### **Executive Summary**

Blame Wall Street for the current financial crisis. Investment banks, hedge funds and commercial banks made reckless bets using borrowed money. They created and trafficked in exotic investment vehicles that even top Wall Street executives — not to mention firm directors — did not understand. They hid risky investments in offbalance-sheet vehicles or capitalized on their legal status to cloak investments altogether. They engaged in unconscionable predatory lending that offered huge profits for a time, but led to dire consequences when the loans proved unpayable. And they created, maintained and justified a housing bubble, the bursting of which has thrown the United States and the world into a deep recession, resulted in a foreclosure epidemic ripping apart communities across the country.

But while Wall Street is culpable for the financial crisis and global recession, others do share responsibility.<sup>2</sup>

For the last three decades, financial regulators, Congress and the executive branch have steadily eroded the regulatory system that restrained the financial sector from acting on its own worst tendencies. The post-Depression regulatory system

<sup>2</sup> This report uses the term "Wall Street" in the colloquial sense of standing for the big players in the financial sector, not just those located in New York's financial district.

aimed to force disclosure of publicly relevant financial information; established limits on the use of leverage; drew bright lines between different kinds of financial activity and protected regulated commercial banking from investment bank-style risk taking; enforced meaningful limits on economic concentration, especially in the banking sector; provided meaningful consumer protections (including restrictions on usurious interest rates); and contained the financial sector so that it remained subordinate to the real economy. This hodge-podge regulatory system was, of course, highly imperfect, including because it too often failed to deliver on its promises.

But it was not its imperfections that led to the erosion and collapse of that regulatory system. It was a concerted effort by Wall Street, steadily gaining momentum until it reached fever pitch in the late 1990s and continued right through the first half of 2008. Even now, Wall Street continues to defend many of its worst practices. Though it bows to the political reality that new regulation is coming, it aims to reduce the scope and importance of that regulation and, if possible, use the guise of regulation to further remove public controls over its operations.

This report has one overriding message: financial deregulation led directly to the financial meltdown.

It also has two other, top-tier messages.

First, the details matter. The report documents a dozen specific deregulatory steps (including failures to regulate and failures to enforce existing regulations) that enabled Wall Street to crash the financial system. Second, Wall Street didn't obtain these regulatory abeyances based on the force of its arguments. At every step, critics warned of the dangers of further deregulation. Their evidence-based claims could not offset the political and economic muscle of Wall Street. The financial sector showered campaign contributions on politicians from both parties, invested heavily in a legion of lobbyists, paid academics and think tanks to justify their preferred policy positions, and cultivated a pliant media — especially a cheerleading business media complex.

Part I of this report presents 12 Deregulatory Steps to Financial Meltdown. For each deregulatory move, we aim to explain the deregulatory action taken (or regulatory move avoided), its consequence, and the process by which big financial firms and their political allies maneuvered to achieve their deregulatory objective.

In Part II, we present data on financial firms' campaign contributions and disclosed lobbying investments. The aggregate data are startling: The financial sector invested more than \$5.1 billion in political influence purchasing over the last decade.

The entire financial sector (finance, insurance, real estate) drowned political

candidates in campaign contributions over the past decade, spending more than \$1.7 billion in federal elections from 1998-2008. Primarily reflecting the balance of power over the decade, about 55 percent went to Republicans and 45 percent to Democrats. Democrats took just more than half of the financial sector's 2008 election cycle contributions.

The industry spent even more — topping \$3.4 billion — on officially registered lobbying of federal officials during the same period.

During the period 1998-2008:

- Accounting firms spent \$81 million on campaign contributions and \$122 million on lobbying;
- Commercial banks spent more than \$155 million on campaign contributions, while investing nearly \$383 million in officially registered lobbying;
- Insurance companies donated more than \$220 million and spent more than \$1.1 billion on lobbying;
- Securities firms invested nearly \$513 million in campaign contributions, and an additional \$600 million in lobbying.

All this money went to hire legions of lobbyists. The financial sector employed 2,996 lobbyists in 2007. Financial firms employed an extraordinary number of former government officials as lobbyists.

This report finds 142 of the lobbyists employed by the financial sector from 1998-2008 were previously high-ranking officials or employees in the Executive Branch or Congress.

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These are the 12 Deregulatory Steps to Financial Meltdown:

#### 1. Repeal of the Glass-Steagall Act and the Rise of the Culture of Recklessness

The Financial Services Modernization Act of 1999 formally repealed the Glass-Steagall Act of 1933 (also known as the Banking Act of 1933) and related laws, which prohibited commercial banks from offering investment banking and insurance services. In a form of corporate civil disobedience, Citibank and insurance giant Travelers Group merged in 1998 — a move that was illegal at the time, but for which they were given a two-year forbearance — on the assumption that they would be able to force a change in the relevant law at a future date. They did. The 1999 repeal of Glass-Steagall helped create the conditions in which banks invested monies from checking and savings accounts into creative financial instruments such as mortgage-backed securities and default swaps, investment gambles that rocked the financial markets in 2008.

#### 2. Hiding Liabilities:

#### **Off-Balance Sheet Accounting**

Holding assets off the balance sheet generally allows companies to exclude "toxic" or money-losing assets from financial disclosures to investors in order to make the company appear more valuable than it is. Banks used off-balance sheet operations special purpose entities (SPEs), or special purpose vehicles (SPVs) — to hold securitized mortgages. Because the securitized mortgages were held by an off-balance sheet entity, however, the banks did not have to hold capital reserves as against the risk of default — thus leaving them so vulnerable. Off-balance sheet operations are permitted by Financial Accounting Standards Board rules installed at the urging of big banks. The Securities Industry and Financial Markets Association and the American Securitization Forum are among the lobby interests now blocking efforts to get this rule reformed.

## 3. The Executive Branch Rejects Financial Derivative Regulation

Financial derivatives are unregulated. By all accounts this has been a disaster, as Warren Buffet's warning that they represent "weapons of mass financial destruction" has proven prescient.<sup>3</sup> Financial derivatives have

<sup>3</sup> Warren Buffett, Chairman, Berkshire Hathaway, Report to Shareholders, February 21, 2003. Available at:

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<sup>&</sup>lt;a href="http://www.berkshirehathaway.com/letters/">http://www.berkshirehathaway.com/letters/</a>

amplified the financial crisis far beyond the unavoidable troubles connected to the popping of the housing bubble.

The Commodity Futures Trading Commission (CFTC) has jurisdiction over futures, options and other derivatives connected to commodities. During the Clinton administration, the CFTC sought to exert regulatory control over financial derivatives. The agency was quashed by opposition from Treasury Secretary Robert Rubin and, above all, Fed Chair Alan Greenspan. They challenged the agency's jurisdictional authority; and insisted that CFTC regulation might imperil existing financial activity that was already at considerable scale (though nowhere near present levels). Then-Deputy Treasury Secretary Lawrence Summers told Congress that CFTC proposals "cas[t] a shadow of regulatory uncertainty over an otherwise thriving market."

# **4.** Congress Blocks Financial Derivative Regulation

The deregulation — or non-regulation — of financial derivatives was sealed in 2000, with the Commodities Futures Modernization Act (CFMA), passage of which was engineered by then-Senator Phil Gramm, R-Texas. The Commodities Futures Modernization Act exempts financial derivatives, including credit default swaps, from regulation and helped create the current financial

crisis.

#### 5. The SEC's Voluntary Regulation Regime for Investment Banks

In 1975, the SEC's trading and markets division promulgated a rule requiring investment banks to maintain a debt-to-netcapital ratio of less than 12 to 1. It forbid trading in securities if the ratio reached or exceeded 12 to 1, so most companies maintained a ratio far below it. In 2004, however, the SEC succumbed to a push from the big investment banks — led by Goldman Sachs, and its then-chair, Henry Paulson — and authorized investment banks to develop their own net capital requirements in accordance with standards published by the Basel Committee on Banking Supervision. This essentially involved complicated mathematical formulas that imposed no real limits, and was voluntarily administered. With this new freedom, investment banks pushed borrowing ratios to as high as 40 to 1, as in the case of Merrill Lynch. This superleverage not only made the investment banks more vulnerable when the housing bubble popped, it enabled the banks to create a more tangled mess of derivative investments — so that their individual failures, or the potential of failure, became systemic crises. Former SEC Chair Chris Cox has acknowledged that the voluntary regulation was a complete failure.

## 6. Bank Self-Regulation Goes Global: Preparing to Repeat the Meltdown?

In 1988, global bank regulators adopted a set of rules known as Basel I, to impose a minimum global standard of capital adequacy for banks. Complicated financial maneuvering made it hard to determine compliance, however, which led to negotiations over a new set of regulations. Basel II, heavily influenced by the banks themselves, establishes varying capital reserve requirements, based on subjective factors of agency ratings and the banks' own internal riskassessment models. The SEC experience with Basel II principles illustrates their fatal flaws. Commercial banks in the United States are supposed to be compliant with aspects of Basel II as of April 2008, but complications and intra-industry disputes have slowed implementation.

#### 7. Failure to Prevent Predatory Lending

Even in a deregulated environment, the banking regulators retained authority to crack down on predatory lending abuses. Such enforcement activity would have protected homeowners, and lessened though not prevented the current financial crisis. But the regulators sat on their hands. The Federal Reserve took three formal actions against subprime lenders from 2002 to 2007. The Office of Comptroller of the Currency, which has authority over almost 1,800 banks, took three consumer-protection

enforcement actions from 2004 to 2006.

### 8. Federal Preemption of State Consumer Protection Laws

When the states sought to fill the vacuum created by federal nonenforcement of consumer protection laws against predatory lenders, the feds jumped to stop them. "In 2003," as Eliot Spitzer recounted, "during the height of the predatory lending crisis, the Office of the Comptroller of the Currency invoked a clause from the 1863 National Bank Act to issue formal opinions preempting all state predatory lending laws, thereby rendering them inoperative. The OCC also promulgated new rules that prevented states from enforcing any of their own consumer protection laws against national banks."

## 9. Escaping Accountability: Assignee Liability

Under existing federal law, with only limited exceptions, only the original mortgage lender is liable for any predatory and illegal features of a mortgage — even if the mortgage is transferred to another party. This arrangement effectively immunized acquirers of the mortgage ("assignees") for any problems with the initial loan, and relieved them of any duty to investigate the terms of the loan. Wall Street interests could purchase, bundle and securitize subprime loans — including many with pernicious, predatory terms — without fear of liability for

illegal loan terms. The arrangement left victimized borrowers with no cause of action against any but the original lender, and typically with no defenses against being foreclosed upon. Representative Bob Ney, R-Ohio — a close friend of Wall Street who subsequently went to prison in connection with the Abramoff scandal — was the leading opponent of a fair assignee liability regime.

## 10. Fannie and Freddie Enter the Subprime Market

At the peak of the housing boom, Fannie Mae and Freddie Mac were dominant purchasers in the subprime secondary market. The Government-Sponsored Enterprises were followers, not leaders, but they did end up taking on substantial subprime assets at least \$57 billion. The purchase of subprime assets was a break from prior practice, justified by theories of expanded access to homeownership for low-income families and rationalized by mathematical models allegedly able to identify and assess risk to newer levels of precision. In fact, the motivation was the for-profit nature of the institutions and their particular executive incentive schemes. Massive lobbying — including especially but not only of Democratic friends of the institutions — enabled them to divert from their traditional exclusive focus on prime loans.

Fannie and Freddie are not responsible

for the financial crisis. They are responsible for their own demise, and the resultant massive taxpayer liability.

#### 11. Merger Mania

The effective abandonment of antitrust and related regulatory principles over the last two decades has enabled a remarkable concentration in the banking sector, even in advance of recent moves to combine firms as a means to preserve the functioning of the financial system. The megabanks achieved too-big-to-fail status. While this should have meant they be treated as public utilities requiring heightened regulation and risk control, other deregulatory maneuvers (including repeal of Glass-Steagall) enabled these gigantic institutions to benefit from explicit and implicit federal guarantees, even as they pursued reckless high-risk investments.

### 12. Rampant Conflicts of Interest: Credit Ratings Firms' Failure

Credit ratings are a key link in the financial crisis story. With Wall Street combining mortgage loans into pools of securitized assets and then slicing them up into tranches, the resultant financial instruments were attractive to many buyers because they promised high returns. But pension funds and other investors could only enter the game if the securities were highly rated.

The credit rating firms enabled these

investors to enter the game, by attaching high ratings to securities that actually were high risk — as subsequent events have revealed. The credit ratings firms have a bias to offering favorable ratings to new instruments because of their complex relationships with issuers, and their desire to maintain and obtain other business dealings with issuers.

This institutional failure and conflict of interest might and should have been forestalled by the SEC, but the Credit Rating Agencies Reform Act of 2006 gave the SEC insufficient oversight authority. In fact, the SEC must give an approval rating to credit ratings agencies if they are adhering to their own standards — even if the SEC knows those standards to be flawed.

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Wall Street is presently humbled, but not prostrate. Despite siphoning trillions of dollars from the public purse, Wall Street executives continue to warn about the perils of restricting "financial innovation" — even though it was these very innovations that led to the crisis. And they are scheming to use the coming Congressional focus on financial regulation to centralize authority with industry-friendly agencies.

If we are to see the meaningful regulation we need, Congress must adopt the view that Wall Street has no legitimate seat at the table. With Wall Street having destroyed the system that enriched its high flyers, and plunged the global economy into deep recession, it's time for Congress to tell Wall Street that its political investments have also gone bad. This time, legislating must be to control Wall Street, not further Wall Street's control.

This report's conclusion offers guiding principles for a new financial regulatory architecture.