger.

But this misses the key point, which Senator Kaufman will no doubt be hammering home this week: There is fraud at the heart of Wall Street.

And we can only hold firms accountable, in both political and legal terms, if they are not too big.

It is much harder to sue a big bank and win; ask your favorite lawyer about this. Big banks can more easily hold onto their customers despite so obviously treating them as cannon fodder (take this up with the people who manage your retirement funds). Big banks spend crazy amounts on political lobbying – even right after being saved by the government (chapter and verse on this in 13 Bankers.)

When you really do want to take on megabanks through the courts – and have found the right legal theory and compelling lines of enquiry – they will threaten to collapse or just contract credit.

No auto dealer has this power. No Savings and Loan could ultimately stand against the force of law – roughly 2,000 S&Ls went out of business and around 1,000 people ended up in jail after the rampant financial fraud of the 1980s.

We should not exaggerate the extent to which we really have equality before the law in the United States. Still, the behavior and de facto immunity of the biggest banks is out of control.

These huge banks will behave better only when and if their executives face credible criminal penalties. This simply cannot happen while these banks are anywhere near their current size.

Fortunately there is precisely zero evidence that we need banks anywhere near their current size – we document this at length in 13 Bankers (in fact, this was a major motivation for writing the book).

Break up the big banks before they do even more damage.

The Discount Rate Mismatch

James Kwak | 19 Apr 2010

... or, how finance is like quantum mechanics.

This guest post is contributed by StatsGuy, an occasional commenter and contributor to this blog.

Many pundits like to discuss the issue of Maturities Mismatch – that banks borrow short (at low interest), lend long (at higher interest), take the profit and (allegedly) absorb the risk. We often hear talk about how the Maturities Mismatch is integrally linked to liquidity risk – the sometimes self-fulfilling threat of bank runs – which the FDIC is designed to fight. Rarely if ever do we see anyone making the connection to the Discount Rate Mismatch . . . In fact you’ve probably never even heard of it, and neither have I.

What is the Discount Rate Mismatch?

It is the difference between the risk-free return on investment that investors demand, and the risk-free return on investment that can be generated by real world investments. And by investors, I do not just mean individual retail investors or hedge funds. I also mean retirement accounts and state pension funds as well, which rely on massive 8% projected returns in order to avoid officially recognizing massive fiscal gaps between their obligations and funding requirements.

It has been well documented that the existence of these gaps implicitly forces state and municipal retirement agencies to engage in risky investments to hit target asset appreciation goals. This strategy sometimes works. And, sometimes, it does not – as Orange County well remembers.

What drives the Discount Rate Mismatch?

Many things drive it – including behavioral and cultural factors that deter savings and encourage short term time horizons – but it’s worth noting that it’s built into modern institutions. Recently, I helped assemble a couple business plans, and was (again) reminded of the fact that standard net-present-value calculations use a 5% or 6% discount rate. That’s a *real rate* (which translates into a 7%-8% nominal rate given typical 2% inflation assumptions).

What does this mean? *Even after controlling for inflation*, getting \$100 next year is worth only \$94 this year, and the value of \$100 in thirty years (controlling for inflation) is a mere \$15.6 dollars today. Of course, these

calculations extend beyond money. The value of 100 megawatts of electricity in 30 years is only 15.6 megawatts today. The value of 100 lives lost in 30 years (holding age constant) is equal to only 15.6 lives today. Wow. Future life is cheap!

Yet that leaves a conundrum – with such dramatic needs for long term investments, how is it that my savings account is paying essentially 0% interest?

How does the Discount Rate Mismatch relate to Maturities Mismatch?

Let's imagine a society where everyone demands 6% real returns before committing money to an investment, but society really needs some long term investments – things like the Hoover dam or the Golden Gate Bridge that pay out over 80 years. Let's say these investments are truly risk free, that there's a lot of money sitting in bank accounts unused, and that the broader economy has lots of unused productive capacity (e.g. low capacity utilization). Why is it unused? Because many people, given a choice between an illiquid investment with 3% real return and holding liquid cash, would rather hold liquid cash. That liquidity offers insurance against unforeseen needs (like losing a job, or a health expense). But if that cash sits in bank deposits, it takes a lot of money out of circulation, and that can cause problems with things like the price level. That's where the banks come in.

If I were to ask you where the money in your savings deposit account is, you might say at the bank. That is not quite right. In truth, your money is in several places simultaneously. In this sense, finance is like quantum mechanics. Money is like Schrodinger's cat – you never know where it is until you actually observe it. (And if everyone tries to observe their money at the same time, that's called a bank run.)

But how can money be in multiple places at the same time? Simple – because you think you have the money, the bank agrees, and so does everyone else – and since everyone believes it, it's true. The money you deposit is lent out, then deposited by borrowers, then lent out again – many times over until it eventually sits in vault cash or on deposit with the reserve or in your pocket. We called this fractional reserve banking, and there used to be a limit on how far this cycle could go (the reserve ratio), but this limit was rendered worthless by technological innovations like sweeping, and Bernanke recently hinted at getting rid of it altogether.

By pooling deposits and making loans, banks “borrow” from deposits at 0% and lend it for 3%, thus they make a profit even though the social discount rate (the rate a retail investor would charge for giving up their liquidity for a long period of time) is 6%. That’s because banks care primarily about the spread (sometimes known as the yield curve). Recently, the yield curve was as sharp as it’s ever been.

By engaging in inter-temporal arbitrage, banks allow society to continue to make investments even during periods of high discount rates – at least for a time. Banks essentially *create temporary money* to make investments without savings. So long as money is continually created, savings are not necessary to sustain investment – credit supplants savings. Citizens don’t need to buy municipal bonds or pay taxes to support public infrastructure – the banks can.

To the uneducated masses, replacing savings with credit may sound a bit frightening, but economists can demonstrate – mathematically – that this credit-based money system is far more efficient than injecting money through the crude process of “printing” and government spending. That’s because endogenous money creation is decentralized – anyone with an opportunity and willingness to take risks (and collateral) can (theoretically) get credit to fund an investment. This, presumably, is why Larry Summers is so infatuated with the credit system, and why Obama argues that credit – not money – is the lifeblood of a modern economy.

Astute readers have probably sensed some danger in the system described above. For example:

- Doesn’t credit dependency to sustain investment give banks a lot of power?
- If credit creation by banks is replacing cash printing by government, doesn’t this have distributional consequences?
- Isn’t credit fueled, leveraged investment rather unstable?
- Doesn’t this system punish cash-based savers? If banks no longer have a reserve requirement, then why should they pay anything for deposits? (Hint – they don’t.)
- Doesn’t all of this mean that the only real limit on lending right now is capital-asset ratios, and willingness to absorb risk? What if weak regulation and financial innovation allow evasion of capital-asset ratios, and banks are not adequately pricing risk for any number of reasons (TBTF, agency problems, bad math, etc.)?

Yes, well, those are all valid concerns. But if there’s ONE THING we should have learned in the past 18 months, it’s that we the people are a

lot less courageous when we're facing unemployment, impoverished retirement, and foreclosure. It's easy to curse Goldman Sachs and the credit-breathing financial dragon of Wall-Street, but what would we do without them when most people would rather consume or hold liquid cash than make investments in the future? Consider:

- The huge level of debt means that if nominal GDP growth fails to hit targets, the system may collapse spectacularly.
- The Discount Rate Mismatch problem is real – without relying on credit, how do we fix it?
- Without the certainty of anticipated consumption, what will drive new investment? With the savings glut in countries like Japan, what will sustain global demand if the US decides to start saving more?
- If our under-funded pension and retirement funds can't hit their 8% returns, how do they meet obligations (especially when those obligations are indexed to inflation but not indexed to life expectancy or medical costs)? How do we cover the federal debt if tax revenues fall?

Make no mistake – until we solve the latter set of problems, we are stuck with the credit based system. Banks know this too, and they hope very much that we lack the political will to do what is necessary to fix our structural problems. That's why any talk of financial reform rings hollow unless it's accompanied by serious proposals to fix the discount rate mismatch problem and deal with unfunded obligations.

But maybe – if we're lucky – we'll get a modern day Pecora who will haul Lloyd Blankfein to the witness stand, and taunt him till he breaks. Imagine, for a moment, Mr. Blankfein losing his cool while ranting in Jack Nicholson's voice . . .

“You want the truth? You can't handle the truth. Son, we live in a country with an investment gap. And that gap needs to be filled by men with money. Who's gonna do it? You? You, Middle Class Consumer? Goldman Sachs has a greater responsibility than you can possibly fathom. You weep for Lehman and you curse derivatives. You have that luxury. You have the luxury of not knowing what we know: that Lehman's death, while tragic, probably saved the financial system. And that Goldman's existence, while grotesque and incomprehensible to you, saves pension funds. You don't want the truth. Because deep down, in

places you don't talk about at parties, you *want* us to fill that investment gap. You *need* us to fill that gap.

"We use words like credit default swaps, collateralized debt obligation, and securitization... We use these words as the backbone of a life spent investing in something. You use 'em as a punchline. We have neither the time nor the inclination to explain ourselves to a commoner who rises and sleeps under the blanket of the very credit we provide, and then questions the manner in which we provide it! We'd rather you just said thank you and paid your taxes on time. Otherwise, we suggest you get an account and start trading. Either way, we don't give a damn what you think you're entitled to!"

As with any great villain, what makes Goldman Sachs so compelling is that their vision of the world is not entirely without a twisted kernel of truth.

Break Up The Banks

Simon Johnson | 20 Apr 2010

By Simon Johnson, co-author of 13 Bankers, as discussed on the Today show this morning with Matt Lauer and Erin Burnett

The biggest banks in the United States have become too big – from a social perspective. There are obviously private benefits to running banks with between \$1 trillion and \$2.5 trillion in total assets (as reflected in today's earnings report), but there are three major social costs that the case of Goldman Sachs now makes quite clear.

1) The megabanks have little incentive to behave well, in terms of obeying the law. There is fraud at the heart of Wall Street, but these banks have deep pockets and suing them is a daunting task – as the SEC is about to find out. The complexity of their transactions serves as an effective shield; good luck explaining to a jury exactly how fraud was perpetrated. These banks have powerful friends in high places – including President Obama who still apparently thinks Lloyd Blankfein is a “savvy businessman”; and Treasury Secretary Geithner, who is ever deferential.

2) The people who run big banks brutally crush regular people and their families on a routine basis. You can see this in two dimensions

A. They are not inclined to treat their customers properly. They have market power in particular segments (e.g., new issues or specific over-the-counter derivatives) and there are significant barriers to entry, so while behaving badly undermines the value of the franchise, it does not destroy the business. Talk to some Goldman customers (off-the-record; they don't want to bite the hand that hurts them). Lloyd Blankfein still claims that the client comes first for Goldman; most of their clients are surprised to hear that.

B. Small investors also lose out. Who do you think really bears the losses when John Paulson is allowed to (secretly, according to the SEC) design securities that will fail – and then pockets the gains?

3) Underpinning all this power is the ultimate threat: Too Big To Fail. If a big bank is pushed too hard, its failure can bring down the financial system. This usually means protection when the system looks shaky, but it can also protect big banks from serious prosecution – if their defenders, like Jamie Dimon, can make the case that this would undermine system stability and slow the creation of credit. (This is

startlingly parallel to the arguments made by Nicolas Biddle against Andrew Jackson during the 1830s; see chapter 1 of *13 Bankers*).

In turn, this puts competitors at a major disadvantage, because the bigger banks can borrow on better terms. The extent of protection provided to management and boards in 2008-09 was excessive, but what really matters is the protection perceived and expected by creditors going forward. And this is all about whether you can credibly threaten the creditors with losses. This, in turn, is about a simple calculus – if a firm is in trouble, will it be saved?

There are simply no social benefits to having banks with over \$100 billion in total assets. Think clearly about this – and if you dispute this point, read *13 Bankers*; it was written for you.

Jamie Dimon Should Debate Us

Simon Johnson | 20 Apr 2010

By Simon Johnson

This weekend Jamie Dimon (head of JP Morgan Chase) told the German newspaper *Welt am Sonntag* that he needs “better access for bankers to politicians” and that the banking industry could do with more influence on politicians. He also mentioned the need for a forum where banks can “demonstrate their arguments to politicians and supply them with the right facts” (that wording is from Reuters’ summary).

We would welcome a debate with Mr. Dimon in any forum, preferably in public and with TV cameras present. We have previously extended a similar invitation to any bank executives – including but not limited to the 13 Bankers in the title of our book.

One of the 13 appeared in an off-the-record panel last summer with me; it’s not clear that he would agree to do the same again today. One other leading person from the financial sector – although not a current top executive – has expressed interest in a public debate; we agreed and now the ball is in his court.

Mr. Dimon regards himself as just trying to make a reasonable case regarding what is sensible public policy regarding banking. We feel the same way about 13 Bankers and the content of BaselineScenario.

If you would like to offer a venue for such a debate or to propose the format, please add that as a comment below or send me email (sjohnson@mit.edu or through this website).

And if you work with or are otherwise in contact with Mr. Dimon, please do share this post with him.

Clinton Confesses: Rubin and Summers Gave Bad (strike that) Excellent Advice on Derivatives

James Kwak | 20 Apr 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.

Considering that much of the disastrous deregulation of the U.S. financial system occurred on President Bill Clinton's watch, I was encouraged by his televised confessional Sunday. He admitted to Jake Tapper that he was led astray by two of his secretaries of the treasury, Robert Rubin and Lawrence Summers.

What an important and timely revelation. Admitting we have a problem is the first step to recovery. With financial rehab next up on the Senate's agenda, it's useful that someone is discrediting those who persist in promoting failed ideas. What to do about the \$450 trillion (notional) over-the-counter (OTC) derivatives market will be at the top of the agenda. This is about big money. Really big. Industry began lobbying last year to protect the annual \$35 billion haul that just five US banks bring in trading derivative contracts.

Reform ideas range from the most sensible recommendation by Professor Lynn Stout (return to a regime where naked credit default swaps are not enforceable), to Senator Blanche Lincoln's very strong amendment (prohibiting the banks that have access to the Fed's discount window from trading derivatives), to the necessary but insufficient (mandating all standard derivatives be cleared on exchanges and requiring collateral to be posted), to the weak (the current Senate bill, rife with exceptions).

Remember, this market includes potent credit default swaps, a key ingredient to the crisis. The existence of this \$60 trillion (now \$45 trillion) notional value market, protecting and connecting counterparties across the system, led to a \$180 billion taxpayer-funded bailout of AIG. And, as we have just learned, CDS played a central role inside the synthetic Abacus 2007-AC1 vehicle, a device that helped Goldman Sachs rob purchasers to pay Paulson.

Yet, in spite of the power of Clinton's admission, or perhaps because of it, just after the interview with Tapper, Clinton counselor Doug Band

swiftly dispatched a disclaimer. In a moment of blatant grade inflation, Band said that Clinton believed Rubin and Summers provided “excellent advice on the economy and the financial system.”

On some level, there is room for admiration. After all, Clinton appeared to own his own mistakes and rejected the Greenspan-Style Blame Game. Retrieving one’s advisors from under the bus and resuscitating their reputations may seem honorable. However, in the same breath, Band placed the blame solely on Greenspan’s “arguments against any regulation of derivatives.” This is nonsense. Greenspan was not alone on this.

Anyone who has watched the Frontline program on Brooksley Born, read 13 Bankers, or reviewed the 1999 report on the OTC derivatives markets by the President’s Working Group (for which Summers was a signatory) knows that Rubin and Summers gave Clinton very, very bad advice and also crushed any reasonable, dissenting voices. On page 16, the PWG report specifically states: “The sophisticated counterparties that use OTC derivatives simply do not require the same protections under the CEA as those required by retail investors.” It’s now time for Doug Band should issue a new update, in which Bill Clinton states that his original on-air recollection was correct.

Moreover, how could Summers’s championing Gramm-Leach-Bliley be considered “excellent advice”? When Jim Leach remarked upon GLB’s enactment, “This is a historic day. The landscape for delivery of financial services will now surely shift,” it’s clear he had no idea how right he was.

Back to Clinton’s original confession. What was the fuss about? Let’s take a look. He revealed that concerning advice from Rubin and Summers on derivatives:

“I think they were wrong and I think I was wrong to take it because the argument on derivatives was that these things are expensive and sophisticated and only a handful of investors will buy them and they don’t need any extra protection, and any extra transparency. . . And the flaw in that argument was that first of all sometimes people with a lot of money make stupid decisions and make it without transparency. . . And secondly, the most important flaw was even if less than 1 percent of the total investment community is involved in derivative exchanges, so much money was involved that if they went bad, they could

affect a 100 percent of the investments, and indeed a 100 percent of the citizens in countries.”

With these comments, Clinton, however vaguely, seemed to admit he was wrong for signing the Commodities Futures Modernization Act of 2000. It would have been nice if he explicitly apologized to Brooksley Born for not heeding her truly excellent, prescient advice. Among other things, the CFMA blocked the SEC from regulating credit default swaps as securities. And, it forbade the states from enforcing anti-gambling laws against those who bought credit protection without owning the underlying reference obligation.

Clinton’s words also challenged the conventional wisdom concerning the “sophisticated investor.” Much of our recent deregulation rested on the premise that sophisticated investors can fend for themselves and have the ability to select and monitor “private,” unregulated investment options, and that such investment choices only affect the direct owners, not underlying investors nor market integrity. Based upon the sophisticated investor myth, deregulators argued, successfully, that a wide swath of complex investment options did not need government mandated disclosure or substantive protections, such as restrictions on conflicts of interest. (I’ve covered some of this history in a draft paper, “Enablers,” and in “Recommendations for Reality-Based Reforms of Hedge Funds and Other Private Pools of Capital.”)

Clinton called attention to the imperfect performance of these so-called sophisticates when he noted that “sometimes people with a lot of money make stupid decisions” and they can affect us all. In light of the sad record of sophisticated investors to match up to the complexity and cunning of securities manufacturers and purveyors, it seems untenable to continue to believe that they can fend for themselves. Since and including the collapse of LTCM, the news pages have been filled with stories of institutions and individuals who meet the legal definitions of “sophistication” being duped or swindled.

One cannot forget that two such people who made “stupid decisions” with billions in other people’s money included Rubin and Summers. Notoriously, during Larry Summers’s tenure at Harvard, certain swaps were put in place; then, according to Nina Munks of Vanity Fair, “for reasons no one can seem to explain, the university simply forgot to (or chose not to) cancel its swaps. The result was a \$1 billion loss.” (The decision about when to cancel the swaps took place after Summers had left Harvard.) And, then, there was Rubin, who, while a board member

at Citibank, earned over \$126 million, yet refused to take personal responsibility for the firm's misuse of derivatives or lax oversight of mortgage underwriting for the loans it purchased.

Finally, the most galling thing about the sophisticated investor presumption is that the same individuals who promote the concept as a means for protecting the shadow banking system hide behind their own pseudo-ignorance, defending themselves for apparently not being able to properly select or monitor investment choices. Let's hope they cannot have it both ways.

The Best Thing I Have Read on SEC-Goldman (So Far)

James Kwak | 21 Apr 2010

By James Kwak

Actually, two things, both by Steve Randy Waldman.

Part of Goldman's defense is that it was in the nature of CDOs for there to be a long side and a short side, and the investors on the long side (the ones who bought the bonds issued by the CDO) must have known that there was a short side, and hence there was no need to disclose Paulson's involvement. Waldman completely dismantles this argument, starting with a point so simple that most of us missed it: a CDO is just a way of repackaging other bonds (residential mortgage-backed securities, in this sense), so it doesn't necessarily have a short investor any more than a simple corporate bond or a share of stock does. Since a synthetic CDO by construction mimics the characteristics of a non-synthetic CDO, the same thing holds. (While the credit default swaps that go into constructing the synthetic CDO have long and short sides, the CDO itself doesn't have to.) Here's the conclusion:

"Investors in Goldman's deal reasonably thought that they were buying a portfolio that had been carefully selected by a reputable manager whose sole interest lay in optimizing the performance of the CDO. They no more thought they were trading 'against' short investors than investors in IBM or Treasury bonds do. In violation of these reasonable expectations, Goldman arranged that a party whose interests were diametrically opposed to those of investors would have significant influence over the selection of the portfolio. Goldman misrepresented that party's role to the manager and failed to disclose the conflict of interest to investors."

Waldman follows this up with an analysis of the premium that Goldman extracted from the buy-side investors and transferred to Paulson (in exchange for its own fee). The point here is that Goldman could have simply put Paulson and the buy-side investors together and had Paulson buy CDS on RMBS directly — but that would have affected the price of the deal, because Paulson wanted to take a big short position. So instead, they created the CDO (a new entity) and then drummed up buyers for it, in order to avoid moving the market against Paulson. The advantage of thinking about it this way is it shows what the function of a

market maker is and how that differs from the role Goldman played in this transaction.

The posts are long, so sit back and enjoy.

Update: Nemo points out that I misinterpreted Waldman's post, and Nemo is right, although I think I got the substance of Waldman's point right. Here is what Waldman says:

"There is always a payer and a payee, and the payee is 'long' certain states of the world while the payer is short. When you buy a share of IBM, you are long IBM and the firm itself has a short position. Does that mean, when you purchase IBM, you are taking sides in a disagreement with IBM, with IBM betting that it will collapse and never pay a dividend while you bet it will succeed and be forced to pay? No, of course not. There are many, many occasions when the interests of long investors and the interests of short investors are fully aligned. When IBM issues new shares, *all* of its stakeholders — preexisting shareholders, managers, employees — hope that IBM will succeed, and may have no disagreement whatsoever on its prospects. . . . The existence of a long side and a short side need imply no disagreement whatsoever."

So I was clearly wrong when I said, "a CDO is just a way of repackaging other bonds (residential mortgage-backed securities, in this sense), so it doesn't necessarily have a short investor any more than a simple corporate bond or a share of stock does."

But — and I don't think I'm engaging in sophistry here — Waldman's underlying point is that even though there is a short position, that doesn't mean that the long and short investors have diametrically opposed interests. That's true of stocks, and it's also true of CDOs. And so it's disingenuous of Goldman to imply that buyers of any CDO always know that there is someone who is actively betting on it to go down in value.

What Should The President Say On Thursday?

Simon Johnson | 21 Apr 2010

By Simon Johnson, co-author of *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*

On Thursday, President Obama will give one of the defining speeches of his presidency. Most presidents are remembered for only 2 or 3 policies or events during their tenure. The SEC case against Goldman Sachs means, like it or not, the legacy of this administration is wrapped up with the outcome of this and related cases.

The president is apparently lining up to give a fairly conventional “support the Dodd bill” speech. This would be major miscalculation.

The Democrats are afraid that if they truly take on the big banks, they will lose campaign contributions and be placed at a major disadvantage for November 2010 and 2012 – “don’t push it too far” is the message from the White House to the Senate. But this just shows the White House has not fully comprehended the modern nature of banking.

The banks are already coming after the Democrats. A pro-big bank group launched advertising yesterday against Harry Reid in Nevada, as well as in Missouri and Virginia; the media spend is eye popping. Neal Wolin (Deputy Treasury Secretary) already declared war on the Chamber of Commerce over consumer protection; the people behind the Chamber are not nice people and they are very angry about what they think will hurt their interests.

If you want to rally the country against oversized banks that serve no productive purpose, you need to really end the Too Big To Fail problem – half measures simply will not convince people or rally sufficient support. And what we have so far is half measures, as understood from left and right – see today’s New York Times – because the “resolution authority” simply cannot work for large complex cross-border financial institutions.

It will help manage the failure – and avoid bailouts – at purely domestic US financial institutions, but it does not help for cross-border institutions because there is no international agreement on how to handle such failures and – I can assure you – there is no prospect for such an agreement in at least the next 20 years. The Dodd bill will help for resolving bank holding companies and for nonbank financial companies, but not for the megabanks.

How can you take on the banks – whose executives are out for revenge because of the consumer protection measures and because of what seems likely to happen on derivatives, and just to show they are still the top dog (e.g., Goldman) – with one hand tied behind your back in November?

What you would like to do is say: look, we had an up or down vote on whether to break-up the biggest banks and my opponent (or his/her party) was steadfastly opposed. You would want the president to state, in his clearest and loudest voice: There is no social value to having banks above \$100 billion in total assets and we all now understand the danger of allowing banks to become 10 times that size – let alone entering the \$2-\$3 trillion range; we will gradually and responsibly force our biggest banks to become smaller. This worked for Standard Oil – no one can claim it hurt the oil industry. And who would really want to go back to having AT&T run a monopoly in any part of telecommunications?

What about the campaign contributions? If confronted on these terms, the top executives of the six megabanks, without question, would spend more money defeating Democrats. But that is exactly the issue you should take to the country. And it's only six banks.

Show people, in gruesome detail, the money being spent by this part of big finance. Go to the nonfinancial sector, to other parts of the financial system, and directly to individuals – asking most clearly for contributions that would replace what the banks have withdrawn and offset what the banks are spending to defeat the president's reform agenda.

Of course, people may choose not to support this effort. They are busy – and everyone has many distractions. Perhaps even the president cannot break through the daily clutter of information and ideas on this issue. But at least he should make a clear and determined effort – by putting the bank size issues accurately in stark and simple terms.

And if people still refuse to come on board, that's fine. But then they shouldn't complain so loudly as the big banks propel us all towards a Second Great Depression.

What Did Robert Rubin Think About Derivatives?

James Kwak | 21 Apr 2010

By James Kwak

First Bill Clinton said he got bad advice from Robert Rubin on derivatives. Then a Clinton adviser issued a statement essentially taking it back and blaming Alan Greenspan. (Jennifer Taub discussed some of the substantive issues on this blog.) Dan Froomkin asked Rubin, who said, “I thought we should regulate derivatives; I thought so when I was at Goldman Sachs and I thought so afterwards.” But Froomkin points out that Rubin was part of the team that suppressed Brooksley Born’s attempt to regulate derivatives back in 1998.

Brad DeLong defends Rubin, although it seems like a somewhat lukewarm defense. DeLong’s point #3 is: “Brooksley Born and her organization are the wrong people to regulate derivatives.” (That’s a statement of Rubin’s thinking at the time.) Norman Carleton, a Treasury official at the time, also defends Rubin with two posts on his blog that spell out DeLong’s point #3. In the first post, he says that Rubin favored regulation but was concerned with giving the CFTC jurisdiction over the OTC derivatives market. In the second, he explains the issue (legal certainty of existing contracts, something I don’t really want to get into here, so go read the argument there) and concludes with this logically plausible but somewhat bizarre argument:

“Rubin had proposed to Born that, instead of the CFTC asking questions about the need for regulation of the OTC derivatives market, the President’s Working Group on Financial Markets issue the questions. Born point blank refused this suggestion, thus pushing Rubin into Greenspan’s camp, much to the relief of ISDA and other Wall Street groups lobbying on this issue. They knew they had a problem with Rubin.

“Brooksley Born was so sure she was right in her legal position that she could not compromise in face of the practical and political realities. While, not to make too fine a point about it, she has been proven right and Greenspan wrong about the dangers of the OTC derivatives market, Greenspan was the better politician. History might have been different if Born had agreed to Rubin’s suggestion.”

I say “bizarre” because Carleton’s implication, not to make too fine a point about it, is that the failure to regulate OTC derivatives is Born’s fault (the title of the post is “The Importance of Political Competence”), because if she had agreed with Rubin’s suggestion, then Greenspan would have been in the minority and derivatives would have been regulated. The picture you get in your mind is Greenspan and Born on the two sides and Rubin in the middle trying to broker a compromise with Born. (Although I wonder why Rubin, one of the most powerful figures in the administration, felt like he had to side with Greenspan simply because Born wouldn’t agree with him.)

So I think the fact of the matter is that we don’t know what Rubin thought about derivatives regulation in the mid-1990s, because somehow he managed to avoid making public statements about it at the time, or at least public statements that anyone can find using Google. (As opposed to Greenspan, all of whose speeches are nicely archived at federalreserve.gov.) It is true that the President’s Working Group report on the topic didn’t come out until 1999, and the Commodity Futures Modernization Act wasn’t passed until 2000, both after Rubin had left the government.

Now, Carleton was there at the time, and he is backing Rubin’s claim that he favored derivatives regulation. So maybe he did. But that still leaves Froomkin’s key issue unaddressed: “Precisely what Rubin told Clinton about the overall merits of regulating derivatives remains a mystery, and *there is no evidence that he ever actively supported their regulation when it mattered*” (emphasis added). If Rubin did favor regulating OTC derivatives, why didn’t he do anything about it? That, to me, is the real question, not what Rubin may have thought in the privacy of his own mind (or the privacy of the Oval Office).

The only answer to this to emerge in this “debate” is DeLong’s point #5: “The Federal Reserve has adequate powers to stem financial crisis and keep it from becoming a threat to the economy, and is also not worried about derivatives.” (Again, that’s a statement of Rubin’s beliefs at the time.) Maybe Rubin’s position was that derivatives should be regulated, but that the Federal Reserve was *already regulating them sufficiently*. It is plausible that one might have held such a belief, although it has been clearly proven wrong in the interim.

The SAFE Banking Act: Break Them Up

Simon Johnson | 22 Apr 2010

By Simon Johnson, co-author of 13 Bankers.

On Wednesday, Senators Sherrod Brown and Ted Kaufman unveiled a “SAFE banking Act” with a clear and powerful purpose: Break up the big banks.

The proposal places hard leverage and size caps on financial institutions. It is well crafted, based on a great deal of hard thinking, and — as reported on the front page of The New York Times this week — the issue has the potential to draw a considerable amount of support.

The idea is simple, in the sense that the largest six banks in the American economy are currently “too big to fail” in the eyes of the credit market (and presumably in the leading minds the Obama administration — which saved all the big banks, without conditions, in March-April 2009). The bill put forward by Senator Christopher J. Dodd, the chairman of the Banking Committee, has some sensible proposals — and is definitely not an approach that supports “bailouts” — but it does not really confront the problem of the half-dozen megabanks.

In the American political system — where the power of major banks is now so manifest — there is no way to significantly reduce the risks posed by these banks unless they are broken up.

These banks are so powerful that they can confront and defy the government, as seen in the twists and turns of the S.E.C. versus Goldman Sachs case. They are also powerful enough to threaten a form of extortion: If reform is tough, according to JPMorgan Chase’s chief, Jamie Dimon, credit will contract, the recovery will slow and unemployment will stay high. Given the size of his bank, that’s a credible threat.

The big banks give a lot of money to politicians on both sides of the aisle and they are now digging in hard to defeat reform. Indeed, there are credible reports of various “front” organizations being used for this purpose.

Under such circumstances, the Brown-Kaufman approach might be thought unlikely to succeed.

But consider how the Republicans are already starting to counterattack the Dodd proposals, the ways in which the broader Dodd-White House approach remains vulnerable, and how exactly the Brown-Kaufman

approach can help the Democratic leadership as it becomes increasingly hard pressed.

The Republicans are saying: the Dodd bill does not end “too big to fail.” Most of their reasons are misleading (“it’s all about Fannie and Freddie really,” “there will be a permanent bailout fund,” “the Federal Reserve needs to lose some of its powers,” etc.). But there is no question that this message will seriously confuse people who are only just starting to pay attention.

As the Republicans have astutely spotted, the Dodd-White House proposals will not actually reduce the size or seriously limit the activities of the megabanks — and a broad cross-section of society completely understands that these institutions brought us into the trauma of September 2008, have become even bigger since then, and still have the incentive to take on an excessive amount of risk.

The S.E.C. case against Goldman has created a great opportunity for the Democrats because it exposes details regarding exactly how big banks are mismanaged and why they treat many of their customers in an unreasonable manner. The electorate now completely understands — even more clearly than a week ago — that the attitudes and compensation structure of the largest banks lie at the heart of our current macroeconomic difficulties.

The Brown-Kaufman bill therefore addresses not just the substantive financial issues of our day but also the tough political situation now facing Democrats. If their SAFE banking bill can come to the floor of the Senate (for example, as an amendment to the Dodd bill) and be voted on — up or down — then we will really get to see which of our elected representatives support overly big banks and which want to bring them down.

The bill might fail, of course, on that basis — but then anyone who opposes it can be branded as a “too big to fail” fan in November and beyond. This would be a clear identifier that would cut through the noise and the disinformation. Did this candidate vote for or against the too-big-to-fail banks? It’s a simple yes or no.

As political logic inserts itself more and more into the economic debate on banking, there is a real possibility that Senators Brown and Kaufman have exactly what the Democrats (and the country) needs.

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

Make The Call Or Get Out Of The Booth: After The President's "Wall Street" Speech

Simon Johnson | 22 Apr 2010

By Simon Johnson, co-author of 13 Bankers: The Wall Street Takeover And The Next Financial Meltdown

Update: The Progressive Change Campaign Committee has a petition that takes you to a page with your senators' names and phone numbers, as well as a script to use when calling them.

The president's rhetoric today at Cooper Union was impressive and his body language indicates a major shift in administration attitudes towards the big banks over the past year. This is commendable.

But there is still the awkward question of legislation that would actually reduce the political power of big banks – and make our financial system significantly safer. The latest indications from the Senate are that there will be some sort of "Dodd minus" compromise bill brought to the floor early next week. The Republicans have substantially backed down from Senator McConnell's "hell, no" position of last week because the polling is crystal clear: Anyone perceived as opposed financial reform will lose badly in November.

But the Democratic leadership is not seizing on this advantage and on the opportunity presented by the SEC case against Goldman Sachs – key figures in the Democratic establishments are too worried about upsetting financial sector donors. As a result, come November, independents will view the Democrats with scorn, while the Democratic base will be far from energized; you do the math.

What can you do? What makes sense in both economic and political terms?

Call your Senator, call Senator Harry Reid (Senate majority leader), and call the White House. Tell them that you support the Brown-Kaufman SAFE banking act (unveiled yesterday) – as an amendment that would greatly strengthen the Dodd bill by capping the size and leverage of our biggest banks. Politely ask the people who answer the phone to make certain that this amendment gets an "up or down vote" in the Senate.

The Brown-Kaufman act is our best near-term chance to reduce the size of Wall Street megabanks that are too big to fail and that threaten

our economy. (If you don't understand why this is important, read 13 Bankers; quickly – this could all be over by this time next week.)

Tell everyone you know why this makes sense and ask them to make the call also. These calls will determine the outcome. If the Democratic leadership understands the groundswell of support for breaking up big banks, the Brown-Kaufman proposal has a chance to come to the floor – and who exactly on the Republican side would like to be on the record as opposing it?

If no one who reads this post speaks out (and makes the call), the Brown-Kaufman amendment will not come to the floor. If some of you speak out, there is a sliver of a chance. And if all of you – and everyone you know and everyone they know – make three simple, short, and friendly phone calls, there will be a vote.

The Consensus on Big Banks Starts To Move

Simon Johnson | 23 Apr 2010

By Simon Johnson, co-author of *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*

The ideology of unfettered finance is crumbling. Whatever you think of the merits of the Goldman case from a legal or short-term perspective, the SEC's allegation – and Goldman's response – have further moved the mainstream consensus away from "finance is generally good" to "big banks are frequently scary."

Senator Ted Kaufman should get a great deal of credit for his well timed charge on this issue – as I argue in BusinessWeek/Bloomberg. But Lloyd Blankfein also gets an inadvertent assist, quoted in the Financial Times yesterday as saying that the SEC case against Goldman would "hurt America."

Mr. Blankfein is starting to sound – and act – a lot like Nicolas Biddle, head of the Second Bank of the United States (by far the most powerful commercial bank of the day), during his confrontation with President Andrew Jackson in the early 1830s.

When Jackson first challenged the Second Bank, many people thought his concerns about the bank's powers were excessive. But then Biddle started to fight back, spending money freely to buy congressional affection (and even leading orators) and attempting to contract credit in order to demonstrate that Jackson was hurting America.

At that point, people understood that Jackson was essentially right. The Second Bank had become so powerful that it could challenge elected executive authority and, if Biddle won, the consequences for democracy would be dire.

We are now in the phase when the most dangerous of our banks – and the people behind them – will go to any lengths to distort the realities and completely mislead people. The only way to deal with this is to do what Andrew Jackson would have done – attack, in no uncertain terms, misrepresentation wherever we find it.

Some friends of ours produced an ad yesterday, which is now on YouTube, which cuts direct to the heart of the matter. Review it and, if you agree with the message, send it to others. Tell them to pass it on – and urge them also to understand why they should call their Senators and the Senate Democratic leadership and insist – firmly but politely –

that the Brown-Kaufman SAFE banking act should receive an up-or-down vote on the Senate floor (my post on that issue, from yesterday, has been updated with a link to make these calls easier for everyone).

We should now view Goldman Sachs and our other five megabanks in the same terms that Andrew Jackson's secretary used for the Second Bank of the United States, "Independently of its misdeeds, the mere power, – the bare existence of such a power – is a thing irreconcilable with the nature and spirit of our institutions" (see p.19 of 13 Bankers).

Greece, The IMF, And What Comes Next

Simon Johnson | 23 Apr 2010

By Peter Boone and Simon Johnson

The latest developments from Europe – including Greece appealing for an IMF program today – may well be a watershed, but if so, it is not a good one. The key event yesterday was that the yield on all the debt of weak eurozone governments widened while German yields fell. The spreads show all you need to know: a very clear and large contagion risk.

The five year Portuguese yields rose from 3.84% to 4.26%. The five year Spanish bonds rose from 2.89% to 3.03%, and the five year Irish bonds rose from 3.74% to 3.97%. These are not minor moves for investment grade sovereign bond funds. This kind of change means, for example (and roughly), you lose 0.5% on the value of a bond in one day. These are bonds that just pay 3% per year – and one such day may be enough to cause “investment grade investors” to decide not to stay involved and not to come back for a long while.

If these bonds transition towards being held by “emerging market investors” (usually quite different people), and stronger European commercial banks decide to limit their exposure to the weaker government’s bonds, we could be in for quite a major increase in yields across the spectrum.

Emerging market investors look at these weaker eurozone bonds – compared to say Argentina with 10% yields – and think they represent unappealing reward for the risk. Greek 5 year bonds rose to 9.4% yesterday from 8.1% the previous day. This is still low for a country on the verge of default.

These higher government bond yields are also hitting banks. No doubt there is a bank run on in Greece to some extent at the wholesale level. This will spread to other banks in the region. Since their marginal funding costs are tied to the creditworthiness of the sovereign, and since the collateral for these banks’ portfolios is tied to local property values and assets, these changes in sovereign yields will have a negative impact on banks’ balance sheets.

Irrespective of the next move – which lies this weekend with the International Monetary Fund and the ministers of finance meeting in Washington for the Fund’s spring meetings – this looks like the moment when the Greek problems really start to generate contagion across the

eurozone region. We'll see rates on government debt trending higher, asset prices (such as real estate) falling even more, and renewed concern about banks on the European "periphery".

What can the authorities do? The only path is a new package of "liquidity assistance" for countries under pressure but not yet ready to call in the IMF. The liquidity is available from the ECB – it can provide emergency loans to all the banks in the region to prevent bank runs from toppling them. But there is also a solvency problem for the weaker countries now under pressure.

To return to solvency, the struggling eurozone countries will need funding for budget deficits and debt rollover for several years. Governments will need to recapitalize their banks with new government-backed debt. The best solution would be for the government to then sell their stakes to larger European banks with more creditworthy sovereigns. SocGen Greece (with all its issues) would be a lot more attractive to Greek businessmen and depositors than National Bank of Greece at the end of all this.

And this is the heart of the problem: Will Germany and other European nations be prepared to provide the large sums needed to refinance several peripheral nations? Will these nations then take the painful austerity measures needed in the midst of recessions in order to get out of this?

When the problem was just Greece, the numbers were already large. In our view, the Greek government needs 150bn euros over three years to be sure it can refinance itself through a recession. The Portuguese will roughly need 100bn euros. If those amounts were made available – will that support the confidence needed to buy Irish and Spanish bonds, or would it scare investors because the protests from Germany would be so large that it would be clear no more funds would be available in bailout mechanisms?

There is no easy answer to this question, but yesterday's action suggested that markets are not at all confident policy makers are going to stop this crisis soon. They are surely right: Greek strikes, a weak Portuguese government deeply in denial, and German hatred for bailouts, all make a path to restore confidence very difficult.

Yesterday was also a wake-up call for the United States. It is no longer reasonable or responsible to say: "US banks have no exposure to Greece". US banks are heavily exposed to Europe, and this is turning

into a serious Europe-wide problem. The US badly needs to make sure this does not spread beyond Greece and Portugal/Ireland.

To restore confidence in buying Spanish and other major European nation bonds, it would surely help to have clear signals that President Obama himself, and the Federal Reserve, are taking an active stance now on making sure this does not spread to become another threat to global financial stability. A broader wall of preventive financing must now be put in place – after all, this is exactly why (in principle) the IMF was recapitalized this time last year.

Such a push by the US would be awkward, to be sure, as the French and Germans (and British) are not keen to have more US involvement in their affairs. But the Europeans have handled matters so badly in the past few months, it is time for a much more scaled-up US role.

Two Senators And Larry Summers On Bank Size

Simon Johnson | 23 Apr 2010

By Simon Johnson, co-author of 13 Bankers

Bank size is suddenly the issue of the day – with politicians lining up to oppose any meaningful restriction on the size of our largest banks. Their reasoning is varied and all quite flawed, particularly when they insist there must be no Senate floor debate on the Brown-Kaufman amendment.

Senator Dick Durbin may be right to say that the Brown-Kaufman amendment is “a bridge too far” and will not pass in this legislative cycle – presumably this sounds like a tactical political assessment. Surely in that case he would not oppose bringing it to the floor of the Senate and allowing that body to prove him right (or wrong).

Senator Chris Dodd opposes the amendment, but his reasoning is rather vague. Here’s what he says in his interview with Ezra Klein, which appeared yesterday,

“It’s not size; we’re preoccupied with size. And I’m not suggesting that any size is okay, but it’s really risk, it’s these other elements in here. A relatively innocuous product line in a relatively small company can pose huge, systemic risk. That said, in our bill, we provide the authority to break up companies. That is clearly in the bill, the authorization to do that under certain circumstances. But I’m not sure that we ought to become so preoccupied with it. And again, I’ve looked at the 13 Bankers book, and so forth, that approach, and hear this, by the way, not just from them, but from CEOs of major corporations. This is not some left/right question. But I just don’t think that it makes a lot of sense. I don’t think it’ll prevail.”

Senator Dodd is completely correct that this is not a left/right question and he is also correct that come CEOs and other heavy hitters from the business sector completely agree with us.

But his other reasoning is shaky. No one disputes that risk is the issue here. But our proposal to reduce bank size is in addition to everything already in the bank bill – so in order for this to be a bad idea, you would need to argue that breaking up the big banks would actually lead to more system risk.

Given what we have learned about the serial incompetence of megabanks, with their distorted incentives and perverse belief systems, such an argument seems like quite a stretch. But it is a stretch that Larry Summers – ever the top level debater – understands that the anti-Brown-Kaufman view implies or even requires:

“Brown: The too big to fail issue, why not go further? Why not just limit the size of banks?

Summers: Jeff, that was the approach America took to banking before the depression. That was the approach America took to lending in the thrift sector, before we had the S&L crisis. Most observers who study this believe that to try to break banks up into a lot of little pieces would hurt our ability to serve large companies, and hurt the competitiveness of the United States. But that’s not the important issue, they believe that it would actually make us less stable. Because the individual banks would be less diversified, and therefore at greater risk of failing because they wouldn’t have profits in one area to turn to when a different area got in trouble. And most observers believe that dealing with the simultaneous failure of many small institutions would actually generate more need for bailouts and reliance on taxpayers than the current economic environment.”

There are two substantive points here (ignoring the rhetorical distraction in the first two sentences).

1) “Most observers who study this believe that to try to break banks up into a lot of little pieces would hurt our ability to serve large companies, and hurt the competitiveness of the United States.”

2) “Because the individual banks would be less diversified, and therefore at greater risk of failing because they wouldn’t have profits in one area to turn to when a different area got in trouble. And most observers believe that dealing with the simultaneous failure of many small institutions would actually generate more need for bailouts and reliance on taxpayers than the current economic environment.”

I’m not sure who the “most observers” are with regard to either point. I have heard the arguments before but, as we review in *13 Bankers* (see the last chapter), neither of these is the mainstream fact-based view regarding big banks.

The idea that breaking up big banks this would “hurt our ability to serve large companies” is often claimed by Jamie Dimon and some other bankers. But it is contradicted and refuted by the CEOs whom Chris Dodd cites. If you find a CFO from a nonfinancial US company who would like to discuss this in more detail (preferably in public, but we also talk to many people off-the-record), send them along – so far, no bankers have accepted our challenge to come out and debate.

On the idea that individual banks are more risky, this is obviously disingenuous. As Summers knows very well, the “risk of failing” depends on the amount of capital that banks have. Large banks have long believed they need less capital because they are well-diversified, but the weaknesses in their thinking were painfully exposed in September 2008.

Again, if you know a top banker who is willing to discuss in public how their risk management systems – broadly and appropriately defined – failed in 2008, and how those flaws have been fixed, please ask them to speak out in detail and with specifics. I understand they may be reluctant to engage in an open debate, but how about at least producing a working paper that has some verifiable evidence in it?

Summers is right that small banks can fail – in fact, they fail all the time in the US and he likes the FDIC resolution mechanism so much that he is proposing this as a way to deal with all financial companies (even though it cannot, by definition, work for large cross-border banks because it is not a cross-border authority). We need a financial system in which firms of all kinds can fail – without this, you no longer have any kind of “market” economy.

So the heart of Summers’s claim is that (1) small banks would all fail simultaneously, and (2) this would be more costly to deal with than what we faced in September 2008. Claim (1) is implausible – nothing is that synchronized, including his main supporting episode (the S&L crisis). Claim (2) is also not supported by any evidence – again, the S&L crisis was much less costly than the September 2008 fiasco (and after the S&L episode many people went to jail and even more thrifts went out of business – what’s our score on this round?)

Can Summers really claim, with any credibility, that a set of troubled smaller banks would have got the incredibly generous package of support received by the 13 bankers and their ilk? Of course not, smaller bankers would have been fired, their board of directors would have been

dismissed, and their creditors would have faced losses (as with all small bank failures).

And Summers – or others – cannot fall back on the 1930s to say “small banks are bad.” The world has changed fundamentally since that time because we have deposit insurance. The domino collapse of small banks was a result of retail runs.

As I travel round the country presenting 13 Bankers to audiences – including leading experts on these issues, as well as just deeply interested and informed individuals – “most observers” agree that breaking up big banks is an additional measure that would reinforce the Dodd bill and reduce system risk. We agree that breaking up the banks is not sufficient for financial stability – we merely insist that it is necessary, particularly in a political system that has been so completely captured by the biggest bankers.

If you or Larry Summers have any evidence to the contrary, please send it to me. Or just put in on the web in a way that people can assess and critique.

Why is this critical question for our country’s future being fixed up behind closed doors? Why not come out into the open and have a proper public discussion as befits a democratic country.

Even better, let the Brown-Kaufman bill come to the Senate floor for a debate and an up-or-down vote. What exactly are the opponents of this suggestion afraid of?

Rewarding Teacher Performance? Resist the Temptation to “Race to Nowhere”

James Kwak | 24 Apr 2010

This guest post is contributed by Kathryn McDermott and Lisa Keller. McDermott is Associate Professor of Education and Public Policy and Keller is Assistant Professor in the Research and Evaluation Methods Program, both at the University of Massachusetts, Amherst.

On March 29, the U.S. Department of Education announced that Delaware and Tennessee were the first two states to win funding in the “Race to the Top” grant competition. A key part of the reason why these two states won was their experience with “growth modeling” of student progress measured by standardized test scores, and their plans for incorporating the growth data into evaluation of teachers. The Department of Education has \$3.4 billion remaining in the Race to the Top fund, and other states are now scrutinizing reviewer feedback on their applications and trying to learn from Delaware’s and Tennessee’s successful applications as they strive to win funds in the next round.

One of the Department’s priorities is to link teachers’ pay to their students’ performance; indeed, states with laws that forbid using student test scores in this way lost points in the Race to the Top competition. A few months ago, James pointed out some of the general flaws in the pay-for-performance logic; here, our goal is to raise general awareness of some statistical issues that are specific to using test scores to evaluate teachers’ performance.

Using students’ test scores to evaluate their teachers’ performance is a core component of both Delaware’s and Tennessee’s Race to the Top applications. The logic seems unassailable: everybody knows that some teachers are more effective than others, and there should be some way of rewarding this effectiveness. Because students take many more state-mandated tests now than they used to, it seems logical that there should be some way of using those test scores to make the kind of effectiveness judgments that currently get made informally, on less scientific grounds.

The problem is that even if you accept the assumption that standardized tests convey useful information about what students have learned (which we both do, in general), measuring the performance gains (or losses) of students in a particular classroom is far more complicated than subtracting the students’ September test scores from their June test scores and averaging out the gains. We’re concentrating

on the statistical issues here; there are other obvious challenges in test-based evaluation, such as what to do for teachers who teach grade levels where students do not take tests and/or subjects without standardized tests.

The first problem has to do with class sizes. In order to compare the score gains among Ms. Jones's students with the score gains of Mr. Smith's students, we need to do statistical analyses.* One thing you learn fairly early in a statistics course is that small populations are tricky, since just a few measurements at the extremes have a greater effect on the mean or other summary statistics. Experts on educational testing think that a population size of about 30 is necessary for analyses of the average performance of a teacher's students to be meaningful. In other words, each teacher needs to have 30 or more students. Even in these days of fiscal austerity, U.S. elementary-school class sizes are generally not this large.

In middle school and high school, where students have specialized teachers for each subject, teachers work with far more than 30 students in any given term or school year; the norm is probably closer to 100 or more (not, of course, at the same time; each teacher is teaching multiple courses or multiple sections of the same course, and seeing different students during each class period). Under these circumstances, the conditions for meaningful teacher-level performance analysis are likelier to be met.

Even here, though, there could still be issues. If all of a middle-school teacher's 100 students are taking the same general seventh-grade math or English course, it makes sense to aggregate all 100 students' performance data. However, if that same teacher has three sections of "General Math 8" and one of "Honors Algebra," it's harder to know what the aggregate across all four class section means. It's even harder to know how to interpret an aggregate of changes in students' test scores if a high-school English teacher's work day includes AP English Literature, remedial English for 10th graders, and two sections of Creative Writing. The aggregate of the scores for the students in these classes who took the state English test that year might be a blunt measure of something about the teacher's effectiveness, but it's hard to say exactly what. If we wanted to know what kind of job this particular teacher does with the AP or remedial class, we'd be back to the class-size issue, since 30 is a big class even at the secondary level.

The second general problem has to do with how students end up with particular classmates and particular teachers. Knowing that Ms. Jones's students gained an average of 6 points on the test and Mr. Smith's gained 10 might tell us that Mr. Smith is the better teacher, or just that Mr. Smith had students who were able for some other reason to make greater gains that year. We can only attribute the difference to something the two teachers did if we have reason to believe that the two groups of students were not systematically different from each other. More formally, we have to be able to assume that the students in the two classrooms are randomly equivalent. This means that the distribution of general academic ability—before Smith and Jones start teaching on the first day of school—is the same in the two rooms (which is not the same thing as all of the students having equal ability). Further, it would imply that the students in one classroom would, on average, have the same access to information, have equally involved parents, come from similar socio-economic backgrounds, etc. Although there are statistical tests** that can control for other, specified variables, such as initial ability or socio-economic status, it is impossible to control for all possible variables. These conditions exist only if students are randomly assigned to classrooms.

Anybody with children in school can attest that this assumption does not withstand contact with reality. Even though strict “tracking” has fallen into disfavor among educators, some schools still divide students into fast, medium, and slow classes. Some school districts still have “gifted” programs that draw the strongest students from across town into particular classes in one school.

Even in schools that do not track their students, many other considerations generate classes that are anything but random groups of students. At the elementary level, where students tend to spend nearly all day with the same teacher, pushy parents are famous for manipulating their kids into the “best” teachers' classes. Because pushy parents' kids often do better in school, those “best” teachers are likely to end up with groups of students whose ability to gain in a year might exceed that of the students assigned to their less sought-after colleagues. Conversely, a particularly thick-skinned principal might engineer class assignments in the other direction, so that the children with the greatest need get the most effective teachers, which would produce the opposite tendency in score gains. Other factors that have to do with the school's organization and resources, or with teachers' various strengths and weaknesses, may also lead to non-random sorting of students. For

example, a particular teacher may be especially good with rowdy boys, or be fluent in Spanish and able to help students transitioning out of bilingual education classes.

At the secondary level, separating students into AP, college-prep, and “regular” versions of core academic subjects is common. Even in untracked secondary schools (like many middle schools), scheduling considerations can produce collections of more, or less, academically able students with more, or less, advantaged parents in particular classes, depending on the patterns in the students’ course selections. These might cancel each other out, for example if the teachers who get the most able collections of students also get the least able ones, but it is not safe to assume that systematic differences in the characteristics of all teachers’ collections of students will always net to zero.

In both Delaware and Tennessee, students’ test-score growth will be combined with other kinds of information to make judgments about teacher performance. Considering data from multiple sources will help overcome some of the issues we’ve raised here. However, looking at “what the numbers say” appeals to policy makers who crave simple indicators of complex phenomena. Legislators and governors don’t have to pass a statistics exam before taking office, and they haven’t had an especially good record of listening to educational testing experts before they mandate new uses for test results. For example, the relevant professional associations have jointly endorsed a set of principles on appropriate uses of tests which, among other things, caution against using a particular test for purposes other than those for which its validity has been studied and confirmed.

Despite this caution, policy makers tend to pile extra uses onto tests once they’ve required that students take them—for example, once they’ve got a test that’s been validated as a measurement of individual students’ mastery of grade-level curriculum, they tend to aggregate the results of that test and use them to rate a whole school’s overall performance, as in No Child Left Behind. The tendency has also been for quantitative performance indicators, even if of somewhat dubious quality, to dominate over other forms of evaluation. We worry that something similar will happen with the use of student performance in determining teachers’ pay, promotion, or retention. “The numbers” look objective to people outside schools, while other measures like analysis of lesson plans or documentation of classroom observations seem by comparison to be imprecise means by which the “education establishment” can continue to protect the incompetent.

Educators have welcomed the Obama administration's willingness to eliminate some of the less logical components of No Child Left Behind, such as the "adequate yearly progress" benchmarks based on unfounded assumptions about how schools improve and on definitions of "proficiency" driven more by political expediency than by an objective definition of what students need to learn in order to succeed in further education and careers. However, even though we're now "racing to the top" rather than trying to ensure "no child left behind," we still risk basing reasonable-sounding policies on unreasonable assumptions and racing (with apologies to Talking Heads) on a road to nowhere.

* Gain scores can be compared through several different statistical techniques. At the most basic a t-test can compare the gain scores of two teachers, and an analysis of variance can compare the gain scores of multiple teachers. More sophisticated methods include ANCOVA where covariates such as the initial ability of the examinee and other factors can be used as a control variable.

** Models such as ANCOVA or regression can be used to help to control for other variables.

The Sickening Abuse Of Power At The Heart of Wall Street

Simon Johnson | 24 Apr 2010

By Simon Johnson, co-author of 13 Bankers

Here's where we stand with regard to democratic discourse on the future of our financial system: leading bankers will not come out to debate the issues in the open (despite being approached by reputable intermediaries after our polite challenge was issued) – sending instead their “astro turf” proxies to spread KGB-type disinformation.

Even Larry Summers, who has shifted publicly onto the side the angels (surprising and rather late, but welcome anyway), cannot – for whatever reason – bring himself to recognize the dangers inherent in our unstable and too-big-to-manage banks. Or perhaps he is just generating excuses that will justify not bringing the Brown-Kaufman amendment to the floor of Senate?

So let's take it up a notch.

I strongly recommend that the responsible congressional committees request and require all assistant secretaries at the US Treasury (and other relevant political appointees over whom they have jurisdiction) to appear before them early next week.

The question will be simple: Please share your calendar of meetings this weekend, and provide us with a complete accounting of people with whom you met and conversed formally and informally.

The finance ministers and central bank governors of the world are in Washington this weekend for the spring meetings of the International Monetary Fund. As is usual, the world's megabanks are also in town in force, organizing big meetings and small dinners.

Through these meetings dutifully troop US treasury officials, providing in-depth and off-the-record briefings to investors.

Banks such as JP Morgan Chase and the other top tier financial players thus peddle influence, leverage their access, and generally show off. They accumulate information from a host of official contacts and discern which way policymakers – their “good friends” – are leaning.

And what is the megabank whisper mill working on? Ignore the “economic research” papers these banks put out; that is pure pantomime for clients-to-be-duped-later. I'm talking about what they are telling the market – communicated in specific, personal conversations this weekend.

They are telling people that, based on their inside knowledge, Greece and potentially other eurozone countries will default on their debt. Perhaps they are telling the truth and perhaps they are lying. Most likely they are – as always – talking their book.

But the question is not the substance of their whisper campaign this weekend, it is the flow of information. Have they received material non-public information from US government officials? Show me the calendar of the top 10 treasury people involved, and then we can talk about whom to summon from the private sector to testify – under oath – about what they were told or not told.

There is no question that the megabanks derive great power and enormous profit from their web of official contacts. We should reflect carefully on whether such private flows of information between governments and “too big to fail” banks are entirely suitable in today’s unstable financial world.

Large global banks make money, in part, through nontransparent manipulation of information – this is the heart of the SEC charges against Goldman Sachs. But the problem is much broader: the Wall Street-Washington corridor is alive and well on its way to another crisis that will empower, enrich, and embolden insiders (public and private) while impoverishing the rest of us.

The big players on Wall Street are powerful like never before – and they use this power to press for information and favors from sympathetic (or scared) government officials. The big banks also appear hell-bent on abusing that power. One consequence will be further destabilizing global financial markets – watch carefully what happens to Greece, Portugal, Ireland, and Spain at the beginning of next week.

It is time for Congress to step in with a full investigation of the exact flow of information and advice between our major megabanks and key treasury officials. Start by asking tough questions about exactly who exchanged what kind of specific, material, market-moving information with whom this weekend in Washington.

The Washington Post Makes A Major Factual Error

Simon Johnson | 25 Apr 2010

By Simon Johnson, co-author of 13 Bankers

Of all the weak, ill-informed, and misleading pieces written on the “resolution authority” – a central tenet of the Dodd bill – by far the most disappointing is the Washington Post editorial in Sunday’s paper.

I fully appreciate that these are complex issues and I understand that journalists frequently write under great time pressure.

But honestly, if you don’t know the answer to a question – you should really just call Treasury, the White House or Senator Dodd’s people. What even they will tell you, in my experience – if you press them hard enough (i.e., don’t fall for the initial spin) is that it is incorrect, or at least significantly incomplete and misleading, to say that the Dodd bill will create:

“an executive-branch resolution process for systemically important firms that is separate from bankruptcy and therefore allows officials to move swiftly to resolve a troubled institution in a crisis.”

This statement is wrong for a simple reason: the Dodd resolution authority would not help resolve (i.e., shut down in an orderly manner) large cross-border financial firms, because the authority is U.S. and not international (or cross-border). Do not misunderstand me: The resolution authority in the bill is a fine idea and worth supporting – it will help create a clear legal framework for the resolution of bank holding companies and nonbank financial companies (i.e., it would extent the FDIC-type resolution process, which is far from being a bailout).

But the Dodd resolution authority simply will not work for the cross-border megabanks; this is not my opinion, this is an incontrovertible fact that is true by definition. A domestic resolution authority does not give you the right to manage the failure process in other countries or across borders – for that you would need an international resolution authority and this is not in the cards now or in the foreseeable future (and the Dodd bill does not change that fact in the slightest).

The Dodd bill has some good pieces, including its domestic resolution authority, but it does not go far enough – and that is the point of the

Brown-Kaufman amendment (mentioned but apparently not at all understood by the Post).

Given that the Washington Post still has a large staff of excellent journalists working around the world, they could try asking G20 deputies about this in detail – or even just consult with top regulators in the UK who can lay this all out for them. And while they are at it, it would be worth writing a story on why there is no G20-level process to establish a cross-border resolution mechanism – and no likelihood of such a mechanism for the next 20 years.

Or the Post could even talk to the people at the top of the megabanks – just don't take their general word at face value regarding claims that the resolution authority will help; ask them to spell out in detail how it would be applied to the cross-border issues at JP Morgan Chase, Citigroup, or Goldman Sachs.

This is not a random topic that has sprung unexpected on editorial writers in the past week. This issue has been hotly debated in public for at least a year. How could the Washington Post, of all newspapers, put its name – at this stage in the game – behind such manifestly inaccurate and misleading statements?

The Post should immediately issue a correction not just on this specific point, but also on their entire editorial position relative to this issue – because once they accept this error (hard I know, but they will be hearing about this a lot), the logic of their existing position crumbles completely.

When Will Senator Dodd Start Taking Yes For An Answer?

Simon Johnson | 26 Apr 2010

By Simon Johnson, co-author of *13 Bankers*

Senator Chris Dodd is a tactical legislative genius – keep this clearly in your mind during the days ahead. In terms of maneuvering for the outcomes he seeks, managing the votes, and controlling the floor, you have rarely seen his equal.

Senator Dodd wants some financial reform – enough to declare victory – but not so much as to seriously undermine the prevalence of megabanks on Wall Street. You can take whatever view you like on his motivation – but Senator Dodd himself is quite open about his thinking and intentions.

Given the mounting pressure from many sides – including Federal Reserve Bank presidents – to implement significantly more reform (see also David Warsh's Sunday evening assessment), for example using some version of the Brown-Kaufman SAFE banking act, how exactly will Senator Dodd prevail?

1) He knows that the Republican leadership will mount a disinformation campaign, trying to muddy the waters by claiming that the Dodd bill “institutionalizes bailouts”. This top-down Republican line is complete and deliberate misrepresentation – designed purely to prevent real reform. Every time it is repeated, Senator Dodd's position becomes stronger because people who really want reform need to rally to his defend his approach.

2) The Republican attacks also justify the Democratic leadership and various pro-reform groups telling people: Don't confuse the message. Everyone in the center and on the left is lobbied to emphasize that Senator Dodd's bill will completely “end too big to fail” – if you deviate from this line, you will be accused of falling in with Mitch McConnell's dangerous views. Expect this pressure to intensify in coming days – requests for responsible and transparent debate on policy options will be drowned out and pushed aside by the pressure for conformity (underpinned by the desire not to undermine Wall Street campaign contributions too much).

3) As the White House pushes back against the Republicans, this will further strengthen Senator Dodd – he is the congressional standard bearer, after all. And everyone knows that he needs 60 senators on his side in order to prevail, so some weakening of the bill is presumed

inevitable and must be accepted in the reasonable name of making some progress.

But this is where the pure genius of Senator Dodd enters the equation – with an audacity that makes you whistle with appreciation for the art (although not the substance).

The presumption is that Senator Dodd is negotiating with one or more Republicans who are the easiest to bring on board. This would make sense if Senator Dodd wanted the strongest bill possible.

Senator Chuck Grassley voted for strong derivatives reform in the Agriculture Committee; Senator Olympia Snowe also seems on board with that agenda. Senators John Thune and Bob Corker are saying in public that Republicans want to vote for reform (although it's a good question what this means exactly). Senator Jim Bunning voted with Senator Bernie Sanders in the Budget committee – on what is being seen as a test vote on breaking up banks (Sanders's press release; Huffington Post coverage). Senator Scott Brown is wavering in broad daylight. Senator George Voinovich is retiring and rumored to be flexible on financial reform issues.

But Senator Dodd is closeted in negotiations with Senator Richard Shelby – who stands for the most pro-Wall Street bill possible.

The goal is apparently not to give up as little as possible and still get a bill. The goal is to bring as many supporters of Wall Street as possible on board with the legislation, at the same time as framing the issues so the pro-reform camp looks bad when it presses for more.

As we head into what is likely to be the decisive week, Senator Dodd controls the clock, can determine what is debated on the Senate floor, and – whenever he feels hard pressed – remind everyone to toe his line or fear the extreme Republicans. At this point, only the White House can bring sufficient pressure for the Brown-Kaufman bill to get an up-or-down vote; the odds are against this being what the White House really wants to do. But keep calling the White House and the Senate Democratic leadership.

The Republicans Help Reform, Inadvertently

Simon Johnson | 27 Apr 2010

By Simon Johnson, co-author of 13 Bankers

No one can publicly oppose what is widely perceived to be “financial reform” – the polls are quite clear on this point. If you want to help Wall Street, your options are:

1) Oppose the Dodd bill, claiming that it would create a more dangerous situation than what exists today. But Senator Mitch McConnell already tried this and was thoroughly debunked, e.g., by Senator Ted Kaufman. There will be rhetorical posturing along these lines, to be sure, but there is no sign of any real traction.

2) Run a comprehensive “astro turf” disinformation campaign, pretending to be the voice of “true reform.” But these efforts are too obvious at this point – and too obviously fraudulent, so this actually helps the pro-reform narrative.

3) Stall for time in terms of preventing the Dodd bill from coming to the floor of the Senate, while working out a backroom compromise that will greatly gut the substance (on consumer protection, derivatives, and/or the resolution authority). This appears to be what the Republicans are focusing on, with Senator Richard Shelby in the lead.

But there is a potential weak point in this Republican strategy.

If the Democratic leadership becomes fed up with Republican stalling – or otherwise sees an opportunity to paint the Republicans as completely obstructionist, they could actually strengthen the bill.

For example, including something like the Brown-Kaufman amendment (or otherwise addressing the issues posed by our six megabanks) would make it easier for people to understand what is at stake. To win on this issue in November, the Democrats may need to simplify their message and make it more powerful. Some relatively pro-Wall Street Democrats are reluctant to do this, but if the Republicans stand united, nothing will pass – so why not propose something stronger that will go down to clear and memorable defeat, particularly after a searing debate?

The Republicans are not the only ones who can maneuver here. By delaying any progress, they are creating an opportunity within the Democratic side to find ways forward that are not entirely designed by Senator Dodd.

The Goldman Sachs appearance between Senator Carl Levin's subcommittee on investigations is one wild card tomorrow. President Obama beginning to become more energized and focused on this issue – including at least one speech this week – is another.

Republican stalling tactics have, in effect, introduced a greater element of randomness into the process.

The Republicans obviously want to slow reform or make it change direction. They should be careful what they wish for.

What Did Goldman Know And When Did It Forget It?

Simon Johnson | 27 Apr 2010

By Simon Johnson

There is a live blog on the Goldman Sachs hearing [now on the Lehrer NewsHour website](#), including comments by Paul Solman and me. The interaction between Goldman and the Senators – Democratic and Republican – is fascinating.

The Goldman executives so far seem to be struggling to recall exactly what happened. The Senators are pressing them hard. This is much more than theater. This is (some) people trying to figure out exactly who did what to whom.

Three Modest Proposals For Goldman Sachs

Simon Johnson | 27 Apr 2010

By Simon Johnson, co-author of 13 Bankers: The Wall Street Takeover and The Next Financial Meltdown

At this stage in the proceedings, the Goldman Sachs' public relations people must be feeling more than a little down. The firm's lawyers are still breathing fire, Lloyd Blankfein trod the fine line between not being apologetic and actually saying "it's capitalism, stupid", and the more junior executives interrogated today did not say anything blatantly incriminating. But the public image of the firm around the world – including with finance ministers and pension funds – has taken a severe beating.

In the interests of finding a more positive and cooperative way forward, here are three suggestions for the PR team to take up with senior management – once they are in mood to think long-term about their "franchise value" again.

1. Come out in support of some form of financial reform. The really clever move would be to support something that is not likely to pass, such as size restriction on the biggest banks – keeping in mind that this would hinder JP Morgan Chase and Citigroup much more than Goldman (which was a much safer size not so long ago). Almost as smart would be to endorse the consumer protection agency for financial products – given that Goldman does not deal with many retail investors. In any case, surprise us with support for something that the administration in general or Mr. Volcker in particular is proposing.
2. Create a corporate pledge not to use "astro turf"/fake grass-roots organizations to spread disinformation, then invite other leading firms to sign on. The current leading fraud in this area is incredibly embarrassing for the financial sector; in the language of Jamie Dimon, it self-demonizes the entire industry. Why would you, Goldman Sachs, want this? This is not a good trade and it is getting worse; the traditional deniability claims will not help against the coming backlash. Close the position – and make sure you get maximum public relations points for doing so.
3. Settle the SEC case as soon as possible. Pay whatever it takes. Agree to change the nature of your business, if necessary. You know that the next crazy boom will take a different form in any

case. All the feds really want to do is to bolt the stable door after the horse is long gone; at least allow them that face-saving measure.

Goldman Sachs is at a crossroads. Either they can significantly change their image in our society or they can face the consequences. All the senators I saw at the hearing today were angry, with good reason, with one or more (or all) of Wall Street's practices.

Senator Ted Kaufman is not a lonely voice any more. He has brought a lot of smart, motivated, and focused mainstream people with him. Goldman should get out of ahead of this curve as quickly as possible – and the other big players on Wall Street should do the same. If the megabanks do not take major steps towards making amends (and themselves safer, in a deep structural sense), we are heading for a long and painful (for the banks and their employees) period of confrontation. It is all so unnecessary.

The Wall Street temptation, of course, will be to just increase campaign contributions – and I'm sure we will see some of that. But remember that Goldman has already become toxic in some European quarters. Politicians would be well advised not to accept their donations at this time; and Goldman would do much better to find more positive, pro-society ways to address the Senate's legitimate concerns about their behavior.

Wake The President

Simon Johnson | 28 Apr 2010

By Simon Johnson, co-author 13 Bankers

Most days we can coast along, confident that tomorrow will be much like yesterday. On a very few days we need to look hard at the news headlines, click through to read the whole story, and then completely change a large chunk of how we thought the world worked. Today is such a day.

Everything you knew or thought you believed about the European economy – and the eurozone, which lies at its heart – was just ripped up by financial markets and thrown out of the proverbial window.

While you slept, there was a fundamental repricing of risk in financial markets around Europe – we'll see shortly about the rest of the world. You may see this called a "panic" and the term conveys the emotions involved, but do not be misled – this is not a flash in a pan; financial markets have taken a long hard view at the fiscal and banking realities in Europe. They have also looked long and hard into the eyes – and, they think, the souls – of politicians and policymakers, including in Washington this weekend.

The conclusion: large parts of Europe are no longer "investment grade" – they are more like "emerging markets", meaning higher yield, more risky, and in the descriptive if overly evocative term: "junk".

This is not now about Greece (with 2 year yields reported around 20 percent today) or Portugal (up 7 basis points) or even Spain (2 year yields up 27 basis points; wake up please) or even Italy (up 6 basis points). This is no longer about an IMF package for Greece or even ring fencing other weaker eurozone economies.

This is about the fundamental structure of the eurozone, about the ability and willingness of the international community to restructure government debt in an orderly manner, about the need for currency depreciation within (or across) the eurozone. It is presumably also about shared fiscal authority within the eurozone – i.e., who will support whom and on what basis?

It is also, crucially, about stabilizing the macroeconomic situation without resorting to more unconditional bailouts. Bankers are pounding tables all across Europe, demanding that governments buy out their position – or bring in the IMF to do the same. We again find ourselves

approaching the point when the financial sector will scream: rescue us all or face global economic collapse.

The White House did not see this coming – and the Treasury's attention was elsewhere. The idea that we can leave this to the Europeans to sort out is an idea of yesterday. Today is very different and much more scary.

President Obama is wide awake and working hard. Someone please tell him what is really going on.

ABACUS: A Synthetic, Synthetic CDO

James Kwak | 28 Apr 2010

By James Kwak

I actually suspected this, but I haven't had the time to look at the marketing documents. But thankfully Steve Randy Waldman did. I don't think I can improve on his description — these things take hundreds of words — but here's a quick summary.

An ordinary CDO is a new entity that raises money by issuing bonds in tranches, uses the money to buy some other bonds (say, residential mortgage-backed securities) and uses the cash flows from those bonds to pay off its own bonds.

A synthetic CDO is similar except instead of buying the underlying bonds, it sells credit default swap protection on those bonds (the reference portfolio) and uses the premiums from the CDS to pay off its own bonds. (The money it raises by selling those bonds is usually parked in low-risk securities so it is available to pay off the CDS if necessary.)

ABACUS was different. There was a reference portfolio. But instead of selling CDS protection on all of those bonds, Goldman said (to paraphrase), "Imagine we sold CDS protection on all of those bonds. Then imagine we used those CDS premiums to issue bonds in tranches A-1, A-2, B, C, D, and FL. The derivative I'm selling you is one that will behave exactly as if it were an A-1 (or A-2) bond in that scenario — even though we're not actually selling all of the tranches."

Does this matter? To think about that, I recommend yet another post by Waldman, in which he takes apart Goldman's claim that it was brokering a trade between a long side and a short side. Goldman likes to say this because it implies that the long side had to know there was a short side, and hence the failure to disclose Paulson's role was not material. But that's not what was going on.

Goldman was creating a new company (a CDO of any variety is a new legal entity) and underwriting bonds issued by that company. In this case, the company's "business" was writing derivatives that were essentially highly customized credit default swaps (since the swaps mimicked what *would have happened* had there actually been a synthetic CDO). An underwriter's role is to induce investors to put their money in the company it is underwriting, which means talking up the qualities of that company while also disclosing its defects; it is *not* to broker a trade between investors who want the company to do well and other investors

who want the company to do badly. And even if the “company” in question is a synthetic synthetic CDO, that doesn’t change.

The Politics of Financial Reform

James Kwak | 28 Apr 2010

By James Kwak

The June issue of *The American Prospect* includes a section on financial reform that is already available online. [Our contribution](#) is on the way the financial sector has used its time-honored techniques to block and water down meaningful reform over the past year. There are also articles by many of the usual suspects, including [Elizabeth Warren](#), [Michael Greenberger](#), [Rob Johnson](#), and [Nomi Prins](#).

To Save The Eurozone: \$1 trillion, European Central Bank Reform, And A New Head for the IMF

Simon Johnson | 29 Apr 2010

By Peter Boone and Simon Johnson

When Mr. Trichet (head of the European Central Bank, ECB) and Mr. Strauss-Kahn (head of the International Monetary Fund, IMF) rushed to Berlin this week to meet Prime Minister Angela Merkel and the German parliament, the moment was eerily reminiscent of September 2008 – when Hank Paulson stormed up to the US Congress, demanding for \$700bn in relief for the largest US banks. Remember the aftermath of that debacle: despite the Treasury argument that this would be enough, much more money was eventually needed, and Mr. Paulson left office a few months later under a cloud.

The problem this time is bigger. It is not only about banks, it is about the essence of the eurozone, and the political survival of all the public figures responsible. If Mr. Trichet and Mr. Strauss-Kahn were honest, they would admit to Ms. Merkel “we messed up – more than a decade ago, when we were governor of the Banque de France and French finance minister, respectively”. These two founders of the European unity dream helped set rules for the eurozone which, by their nature, have caused small flaws to turn into great dangers.

The underlying problem is the rule for printing money: in the eurozone, any government can finance itself by issuing bonds directly (or indirectly) to commercial banks, and then having those banks “repo” them (i.e., borrow using these bonds as collateral) at the ECB in return for fresh euros. The commercial banks make a profit because the ECB charges them very little for those loans, while the governments get the money – and can thus finance larger budget deficits. The problem is that eventually that government has to pay back its debt or, more modestly, at least stabilize its public debt levels.

This same structure directly distorts the incentives of commercial banks: they have a backstop at the ECB, which is the “lender of last resort”; and the ECB and European Union (EU) put a great deal of pressure on each nation to bail out commercial banks in trouble. When a country joins the eurozone, its banks win access to a large amount of cheap financing, along with the expectation they will be bailed out when they make mistakes. This, in turn, enables the banks to greatly expand their balance sheets, ploughing into domestic real estate, overseas

expansion, or crazy junk products issued by Goldman Sachs. Just think of Ireland and Spain, where the banks took on massive loans that are now sinking the country.

Given the eurozone provides easy access to cheap money, it is no wonder that many more nations want to join. No wonder also that it blew up. Nations with profligate governments or weak financial systems had a bonanza. They essentially borrowed funds from the less profligate elsewhere in the eurozone, backed by the ECB. The Germans were relatively austere; the periphery enjoyed the boom. But now we have moved past the boom, and someone in Greece, Portugal, Spain, Ireland and perhaps Italy has to repay something – or at least stop borrowing without constraint. So Mr. Trichet and Mr. Strauss-Kahn go, cap in hand, to ask Germany for further assistance.

There are three possible scenarios. First, the ECB may be allowed to really let loose with “liquidity” – and somehow buy up all the bonds of troubled eurozone nations. But this is exactly the process that always and everywhere brings about high inflation. The Germans would fight hard against such a policy, although it would prevent default.

Second, officials still hope that bond yields for weaker governments widen but then stabilize. This is bad news for troubled eurozone countries, but they manage to avoid default. The rest of the world grows by enough to pull up even the European “Club Med + Ireland”. Call this the trickle down scenario or just a miracle.

Most likely, the situation is about to turn much worse and a third scenario unfolds. The nightmare for Europe is not at this point about Greece or Portugal – it is all about Italian and Spanish bond yields. This week those yields are rising quickly from low levels, while German yields are falling – so this spread is widening sharply. The yields for Spain – for example – are rising because hitherto inattentive investors, who always thought these bonds were nearly as safe as cash, suddenly realize there are reasonable scenarios where those bonds could fall sharply in value or even possibly default. Given that Spain has 20% unemployment, an uncompetitive exchange rate, a great deal of public debt, and a reported government deficit of 11.2 percent (compared with headline numbers for Greece at 13.6 percent and Portugal at 9.4 percent), everyone now asks: Does a 5% yield on Spain’s ten year bonds justify the risk? The market is increasingly taking the view that the answer is no, at least for now. So, we can anticipate Spanish (and Italian) yields will keep rising. In turn, this causes other asset prices to fall in those nations, thus

worsening their banking systems, and hence leading to credit contraction and capital flight. It is a dismal prognosis.

Then it gets worse. As rates rise, traditional investors in euro zone bonds, which are pension funds and commercial banks, will refuse to take more. There will be no buyers in the market and governments will not be able to roll over debts. We saw the first glimpse of this on Tuesday, when both Spanish and Irish short term debt auctions virtually failed. Once this happens more broadly, the problem will be too big for even Mr. Trichet or Ms. Merkel to solve. The euro zone will be at risk of massive collapse.

If this awful but unfortunately plausible scenario comes about, there is a clear solution – unfortunately, it is also anathema to Mr. Trichet and Ms. Merkel, and thus unlikely to be discussed seriously until it is too late. This is the standard package that comes to all emerging markets in crisis: a very sharp fall in the euro, restructuring of euro zone fiscal/monetary rules to make them compatible with financial stability, and massive external liquidity support – not because Europe has an external payments problem, but because this is the only way to provide credible budget support that softens the blow of the needed austerity programs.

The liquidity support involved would be large: if we assume that roughly three years of sovereign debt repayments should be fully backed – and it takes that kind of commitment to break such negative sentiment – then approximately \$1 trillion would be needed to backstop Greece, Portugal, Spain and Italy. It may be that more funds are eventually needed – but in any case, the amounts would be less than the total reserves of China. These amounts would also be reduced as the euro falls; it could be heading back to well under \$1 per euro, which is where it stood one decade ago.

External financial support would only make sense if combined with key structural reforms, including an end to the repo window at the ECB. As former UBS banker Al Breach recently argued, the ECB could instead issue bonds to all nations which would then be used subsequently for monetary operations – every central needs a way to add or subtract liquidity from the financial system. These bonds would need to be backed by a small “euro zone” tax, thus making the ECB more like other central banks around the world. It would no longer accept bonds of “regional governments” in the union as collateral, and instead would buy and sell “eurozone” bonds. These new eurozone bonds would also offer a way for governments to roll over some of their existing debts.

If the eurozone does need this package, it cannot be managed under a “business as usual” model. The funds would need to come from the G20, and extremely tough decisions over fiscal and monetary policy need to be handled in a fair and reasonable manner. Someone needs to be in charge on behalf of Europe (would this be the European Commission, or Ms. Merkel and the German government?) and someone needs to represent the G20.

By far the most natural G20 partner to manage this process is – despite all its baggage – the IMF, but there’s a serious problem. Mr. Strauss-Kahn, the current head of the IMF today, very much wants to become the next President of France. There is no way for the G20 to provide funding that he would guide – he has an obvious and unavoidable conflict of interest, and no incentive to make the tough decisions today that are required to sort out the euro zone.

Mr. Strauss-Kahn should resign and a respected financial leader of a relatively independent country should take charge at the IMF. One potential choice would be Mark Carney, the current Governor of the Bank of Canada. Or, if the G20 agrees – finally – that it is time to phase out the leading role of the G7 (which has not done well of late), Montek Ahluwalia of India would be an outstanding candidate.

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.

Frank Luntz Hasn't Read 13 Bankers (And That's A Good Thing)

Simon Johnson | 29 Apr 2010

By Simon Johnson, co-author of 13 Bankers: The Wall Street Takeover and The Next Financial Meltdown

Frank Luntz is the midst of making one of the great mistakes of modern American politics. He seems to have completely missed the change in plot line on financial reform over the past few months – ever since Ted Kaufman waded into the fray, started to bring other key figures with him, and really moved mainstream thinking (as manifest, for example, in the Goldman Sachs hearing this week).

This is about the “arc of the fraud”. The financial system committed fraud during the boom (liar loans and misrepresentation to customers of all kinds); fraud during the bailout (“if you ruffle our feathers, we will collapse”); and now fraud during the serious attempts at reform (e.g., the astroturf/fake grassroots nonsense.)

Luntz thinks this is about higher costs being passed on to consumers and wants to fight in November on “the Democrats are just about special interests”. That would be terrific – for the Democrats – and Mr. Luntz should be encouraged in this endeavor.

Mr. Luntz insists that it is not about what you say, but about what you hear. I couldn't agree more – this is readily apparent as I travel the country talking to many people about fixing the financial system and what we need to do going forward.

This is what people hear: “fraud”. They understand that our biggest banks and other financial players have become too big and too powerful. They know these people need to be reined in and they also realize this is going to be a heck of a fight – most likely over many years. They understand that Wall Street took over Washington and has run it, in large part, for too long – this is the central point of 13 Bankers; if anything, readers now find this rather obvious.

Some of this fraud will go unpunished, because our legal system fell behind the curve – and because the people at the heart of these frauds are very smart. But this just means we need to try harder and for longer to reform our system.

Of course we won't get this all done in this legislative cycle – everyone gets this. But that is not a message of despair and defeat – it is a call to defiance and determination.

If you think Mr. Luntz can credibly present himself as the defender of us all against narrow special interests, you should be worried. If instead regard his position as untenable under pressure, do all you can to encourage this approach.

Just don't send him a copy of 13 Bankers – we really do not want him to figure out what is going on.

Update on ABACUS

James Kwak | 29 Apr 2010

Read the “[synthetic, synthetic CDO](#)” post first if you haven’t already.

The reasonable counterargument, for example [here](#), is that because these are derivatives, there logically speaking *must* have been someone on the other side of the trade from the buyers, and the buyers should have known that — who that is doesn’t need to be disclosed. I think this is true to a degree, but not to the degree that Goldman needs it to be true.

Take an ordinary synthetic CDO. Back in 2005-2006, a bank might create one of these because it knows there is demand on the *buy side* for higher-yielding (than Treasuries) AAA assets. To do this, the CDO has to sell CDS protection on its reference portfolio to someone. That someone could in the first instance be the bank. But then the bank’s “short” position goes into its huge portfolio of CDS, which may overall be long or short the class of securities (say, subprime mortgage-backed securities) involved. The bank is constantly hedging that portfolio via individual transactions with other clients or other dealers, so there’s no one-to-one correspondence between the long side of the new CDO and any specific party or parties on the short side.

Let’s say for the sake of argument that the bank, prior to the new CDO, was exactly neutral on this market. The new CDO makes it a little bit short. So the bank will go out and hedge its position by finding someone else to lay the short position onto. But first of all, there’s a good chance it will divide up the short position and hedge pieces of it with different people. Those people may be buying the short position not because they want the subprime market to collapse; they might be partially hedging their own long positions in that market. Second, there’s an even better chance that it won’t sell off *exactly* the short position it just picked up from the CDO; it will buy CDS protection on a bunch of RMBS that are similar to the ones it just sold CDS protection on (which ones will depend on what the market is interested in), so in aggregate it comes out more or less the same.

So ultimately the “short” side of the CDO gets dispersed between the bank’s existing CDS portfolio and the broader market. So yes, there must be a short interest out there that is exactly equivalent to the long interest. But there doesn’t have to be a party or even an identifiable set of parties who have exactly the short side of the new CDO and want it to collapse, let alone a party that helped structure the CDO because it wanted to be

on the short side. There's a big difference between the market as a whole and one hedge fund.

Now, are things different with a synthetic synthetic CDO, as I have called it? Maybe. The pro-Goldman argument would be that ABACUS was so highly structured — basically, each tranche was a single complex derivative with a long side and a short side — that the long investors must have realized that there was a single party, or a small number of parties, on the other side. But that doesn't necessarily hold. Just like a synthetic CDO, Goldman could have whipped this thing together because it thought it could sell it, and Goldman could have planned to hedge it the usual way — partially with its inventory and partially through a lot of small transactions dispersed throughout the market.

As always, I draw on Steve Randy Waldman.

The Role of Government

James Kwak | 30 Apr 2010

By James Kwak

Last week Simon gave a talk sponsored by Larry Lessig's center at Harvard. Afterward there was a dinner and then another question-and-answer session. Jedediah Purdy (another person to write a book while at Yale Law School; he is now a professor at Duke's law school) asked a question that I have rephrased as follows (the words are mine, not Purdy's; I may have also distorted his original question so much that it is also mine):

"You've criticized the government for withdrawing from the economic and particularly financial sphere and allowing private sector actors to do whatever they wanted. Do you think the government should simply act so as to correct the imperfections in free markets? Or do you see a positive role for government in determining what kind of an economy we should have?"

I think it's noteworthy that the people you would probably consider the most outspoken critics of Washington and its capture by free market ideology in recent decades — Joseph Stiglitz, Simon and I, Yves Smith, etc. — take pains to insist that we are all, in fact, in favor of free markets. (It's a caveat I've made in several interviews.) The usual argument is that markets have failings — due to information asymmetries, externalities, the works — and that government policy should correct for those failings, instead of pretending that they don't exist, à la Alan Greenspan. The conceptual model is that the government policies should exactly correct for those market problems — for example, imposing carbon taxes that exactly account for the externalities of carbon emissions — and then get out of the way.

Dean Baker makes an observation in his book, *False Profits: Recovering from the Bubble Economy*, in a different context, that I think reflects the same issue. Discussing the political debate over the early 2009 stimulus package, he writes (p. 109):

"President Obama never gave the people of the United States the basic economics lesson they badly needed to understand the rationale for the stimulus. In a country that had been conditioned by both parties and the media to think that deficits are always

bad, the idea that the government would deliberately run very large budget deficits didn't make sense to most people."

What lessons are we learning from this crisis and recession? So far, the lessons we are learning, if any, are modest, and are ones that many people (just not those in power) already knew, having to do with incentive structures under limited information, the distorting impact of implicit government guarantees, the limits of a disclosure-based regulatory regime, the problem of regulatory capture, etc. The thinking is that we'll modify the system to take these factors into account, and then the magic economic machine will go on ticking. There don't seem to be any big lessons.

What would such bigger lessons be? Purdy floated the idea that the government should promote equality of opportunity. "Doesn't it do that already?" you might ask. It makes a small effort via the public education system, but I believe even the most outspoken advocates of public schools would acknowledge that they currently do little to correct for the massive inequalities in starting points across our society. For the most part, our government does little to level the playing field, we have low levels of social mobility as a result,* and our elected politicians are fine with that.

I spoke to Purdy after the event and he thought the strongest argument against a positive role of government is "the competence issue." After all, Simon and I just wrote a book about how regulators and politicians became intellectually captured by a single industry; if that's your basic view of the government, do you really want the government deciding what the economic goals of society should be? So on a practical level, most reformers who favor a more active governmental role usually limit the government to correcting known problems with the free market. That's the conservative position, in the sense of Edmund Burke, probably my favorite conservative of all time. But it's not terribly satisfying.

* For example: "By international standards, the United States has an unusually low level of intergenerational mobility: our parents' income is highly predictive of our incomes as adults. Intergenerational mobility in the United States is lower than in France, Germany, Sweden, Canada, Finland, Norway and Denmark. Among high-income countries for which comparable estimates are available, only the United Kingdom had a lower rate of mobility than the United States."



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