Reflections on a Global Crisis:

How Ethical Failures and Institutional Corruption Produced the Great Recession

by Gregg Fields

Blog posts from the Edmond J. Safra Center for Ethics at Harvard
www.ethics.harvard.edu

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The IC Press

The Standard Deviation: Institutional Corruption and Our Off-Course Economy

Sometimes it's hard to say when you first go off course.

In September 2008, I had just arrived to teach at Beijing's Tsinghua University. I'd been warned about the city's notorious smog. But pollution controls during the Olympics meant the city was blanketed not by noxious air but the sweet smell of success on the world stage.

Alas, the clear air didn't last. And I found Beijing to be a hazy, crazy place to get around. I got lost constantly. My second week I ventured into a hutong, one of those charming, though rapidly disappearing, alleyway neighborhoods. After a number of turns, I realized I was lost yet again. Of course I had no map. They say one good turn deserves another, but it turns out every bad one does, too. Only after much aimless wandering did I decipher where I was and, more importantly, feel confident of the direction to take.

Which brings me to the point of this compilation.

As I arrived in a rising China, the American economy was crashing. On September 15 the venerable Lehman Brothers entered bankruptcy. A day later, the Federal Reserve seized insurance giant AIG in an $85 billion bailout. In early October, President George W. Bush put his signature on the $700 billion Troubled Asset Relief Program, or TARP, to prop up financial institutions that, by government policy, were deemed too big to fail.

The reaction in China was shocked disbelief, mixed with some abiding optimism about how their own country seemed decoupled from America's problems. Theirs was a quirky capitalism. MIT professor Yasheng Huang referred to it as Capitalism With Chinese Characteristics in his 2008 book. America's voracious appetite for Chinese manufactured goods was an important component of China's rising prosperity, but domestic consumption was also rising, and it wasn't like exports were going to disappear. But in addition to its dependence on selling to the U.S., China itself was a major purchaser of American products—specifically, U.S. Treasury securities. China, in fact, had just replaced Japan as the largest foreign holder of U.S. debt. Its economic health, it turned out, relied on the integrity of American economic governance just as much as the rest of the world did. The notion of decoupling was a fallacy. China's implicit trust now seemed woefully misguided.

This Time It's Different

Recessions never scared me before. Growing up in the Ohio Valley, industrial cycles meant steel and auto plants periodically idled while supply and demand re-synchronized. And as a print journalist in an internet world, I knew firsthand that disruptive technologies can induce industry-specific contractions.

But 2008 was frightening. As to depth, it was the deepest downturn since the Depression. As for breadth, foreclosures and job losses stretched from sea to shining sea.

Finally, this wasn't a traditional recession. This painful episode felt rooted in betrayal. Private and public institutions trusted by the American public—and indeed, the world—to safeguard the economy had failed. And not by accident. Whether it was the stewards at the Fed, the financial engineers on Wall Street, or the 535 elected members of Congress, the question remained: How had

so many vital institutions, seemingly in concert, been so derelict in their duties?

In 2010 I returned to the U.S. and began, as a journalist, searching for answers. In 2012 that led me to the Lab at the Edmond J. Safra Center for Ethics at Harvard University, which was in the midst of a five-year project looking at the concept of "institutional corruption."

What is institutional corruption, and why did the Edmond J. Safra Center for Ethics care?

Nouveau Corruption

Institutional corruption is markedly different from your "garden variety" crooked behavior. It's typically perfectly legal and often ethically defensible. (That may explain why so few prosecutions related to the crash have occurred.) It doesn't involve secret bags of cash or anonymous offshore accounts. The corruption is produced not by individual villainous actors but rather by systems that turn virulent after infection by distorting ethical influences.

The Lab's project was particularly pertinent. Professor Lawrence Lessig, Director of the Center, applied the concept of institutional corruption to Congress in his 2011 book *Republic, Lost: How Money Corrupts Congress—And a Plan to Stop It*. And Lab researchers there had examined key industries like pharmaceuticals and health care, and topics like environmental regulation, using similar protocols. A common casualty of institutional corruption is the public's trust. That was clearly an issue following the 2008 financial collapse, and remains one today.

I embarked on my project. But I quickly saw that institutional corruption isn't always easy to see. It often felt like trying to draw a line with just one point. Over time, however, some suspicious symptoms repeatedly surfaced. One was regulatory capture, where an industry largely dictates the rules it is governed by. In the years leading up to 2008, both political parties as well as watchdog agencies fervently embraced banking deregulation. The industry increasingly was its own overseer.

With institutional corruption there are often conflicting constituencies. An example might be Wall Street's marketing of toxic mortgage-backed securities to investors, even as the firms were secretly placing bets that the instruments would fold.

And frequently institutional corruption is marked by a mutual dependency that doesn't serve the public interest. In *Republic, Lost*, for instance, Lessig tracks Congressional dependence on deep-pocketed donors, who in turn benefit from friendly legislation. This phenomenon is known as dependence corruption.

Sure enough, the so-called FIRE sector, for finance, insurance and real estate, is routinely ranked at or near the top in both campaign contributions and lobbying expenditures.

The research in this volume attempts to illustrate not just what happened in 2008, but the central role that institutional corruption played in this tragic economic episode. These articles and essays are a series of snapshots. They frame what was happening at a specific place and time, based on the best information that was available. Parts of this analysis are now in common consciousness; they seemed more original when I first wrote them. In other cases, there are suggestions for reforms that remain a work in progress, particularly calling to account those actors responsible for the lost financial, social and political capital our country is yet to recover.

Another goal is to apply this research toward improved regulation in the future. America can't afford another collapse of the magnitude of 2008. Yet, from a regulatory standpoint what's striking isn't how much has changed, but how much hasn't. The Dodd-Frank Wall Street Reform and

Consumer Protection Act, passed in 2010, was touted as a landmark law that would overhaul banking oversight. But its implementation has been stalled by withering political infighting in Washington and relentless industry lobbying and court challenges – all of which suggest institutional corruption, at least potentially, remains a potent force.

To close on a positive note: As I discovered that day in Beijing, sometimes it helps to have a map. In that vein, perhaps this volume can be a beginner's guide for others exploring institutional corruption. Ultimately, however, the best measure of success is knowing intuitively when you're heading in the right direction.

October 11, 2012

The Banker Had No Face

Read this original blog post by Lab Fellow Gregg Fields, on the absence of personal accountability in mortgage fraud cases.

The Banker Had No Face:
Assessing Institutional vs. Managerial Responsibility in Mortgage Fraud Lawsuits

In journalism school, every student eventually learns about the "Five W's." It stands for Who, What, When, Where, Why. Then they're taught about the H -- How.

It's actually a useful framework for anyone conducting an investigation. But it's apparently a methodology that isn't embraced by government agencies allegedly digging into the root causes of the economic crisis.

A recent exhibit: New York Attorney General Eric Schneiderman's lawsuit against affiliates of JPMorgan Chase. The civil complaint is about their role in massive losses investors suffered on residential mortgage backed securities, or RMBS.

A similar lawsuit was filed this week against Wells Fargo by Manhattan U.S. Attorney Preet Bharara.

The Schneiderman lawsuit, filed in early October, has garnered a fair amount of press, and some observers are even suggesting he may be laying the groundwork for an Eliot Spitzer-style assault on Wall Street.

The complaint has some rich details. There is the what -- the alleged rip-off of investors. There is the when, in that it occurred right before the Great Recession. Where is easy enough, in New York, of course. And the why is a no-brainer: Quick profits for the bankers, almost immediate losses for the investors.

The how includes details on how borrowers got mortgages they couldn't possibly afford, and the loans were soon sold off to unsuspecting investors whose portfolios then sank.

An incomplete picture

But if the complaint were an assignment for Journalism 101 it would have to be returned as an Incomplete. The reason: There is no "Who." Schneiderman weaves a captivating tale that, in its best moments, conjures up comparisons with last year's capsizing of the Concordia off the coast of Italy.

With one big difference. The Concordia had a captain, and we learned a lot about him -- not much of it complimentary -- in the weeks after that tragedy. In contrast, Schneiderman's lawsuit never says who was at the helm as securities marketed as investment grade ran aground and plunged underwater almost immediately.

The lack of suspects fits an increasingly popular legal strategy by regulators. Specifically, companies are often taken to task -- or at least, to court -- but not the managers who run them.

It may be true that at least in terms of free speech corporations are people. But this has nothing to do with the Citizens United decision. And it begs a perplexing question: Can a corporation be guilty of something when its management isn't?

Schneiderman sued under a New York state law, called the Martin Act, which actually doesn't require prosecutors to prove intent to commit fraud. So that might explain Schneiderman's strategy.

But the shortage of names is prevalent in federal actions, too, however. U.S. District Attorney Bharara's civil fraud lawsuit against Wells Fargo concerns allegedly shoddy handling of mortgages backed by the Federal Housing Administration. It cost the FHA hundreds of millions of dollars. Who did it? "Yet another bank has engaged in a longstanding and reckless pattern" Bharara said in a statement. Who, specifically? We can only speculate.

A bearish indicator

First, a couple of disclaimers. One, both banks have said they intend to fight the charges.

And certainly the case against JPMorgan Chase is something of a legal labyrinth. It may be the named defendant, but that's more by default than anything overt. The case Schneiderman is bringing focuses primarily on the actions of Bear Stearns & Co., which JPMorgan bought in 2008 in a marriage arranged, ironically, by the federal government. Its wedding gift was $29 billion in assistance from the Federal Reserve Bank of New York.

At a Council on Foreign Relations event this week, JPMorgan CEO Jamie Dimon said his company has lost between $5 billion and $10 billion on the Bear Stearns deal. According to press reports, he made clear he didn't appreciate Schneiderman's lawsuit.

Another prime violator, according to Schneiderman, was EMC Mortgage Corp., a Bear Stearns subsidiary that bought mortgages for the parent and which JPMorgan now owns. (Schneiderman co-chairs a massive inter-agency group investigating the mortgage mess.)

The narrative in the complaint is sadly familiar to anyone who followed the mortgage meltdown. Bear Stearns was making a killing packaging home loans into securities that were then sold to investors. So Bear Stearns primed the pump, pushing lenders like EMC to approve risky mortgages, all the while touting them as sound quality.

We all know it didn't work out. And it's hard to fault Schneiderman for taking action. After all, New York's credibility as a reputable financial market is on the line. That's one of the most lucrative industries in his state.

An empty lineup

But if the actions the lawsuits describe no longer are shocking, the complete absence of human defendants feels like a sucker punch. Consider this line from Schneiderman's complaint: "At all relevant times, defendants committed the acts, caused or directed others to commit the acts, or permitted others to commit the acts alleged in this complaint."

Fine. However, the defendants in this case are inanimate. They are legal entities. True, the lawsuit adds that it means "those acts were committed through their officers, directors, employees, agents and/or representatives."

Which begs the question: Who? Which individuals committed the acts? And if they were acting "within the actual or implied scope of their authority," then we need to know who gave -- or

implied -- that authorization.

It would be less worrisome if Schneiderman's faceless predators were an anomaly in the current regulatory environment. But the truth is that Schneiderman's approach is increasingly the norm. In far too many regulatory actions, the thinking seems to be that train wrecks can't be blamed on conductors who ignored the signals, then took the wrong track.

Size matters

There are a number of reasons why regulators would understandably prefer taking on companies rather than officers. For one thing, regulators are outgunned and underfunded. The organizations they oversee are much bigger than the agencies themselves. As one example, the Securities and Exchange Commission has about 3,800 employees. JPMorgan has a quarter of a million, give or take.

Then there's the mismatch in resources. In fiscal 2011, the SEC had a budget authority of about $1.6 billion. JPMorgan's London Whale trader alone *lost* roughly four times that much, and Dimon, described it as a "tempest in a teapot." That's some teapot.

For regulators, the clear lesson is, if you're running low on fuel, look for shortcuts. And keeping legal actions simple is one way to reduce a lawsuit's travel time.

Secondly, financial institutions -- particularly of the too big to fail variety -- seem to take these actions, and their often considerable settlement amounts, as a simple cost of doing business. That's perfectly logical. The fines aren't designed to do real damage to their core business. And the odds are very good that the company will neither admit nor deny guilt as part of wrapping things up.

The price we pay

It would be tempting to ask, "So who gets hurt?" And the answer is, all of us. Admittedly, the city on a hill analogy does get overused. But American exceptionalism is a fundamental value among a great many of this country's citizens, and even among a sizable slice of people who live in other lands. Central to this belief is the notion that we are a nation of law-abiders, governed by a system of laws.

What to make, then, of investigations that consistently produce smoking guns, but fail to find fingerprints? To have a corporation pay a fine shouldn't absolve any individual of personal responsibility. Nor should it excuse regulators from performing their appointed duties. Banks are backed by the full faith of the U.S. government, and Americans need to have full faith that the regulatory process is rigorous and thorough. What happens when this confidence wanes?

If that sounds a tad too philosophical, consider the more practical consequences. The American standard of living is dependent on the economy's ability to attract capital. I have nothing against the Federal Reserve's QE1, 2 and 3. But the most effective form of economic stimulus is confidence. And people won't place their faith in a regulatory system that routinely produces heat but no light. It's a sham form of transparency that, frankly, is easy to see through.

To be sure, regulators do crack the whip on occasion. The Securities and Exchange Commission recently disclosed a laundry list of actions taken against players in the mortgage meltdown. Goldman Sachs, something of a poster boy, agreed to pay $550 million and to reform its business practices.

Just this year alone, Bharara, the U.S. attorney in New York, has obtained settlements of $158 million from CitiMortgage, $202 million from Deutsche Bank and $132.8 million from an organization called Flagstar.

And sometimes people -- real people -- pay the price. The former CEO of American Home Mortgage, Michael Strauss, settled SEC charges by paying a $2.45 million fine and agreeing to a five-year ban on being an officer or a director. (Considering his company was defunct, one wonders how much demand there is for his services.)

But it's worth noting that Strauss earned over $3 million in just 2006, and that a loan backed by his company's stock netted him a profit of more than $2 million before it all collapsed, according to the original SEC charges. He is described as a resident of Southampton, N.Y., a burg not known for its mean streets. As part of his settlement, he neither admitted nor denied wrongdoing, according to the SEC.

Also on the SEC list is the now-notorious settlement with Citigroup. The SEC charged a Citigroup subsidiary with, in essence, betting against its own investors in a collateralized debt obligation, related to housing, that Citi was promoting.

The judgment call

Citi agreed to settle for $285 million, without admitting or denying guilt. No senior officers were named, and a mid-level manager sued by the SEC was found not liable by a jury.

But the settlement was thrown out late last year by U.S. District Judge Jed Rakoff.

Mr. Preet Bharara, US Attorney for the Southern District of New York

Rakoff's rejection is being appealed -- ironically, by both defendant Citi and plaintiff SEC -- and his action may yet be overturned. But a group of 19 legal scholars filed a friend of the court brief in support of Rakoff. Their reasoning: The SEC's perpetual policy of settling is an ineffective deterrent. "Citigroup and its affiliates have been enjoined from violating securities laws four times since 2000, yet have not been the subject of a contempt proceeding," the scholars said.

And in his eloquent opinion, Rakoff argued, simply yet forcefully, that the SEC hadn't met its legal, if not ethical, obligations.

"In much of the world, propaganda reigns and truth is confined to secretive, fearful whispers," Rakoff wrote. "Even in our nation, apologists for suppressing or obscuring the truth may always be found. But the SEC, of all agencies, has a duty, inherent in its statutory mission, to see that the truth emerges."

As journalism students can tell you, it all starts with who.

November 3, 2012

No Charge

"In some cases there is a lack of law. In others, there are too few resources. And perhaps most significantly, this financial crisis, unlike its predecessors, comes after years of shuffling the regulatory deck, dealing the government a losing hand – so they fold."

No Charge: Why Regulatory Institutions Have Prosecuted So Few Bankers; and Why It Matters

Gregg Fields

They were icons of the industries they dominated.

Michael Milken of junk bond fame. Charlie Keating of the infamous Lincoln Savings. Enron gurus Andrew Fastow and Jeffrey Skilling.

Of course, they all have something else in common: each went to jail. They were incarcerated despite political connections that would be the envy of anyone on K Street. In the Senate, we had the famously faithful Keating Five. President George W. Bush was so chummy with Enron executives that he referred to its CEO, Ken Lay, as “Kenny Boy.”

And of course, all could pay the most brilliant legal defense counsel imaginable. And perhaps they did. It didn’t keep them out of prison. (Keating served four years before his original conviction was overturned; on the eve of a retrial he entered a plea agreement and was sentenced to time served. Lay died prior to his sentencing.) While the criminal cases against these financiers didn’t restore the losses suffered by the victims, Americans could at least take comfort in knowing that justice does get served, even against the rich and powerful.

Which begs an obvious question: what has changed? The financial collapse that still haunts the U.S. economy dwarves anything since the Great Depression. There is ample evidence that certain actions warrant digging deeper. And of course, there is an implicit benefit to society when the rule of law prevails.

But so far the prosecutions related to the banking and housing collapses are of actors who, in the scheme of things, are mere bit players. A one-time mortgage executive, Lee Farkas, was convicted of fraud in 2011. But his firm, Taylor, Bean & Whitaker, was hardly a Wall Street kingpin.Angelo Mozilo, of mortgage giant Countrywide Financial, had a marquee name, and paid a huge fine to the Securities and Exchange Commission – a $22.5 million penalty plus $45 million in what the SEC called ill-gotten gains. But a grand jury criminal investigation of him was later dropped.

A new kind of crisis

A review of the record, and interviews with banking and legal experts, paints a picture of why, in terms of criminal accountability, it really is different this time -- and not, say critics, in a good way. Specifically, there appear to be three very powerful forces at work, all of which mean individuals are less likely to be blamed, in either criminal or civil complaints, for financial malfeasance.

In some cases there is a lack of law. In others, there are too few resources. And perhaps most significantly, this financial crisis, unlike its predecessors, comes after years of shuffling the regulatory deck, dealing the government a losing hand – so they fold.


William Black, Associate Professor of Economics and Law, UMKC

"Banks fail for lots of reasons," said William Black, an associate professor of economics and law at the University of Missouri-Kansas City. Among numerous regulatory positions, Black was formerly the litigation director of the old Federal Home Loan Bank Board. "When banks fail, it's not necessarily a case of homicide. So you look. But they didn't look."

Experts say it's simplistic to say that a major collapse is prima facie evidence of criminal culpability. For one thing, making bad investments, provided there is no fraud involved, likely falls under the so-called business judgment rule. That legal principle essentially immunizes officers and directors, provided they acted in good faith. It is considered a very high bar to overcome, and perhaps it is part of the reason why prosecutors are wary of going after individuals.

"This was more of a business cycle crisis," said Ken Thomas, a Wharton lecturer in finance and independent banking analyst. "There were lots of bad decisions, but this was the Great Recession."

Thomas, who has written extensively on banking regulations, said that over the years banking laws have grown more opaque, raising another legal hurdle. To give one example, there have been rampant allegations about questionable trading in derivatives. (At its simplest, a derivative is a contract that derives its value from something else. A classic case would be a "futures" contract, which allows someone to purchase, for instance, a barrel of oil at a set price on a certain date, regardless of market price on the delivery date. The goal, theoretically, is to hedge risks.)

The derivatives market has mushroomed in recent years, growing roughly seven-fold from an estimated $80 trillion in notional value in 1998 to more than $600 trillion today, according the Bank for International Settlements, which comprises the world's leading central banks. (Notional value is the value of the assets involved; the actual worth of a derivative contract itself would be much less.) But regulation often moves at a much slower pace than market innovation. And in any case, derivatives were effectively not regulated at all – a decision expressly supported by the Clinton administration in 2000, when the newly passed Commodity Futures Modernization Act removed "over the counter" derivatives, or those traded between private parties like banks, from regulation. The law led to a sharp increase in inter-bank trading in credit default swaps, or contracts that pay off loans that go bad. Credit default swaps were a major reason why the mortgage crisis soon spiraled out of control.

"The grey area has gotten very big," said Thomas. "Things you think would be convictable just are not. Things that were clear-cut black and white back in the S&L crisis no longer are."

No time to lose

Another detectable dichotomy between the current crisis and previous ones is this: Washington was in a much weaker bargaining position this time precisely because of the scope of the collapse.

Consider that Milken's Drexel Burnham Lambert and its junk bond empire disappeared from the scene after pleading nolo contendere to government charges. Keating's Lincoln Savings was seized by regulators and then sold off. Hundreds of other S&Ls were put out of business as well.

Enron was forced into bankruptcy and was soon gone. So was its accounting firm, Arthur Andersen, which was convicted by a jury of obstruction of justice, for shredding Enron documents that the Justice Department was seeking. (Years later the conviction would be overturned by the U.S. Supreme Court, but it was too late to save the firm.)

By contrast, during this crisis, the federal government fought doggedly – at a cost of hundreds of billions of dollars – to save the institutions most publicly linked to the collapse. In the process, the federal backstop expanded from banking to insurance to seemingly unrelated industries, like auto manufacturing. "The S&L crisis was focused on one industry," said Thomas. "This one was across every economic sector."

Regulation on a budget

The dearth of prosecutions may also be the simple result of too few resources.

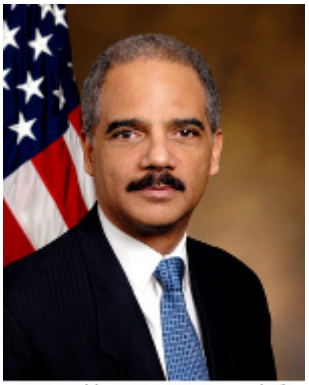
In the late 1980s, during the S&L crisis, bipartisan support created the Financial Institutions Reform, Recovery and Enforcement Act, or FIRREA. (It passed the Senate 91-8 and the House by 320-97.) Among other things, it created the Resolution Trust Corp., a new agency charged with cleaning up the zombie thrifts that were headed for collapse. In other regulatory innovations, FIRREA deactivated the moribund Federal Home Loan Bank Board, and placed oversight of the industry under a newly created Office of Thrift Supervision (which has since been merged into the Office of the Comptroller of the Currency.)

Thanks to FIRREA funding, by early 1992 the Justice Department reported that it had charged roughly 1,000 people with S&L fraud, 30 percent of whom were officers, directors, or top executives. The conviction rate was over 90 percent, agency officials said at the time.
However, the regulatory momentum underwent a fundamental shift in the 1990s, one that meant sharp cutbacks in government manpower, at least when it comes to financial regulation.

A case in point is the Federal Deposit Insurance Corp., which of course plays a major role in regulating banks. In 1990, just after FIRREA passed, the FDIC had 19,247 employees. By 1992, the agency's payrolls swelled to 22,459, partly because of RTC hires. But the numbers began a sharp contraction in the mid-1990s. By 2006, as dangerous lending practices were at their zenith, the FDIC was down to just 4,476 workers, or less than a fourth of the peak. As the banking crisis grew, FDIC's employee count did rise, to 8,150 in 2010. But it has since fallen back to currently just 7,626, according to the latest FDIC figures.

"When you have this kind of regulatory race to the bottom, you're not going to get the leaders," says Black.

The FDIC is hardly alone. Under U.S. Attorney General Eric Holder, for example, the Department of Justice has been in a hiring freeze for nearly two years. According to a recent report on the front page of theFinancial Times, the DOJ is taking advantage of America's lawyer glut and using unemployed attorneys – who are working as unpaid prosecutors.


Eric Holder, Attorney General of the United States

A strong defense

Money and people are always an issue with litigation, of course. But it is particularly nettlesome in this case, precisely because of the complexity of modern banking. The expertise to unravel what happened,

and then trace it backward to individuals, is expensive. As with the Agatha Christie thriller, *Murder on the Orient Express*, the casualty is easy to see. Identifying the suspect takes an investigator as savvy as Hercule Poirot. “You have to be trained in spotting these types of fraud,” said Black.

The resources are also scarce in the field. In fiscal 2008, when the financial crisis began, the Department of Justice’s total budget allocations for U.S. Attorneys’ offices nationwide was $1.018 billion, according to data obtained by the Washington Post through a Freedom of Information Act request. In fiscal 2011, it was $1.122 billion, for an increase of just 10 percent spread over three fiscal years. And that’s for all U.S. Attorneys’ activities.

Furthermore, the reality is that many potential criminal targets “had so much money, they could hire the best lawyers around,” said Thomas. By contrast, a 2009 survey by the National Association of Assistant U.S. Attorneys found that the top salary for an assistant U.S. attorney was $153,000 annually. Those without experience can earn as little as $50,287, depending on location, according to the DOJ website.

A long-term decline

While there may be disagreements about the causes, what is clear is that white-collar prosecutions have tumbled, according to the Transactional Records Access Clearinghouse at Syracuse University. TRAC found that white-collar crime prosecutions for the first 10 months of fiscal 2012 are down 16.5 percent from the previous year. Although they are up a bit – 6.7 percent – from five years ago, they are 11.9 percent below from 10 years ago, and 18.6 percent from 20 years ago. The trend is even sharper with bank fraud prosecutions. They are down 17.2 percent in the last year, 29.6 percent over the last five years, and 55 percent from 10 years ago. They are off by 47 percent from 1992.

Amid the scarcity of resources, some regulators are combining forces. But the results have been mixed. The DOJ and 49 states, for instance, negotiated a $25 billion settlement with five major mortgage lenders earlier this year. It was the largest multistate settlement since the Big Tobacco accord of 1998.

However, the states are not legally required to provide homeowner relief with their share of the settlement. According to a recent report by Enterprise Community Partners, a housing advocacy group, less than half the $2.5 billion disbursed so far is going toward housing programs. A second multi-jurisdiction entity formed earlier this year was the Residential Mortgage- Backed Securities Working Group, a state-federal effort backed by the White House. The most public result so far is a civil suit by New York Attorney General Eric Schneiderman, co-chair of the group, against JPMorgan Chase.

But legal experts have noted that civil complaint primarily targets the activities of Bear Stearns. Ironically, JPMorgan actually purchased Bear Stearns with more than $29 billion in assistance from the Federal Reserve Bank of New York. Furthermore, the complaint does not name any individuals. A similar civil lawsuit was filed recently against Bank of America by Preet Bharara, the U.S. attorney in Manhattan.

Looking ahead, other regulatory agencies with a role in future financial oversight say they are being starved. The Dodd-Frank Act of 2010, for instance, gave much of the responsibility for regulating derivatives to the Commodity Futures Trading Commission. Yet, the agency’s budget has remained static despite its new responsibility. In fact, the CFTC’s current $205 million budget

would be cut by $25 million, if critics in the House have their way for fiscal 2013. The White House had asked for a CFTC funding increase, to just over $300 million. (Fiscal 2013 started Oct. 1, but its budget has not been passed; the federal government is operating on stopgap measures that run through next March.)

One of the strongest supporters of trimming CFTC funding is Rep. Jack Kingston, a Georgia Republican and member of the powerful House appropriations committee. “Some members of Congress look at every issue as an opportunity to grow the government and hire more people,”Kingston said in June. “It’s certainly not the path to economic recovery. It’s also not the most effective way to ensure the integrity of the commodity, futures, and swaps markets.”

But Gary Gensler, CFTC chairman, countered that its limited resources mean the agency cannot possibly interpret, and enforce, the Dodd-Frank Act, which runs some 2,000 pages long, without more resources. “The result of the House bill is to effectively put the interests of Wall Street ahead of those of the American public by significantly underfunding the agency Congress tasked to oversee derivatives – the same complex financial instruments that helped contribute to the most significant economic downturn since the Great Depression,” said Gensler, himself a veteran of Goldman Sachs.

In a sports analogy, he likened the subcommittee’s proposed cuts to multiplying the number of NFL games by eight, without hiring any additional referees. “Imagine the mayhem on the field, the resulting injuries to players, and the loss of confidence fans would have in the integrity of the game,” he said.

What’s certain, said Black, the UMKC professor, is that the current muddle means investigating possible financial crimes, and prosecuting when warranted, will be a rare occurrence. “Prosecuting these people is like getting to the top of Everest,” Black said. “It’s hard, but it’s not impossible. But you need a guide.”

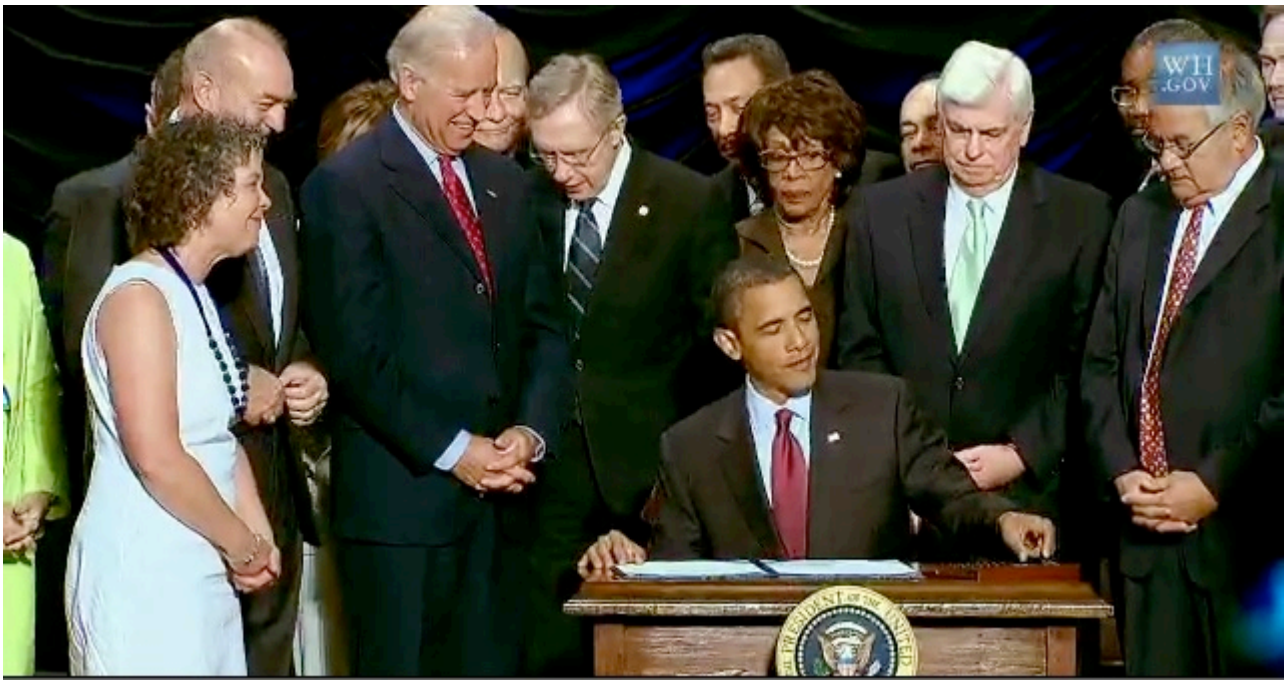
November 13, 2012

Reformers at Bay

Gregg Fields

The re-election of President Obama and Congressional gains by the Democratic Party would theoretically provide momentum for the implementation of the Dodd-Frank Act.

Reformers At Bay: Analyzing Institutional Failure in the Implementation of Dodd-Frank



Mitt Romney, after all, vowed during his campaign to repeal the financial reform law altogether. Though most pundits saw that as a long shot, clearly financial reform wouldn't have been a priority in a Romney administration.

Meanwhile, Dodd-Frank has a new high-profile advocate in the Senate: Elizabeth Warren, the Massachusetts Democrat. Warren created the Consumer Financial Protection Bureau, mandated by Dodd-Frank. It was at last summer's Democratic convention that Warren blasted "Wall Street CEOs—the same ones who wrecked our economy and destroyed millions of jobs." (It's safe to say they think the same of her.)

And of course, during second terms presidents begin thinking about their legacy. In that regard, the Dodd-Frank Wall Street Reform and Consumer Protection Act could be something of a legislative jewel in Obama's crown, along with the Affordable Care Act.

Nevertheless, the recent record suggests that Dodd-Frank faces a rough road ahead. It will pretty clearly remain the law of the land. But at 2,000 pages it is an extremely complicated one, covering everything from student loans to credit default swaps.

Financial industries and other business interests have already geared up to fight. And so far, they've done well in court.

But perhaps the most significant threat to implementing Dodd-Frank is, simply, institutional inertia by the agencies that should be taking the lead. Much of the financial regulatory infrastructure is facing stagnant budgets, declining headcounts and powerful Congressional critics. And a little-known law from the 1990s makes it much tougher for regulators to put new rules in force.

In that sense, the post-election question isn't whether Dodd-Frank will survive. Rather, it's whether it will make a difference. "Dodd-Frank was an unusual law, in that so many of the hard decisions were handed off, with deadlines," said James Overdahl, a former chief economist at both the Securities and Exchange Commission and the Commodity Futures Trading Commission. "More than a law, it's an instruction to regulatory agencies to develop law."

Past As Prologue

When discussing Dodd-Frank, it helps to start with its historical significance. It is pretty clearly the most sweeping effort to restructure the nation's financial system since Franklin Roosevelt's New Deal. And that is perhaps fitting, since it addressed the biggest economic collapse since the Great Depression.

Furthermore, Dodd-Frank was created during a political alignment that is rare in Washington. Specifically, the Democrats controlled the House and the Senate for two years after Obama was elected. He signed Dodd-Frank into law just months before the Democrats were trounced in House races in 2010, producing a legislative gridlock that surely would doom the measure were it introduced today.

To be sure, Dodd-Frank has had some impact already. The Office of Thrift Supervision, which supervised institutions with savings and loan charters, has been merged into the Office of the Comptroller of the Currency, which is widely viewed as a stricter overseer.

And though Congressional opposition doomed Warren's expected nomination to run the CFPB, the agency itself is operational under its director, Richard Cordray.

But by most measures, Dodd-Frank needs to pick up the pace. According to Davis Polk, a global law firm that has closely tracked Dodd-Frank progress, as of Nov. 1 a total of 237 rule-making deadlines have passed. But in 61 percent of those cases the deadlines weren't met. In 33 cases, rules haven't even been proposed.

Even when rules are adopted, they can face legal firefights – battles that regulators often lose. Under the Administrative Procedure Act, originally passed in 1946, federal courts generally have the right to review rules promulgated by federal agencies.

But more recent deregulation gives challengers to Dodd-Frank a greater chance of success. Specifically, a law passed in 1996 during the Clinton administration, called the National Securities Markets Improvement Act, requires that the SEC must consider the effect of any new rule on "efficiency, competition and capital formation."

That requirement has contributed to a string of courtroom losses for regulators, particularly the CFTC and the SEC.

There have been mutterings of judicial bias, particularly regarding the U.S. Court of Appeals of the D.C. Circuit. But that view was disputed in a recent Wall Street Journal op-ed piece, titled "Why Dodd-Frank Rules Keep Losing In Court," by Eugene Scalia, a Washington attorney (and son of the Supreme Court justice). He has successfully sued the SEC four times.

"For the SEC and CFTC, this sort of litigation is relatively new," he wrote. "Until recently, their rules were seldom challenged." But increased judicial review is a good thing, he said, "given the important Dodd-Frank rule-makings that lie ahead."

Benched By The Bench

A recent court case illustrates the dynamics at work. The Securities Industry and Financial Markets Association (SIFMA) and the International Swaps and Derivatives Association sued the CFTC. They opposed a new rule, adopted after Dodd-Frank, limiting the size of positions that traders can take on 28 different commodities. The CFTC said its goal was to reduce risk and limit volatility.

In September of this year, Robert Wilkins, a judge for the U.S. District Court for the District of Columbia, granted the industry associations a summary judgment – vacating the rule and sending it back to the CFTC to develop a new one, if it chooses. Among other problems, "the CFTC's error in this case was that it fundamentally misunderstood and failed to recognize the ambiguities in the statute," the court's opinion said, referring to Dodd-Frank.

Not surprisingly, the decision was praised by T. Timothy Ryan Jr., SIFMA's CEO, while Gary Gensler, a former Goldman Sachs executive who now heads the CFTC, expressed his frustration.

"I believe it is critically important that these positions limits be established as Congress required," Gensler said. The agency has indicated it may appeal.

This was, admittedly, just one rule and Gensler may yet find an approach that passes court muster. But it points to just how arduous the process of adopting Dodd-Frank is. And of course, going forward, the CFTC is in charge of regulating financial derivatives, the complex contracts that played such a central role in the 2008 banking collapse.

The U.S. Court of Appeals for the D.C. Circuit has also been tough on regulators. In one example, in 2010 the SEC adopted a so-called "proxy access rule." Championed by SEC Chairman Mary Schapiro, the rule was adopted after Dodd-Frank and was designed to make it easier for dissident shareholders to get candidates elected to corporate boards.

But the U.S. Chamber of Commerce and the Business Roundtable sued. And in 2011 a three-judge panel of the U.S. Court of Appeals for the D.C. Circuit threw the rule out.

"We agree with the petitioners and hold the Commission acted arbitrarily and capriciously" the appeals court ruling found.

Overdahl, the former SEC economist, said the ruling wasn't completely surprising. "The SEC has been on a short leash with the (appeals) court," he said.

A Pause in Progress

Whether courtroom setbacks will have a chilling effect on future SEC rule-making is subject to speculation. But it's perhaps worth noting that in August Schapiro said the SEC wouldn't pursue toughening regulations for money market mutual funds, such as requiring them to strengthen their cash reserves. There were debilitating runs on money market funds in 2008 at the height of the financial panic.

It isn't clear where that issue will go from here. This week, the Financial Stability Oversight

Council, or FSOC, created by Dodd-Frank and comprising the top federal financial regulators, met and pledged to continue pushing for stricter money market fund rules.

What's clear is that more courtroom battles are certain.

Recently, CME Group, which owns the Chicago Mercantile Exchange, sued in U.S. District Court in Washington to block a new CFTC rule that would require greater disclosure of "swaps" transactions, a form of financial derivative. The CFTC hasn't replied to the filing yet.

Ultimately, some experts say implementing Dodd-Frank boils down to a simple question: Who will pay for it?

"While much progress has been made, U.S. regulators are operating with limited resources to implement reforms that apply to very complex markets and institutions and are essential for the national economic interest," the FSOC said in its 2012 annual report.

It added: "Ultimately, for these reforms to be successful, regulators must have the necessary resources to undertake their policymaking, supervisory and enforcement responsibilities."

January 18, 2013

On Confidence Lost

Gregg Fields

Massive regulatory failures preceded the recession. The legacy is diminished faith in America's global economic leadership.

On Confidence Lost: Does the World Still Trust Washington to Steer International Financial Reform?

For regulators, it was the economic equivalent of a Rodney Dangerfield moment.

AIG, the insurance giant saved by an infusion of $182 billion from Washington in 2008, recently considered joining a lawsuit against the federal government. The argument: the terms of the life-saving bailout had been far too onerous for shareholders. The original lawsuit was filed by former AIG Chairman Maurice Greenberg, who invited his old firm to join him.

It was an episode with absurdist overtones. Who bites the hand that feeds you $182 billion? Adding to the irony, AIG had just unveiled TV ads proclaiming "Thank you, America" for coming to its rescue.

Ultimately, the company passed, but not before senior officials of the Treasury Department and the Federal Reserve Bank of New York gave a presentation to AIG's board, according to *The New York Times*.

It wasn't the only recent instance where federal regulators, to paraphrase the late Dangerfield, got no respect. Indeed, the problem is going global. Other countries, mindful of the regulatory failures that preceded the 2008 collapse, are openly bristling at Washington's efforts to reassert its global economic leadership, an uncharacteristic stance with far-reaching implications.

The issues we want to focus on are international connections, said David Skeel, corporate law professor at the University of Pennsylvania and author of *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences*. "But we're seeing fallout. There's a lot less deference to the U.S. than there used to be. There's less of a feeling that the ways we do things are superior."

Why the resistance? Some blame a lingering bitterness over the institutional failures that were a core cause of the 2008 economic collapse. Once the world's regulatory standard-bearer, the market meltdown revealed that U.S. financial oversight was rife with industry-friendly regulations. There remains the issue of a complicit Congress, dependent on campaign contributions from Wall Street. And even when regulators mean well, the difference between the checks that agencies should perform and the balances of people and money required can seem woefully lopsided.

That institutional ineffectiveness is crimping American credibility at a critical juncture. The dangerous derivatives trading that drove AIG to the brink of collapse is still largely unregulated. Last year's London Whale trading scale at JPMorgan demonstrates it's an ongoing threat.

True reform clearly requires extensive international cooperation. Yet, many countries seem wary of

Washington's ways -- and mistrustful of its motivations.

American regulators still lead in influence, "but not the way they once did," Harvey Pitt, the former chairman of the Securities and Exchange Commission, told me. "If you're the leader you can have a lot of sway, but not if you embrace what I call American geocentrism."

Border disputes

A closer look at a recent episode involving the Commodity Futures Trading Commission, or CFTC, illustrates the dynamics at work.

Title VII of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* put the CFTC, primarily, in charge of bringing swaps, a form of derivatives, under regulatory oversight. Previously, derivatives were largely unregulated.

(Derivatives are complex, and come in all shapes and sizes. But at their simplest they act like insurance policies against financial shifts. But when movements are unusually swift, steep and large, as when the subprime mortgage market collapsed, the damage can quickly rip through the entire system.)

The danger, of course, is that if U.S. laws are too strict, and apply only domestically, rogue practices will simply migrate to the country of least resistance. In an age of electronic trading, trading can be conducted anywhere.

"As the (CFTC) and the international regulatory community move forward, we all recognize that risk has no geographic boundary and money can move in and out of markets and jurisdictions in milliseconds," Gary Gensler, the CFTC chairman, said recently.

But if an international standard is developed, and everyone adheres to it, that problem could be curtailed. So last year, the CFTC announced plans for a set of rules governing cross-border transactions in swaps. Much of it focused on defining a "U.S. person," which would include U.S. corporations and affiliates overseas. CFTC standards regarding derivatives would apply to foreign entities trading swaps with U.S. persons.

It was a bold move at extra-territorial reach for the CFTC -- and the reaction was a furious rebuke. "Washington, we have a problem," pronounced Patrick Pearson, head of the financial infrastructure unit at the European Commission, at a November meeting of international regulators, according to*Bloomberg News*.

Other countries, including traditional economic allies like Japan, also balked. And on Dec. 21, Gensler announced he was tabling the cross-border transaction rules until next summer. The delay "provides time for the (CFTC) to work with foreign regulators," he said.


Gary Gensler, current Chairman of the CFTC

Beat the clock

In isolation, the CFTC's difficulty in asserting its authority might not seem alarming. America regularly has disputes with even its closest economic partners. And some sources interviewed said Gensler should have known other countries don't like being told what to do. (A CFTC spokesman said Gensler wasn't available for an interview.)

As for the delay -- well, that's more the norm than the exception with Dodd-Frank. As of Jan. 2, regulatory agencies overall have missed

roughly 60 percent of the law's required rule-making deadlines, according to the Polk Davis law firm, which tracks the law. (Gensler has testified to Congress that his goal is to construct rules "in a deliberative way -- not against a clock.")

But to some skeptics the endless inaction smacks of deliberate dead-end dithering -- and gives financial giants time to lobby for more palatable rules.

"Wall Street and its army of lobbyists will use the additional time to continue their war on financial regulation that may hurt their profits, but which will protect the American people from having to bail them out again," Dennis Kelleher, President and CEO of a pro-reform group called Better Markets, said when the cross-border transaction rules were delayed. "If the rules don't apply overseas, then U.S. firms will just move their businesses to offshore markets and avoid the rules that protect U.S. investors, markets and economy."

In a follow-up interview, David Frenk, the director of research at Better Markets, said that, with Dodd-Frank, "it's staggering the impact the industry is having with this thing."

As for cross-border transactions rules, "I think we'll end up with a compromise that waters it down," he said. "That's not a good outcome. The statute is there for a reason."

Sizing up the situation

Perhaps. But some complain that Dodd-Frank doesn't seem to recognize regulatory realities. And even former Rep. Barney Frank, the Massachusetts Democrat whose name is on the law, acknowledges it has one significant shortfall.

One issue is this: the notional value of derivatives contracts around the world exceeds $600 trillion, according to the Bank of International Settlements.

The CFTC has approximately 700 employees in total. CFTC employment is up about 10 percent from the 1990s, according to a budget request Gensler filed last year with Congress. But the futures market has grown fivefold in that time, and Dodd-Frank added oversight of the swaps market, which is eight times bigger than the futures market.

So the question isn't so much if the CFTC has the right ideas, but whether it's big enough to implement them. Pitt, the former SEC chairman, used an analogy to illustrate the dilemma.

"When I was little, I had a doggie and I worried that he chased cars," Pitt said. "And I was never sure what would happen if he caught one."


Harvey Pitt, 26th Chairman of the SEC (2001-3)

Jeff Harris, a former chief economist at the CFTC, and currently a finance professor at Syracuse University, said size isn't the only thing that matters. Other issues are experience and expertise.

Traditionally, the CFTC oversaw markets in agricultural commodities like soybeans. Putting together massive international agreements on regulatory restructuring is something else altogether.

"The CFTC hasn't historically been at the table for negotiations of this type," Harris told me. Furthermore, because derivatives were previously unregulated, other countries are being asked to put their faith in a U.S. system that is actually a work in progress.

"Part of the problem with Dodd-Frank is, it steps into areas where

there wasn't much regulatory oversight at all," Harris said.

Twice as nice

Other observers say Dodd-Frank ignored a relatively simple but potent fix, for the reason that it might crimp Congressional campaign fundraising.

The issue is merging the CFTC with the much larger SEC. Experts say it's only logical, given the scarcity of regulatory resources. "Merging the SEC and CFTC has been a no-brainer for decades," Skeel, the corporate law professor at Penn, told me.

Frank, who didn't run for re-election, concurred. "The existence of a separate SEC and CFTC is the single largest structural defect in our regulatory system," he said in a November press release.

The stumbling block is that the CFTC doesn't report to the same Congressional committees as the SEC. More committees mean more members of Congress to receive campaign money.

It's particularly relevant here, because FIRE -- for finance, insurance and real estate -- was the most generous sector of all in the 2012 campaign cycle, contributing more than $573 million to various candidates, according to OpenSecrets.org.

Frank introduced legislation -- whose prospects are bleak -- to merge the agencies in November. Adding it to Dodd-Frank would have doomed the law, he said. "Had we sought to merge those institutions in the overall financial reform bill, it would almost certainly have caused the defeat of the legislation," he said.

The platinum standard

The global resistance to U.S. leadership, and the plodding implementation of Dodd-Frank, is in stark contrast to Washington's regulatory heritage.

Indeed, historically American regulators were a veritable rapid response team whenever -- and wherever -- economic disasters struck. In 1987, for instance, a new Federal Reserve chairman named Alan Greenspan moved quickly to stabilize world financial markets after the infamous Black Monday stock market crash.

And the U.S., either on its own or in concert with international bodies like the International Monetary Fund, played lead roles in dramas like the Mexican peso crisis of 1994 or the Asian economic panic of the late 1990s.

But the current impasses reflect the cost of lost credibility after regulatory failures of the kind that preceded the Great Recession. And in many ways, that may prove to be the greatest loss of all.

Said Pitt: "One thing we've seen with the subprime meltdown, Enron and other scandals is, the U.S. regulatory regime is not perceived as the platinum standard."

February 11, 2013

Burning Down the House

Gregg Fields

A new federal lawsuit against Standard & Poor's raises a vexing question: Where is the line between an opinion that is paid for, and one that is bought?

Burning Down The House: Dependency Corruption Issues in Credit Rating Practices

Who knew that tweaking the lyrics to a Talking Heads song could so accurately reflect what happened during the mortgage meltdown?

In March 2007, an analyst at Standard & Poor's noticed something about the subprime mortgage-backed securities that had received relentlessly rosy ratings from S&P: They were crashing.

So the analyst sent an email to his colleagues, providing his own version of the Talking Heads' classic "Burning Down The House."

"Subprime is boiling over/ Bringing down the house," one of his three stanzas read in part. It was a fitting tribute to a band also known for their concert movie, "Stop Making Sense." The analyst even videotaped himself singing his ditty, while his S&P coworkers laughed.

Heart of the matter

That picture -- of S&P fiddling while its customers got burned -- is one of several disturbing take-aways from a civil lawsuit filed last week against S&P and its corporate parent, McGraw-Hill Cos. The case was filed in U.S. District Court for the Central District in California by the Department of Justice.

The DOJ claimed S&P's actions on how it rated mortgage-backed securities -- and a related type of investment known as collateralized debt obligations -- cost federally insured financial institutions more than $5 billion. And it didn't have to happen, U.S. Attorney General Eric Holder said at a press conference.

"Put simply, this alleged conduct is egregious -- and it goes to the very heart of the recent financial crisis," Holder said.

In examining the voluminous case -- it runs 119 pages long -- a picture emerges of a system that appears to be built on a foundation of a perfectly legal form of dependency corruption. (This isn't a criminal case -- the lawsuit is seeking damages suffered by federally insured financial institutions.) More broadly, considering how the mortgage meltdown shook the world, the case is a prime example of why institutional corruption issues should be a public policy priority.

First, it's helpful to define some terms. Dependency corruption is a system where institutions responsible for serving the public become dependent -- typically, financially -- on relationships that skew their ability to perform their duties.

The example most often used is the relationship between Congress and large campaign contributors. Congress is dependent on large contributors to finance the massive cost of campaigns. This

dependency -- in the 2012 cycle, the financial industries were the most generous donors -- can skew the incentive Congress has to put the public first.

How it rates

At first blush, the S&P case might not seem to fit this model. Most notably, it isn't a government entity; it's part of a corporation that properly seeks to earn profits. And it doesn't take campaign contributions.

But S&P plays a quasi-regulatory, and vital, role in the financial markets. It is, in fact, designated a nationally recognized statistical rating organization, or NRSRO, by the Securities and Exchange Commission. There are only ten.

S&P rates creditworthiness. And the case filed last week concerns its involvement in assigning ratings to residential mortgage-backed securities, or RMBS, from 2004-07.

It was a heady time, with the housing market booming and investment houses buying up massive pools of home loans that became the collateral for securities then sold to investors.

That would all be fine, except for a couple of issues. One, many of the home loans were "subprime," or those made to impaired borrowers. As we now know, they were ticking time bombs that, when they exploded, produced collateral damage throughout the economy.

Two, and a more significant problem, according to the lawsuit: Investors bought the securities based on the presumably objective -- and laudatory -- ratings issued by S&P.

Co-dependent

And that's the difficulty, said Holder. S&P wasn't impartial. And in fact, the lawsuit contends that, in its efforts to protect profits, S&P kept high ratings on questionable securities long after even its own employees were feeling queasy over soaring default rates. (At one point, some executives looked at the high defaults and thought they were typos.)

S&P "falsely claimed that its ratings were independent, objective and not influenced by the company's relationship with the issuers who hired S&P to rate the securities in question," Holder said, adding that "in reality, the ratings were affected by significant conflicts of interest, and S&P was driven by its desire to increase its profits and market share to favor the interests of issuers over investors."

The issue is one of dependency. S&P was paid by the people who created and marketed the securities being graded. Give them a low rating, and there's always a chance they'll go elsewhere. Cut an existing rating, and you risk losing a lucrative business relationship.

As even one unnamed S&P client told an analyst at the company: "I mean, come on, we pay you to rate our deals, and the better the rating the more money we make?" the client wrote in an email reprinted in the complaint.

"How are you possibly supposed to be impartial?"

The lawsuit details how S&P -- one of the more venerable names in American finance -- internally developed stricter analytical standards as the problems became clear. But they weren't implemented, in part because the company believed it could send clients to its rival, Moody's.

Furthermore, if S&P produced a rating the issuers deemed too negative, the client could reject the

analysis -- greatly reducing the fee S&P would collect.

20/20 Hindsight

Nothing has yet been proven in court, so it's important to characterize the government's accusations as "alleged." And it's worth noting that S&P's alleged victims include titans like Citibank and Bank of America, institutions not often described as naive.

For its part, S&P responded that it did nothing wrong, saying "20/20 hindsight is no basis to take legal action against the good-faith opinions of professionals."

The company added: "Claims that we deliberately kept ratings high when we knew they should be lower are simply not true." The company said that, in the past five years, it has spent roughly $400 million "to reinforce the integrity, independence and performance of our ratings" and "introduced more stringent criteria" to obtain the coveted AAA rating.

But the reality is that reforms of credit rating practices have a sketchy record of success. In fact, many of the episodes detailed in the lawsuit occurred in 2007. That would be the year after the Credit Rating Agency Reform Act of 2006 was passed.

That law, critics say, had a fatal flaw. It required the SEC to oversee credit rating agencies, but it specifically precluded the agency from regulating the "procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings."

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act mandated that the SEC form an Office of Credit Ratings. It's still a bit early to see how effective it will be, although it did send a report to Congress late last year discussing, in general terms, ways to strengthen the ratings system.

The road ahead

By the summer of 2007 -- several months after the unnamed analyst did his David Byrne imitation -- S&P (as well as other credit rating agencies) could no longer deny the obvious. Hundreds of securities got sweeping downgrades. Financial institutions had to record massive losses. The economy began to take on water.

In 2011, the permanent subcommittee on investigations of the U.S. Senate issued a massive report, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," that castigated the way ratings on mortgage-backed securities were propped up until it was too late.

"The most immediate cause of the financial crisis was the July 2007 mass ratings downgrades by Moody's and Standard & Poor's that exposed the risky nature of mortgage-related investments that, just months before, the same firms had deemed to be as safe as Treasury bills," reads the 639-page report.

The report added: "In the end, over 90 percent of the AAA ratings given to mortgage-backed securities in 2006 and 2007 were downgraded to junk status. When sound credit ratings conflicted with collecting profitable fees, credit rating agencies chose the fees."

It was a system that, according to the lawsuit, prolonged S&P's ride in the mortgage-backed market. But to use the title of another Talking Heads song, it also ultimately proved to be a road to nowhere.

March 9, 2013

John Reed: On the Value of Values

Gregg Fields

For those who study institutional corruption, one of the most confounding difficulties can be establishing its boundaries -- particularly the tipping point at which it veers into the criminal variety.

The challenge is particularly vexing for those examining the aftermath of the 2008 financial crisis. Wall Street recklessness pretty clearly crashed the world economy. A host of civil complaints -- and settlements -- have outlined egregious behavior at banks, credit rating agencies and other financial players. Which begs the question: How is it possible that no crime was committed?

In an insightful lecture Thursday evening, sponsored by the Edmond J. Safra Center for Ethics, one of the most noted financial figures of his generation shared his insights on the subject. John Reed, the former Citigroup leader, who became chairman of the MIT Corp. in 2010, made clear his distaste for the ways Wall Street evolved through the years, nurturing activities that would lead to the financial collapse.

But, he added, that doesn't automatically translate to a criminal activity. "Did the industry become corrupt?" Reed said, speaking to a receptive crowd in Austin Hall. "Yes, in my mind."

Crime vs. Corruption

Yet, he elaborated by noting that the corruption concerned the institutions' business models and corporate cultures. Ultimately, it resulted in the institutions becoming dependent on relationships that didn't serve the public interest. "I don't think it was largely a criminal thing," he said. "I think it was largely a corrupt thing."

What's the difference? Crime, obviously, relates to laws. Corruption of the kind Reed outlined relates more to values -- though not the financial kind. (His lecture was titled, "Shareholder value vs. values.")

For instance, when he joined Citibank in 1965 the highly regulated industry "was almost a utility," he said. "It was a world, at the time, where the customer was first." Citibank didn't even have a formal budget, he said, and earnings were something of a corporate afterthought.

As he rose through the ranks, Reed himself became known as one of the industry's top innovators. Most notably, he revolutionized consumer banking by leading a relentless push in the 1970s to install ATMs at Citibank branches, with the rest of the industry racing to catch up. He retired from Citigroup in 2000.

In his lecture, Reed spoke of several factors that, over time, converged to create the shift in American corporate values that led to the financial crisis. One, the comparatively genteel world of finance became more cutthroat, he said. An example was, in the 1980s, the widespread practice of "greenmail," where outside investors would buy stakes in companies, then demand a premium to go away.

That led to a growing fixation on "shareholder value." High stock prices could help thwart

greenmailers. And companies began adopting compensation based on stock options -- the theory being that management is rewarded if shareholders are. Compensation soared. In one case at his bank, he said, executives who were in line for a total of $40 million in bonuses instead got options which ultimately were worth more than $200 million.

An engineered crisis

For banks, an additional factor was the rise of so-called financial engineering. Traditional lending is a low-margin business, with a limited upside potential. So increasingly they turned to new products like mortgage-backed securities, which offered greater returns. Over time, a proliferation of other financial products came on line.

Profits rose, and banker pay soared. But in the process, the historic banking culture -- the values Reed encountered as a trainee in the 1960s -- were altered. Bankers were now traders rather than lenders. “Instead of being customer-centered, you become salesmen who sell products to investors,” Reed said. “All the inducements were running in the wrong direction.”

In the years preceding the financial crisis, the prevailing values led Wall Street to market questionable products like derivatives and subprime mortgages. “The industry started inventing things that weren’t so good,” Reed said. “We created a garbage industry.”

In a question and answer session following his lecture, Reed acknowledged being at the center of an event that some critics say contributed to the financial crisis. In 1998, Citicorp merged with Travelers Group, run by financier Sandy Weill. Travelers Group was a financial conglomerate whose properties included a namesake insurance company and an investment house called Salomon Bros. It was billed in *The New York Times* as the largest corporate combination ever.

The merger of all these financial businesses led to the repeal of the Glass-Steagall Act, which historically barred traditional banks from engaging in the riskier activities of Wall Street investment banks. Glass-Steagall’s demise, some critics contend, unleashed banks and helped inflate the massive credit bubble that would later burst and usher in the Great Recession.

“I wouldn’t do the merger” today, Reed said. “It was a mistake. Not on business grounds, but a mistake on social grounds.” Of commercial versus investment banking, he added: “I do believe now there is no upside to putting these two businesses together, and a tremendous cultural downside.”

The same players

He is a proponent of the proposed Volcker Rule. Part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Volcker Rule would re-build some of the old firewalls between investment and commercial banking. But the rule is yet to be implemented, bogged down by fierce industry opposition. “Anyone who says you can’t do it is just lying,” he said.

After retiring from Citigroup, Reed was named interim chairman of the New York Stock Exchange in 2003 after its previous chairman, Richard Grasso, resigned in a controversy involving his compensation. Reed agreed to do the job for $1.

Despite the passage of Dodd-Frank in 2010, Reed acknowledged not a lot has changed. For one thing, the people who led Wall Street before largely lead it now. “I was quite surprised the CEOs and boards continued as they were before,” Reed said.

Industry reforms have languished. Reed suggested one problem is Dodd-Frank itself. It is so big,

and so vague, that the ability of regulatory institutions to implement it is effectively blunted. Credit “the power of the lobbyists,” Reed said, adding: “It’s very much in their interest to have legislation that runs 10,000 pages.”

March 29, 2013

Whale-Sized Institutional Corruption

Gregg Fields

"It's a complete tempest in a teapot." JPMorgan Chase CEO Jamie Dimon on its London Whale trading losses, April 13, 2012

Clearly, Jamie Dimon has no gift for meteorology. When he made his infamous "tempest in a teapot" comment, the brewing storm of multi-billion dollar losses on derivatives at JPMorgan might more accurately have been described as a trans-Atlantic hurricane.

Whale-Sized Institutional Corruption: Regulatory Capture and the JP Morgan Derivatives Scandal

In a withering report released earlier this month, the Senate Permanent Subcommittee on Investigations paints a portrait of a multi-trillion dollar financial institution that gambled wildly on risky derivatives, freely rewrote their value to minimize reported losses, then doubled down on its bets when the red ink began to spew. All of this occurred under the allegedly watchful eye of American regulators.


Sen. Carl M. Levin (D-MI)

For many, the report was a sobering reminder that, five years after the economic crisis, reining in risky trading by banks is at best a work in progress. "Our investigation brought home one overarching fact: the U.S. financial system may have significant vulnerabilities attributable to major bank involvement with high risk derivatives trading," Sen. Carl Levin, the Michigan Democrat and chair of the subcommittee, said in an opening statement at a hearing on March 15, one day after the report was released. "The four largest U.S. banks control 90 percent of U.S. derivatives markets, and their profitability is invested, in part, in their derivatives holdings, nowhere more so than at JPMorgan."

(Some very quick background: In early 2012, JPMorgan's chief investment office – or CIO – in London "placed a massive bet on a complex set of synthetic credit derivatives," according to the report. These trades were "so large in size that they roiled world credit markets." The phrase London Whale was reportedly a nickname for a JPMorgan trader named Bruno Iksil, known for making huge bets on derivatives. Some co-workers also reportedly called him Voldemort.)

In reading the massive report, (click here to download) it is impossible to miss the role that institutional corruption – in the form of regulatory capture – appears to have played in enabling the London Whale scandal to occur.

Regulators in Captivity

The theory of regulatory capture is most often linked to George Stigler, a Nobel-winning economist. It refers to the process by which regulatory agencies come to be "captured" by the industries they are overseeing. From there, serving the needs of the industry takes precedence over protecting the public.

In the case of JPMorgan, it appears to have worked like this: JPMorgan's chief regulator was the Office of the Comptroller of the Currency. But as a practical matter, the report contends, JPMorgan called the shots. "The OCC tolerated resistance by JPMorgan Chase to regulatory requests and failed to establish a regulatory relationship that mandated the bank's prompt cooperation with OCC oversight efforts," the report reads.

The subcommittee examined more than 90,000 documents in the course of its investigation, and the report runs 300 pages long. Most of the attention has focused on how the trades by the bank's CIO – followed by an increasingly frantic salvage effort – went horribly wrong, yet undetected by the OCC. But while the report levels plenty of criticism at JPMorgan, it also castigates the OCC for disastrous neglect of its regulatory duties.

"Over the past two years, the OCC failed to notice or investigate bank reports of CIO risk limit breaches, failed to realize when monthly CIO reports weren't delivered, failed to insist on detailed trading data from the CIO needed for effective oversight, and failed to take firm action when the bank delayed or denied its requests for information," the report says.

Establishing Boundaries

How could an agency seemingly as powerful as the OCC be captured by an industry? It helps to remember that JPMorgan isn't your typical bank. It has assets of $2.4 trillion. At several points, the report suggests, the company successfully convinced the agency it was overstepping its mandate. "Along the way, at times, bank personnel lectured OCC examiners about being overly intrusive," the report notes.

Often, the bank would resist giving out information to regulators. Conversely, after some examiners complained, it responded by burying them with a database of 60,000 derivatives contracts that examiners found incomprehensible.

"While the OCC's difficulty in obtaining information offers additional proof of the bank's unacceptable conduct, they also highlight, once again, the OCC's failure to establish an effective regulatory relationship with JPMorgan Chase," the report found.

And on some occasions, when the numbers revealed an inconvenient truth, the bank forgot to report them. Because the actual value of derivatives can be difficult to determine, sometimes the numbers got "tweaked" to make the losses appear smaller.

All too often, the OCC simply took the bank's word for it. "Ultimately, the OCC's excessive trust in the bank allowed the bank to avoid scrutiny... and was a central reason for the OCC's failure to challenge the unsafe and unsound derivatives trading activity,'' the report says.

The OCC was so successfully kept in the dark that it learned of the enormity of JPMorgan's problems from news stories that began appearing in early April of last year. "The OCC told the subcommittee that it was surprised by the stories and immediately directed inquiries to the bank to obtain more information," according to the report. For reasons that aren't entirely clear, the OCC accepted JPMorgan's assurance that everything was fine. The OCC "actually considered the matter closed in late April," the report concludes.

While You Were Out

It helped that, at times, the OCC appeared to be asleep at the switch. For instance, JPMorgan did tell

the OCC when the trading loss reached $1.4 billion, big enough to trigger alarms. The regulatory response: nothing. It seems the examiner who normally reviewed that report “was then on vacation, his subordinates failed to notice the size of the loss and no one made any call to the bank to ask about it,” the subcommittee found.

JPMorgan’s London Whale scandal isn’t the only recent evidence of regulatory capture by Wall Street’s financial institutions. Another is the failure of Washington to implement the so-called Volcker Rule, named for former Federal Reserve Chairman Paul Volcker. The rule would theoretically restrict banks’ ability to trade in derivatives with their own capital – so-called proprietary trading – although conducting such services for clients would be permitted.

The Volcker Rule is contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act passed nearly three years ago. And it might have prohibited some of the London Whale trading. But the rule is yet to be adopted, in part because of relentless resistance by major banks. In fact, Dimon has been among its staunchest critics. (Dimon has acknowledged he was “dead wrong” when he made the tempest in a teapot comment, however.)

In May of last year, the OCC got a new comptroller – Thomas Curry, formerly a board member at the Federal Deposit Insurance Corp. and former commissioner of banks for Massachusetts. According to the subcommittee report, OCC officials initially assured him the JPMorgan losses were no big deal. Curry begged to differ.

Curry is seen by some as the reformer the OCC needs. Others don’t seem so sure. In a February hearing, Sen. Elizabeth Warren pressed banking regulators on the dearth of prosecutions stemming from the 2008 banking crisis. “We do not have to bring people to trial,” Curry said. “We have not had to do it, as a practical matter, to achieve our supervisory goals.”

What’s important to remember, Sen. Levin said at the recent JPMorgan hearing, is that regulatory failure like that exhibited in the London Whale saga must end. Regulatory capture, after all, is an insidious form of institutional corruption. More than a mere economic theory, it’s a threat to the wellbeing of millions of Americans.

“When Wall Street plays with fire, American families get burned,” Levin said. “The task of federal regulators, and of this Congress, is to take away the matches. The whale trades demonstrate that task is far from complete.”

April 5, 2013

How the Fed Came to See the Light

Gregg Fields

In 1913, Louis Brandeis, a future Supreme Court justice, wrote an article for *Harper's Weekly* that argued forcefully for greater transparency in government. "Sunlight," he said, "is said to be the best of disinfectants."

As it happens, 1913 is also the year the Federal Reserve Act was passed.

How the Fed Came to See the Light: The Growing Role of Transparency in Monetary Policy

But the newly created central bank didn't seem to share Brandeis's esteem for open governance. Shrouded in mystery, the powerful and surreptitious Fed produced a league of investigative economists known as Fed-watchers. The rare utterances by the Fed and the Federal Open Market Committee -- the arm that sets rates -- were said to be written in a dialect called Fedspeak, each word scrutinized for hidden meaning. Books about the Fed had titles like *Secrets of the Temple*, a 1989 bestseller by William Greider.

The closed-mouth approach was emulated by central banks around the world. As Montagu Norman, who became governor of the Bank of England in the 1920s reportedly said: "Never explain, never excuse."

That philosophy was firmly in place when Janet Yellen began work as a staff economist at the Fed in 1977. It was a time when "the conventional wisdom among central bankers was that transparency was of little benefit for monetary policy and, in some cases, could cause problems that would make policy less effective," Yellen, now vice chair of the Fed, told the Society of American Business Editors and Writers in Washington on Thursday, April 4.

Much has changed, in no small part due to the financial crisis, when a besieged Fed had to reassure a panicked world. Communication and transparency would play a vital role in stabilizing the global economy. That newfound openness continues, and Yellen made clear she embraces the Fed's greater transparency. In today's world the Fed doesn't just say what it has done, it outlines what it plans to do.

"The effects of monetary policy depend critically on the public getting the message about what policy will do months or years in the future." she said.

The next Fed chief?

Yellen's views on transparency are important for a couple of reasons. One, as Brandeis suggested a century ago, transparency can be an effective deterrent to institutional corruption. While there's room for debate, there is no question that the secretive Fed, as an institution, has often been criticized for policies that seemed to favor banks over people. Furthermore, some have argued that its failure to contain the asset bubbles in things like real estate contributed to the banking crash. (The Fed's dual mandate is to stimulate employment and contain inflation -- policy goals that often clash. Fed members who prioritize job creation are known as "doves" while inflation fighters are referred to as "hawks.")

Whether the criticisms are justified isn't the entire point. The simple fact is that the public often didn't know much about Fed policies that directly affected them.

Yellen's views are also noteworthy because she is considered the front-runner to replace Ben Bernanke when his term expires next year. If that should happen, there's every reason to believe the Fed would continue on a path toward greater transparency. (In terms of policy, she is known for being a "dove.") Married to Nobel laureate George Akerlof, she would be the first woman to lead the Fed.

"But it isn't just Yellen's second X chromosome that makes her interesting," John Cassidy, author of 2009's *How Markets Fail: The Logic of Economic Calamities*, wrote recently in *The New Yorker*. "In a field noted for its conservatism and adherence to free-market orthodoxy, she has long stood out as a lively and liberal thinker who resisted the rightward shift that many of her colleagues took in the eighties and nineties."

To be sure, the Fed's move toward transparency was glacial. In 1994, for instance, the FOMC began issuing bulletins when it changed policies on interest rates. But no details as to why were provided. In the early 2000s it began providing its views on the economic outlook.

But the need for clear and prompt communication went into overdrive when the Great Recession slammed the world economy. Suddenly, the Fed had to communicate with a world that was fearful and angry. When cutting rates to zero provided limited relief, the Fed had to invent, and explain, new policies. An example is the so-called "quantitative easing," where it tried to stimulate the economy not by lowering rates but by pumping liquidity into banks.

Crisis management

"The situation in 2008 and 2009 was like nothing the Federal Reserve had faced since the 1930s," she said. "Beyond the task of describing the new policies, extensive new communication was needed to justify these unconventional policy actions and convincingly connect them to the Federal Reserve's employment and inflation objectives."

The result was a Fed that embraced transparency with the vigor it once resisted it. In 2010, Bernanke asked Yellen to lead a newly created subcommittee on communications. In 2011, Bernanke took the unprecedented step of holding press conferences after the FOMC's quarterly meeting. They are streamed live on the Internet. It was, at the time, considering a revolutionary break with tradition.

In early 2012, the FOMC released a statement outlining its longer-term goals and monetary policy -- detailing, for instance, how it planned to let interest rates remain at record lows several years.

In the process, Yellen said, transparency was transformed from an experiment in accountability to a vital policy tool. That, she said, serves the public interest. For example, it takes the guesswork out of deciphering the Fed's long-term goals and strategies, reducing market uncertainty. "It's a revolution in our understanding of how communication can influence the effectiveness of monetary policy," she said.

No simple solutions

Clearly, transparency is no economic cure-all. Today's unemployment report -- which showed just 88,000 new jobs created last month -- shows the recovery is far from complete. Furthermore,

financial regulators have come under fire for the sluggish pace at which the Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in 2010, is being implemented.

When I asked Yellen about Dodd-Frank, she said the sheer size of the mandate -- the law is over 2,300 pages long -- has created quite a logjam.

“It has been an enormous challenge to implement all that is in Dodd-Frank,” she said. The Fed made a list after the law passed, she said, and identified 257 separate projects required by Dodd-Frank. Furthermore, adopting financial rules requires a great deal of time-consuming cross-agency cooperation, both in Washington and around the world. “We’re working with regulators all around the globe to see if we can move together jointly,” she said.

Looking ahead, Yellen said it’s possible that an improved economy may eventually take the urgency out of Fed communications. “But I hope and trust that the days of ‘never explain, never excuse’ are gone for good, and that the Federal Reserve continues to reap the benefits of clearly explaining its actions to the public,” she said.

April 12, 2013

Wheel of Fortune

Gregg Fields

In 2008, shortly after becoming chief of staff for the newly elected President Obama, Rahm Emanuel pondered the implications of the crumbling economy and pronounced: "You never want a serious crisis to go to waste."

Wheel of Fortune: As Regulators Spin Off Duties, Ex-Regulators Cash in as Consultants

It would appear that a select core of consultants employed by federal banking regulators took his advice to heart. A riveting Senate subcommittee hearing this week revealed how the foreclosure crisis may have wreaked unfathomable pain on millions of Americans, but for banking consultants certified by regulators, it meant a multi-billion dollar payday.

From an institutional corruption standpoint, the so-called Independent Foreclosure Review, initiated in 2011, bears scrutiny from several angles. From a revolving door position, the consulting firms who raked in huge fees are brimming with former regulators and other insiders. On the issue of transparency, what the consultants actually found remains largely undisclosed – even though the information is in the hands of regulators who ostensibly serve the public. As for conflicts of interest, there's the subject of whether regulators' first loyalty is to the public or the institutions they oversee. And there are unsettling symptoms of dependence corruption: The banks were paying the consultants who were examining them. Finally, there's the overriding issue of just why regulators are doling out contracts rather than do the job themselves.

What's clear is that this unprecedented effort to funnel public oversight functions to profit-driven firms on a massive scale was rife with problems that precluded achieving the primary public policy goal – assisting distressed homeowners. In a report released earlier this month, the Government Accountability Office listed a litany of issues and advised that "the foreclosure review process offers an opportunity for the regulators to leverage this experience to help ensure that similar difficulties are better addressed in future efforts." It was the second time the GAO issued a report critical of the foreclosure review.

Hope and Promise

Time will tell if the GAO's hopes are realized. But first, some quick background on the promising beginning when the foreclosure review effort was announced.

In 2011, 14 large mortgage servicers – including most of the country's major banks – were ordered by the Federal Reserve and the Office of the Comptroller of the Currency to hire the consultants to review foreclosures filed in 2009 and 2010. The mission: look for legal errors, shoddy paperwork and other problems, to determine possible damages. Sampling was allowed, to ascertain the error rate.

"These comprehensive enforcement actions, coordinated among the federal banking regulators, require major reforms in mortgage servicing operations," John Walsh, acting Comptroller of the

Currency at the time, said. “These reforms will not only fix the problems we found in foreclosure processing, but will also correct failures in governance and the loan modification process and address financial harm to borrowers.”

No question, many of the consultants hired knew banking – they were in fact former regulators themselves. Perhaps the most prominent consultant was Promontory Financial Group, founded by Eugene Ludwig, who formerly headed the OCC in the Clinton administration.

Though it was only founded in 2001, Promontory has quickly become known as a Washington power player. Just recently it also hired Mary Schapiro, who left as head of the Securities and Exchange Commission last December. Press reports regularly refer to Promontory as a “quasi-regulator” for its role as a conduit between government and bankers.

Regulators initially wanted the job done in 120 days. In fact, it’s a task that will never be completed. The Independent Foreclosure Review was scuttled prematurely in January, and a settlement with most of the banks, covering 90 percent of the cases, was announced. The agreement was touted as valued at $9 billion. However, homeowners are actually only entitled to $3.6 billion in cash, the rest of it in things like advice on avoiding foreclosure.

Regulators had let it be known that some recipients would get up to $125,000. But this week the Fed and OCC issued a payout schedule that showed a bare handful of people will receive that amount. Most of the recipients had mortgage servicing issues, but didn’t face foreclosure. For the majority of those the payment is just $300.

At Thursday’s hearing of the Senate’s subcommittee on financial institutions and consumer protection, both regulators and consultants defended their reviews, though acknowledging certain flaws. But Sen. Elizabeth Warren, the Massachusetts Democrat, said the process smacked of cover-up.

Little Specific Information

Warren said she and Rep. Elijah Cummings, a Maryland Democrat, had made 14 specific requests for documents from the OCC and the Fed since January. “You have provided only one full response, three partial or minimal responses and no responses to nine requests,” Warren said. “You’ve provided little specific information, such as the number of improper foreclosures.”

Sen. Sherrod Brown, an Ohio Democrat who chairs the subcommittee, said that the role of former regulators as consultants raises the troublesome issue of revolving door syndrome. Even if consultants and regulators mean well, the constant flow of regulatory talent to lucrative jobs at shops like Promontory produces what Brown called “cognitive capture.” In other words, the adversarial element of the banker-examiner relationship is supplanted with more symbiotic thinking. With “the influence of the revolving door, bright-line rules become all the more important,” he said.

Besides its former regulators on staff, Promontory’s advisory board includes Alan Blinder, the highly regarded Princeton economist and former vice chair of the Fed, Arthur Levitt, the former chief of the SEC, and Stephen G. Thieke, who was executive vice president of the Federal Reserve Bank of New York in the 1980s before becoming a managing director of JPMorgan. The company’s co-founder, Alfred Moses, was once special counsel to President Carter.

Such close ties might call into question the influence the independent consultants have with

regulators. But Daniel Stipano, the OCC's deputy chief counsel, maintained that's a non-issue.

"In all of these cases, the OCC considers the qualifications" of the consultants, Stipano said at the hearing. "The OCC also oversees and monitors the work of the consultants."

But that system failed – badly – during the Independent Foreclosure Review, both sides agreed, in one of the hearing's few moments of consensus. Consultants testified that it was immediately apparent that the 120-day deadline was unrealistic for reviewing 4 million home loans. Some consultants began sending work abroad, Brown said.

"We had a history of requiring banks to retain consultants in the past," said Richard Ashton, deputy general counsel for the Fed. With foreclosures, "we thought that model could be adopted. What we found out, in practice, was the scope was so extensive it just was not effective."

Brown, meanwhile, repeatedly asked why, if the program was so badly flawed, billing was allowed to rise to $2 billion before the plug was pulled. "I don't think that decision was driven by compensation being paid to consultants," Stipano, of the OCC, said.

The Outsiders

The Senate hearing was titled, "Outsourcing Accountability?" And its focus on outside consultants reflected a growing reality that has institutional corruption implications. Specifically, regulatory agencies are increasingly reliant on consultants because they lack the institutional resources to do the job themselves. This has the effect of introducing a profit-oriented constituency into an oversight function that is purportedly accountable first and foremost to the public.

"The problem with having the OCC do the job itself is, it's just beyond the means" of any banking agency, Stipano said. He said the agency might have needed to triple its staff to handle the foreclosure reviews, something that wasn't feasible.

After a recess, Brown returned to a situation that hinted at what students of institutional corruption sometimes call dependence corruption. The dynamics: The consultants are there at the behest of the regulators. But they're actually the client of the banks, who are paying the fees. (At Thursday's hearing, PricewaterhouseCoopers, one of the lead consultants, said it billed over $400 million conducting foreclosure reviews.)

"You work for the banks, they pay you, but you're supposed to represent the public interest," Brown said to several consultants who'd been asked to testify. "That's almost an inherent, automatic conflict of interest." It's a pattern that resembles the highly criticized pre-crisis pattern with credit rating agencies, which gave glowing ratings to toxic mortgage securities being offered by their clients.

Konrad Alt, managing director of Promontory Financial, conceded there's an issue. "There is an inherent conflict, and you are right to focus on it," he said. But he added that, "there are checks, and the primary check is regulatory oversight. We met with regulators constantly."

Clearly Not Transparent?

Warren, however, added that conflict of interest concerns extend to regulators as well. When the foreclosure review was announced in 2011, it was hailed as an effort to bring relief to besieged homeowners. But in practice regulators appear to be siding with banks, she said. As one example, consultants gathered data on foreclosures that appear to have violated laws. But the OCC is keeping

that and most other information collected to itself. Given the dearth of details, it's impossible to judge whether the settlement is fair or not, Warren said.

Stipano, the OCC official, said revealing information like error rates on foreclosures would violate confidentiality agreements it has with financial institutions, although it could occur in the future.

"So you've made the decision to protect banks, but not to help families that have been foreclosed illegally," Warren said. "You know individual cases where banks violated laws and you're not going to help the homeowners. Without transparency we can't have any confidence in your oversight or that the markets are functioning properly at all."

April 20, 2013

Capital Opportunities

Gregg Fields

Charles Lewis didn't plan a career as a crusading journalist in Washington. In fact, he had planned on going into politics himself. The Delaware native arrived in D.C. in 1974, as an intern for the late Sen. William Roth, a Republican.

Capital Opportunities: A Watchdog Journalist's Take on Washington's Legalized Corruption

The Watergate scandal was cresting, and it sparked a disenchantment that steered Lewis to reporting. "I didn't really become obsessed with corruption," Lewis said Thursday night, in a lecture sponsored by the Edmond J. Safra Center for Ethics. "But I began to notice patterns."

His journalism career included stints at ABC News and the 60 Minutes news program. But even as his career flourished, the former Eagle Scout became unsettled by a growing belief that Washington -- and corporate journalism -- operated by rules that all too often provided cover for abhorrent public governance. And one recurring pattern he noticed was that typically no laws were broken. "Most of the problems seemed to be legal," he said.

In 1989, Lewis left TV and founded the Center for Public Integrity, one of the pioneers of the nonprofit investigative journalism movement. "I don't necessarily recommend walking out of your job not knowing what you're going to do next," Lewis, who funded the startup himself, said. "But that's what I did."

The CPI has since won innumerable awards and salutations, and Lewis himself received a prestigious MacArthur Fellowship in 1998. But the CPI will perhaps forever be best known for revealing how the Clinton White House rewarded major donors with stays in the Lincoln bedroom.

"We are the skunk at the garden party," he acknowledged to *American Journalism Review* in a 2005 profile. The article noted that he got his start poking at power early, with a high school newspaper column that anonymously took administrators like the principal to task.

Reporting For Duty

When he founded CPI, Lewis was as frustrated with the clubby world of inside-the-Beltway journalism as with questionable conduct by government officials. An example: the dearth of reporting related to the Iran-Contra scandal. In Iran-Contra, high officials in the Reagan administration secretly sold arms to Iran in part to covertly raise money for funding Nicaragua's Contra rebels, which Congress had explicitly barred.

"Most reporters found out about it from the Attorney General announcing it," he said. The scandal led to the indictment of several top Reagan administration leaders, including Defense Secretary Caspar Weinberger. Weinberger would be pardoned by President George H.W. Bush prior to trial. Although the scandal dates back more than 25 years, the reality is that the coverup continues, Lewis said. "We still don't have all the Iran-Contra documents," he said.

Lewis left the executive director's job at CPI in 2005 and is currently a professor at American University in Washington, where he is executive editor of the Investigative Reporting Workshop.

In his talk, Lewis emphasized that, in most cases, egregious conduct by Washington's officialdom isn't illegal. That's the problem. "The thing that bothers me is this word corruption," he said. "Most people think it means illegal. It doesn't mean that, if you look it up. You can call it systemic corruption. I call it legal corruption." (And for the record, the Edmond J. Safra Center prefers the term "institutional corruption.")

Around We Go

An example of the kind of corruption Lewis was referring to: the unrelenting revolving door, where government officials leave to work for much bigger salaries at entities they formerly regulated. When the CPI looked at the U.S. Trade Representative's office, it found that 47 percent of people who quit went to work for foreign governments or corporations. In another case, he found that 80 percent of departing employees from the Superfund hazardous waste cleanup program left for jobs with contractors to the Environmental Protection Agency.

Besides the revolving door, he found that regulatory capture, a common institutional corruption syndrome, is very real in Washington. The U.S. Forest Service, for instance, was "basically shilling for the timber industry."

And the conflicts of interest arising from campaign contributions were symbolized when Congress refused to toughen food inspection standards -- pleasing powerful agribusiness interests -- despite rising numbers of E. coli infections. "Funny, that legislation requiring the USDA to do it just never made it out of committee," Lewis said.

Furthermore, a close examination of defense spending showed it primarily went to companies that gave lavishly to the political process, and frequently employed former military officials to do their bidding. "Essentially, what we found was 40 percent of all defense contracts have no competitive bidder," he said. "There's all this transparency issue."

Money Changes Everything

It is the defining role of money in Washington which Lewis finds the most intriguing. For instance, when magazine publisher Malcolm Forbes ran for president largely on a "flat tax" platform, Lewis took Forbes's financial disclosure forms to an accountant. The conclusion: a flat tax would cut Forbes's tax bill in half.

On a broader level, Lewis concluded that all the money funneled to candidates simply undermines democracy. "I noticed that the presidential candidate who raised the most money the year before the primaries was getting the nomination every time," he said. "It meant money was dictating our choices even before there was a single vote." He later added: "Money and power go together -- always."

That conclusion led to "The Buying of the President," a series of books, beginning with the 1996 campaign, that document the financial forces that determine who occupies the Oval Office. His assessment: "We have a really fundamentally broken system here." In Washington, he said, "we always say it's the most expensive election in history -- until the next election."

Despite having reached some somber conclusions regarding Washington corruption, Lewis actually

spoke with a gentle and self-deprecating tone. He acknowledged not having the answer to the institutional corruption problems plaguing Washington. “It’s not enough to throw the bums out in the next election,” he said. “It’s actually a much more endemic problem.”

But he did offer a theory as to why Frank Capra never made a sequel to *Mr. Smith Goes To Washington*. “It becomes a Stephen King movie,” he quipped.

April 25, 2013

Institutional Corruption and the Big Bang Theory

Gregg Fields

Like long-ago explorers of the Nile, those searching for the source of institutional corruption face a complicated task. Downstream, it's comparatively easy to spot the currents of cash, conflicts and captured regulatory agencies.

But where are the headwaters? This week, a proposed banking reform law provided valuable insight into how the process starts.

The bill unleashed a series of explosive reactions from Wall Street, where it was viewed as an invasion of their economic ecosystems. Powerful trade and lobbying groups, plus a recently minted industry-funded study, blasted the proposal. And in Congress, where financial industries are the number one donor, there was a deafening silence – not one co-sponsor signed on, according to the*Financial Times*.

So while the fate of the proposal remains uncertain, and its merits or lack of them can be honestly disputed, its hostile reception provided a rare glimpse at the moment of conception for a process that in the past gave rise to institutional corruption. Exhibit A would be the regulatory failures prior to the 2008 economic collapse.

Exhibit B might be what hasn't happened since. Five years after the crisis, safeguards against future publicly financed bank bailouts are yet to be instituted, amid perpetual Washington infighting and industry lobbying that totaled $482 million last year, according to opensecrets.org. By leaving taxpayers vulnerable to funding future bailouts, the public interest clearly hasn't been served – a key indicator for institutional corruption.

"If big banks want to continue risky practices, they should do so with their own assets," said bill co-sponsors Sens. Sherrod Brown, an Ohio Democrat, and David Vitter, a Louisiana Republican, in a prepared statement. "Our bill will ensure a level playing field for all financial institutions by ending the subsidy for Wall Street megabanks to have adequate capital to back up their liabilities."

TBTF, The Sequel

The legislation in question is nicknamed TBTF, for Terminating Bailouts for Taxpayer Fairness Act. It's something of a playful acronym because it takes aim at another TBTF – the so-called too-big-to-fail regulatory policy. Too big to fail holds that some banks are so systemically important that allowing them to fold would imperil the economy. Critics contend it's a license to, economically speaking, drive recklessly.

The battle for hearts and minds began in earnest Wednesday morning, when Brown and Vitter announced their proposal in an op-ed in *The New York Times*. "Progressives and conservatives can debate the proper role of government, but this is one principle on which we can all agree: The government shouldn't pick economic winners or losers," they wrote.

Too big to fail was the justification for government bailing out banks in 2008. The new law would require banks to raise their levels of capital, or net worth. That wouldn't end too big to fail. But it

would theoretically diminish the chances of bailouts because banks would have more resources to weather a downturn. The capital standard would be most rigorous, at 15 percent, for banks over $500 billion in assets: JPMorgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs and Morgan Stanley, according to Federal Reserve figures.

“Our number one goal is to protect taxpayers from financial risks and the best way to do this is by implementing a systemic solution, increasing the minimum amount of capital the mega banks are required to have,” Vitter said. (Under the bill, the U.S. would also walk away from the international Basel III banking reform measures.)

Almost immediately came the response from the Securities Industry and Financial Markets Association, or SIFMA. Among other things, it questioned whether banking regulation was the responsibility of the Senate. Reforms regarding too big to fail have been mandated by the Dodd-Frank Act, it noted. And abandoning Basel III “would be an abdication of U.S. leadership,” it said.

“We should focus on completing the remaining rulemakings mandated by Dodd-Frank instead of enacting new legislation that would undermine the U.S.’s standing in the global financial system,”SIFMA said.

How Things Don’t Work

It’s worth questioning, however, whether relying on Dodd-Frank is essentially voting for the status quo. The law passed nearly three years ago, and has become something of a poster child for institutional inertia. According to the Davis Polk law firm, which tracks Dodd-Frank, 63 percent of the law’s rulemaking deadlines haven’t been met.

In some cases, critics say the 2,300-page Dodd-Frank law corrupts the regulatory process by scattering oversight of banks among an almost unlimited number of agencies. These include the Securities and Exchange Commission, the Office of the Comptroller of the Currency, the Federal Reserve, the FDIC and the Commodity Futures Trading Commission. Regulatory capture is easier because banks can play one agency against another as they adopt inter-agency rules. Also, regulators are often outgunned by industry. SIFMA, for instance, has successfully sued the CFTC – which Dodd-Frank charged with regulating derivatives, without allocating any resources – to overturn new rules that got adopted.

The financial industry is also developing an arsenal of intellectual capital that makes the case against reforms. On April 9, a leaked draft of the Brown-Vitter proposal appeared in news reports. On April 10, the Clearing House Association, a trade group owned by the world’s largest commercial banks, released a fortuitously timed study by Oxford Associates. It concluded that raising capital standards for banks could mean a significant drop in economic growth – perhaps a loss of 1 million American jobs over nine years.

“We urge policymakers to carefully consider the economic and employment tradeoffs as they debate further increases to bank capital levels,” said Paul Saltzman, president of the Clearing House Association.

Curiously, the industry-funded study’s findings clash with previous studies by organizations like the International Monetary Fund and the Bank of England. The IMF’s 2012 study conceded tighter regulation might increase banks’ costs. “Yet banks appear to have the ability to adapt to the regulatory changes without actions that would harm the wider economy,” the IMF study said.

In explaining the disparate conclusions, the Clearing House said, “Oxford sought to improve upon the assumptions of prior studies to better align them to the economic and regulatory reality in the United States.”

The dueling studies aren’t the only conflicting narratives. For instance, several critics on Wednesday described the proposal as a “bank breakup” bill, even though it doesn’t call for that.

Good-Bye To All That

Ultimately, some Washington insiders were already writing the bill’s obituary. Sen. Tim Johnson, chairman of the Senate Banking Committee, has previously said he believes Dodd-Frank should be implemented before Congress tackles other financial regulatory issues, according to Bloomberg. The opensecrets.org website ranks securities and investment firms first in campaign contributions to Johnson, who’s from South Dakota, while commercial banks are third.

Furthermore, the ranking Republican on the Senate Banking Committee, Mike Crapo of Idaho, recently told Bloomberg he believes capital requirements are the job of regulators, not Congress. Crapo’s top two contributors are JPMorgan and Goldman Sachs, according to opensecrets.org.

Curiously, the one point of consensus regarding the bill was that too big to fail should be scrapped. “We continue to believe that no institution should be too-big-to-fail and that taxpayers should never again be put at risk in a future financial crisis,” SIFMA said.

But Brown and Vitter noted that, while Washington dithers, banks deemed too big to fail are actually getting bigger. According to Brown, the four biggest banks are today $2 trillion larger than before the crisis.

May 10, 2013

Banking on Tomorrow

Gregg Fields

Ever since the economic crisis, there has been one point of broad agreement: banking reform is needed. There is even a 2,300-page law, the Dodd-Frank Wall Street Reform and Consumer Protection Act, which demands it.

But the crisis occurred five years ago. Dodd-Frank is about to turn three. And yet, political and regulatory gridlock in Washington has resulted in surprisingly little progress toward overhauling how banks look, act, or are overseen.

Banking on Tomorrow: Why Today is Never Good for Financial Reform

The biggest banks, whose implosion produced the Great Recession, are today even bigger. The top four institutions have added nearly $2 trillion in assets since Washington bailed out Wall Street in 2008. And their profits have soared even as the rest of the country endures one of the most tepid economic recoveries in recent history.

This week, a conference organized by the Federal Reserve Bank of Chicago compellingly illustrated why financial reform remains, at best, a work in progress. As speakers from government, industry, and academia spoke, the only clear consensus was that no one agrees on how to proceed. The stalemate has produced the kind of public policy paralysis that is frequently an indicator of the phenomenon known as institutional corruption.

Thomas Curry, who heads the Office of the Comptroller of the Currency, the primary regulator of national banks, said the sheer size of the mission is part of the problem. Dodd-Frank, he noted, requires some 200 new regulatory rules to be written—most of which haven't been, according to Davis Polk, a law firm that tracks the law's progress.

Dodd-Frank demanded 70 studies of the law's impact. And there are more than 1,000 other provisions of Dodd-Frank that will directly affect financial institutions, Curry said. "Carrying out these mandates has been a major preoccupation for the regulatory agencies," he said. "The job is still not complete; important rule writing remains."

Unfinished Business

Indeed, one of the most glaring unwritten rules is the one named for former Federal Reserve Chairman Paul Volcker. The Volcker Rule is designed to prevent banks from gambling with their own capital on risky investments like derivatives, those complex instruments whose ability to plunge in value pushed banking to the brink. Once considered a crowning achievement of Dodd-Frank, the Volcker Rule remains—well, conceptual.

What's taking so long? At least part of the problem appears to be that, in Washington today, there is no end to the number of agencies that regulate financial services. Different sectors of the banking industry are regulated by the OCC, the Federal Reserve, the FDIC, the SEC, the Commodity Futures Trading Commission, and Congress. Furthermore, there is the wild card of federal courts,

where an agency's rules can be legally challenged—and frequently are overturned.

Turf wars among agencies, and the deep pockets of an industry that spends more than $9 million a week on lobbying, according to opensecrets.org, can produce protracted paralysis, Curry acknowledged.

"A certain amount of professional disagreement among agencies is inevitable," Curry conceded. "Before and during the financial crisis, it was sometimes the case that one agency identified a risk that it thought warranted joint action, and others disagreed. Sometimes, that meant action was not taken in a timely manner. We can't let that happen again."

Dodd-Frank supposedly takes a step in a unifying direction by forming the Financial Stability Oversight Council, which comprises the country's top financial regulators. But critics have questioned if it will diminish political influences on regulation, since the FSOC's chairman, by law, is the U.S. Treasury Secretary, a political appointee.

And on a practical level, there is ample evidence of endless inter-agency inaction on Dodd-Frank reforms. An example is the "too big to fail" policy, where some banks are deemed too crucial to the economy to be allowed to collapse.

The reckless behavior that brought on the banking crisis produced calls to end "too big to fail." But no one seems to know how to do that, and the language of Dodd-Frank is so complex that even academics who study the law disagree on whether it ends "too big to fail" or, in fact, codifies it.

Too Big To Jail?

The diffusion of regulatory power virtually precludes a unified response to the problem. Furthermore, U.S. Attorney General Eric Holder, in a comment earlier this year, suggested that big banks can't be reined in by government without risking collateral damage to the rest of the economy.

"I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if we do prosecute—if we do bring a criminal charge—it will have a negative impact on the national economy, perhaps even the world economy," he told a Congressional committee in March. In further hints at the daunting dogmatic divides crimping reform efforts, some speakers at the Fed conference, which is focused on so-called Systemically Important Financial Institutions, or SIFIs, said size isn't the problem, anyway. "It is essential that the concept of 'too big' be distinguished from 'too big to fail,'" said Rodgin Cohen, a partner at Sullivan & Cromwell law firm and a widely influential figure in financial and regulatory matters. "It should be recognized that 'big is bad' represents a departure from every other sector," he added. "In no other industry are the largest entities subject to greater requirements because of their size."

And the reality is that, even when regulators want to take actions that would protect the public, their institutional powers have been curtailed by a couple of decades of feverish deregulation. Mary Schapiro, who headed the SEC until late last year, related a personal example. During the crisis, a money market fund sponsored by the doomed Lehman Bros. investment house became illiquid, sparking a panicked run throughout the entire money fund industry. Calm was restored only after the Treasury stepped in with a temporary liquidity guarantee for investors.

Speak Up

To Schapiro, the episode revealed a clear need to impose reforms on money funds—such as requiring greater capital cushions against losses. But her idea went nowhere, drawing fierce opposition from the industry. She abandoned the idea when three of the five SEC commissioners sided against her. “I have long said I consider money market reform to be an important unfinished business,” Schapiro, who now works for Promontory Financial Group, a kingpin consulting firm in Washington, said Thursday.

While Schapiro ultimately failed at reforming money market funds, she indicated she didn’t regret going to battle. “When regulators identify a potential systemic risk . . . we must speak up,” she said.

May 10, 2013

The Shadow Knows

Gregg Fields

In the years since the economic crisis, so many Wall Street acts of galling greed and endless avarice have been brought to light that they've lost their ability to shock.

The Shadow Knows: Ben Bernanke Battles Non-Bank Banks

Nevertheless, from an institutional corruption perspective the roots of the debacle are still somewhat shrouded in mystery. How could regulators have not detected the tsunami about to crash into shore? How could the relatively insignificant market in subprime mortgages bring down financial titans that, economically speaking, had towered over the world for decades?

In an insightful speech on Friday, May 10, Federal Reserve Chairman Ben Bernanke provided fresh perspectives into the regulatory failures that preceded the crash, and outlined his agency's efforts to revitalize financial oversight. His remarks touched on several topics familiar to students of institutional corruption, such as the need for transparency and the proper enforcement authority, and resources, for regulators.

The bottom line, he added, is that there is no substitute for constant vigilance. It's a marked contrast to the pre-crisis years, when Washington—where financial industries are among the most dominant campaign donors and lobbyists—turned a blind eye toward abuses that would later wreck the economy.

"Systemic risks can only be defused if they are first identified," Bernanke said, speaking at a conference organized by the Federal Reserve Bank of Chicago. "That said, it is reasonable to ask whether systemic risks can in fact be reliably identified in advance; after all, neither the Federal Reserve nor economists in general predicted the past crisis."

Out of the Shadows

Bernanke took the helm at the Fed in 2006, on the eve of the worst financial crisis since the Great Depression. His tenure has been marked by an abrupt departure from historic Fed protocol. Traditionally, the agency was notoriously secretive. Under Bernanke, Fed monetary policy and economic goals are regularly relayed to the public. Bernanke's predecessor, Alan Greenspan, virtually never gave interviews. Bernanke holds quarterly press conferences. "He has led the Fed to new levels of responsiveness and transparency," Charles Evans, president of the Chicago Fed, said.

While transparency is often considered an antidote to institutional corruption, however, Bernanke's open style has its critics, as does his policy of near-zero interest rates—an effort to revive a moribund economy. "The time has come for the Fed to recognize that it cannot stimulate growth and that a stronger recovery must depend on fiscal actions and tax reform by the White House and Congress," Martin Feldstein, Harvard professor and chairman of the Council of Economic Advisers under President Ronald Reagan, wrote in *The Wall Street Journal* this week.

As Nobel laureate Paul Krugman put it in *The New York Times* on Friday, May 10: "For whatever

reason, many people in the financial industry have developed a deep hatred for Ben Bernanke."

Obviously Not Transparent

Of course, some may view the financial world's dislike of Bernanke as a good thing. Prior to the collapse, the cozy relations between Wall Street and Washington appear to have contributed to regulatory capture, characterized by the frenzied deregulation of banking.

In his talk, Bernanke said one explanation for the regulatory shortcomings preceding the crash was a lack of transparency. Specifically, much of the financial risk was created in the world of what's called shadow banking. The definition of shadow banking is often debated, but typically refers to organizations that perform financial functions but are outside the regulated banking system. Hedge funds, insurance firms, and money market funds are often cited as examples.

In the years prior to the crisis, the shadow banking system thrived, growing from an estimated $26 trillion in assets worldwide in 2002 to $62 trillion by 2007, according to the Financial Stability Board, an international regulatory body.

By way of contrast, commercial banks in the U.S. have assets of roughly $13 trillion, according to the Fed's most recent statistics. The shadow banking system's growth, Bernanke said, is at least partly attributable to the fact that "financial activities tend to migrate from more-regulated to less-regulated sectors."

Although shadow banking is perfectly legitimate and performs vital financial services, it operates without the explicit guarantees of federally insured banks. But in an era of deregulation, investors didn't seem to realize the difference. Meanwhile, shadow banks and those backed by the government became tangled in an interconnected web that ultimately ensnared both, Bernanke said.

"Investors were lulled by triple-A credit ratings and by expected support from sponsoring institutions—support that was, in fact, discretionary and not always provided," Bernanke said. "When investors lost confidence in the quality of the assets or in the institutions expected to provide support, they ran." Panic ensued.

Complexity Theory

Bernanke's comments reveal just how complex the issue of institutional corruption is when it comes to modern financial regulation. For instance, while there has been a great deal of emphasis on what regulators failed to see, the systemic risks of shadow banking flourished in places where regulators weren't allowed to look.

Additionally, in a world where money moves over the Internet, it isn't clear how regulators can hope to keep regulated banks and shadow banks from commingling. And of course the role of government backing raises the risk of moral hazards. FDIC insurance, for instance, was supposed to protect depositors. Yet, the bailouts of Wall Street actually protected shareholders, private investors, insurance firms like AIG and even most bank executives, very few of whom lost their jobs. (Virtually none have been prosecuted.)

As for the future, Bernanke held out hope that new powers granted by the Dodd-Frank Wall Street Reform and Consumer Protection Act will enhance regulators' ability to shine lights into shadow banking's darker corners.

Specifically, it creates the Financial Stability Oversight Council, which comprises the top financial

regulators. The theory is that this will bolster inter-agency cooperation and reduce the regulatory squabbling that has been known to occur.

Furthermore, the FSOC is allowed to designate non-bank companies as a Systemically Important Financial Institution, or SIFI. As such, it would be subject to stricter regulatory scrutiny. (As with almost everything involving Dodd-Frank, however, progress is slow. The SIFI designation process is underway, Bernanke said.)

Furthermore, the Fed is stepping up—and recalibrating—its monitoring of financial institutions. It is now placing greater emphasis on systemic risks, the kind that could bring the whole industry crashing down. Historically, it focused on the health of individual institutions.

Whether this will eliminate the kinds of regulatory failures that preceded the economic crisis isn't known. Nevertheless, the efforts appear to reflect the recognition by the Fed that oversight as practiced previously simply didn't work.

"This new regulatory framework is still under construction, but the Federal Reserve has already made significant changes to how it conceptualizes and carries out both its regulatory and supervisory role and its responsibility to foster financial stability," Bernanke said.

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The Tower of Institutional Corruption

Gregg Fields

In 1963, the political theorist Hannah Arendt produced "Eichmann in Jerusalem: A Report On The Banality of Evil," a chronicle of the trial of Hitler's infamous, murderous henchman. Arendt stated the controversial viewpoint, "The trouble with Eichmann was precisely that so many were like him, and that the many were neither perverted nor sadistic, that they were, and still are, terribly and terrifyingly normal."

A riveting—if at times dispiriting—new book by British journalist Adam LeBor puts Arendt's theory in a different context. It's titled "The Tower of Basel: The Shadowy History of the Secret Bank that Runs the World." (PublicAffairs, Perseus Books Group).

The Tower of Institutional Corruption: The Bank for International Settlements In The Nightmare Years

The book might have been subtitled, "The banality of institutional corruption." The shadowy organization that LeBor refers to is the Bank for International Settlements. For those who haven't heard of it, the BIS isn't the kind of place where you go to get free checking. It is a central bank for central banks.

And it is unquestionably powerful and influential. Among other things, it hosts the Basel Committee on Banking Supervision, the international agency that has been trying—with mixed results—to bolster capital levels for financial institutions around the world. And it also hosts the Financial Stability Board, which acts as a coordinator of economic regulatory authorities around the globe. According to LeBor, BIS members regularly meet in private meetings—every other month on a Sunday at 7 p.m.—over lavish meals to hash out, in essence, how to run the world.

The BIS is secretive, no question. As one example, its website notes that its archives are open to the public—provided the records are over 30 years old, "with the exception of a limited number of records."

Despite some high hurdles, LeBor succeeds at peeling away at least some of the BIS's facade to reveal a great deal of how it operates. Its founding statutes call for the BIS to "promote the cooperation of central banks and to provide additional facilities for international financial operations," LeBor writes. That benign sounding mission would later become the justification for participating in some of the most horrendous crimes in human history.

Setting The Stage

The BIS was formed in 1930, largely to process the World War I reparations required of Germany. It also performed the function of providing liquidity to European governments, which were struggling with economic instability, currency fluctuations and the Great Depression. Central banks of most large European countries joined to create the BIS. (The U.S. Federal Reserve did not join until 1994, although its allotted shares were held by American banking interests.) Basel, in neutral

Switzerland, was a natural headquarters pick.

BIS describes itself as the world's oldest international financial institution, which was a novel business model in 1930. One mechanism used to perform its duties was having countries assign their gold reserves to BIS accounts—though the gold itself might be stored elsewhere—and payments between countries were processed by officials in Basel.

By now, you've probably guessed where this is going. Adolf Hitler rose to power and Germany within a few years was unleashing its formidable war machine across Europe and setting the stage for what would become the Holocaust.

It would be reasonable to assume that the BIS then went out of business. Clearly, there weren't going to be any reparations forthcoming from the Third Reich. But the BIS became, in essence, an ATM for Berlin, LeBor argues, treating the murderous regime as if it were just another government. (The British-born LeBor, a foreign correspondent based in Budapest, clearly has the credentials for this work. His previous book, Hitler's Secret Bankers, examined collaboration of Swiss bankers with Nazis and was short-listed for Britain's prestigious Orwell Prize.)

He devotes a great deal of Tower of Basel to an episode which, though highly controversial at the time, is often overlooked by history. After Germany annexed the Sudetenland province of Czechoslovakia in 1938, Czechoslovakian leaders transferred much of the country's gold to two accounts at the Bank of England for safekeeping, LeBor writes. One account was in the name of the BIS and another was in the name of the National Bank of Czechoslovakia itself.

In early 1939, German officials demanded Prague hand over 14.5 metric tons of gold, supposedly to back Germany currency now circulating in the Sudetenland. In essence, LeBor notes, Berlin was demanding Czechoslovakia "supply the gold to pay for the loss of its territory."

A month later, Germany invaded Prague and Czechoslovakia ceased to exist. Three days later, the Reichsbank demanded the National Bank of Czechoslovakia order the gold in its BIS account transferred to Germany. They were also ordered to request the Bank of England transfer the 27 metric tons of gold in the National Bank of Czechoslovakia account there to Germany.

"The BIS transfer order went through," LeBor writes. He adds that "Nazi Germany had just looted 23.1 metric tons of gold without a shot being fired."

The Bank of England did refuse to transfer the gold in the National Bank of Czechoslovakia account there. Nevertheless, the BIS transaction gave the Third Reich a new source of funding with which to finance its war effort.

The process was repeated throughout the war years, as Germany used plundered wealth to stoke its war machine. Accompanying the looting of central bank assets were proceeds from the "Aryanization" of Jewish-owned businesses that were stolen from their owners. Meanwhile, Germany gained ever greater influence at the BIS, leading to the completely reasonable assumption that it had a firmly pro-Nazi slant.

Its multi-national staff—the president from 1940-46 was an American named Thomas McKittrick—got along well, LeBor reports. When the battles got within shooting distance—Basel borders Germany and France—the bank simply retreated to temporary quarters in the Swiss interior.

Institutional Blindness

LeBor's recounting of the nightmare years of World War II is fittingly chilling. And perhaps

unwittingly, LeBor's investigation raises a troubling question: At the BIS, where did the institutional corruption actually begin, and could it have been prevented or stopped?

One fact is undeniable: From the beginning, the BIS achieved immunity from essentially all banking regulation and international laws. Although it functioned as a central bank, it wasn't actually connected to a government. It was virtually self-governing. Located in neutral Switzerland, it gained another layer of protection by not being subject to even the notoriously secretive Swiss banking laws. For years it didn't bother to put a sign on its door. That autonomy continues.

The lack of transparency and accountability thwarted officials in Washington and Europe who wanted the BIS to be shut down. (At the Bretton Woods Conference in 1944, where plans for the post-war monetary system were developed, Norway, the U.S. and others worked to have the BIS dismantled. The effort ultimately failed.)

What is most shocking in LeBor's book is the moral blindness of BIS officials. Their goal was, apparently, to simply grease the wheels of global commerce. Their eyes were shut to the horrors in front of them.

After the war, the BIS reinvented itself as a natural team captain for the rebuilding of Europe. It didn't merely survive—it thrived. Its curved headquarters opened in 1977 and its multilingual workforce quickly earned it the nickname the Tower of Basel, a reference to the Tower of Babel story in the Bible.

Clearly, the BIS is far from the only institution shown to have been, at best, indifferent to the slaughter of Europe's Jews and the Nazis' other crimes against humanity. As a story in The New York Times recently noted: "The list of institutions and industries that have been accused of whitewashing their links to the Third Reich is long, including various governments, the Vatican, Swiss banks and American corporations like IBM, General Motors and DuPont."

Judging by other reviews, I'm also not the only reader to feel LeBor writes a bit too conspiratorially about the modern-day BIS. "Mr. LeBor's polemical tone makes his book compelling, though at times you wonder if he wrote it in a hut in the Idaho backwoods while waiting for the United Nations and the staff of Goldman Sachs to invade and carry off his firstborn," is how The Wall Street Journal put it.

But Lebor's important new book shows that the Third Reich didn't rely on bombs and bullets alone. It was also aided by the banality of institutional corruption.

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Simply Fab

Gregg Fields

The Beatles may have been the Fab Four, but at Goldman Sachs a few years back, Fabrice Tourre was the Fab One. The trader had a clear gift for enticing sophisticated investors into less than fabulous vehicles like subprime mortgage securities.

Simply Fab: Institutional Corruption and the Trial of Fabrice Tourre

The question that remains: can he prove as persuasive to the New York jurors who hold his fate in its hands? Tourre is facing civil charges brought by the Securities and Exchange Commission for his actions at Goldman Sachs.[1] Pundits have portrayed this trial as the beleaguered SEC's last chance to prove it can win big cases against Wall Streeters involved in the 2008 financial collapse. However, no matter what the jury decides, the clear verdict of this trial is that institutional corruption is a common characteristic along the Wall Street-Washington axis.

It's understandable if you've never heard of Fabrice Tourre. Goldman Sachs may be a titan on Wall Street, but Tourre was more of a rank-and-file foot soldier. When it filed its suit against him in 2010, the SEC's first reference to Tourre calls him an "employee." Officially, he was "a vice president on the structured correlation trading desk." He wasn't yet 30.

Despite his youth, Tourre was the central player in what would become a legendary episode in the mortgage meltdown. In 2006, a hedge fund named Paulson & Co., run by a man named John Paulson, began to suspect the subprime mortgage market was set to collapse.

Paulson saw a once-in-a-lifetime opportunity: make huge and complicated bets against securities backed by home loans likely to go bad. (This process of making money off an investment that goes south is known as selling short.) For help, he turned to Goldman Sachs and was led to Tourre.

Tourre, in turn, agreed to put together a security named ABACUS 2007-AC1. The reference to the ancient Chinese counting machine is ironic, because the mortgage-backed securities that went into it were picked largely because they didn't add up. Tourre, with heavy influence from Paulson, assembled a portfolio whose weakness was its greatest appeal, according to the SEC.

But Goldman's marketing materials to investors represented the portfolio as having been selected by a third company name ACA Management. Paulson's role wasn't mentioned at all. And "Tourre also misled ACA into believing that Paulson invested approximately $200 million in the equity of ABACUS 2007-AC1," when in fact Paulson was betting big that large losses loomed, according to the SEC complaint.

Paulson paid Goldman Sachs $15 million for putting the deal together. It closed on April 26, 2007. By October, a whopping 83 percent of the securities in ABACUS had been downgraded and the other 17 percent were on negative watch. Three months later, 99 percent of the portfolio had been downgraded. Investors were out $1 billion, which was the approximate profit for Paulson.

The Influence of Influences

In a recent paper, Lawrence Lessig, who heads the Edmond J. Safra Center for Ethics, offered this working definition of institutional corruption: "Institutional corruption is manifest when there is a systemic and strategic influence which is legal, or even currently ethical, that undermines the institution's effectiveness by diverting it from its purpose or weakening its ability to achieve its purpose, including, to the extent relevant to its purpose, weakening either the public's trust in that institution or the institution's inherent trustworthiness."

In that context, the Tourre case is a veritable textbook example of such influences, and of lost trust. Furthermore, the case has another trait common in cases of institutional corruption: no one has been accused of a crime. Goldman was a co-defendant in the SEC's case against Tourre, but all the charges are civil.

Paulson and his company have never been implicated by the SEC at all. Indeed, the SEC complaint includes a Paulson & Co. memo that suggests the company was simply taking advantage of an opportunity created by the mutual benefits Wall Street's major players reaped from churning out zombie securities despite the dangers.

"In my opinion this situation is due to the fact that rating agencies, (collateralized debt obligation) managers and underwriters have all the incentives to keep the game going, while 'real money' investors have neither the analytical tools nor the institutional framework to take action before the losses . . . are actually realized," the unnamed Paulson employee wrote. It is a situation that sounds a great deal like the phenomenon known as dependence corruption—where mutual interests skew institutional behavior in ways that don't serve the public interest.

According to an email obtained by the SEC, Tourre himself wrote an acquaintance: "The whole building is about to collapse anytime now. . . Only potential survivor, the fabulous Fab." Keep in mind that this was several months before the ABACUS deal closed.

The ABC's of the SEC

Another institutional actor in this case is, of course, the SEC. The agency managed to quickly get a$550 million settlement with Goldman just months after filing its complaint. It was the largest penalty ever assessed by the enforcement agency.

"This settlement is a stark lesson to Wall Street firms that no product is too complex, and no investor too sophisticated, to avoid a heavy price if a firm violates the fundamental principles of honest treatment and fair dealing," Robert Khuzami, the agency's director of enforcement at the time, said. While $550 million is unquestionably a lot of money, it's worth noting that in its most recent fiscal quarter Goldman's net earnings were $1.93 billion.

Furthermore, Goldman settled the case without admitting or denying the allegations against it. Settling cases without requiring the defendants to acknowledge guilt is a common SEC practice, but has drawn criticism that it reflects an abdication of institutional responsibilities, particularly in regard to investigating and determining what happened. In 2011, U.S. District Judge Jed Rakoff rejected a $285 million SEC settlement with Citigroup in a mortgage-related case. The SEC "has a duty, inherent in its statutory missions, to see that the truth emerges; and if it fails to do so, this court must not, in the name of deference or convenience, grant judicial enforcement to the agency's contrivances," Rakoff wrote. In something of a rare convergence, both the plaintiff SEC and defendant Citigroup have appealed his decision.

Finally, it's worth pondering why Tourre, who now is working on a doctorate at the University of Chicago, is the only Goldman employee who was pursued by the SEC. The SEC complaint makes clear that Tourre was in regular contact with other Goldman officials. The transaction was approved by Goldman's mortgage capital committee, "which included senior-level management."

In going after a virtual unknown, the SEC pattern is similar to one it followed in the Citigroup case referenced above. That, too, involved the marketing of risky mortgage-backed investments, but the only person brought to trial was a midlevel executive named Brian Stoker. A jury would later clear Stoker, and one juror later told The New York Times he was a bit baffled why the SEC cast such a small legal net. "I wanted to know why the bank's CEO wasn't on trial," Beau Brendler, jury foreman, told the Times.

1 Much of the details and quotes in this article are drawn from the 2010 SEC complaint filed against Tourre and Goldman Sachs.

PS, Aug. 2, 2013. Fabrice Tourre's trial lasted 11 days. On Thursday, Aug. 1, 2013, a Manhattan federal jury found Tourre liable for six of the seven civil fraud counts he faced. His punishment will be determined at future proceedings and may include fines and a possible ban from working in the financial industry.

August 2, 2013

On The Edge

Gregg Fields

It's relatively easy to spot common characteristics of institutional corruption. Things like conflicts of interest, way-too-cozy relationships between industry and government, and a general lack of transparency are often indicators that institutional actions are being driven by influences that don't serve the public interest.

On The Edge: The SAC Capital Indictment Draws a New Line on Institutional Corruption

Typically, institutional corruption has another common feature: It isn't a crime. Election financing may be dominated by mega-donors, and regulations often seem to ultimately favor those who spend the most on lobbying. But campaign contributions and aggressive lobbying are hardly criminal conduct.

A recent indictment in New York suggests that the legal sands of institutional corruption may be shifting, however. The case is United States of America v. S.A.C. Capital Advisors and several related corporate entities. SAC is a hedge fund run by financier Steven A. Cohen, who hasn't been charged himself, although he does face civil procedures from the Securities and Exchange Commission for how he ran his firm.

"As described below, this indictment charges the corporate entities responsible for the management of a major hedge fund with criminal responsibility for insider trading offenses committed by numerous employees and made possible by institutional practices that encouraged the the widespread solicitation and use of illegal inside information," the indictment, unsealed on July 25 by Preet Bharara, U.S. Attorney in Manhattan, begins.

The indictment then takes aim at an alleged corporate culture brimming with institutional corruption. "Unlawful conduct by individual employees and an institutional indifference to that unlawful conduct resulted in insider trading that was substantial, pervasive and on a scale without known precedent in the hedge fund industry," the indictment charges. The alleged actions took place between 1999 and 2010.

The allegations are similar to those the SEC has made in a number of civil complaints against the SAC organization and associated individuals. (The SEC doesn't have authority to bring criminal actions.)

The criminal indictment's language is striking for a couple of reasons. One, it makes clear this is not some mere civil inconvenience to be settled with a wrist-slap fine and a consent decree where the company neither admits nor denies guilt.

Secondly, it places the blame for the actions on an institution. Although some SAC employees have been charged separately—and some have already pleaded guilty—this indictment is notable in that it, in effect, criminalizes corrupt corporate cultures. In the fight against institutional corruption on Wall Street, it would seem, the stakes have been raised. And no doubt many would argue that it's about time, considering the dearth of prosecutions related to the financial collapse of 2008.

Trimming Hedges

A useful place to start the SAC story would be the definition of "hedge fund." What, exactly, is that? Despite being shrouded in secrecy, hedge funds are essentially private mutual funds for very rich people. They are largely unregulated. The word "hedge" refers to their historical role in using various trading strategies to hedge risks—particularly with an eye toward trimming potential losses—for well-heeled investors. However, modern hedge funds are most noted for aggressively seeking sky-high returns through the use of sophisticated financial instruments like derivatives contracts and highly leveraged transactions.

It's incredibly lucrative for some. SAC, for instance, typically charged its investors three percent of their assets annually, plus it got to pocket up to 50 percent of all investment returns, according to the indictment. Cohen's personal fortune has been estimated at north of $9 billion, although clearly it could be set for a large fall if SAC's investors flee. (He also stepped up to the plate and became aminority owner of the New York Mets. The Mets owners were in a financial pinch at the time over investments made with Bernie Madoff.)

SAC, according to the indictment, flourished by encouraging its portfolio managers and analysts to gain an "edge" on the competition. And this edge, says the indictment, primarily consisted of ferreting out inside information on companies, then making or selling investments based on this knowledge before it was publicly disclosed. SAC theoretically had internal compliance systems, but the indictment portrays them as so limited as to be no match for traders who stood to earn millions of dollars by shirking the rules.

"The predictable and foreseeable result, as charged herein, was systematic insider trading by the SAC entity defendants resulting in hundreds of millions of dollars of illegal profits and avoided losses at the expense of members of the investing public," the indictment says. They gained the inside information simply by currying favor from employees in the know at the companies whose shares they owned.

Drug Deal

Here's an example. In 2008, the SAC hedge fund's largest investment was $700 million in two drug companies, Elan and Wyeth. On July 18 of 2008, Mathew Martoma, a portfolio manager specializing in health care, obtained negative inside information on a drug trial Elan and Wyeth were conducting. The information came from a doctor involved in the trial, and Martoma went to Michigan to meet with the man in person. According to SEC documents, the man is Dr. Sidney Gilman, a former professor at the University of Michigan Medical School, who was overseeing the trial's safety monitoring committee. According to the SEC, Dr. Gilman settled and agreed to cooperate with the SEC. He also received a non-prosecution agreement with prosecutors.

On Monday, July 21, 2008, after receiving the negative information, SAC began selling its entire $700 million position in the companies, then shorted $260 million of the stock. (Shorting is a form of investing where you profit if a stock falls in price.)

The drug at issue was bapineuzumab, an experimental Alzheimer's experiment. According to a *Wall Street Journal* article on July 30, 2008, the trial results had been issued at the International Conference on Alzheimer's Disease and "remain inconclusive and may underwhelm many scientific experts and investors."

Noted Marketwatch.com: "Shares of Elan Corp and Wyeth were battered Wednesday, the day after

the companies released more clinical data on their hotly anticipated Alzheimer's therapy bapineuzumab."

By selling early, "The SAC Hedge Fund's profits and avoided losses from this illegal insider trading amounted to approximately $276 million," the indictment alleges. Martoma, who reportedly fainted the first time FBI agents approached him at his South Florida home last year, has been indicted for insider trading but has maintained he is innocent. He earned a $9.8 million bonus in 2008, according to SEC documents, but never was able to duplicate his performance that year and was fired by SAC in 2010.

Earlier this year, CR Intrinsic Investors, the SAC affiliate that handled the trading in the drug companies, agreed to pay the SEC more than $600 million to settle charges that it participated in insider trading.

A similar situation occurred the month after the Elan-Wyeth episode. An analyst named Jon Horvath learned on Aug. 18 from a contact that Dell, the computer maker, would soon be reporting disappointing earnings. On Aug. 26, SAC unloaded its $12.5 million in Dell holdings. Two days later, on Aug. 28, Dell indeed reported disappointing earnings. According to a CNNMoney.com clip at the time, net income fell 17 percent compared to the same quarter a year earlier. "Shares of Dell plunged after-hours on the news," CNNMoney.com reported. By selling early, SAC avoided losses of $1.7 million, the indictment says. (Horvath pleaded guilty to insider trading last year.)

What's Wrong

Although the institutional corruption concerns regarding the SAC allegations are pretty self-evident, they nevertheless bear a proper analysis.

Consider the simple issue of transparency. If one buys the premise that robust financial markets are good for society, then it only follows that the public must have trust in the integrity of those markets. Transparency can go a long way toward establishing such trust. But SAC, according to the civil and criminal cases, chose to invest based on secret information it gained illegally.

Another common indicator of institutional corruption is what is known as dependence corruption—where two parties are united by motivations that don't serve the public interest. A common example is the dependence of Congress on mega-donors, who depend on Congress for legislation that may not necessarily serve the public but, rather, the economic interests of the donors.

The SAC case provides a new facet to the dangers posed by dependence corruption. To wit, companies depend on large investors to support their stock price. Large investors depend on corporate performance to help their portfolios grow. If insider trading is allowed to flourish, a corporation would only naturally be motivated to tell large investors ahead of time if, say, a news event was going to impact the stock. It's only logical to presume that smaller investors would get material news later—they're simply less important in the scheme of things. As an example of what dependence corruption can do the public trust, think of the reputations of credit rating agencies and their banking clients following the implosion of highly-rated mortgage securities that preceded the housing collapse.

Another issue often linked to institutional corruption is the revolving door syndrome. It typically refers to public servants leaving for lucrative private sector jobs. But in the SAC case, the government alleges employees were hired primarily because they could provide the "edge" of inside information. In such a context, it's certainly plausible that insiders at a company could share

information with the hope of joining the hedge fund later. (A world where, as we have seen, Martoma's annual bonus was $9.8 million.)

To be sure, there are unanswered questions in the SAC case. Among the most noteworthy: Why wasn't Cohen indicted? In July, the SEC instituted administrative proceedings against him, based primarily on transactions that are detailed in the indictment against his companies. Yet, the current indictment refers repeatedly to "the SAC owner," and never mentions Cohen by name.

Game On?

The answer may be that, simply, the case isn't over. On July 30, for instance, Bharara, the U.S. Attorney in New York, brought charges against a research analyst formerly based in San Francisco. It's alleged the analyst fed information to Richard Lee, an SAC portfolio manager, about Microsoft and Yahoo. Lee pleaded guilty on July 23 to one count of conspiracy and one count of securities fraud.

Charles Gasparino, author of the newly published *Circle of Friends*, a book about the government's more recent investigations of insider trading, wrote in *Time* magazine last week that pundits who think Cohen has beat the rap are probably wrong. "In other words, don't be surprised if you see an indictment of Cohen in the coming weeks as well," he wrote.

For his part, Bharara hasn't publicly tipped his hand as to plans for Cohen. However, when he unsealed the indictments on July 25, he described the SAC organization in terms that made clear that the antidote to institutional corruption is institutional integrity—which sometimes requires the heavy weight of criminal prosecution. "Companies, like individuals, need to be held to account and need to be deterred from becoming dens of corruption," Bharara said in a prepared statement. "To all those who run companies and value their enterprises, but pay attention only to the money their employees make and not how they make it, today's indictment hopefully gets your attention."

August 22, 2013

One Holy Mess

Gregg Fields

They are scenes reminiscent of a Dan Brown novel: whispers of money laundering and connections to the mafia; a banker found hanging from the Blackfriars Bridge in London; and a powerful American consulting firm delving into the secrecy-shrouded financial arm of the Vatican.

One Holy Mess: Pope Francis Fights Institutional Corruption at the Vatican Bank

But the drama surrounding the Institute for Religious Works, commonly known as the Vatican Bank, is not a sequel to the controversial bestseller *The Da Vinci Code*. The Vatican's banking unit is in the middle of a firestorm of controversies and acknowledged lapses in oversight. The cleanup started under Pope Benedict XVI but has been thrown into high gear by Pope Francis. There are signs already that greater transparency and increased regulatory oversight are in the pipeline.

In a broader context, the saga of the Vatican's bank is a telling example of how, given the right conditions, institutional corruption can infest organizations blessed by moral authority and endowed with a mission of public service. It shows how institutional corruption can insidiously erode the public's trust in respected organizations, reducing the effectiveness of their leadership. It classically illustrates the moral hazards that arise when relations between the regulator and the regulated grow too cozy—in this case, they were virtually the same entity.

"To the consternation of the public and to the continued embarrassment of Catholics worldwide, the Vatican bank remains a rich source of material for Italian journalists, conspiracy theorists and anyone else who wants to build a case for Vatican intrigue," wrote Francis J. Butler, former president of the Foundations and Donors Interested in Catholic Activities, in a recent commentary for the independent U.S. newspaper National Catholic Reporter. "The question before Pope Francis is whether the elimination of the Vatican bank entirely—which would mean giving up about $86 million euro in yearly profits—would be the only sure way to be free of further financial scandal."

An Eternal Issue

The Vatican, of course, is one of the highest profile organizations in the world. In that sense, the pontiff's banking reform efforts will naturally be widely watched around the globe, particularly the 1.2 billion Roman Catholics. Its bank, which most commonly goes by IOR, the Italian acronym for Istituto per le Opere di Religione (in English, the Institute for Religious Works) has been a lightning rod for controversy almost since its founding by Pope Pius XII in 1942, in the depths of the horrors of World War II.

If Pope Francis succeeds in saving the IOR and restoring its credibility, the results may prove to be a persuasive template for those addressing institutional corruption in other powerful entities such as Congress or Wall Street. Yet, as with financial reform following the financial crisis, the effort to rehabilitate the IOR is now several years old, illustrating the intractable nature of institutional corruption.

“Since 2010 the IOR and its management have been working hard to bring structures and processes in line with international standards for anti-money laundering,” Ernst von Freyberg, the IOR’s president, said this summer in announcing a management restructuring that saw the IOR’s director and deputy director resign. Von Freyberg, a German industrialist, was hired to clean up the bank earlier this year. “While we are grateful for what has been achieved, it is clear today that we need new leadership to increase the pace of this transformation process,” he said.

Scandals linked to the IOR are hardly new. It has been accused, though never found liable, for colluding with Croatia’s collaborationist government to steal assets from Hitler’s victims during World War II. A suit filed in the U.S. by Holocaust survivors, Alperin v. Vatican Bank, was ultimately dismissed on grounds that IOR is protected by the Foreign Sovereign Immunity Act. (Collaboration controversies have also long dogged the Bank for International Settlements, based in Basel, most recently in the book *Tower of Basel* by Adam LeBor.)

In the 1960s, controversy flared when the IOR hired Italian financier Michele Sindona as a financial advisor. The problem: Sindona was a central player in a seemingly endless number of banking collapses and financial swindles in Italy. His major American holding, Franklin National Bank, collapsed in 1974—reportedly costing the Vatican tens of millions of dollars—and he eventually was given a 25-year sentence for fraud related to the debacle. He was later extradited to Italy to face other charges, and died in prison in 1986 of cyanide poisoning. Whether it was suicide or murder was never determined.

Perhaps the most notorious blemish on IOR’s past, however, is the 1982 collapse of Italy’s largest bank, Banco Ambrosiano, with which the Vatican, as a shareholder, had a strong working relationship. Banco Ambrosiano’s chairman, Roberto Calvi, whose Vatican ties had earned him the nickname “God’s banker” despite a conviction for illegal foreign exchange transactions, was laterfound hanging from London’s Blackfriars Bridge. An initial finding of suicide was later discredited and it is now generally accepted that he was murdered. (A highly fictionalized character based on Calvi was a subplot in Godfather III.)

“Our biggest issue is our reputation,” von Freyberg conceded in an interview with Vatican radio earlier this year.

Self-regulating

How could a city-state with a population of 800 become so enmeshed in international financial intrigue? In essence, the IOR operated much like an “offshore” banking haven like Grand Cayman or Bermuda. Like those small islands, the Vatican City-based IOR had sovereign status. Its regulator is the Financial Information Authority, an internal watchdog of the Vatican. In recent weeks, the Vatican has essentially conceded that this led to what students of institutional corruption might call regulatory capture. In early August, the pope issued a Motu Proprio—a decree at his own initiative—that increased the FIA’s powers of supervision over the IOR.

Those who study institutional corruption often conclude that a lack of transparency is a contributing factor. It’s a relevant point in this case, because the IOR was perhaps the least transparent financial institution in the world. No branches, no shareholders and essentially no central banking authorities to whom it must answer.

It also has a structure that significantly limits the constituencies to whom it must answer. It doesn’t make loans, for instance, or perform other traditional bank functions. Only people like Vatican

employees, clerics, and entities like charities and dioceses affiliated with the Holy See (the authority and government functions of the papacy) are allowed to have accounts. In one example of how inscrutable its operations were, the bank only developed a website in summer 2013.

Certainly, religious organizations are often granted a great deal of leeway in terms of privacy regarding their operations. However not many institutions own their own bank—one that, according to its new website, www.ior.va, has more than $9.4 billion in assets.

Outside Influences

Despite the publicly announced cleanup efforts, scandals have continued. One example concerns the case of Monsignor Nunzio Scarano. He was arrested earlier this year over an alleged plot to bring 20 million euros in cash into Italy. According to press reports, he is also being investigated for money laundering in southern Italy. The Vatican's criminal court has frozen Scarano's accounts.

It is worth noting, meanwhile, that the Vatican financial reforms, which gained traction under Pope Benedict XVI and are clearly gaining momentum now, came only after years of bruising international pressures. In 1989, the G-7 countries including the United States, Italy and the United Kingdom banded together to form the Financial Action Task Force, to coordinate international money laundering efforts. One of the biggest concerns then, at least for the U.S., was drug smuggling proceeds.

In the 1990s, Moneyval, an organization comprising smaller states belonging to the Council of Europe, was formed to combat money laundering. Global anti-money laundering initiatives gained new urgency after the terrorist attacks in 2001, with a number of international agreements forcefully lifting the shrouds of secrecy that had been one of the leading competitive advantages that banking havens historically enjoyed.

The Vatican only joined Moneyval in 2011, which led to a Vatican-requested review of IOR released last year. The report found the Vatican had "come a long way in a very short time" but that "further important issues still need addressing in order to demonstrate that a fully effective regime has been instituted."

Besides bringing in von Freyberg, Promontory Financial Group, the prominent Washington consulting firm, has been hired to conduct a forensic review of the bank's finances. In May, it signed an information sharing agreement with the U.S. Financial Crimes Enforcement Network (FinCEN).

"The IOR is engaged in a process of comprehensive reform, to foster the most rigorous professional and compliance standards. These efforts are based on the legal framework set forth by the Vatican, in cooperation with international bodies," von Freyberg, the president, says in a letter posted on theIOR website. "This includes implementing strict anti-money laundering processes and improving our internal structures. We are conducting an extensive evaluation of all our clients' accounts, with the aim of closing down those relationships that do not conform to our strict standards."

Restoring Faith

In that regard, von Freyberg has hit upon what many observers have missed about the scandals surrounding the IOR. True, there appear to have been a number of unsavory characters with whom it associated. But what likely attracted them was a system that was easily subject to influence. A mutually dependent relationship—one might call it dependence corruption—seems to have

developed between IOR and people that ultimately sullied the reputation of the institution. Long term, that undermined its moral authority.

As Lawrence Lessig, director of the Edmond J. Safra Center for Ethics, wrote recently: "Institutional corruption is manifest when there is a systemic and strategic influence which is legal, or even currently ethical, that undermines the institution's effectiveness by diverting it from its purpose or weakening its ability to achieve its purpose, including, to the extent relevant to its purpose, weakening either the public's trust in that institution or the institution's inherent trustworthiness."

That would suggest the IOR faces two challenges. One, it must create new systems that eliminate its vulnerability to the influences that lead to institutional corruption. Secondly, and perhaps more importantly, it must re-strengthen the credibility that lies at the heart of the public's trust.

The question in this case is whether it's too late. Pope Francis raised that possibility himself in a press conference earlier this summer. "Some say perhaps it would be better as a bank, others say it should be an aid fund, others say it should be shut down," he said, during the return flight from his papal visit to Brazil. "But the hallmarks of the IOR—whether it be a bank, an aid fund, or whatever else—have to be transparency and honesty, they have to be."

September 23, 2013

Obstructive Criticism

Gregg Fields

Five years ago this month, the collapse of Lehman Brothers heralded the arrival of the worst economic crisis since the Great Depression. A half-decade on, what's most shocking isn't how much has changed but, rather, how much hasn't.

Obstructive Criticism: Why Dodd-Frank Is Falling So Far Behind

The calls to prosecute the perpetrators? They have largely gone unheeded. And with the statute of limitations on most possible offenses running out, it's pretty clear that courtrooms won't be meting out meaningful punishment.

In terms of structural change, there were widespread demands to ban dangerous forms of securities trading by government-backed banks, to reinvent the way banks are regulated and even break up the largest institutions, in a repudiation of the long-observed "too big to fail" policy. "Too big to fail" contends that some organizations, if they sink, will take the economy down with them.

Earlier this year, a group of senators including Elizabeth Warren, the Massachusetts Democrat, and John McCain, the Arizona Republican, introduced a Senate bill with these goals in mind. The bill, called the 21st Century Glass-Steagall Act, after the Depression era law that separated Main Street commercial banks and Wall Street investment houses, would "reduce risks to the financial system by limiting banks' ability to engage in certain risky activities and limiting conflicts of interest."

Yet the proposal has gone nowhere. And the institutions at the heart of the crisis, their industry and even their leadership remains largely intact. In fact, in an America that has tired of supporting too-big-to-fail banks, it's worth noting that they're now even bigger. The four largest banks—JPMorgan, Citigroup, Bank of America and Wells Fargo—have assets of $7.8 trillion, according to the most recent Federal Reserve data. When the crisis hit, the top four had $1 trillion less in assets. (Wachovia, reeling in the crisis, was taken over by Wells Fargo, which replaces it as fourth-largest.)

"These banks are too big to manage and they're too big to regulate," Sen. Sherrod Brown, a Democrat from Ohio, recently told the Los Angeles Times. "Too-big-to-fail hasn't been fixed."

Depend On It

For students of institutional corruption, the crash and the responses to it were often, and accurately, attributed to the phenomenon known as dependence corruption. Dependence corruption is typically the result of an institution or individual having dual dependencies with dueling interests.

A frequently cited example is the credit rating agencies that simultaneously were supposed to provide guidance to investors in risky mortgage securities, while also pleasing their fee-paying clients, the investment firms selling the securities. The evidence is that the agencies' greater loyalty was ultimately to the latter.

And of course, there was the dependence corruption of Congress. As outlined by Larry Lessig, director of the Edmond J. Safra Center for Ethics, in his bestselling book *Republic, Lost*, Congress

depends on Wall Street donations for campaigns—a conflict with the Congressional mission to be "dependent on the people alone," as it was phrased in the Federalist Papers No. 52.

And yet, campaign contributions in federal races from the FIRE sector—which comprises finance, insurance and real estate—rose to $664 million in the 2012 election cycle from $513.3 million in 2008, according opensecrets.org. Lobbying expenditures for the FIRE sector topped $487 million last year, up $30 million since 2008.

Shortchanged

Why haven't things changed? The crisis produced a 2010 law that was supposed to yield fundamental change. It's called the Dodd-Frank Wall Street Reform and Consumer Protection Act. It is designed to bolster bank safety, empower regulators and, in the process, restore the public confidence that is all too often a casualty of institutional corruption.

But Dodd-Frank is now over three years old and is only plodding toward becoming the law of the land. According to Davis Polk & Wardwell, a law firm that closely tracks the law, some 280 regulatory rules were supposed to have been written by now. But the deadline has been missed for more than 61 percent of them.

Dependence corruption alone can't explain the slow pace. Although some regulators may have motivations for pleasing bankers—such as the possibility of going to work for them at higher pay—they clearly don't have the immediate financial dependence of donor-seeking Congress members or fee-based ratings agencies.

Rather, the inertia of Dodd-Frank reveals yet another form of institutional corruption. Call it*obstruction corruption*. Obstruction corruption is linked to, but different from, dependence corruption. Dependence corruption is characterized by mutually beneficial relationships that ultimately don't serve the public interest.

Obstruction corruption, in essence, is the mirror image of dependence corruption. Obstruction corruption prevents the formation of relationships that could produce reform. Laws that are long, complex and subject to interpretations that produce interminable delays are a frequent sign of obstruction corruption. It helps explain why more than 61 percent of the Dodd-Frank rules deadlines have been missed.

In its research, Davis Polk has several examples of how hopelessly obstructed the path to implementing Dodd-Frank is. For instance, many analysts have noted that Dodd-Frank is lengthy—over than 2,300 pages long.

But that's just a preview. In a highly entertaining infographic, Davis Polk notes that there have now been 15 million words of regulatory rules written—or 42 words published in the Federal Register for every word in the law itself. (It would also equal 28 copies of Tolstoy's *War and Peace*.)

That comes to 13,789 pages of Dodd-Frank rules—and remember, more than 60 percent of the deadlines haven't yet been met. If you're looking for a central source, forget it: the rules have been created by 10 different regulatory agencies.

Davis Polk found that 4,259 public meetings have been held regarding Dodd-Frank, and notes that the longest proposed rule, a mortgage disclosure requirement from the Consumer Financial Protection Bureau, is 342 pages long.

Washington Inaction

Robert Kaiser, the associate editor and senior correspondent of the Washington Post, was there when Dodd-Frank was created. He is the author of *Act of Congress*, a riveting recent book borne of months of eyewitness reporting while former Rep. Barney Frank and former Sen. Chris Dodd, both Democrats, pushed the measure through Congress.

In a recent lecture to the Edmond J. Safra Center for Ethics, Kaiser said the delays and complexity were no surprise. "You could not write Dodd-Frank regulations in Congressional committees," he said. It would simply take too long. "All big modern bills have left rule-writing to the regulators."

And that's a problem, Kaiser said. He used as an example the much-heralded Volcker Rule, named for former Federal Reserve Chairman Paul Volcker. The Volcker Rule is intended to prohibit banks from gambling with their own money on so-called proprietary trading, in risky securities like derivatives.

But amid a withering onslaught of lobbying and regulatory in-fighting, the effort has stalled. "The Volcker Rule, three years later, is not written," Kaiser said.

That delay points to the institutional corruption phenomenon that Malcolm Salter, Harvard's James J. Hill Professor of Business Administration, Emeritus and adviser to the Edmond J. Safra Center, refers to as "gaming."

Gaming is "one of the most corrosive forms of institutional corruption in business," Salter wrote in "Lawful but Corrupt," a December 2010 working paper. "Institutional corruption refers to company-sanctioned behavior and relationships that may be lawful but either harm the public interest or weaken the capacity of the institution to achieve its primary purposes."

Dodd-Frank, with its hundreds of required rules, is a prime gaming opportunity, Salter predicted at the time. And that proved true, he contends in "Is Financial Reform Being Gamed?," a paper published recently by the Edmond J. Safra Center. "The current rule-making process has already extended way beyond the two years originally envisioned for conforming to the Dodd-Frank Act—a result of the complexity of the issues involved, extensive comment periods of proposed regulations, aggressive industry lobbying, and the inability of regulatory agencies to agree on final regulatory language," Salter wrote. Like Kaiser, he argues that the fate of the Volcker Rule is far from certain, noting that among other problems, "Congress left plenty of leeway for regulators to design (bend?) how the final rule will look," Salter wrote.

Disinterested

Obstruction corruption and gaming appear to have gathered momentum in the deregulatory fervor that has gripped much of Washington for more than 20 years. But accompanying them has been an equally important trend that might be referred to as *dis*regulation. Disregulation refers not to the loosening of oversight, which we often describe as deregulation. Rather, it involves simply banning rules altogether.

For example, much of the economic carnage in 2008 was due to losses on derivatives, those complex and risky contracts that left the major banks way too leveraged for their own good.

But the derivatives market didn't collapse because of bad, or broken, rules. The truth is, there weren't any: the Commodity Futures Modernization Act of 2000 specifically obstructed

theCommodity Futures Trading Commission from regulating them.

Similarly, many Americans undoubtedly wondered where the regulators were when banks amassed such risky portfolios. Bank deposits are guaranteed by the FDIC, and taxpayers have the FDIC's back. Risky securities trading was historically confined to the trading houses like Merrill Lynch (and Lehman Bros.), which had no government backing.

However, the Gramm-Leach-Bliley Act of 1999 demolished the wall between Main Street banks and Wall Street traders. "Today Congress voted to update the rules that have governed financial services since the Great Depression and replace them with a system for the 21st century," then-Treasury Secretary Lawrence H. Summers said at the time. By repealing the Depression-era Glass-Steagall Act (which incidentally was just 37 pages long), Gramm-Leach-Bliley effectively disregulated banking.

As Kaiser said in his lecture: "Regulatory waiving has been a central part of the legislative process in this modern era."

Dodd-Frank may yet prove to be the true reform legislation that it was touted as in 2010. But if so, it will clearly have to overcome the institutional corruption challenges of dependence corruption, obstruction corruption and disregulation.

"Much of Dodd-Frank is dying on the vine," Bart Chilton, a commissioner with the Commodity Futures Trading Commission, which has been charged with regulating derivatives, told Yahoo Finance's "The Daily Ticker" earlier this year. "Lobbying, litigation and lawmakers who have tried to defund and defang Dodd-Frank have all brought rule writing to a crawl."

October 1, 2013

Blurred Lines

Gregg Fields

When people become members of Congress, they take an oath that is, overall, pretty inspiring. But with the federal government in the midst of a progressive shutdown, it is worth probing a bit deeper to reconcile the oath of office with the hopeless gridlock that has gripped official Washington for several years now.

Blurred Lines: Institutional Corruption and the ethics of a government shutdown

"I, (name of Member), do solemnly swear (or affirm) that I will support and defend the Constitution of the United States against all enemies, foreign and domestic; that I will bear true faith and allegiance to the same; that I take this obligation freely, without any mental reservation or purpose of evasion; and that I will well and faithfully discharge the duties of the office on which I am about to enter. So help me God." Each member of Congress must make this oath before being sworn in.

While there is more than enough partisan political mudslinging to go around, and much speculation on who will benefit or suffer the most politically from the shutdown, the horse-race analysis that focuses on who will win, place or show doesn't sufficiently address the ethical issues involved.

For the purposes of research conducted at the Edmond J. Safra Center for Ethics, the broader question might be examined through the prism of institutional corruption. That question might be framed this way: Is the government shutdown a form of, a result of, or a cure for, institutional corruption? If Washington is riddled with institutional corruption—and a great deal of research from the Safra Center indicates it is—then it is legitimate to ask if Congress is supporting and defending the Constitution with this shutdown. Conversely, it's worth exploring whether members of Congress are failing to faithfully discharge their duties of office.

Historical Perspectives

Of course, feelings of distrust and disgust related to government have a long and prominent history in the United States. Those sentiments can be found at virtually any point along the left to right political continuum. For the modern conservative movement, one compelling view of government was framed in Ronald Reagan's first inaugural address in 1981. "In this present crisis, government is not the solution to our problem; government is the problem," Reagan told a stagflation-weary country, which warmly embraced his message, if his two landslide victories are any indicator.

Nevertheless, there is also widespread evidence that Americans of many different political persuasions believe shutting the government down is, to paraphrase the oath of office, an evasion of Congressional duties. Even believers in American exceptionalism seem to feel this is—well, an exception.

A Washington Post-ABC News poll released Monday found that only one in four approve of Congressional Republicans' handling of the budget negotiations that have produced the standoff. Yet, Democrats didn't fare a whole lot better, with just 34 percent approving of their conduct.

President Obama, whose landmark Affordable Care Act produced the funding feud with the House that led to the shutdown, fared best. But with 41 percent approval he still fell well short of a majority.

To help delineate the role of institutional corruption in the current imbroglio, it's useful to turn to the writings of Dennis Thompson. Thompson, the Alfred North Whitehead professor of political philosophy at Harvard, developed the concept of institutional corruption in the 1990s, particularly in his book *Ethics in Congress* (The Brookings Institution, 1995).

"Like all forms of corruption, the institutional kind involves the improper uses of public offices for private purposes," Thompson wrote in his introduction. "But unlike individual corruption, it encompasses conduct that under certain circumstances is a necessary or even desirable part of institutional duties."

The role of money was central to Thompson's argument. Money "can corrupt the quality of decisions and policies of government. But money can also corrupt the process, even when it is not possible to point to specific ways in which the outcomes of the process are corrupted," Thompson wrote on pages 115-116.

Those words were written 18 years ago, in a year the federal government also shut down. In that sense, they accurately reflect the gridlock that has now crippled the capital of the world's most powerful country for nearly two decades. Whether you feel the blame for any shutdown is with the House, the Senate or the White House, it's worth noting that the leaders of each branch proclaim their conduct is justified. The shutdown may seem to be a corruption of the oath of office. But as Thompson noted, it's hard to pinpoint specifically where the process became corrupted.

The Spirit's Not Willing

In the book *The Spirit of Compromise* (Princeton University Press, 2012), co-authored by Thompson and Amy Gutmann, president of the University of Pennsylvania, they make the case that breaking through such logjams is a prime responsibility for those in office. "Compromise is difficult, but governing a democracy without compromise is impossible," they wrote.

Set aside for a moment one obvious question: If a democracy isn't functioning, is it still a democracy? Rather, consider what about Washington today makes compromise an unattractive option. After all, the president and members of Congress run for positions of governance.

The evidence clearly suggests voters think government should be running. In a September 23CNBC All-America Economic Survey, Americans opposed defunding Obamacare 44 percent to 38 percent. And if it meant shutting down the government and defaulting on U.S. debt, 59 percent of Americans oppose defunding Obamacare. So clearly Congress isn't dependent on the people alone when making its governing (or non-governing) decisions.

What are these other dependencies? A great deal has been written about the influence of Tea Party activists on the Republican efforts to defund Obamacare, which is at the heart of the budget impasse producing the shutdown.

But it's important to point out that Obamacare, which passed along partisan lines, was itself full of gifts for deep-pocketed political players. The White House, for instance, preserved pricing power for pharmaceutical companies enacted under the Medicare Prescription Drug, Improvement and Modernization Act of 2003, winning vital support for Obamacare from Big Pharma.

Similarly, the White House abandoned plans for a “public option” form of health care insurance that would have saved government an estimated $150 billion by increasing competition with private health insurance providers, noted Lawrence Lessig, director of the Safra Center, in his 2011 book*Republic, Lost*. “The lesson here is obvious,” Lessig wrote on page 184. “There are ‘institutional constraints’ on change in America.”

(Those constraints perhaps explain the sluggish pace of implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, the other landmark legislation of Obama’s first term. According to the Davis Polk law firm, which tracks the law’s progress, regulators have missed more than 60 percent of the rule-making deadlines for Dodd-Frank.)

Just as the current budget standoff revolves around money, so does money elevate the role health care plays in the national agenda. In 2011, the U.S. spent $2.7 trillion on health care, according tofigures from the Centers for Medicare and Medicaid Services, a federal agency.

The health sector was the top-ranked industry in lobbying spending in 2012, according to opensecrets.org, which estimated it spent $488.96 million. So far this year, as of the end of July, it has spent another $243 million on lobbying, according to opensecrets.org. As for campaign donations, various health-related entities contributed $83.8 million to members of Congress in the 2012 election cycle. Presidential candidates got $42 millionfrom the health sector, opensecrets.org said.

A Federal(ist) Case

Obviously, such huge volumes of money have the potential to shape public policy priorities. And that’s a problem, Lessig writes, because Congress, as outlined in the Federalist Papers No. 52 “ought to be dependent on the people alone.” Clearly, Congress—and for that matter, the White House—are dependent on constituencies other than the people alone when it comes to how the federal government is run (or isn’t.) Lessig refers to this condition as “dependence corruption.” That is, dependence on constituencies whose interests conflict with serving the public. “That competing dependence produces an error,” he writes on page 20 of *Republic, Lost*. “A corruption.”

How this will all play out isn’t clear. But clearly the stalemate that has produced protracted paralysis isn’t something Reagan would look fondly on. At least on that hopeful inaugural day, he pledged to restore public trust by reforming government to serve the public interest. “Now, so there will be no misunderstanding, it's not my intention to do away with government,” he said after taking his oath. “It is rather to make it work—work with us, not over us; to stand by our side, not ride on our back.”

In Reagan’s view, it would appear, faithfully discharging his duties meant running government, not closing it down.

October 15, 2013

Seeing What Isn't There

The American writer Gertrude Stein, in describing a visit to her childhood home of Oakland, would later write, “There is no there there.” Were she still alive, she might say the same about aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Seeing What Isn't There: Resolving Failed Banks after Dodd-Frank

Most of Dodd-Frank’s mandated rules, for instance, haven’t been written. The idea that the law spelled the end of “too big to fail” runs counter to the fact that many major banks are actually getting larger. And episodes like JPMorgan Chase’s derivatives scandal—nicknamed the London Whale—suggest that practices that brought the world economy to the brink of ruin are still running full throttle even though Dodd-Frank was designed to rein them in.

If all that weren’t evidence enough, a recent spate of filings by the country’s major financial institutions once again suggests that the allegedly great and powerful Dodd-Frank is less like the omnipotent Wizard of Oz and more like the weak-willed man behind the curtain.

The filings at issue are “resolution plans” of major banks. They’re nicknamed “living wills” because they require institutions to outline how their affairs are to be handled should they experience a life-threatening shock like the one in 2008. The plans must be filed annually, under Dodd-Frank’s 165(d) rule adopted by the Federal Reserve and FDIC.

Tougher Rules?

The regulatory goal of the living wills is to prevent a repeat of the wildly unpopular bailouts of 2008. “Under the Dodd-Frank Act, bankruptcy is the preferred resolution framework in the event of a systemic financial company's failure,” James R. Wigand, then-director (now retired) of the FDIC’s Office of Complex Financial Institutions, testified to Congress earlier this year. “Ensuring that any institution, regardless of size or complexity, can be effectively resolved through the bankruptcy process will contribute to the stability of our financial system and will avoid many of the difficult choices regulators faced in dealing with systemic institutions during the last crisis,” Wigand said.

The living wills were first required in 2012, although they were somewhat incomplete. In fact, regulators found them to be so flimsy that earlier this year they outlined a lengthy list of details that banks had to include in 2013 plans. They also extended the deadline for plan submissions by three months, to October 1.

“The Plan’s strategic analysis should be presented in a concise Narrative form that discusses the Covered Company’s overall resolution strategy under the U.S. Bankruptcy Code and/or other appropriate insolvency regimes. The Narrative should discuss the critical steps of the resolution process and how identified weaknesses or impediments may be addressed,” the regulatory guidance said.

Regulators have now released the public portions of the 2013 plans, in which banks were to take

into account “adverse” and “severely adverse” economic conditions and consider issues like international cooperation as distressed global banks deal with regulators and assets in other countries. Yet, despite the tougher regulatory guidance, the new living wills read less like final wishes and more like wishful thinking.

“We believe that the resolution planning process, as required by our supervisors, is a critical building block in the development of orderly resolution plans for major financial institutions that will address the ‘too big to fail’ problem, an objective we fully support,” Goldman Sachs says in its plan. “We also support the goal that all financial institutions, regardless of size or complexity, should be able to be resolved without cost to the taxpayer.”

Regulators and, by extension, taxpayers, have no need to worry, Goldman Sachs assures us. “The plan does not rely on the provision of extraordinary support by the U.S. or any other government to the firm or its subsidiaries and would result in no loss to the FDIC Deposit Insurance Fund,” contends Goldman Sachs.

For this article, the resolution plans of Goldman Sachs, JPMorgan Chase, Citicorp and Bank of America were reviewed. What’s striking isn’t how complicated the resolution plans are but, rather, how simply they describe the envisioned orderly liquidation, if it comes to that, of global institutions that have trillions of dollars in assets, with operations around the world.

JPMorgan Chase, for instance, believes “that our resolution plan would effectively resolve the firm within a reasonable timeframe, without systemic disruption and without exposing taxpayers to the risk of loss,” its resolution plan reads. It later adds: “The resolution plan would not require extraordinary government support, and would not result in losses being borne by the U.S. government.”

While those are certainly laudable goals, firm details in the resolution plans are tough to find. Admittedly, the public plans aren’t a full accounting, but rather summaries. Presumably, the full plans filed with examiners contain greater detail.

Theories of Reality

Nevertheless, students of institutional corruption might question whether these theoretical plans can withstand inevitable economic, political and ethical realities that a collapse like 2008’s would undoubtedly unleash.

Indeed, an analysis might begin with the concept of regulatory capture. Regulatory capture occurs when industry holds powerful influence over the regulatory rules it lives by. Regulatory capture is often a symptom of institutional corruption.

Regulatory capture has often been blamed, at least in part, for the banking collapse of 2008. Oversight agencies had a hands-off policy toward risky practices like derivatives trading, for instance, in part because Congress had expressed deregulated derivatives with the Commodity Futures Modernization Act of 2000. Similarly, regulators sat idly by as banks took massive risks in products like subprime mortgages in the years leading up to the collapse.

Yet, while Dodd-Frank is touted as a “reform” law, it’s worth asking if it changes that laissez-faire regulatory environment. Specifically, why are banks outlining how their problems will be resolved in the next crisis? Shouldn’t it be regulators calling the shots?

“I believe the entire concept is flawed, and it is just another piece of paper from the Beltway that is

supposed to give comfort and assurance to everyone, especially the regulators, that the too big to fail problem has been resolved," Ken Thomas, a Miami-based banking analyst and longtime Wharton lecturer told me. "With all due respect to Marx, I consider living wills The Opiate of the Regulators."

Global Reach

Another frequent contributor to institutional corruption is conflicting constituencies. That is, an institution beholden to more than one constituency must inevitably prioritize one over another. That becomes an institutional corruption issue if the preferred constituency doesn't serve the public interest.

It's particularly relevant regarding banks, because their very structure requires them to serve multiple constituencies. Most notably, they aren't regulated by Washington alone. Many if not most of their assets are going held in foreign countries, who may or may not go along with U.S.-approved resolution plans. In its guidance, the FDIC asked banks to "identify and quantify, among other things, the actions . . . to avoid the adverse consequences of ring-fencing by host jurisdictions."

Citigroup, for instance, derives more than half of its revenue and income from operations outside North America, according to its resolution plan. Citigroup says its resolution plan "addresses how Citi's non-U.S. operations would be impacted in the event of failure at the Citigroup parent." Details, however, are not forthcoming.

The problem, to some observers, is that the resolution plans aren't pre-emptive. They don't actually require banks to significantly restructure their balance sheets and abstain from riskier practices. Rather, the plans are their best guess about how they'll respond should a disaster occur.

Among other things, they presume they'll be able to orderly liquidate their assets in a timely manner at reasonable prices, even though the history of financial panics suggest that won't be the case.

"Today's markets trade on seconds and milliseconds of new data, and any hint of a serious problem at a (too big to fail bank) means that it must be immediately dealt with by the regulators," Thomas, the banking analyst, told me.

In a recent speech, Martin Gruenberg, chairman of the FDIC, acknowledged that institutional challenges remain on the issue of resolving failed financial institutions. And until regulators actually are tested by a failure, "there will no doubt continue to be skepticism about the capability and will of regulatory authorities to impose the consequences of failure on the shareholders, unsecured creditors, and managers of these firms," he said in a speech earlier this month to the Volcker Alliance, a public policy organization founded by former Federal Reserve Chairman Paul Volcker.

With that in mind, the FDIC plans to release a fuller description of the resolution process later this year, Gruenberg said. Time will tell if there's a there, there.