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Banks: A Broken Social Contract

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The first symptoms of cancer can be mistaken for any mundane sickness—fatigue, fever, bloating, headaches. You can treat these symptoms for months—even years—while the cancer grows undetected. Sometimes, you treat the symptoms for so long that by the time the cause—the aggressive tumor—is detected, it's too late and all you can do is just keep treating the symptoms.

Financial crises are akin to cancer symptoms. Though the crisis and ensuing panic is itself painful, the root problem is often less obvious, but much more consequential. As the dust has settled on the 2008 crisis and the ensuing reforms, it's time to ask: Did we treat the disease or just its symptoms?

The crisis is best understood in historical context. Specifically, the latest epoch of banking policy has been one of deregulation. The banks asked to be free from the heavy legal restrictions and regulations imposed after the Great Depression, and the politicians obliged. To be sure, many of the restrictions needed to be updated or repealed. And they were. But as the banks were deregulated, a new philosophy began to dominate the academy, industry, and the minds of policymakers. The theory was that the country would benefit from a competitive and profitable banking system, which was possible only if government stayed out of the business of banking. Policymakers took figurative—and, in one famous photo-op of leading banking regulators—literal chainsaws to regulations with the assumption that a competitive banking sector could regulate its own excesses and that the "market" would

punish weak banks with failure and strong banks with profits. Indeed, firms were profitable for many years and they became more efficient as they left low-profit areas like poor inner city and rural neighborhoods and formed conglomerates that could lower costs through scale and scope. Few insiders questioned the new philosophy in flush times, but when the music stopped, it became clear just how much government intervention had stood between the banks and the abyss.

The crisis revealed three specific problems. The first was that the banks and non-bank financial institutions created due to deregulation were huge, interconnected, and highly leveraged. Their size meant that their failure could take down major portions of the economy and hurt undeserving victims such as pension fund holders and savers. They were, in other words, Too Big To Fail (TBTF). As it turned out, no one had the stomach to stick to market discipline in the foxhole. Hank Paulson and Ben Bernanke brought in all the top bankers and forced them to take a bailout. Once it was clear that AIG's massive shortfall threatened the entire economy, there was no choice but to do everything possible to prevent it, including the federal government buying the firm.

Second, the panic started in the "shadow banking" sector and showed that the short-term credit transactions and derivatives that non-bank financial institutions traded and used for funding for years were similar to banking, and thus prone to runs. Lehman failed overnight because its creditors acted like the townsfolk of Bedford Falls demanding their money from Bailey's Building & Loan lest it fail by morning. Except these shadow banks were unregulated and unprotected by the FDIC. As this country figured out the hard way during

the Great Depression, creditor confidence is psychological, and only government intervention in the form of FDIC insurance can stop bank runs.

Third, the entire premise of deregulation rested on an assumption that individual firms and market players could accurately calculate and manage risks, or “self-regulate.” Every firm had a risk management team made up of lots of math Ph.D.s, or “quants,” who would run data-driven “stress tests” or calculate Value at Risk, and once they had a handle on risks of loss, they could hedge that risk with insurance. Who sold all of that insurance? AIG. Regulators didn’t get too involved, and they outsourced a lot of their typical supervisory duties to firms’ internal risk models, confident that the market could rationally digest information and punish without externalities. As it turned out, those models could be overly optimistic and market discipline could be erratic and ignorant.

So did Dodd-Frank fix these problems?

Policymakers have repeatedly promised that Dodd-Frank did away with TBTF, but that’s not fully accurate. Here’s what Dodd-Frank does: Each firm has to submit a “living will” that lays out a plan for how it can be liquidated in the event of its failure, without causing chaos or requiring a bailout. The regulators recently reviewed these plans and determined that five out of the largest eight banks do not have a credible plan to avoid financial chaos or government rescue in the event of a failure. In other words, they are still too big to fail. So it’s back to the drawing board for the banks.

Dodd-Frank also amended the Federal Reserve’s emergency bailout authority outlined in Section 13(3) of the Federal Reserve Act. It can no longer save just one firm the way it did during the crisis—it would have to create a fund with

"broad-based eligibility." The catch is that the banks that emerged from the crisis are bigger and fewer in number. So even if a broad-based fund were created, the beneficiaries would likely be the same players as in 2008. Moreover, it's hard to believe that if we faced another potential abyss, policymakers would not act forcefully to prevent the feared widespread catastrophe. It's not as though the Fed or the Treasury felt bound by law when it administered the 2008 bailout, stretching the Fed's emergency powers to the breaking point.

As for shadow banking, the biggest step has been to identify the scale and nature of the problem. By my count, Federal Reserve Board officials mentioned shadow banking in exactly zero speeches from 2003 to 2008 and in 20 percent of their speeches from 2010 to 2016. Just talking about the problem 20 percent of the time as opposed to zero is a huge leap toward addressing it. Dodd-Frank also created a new super-regulator, the Financial Stability Oversight Council, to oversee any large institution that looks and smells like a bank. The Fed will then supervise any non-bank that the council designates as a Systemically Important Financial Institutions (SIFI). Already this designation has faced a setback as a D.C. court, overconfident and suffering from amnesia about the systemic risk non-banks can cause, overturned MetLife's SIFI designation. Other SIFIs are said to be lining up to challenge their designation as well.

As for those risk management models, the Fed doubled down on them and brought them in-house. Even as the intellectual father of free markets and deregulation, Alan Greenspan, admitted there was a flaw in his assumptions about market discipline, the foundational theory of risk management was not thrown out. One of Dodd-Frank's most significant regulatory changes is the

annual stress testing of large firms. The Fed, using its own risk model based on historical data, runs each firm through a stress test to project if it can survive a shock. The good news is that the Fed is no longer deferring to pure "self-regulation," the test's "financial shocks," or stressors, are worse than what the firms were modeling before 2008, and every firm is subject to the test with results made public. However, the Fed's stress testing is built on the same foundation as the faulty risk management enterprise—the assumption that we have enough information today to design a hypothetical scenario that would accurately predict and prepare for a system-wide panic tomorrow. There are many reasons this premise is dubious, not least of which is that the firms were essentially doing this for years before the crisis and their models missed huge problems.

Even as Dodd-Frank has attempted to fix the major problems the crisis revealed, the law falls short of real reform. In some ways, that is because in tone and structure, Dodd-Frank has more in common with the deregulatory laws of the last 30 years than with the reforms of the New Deal era or even the recent post-crisis populist sentiment. When policymakers were faced with the choice to make structural or incremental changes, they chose incremental. They didn't break up the banks or cause a significant restructuring of their business model. Regulators also chose complexity over simpler tools of reform—technical fixes over a system overhaul. (The one major counterpoint in Dodd-Frank is the creation of Elizabeth Warren's Consumer Financial Protection Bureau, which is a major structural reform aimed at protecting people against financial industry excess. The agency has been vilified by the financial sector since its inception, but like its founder, the agency has been strong and, as far as we know, uncorrupted.)

More consequentially, policymakers probed no further than the crisis required. They identified the symptoms and are working on treating them, but missed the cancer that is still growing. They did not realize that this was not just a narrow banking crisis to be fixed through banking regulation.

Indeed, banking policy has always implicated much more than just bank safety, but also affects social policy, democracy, and the creation or elimination of inequality. Alexander Hamilton thought that banks would be the most important instrument of public policy. Thomas Jefferson said that banks were more dangerous than standing armies and sought to reduce their power over the common man. Andrew Jackson waged a misguided "bank war" against the national bank because he believed that the national bank was about "the advancement of the few at the expense of the many." After the crisis of 1907, Woodrow Wilson called for the end of the "monopoly of big credits" that would hinder "the true liberties of men." After the Great Depression, Louis Brandeis declared that the nation's banks should be treated as a "public utility" instead of a "private affair" because banks gain their disproportionate power through the use of "other people's money." FDR excoriated the banking system proclaiming that "the rulers of the exchange of mankind's goods have failed" and "the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and minds of men." Roosevelt saw the crisis as a threat to the "future of essential democracy" and took it as a mandate to use "direct, vigorous action" to fight for "the social values more noble than mere monetary profit."

These leaders may have been wrong in their specific proposals, but they each understood something that current lawmakers are missing: Banking regulation is just as much about liberty, democracy, equal opportunity, and

equality as it is about risk or liquidity. We need to make sure banks are operating safely, but we also need to make sure they are serving the people.

While Washington and Wall Street proclaimed after the bailouts that "we were all in this together," the effects of the financial crisis were largely borne by the poor and middle-class people who were foreclosed upon even as the banks were being bailed out. As it turned out, we did not rise and fall together. Wall Street is rising and the public continues to fall. The last ten years have been defined by historic inequality, the rise of true poverty in America, and a growing racial wealth gap. What the Obama Administration ignored is what was central in previous post-crisis responses: that inequality and banking policy are entwined. Without state intervention, credit naturally flows to the wealthy.

Against the backdrop of widespread foreclosures, job losses, economic stagnation, and a growing wealth gap, Dodd-Frank seems weak and narrow, technical to a fault, trees instead of forest. Even if the legislation had managed to regulate shadow banking effectively, fixed TBTF, and gotten systemic risk under control, it failed to recognize the cancer underneath. Wall Street's gains are not Main Street's gains, but its losses are Main Street's losses.

The cancer is that we have a broken social contract—the public supports the bank, but the banks aren't obliged or interested in supporting the public. In fact, after the crisis several insiders revealed that in fact some traders viewed their clients as prey. Dark pools were created to front-run customer orders, and some firms were shorting the very investments they had induced their clients to buy. The Panama Papers show what many have suspected—that the major banks are helping high net-worth clients evade laws as well as

potentially billions of dollars in tax revenue. Meanwhile, these same firms are lobbying heavily to destroy regulations that protect the public. This is not as hard as it sounds. Currently, there are five financial industry lobbyists on Capitol Hill for every one legislator.

The last crisis revealed overlooked problems in the financial system. Since those problems have been identified, they will not easily be ignored in the future. Now we need to work on addressing the reason regulators missed the problems for so long—namely, that they believed in the dogma that government should not intervene in any way that threatened bank profits, that the banks could manage their own risks, and that it was possible for the government to stay out of it when banks failed. We need to reignite if not the fight at least the healthy debate of industry versus public that has long been central in banking policy. We need to be realistic about what banks are: the central engines of democracy, and therefore necessarily tied to the state. They are not the enemy, but they do have public responsibilities that we ignore at our peril.