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I am Superman: The Federal Reserve Board and the Neverending Crisis **R. Christopher Whalen**

Abstract: This article asserts that, in dealing with the 2007-2009 financial crisis, the Federal Reserve Bank (Fed) has placed its role as monetary agency and de facto steward of the market for U.S. Treasury debt ahead of its statutory responsibility for ensuring the soundness of the private banks. This is not to say that the Fed supplies whatever credit the government wants — at least not yet — but in terms of both the provision of credit to the private financial system and the price of this credit, the growing fiscal imbalances of the U.S. government seem to be playing an increasing role in Fed policy decisions. This paper explores some of the issues involved in recent Fed policy decisions and draws some preliminary conclusions as to the conflicts between the Fed's role as central bank and also as prudential supervisor.

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I am Superman: The Federal Reserve Board and the Neverending Crisis
R. Christopher Whalen

I am I am I am Superman and I know what's happening.
I am I am I am Superman and I can do anything.

“I am Superman”
R.E.M.
(1986)

During the 2007-2009 financial markets crisis, the Fed seemingly left behind the mandate to conduct monetary policy in such a way as to achieve price stability and full employment. Specifically, the decisions taken during the financial crisis seem to be an effort to placate political constituencies by bailing out private sector banks and, earlier, by not exercising appropriate prudential supervision of Fed members banks and bank holding companies (BHCs). It needs to be said that nowhere in the Federal Reserve Act (FRA) or the various employment acts passed by Congress over the past half century is the central bank charged with maintaining sound money. Enlightened self interest, however, suggests that a central bank that overtly embraces the use of inflation through mechanisms such as quantitative easing to subsidize the issuance of public debt by the Treasury and various government sponsored entities (GSEs) is in political terms signing its own death warrant.¹

Far from being an objective and fair prudential regulator, over the past several decades the Fed has shown a willingness to bend the rules or even launch into new, speculative areas of public policy, all in the name of appeasing the short-term political agenda of the Congress and the largest U.S. financial institutions. Maintaining access to cheap credit for the private sector as well as the stability of the largest banks, which include several of the most significant underwriters and dealers in government securities, may be seen as a means to larger ends, namely: (1) maintaining the appearance of positive levels of economic output and (2) preserving the ability of the Treasury to refinance existing debt

¹ This essay reflects research by the author for an upcoming book, *Inflated: How Money and Debt Built the American Dream*, scheduled for release by John Wiley & Sons in November 2010, and is used with permission.

and also issue debt.² This essay discusses the ability of the Fed to act as an effective prudential regulator, especially in the context of the accommodation of deteriorating fiscal and governance structures of the U.S., and suggests some possible means of improving the current system.³

Bank Regulator or Monetary Authority?

As the bank of issue and the provider of credit to the financial system, the Fed has the leading role among U.S. prudential regulators with respect to providing market and liquidity risk management, and general market oversight and surveillance. It is debatable as to whether the central bank has done a satisfactory job of its market surveillance function. Until the most recent crisis, market surveillance activities by the Fed have been limited. This self-imposed incapacity goes back to the early 1990s and the sudden end of the tenure of E. Gerald Corrigan as the President of the Federal Reserve Bank of New York.⁴

After 1986, when regulatory responsibility for the government bond market had been explicitly given to the Securities and Exchange Commission (SEC), the Fed of New York (FRBNY), at Corrigan's instruction, had largely curtailed its surveillance of the market for Treasury debt, particularly the informal "when-issued" market in Treasury paper before each auction. As Martin Mayer noted in his book, *Nightmare on Wall Street: Salomon Brothers and the Corruption of the Marketplace*:

Neither in Washington nor in New York did the Fed seem aware that the dangers of failure to supervise this market had grown exponentially in 1991. Like the

² The average maturity of the \$11 trillion in U.S. federal debt is only about 5 years, meaning that the entire corpus of debt must be refinanced each decade or so, this in addition to the new incremental debt issued each year. This precarious position for the Treasury was created by Undersecretary Peter Fisher, who in October of 2001 announced that the Treasury would suspend issuing 30-year Treasury bonds. Fisher's decision, made at a time when receipts to the Social Security system were masking the overall federal deficit, has gradually shortened the duration of the outstanding public debt of the United States.

³ The Fed's quantitative easing policy and various bank rescues since 2007 amount to direct monetization of what are arguably fiscal expenditures. As in the 1930s, Congress has ratified many actions by the Fed and Treasury in 2008 and 2009 after the fact.

⁴ Whalen, Christopher (1993), "Gone Fishing: E. Gerald Corrigan and the Era of Managed Markets," The Herbert Gold Society. <http://www.rewhalen.com/pdf/fishing.pdf>.

Federal Home Loan Bank Board in its pursuit of making the S&Ls look solvent in 1981-82, the Fed had adopted tunnel-vision policies to save the nation's banks. And just as excessive kindness to S&Ls in the early 1980s had drawn to the trough people who should not have been in the thrift business, Fed monetary policies in the early 1990s created a carnival in the government bond business.⁵

The Fed's chief area of competency, after all, is supposed to be monetary policy, but surveillance of the government debt markets has also been an important activity — and one that has been handled unevenly. For the reasons discussed below, giving the Fed direct responsibility for financial institution supervision and consumer protection has been a disaster, at least in the view of this author.⁶ There are several reasons for this view:

- First, because of chronic U.S. fiscal and external deficits, the U.S. central bank already has its hands very full with monetary policy and does not give adequate attention to prudential regulation. The focus by the Fed on credit expansion, as opposed to price stability and interest rates, and a lack of attention to choices being made with respect to market structure and the regulation of Fed member banks served to make the crisis of 2007-2009 far more difficult than ought to have been the case.
- Second and as an outgrowth of the first point, there is what we shall call the “superman complex” operating at the Fed, thus this essay's epigraph. Because of the growing fiscal imbalances in the U.S. economy and the need to compensate for these imbalances by expanding credit, the Fed is called upon more and more to rescue the private economy from the resulting market volatility. Fed officials fall into the trap of believing that direct intervention in the financial markets is actually helpful, instead of an act of interference in the political process of American democracy. The rescue of Bear, Stearns, American International Group (AIG) and Merrill Lynch are three cases in point. The Fed should have declined to act directly to bail out these

⁵ Mayer, Martin (1993), *Nightmare on Wall Street: Salomon Brothers and the Corruption of the Marketplace*, NY: Simon & Schuster.

⁶ The author has worked as a bank analyst and investment banker for almost three decades. He was a management trainee at the Federal Reserve Bank of New York and worked in the bank supervision and foreign currency functions of that institution. His firm, Institutional Risk Analytics, is a rating agency and consulting firm that publishes quarterly performance benchmarks and stress indicators for all U.S. banks.

institutions, but instead offered to finance a rescue operation led by the Treasury. The Treasury would have then needed to obtain the fiscal authority from the Congress.

- Central banks, by definition, seem to tend to be authoritarian and regressive in their thinking and not open to contradiction, a behavior usually evidenced by concern over maintaining “confidence” in the financial system. This overarching concern with public perception and confidence is an outgrowth of a currency system that, in fact, has no backing independent of government. In the fiat currency system that has existed in the U.S. since the 1930s and especially since President Richard Nixon formally broke the link between the dollar and gold in 1971, international confidence in the dollar has become a function of the political credibility of the Fed and the entire U.S. government.
- Finally, there appears to be something about central banks and the study of macroeconomic policy in general that seems to make the inhabitants of the given agency concerned believe in the possibility of an all-encompassing “God’s eye view” of markets and agents. The key priorities in risk management and prudential regulation, however, are quite the opposite. In the surveillance of financial institutions and markets, attention to the particular and idiosyncratic factors is absolutely essential to managing risk or identifying potential systemic issues. The top down view that may seem useful to economists for monetary policy is useless for assessing credit and market risk.

In short, there seems to be operating at the Fed, on the one hand, a belief that financial institutions can be managed from on high, in the same top-down fashion as is used in the execution of monetary policy. On the other hand, there is also an unwillingness among the leadership of the central bank to admit when they are wrong, especially when it comes to the development or recognition of systemic risks in the financial system and for the reasons discussed. Consider some examples.

- In 2005, an economist named Raghuram Rajan questioned the value of financial innovation in a speech at the Fed’s annual Jackson Hole retreat. “Mr. Rajan quickly came under attack as an anti-market Luddite, wistful for old days of regulation. Today, however, few are dismissing his ideas. The financial crisis has savaged the reputation of Mr. Greenspan and others now seen as having turned a blind eye,” reported Justin Lahart of the *Wall Street Journal*.⁷
- In 2008, Tobias Adrian and Hyun Song Shin published an excellent analysis of the link between monetary policy and the balance sheets of financial institutions. The paper, “Money, Liquidity and Monetary Policy,” is part of a larger body of work by the authors and asserted that the monetary policy transmission mechanism runs through the balance sheets of financial institutions. This implies that monetary policy and regulatory policy are intertwined. Yet the Fed continues to this day to view monetary policy and bank supervision as entirely separate silos with zero real rates having no implication for the stability and soundness of banks and BHCs.⁸
- In a 2008 interview, Roger Kubarych described how officials of the Federal Reserve Bank of New York were told by a respected market participant as early as February 2007 that the failure of New Century Financial was the start of a larger contagion in the private market for subprime asset-backed securities (ABS), yet the warnings were ignored.⁹ More, this author has personally interviewed scores of bank supervisory personnel over the past eight years who knew that subprime originators such as Washington Mutual (WaMu) and Countrywide were in trouble as early as 2006. Indeed, WaMu had begun to shrink assets and show signs of distress as early as the end of 2005.

⁷ Lahart, Justin (2009), “Mr. Rajan Was Unpopular (But Prescient) at Greenspan Party,” *The Wall Street Journal*, January 2. <http://online.wsj.com/article/SB123086154114948151.html>.

⁸ Adrian, Tobias and Hyun Song Shin (2008), “Money, Liquidity and Financial Cycles,” Princeton University, June. <http://www.princeton.edu/~hsshin/www/CImoney2.pdf>.

⁹ Whalen, Christopher (2008), “Fed Chairmen and Presidents: Roundtable with Roger Kubarych and Richard Whalen,” *Institutional Risk Analyst*, October 30.

There are many other instances in the 2005-2007 period when experts from the world of banking, housing, loan servicing and investment banking told Fed officials that there was a problem brewing in the financial markets. Yet the central bank discounted these reports and instead remained focused on monetary policy. Despite claims by Fed officials of success in dealing with the most recent crisis, the fact is that the Fed was so focused on fighting the perceived risk of deflation earlier in the decade that the central bank actually created the circumstances for the subprime crisis that resulted in the failure of a number of large banks and primary dealers.

In 2001, when the U.S. economy experienced a “mini” recession, Fed Chairman Alan Greenspan and the Federal Open Markets Committee (FOMC) responded by dropping interest rates to very low levels. Critics of Chairman Greenspan have subsequently criticized the Fed for keeping rates too low for too long and thereby causing the bubble in real estate later in the decade. But what many observers fail to appreciate is that the Fed, operating in real time, was mostly concerned with deflation a la Japan.

“During the period after 2001, people in the Fed were worried about repeating the deflationary experience of Japan,” David Kotok, CEO of Cumberland Advisers said in a June 2010 interview with the author.¹⁰ “They chose policies that were designed to blunt the risk of deflation, but they failed to appreciate the other risk, namely encouraging a bubble in the domestic real estate market. It is easy to criticize the Fed in hindsight, but the central bank operates in real time. In this case the perceived solution to one problem created another.”

Based upon the work done by the author’s firm in analyzing and rating U.S. banks, it appears that the Fed’s motivation in the early 2000s was not to create a bubble in the housing market, but to keep the level of nominal economic growth and employment above some acceptable minimum level. Large subprime lenders such as Citigroup, a bellwether of an economy where the average borrower is subprime, experienced significant increases in credit losses during the 2001-2003 period, credit losses far above

¹⁰ Unpublished June 2010 interview with the author.

the bank's peers and also higher than many market analysts thought possible. The FOMC took the federal funds rate from 5 percent at the end of 2000 down to just above zero by the end of 2003, causing officials at the central bank to consider new policy alternatives for operating in an environment of very low nominal interest rates.¹¹

Had Chairman Greenspan and the FOMC raised interest rates sooner, the bubble in the housing market might not have been nearly as large, but the U.S. economy might well have weakened rapidly because of a basic lack of economic strength, a problem that continues to the present day. Henry Kaufman, among others, has warned for decades about the connection between monetary "gradualism" and instability in financial markets. Given the dramatic increase in Fed monetary intervention in the most recent crisis, the warnings of Kaufman that a low rate environment allows "credit creation to flourish, and its deflationary and destabilizing impact on the system is only recognizable with a delay" seem more important than ever.¹²

By, on the one hand, encouraging extreme swings in economic performance through overly accommodative monetary policies, while on the other encouraging the expansion of unregulated over-the-counter (OTC) markets for complex assets and derivatives, the Fed orchestrated many of the factors that contributed to the financial crisis.

As discussed in greater detail below, the fiscal priority of maintaining at least nominal economic growth seems to directly conflict with the duty to maintain the safety and soundness of regulated financial institutions.¹³

Monetary Policy and Prudential Regulation: Conflict of Visions

¹¹ Federal Open Market Committee (2003), "Briefing on Monetary Policy Alternatives," October 28. <http://www.federalreserve.gov/monetarypolicy/files/FOMC20031028bluebook20031023.pdf>.

¹² Kaufman, Henry (2009), *The Road to Financial Reformation: Warnings, Consequences, Reforms*, Hoboken: John Wiley & Sons: 186.

¹³ The maintenance of low inflation and sound money, even of a fiat variety, are certainly necessary conditions for bank safety and soundness. Banks which hold worthless fiat currency as assets obviously have no economic or social utility, no matter how well run.

Most major industrial nations in the world do not give the central bank paramount responsibility for bank safety and soundness, and for good reason. The monetary agency typically is charged with the currency system, price stability and economic growth generally, although it must be said that there are no hard and fast rules. Interestingly, if the new British Chancellor of the Exchequer George Osborne has his way, the United Kingdom (UK) may go back to its previous situation with the Bank of England having bank supervision authority.

It seems that every country that separated bank supervision from central banking now, post crisis, wants to combine them, while every country where they had been joined wants to separate them. In fact there is no clear-cut model that is convincing either way, arguing in favor of those who have called for a flexible, evolving approach to the regulation of markets and institutions.

The author believes that, consistent with the models of checks and balances in America's governance structures, separation of the monetary and prudential functions is a good point of departure for any nation. This does not mean that these two agencies should not work in harmony, but the monetary and prudential regulatory tasks should have separate owners in a bureaucratic sense and each should be held separately accountable to the public. Being both a monetary authority and a prudential regulator creates political conflicts of interest and of personalities that arguably make it impossible to do a good job of either task when these responsibilities are put under one roof. Robert Eisenbeis and George Kaufman (2007) and Gillian Garcia (2007) all describe the conflicts that can arise with respect to bank resolutions and market crises that involve different governmental agencies and jurisdictions, both among agencies within the same country and among different nations.¹⁴

¹⁴ Benink, Harald, Charles A. E. Goodhart and Rosa Maria Lastra, eds. (2007), "Prompt Corrective Action and Cross-Border Supervisory Issues in Europe," The Financial Markets Group Special Paper 171, The London School of Economics and Political Science, April.
http://feweb.uvt.nl/pdf/2009/LSE_Special_Paper_PCA.pdf.

In addition to the political conflicts that arise between the Fed's role as monetary authority and prudential regulator, the more narrow issue of regulation must be considered. While some people claim that the Glass-Steagall Act law dividing banking and commerce has been repealed, the Bank Holding Company Act of 1956 and, in particular, the 1970s amendments to that law that truly separated banking from commerce, particularly insurance, are still extant.¹⁵ This law makes the Fed the protector of a cartel of semi-monopolies known as bank holding companies and with particular emphasis on the largest banks, financial houses which are dealers in U.S. Treasury and agency debt.

The Fed's enforcement of the cartel among the largest U.S. banks is illustrated by the fact that, subsequent to the crisis, the top four BHCs and broker-dealers, such as Merrill Lynch, Bear Stearns, Countrywide and Washington Mutual, were merged with other large BHCs, instead of being sold to other entities. The financial reform legislation that was pending in the Congress as this paper was written provides the Fed more authority over financial institutions than ever before, but with no accountability for its increasingly destructive behavior.

Specifically, merging large troubled banks and dealers is hardly a way to enhance the safety and soundness of the financial system and arguably works against ending "too big to fail." Yet the Fed seems incapable of liquidating large banks for fear that it will undermine confidence in the Treasury's debt markets and the dollar. Fed officials will no doubt find such comments distasteful. The fact remains, however, that the Fed, by placing systemic priorities ahead of enforcing prudential rules, is the enabler for many of the problems affecting the American political economy. This particularly applies to the increasingly unstable financial behavior of the largest banks. But it must be said that the same is true of the other regulators, especially in the European Union (EU).

¹⁵ Whalen, Christopher (2008), "A Change in Bank Control: Interview With Ernest Patrikis," *Institutional Risk Analyst*, July 9.

The Europeans, in their collective obsession with Basel II capital standards, also were enablers of financial innovation along with the Fed and other U.S. regulators. EU regulators allowed dealers in London and Paris to participate in the subprime phenomenon in New York. Private banks and state-sponsored entities in the EU then bought some of the worst of the subprime originations. The EU is in the process of subsidizing the losses on these subprime exposures as well as buying the debt of insolvent nations such as Greece from EU banks. One of the biggest examples of EU regulatory incompetence was the treatment of guarantees provided to EU banks by AIG as part of the capital standards regulatory avoidance program. There is plenty of blame to go around. The point of this paper is not to insult anyone personally or in particular, but instead to illustrate the conflicts inherent in the current system that make it difficult for the Fed to be both an effective prudential regulator and monetary authority.

Among the fallacies motivating the current legislative reform proposals in the Congress is the idea that the Fed would ever willingly stand by and liquidate one of the top banks in the U.S. Until the Fed is willing to support the liquidation of a large banking institution for failure to manage risk, the central bank will have no credibility as a prudential regulator. But when push comes to shove, monetary policy and the Fed's duty to preserve market access for the Treasury will override any other consideration. And the funny part is the Fed is defending an anachronism in the primary dealer system.

Veteran observers such as Robert Eisenbeis of Cumberland Advisors, who worked for many years as a researcher at the Fed focused on the dealer community, have argued that the Fed should go to continuous intraday trading of Fed funds, which would eliminate the primary dealer system. Indeed, the rise of non-competitive bids in Treasury auctions by significant Buy Side firms may be an indicator that the dealer system is going the way of the trading floor. But the Fed is loath to end the primary dealer system, even though a majority of the dealers are now foreign owned.

Since the 2007 fiscal crisis, the Fed has taken extraordinary and extra-legal power over the U.S. economy, and assumed a de facto fiscal role a la the Reconstruction Finance

Corporation of the 1930s and 1940s. Using the emission of trillions of dollars in new fiat dollars to bail out the Treasury and the banking system, the Fed has become the chief fiscal authority in the U.S. There are a couple of related issues here:

- First, the Fed's loans to AIG and other entities during the crisis seem to be a violation of the FRA. The act envisions the Fed making fully secured loans that are collateralized with marketable securities. Instead, in the case of AIG and perhaps other assets financed by the central bank in the wake of the collapse of Lehman Brothers, the central bank has ended up holding an equity position — and an illiquid one at that. As Alan Meltzer said in testimony before Congress earlier this year: “During the Great Depression Congress authorized section 13 (3) that told the Federal Reserve to lend directly to small and medium sized firms that could not get accommodation from the banks. In this crisis, Section 13(3) was used to lend to AIG. This stretched the original purpose beyond any reasonable interpretation. Congress should remove this authority.”¹⁶
- The second issue is the use of quantitative easing to absorb all of the inventory of mortgage-backed securities, agency debt and Treasury securities that the Sell Side firms on Wall Street could not or would not finance in the wake of the Lehman collapse. In a market that was “financed rather than funded,” in the absence of confidence the Fed became the only source of liquidity. In the wake of the subprime crisis, researchers have begun to quantify and define the difference between funding an asset with core deposits and “hot money” in the form of repurchase agreements, but such distinctions have been obvious for years. In 2004-2005, for example, the Corrigan group explicitly discussed the risks involved in using short-term market sources to fund long-term assets. As discussed in detail below, the bilateral OTC market structure that made this all possible was encouraged by the Fed and other agencies as part of “financial innovation.”

¹⁶ Meltzer, Allan H. (2010), “Testimony, House Financial Services Committee,” March 17. http://www.house.gov/apps/list/hearing/financialsvcs_dem/meltzer.pdf.

- Third, and related to the first point, is the aggressive moves by the Fed to prop up the remaining primary dealers and essentially buy the debt issuance of the Treasury during periods of late 2008 and 2009 when the markets were dysfunctional. The merger of Merrill Lynch into Bank of America and the acquisition of Bear Stearns by JPMorgan both represented overt attempts to preserve the infrastructure of the primary dealer community, in the view of the author, more than efforts to fight perceived systemic risk.

In each case, the Fed interposed its balance sheet and credit to save the financial markets from a liquidation and orchestrated mergers among some of the largest banks, arguing in essence that bailing out these private firms was necessary to save civilization from complete collapse. Yet the fact remains that Lehman Brothers did fail, it did go through bankruptcy and the world did not end. As Peter Wallison of the American Enterprise Institute wrote in a recent commentary:

Unlike Bear, Lehman was likely not solvent, and it had certainly become illiquid by the time it filed for bankruptcy. Nevertheless, despite all the market turmoil that followed Lehman's bankruptcy filing, there was only one case of a Lehman counterparty or creditor failing because of Lehman's inability to meet its financial obligations. That case was the Reserve Fund, a money-market fund that held a substantial amount of Lehman's commercial paper. The Reserve Fund's losses caused it to "break the buck" — in other words, it failed to maintain a \$1 per share redemption value — and triggered runs at other money-market funds where investors felt they might be at risk of a similar loss. The threat to "thousands of counterparties" that Bernanke envisioned occurring if Bear had not been rescued never materialized after Lehman filed for bankruptcy.¹⁷

The instability of financial institutions and heightened volatility observed in the financial markets is merely a symptom of a far greater fiscal disorder in Washington and one that is deliberately perpetuated by the central bank. While critics of Chairman Greenspan like to blame him for the subprime bubble, not nearly enough attention is paid to the fact that American presidents from Bill Clinton forward allowed the Fed Board to become

¹⁷ Wallison, Peter J. (2010), "Ideas Have Consequences: The Importance of a Narrative," *Financial Services Outlook*, May. <http://www.aei.org/outlook/100960>.

very narrowly focused on monetary policy. Only very recently has the Obama Administration made a deliberate attempt to nominate Fed governors who are not primarily economists — yet another legacy of the tenure of Chairman Greenspan. It is interesting to note that of the recent appointments by President Barack Obama, Dan Tarullo is a lawyer, Peter Diamond is an expert in Social Security and fiscal policy, Janet Yellen is an economist, Elizabeth Duke is community banker and Sarah Bloom Raskin, Maryland's commissioner of financial regulation.

Chairman Greenspan may not have been a particularly good economic prognosticator, but he was and is an exceptional politician. In 1992, when President-elect Bill Clinton invited Alan Greenspan to Little Rock, Greenspan jumped at the chance and reintegrated himself back into the White House policy loop he knew so well.¹⁸ By accommodating the political concerns of the White House, Greenspan gained effective control over the Fed's Board of Governors through his entire term and thus the Board and its staff tended to be focused almost entirely on monetary policy.

What Fed Independence?

We should recall the political battle between the Fed and Treasury from the late 1940s to 1951 over maintaining the artificially low interest rates prevailing during World War II, a struggle that restored the nominal independence of the central bank. In the Fed-Treasury Accord of 1951, the two agencies agreed on a set of rules with respect to their respective operations whereby the Fed would seek to maintain the Treasury's ability to issue debt while limiting the degree of monetization of federal obligations.¹⁹ In the intervening years, however, the political independence of the central bank has been steadily eroded by the fiscal excesses of the Treasury. Today the Fed can neither conduct credible monetary policy nor act as a good steward of the banking industry because of the enormous conflicts between monetary policy and prudential supervision.

¹⁸ Woodward, Bob (2001), *Maestro: Greenspan's Fed and the American Boom*, NY: Simon & Schuster: 95.

¹⁹ Hetzel, Robert L. and Ralph F. Leach (2001), "The Treasury-Fed Accord: A New Narrative Account," Federal Reserve Bank of Richmond *Economic Quarterly*, Winter: 33-34.

Compared with the capitulation by Chairman Bernanke and the FOMC during the 2008-2009 market collapse, when the central bank subordinated itself to the Treasury in order to bail out banks and whole markets, the posture of the Fed in 1950 was remarkable. By refusing to cave in to pressure from President Truman, Fed Governors such as Mariner Eccles and Chairman Tom McCabe, and FRBNY President Allan Sproul were heroes in the American story of money and debt. Truman had refused to re-appoint Eccles as Fed Chairman because of the dispute over interest rates, but Eccles remained on the Board to support McCabe for the balance of his tenure as governor. Even when Chinese troops attacked American troops in Korea, the Fed refused to change its plans to restore market interest rates to the U.S. markets.

In a telling lesson for today's policy makers, only when the Fed regained control of monetary policy in 1951 were market rates really reflective of investor sentiment and risk instead of the carefully controlled market that reflected the wartime fiscal priorities of the Treasury. More important, inflation started to subside, at least prior to the Korean War. The Fed now faces precisely that same choice between political expedience and the soundness of the financial system and the dollar. Today maintaining the short-term stability of the U.S. economy by targeting private credit creation is the Fed's new "wartime" task. Since many senior Fed officials tend to hold beliefs regarding economic policy ranging from neo-Keynsian socialism to various variations of the Taylor Rule, credit targeting and direct intervention to bail out failed banks is hardly a great leap of faith. In a speech to Humboldt University in Berlin in June 2010, George Soros illustrated the basic dilemma facing the Fed and all global central banks:

In the week following September 15, 2008 global financial markets actually broke down and by the end of the week they had to be put on artificial life support. The life support consisted of substituting sovereign credit for the credit of financial institutions which ceased to be acceptable to counterparties. As Mervyn King of the Bank of England explained, the authorities had to do in the short-term the exact opposite of what was needed in the long-term: they had to pump in a lot of credit, to replace the credit that had disappeared, and thereby reinforce the excess credit and leverage that had caused the crisis in the first place. Only in the longer

term, when the crisis had subsided, could they drain the credit and reestablish macro-economic balance.²⁰

The increasingly visible schizophrenia in Fed policy roughly parallels the compromises in terms of monetary policy that the Fed has been forced to make since the 1970s. Not since Fed Chairman Paul Volker (1979-1987) has a Fed chairman been willing to confront a President and the Congress over inflation and fiscal excess. But since the departure of Paul Volcker and the arrival of Alan Greenspan, the Fed has entered a period of increased accommodation and virtually no conflict with either the Congress or the Executive branch. John Taylor refers to this period as being “From Great Moderation to Great Deviation to Great Recession.” He observes:

Why did the Great Moderation end? In my view, the answer is simple. The Great Moderation ended because of a “Great Deviation,” in which economic policy deviated from what was working well during the Great Moderation. Compared with the Great Moderation, policy became more interventionist, less rules-based, and less predictable. When policy deviated from what was working well, economic performance deteriorated. And lo and behold, we had the Great Recession.²¹

The compromises made by the Fed to fulfill the twin legal mandates of 1) full employment and 2) price stability have made it increasingly difficult if not impossible for the Fed to also function as an effective prudential regulator. Simply put, the Fed is so busy keeping the U.S. economy growing at some minimal, politically acceptable level of growth and at the same time working to prevent the over-indebted U.S. government from sliding into monetary collapse that managing the nation’s banks has at best taken a back seat. The real problem in the U.S. over the past decade was that Bernanke and the other members of the Fed Board were so committed to targeting a minimum level of private credit expansion that they ignored other indications that something was seriously amiss in the financial system.

²⁰ Soros, George (2010), “George Soros Speech at Humboldt University,” June 23. http://www.georgesoros.com/interviews-speeches/entry/george_soros_speech_at_humboldt_university/.

²¹ Taylor, John B. (2010), “Getting Back on Track: Macroeconomic Policy Lessons from the Financial Crisis,” Federal Reserve Bank of St. Louis *Review*, May/June. <http://research.stlouisfed.org/publications/review/10/05/Taylor.pdf>.

It needs to be said that whole generations of Fed officials have been groomed to act (if not believe) that current U.S. fiscal policy is sustainable, thus the agency has an abrasive self-confidence about all of its policy prognostications. Yet the central bank almost never says no to demands for liquidity from either the financial markets or the Treasury. It can be argued that coming out of the 1990s, when Treasury ran a primary surplus including receipts for Social Security, Fed policy was too accommodative because of a false sense of confidence regarding the fiscal outlook. Many economists actually talked about the Treasury paying down most of the public sector debt during this period, this even though the surplus was transitory. Studies were performed on how to conduct monetary policy in a market where there was no significant public sector debt. To his credit Chairman Greenspan raised the very medium and long term fiscal issues regarding Social Security and other unfunded mandates that have since driven federal budget deficits into the stratosphere. It is interesting to note that 2010 marked the inflection point when contributions to the Social Security trust fund are now smaller than benefit payments.

A Culture of Innovation

In the same way that the Fed gradually has been forced to accommodate monetary policy to the increasingly dissolute fiscal behavior of the Congress and the U.S. Treasury, it has likewise been forced by political pressure from the Congress and the Executive Branch to essentially allow the largest banks to do everything and anything in search of profit. The Fed's lack of leadership in terms of market structure in the U.S. makes arguing over distinctions about the solvency of supposedly private banks seem a little absurd. Martin Mayer told Gretchen Morgenson of the *New York Times*: "This insistence that you mustn't slow the pace of innovation is just childish," Mayer said. "Innovation has now cost us \$7 trillion," he added, referring to the loss in household wealth that has resulted from the crisis. "That's a pretty high price to pay for innovation."²²

²² Morgenson, Gretchen (2010), "It's Time for Swaps to Lose Their Swagger," *The New York Times*, February 27. <http://www.nytimes.com/2010/02/28/business/economy/28gret.html?pagewanted=all>.

The Fed's abandonment of the decades of success in using leverage ratios to define well capitalized banks, which kept down the number of failures, seems to be a direct contributor to the scale of the financial crisis. The entire framework of the Basel II capital accord was a celebration of efficient market theory and the OTC marketplace. Contemporary risk measurement concepts such as "Value at Risk" were substituted for traditional, consistent and deterministic measures of solvency. In many cases, the valuation models and solvency measures were generated by the banks themselves and were thus made peer comparisons impossible. One of the greatest and least remarked upon failures of the Fed and other global regulators during this period was allowing the banks, in effect, to set their own rules.

The era of financial innovation under Chairman Greenspan was a time when the Fed Board and their counterparts at the Bank for International Settlements loosed themselves from the bounds of earth and embraced relativity in assessing bank safety and soundness. When you add the opacity of the financial products in the OTC markets and the poor methods for managers or regulators to gauge the credit and market risks of these securities, the scenario for the 2007-2009 market disaster was perfect.

If you really examine the collapse of Lehman Brothers and Bear, Stearns & Co., in both cases the firms had more than adequate capital, at least as governed by the marketplace. While it might be argued that more capital would have made these organizations more stable, especially given their true risk profiles, this author believes that the issue of market structure was the determining factor in these failures. Citigroup too had levels of capital that, while below peer, were still in the right neighborhood. But in each case, it was the risk-taking activities of these banks that made whatever capital they had in place irrelevant — often by an order of magnitude or more. If you doubled the capital of Lehman or Bear Stearns or WaMu, for example, would it make the financial system less risky? Would these institutions have survived? Since they held sufficient capital, at least according to regulations, and did not survive, the answer must be no.

“Our system evolved from one funded by intermediaries, to one largely financed by markets,” noted FRBNY Executive Vice President Terrence Checki in a December 2009 speech to the Foreign Policy Association. “The traditional ties between borrower and creditor were weakened as credit risk became just another commodity to be traded and distributed.”²³ The same wave of selling and collateral demands would have destroyed the largest commercial banks too. Were it not for the extraordinary actions by the Fed to essentially float the entire rancid corpus of private label residential mortgage securitizations on the rising tide of liquidity in the form of quantitative easing, many more institutions likely would have failed.

One of the key issues that global regulators and their political leaders still don't seem to understand is that while the crisis that began in 2007 did start in the market for non-bank finance, much of the market for ABS and derivatives was sponsored by the banks themselves and/or the Buy Side clients of the largest banks. In the world of off-balance sheet or "OBS" vehicles and OTC derivatives, the effective leverage on the capital of banks and non-bank dealers was infinite and still remains today far higher than official capital ratios suggest. In a risk adjusted and economic sense, the total assets and liabilities of a financial institution includes all securitizations, variable interest entities (VIEs), and derivatives exposures.

For example, Wells Fargo's market “footprint” includes \$1.7 trillion in securitizations and VIEs that are not consolidated under Financial Accounting Standards Board (FASB) 166/167. These off-balance sheet vehicles were “financed rather than funded,” to again borrow Checki's expression. The apparent liquidity for these vehicles collapsed as soon as concern about counterparty credit risk became pronounced. The Fed and other regulators actively encouraged banks to increase their leverage via OBS securitizations, VIEs and OTC derivatives. The regulators accommodated these activities to increase effective leverage in order to enhance the appearance of nominal profitability of the large banks.

²³ Checki, Terrence J. (2009), “Comments to the Foreign Policy Association of New York,” December 2.

The True Nature of Credit Default Swaps

In order to understand the negative impact of the OTC markets and especially the market for credit default swaps (CDSs) and similar instruments on prudential regulation, both from an institution and systemic perspective, it is important to review some key issues that many regulators and policy makers still do not fully appreciate:

- **Symmetry vs. Asymmetry:** While OTC contracts for interest rates, currencies and even energy tend to be symmetrical and thus self-regulating in terms of balancing risk positions, the OTC credit markets are not. CDSs and similar derivatives are contingent or “barrier” options to use the insurance industry term. Thus while OTC “swaps” in interest rates or energy tend to help diversify and balance risk, CDSs can be used to create highly toxic concentrations of risk on one side of a given trade. Since there is cash settlement for these CDS contracts and no credit or market oversight, as is found in a multilateral exchange, these concentrations go unnoticed. In the case of AIG, this factor became fatal and caused the collapse of the entire company.²⁴
- **Back Office vs. Front:** Starting in 2007, then FRBNY President Tim Geithner and other members of the OTC dealer community began to focus on the back office problems in this unregulated market. While much of the attention focused on the issue of clearing these bespoke, non-standardized contracts, Fed officials missed the fact that much of the volume in the market was still not being reported to the clearinghouse. Specifically, AIG was not reporting its sales of CDS contracts to Fiserv or the New York clearing house. Thus neither the Fed nor the other regulatory agencies were aware of the exposures being created in the front office of AIG. Meanwhile, Goldman Sachs, Deutsche Bank, JPMorgan and other dealers essentially looted AIG and then forced the Fed to bail out their client!²⁵

²⁴ Morgenson, Gretchen and Louise Story (2010a), “How Goldman Pressed A.I.G. for Cash,” *New York Times*, July 1, B1.

²⁵ Morgenson and Story (2010a). See also Morgenson, Gretchen and Louise Story (2010b), “In U.S. Bailout of A.I.G., Forgiveness for Big Banks,” *New York Times*, June 29: A1.

Ironically one often cited explanation for the crisis of 2007-2010 is that because Bear Stearns and Lehman were not part of the "bank" club, these firms failed. Goldman Sachs and Morgan Stanley were saved only via extraordinary efforts by the Fed and conversion of these broker-dealers into ersatz commercial banks. But the wave of selling and demands for cash and collateral that almost destroyed all of the non-bank dealers was a function of confidence, not capital. All of the major banks in the U.S., whether a commercial bank or broker dealer, were effected equally in the collapse of the OTC marketplace.

Toward A Rules-Based Regulatory System

By deliberately encouraging and tolerating the growth of complex OTC instruments inside banks, Fed officials have been sowing the seeds of our collective destruction — but the arrogance of Fed officials makes them believe that they are capable of managing such a financial system. One of the great paradoxes of our time is the insistence of intelligent, well-educated economics professionals who model the likely outcomes in our economy without understanding many of the details. As long as behavior is expected to be rational, actual outcomes will follow the models.

David Colander of Middlebury College testified before the House Science and Technology Committee in September 2009 on the difficulty of applying the tools of the hard sciences to social sciences such as economics or quantitative modeling:

Using models within economics or within any other social science, is especially treacherous. That's because social science involves a higher degree of complexity than the natural sciences. The reason why social science is so complex is that the basic unit in social science, which economists call agents, are strategic, whereas the basic unit of the natural sciences are not. Economics can be thought of the physics with strategic atoms, who keep trying to foil any efforts to understand them and bring them under control. Strategic agents complicate modeling enormously; they make it impossible to have a perfect model since they increase the number of calculations one would have to make in order to solve the model beyond the calculations the fastest computer one can hypothesize could process in

a finite amount of time. Put simply, the formal study of complex systems is really, really, hard. Inevitably, complex systems exhibit path dependence, nested systems, multiple speed variables, sensitive dependence on initial conditions, and other non-linear dynamical properties. This means that at any moment in time, right when you thought you had a result, all hell can break loose.²⁶

Unfortunately, few of the people who work for the Federal Reserve Board and other prudential regulators in Washington have apparently heard this news. Classical economists such as John Stuart Mill “recognized the economy’s complexity and were very modest in their claims about the usefulness of their models,” Colander continues. But at the Fed’s Board of Governors in Washington, the belief in possibility of a God’s eye view of the global markets and even the inner workings of institutions and complex securities remains intact. Despite public comments by the Fed regarding the need to reduce systemic risks, the Fed’s support for highly destabilizing asset classes such as OTC derivatives remains unchanged. At a March 20, 2010 speech to the Independent Community Bankers, Chairman Bernanke said:

It is unconscionable that the fate of the world economy should be so closely tied to the fortunes of a relatively small number of giant financial firms. If we achieve nothing else in the wake of the crisis, we must ensure that we never again face such a situation.²⁷

And yet in the maneuvering and lobbying over financial reform legislation during the past year and more, the Fed has gone out of its way not only to preserve its regulatory turf, but to defend and keep as unaffected as possible the activities of the largest dealer banks in instruments such as OTC derivatives, instruments for which there is no real market nor any connection to the real economy. Keep in mind that when you explicitly depend upon efficient market theory to identify risk or manage prudential soundness of

²⁶ Colander, David (2009), “The Risks of Financial Modeling: VaR and the Economic Meltdown,” Testimony submitted to the Congress of the United States, House Science and Technology Committee, September 10.
http://democrats.science.house.gov/Media/file/Commdocs/hearings/2009/Oversight/10sep/Colander_Testimony.pdf.

²⁷ Bernanke, Ben (2010), “Preserving a Central Role for Community Banking,” Independent Community Bankers of America National Convention, March 20.
<http://www.federalreserve.gov/newsevents/speech/bernanke20100320a.htm>.

banks, you are flying blind. That is precisely the situation with OTC credit derivatives. Rajiv Sethi Professor of Economics, Barnard College, Columbia University, argues that:

Generally speaking, stability in financial markets depends on the extent to which trading is based on fundamental information about the securities that are changing hands. If too great a proportion of total volume is driven by strategies that try to extract information from market data, the data itself becomes less informative over time and severe disruptions can arise.²⁸

The Fed's fierce opposition to efforts by former Fed Chairman Paul Volcker to force banks out of OTC derivatives for their own account illustrates the degree of capture by the banks over their supposed prudential regulator. The sad fact is that OTC derivatives increase systemic risk far beyond the native risk that exists in the real economy. Some current and former regulators contend that these instruments are a fact of life and proposing some systematic means of managing their risk is unacceptable. But OTC derivatives may be impossible to risk manage and are thus impossible to regulate, particularly in times of market stress. As already discussed, the key flaws of the OTC markets, including dependence upon a bilateral credit and collateral relationship, and the lack of symmetry in CDSs, are issues that a central clearing facility only partly address. As the author had learned as a risk practitioner over several decades, liquidity risk exists only in particular transactions and cannot be measured or managed in aggregate.

An Objective Basis for Finance and Regulation

One of the core fallacies of the Fed as a prudential regulator is the notion that models can effectively manage risks inside large financial institutions. The term "model" as it applies to finance or regulatory structures such as Basel II can be described as a simulation of reality in terms of predicting future financial outcomes or events. The author Nassim Taleb says the term "VaR" or value at risk describes a statistical estimate

²⁸ Sethi, Rajiv (2010), "The New Market Makers," June 4. <http://rajivsethi.blogspot.com/2010/06/new-market-makers.html>.

of “the expected maximum loss (or worst loss) over a target horizon within a given confidence interval.”²⁹

VaR models and similar statistical methods pretend to estimate the largest possible loss that an investor might experience over a given period of time to a given degree of certainty. The use of VaR type models, including the version imbedded in the Basel II agreement, involves a number of assumptions about risk and outcomes that cannot be effectively hedged, yet public officials such as Chairman Bernanke and other Fed official pretend otherwise. More important, the widespread use of these statistical models for risk management and the regulation of financial markets suggests that large financial institutions, especially those active in OTC derivatives markets, are subject to periodic “Black Swans” in the form of risk events that cannot be anticipated.³⁰

But this author takes a different view. There is no such a thing as a “Black Swan.” A more likely explanation is that leaders at the Fed, in finance and in politics, simply made the mistake of, again, believing in what were in fact flawed models and blinded themselves to what should have been plainly calculable risks created by deviations from established prudential norms. When John Taylor talks about the Great Deviation in terms of Fed monetary policy in the 2000s, we should also speak of the deviation in terms of what was acceptable in the financial markets and in terms of prudential regulation.³¹

As early as 2004 with the publication of the policy statement on “Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities,” the Fed, prudential regulators and SEC all publicly recognized that there were legal and reputational risks to banks dealing in OTC derivatives. Yet nothing was done to rein in this activity. If financial markets and the models used to describe them are limited to

²⁹ Taleb, Nassim (1997), “Against Value-at-Risk: Nassim Taleb Replies to Philippe Jorion.” <http://www.fooledbyrandomness.com/jorion.html>.

³⁰ For an excellent discussion of the misuse of mathematics and other quantitative tools expropriated from the physical sciences by economists, regulators, and investment professionals, see Whalen, Christopher (2008), “New Hope for Financial Economics: Interview with Bill Janeway,” *Institutional Risk Analyst*, November 17.

³¹ Taylor (2010).

those instruments that can be verified objectively, then we no longer need to fear the ravages of Black Swans or systemic risk. The source of systemic risk in the financial markets is fear born from the complexity of opaque securities for which there is no underlying basis. And yet the Fed's Washington staff, in their arrogance, believe that OTC derivatives, which have no observable cash markets, may be substituted for cash securities and that to do so is consistent with safe and sound banks.

The real sea change that is required by the Fed and other prudential regulators to recover credibility is to insist that most OTC transactions be standardized and migrated to public, multilateral exchanges. Non-standard OTC products should be subject to rigorous reserving and disclosure, as proposed in pending reform legislation. If we accept that the sudden change in market conditions or the "Black Swan" event that Taleb and other theorists have so elegantly described arises from a breakdown in prudential regulation and basic common sense, and not from some unknowable market mechanism, then we no longer need to fear surprises or systemic risk. To avoid systemic risk, we need to simply ensure that all of the financial instruments in our marketplace have an objective basis, including a visible, cash basis market that is visible to all market participants.

If investors cannot price a security without reference to subjective models, then the security should be banned from the U.S. markets as a matter of law and regulation. Simply saying that we must accept the existence of OTC markets because they enhance bank profits, even though we know that these instruments also increase systemic risks, is an act of intellectual cowardice. The Fed needs to develop the courage to say no to the banking industry and, in so doing, might be surprised by the level of public support for greater sanity in the world of finance.

As Graham and Dodd wrote nearly a century ago, the more speculative the inputs the less the analysis matters.³² Models only have real value to society when their workings are disciplined by the real world. When investors, legislators and regulators all mistook

³² Graham, Benjamin and David Dodd (2002), *Security Analysis: The Classic 1940 Edition*, NY: McGraw-Hill Professional: 343.

models for markets, and even accepted such speculations as a basis for regulating banks and governing the OTC markets for all types of securities, we as a nation were gambling with our patrimony. Were the failures of Bear Stearns, Lehman Brothers, WaMu or the other "rare" events really anomalous? Or are we just making excuses for our collective failure to identify and manage risk?

Supporting “Financial Innovation”

While the leadership of the Federal Reserve Board is largely drawn from the world of monetary economists, historically there were virtually no economists in the Board’s Division of Supervision and Regulation (DS&R). It is especially relevant that during the key time of the tenure of Alan Greenspan leading up to the crisis, a non-economist named Rich Spillenkothen headed the DS&R for many years. During this time, when some Fed officials set records for tenure at any federal agency, the DS&R was regarded by some close observers of the Fed as being behind the curve on financial innovations.

When JPMorgan Chase, Citibank and some of the other large, internationally active banks began to expand into OTC securities and derivatives, and lobby in Washington for even greater powers and exemptions, the Fed Board and other agencies were either caught unaware or actively assisted in the process of liberalization of prudential rules. Though Chairman Greenspan relegated both DS&R and Consumer Affairs to non-priority status, this did not prevent many Fed governors and staffers from actively supporting the expansion of the OTC market for subprime debt and derivatives, a posture that continues to this day.

In October of 2009, Fed Chairman Ben Bernanke and Governor Dan Tarullo promoted Patrick M. Parkinson as director of the Division of Banking Supervision and Regulation. Parkinson had formerly worked as a senior official in the DS&R at the Fed, where he was known as a brilliant researcher and also a tireless advocate for bank participation in OTC derivatives and other forms of “financial innovation.” As already noted, OTC products

were enshrined in the Basel II framework, so Parkinson's support for OTC was typical of many Fed officials and is used as a general illustration.

The Fed press release announcing Parkinson's appointment noted that as an economist and senior adviser in the Board's Division of Research and Statistics, Parkinson served as the division's deputy director. Of note, Parkinson served as the Chairman's principal staff adviser on issues considered by the President's Working Group (aka the "Plunge Protection Team") on Financial Markets from 1993 to 2008.

In addition, at the time of his promotion, the *Wall Street Journal* reported that Parkinson "recently took a leave from the Fed to work at the Treasury, where he was an architect of the Obama administration's proposed overhaul of financial regulation. The administration's financial-revamp plan, now pending in Congress, would give the Fed more authority over systematically important financial institutions and move consumer regulation to a separate agency."³³

Notice, too, the stint by Parkinson working for the President's Working Group, a semi-public entity which lobbies regulators on public policy, and even distributes white papers and other documents to federal and state prudential regulators, but is completely unaccountable to the Congress or the public. Keep in mind too that when Alan Greenspan, Robert Rubin, Phil Gramm and Larry Summers were attacking U.S. Commodity Futures Trading Commission head Brooksley Born more than a decade ago for suggesting that OTC derivatives ought to be better regulated, Fed staffers like Parkinson were on Capitol Hill laying down a supporting barrage of barnyard debris for the big banks. And instead of being disciplined for his more than decade long role in encouraging this fiasco, Parkinson was promoted to head the Fed's key DS&R by Chairman Bernanke.

³³ Reddy, Sudeep and Damien Paletta. 2009. "Fed Chooses Staff Economist as Head of Bank Supervision." *Wall Street Journal*, October 21. <http://online.wsj.com/article/SB125607088907997189.html>. See also Harwood, John (2010), "Obama Looks to Close Sale on Financial Reform," *New York Times*, April 22. <http://dealbook.blogs.nytimes.com/2010/04/22/obama-looks-to-close-sale-on-financial-reform/?scp=1&sq=Obama%20looks%20to%20close%20sale%20on%20financial%20reform&st=cse>.

In May of 1999, for example, Parkinson testified on modernization of the Commodity Exchange Act (CEA) before the Subcommittee on Risk Management, Research, and Specialty Crops, Committee on Agriculture, U.S. House of Representatives. In that testimony, he said that the Congress did not need to extend the CEA to OTC derivatives. Parkinson also warned that regulation of OTC derivatives might make U.S. banks uncompetitive:

[I]f the United States continues to impose what market participants perceive as unnecessary regulatory burdens, such systems could instead develop abroad. In particular, much of the existing activity in financial derivatives consists of transactions between large global financial institutions, all of which already have substantial operations in London.³⁴

In 2005, when Parkinson appeared before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, he was still singing the Greenspan song of free market discipline and how the OTC derivatives markets did not need to be subjected to prudential oversight and regulation. Indeed, Parkinson's comments on behalf of the Fed Board of Governors were explicitly linked to the work of the President's Working Group and their efforts to stymie regulation of OTC derivatives:

The Federal Reserve Board believes that the [Commodities Futures Modernization Act of 2000] CFMA has unquestionably been a successful piece of legislation. Most important, as recommended by the President's Working Group on Financial Markets in its 1999 report, it excluded transactions between institutions and other eligible counterparties in over-the-counter financial derivatives and foreign currency from regulation under the Commodity Exchange Act (CEA). As the Working Group argued, regulation of such transactions under the CEA was unnecessary to achieve the act's principal objectives of deterring market manipulation and protecting investors. Such transactions are not readily susceptible to manipulation and eligible counterparties can and should be expected to protect themselves against fraud and counterparty credit losses...

³⁴ Board of Governors of the Federal Reserve. 1999. "Testimony of Patrick Parkinson, Associate Director, Division of Research and Statistics, on Modernization of the Commodity Exchange Act, before the Subcommittee on Risk Management, Research, and Specialty Crops, Committee on Agriculture, U.S. House of Representatives" May 18. <http://www.federalreserve.gov/boarddocs/testimony/1999/19990518.htm>.

Consequently, the Board believes that major amendments to the regulatory framework established by the CFMA are unnecessary and unwise.³⁵

By November 2008, when Parkinson again appeared before the Congress, he was singing a new tune — yet only an incremental change. The basic Fed line was to advance “reforms” to the OTC derivatives markets, but to continue supporting the use of OTC derivatives by the largest banks. He testified on credit derivatives:

As noted in my earlier statement, supervisors have worked with market participants since 2005 to strengthen the infrastructure of credit derivatives markets through such steps as greater use of electronic confirmation platforms, adoption of a protocol that requires participants to request counterparty consent before assigning trades to a third party, and creation of a contract repository, which maintains an electronic record of CDS trades. Looking forward, the most important potential change in the infrastructure for credit derivatives is the creation of one or more central counterparties (CCPs) for CDS.³⁶

And this basic policy by the Fed continues to this day. Yet notice that none of the reforms that are summarized above by Mr. Parkinson really address the fundamental problem of valuation and liquidity in the OTC markets for CDSs. Yes, having a central counterparty for all OTC CDS trades is a fine idea. But the fact that it took Fed officials the better part of a decade to reach this conclusion is incredible. The fact is that the multilateral exchanges have had central counterparties since the 1930s and even before, yet for some reason the Fed thought that OTC markets could function without this basic and well-accepted risk management feature.

Despite their belated and only partial demonstrations of contrition, many Fed officials apparently do still believe that trading in OTC derivative contracts on a bilateral basis is consistent with bank safety and soundness. As already noted, the same Fed economists

³⁵ Board of Governors of the Federal Reserve. 2005. “Testimony of Patrick M. Parkinson, Deputy Director, Division of Research and Statistics, on the Commodity Futures Modernization Act of 2000, before the Committee on Banking, Housing, and Urban Affairs, U.S. House of Representatives.” September 8. <http://www.federalreserve.gov/boarddocs/testimony/2005/20050908/default.htm>.

³⁶ Board of Governors of the Federal Reserve. 2008. “Testimony of Patrick M. Parkinson, Deputy Director, Division of Research and Statistics, on Credit Derivatives, before the Committee on Agriculture, U. S. House of Representatives,” November 20. <http://www.federalreserve.gov/newsevents/testimony/parkinson20081120a.htm>.

believe that big is better in the banking industry, even though the overwhelming data of historical data on the net losses of large banks and statistical evidence regarding risk suggests otherwise.³⁷ The more conservative bank supervision personnel in the DS&R in Washington, at the 12 regional Federal Reserve banks and within agencies such as the Office of the Comptroller of the Currency, Office of Thrift Supervision and Federal Deposit Insurance Corporation (FDIC), often opposed ill-considered liberalization efforts such as OTC derivatives and the abortive Basel II accord. But the Fed's powerful but isolated Washington staff of academic economists almost always had its way. And the Congress supports and encourages the Fed even as that agency's policies undermine the safety and soundness of our financial markets.

The result of our overly generous tolerance for economists dabbling in the real world of banking and finance is a marketplace where some of the largest U.S. banks are in danger of insolvency, because their balance sheets are laden with illiquid, opaque and thus toxic OTC instruments which nobody can value or trade. Comments by Fed officials made over the years to the Congress lauding the very same OTC cash and derivative instruments which caused the financial crisis are a matter of public record, yet none of the Fed officials in question have been censured or held accountable with the exception of some perfunctory public hearings before Congress.

Proposals for Improving Financial Regulation

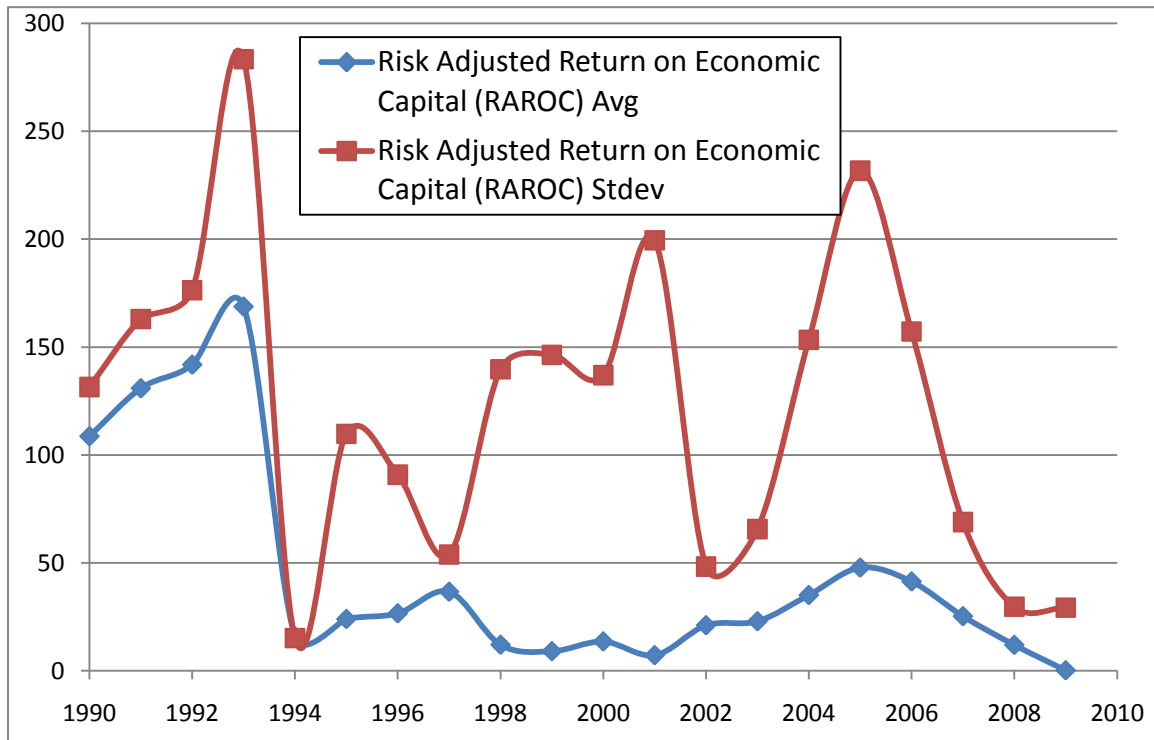
Making financial regulation effective again must start with a discussion of limits on risk taking activities by banks, particularly the use of OTC instruments and off-balance sheet securitizations and VIEs, the very toxic waste that now pollutes the Fed's balance sheet. The FASB rule requiring the repatriation of all OBS vehicles back onto the balance sheets of the sponsor banks at the end of last year started that process, but it will also illustrate that the problem is the effective leverage employed by banks, not static measures of capital, assets and liabilities.

³⁷ I recommend Martin Mayer's 2001 book, *The Fed: The Inside Story of How the World's Most Powerful Financial Institution Drives the Markets*, particularly Chapter 13, "Supervisions," on the Fed's role in bank regulation.

For example, former Chairman Greenspan is dead wrong when he calls the 2007-2009 financial crisis a "once in a century" event. If you as Fed chairman allow banks to continue to traffic in OTC derivatives and structured assets, then the only certainty is that the present systemic crisis will become the norm, not a "rare event" as Chairman Greenspan asserts. But these behaviors must be seen in the context of financial and fiscal actions by the Treasury and the Congress that are equally reckless. The banks on Wall Street merely mimic what they see in Washington.

The second aspect of this discussion about the regulation of markets and financial institutions that the leaders of the U.S. regulatory community must recognize is that risk-adjusted returns for larger commercial banks have been falling in the U.S. for almost a decade. Even with the supra-normal nominal returns earned by some larger banks from OTC and the mortgage bubble, the overall trend measured via the return on risk-adjusted return on capital (RAROC) calculated by The Institutional Risk Analytics (IRA) Bank Monitor in our Economic Capital model has been down, with less and less diversity observed among bank business models. The chart below shows RAROCs for the top 100 U.S. banks by assets for the period 1989 through 2009.

Risk Adjusted Return on Capital (%)



Source: FDIC/The IRA Bank Monitor

Despite the observable decline in risk-adjusted returns by large U.S. banks, the economists who populate the Fed continue to believe that current policies of supporting OTC cash and derivatives markets and other “innovations” are helping bank profitability and soundness, in nominal if not real terms. In fact, the banking industry and investors are responding to changes in the financial markets and the competitive environment that are largely caused by the Fed and Treasury. Unfortunately, with the growth in government debt and mandates, no amount of new prudential regulation will suffice to make the markets more stable. But you will never hear anyone at the Fed talk about such things, at least not in public, because doing so would hurt confidence.

We can place considerable blame on the Fed for the subprime crisis, but it must be said that an equally important factor was the tendency of Congress to use financial regulatory and housing policy to raise money and win elections. Members of Congress in both parties have freely used the threat of new regulation to extort contributions from the banking and other financial industries, often with little pretense as to their true agenda.

Likewise, the Congress has been generous in providing the banking industry with new loopholes and opportunities for regulatory arbitrage, enabling the very unsafe and unsound practices in terms of mortgage lending, securitization and the derivatives markets that has pushed the global economy into a deflationary spiral. But during most of the past decade or more when the Congress was creating new opportunities for “innovation,” Fed officials were either supportive of such liberalization efforts or silent as to the risks.

The subprime housing bubble that began the present crisis came about with the active support of the Congress, two different political administrations, the GSEs, the mortgage, real estate, banking, securities and homebuilding industries, and many other state and local organizations. It should also be recalled that the 1991 amendment to the Federal Reserve Act which allowed the Fed of New York to make the ill-advised bailout loans to AIG and other companies was added to the FDIC Improvement Act (FDICIA) legislation in the eleventh hour, with no debate by the Congress. The provision was added by members of the Senate Banking Committee and at the behest of officials of the Federal Reserve. The FDICIA legislation, let’s recall, was intended to protect the taxpayer from loss due to bailouts for large financial institutions.³⁸

The Neverending Crisis

It is important to understand that the same mindset of Fed officials that views speculative instruments such as OTC derivatives as an acceptable part of the financial markets is an outgrowth of the distorted worldview of the Fed more generally regarding the American political economy. Since President Richard Nixon took the U.S. Treasury off of the gold standard in 1971 and Washington embraced a policy of using deficit spending to maintain full employment, the Fed has been forced to rationalize a series of increasingly inconsistent policies pursued by the Congress and successive inhabitants of the White

³⁸ When the amendment to Section 13 of the FRA was adopted by the Senate, Fed Vice Chairman Don Kohn, then a senior Federal Reserve Board staffer, reportedly was present and approved the amendment for the Fed, with the knowledge and support of Gerry Corrigan, who was then President of the Federal Reserve Bank of New York and Vice Chairman of the FOMC. See also Whalen, Christopher (2009), “IndyMac, FDICIA and the Mirrors of Wall Street,” *Institutional Risk Analyst*, January 6.

House. It is interesting to observe that the financial crisis of 2007-2009 so badly damaged the credibility of America's political establishment that elements of the military and intelligence communities have begun to actively monitor and assess developments in the financial markets.³⁹

The idea of "financial innovation" is a canard adopted by the Fed and other central banks to maintain the appearance of profitability at some of the world's largest banks. As already discussed, Fed officials have known for more than a decade that the largest money center banks are not truly profitable without the supra-normal profits generated by OTC derivatives. An analyst for JP Morgan estimated that if the money center banks were required to exit OTC dealing activities as was threatened during the financial reform process, equity returns for these banks could fall by as much as one-third and reduce global investment bank return on equity to 11 percent from almost 20 percent today.⁴⁰ Yet on a risk adjusted basis, many of the largest U.S. banks often display negative returns even with the OTC derivatives flows factored into the mix, suggesting that, on net, the operation of the OTC derivatives markets is actually a drain on the real economy.

Benjamin M. Friedman, writing in *The New York Review of Books* on May 28, 2009, "The Failure of the Economy & the Economists," describes the market for credit defaults swaps in a very concise way and in layman's terms.

The most telling example, and the most important in accounting for today's financial crisis, is the market for credit default swaps. A CDS is, in effect, a bet on whether a specific company will default on its debt. This may sound like a form of insurance that also helps spread actual losses of wealth. If a business goes bankrupt, the loss of what used to be its value as a going concern is borne not just by its stockholders but by its creditors too. If some of those creditors have bought a CDS to protect themselves, the covered portion of their loss is borne by whoever issued the swap. But what makes credit default swaps like betting on the temperature is that, in the case of many if not most of these contracts, the volume of swaps outstanding far exceeds the amount of debt the specified company owes. Most of these swaps therefore have nothing to do with allocating genuine losses

³⁹ During the past three months, the author has been contacted by no less than three agencies in the U.S. intelligence community under the pretext of studying risks in the U.S. financial system.

⁴⁰ Dawn Kopecki, "U.S. Bank Profits May Suffer on Senate Bill, JPMorgan Says," *Bloomberg News*, May 27, 2010.

of wealth. Instead, they are creating additional losses for whoever bet incorrectly, exactly matched by gains for the corresponding winners. And, ironically, if those firms that bet incorrectly fail to pay what they owe—as would have happened if the government had not bailed out the insurance company AIG—the consequences might impose billions of dollars' worth of economic costs that would not have occurred otherwise.⁴¹

The dirty little secret that the Fed does not want to reveal is that the market for OTC derivatives is a tax, a form of gaming such as a lottery that effectively subsidizes the largest banks in the world. The Fed accepts and even encourages this situation because it knows that without the excess profits from OTC derivatives, many of the largest U.S. banks would wither and gradually die, as has been the case with the banking sector in Europe. The hollowing out of the real economy in the U.S. has forced the banking system to focus more and more on speculative activities for survival. The Fed knows that it is only one fiscal crisis away from the same situation that prevails today in the UK, France and Germany, where decapitalized banking systems are collapsing back into the arms of equally enfeebled, heavily indebted states. But it is interesting to note that, unlike the U.S., the EU member states seem to be determined to aggressively attack these fiscal deficits.

By subsidizing and protecting the U.S. banking system, the Fed seemingly believes that it is ultimately supporting its primary objective of keeping America's wobbly ship of state on an even keel. As former Fed Governor Alan Blinder said in 1994: "The last duty of a central banker is to tell the public the truth."⁴² But this, of course, assumes that we know the truth in the first instance. By encouraging and facilitating the fiscal excesses of Washington, the Fed has not only set a bad example for the banks and companies that make up the real economy, but it has poisoned the proverbial pond for all of the citizens of the world economy with a consistent policy tolerating growing inflation and debt. In such an environment, talking about sound banks or stable financial markets is absurd.

⁴¹ Friedman, Benjamin M. (2007), "The Failure of the Economy & the Economists," *The New York Review of Books*, May 28. <http://www.nybooks.com/articles/archives/2009/may/28/the-failure-of-the-economy-the-economists/>.

⁴² Blinder, Alan. 1994. PBS Nightly Business Report.

Richard Alford, who worked in the foreign exchange function of the Federal Reserve Bank of New York at the same time as the author, commented in the crisis of 2007-2009 from a risk management and public policy perspective:

Policymakers would like everyone to believe that the recent crises were random unpredictable Black Swan events. How can they be blamed for failing to anticipate a low probability, random, and unpredictable event? If on the other hand, the crises had observable antecedents, e.g. increased use of leverage, maturity mismatches, near zero default rates, and spikes in housing price to rental rates and housing price to income ratios, then one must ask: why policymakers did not connect the dots, attach significant higher than normal probabilities to the occurrence of severe financial disturbances, and fashion policies accordingly? Ultimately, that is a question that Ben Bernanke and the rest of the federal financial regulatory community still have yet to answer.⁴³

The monetary policies blessed by the Fed over the past forty years have ensured greater financial instability for banks and financial markets in the years ahead, not because the Fed is a bad regulator per se, but because its first job will always be keeping the U.S. Treasury floating on an ever expanding sea of dollars — even if this means destroying the private capital in banks and non-financial companies as a consequence. To really be “superlative” in this challenging time, Fed Chairman Bernanke, Governor Tarullo and their colleagues on the Federal Reserve Board need to start reclaiming the independence of the central bank, as their predecessors did in the 1950s and the 1970s, by learning how to say no. Then Chairman Bernanke can take his place next to predecessors like Eccles, McCabe and Volcker and say “I am superman.”

⁴³ Alford, Richard (2009), “Systemic Risk: Is it Black Swans or Market Innovations?,” *Institutional Risk Analyst*, August 18.

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