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Deregulation of Wall Street Fuels Credit Crisis

By Michael Blatchley

The mortgage crisis has tightened its stranglehold on the global economy, decimating some of the most longstanding and venerated financial institutions in the United States within a matter of weeks. In response to this crisis, Congress passed an emergency bill representing one of the most drastic and expensive government bailouts in history. Whatever one's views on the merits of the plan, the commitment of $700 billion in taxpayer funds — representing approximately 6 percent of the current gross national product — is staggering by any measure. (In comparison, the government's bailout of the savings and loan institutions in the 1980s was only 3.7 percent of GDP.)

While it may be true, as the Federal Reserve Chairman noted in urging his colleagues to support the federal bailout, that "[t]here are no atheists in foxholes and no ideologues in financial crises," it is now clear that a particular ideology — and the policies it encouraged — played a significant role in bringing about the current economic crisis. For more than a decade, that philosophy — an unquestioned faith in the virtues of the free market and an unencumbered contempt for governmental regulation and private enforcement of legal rights — has been successfully championed by the engineers of this economic calamity and their allies in government. Even while the events of this past month have exposed the fundamental flaws of this approach, with some of the most ardent advocates of deregulation admitting a need for greater oversight, amazingly, certain proposals now receiving serious consideration by policymakers threaten to reintroduce elements of this now-discredited view.

The Collapse

Over the past several months, several former titans of Wall Street were either gobbled up by the government or allowed to fail under the crushing weight of the illiquid mortgage-related assets held on their balance sheets. The speed and severity of their collapse has been dizzying.

On September 7, 2008, the government took control of Freddie Mac and Fannie Mae, in an attempt to prevent the faltering mortgage market from grinding to a halt. While officials hoped that the federal rescue of Freddie Mac and Fannie Mae would calm a jittery market, mounting losses at financial institutions continued to halt the markets' desperate quest for capital and liquidity.

Less than a week later, on Monday, September 15, 2008, Lehman Brothers Holdings Inc. ("Lehman Brothers") — a bank founded before the Civil War and a survivor of the Great Depression — filed for bankruptcy, the largest in United States history. That same day, Merrill Lynch & Co., Inc. ("Merrill"), the venerated bull of Wall Street, barely escaped the same fate.

After posting more than $40 billion in write-downs and credit losses over the past year, Merrill was scooped up by Bank of America at a 60 percent discount to its stock price.

The September 15 upheaval at Lehman Brothers and Merrill sent the markets into a tailspin, with the Dow Jones Industrial Average plunging 504 points that day, the largest decline since the terrorist attacks of 2001. By Wednesday, the Federal Reserve was rushing to put out the next fire. Although federal officials had spurned earlier requests by American International Group, Inc. ("AIG") for funding, the government now recognized that the collapse of world's largest insurer would have unknown ripple effects throughout the global economy, and stepped in to provide an $85 billion emergency loan in exchange for an 80 percent stake in the company.

On September 25, the Federal Deposit Insurance Commission ("FDIC") seized control of Washington Mutual ("WaMu") on the bank's 119th anniversary, placing the nation's largest savings and loan association into receivership. On September 29, the FDIC helped avert the collapse of Wachovia Corporation, formerly the nation's sixth-largest bank, by orchestrating the sale of its assets and liabilities, including its retail operations and banking units, to Citigroup, Inc. (By the end of the week, Wells Fargo announced a surprise deal to acquire the entire bank for seven times the amount Citigroup had offered.)

As these major financial firms scrambled for capital, investors remained unwilling to trust the valuations the banks assigned to their mortgage-related holdings, credit problems spread globally — banks hoarded cash and clamped down on lending, threatening to stifle consumer and business spending. This vicious cycle, Federal Reserve Chairman Bernanke warned Congress, is similar to that which triggered the Great Depression.

The Cause of the Crisis

As we now know, the wholesale adoption of unrealistically lax lending standards, an unfounded belief in the supposed miracles of mortgage securitization and an unchecked willingness to excessively leverage risky bets, not only jeopardized the interests of investors, but posed systemic risks to the entire economy.

As Wall Street and others saw that fees could be generated by pooling mortgages and repackaging them into mortgage-backed securities, banks began to relax their lending standards and make mortgage loans primarily to sell them on to other financial institutions. These securities could then be pooled again, new instruments would be created, and the same process would be replicated over and over. Emboldened by the rationale that the sale of these loans transferred risk off their balance sheets, banks then relaxed their underwriting standards in an effort to originate more loans to meet the Wall Street demand for securitized instruments — a process that created spillover effects and systemic risks that were woefully neglected by regulators.

While the ultimate fallout from this crisis is still unknown, the motive for such reckless risk-taking is clear: the securitization of the real estate bubble not only inflated asset prices, it also inflated profits and executive compensation. The Wall Street firms that presided over the lax lending standards and repackaging of toxic mortgage-related assets were beneficiaries of an enormous transfer of wealth, with the five major investment banks paying more than $3 billion in the last five years to their top executives.

Merrill Lynch paid its chief executive, Stanley O'Neal, who was ousted in November 2007 following the firm's announcement of $7.9 billion in write-downs, $172 million in executive compensation from 2003 to 2007. Before the Bank of America buyout, O'Neal's successor, John Thain, pocketed $86 million, having just begun work last December. Kerry Killinger, who acted as CEO of WaMu up until several weeks before its collapse, received $54 million over the past five years and is now entitled to a golden parachute valued at approximately $44 million. Killinger's successor, Alan Fishman, is slated to receive almost $20 million for the 17 days he spent on the job. Former Bear Stearns CEO James "Jimmy" Cayne made off with $161 million before his company was "sold" (with guarantees from the federal government) to JPMorgan Chase & Co. in June. Lehman Brothers, AIG, Fannie Mae and Freddie Mac — all reportedly under FBI investigation because of the mortgage crisis — paid their top executives a total of $1.4 billion in salaries, bonuses and stock-related pay from 2003 to 2007.

A Belated Acknowledgement

Seeing that the subsequent collapse of other major Wall Street institutions was further cutting off the flow of capital through the economy, Congress enacted a $700 billion taxpayer-funded proposal to buy distressed mortgage-related assets from these financial institutions — a plan intended to stem the cascade of financial institution failures and avert a slide into a severe recession. The law's supporters hope that removing these risky assets from the market and providing an injection of much needed capital will instill certainty and confidence into the markets and prompt banks to begin lending again.

While many disagree on the merits of the bailout law — whether the plan will achieve its purpose or what the ultimate cost to taxpayers might be — a consensus has emerged that a lack of regulation and government oversight laid the groundwork for the current crisis, enabling a powerful few on Wall Street to wreak havoc on the global economy.

Secretary Paulson recently stated that the past several weeks have demonstrated "in vivid terms that our financial regulatory structure is suboptimal,

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duplicative and out-dated" — quite a reversal from his statement in March of this year that he did not believe "it is fair or accurate to blame our regulatory structure on the current turmoil." Securities and Exchange Chairman ("SEC") Christopher Cox, reacting to a damning report by the SEC's inspector general detailing the agency's missteps in handling the Bear Stearns collapse, just last week admitted that the SEC's policy of ''voluntary regulation" of investment banks was a failure that contributed to the current crisis.

Ironically, many of those now calling for increased regulation are the same officials who only recently urged that such regulation was a source of weakness that threatened America's capital markets.

Just one year ago, Treasury Secretary Paulson sought a severe curtailment of investor rights, arguing that excessive litigation and regulation was threatening American "competitiveness." Secretary Paulson encouraged the Committee on Capital Markets Regulation, also known as the "Paulson Committee," which advocated relaxing numerous regulatory protections and weakening shareholder rights, an agenda premised on the notion that the threat of litigation decreased the competitiveness of the United States capital markets. While the Paulson Committee's assertions were dubious when made (at the time the Committee issued its Interim Report, the number of initial public offerings on U.S. exchanges had actually reached its highest level since 2000), the unfolding of the credit crisis reveals the extent to which they were flat-out dangerous.

The Paulson Committee report was but one of many efforts over the past decade by those opposed to strong protections for shareholders. Other successful initiatives, including Congress' enactment of the Private Securities Litigation Reform Act in 1995, which restricted the ability of investors to sue companies for misstatements and unrealistic projections, not only paved the way for the corporate misconduct exemplified in the Enron and WorldCom scandals, but also helped foster the excessive risk-taking that led to the current crisis. Having gained political power, like-minded deregulatory advocates were entrusted with overseeing the very institutions they believed were standing in the way of America's competitiveness, leading to complacency, disinterest and an unwillingness to enforce the regulatory protections that a healthy economic system depends on.

The last several weeks have made one thing painfully clear: Shareholder litigation and governmental regulation do not harm American competitiveness and did not cause the current crisis — they are the means by which we ensure the honesty, transparency and accountability that are integral to properly functioning capital markets.

As explained by Nobel Prize-winning economist Edmund Phelps in a recent editorial: "What has occurred is not just an old-fashioned banking crisis but also a banking scandal. Most of the big banks were shot through with short-termism, deceptive practices and self-dealing. We must institute basic changes in corporate governance and in management practice to restore responsibility and honesty for the sake of the economy and for the self-respect of the country."

In order to restore such honesty and responsibility, we need the tools to hold those who would betray these ideals accountable, and the willingness to use them.

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