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John W. Cioffi

The Global Financial Crisis: Conflicts of Interest, Regulatory Failures, and Politics

The Lehman Brothers investment bank collapsed on September 10, 2008 and filed for bankruptcy five days later. As credit froze and debt market liquidity evaporated, a global economic collapse became an imminent possibility—and was only averted by unprecedented governmental and central bank interventions around the world. Some have argued that the crisis was the product of a "perfect storm" of random market developments, or of the failure of economic models to account for outlier market conditions. As this report shows, however, these explanations do not get at the root of the problem, as it was pervasive regulatory failures that created the conditions for the crisis and fueled the catastrophic contagion of financial sector collapses from 2007 through 2009.

This report outlines the ways in which the financial crisis spread from the unregulated and least regulated areas of the financial system. These included mortgage lending practices and standards, securitized debt instruments, derivatives, credit rating agencies, financial institution leverage ratios, and the investment banks, off-balance sheet vehicles, hedge funds, and the array of entities, markets, and counterparty relationships comprising the shadow banking system. Furthermore, these regulatory deficiencies were the products of politics, of a neoliberal turn of American economic and regulatory policy embraced by both the Republican and Democratic parties. This policy trajectory eroded state regulatory capacity while it enriched and empowered the financial sector.

After detailing the financial and regulatory frameworks surrounding mortgage-backed securities (MBS) and collaterized debt obligations (CDO), this report considers the role of the MBS and CDO markets in triggering and worsening the financial crisis of 2007-2009. Finally, the report outlines the contours of financial reform proposed in the aftermath of the crisis. What is clear from these reform efforts is that, in order to minimize continued risks to national and global financial systems, rules must effectively regulate derivatives, address the "too-big-to-fail" problem of systemically vital financial institutions, and extend financial regulation to the broader shadow banking system. Finally, conflict of interest regulation should extend to debt ratings agencies, and stronger enforcement mechanisms are needed to ensure that legal reforms are not rendered meaningless in practice.

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Introduction

The Lehman Brothers investment bank collapsed on September 10, 2008. Unable to find short-term financing or a buyer in the absence of a government bailout, one of the world's largest and globally interconnected investment banks imploded as vast—and largely undisclosed—losses on mortgage-backed securities and related derivatives destroyed confidence in the bank's solvency. Lehman's bankruptcy set off a global financial panic. A domino-like fall of other major American banks, a chain reaction of runs on the shadow banking system, and international market crashes followed with breathtaking speed.

The Lehman collapse came at the tail end of my decade-long research on the political foundations of corporate governance and financial regulation in the United States and Europe (and the basis of *Public Law and Private Power,* forthcoming from Cornell University Press). To understand these subjects, one must go well beyond economic data to interview policy makers, regulators, and professionals responsible for the formulation and implementation of the extraordinarily complex policies and rules governing the financial sector and its relations with those outside it. It also requires painstaking research through the review of primary legislative and regulatory documents, including committee reports, agency notice and comment and enforcement proceedings, and the records of court cases that reflect the technical complexity and the intense political and economic conflicts over financial sector regulation and governance.

This research revealed the fundamental transformation of capitalism from the era of post-war industrial capitalism to a new era of international finance capitalism. At a deeper level, conflicts accompanying the rise of finance capitalism were over the relative power of the regulatory state and of large financial institutions. Perhaps even more striking was the embrace of this new political economic order not only by the political right, but also by the Democratic Party in the United States. Finally, the resultant policy paradigm produced by this political and economic transformation increasingly privileged and empowered the financial sector and financial markets as the primary drivers of economic adjustment, efficiency, and innovation—despite abundant evidence of serious market failures and increasingly severe financial crises. The global financial crisis of 2007-2009 represented the tragic culmination of this political economic trajectory.

Pervasive regulatory failures created the conditions for the crisis and fueled the catastrophic contagion of financial sector collapses from 2007 through 2009. Financial markets and institutions have always been particularly vulnerable to extreme volatility in the form of speculative booms and bubbles, market crashes, and bank runs. Yet the foundational role of credit as a precondition for economic activity leaves capitalist economies extraordinarily vulnerable to financial crises, as well as the need to restore the flow of credit through the financial sector in their aftermath. In the United States, post-New Deal financial regulation had ameliorated or limited these market and governance failures to prevent the kind of catastrophic financial crises that produced the Great Depression. For decades, that regulatory regime provided the foundations for a stable, yet extraordinarily dynamic, market-driven financial system.

As this report indicates, however, the emergence of neo-liberal finance capitalism since the mid-1980s exacerbated these market failures, which in turn generated increasingly serious financial crises. The American real estate bubble and the global boom in securitization and related derivatives from 2003 to 2007 aligned these flaws of the market in a way that amplified their destructive effects to a catastrophic level. This boom reflected the penetration and displacement of traditional banking by an opaque, over-levered, and largely unregulated shadow banking system comprised of investment banks, off-balance sheet special purpose vehicles, hedge funds, debt and money markets, and derivatives and related counterparty relationships. The collapse of that system during the crisis of 2007-2009, in turn, was not really a financial market crash or liquidity crisis, but rather the largest banking run in history that revealed the insolvency of the shadow banking system (see Reinhardt and Rogoff, 2010).

The global financial crisis revealed serious failures and flaws in financial sector regulation in most industrialized countries, but no regulatory failures were so consequential or glaring as those in the United States. For nearly thirty years, the U.S. has been the driving political force behind neoliberal deregulation and the market-driven form taken by contemporary finance and financial globalization. During the past decade, the American financial system pioneered the kinds of debt securitization and derivatives that proved so destructive. Conflicts of interest, asymmetries of information and power, and systematically fraudulent and predatory behavior pervaded securities markets and financial institutions. These, in turn, drove reckless lending, speculation, and investment that fueled the most massive asset bubble in history, ultimately leading to the collective implosion of the country's largest financial institutions—which survived only by the credit (if less than full faith) of the federal government and the American taxpayer.

The global financial crisis was the product of regulatory politics, not of a freak "perfect storm" of random market developments and failures, nor the failure of economic models to account for "fat tails" (a higher frequency of extreme market conditions than normal

distribution would predict). The crisis spread from the unregulated and least regulated areas of the financial system: mortgage lending practices and standards, the investment banks (or "broker dealers") and hedge funds of the shadow banking system, securitized debt instruments, derivatives, credit rating agencies, and leverage ratios. Corporate governance within the financial sector incentivized managerial and investor recklessness in relentlessly pursuing short-term maximization of shareholder value. At each weak point, opportunism and conflicts of interests took hold, metastasized, and engulfed the rest of the financial system.

The collapse of [the banking] system during the crisis of 2007-2009... was not really a financial market crash or liquidity crisis, but rather the largest banking run in history that revealed the insolvency of the shadow banking system.

These legal loopholes and regulatory deficiencies were the products of politics. The interwoven failures of the public law and private incentives fueled the increase of pathological behaviors and systemic risks. The failure of the regulatory state represented by the financial crisis was the product of the neoliberal turn of American economic and regulatory policy embraced by both the Republican and Democratic parties. Neoliberalism, to simplify matters substantially, represents an ideology and policy agenda informed by a doctrinaire form of neoclassical economics positing that the market promotes the most efficient use of resources and maximizes economic growth. This idealization of the private sector conceived of markets as largely self-regulating and thus provided a justification for deregulation and limits on regulatory enforcement. Supported by a potent coalition of pro-business interest groups, neoliberalism came to dominate policy making in the United States after the 1970s, and in no area was it more influential than financial services.

This policy trajectory eroded state regulatory capacity while it privileged, enriched, and empowered the financial sector. There was more than ample warning of trouble to come. Market and regulatory failures had already spawned serious financial and economic crises, including the crash of the junk bond market in the late-1980s, the savings and loan crisis of the late 1980s and early 1990s, the LTCM hedge fund collapse in 1998, the late 1990s stock market bubble and its crash in 2000-2001, and the subsequent Enron-era corporate governance and accounting scandals. Political actors not only failed to enact adequate reforms despite the increasing severity of earlier crises, they continued to deregulate the financial sector. Furthermore, regulators failed to adequately enforce many of the rules that were in place.

This report proceeds by first detailing the financial and regulatory frameworks surrounding mortgage-backed securities (MBS) and collaterized debt obligations (CDO). Next, it considers the role of the MBS and CDO markets in triggering and worsening the financial crisis of 2007-2009. Finally, the report outlines the contours of financial reform proposed in the aftermath of the crisis, and the continuing risks to financial systems as well as political systems.

The Systemic Failure of Regulation

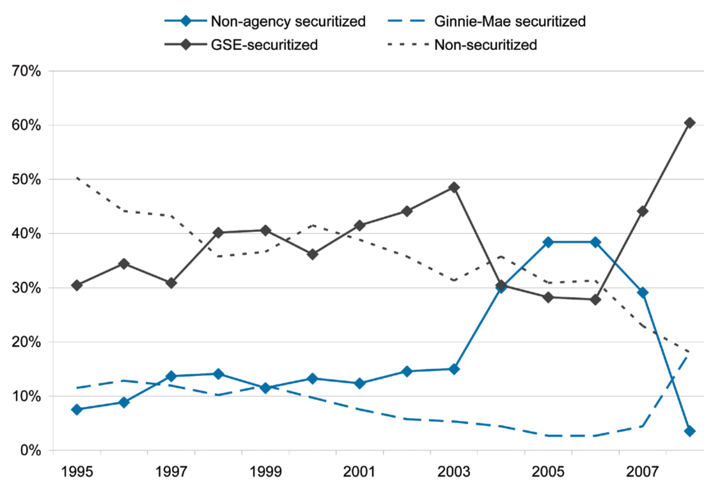
The financial crisis that culminated in the panic of September-October 2008 had been brewing since early 2007, after the American real estate market peaked and mortgage defaults started to rise in late 2006. But the causes of the crisis originated much earlier in a series of policy decisions, regulatory reforms, and legislative changes. These changes reflected both the growing political influence of large financial institutions and widespread faith in the efficiency and self-regulating capacity of financial markets, the sophistication of the financial sector, and the benefits of financial innovation. The reality that followed from this merger of faith and power was a proliferation of conflicts of interest and information asymmetries in the financial system enabled by politics, law, and regulation. This relationship between market breakdowns and regulatory failures becomes clear from a review of the securitization process that led to the financial crisis.

During the early 2000s, American financial institutions began a widespread adoption of an "originate and distribute" mortgage lending and securitization business model (Fender and Mitchell, 2009). The strategy took advantage of lax federal financial regulation and the Federal Reserve's repeated policy response to financial crisis: low interest rates without any increased regulation or oversight. In response to a series of financial and economic crisis from 1994 through 2002, the Fed repeatedly slashed interest rates to historically low levels. The Federal Reserve had regulatory means available to address potentially dangerous forms of leverage and speculation by adjusting margin and capital reserve requirements, but consistently refused to use them. Instead, under Alan Greenspan's chairmanship, the Fed used loose monetary policy as a post hoc response to domestic and foreign financial crashes. Low interest rates increased liquidity and provided for cheap credit. Unlike a direct Keynesian stimulus of consumer demand or business investment, low interest rates stimulated demand indirectly by increasing private debt and inflating asset bubbles.

Figure 1 shows how private lending and mortgage securitization ("non-agency securitized"), not loans securitized by government

sponsored entities ("GSEs"), inflated the subprime mortgage bubble after 2003. Securitization, as discussed in detail below, pools a large number of illiquid assets, such as mortgage loans, and uses their underlying assets and cash flow rights as the basis for tradable securities. This can be greatly beneficial and is certainly not inherently destabilizing or destructive. GSEs have securitized mortgages for decades as a means of fostering lending and thus home ownership. However, as evidence mounted that securitization and a growing real estate bubble were reinforcing each other, the Federal Reserve refused to use its regulatory powers to curb predatory or excessively risky mortgage lending, or to deploy prudential regulatory oversight to ensure adequate bank capital levels and containment of systemic risk. It would not even acknowledge the existence of an asset bubble.

Figure 1. Residential Mortgage Originations and Securitization, 1995-2008



Source: Financial Crisis Inquiry Commission, "Preliminary Staff Report: Securitization and the Mortgage Crisis," April 7, 2010, http://fcic.gov/reports/

Anti-regulatory sentiment went far beyond the Fed. The multiplicity of banking regulators left gaps in the law that financial institutions used to escape supervision and restrictions altogether. Aside from these legal blind spots, bureaucratic fragmentation created perverse incentives for regulators to engage in a "race to the bottom" to protect turf. And in the case of the notoriously lax Office of Thrift Supervision and Office of the Comptroller of the Currency, agencies sought to maximize fees paid by regulated entities. Finally, interest group politics and the interests of congressional committees in retaining oversight of these ineffective overseers insulated them from abolition or consolidation.

Regulatory fragmentation increased the incidence and importance of regulatory arbitrage--the ability of financial firms to choose their regulator among the federal options. Further, financial institutions could, and did, strategically organized their corporate structures, business models, and financial products to ensure regulation by the most lenient regulator or evade regulation almost entirely. For example, AIG and Countrywide maneuvered themselves into oversight by the laissez faire Office of Thrift Supervision. The boom in derivatives in part reflected the fact that they were unregulated, despite being designed in many cases to mimic or replicate regulated securities or insurance policies. Since the early 1980s, avoidance of established domains and constraints of banking and securities regulation spurred much of the extraordinary growth of the shadow banking system--and the risks it posed the global financial system and economy.

This prevalence of deregulation and "light touch" regulatory approaches also reflected a widely held belief in the self-regulating capacities of markets and firms. One important example of what economist Willem Buiter has called "cognitive capture" were policy decisions that allowed financial institutions to increase leverage, the amount of debt relative to equity, that magnifies returns per share but also magnifies losses and risk of default.

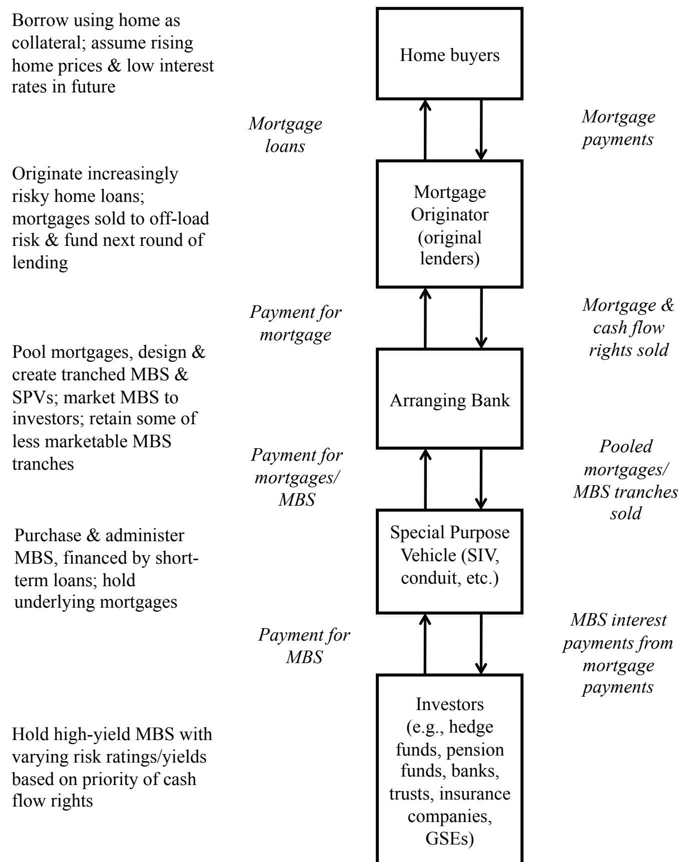
The Fed's rejection of regulation and continued low interest rates fostered mutually reinforcing real estate and securitization bubbles. Figures 2 and 3 sketch the basic steps and relationships in the securitization of mortgage backed securities (MBS) and collaterized debt oblications (CDO). Even these simple, stylized renderings suggest the complexity of the processes and the webs of relationships they form (Figure 4). Mortgage lenders (originators) immediately sold the loans they issued to an investment bank (the arranger) that pooled and securitized them by slicing the cash flow rights into "tranches" of mortgage-backed securities (MBSs). (Figure 2) The priority of cash flow rights to the underlying mortgage payments define these tranches, with the lower tranches posing higher risks of default rated lower and paying higher interest rates.[1] Lower tranche MBSs (e.g., rated less than AAA, and often BBB-just below "junk" status) were then pooled and their cash flows sliced once again into tranches of collateralized debt obligations (CDOs) with senior tranches once again rated AAA.[2]

Shell Games: Failure of Disclosure and the Rise of Leverage

Arranging banks moved the MBSs and CDOs off their books by creating highly leveraged "special purpose vehicles" (SPVs), structured investment vehicles" (SIVs), and "conduits" (shell corporations or trusts ostensibly legally separate from the arranging bank) to purchase them and then sell the tranched securities to investors. They also engaged in second order securitizations by bundling lower tranches of multiple CDOs into another SPV and marketed them as an even more complex, opaque, and highly leveraged "CDO

squared."[3] In each stage of securitization, a disproportionate share of securities created, often over 80 per cent, were classified as senior tranche obligations with AAA ratings giving the impression that they were as safe as government bonds, and far safer than the debt underlying them (Nadaud and Sherlund, 2009). The AAA CDO bonds were protected from default by ever-thinner layers of higher risk equity and lower tranche securities.

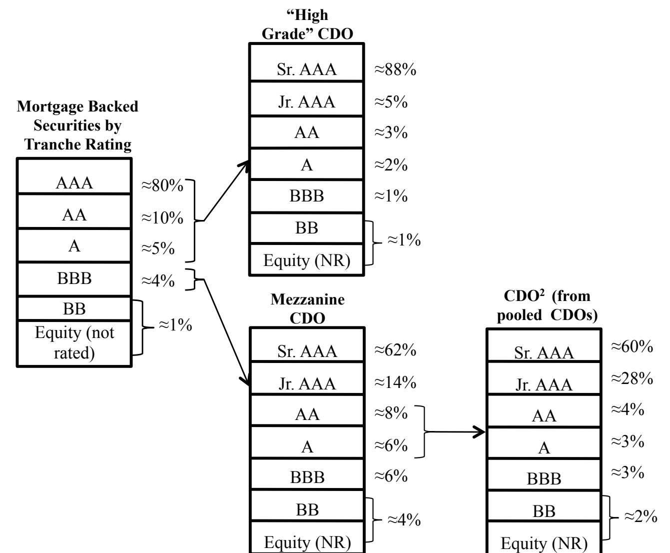
Figure 2. Subprime MBS Securitization and Distribution



These entities financed purchases of the arranging banks' long-term CDO assets by heavy short-term borrowing in the commercial paper market. During the securitization boom, they became critical components of the shadow banking system that had exploded in size since the 1980s. By offsetting long-term assets (unsold or retained MBSs or CDOs) with short-term liabilities (typically commercial paper financing), these SPVs took on the crisis-prone characteristics of banks, but without effective prudential regulation and deposit insurance that had prevented bank runs since the Great Depression. Yet, SIVs and conduits often remained tethered to the banks that created them by guaranteed credit lines that, in a crisis, could push their leverage enhanced risks back onto creators with potentially devastating results.

The banks' SIVs and other vehicles exploited loopholes in the accounting rules to scrub residual risks from MBSs and CDOs from their balance sheets and disclosure statements. The structure of the securitization process and the operation of accounting rules effectively circumvented the disclosure regime imposed by securities and banking regulation, and the calculation of risk-based capital requirements under banking regulation and the Basel Accords. The use of off-balance sheet vehicles to hide liabilities and financial risks supposedly had been fixed by provisions of the Sarbanes-Oxley Act of 2002 (Sox) and regulatory reforms adopted by the SEC and Public Company Accounting Oversight Board (PCAOB) after similar subterfuges played a role in Enron's notorious accounting frauds and bankruptcy. Critics had attacked Sox and the PCAOB relentlessly for being overly burdensome on business. The more serious problem turned out to be that the post-Enron reforms failed to correct the very abuses that inspired them. The compliance costs of those reforms pale in beside the price for that failure.

Figure 3. CDO Formation and Structure



The steady erosion and repeal of the Glass-Steagall Act's separation of commercial and investment banking worsened the increasing concentration of risk in the banking sector. Large numbers of Democrats also joined Republicans in accepting, and at times championing, the deregulation of banking and securities business. The Clinton administration and a large majority of Democrats in Congress supported the final repeal of Glass-Steagall by the Gramm-Leach-Bliley Act of 1999, which allowed the formation of Citigroup as an immense and sprawling institution that encompassed investment banking, commercial banking, and insur-

ance. Clinton's Treasury Secretary (and former Goldman Sachs CEO) Robert Rubin left government to become the Vice Chairman of Citigroup and would encourage the bank to become more deeply involved in issuing and trading securitized debt instruments like CDOs. More broadly, the repeal of Glass-Steagall allowed traditional banks to become far more involved in the creation, marketing, and investment in exotic debt securities than would have been permitted under the New Deal regulatory regime.

At the same time, traditional securities regulation by the SEC, once a jewel of the post-New Deal regulatory state, eroded by neglect and design. Under Chairman Christopher Cox, SEC enforcement actions declined at an accelerating rate from 2005 to 2008 as lengthy, burdensome, and contentious authorization and review processes systematically discouraged investigations of large financial institutions.[4] The dollar value of SEC penalties fell 39 per cent in 2006, 48 per cent in 2007, and 49 per cent in 2008 (Farrell, 2008). The number of enforcement attorneys declined over 11 percent over this period.[5]

SEC enforcement actions declined at an accelerating rate from 2005 to 2008 as lengthy, burdensome, and contentious authorization and review processes systematically discouraged investigations of large financial institutions.

The SEC also took the lead in relaxing leverage limitations on investment banks in 2004 (Buiter, 2008). As part of a political deal to head off stricter EU regulation of American investment banks, the banks' CEOs agreed to SEC monitoring in exchange for the ability to use their own quantitative risk models to calculate capital requirements and thus increase leverage levels—a form of self-regulation without the check or balance of formal enforcement power. The vote was unanimous, uncontroversial, and followed a meeting the lasted less than an hour (Labaton, 2008). Commissioners with long and distinguished records as zealous regulators approved the measure. The rule change led to the massive increase in average leverage ratios among major American investment banks and hedge funds from under 10:1 to approximately 27:1 at the height of the real estate and CDO bubble—meaning that a 4 per cent decline in asset value would wipe out the equity and the solvency of the average institution (Tett, 2009b: 134). As a result, financial institutions levered up their bubble-driven profits while creating a financial system increasingly prone to panic and systemic collapse.

The Ratings Game

The financial alchemy of securitization depended on the assistance of ratings agencies to make the "senior" tranches marketable. Since the mid-1970s, the three dominant ratings agencies, Standard & Poors, Moody's, and Fitch, have been recognized by the Securities and Exchange Commission as "nationally recognized statistical rating organizations" (NRSROs). Since the 1970s, federal regulators empowered NRSROs as market gatekeepers, and created a de facto regulatory cartel, by mandating the use of their ratings to determine the capital requirements of broker-dealers and the eligibility of securities for purchase by savings and loans, credit unions, and federally regulated pension funds. Unlike SPVs and SIVs, the NRSROs escaped post-Enron regulatory reforms despite their manifest ratings failures during the stock market bubble of the 1990s. That omission would prove disastrous.

Ratings were indispensible to the creations and marketing of MBSs and CDOs. Investors relied on ratings of complex debt securities in largely unregulated, opaque markets where their risks and the value of underlying assets were difficult to discern. However, the issuer banks paid the rating agencies' fees directly and up front, creating conflicts of interest and leaving the NRSROs with no residual risk to discourage unduly generous ratings. Further, in an odd twist of constitutional law, debt ratings are considered opinions under the First Amendment and shielded from civil liability even if grossly negligent. Using flawed risk models and under pressure from banks, the NRSROs routinely underpriced the high and rising mortgage risks underlying these securities and gave AAA ratings to top tranches comprising 85 to 90 per cent of many MBS and CDO issues. With this seal of approval, other financial institutions and pension funds could buy the securities without triggering regulatory risk or capital reserve limitations.

The Explosion of Credit Default Swaps

Credit default swaps (CDSs) provided the final essential ingredient of the CDO boom. These derivatives served as a form of unregulated insurance on securitized debt instruments, including CDOs. If the CDOs defaulted, the seller of the CDS protection compensated the buyer for the loss of the CDO's value. The London-based financial products unit of AIG, the world's largest insurance company, became the world's largest CDS issuer in the CDO market.[6] Should the protection seller have a coveted AAA credit rating, as was the case with AIG, CDS risk hedging effectively extended that rating to a growing share of the big banks' balance sheets, allowing them to further avoid capital requirements and increase leverage (Nocera, 2009).

As "over the counter" (OTC) securities not traded on any

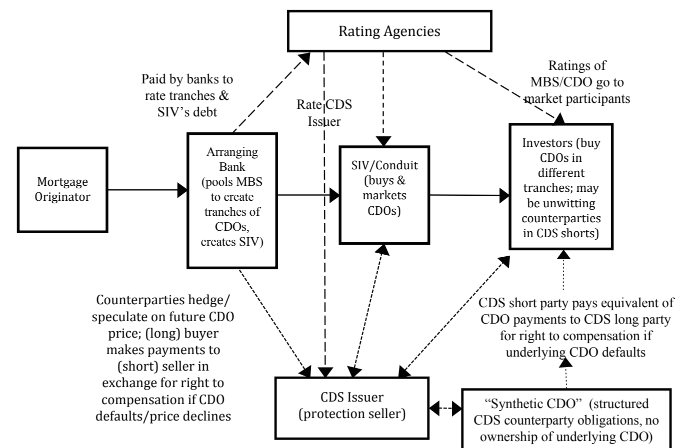
regulated exchange with transparent pricing, CDSs and the CDOs underlying them were far removed from regulatory oversight. They were intrinsically difficult to value, and no one knew with confidence who held them and in what amounts. These characteristics made the CDS business immensely profitable—and dangerous. Freed from regulation, CDS issuers like AIG were not required to set aside reserves to cover potential claims or collateral calls in the event of defaults, price declines, or ratings downgrades. In the regulatory netherworld of derivatives, investors could place immense and highly leveraged bets on the CDO market through "naked CDS" issues (protection bought by a party that did not own the "insured" assets) and "synthetic CDOs" comprised solely of derivatives designed to mimic the CDO cash flow payments to investors coupled with naked CDS protection for parties betting that CDOs would default.[7] (See Figure 3)

Derivatives like CDSs were not merely largely unregulated; they were preemptively deregulated—and with the complicity of Democrats in the Clinton White House and Congress. Republicans had long championed financial deregulation, but the Democratic Party had embraced much of the cause since the early-1990s. During the Clinton administration, Greenspan, Treasury Secretary (and former Goldman Sachs CEO) Robert Rubin, and then-Assistant Treasury Secretary Lawrence Summers rolled back an attempt to regulate derivatives by Brooksley Born, then Chair of the Commodities Futures Trading Commission (Faiola, et al., 2008). Countering to warnings that the unregulated marketing and trading of derivatives posed enormous potential systemic risks, they argued that regulation would hamper beneficial financial innovations, and that the self-interest of technically sophisticated parties, along with the efficiency of global markets would provide adequate self-regulation (see, e.g., Greenspan, 2002).

Phil Gramm, then the powerful Republican chairman of the Senate Banking Committee, led the effort in Congress to foreclose any future regulation of derivatives (Lipton and Labaton, 2008; Lipton, 2008). A former economics professor and leading critic of regulation, Gramm drafted the Commodity Futures Modernization Act of 2000, which barred virtually all regulation of derivatives and swap transactions. With the broad acquiescence of the Clinton administration and congressional Democrats, he slipped it into an enormous omnibus budget bill with barely a murmur of dissent. In less then a decade, unregulated derivatives would become a multi-trillion dollar market. Estimates of the subprime CDS market itself would total over trillion dollars by 2007.

The complexity, opacity, and explosive growth of the CDS markets both obscured and magnified systemic risk by creating impenetrable uncertainty over the size and location of potential liabilities and enabling a massive buildup of undisclosed one-way (unhedged) bets on future asset prices. CDSs unleashed a massive expansion of financial speculation as parties on either side of CDS trades placed, in the aggregate, trillions of dollars worth of bets on CDOs. By the end of the boom, the nominal (face) value of CDS issues exceeded the value of CDOs by an estimated ratio of 10:1. The mutation of CDSs into synthetic CDOs kept the real estate and securitization bubbles growing by allowing banks, most notoriously Goldman Sachs, to continue arranging deals financed and designed to fail by hedge funds shorting the precarious MBS and CDO markets. The culminating predatory behavior of investment banks at the center of the securitization cycle and the conflicts of interest within the shadow banking system helped to fatally destabilize the global financial system.

Figure 4. Relationships in the CDO and CDS Securitization Web



The Lending-Securitization Cycle and the Web of Conflicts

Surging investor demand for CDOs and a global financial system awash in cheap credit provided the capital to channel back into mortgage lending that sustained the lending-securitization-lending cycle that further inflated the real estate bubble. This cycle also drove the massive expansion of credit and leverage within the largely unregulated shadow banking system of investment banks, SIVs, hedge funds, and CDS issuers. The securitization machine depended on continually rising real estate prices to ensure low default rates on mortgages, and the risk models the banks and ratings agencies used assumed they would.

None of the parties linked in the securitization web acknowledged, or even understood, the dangers posed by an increasingly ob-

vious real estate bubble. Many parties maintained an illusory sense of security based on blind faith in the financial alchemy of securitization, flawed risk management models, systematically erroneous debt ratings, and the risk spreading properties of derivatives. Other parties within the complex tangle of counterparty risks actively fashioned and opportunistically exploited the conflicts of interest and information asymmetries they helped create and that government regulation, eroded over decades by entrenched political forces, failed to address or even recognize.

The web of relationships within the securitization process was riddled with conflicts of interest and veiled in opacity that incentivized reckless and predatory behavior, creating the conditions for a global financial panic. Mortgage lenders had an incentive to debase lending standards for loans they sold off immediately. The issuing banks externalized risks by selling off CDOs as quickly as possible, often marketing them around the world through off-shore subsidiaries that further insulated them from regulatory oversight and tax laws. Banks obscured the location and size of their growing residual exposure to CDOs through SIVs or CDS hedging. The end of the legal separation of commercial and investment banking in the U.S. allowed large commercial banks with investment banking units to join in the securitization boom. With government and corporate bond yields depressed in an environment of prolonged low central bank rates, investment funds around the world seeking higher yield drove demand for CDOs while taking advantage of cheap credit to boost returns through increased leverage. Fund managers mistook (or ignored) systematically underpriced risk and fueled increasing demand for CDOs—satisfied by packaging of ever-lower quality mortgages into ever-riskier CDOs.

The Financial Crisis of 2007-2009

Subprime mortgage lending and the related MBS and CDO markets stalled in 2006 and began to implode in the summer of 2007. Soaring subprime default rates during 2007 and 2008 finally triggered the collapse of the MBS and CDO market. In March 2008, Bear Stearns' heavy losses on and exposure to CDOs precipitated a panic cut off its financing; its capital evaporated within days. The Federal Reserve Bank of New York arranged Bear Stearns' purchase by JPMorgan Chase by guaranteeing $30 billion in the collapsing investment bank's assets to sweeten a deal that wiped out the failed institution's shareholders. Lehman Brothers was even more exposed to the imploding CDO market. Its senior managers, along with many of the bank's counterparties and other market participants, still hoped for a market recovery, a merger with another bank, or a bailout. This widespread wishful thinking ignored market fundamentals, which dictated a huge decline in real estate prices and a wave of mortgage defaults, and fatally misjudged the political situation. At the highest levels of the U.S. Treasury and Federal Reserve, officials were shocked by the breadth and depth of hostility towards the Bear Stearns bailout and remained deeply concerned over the moral hazards of a second bailout (Solomon, et al., 2008). Placing their faith in rational self-interest and efficient markets, the officials bet that major banks, investors, and counterparties had unwound, hedged, or otherwise addressed their exposure to a potential Lehman bankruptcy. Returning to form they rejected government intervention and let Lehman Brothers fail (Solomon, et al., 2008; Reddy and Hilsenrath, 2008). They bet wrong.

Lehman Brothers' bankruptcy set off a cascade of financial catastrophes. It triggered a wholesale collapse of the MBS and CDO markets. Disclosure regulation failed during both the bubble and the crash. Market participants had no idea where enormous bad debts and risk exposures were located and which institutions would be next to fall. Mark-to-market accounting rules adopted in the aftermath of the Enron-era accounting scandals helped inflate the asset bubble on the way up; they now accelerated the crash as by forcing financial institutions to book huge current losses. Investors and institutions hoarded what cash or liquid assets they had. Financial panic accompanied a global chain reaction of deleveraging as liquidity disappeared, counterparty risks soared, and credit contracted. The credit crunch froze short-term interbank lending and rendered otherwise solvent institutions incapable of financing continuing operations. Large, interconnected, and overleveraged financial institutions and investment funds suffered immense losses on accumulated securities holdings when they could find no buyers at precisely the moment they most desperately needed to sell assets to rebuild capital cushions and loss reserves.

Lehman's plunge into bankruptcy had the unanticipated consequence of freezing the securities held in customer accounts at the moment they most desperately needed to sell them to raise capital. Money market funds, long regarded as dull and safe, were among those with frozen accounts and suffered a run by investors following unprecedented losses. The run on these funds deprived the commercial paper market of one of its most important sources of funding. The collapse of the commercial paper market cut off highly levered SIVs and conduits from their principal sources of short-term finance and, in many cases, forced their liabilities back onto arranging bank balance sheets to accelerate the systemic collapse.

The massive wave of bond defaults triggered billions in claims

by a large number of counter-parties holding CDS protection and bond insurance. Default claims threatened major bond insurers with bankruptcy. CDSs claims dwarfed the value of the underlying defaults by approximately an order of magnitude and threatened AIG and some of the world's largest financial institutions with insolvency. The absence of regulation had obscured the fact that, instead of spreading risk, the rampant CDS speculation exemplified by AIG had concentrated, amplified, and globalized systemic risk.[8] More recently, SEC civil charges against Goldman Sachs alleging fraud in marketing synthetic CDOs has highlighted the destructive and extractive tendencies of financial innovation and large financial institutions.

Within weeks, the global financial panic unleashed by the Lehman bankruptcy transformed Wall Street and the American political economy. Bank of America bought Merrill Lynch at a distress price in a government-brokered deal. Cut off from short-term operational financing, Goldman Sachs and Morgan Stanley were unable to continue as investment banks and became bank-holding companies to qualify for government bailout funds. The Treasury and Federal Reserve effectively nationalized AIG and bailed out Citigroup and Bank of America, in the process becoming their largest investor. Unprecedented and controversial federal lending and asset guaranty programs propped up the entire shattered financial system by supporting the very institutions that had caused the collapse. As the November presidential election loomed, the Bush administration relied primarily on Democratic support to pass the controversial $700 billion Troubled Asset Relief Program (TARP). Even more controversially, the government paid off CDS claims against AIG at 100 cents on the dollar—without transparency or accountability—to provide an additional unrecoverable $80 billion "backdoor bailout" to some of the world's major financial institutions.[9] These were merely the most visible forms of government intervention on an extraordinary scale (Montgomery and Kane, 2008). As of September 2009, the American government's support for the financial sector totaled $545.3 billion in expenditures (of which $72.9 billion had been repaid) and another $23.7 trillion in asset guarantees (representing nominal asset value, not the likely real costs).[10]

The Post-Crisis Politics of Reform

In the immediate aftermath of the global financial crisis and the collapse of Wall Street, there was a near universal expectation that a revival of the regulatory state would rapidly transform financial sectors and markets around the world. Obama White House Chief of Staff Rahm Emmanuel repeatedly noted that "a crisis is a terrible thing to waste," but it is far from clear that the American political system is currently capable of learning the lessons of an economic near-death experience or delivering substantial structural and regulatory reforms based on them. The political and policy responses to the crisis, however, have been slow and modest. The Obama administration has refused to pursue, and has been noticeably reluctant to endorse, far-reaching financial system reforms. The tepid approach to financial system reform and re-regulation now poses enormous political risks to the Obama presidency and the Democratic majorities in Congress.

With Treasury Secretary Timothy Geithner in the lead, the Obama administration set out a regulatory reform agenda calling for the creation of a consumer financial products regulatory agency, consolidation of federal regulatory authority over financial markets and services, strengthening the role of the Federal Reserve as part of this regulatory restructuring, and regulation of derivatives. Widely criticized as too timid, yet also opposed by the financial sector as excessive, the financial reform agenda stalled in Congress. The legislative process has blocked or enfeebled some of the most important proposals, such as those seeking to shrink too-big-to-fail banks, regulate derivatives, monitor and control systemic risk, develop a resolution mechanism to handle bankruptcies of large systemically sensitive financial institutions, and protect consumers of financial products.

To some extent, the sluggish pace and meandering path of reform reflects a political paradox of the financial crisis: the financial sector's economic weakness shielded it at precisely the moment when it was politically weakest. The structural importance of finance to the functioning of the economy is never as evident as when lending collapses during a financial crisis. The magnitude of the crisis caused by the financial sectors' self-destructive expansion of credit made its rescue more pressing than its fundamental reform.

However, nearly two years after the nadir of the financial crisis, the sluggish pace and compromised character of financial system reform reflects the dysfunctional and debased state of American politics in an era of increasingly bitter partisan struggles for power and undiminished influence of business lobbies. Institutional constraints, and the partisan politics of interest group coalitions, in addition to ideological and intellectual blinders, limit government's capacity to exploit crisis situations for purposes of reform. Republican obstruction in Congress (particularly in the Senate) and the influence of financial interests within a fractious Democratic Party paralyzes policy making. A proliferation of institutional veto-points, along with the pro-business bias of interest group and coalitional politics, impede major policy changes and typically requires broad agreement

for their passage.

The threat of a second Great Depression has abated, at least for the moment, but the political, economic, and regulatory consequences and implications of the financial crisis and the Great Recession linger. On the one hand, the importance of regulating and governing large, systemically important financial institutions became a matter of paramount importance. On the other hand, saved by vast infusions of public funds and assets guarantees, the bailout expanded the size and political power of the largest financial institutions, and they have fought to shape regulatory reform when they could not kill it. Even in a weakened state, the financial sector remains a powerful force in American politics, and its interests are most intense when fighting reforms threatening the most profitable business activities of surviving financial institutions that have grown larger through public subsidies. In 2009, the six largest American banks held assets worth over 60 per cent of GDP (up from less than 20 per cent in 1995) and two-thirds of all deposits.[11] Explicit or implicit federal recognition of these institutions as too-big-to-fail lowered their costs of capital, setting the stage for further sectoral concentration.[12] Neoliberal finance capitalism mutated into an inversion of the liberal market ideal. American finance capitalism now embodies a fusion of public and private power corrosive to democratic governance and threatening to economic welfare (Johnson and Kwak, 2010, Smith, 2010).

Things were not supposed to turn out this way. Finance capitalism was supposed to be increasingly efficient, productive, and stable. The financialization of the economy was supposed to drive growth, adjustment, and innovation, while derivatives spread and tamed risk. Rational self-interest was supposed to constrain managerial opportunism and control downside financial risks to the financial system and the economy. Instead, the financial sector and its innovations became extractive, destabilizing, and destructive. Risk was concentrated in major financial firms, and then magnified by increasing leverage and enormous exposures to losses on derivatives. The regulatory politics of finance capitalism during the past twenty-five years played an important role in creating the conditions for this crisis, and the growth and concentration of the financial sector this politics and the crisis it unleashed now has important—and troubling—implications for political economic development.

The corrosive perception of state capture by the financial sector is not only one of the most serious threats to the Democratic Party's electoral fortunes, it is also a portent of an intensifying legitimacy crisis afflicting American politics across the political spectrum. Financial collapse exposed massive regulatory failures and revealed the intellectual, ideological, and economic bankruptcy of the neoliberal variant of finance capitalism. Should efforts to reform the financial system fail, and thus fail to prevent another serious crisis, the next catastrophic bankruptcy may be political.

What is clear from the complexity of this most recent crisis is that financial reform must be multi-pronged, with rules that effectively: 1) address the "too-big-to-fail" problem of increasingly huge and systemically vital financial institutions, 2) extend financial regulation to the broader "shadow banking system" to reduce aggregate systemic risk, 3) regulate derivatives and construct transparent markets on which to trade them, 4) create a strong, independent consumer financial protection agency, 5) subject debt ratings agencies to regulation to contain conflicts of interest and deter inflated ratings, and 6) strengthen enforcement authorities and mechanisms to ensure that legal reforms are not rendered meaningless in practice.

Finance capitalism has entered a new and arguably non-liberal phase, but its political, institutional, and regulatory character at the national and international levels remains contested and unclear. People and their governments enter crises empowered and constrained by the institutional capacities, political ideologies, and partisan divisions history has bequeathed them. The risk is that a historic opportunity for reform may be lost and with it a last, best chance to avoid an even worse political and economic fate in the future.

Notes

[1] For the development of this securitization model, see generally Tett, 2009; Smith 2009.

[2] This discussion necessarily simplifies the extraordinarily complex, diverse, and often opaque structural features of securitization and "structured finance." It also glosses over terminological inconsistencies common in practice.

[3] Moreover, CDOs encompass a much wider array of securitized debt instruments, ranging from private equity loans to credit card debt. The crash in mortgage-backed CDOs also undermined the markets for these instruments, intensifying and broadening the credit crunch.

[4] See Adler, 2008; Scannell and Craig, 2008; see generally GAO, 2008.

[5] Farrell, 2008; GAO, 2008. By the time of Bear Stearns' collapse in March 2008, the SEC, the bank's primary regulator, was deemed so marginal that it was barely included in the crisis management efforts led by the Treasury and Federal Reserve. Scannell and Craig, 2008.

[6] For an analysis of AIG's CDS business, see generally Sjostrom, 2009; Dennis and O'Harrow, 2008; O'Harrow and Dennis, 2008a, 2008b.

[7] Incredible as it seems in hindsight, "synthetic" CDOs were a product of investor demand for CDOs far in excess of supply.

[8] See Tett, 2009; Nocera, 2009. Advocates of deregulated derivatives markets had claimed that they spread risk efficiently among

sophisticated parties according to their ability and inclination to bear it, thus contributing to financial system stability. A long line of critics had countered that derivatives were too complex to be understood by even sophisticated financiers and fostered dangerous levels of systemic opacity and potential volatility. The events of late-2008 proved the critics correct.

[9] Walsh, 2009. A partial list of AIG bailout recipients includes (in billions): Goldman Sachs ($12.9), Société Générale ($12), Deutsche Bank ($12), Barclays ($8.5), Merrill Lynch ($6.8), Bank of America ($5.2), UBS ($5), Citigroup ($2.3) and Wachovia ($1.5).

[10] SIGTARP, 2009a: 137-138, Table 3.4, 2009b: 31. The IMF's (2009) estimate of the ultimate costs was still $3.68 trillion ($1.85 trillion in asset purchase commitments; $1.83 trillion in guarantee commitments).

[11] Johnson and Kwak, 2010: 203, fig. 7-1; Cho, 2009; Faiola, et al., 2008.

[12] In 2007, large American banks (in excess of $100 billion in assets) paid 0.08 percent less interest in borrowing costs than smaller rivals; by late 2009 that advantage quadrupled to 0.34 percent. Cho, 2009 (using FDIC figures).

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