OCCUPY FINANCE

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"If you have an apple and I have an apple and we exchange these apples then you and I will still each have one apple. But if you have an idea and I have an idea and we exchange these ideas, then each of us will have two ideas."
George Bernard Shaw

In memory of Peter Reich, 1931-2013.
He shared ideas with us about the book, and we deeply miss sharing the result with him.

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Fighting Our Way Out of the Financial Maze

"Them that's got shall get
Them that's not shall lose
So the Bible said
And it still is news"

Billie Holiday, "God Bless the Child"

When frightening and destabilizing events were taking place in the financial world during the fall of 2008, it seemed like every day a new institution was on the brink of collapse and could be saved only by huge infusions of taxpayer money. After the dust — or rather, the dollars — had settled, we citizens naturally assumed that there would follow a day, or many months, of reckoning. How had the American economy arrived at such a moment, who was responsible, and what did we need to do to ensure that the same catastrophe would not happen again?

Five years have passed. Banks that were "Too Big to Fail" have gotten bigger, with the encouragement of the government. Wall Street continues to bundle and trade the many debts of average Americans. Big trading risks are taken by people who ignore regulations and their own internal warning systems, leading to enormous losses — e.g. JPMorgan Chase. The elements of the next crisis are being put in place at this very moment by some of the same people and institutions that brought us the last one. They are making money, lots of it, while the making is good.

There has been no reckoning. There have been no apologies. There have been no serious changes to the laws, to the reputations of the significant players in the crisis, or to the way business is conducted. Not only were the people responsible for the financial meltdown not prosecuted, they walked away with millions of dollars in profits even though they caused the companies they worked for to face bankruptcy. We do not even know exactly what happened to the billions of dollars that were handed over to private firms, except that almost none of it made its way to mortgage holders trapped by forces they could neither anticipate nor control. There has only been great suffering and the loss of homes, jobs, and confidence in a better future.

To add many insults to our economic injuries, the architects of austerity in Congress, the White House, and various state and local governments are requiring us to continue paying for the bailout with cuts in benefits, hikes in tuition, and loss of city, state and federal government services. Even worse, we are informed that we regular citizens, not the bankers and financiers, are the ones really responsible for any continuing fiscal distress, due to our profligate ways, our unpayable mortgages, and our pensions and health care costs.

This book is our reckoning. Some of us have long experience in the world of finance, having worked in banks or hedge funds or as financial advisors. Others of us are teachers, lawyers, students, or Teamsters who started out with a limited understanding of "securitization," "credit default swaps," and "collateralized debt obligations" but have taught ourselves about these instruments because we recognize their importance within our current economy. We have found that you do not need a PhD in math or economics to understand what is happening. We have also learned that it is imperative for us to know as much as we can about the workings of the financial system because some of the most interesting facts never get reported. Contrary to what the 1% would have us believe, the way things are is not the way they once were, not the way they have to be, and most importantly — not the way they should be.

The effects of the increased hold of the financial sector on ordinary American lives have come to our streets, where there are fewer police officers; to our schools, where there are fewer teachers; to our pension funds, which are being put at risk in speculative investments; and to our friends and family who face repaying mind-boggling student loans but are unable to find work that pays a living wage. We know that we cannot wait for other people — presidents, senators, regulators, CEOs, economists — to fix our system. They haven't. They won't.

Some kinds of cheating are publicly condemned. Athletes accused of using performance-enhancing drugs are exposed and forfeit their titles; teachers and administrators who alter test scores lose their jobs and are arrested. But where is the outrage when whole laws are written for and by big banks and financial firms to give them unfair advantages in relation to competition, tax policy, and influence within government? Why do the tax laws provide that the compensation of hedge fund managers does not count as “salary” and thus is taxed at a much lower rate? How much money is legally kept in off-shore accounts by businesses that use our infrastructure to secure their profits?

In this country we have been encouraged to trade the ideal of economic justice for that of equal opportunity, but this bargain, which never really existed, has been revealed as a cruel hoax. What we have is a lottery economy in which a very few people do extremely well and the rest of us are supposed to bend our energies toward becoming one of those lucky few. We are urged to think of ourselves as rugged individualists, and yet none of us gets through the day without the support of the people and the institutions around us. We who feel responsible for others as well as ourselves, for Americans who have lost their homes and are living in their cars or Bangladeshis who risk their lives in sweatshops, need to step up. We must join together to demand policies and laws that enable a robust and productive economy that distributes its rewards widely, rather than one which plays roulette with the nation’s wealth for the benefit of the few. When the foundations of our society — education of our children, care for the sick and injured, security for our elderly — are viewed simply as opportunities for the creation of ever more “innovative” financial products and profit centers, we erode the very basis of the communities that keep us all safe. We become prey for the financial predators.

We know that the way it is is not the way it has to be. Economic arrangements, however complex, opaque, and interconnected, are created by human beings and can be changed by them — by us. Taking on this responsibility is daunting, but also exhilarating. It is the first step in the direction of economic justice.

1. Heads They Win, Tails We Lose

"It is true, I earn my living.
But, believe me, it is only an accident.
Nothing that I do entitles me to eat my fill.
By chance I was spared.
(If my luck leaves me
I am lost.)

Bertolt Brecht

To have a sense of how banks and other financial entities have entangled American families in ever more complex economic arrangements, it will be useful to remind ourselves of what an average family's financial life looked like as recently as two generations, or forty years, ago. In general, a family had two outstanding debts: a mortgage on their home and a car loan. A small percentage of families took out an additional loan to help pay for a child's college expenses. The chances are excellent that the family got the mortgage from a local bank that would keep the loan until it was paid off and bought the car at a local lot.

Many families had a breadwinner, or sometimes two, whose jobs provided pensions and health insurance, among other benefits. Almost no families had credit cards. Only a minority of families had investments in the stock market. Therefore, at any particular moment, it was clear to the family where they stood — they knew how much they owed and to whom, what their interest rates were, and when their loans would be paid in full. They could also plan for retirement.

Not coincidentally, before ATM cards and the Internet, banks and stores had regular hours and were sometimes closed, on Sundays for instance. People were more likely to think in advance about what they were going to spend and would be reluctant to spend money they did not have.

How far we have come! A modern family, if it is one of the millions of families unlucky enough to have bought a house during the recent real estate bubble, probably has either a mortgage with a very high fixed rate or an adjustable-rate mortgage which began with a low teaser-rate, to encourage the family to buy, and subsequently rose to an unmanageable level.[1] The family could have had no way of knowing that the mortgage broker and the realtor and the bank representative and any lawyers involved had no interest in their ownership of the home or whether they could afford to pay for it or what would happen in one or two years — because all of these parties had collected their fees and the mortgage had been sold off to other interests. Most people had no knowledge or understanding of "securitization" and had no idea that their mortgage was now an entirely different financial product from the mortgage of their parents or grandparents.

In a naive way, we all tend to think, "People who lend money want to be paid; they wouldn't lend it if they didn't seriously expect to be paid." But of course this is no longer the case. Loans are made because the lender makes money from the debt and from fees associated with arranging for the loan — whether or not the borrower eventually defaults. We are suspicious when a stranger on the street offers to sell us a Rolex watch for fifty dollars, but why would we have had those same suspicions about the largest mortgage company in the U.S.A., Countrywide? One of many outrageous tactics of mortgage brokers was to steer families with good credit into signing for a subprime loan, at much worse rates, because the broker would then make a bigger profit.[2] When home prices were rising, a number of families with regular fixed-rate mortgages were encouraged to take out second mortgages or home equity loans, which were open to all of the same manipulations to generate higher fees as initial mortgages were. As we all now know, when the housing bubble deflated, many homeowners were caught paying exorbitant amounts for mortgages that were now valued at far more than their houses were worth. Thus it happened that what used to be considered the major forward-looking purchase in a family's life became, instead, a financial trap that a family could not escape without, at best, ruining its credit and, at worst, ending up homeless.

Car purchases also used to be more straightforward, although buyers have always been somewhat wary of car dealers. Now among the many ways a family can buy a car are:

- PCP or Personal Contract Purchase in which the buyer pays an agreed-upon amount for a fixed number of months and then has a hefty final payment before gaining ownership
- HP or Hire Purchase loan, which is similar to a PCP agreement but has some different features

- Borrowing from an online financial institution, with associated complexities and the lack of any particular person to explain the terms
- Using the money from a second mortgage or home equity loan
- Using a credit card
- Arranging the loan through the dealer

So our average American family has had two financial balls to juggle. And almost all families now have a third: credit cards.

The Normalization of Buying on Credit

Even though credit cards existed before the 1980s, a comparatively small number of people had access to them and used them. They were originally intended for customers with good credit as a convenience, to encourage them to do business with the issuing bank or institution. Diners Club cards, introduced in the 1950s, were one of the first general purpose cards (as opposed to department store charge cards). Complicating the introduction of credit cards that could be available to most Americans was the fact that interstate banking laws prohibited banks in one state from lending to customers in another, and each state set its own interest rate ceiling.

In 1978, however, the Supreme Court ruled, in the case of Marquette National Bank of Minneapolis v. First of Omaha Service Corp, that nationally chartered banks could do business across state lines and, most importantly, could charge people in other states the interest rate set in the bank's home state.[3] Bank deregulation had begun for real! This meant that banks could issue cards with more or less uniform high interest rates after they had incorporated in states like South Dakota that placed no limits on the interest banks could charge. By the 1980s, the proliferation of credit cards and their use and abuse began in earnest. Soon it seemed that everyone from heads of families to college freshman had at least one and sometimes many credit cards, and they used them a lot.

Note that our average family is already paying for a mortgage and a car and has severely limited discretionary funds. But credit cards enable this family to buy more goods and services, and thus to go further into debt, since most people do not pay their full credit card bill each month and are charged interest on the unpaid balance — interest as high as 29.99%.[4] Also, most people use more than one credit card. Often those cards are not used for flat-screen televisions or new clothes but, instead, for necessities like medical bills and food. A further complication of credit cards comes when the card holder is late with or misses a payment. Even though many people are aware of the high rates of interest they are being charged on their cards, they are often unaware of how large the late fees are and how these get added to their overall bill. Then these additional fees start to accrue, just as they do if payment is late for a mortgage or a car loan.

This would be the time to reflect on the fact that salaries for most American workers have remained stagnant or have even gone down in the last two generations. Median earnings for prime-age (25-64) working men have declined from 1970 to 2010, falling by 4%. But this statistic only accounts for working men, not those on disability or incarcerated or unemployed. The real decline is much greater.[5] Women have made more progress, but of course they started at a lower pay level. However even women's wages are down by 6% since 2000. It becomes more and more obvious that credit cards have been used to take up the slack. It is also obvious that credit card issuers, which are primarily the major banks, have made enormous profits from credit card interest payments and late fees. So we have a neat transfer of wealth from regular families to financial institutions — specifically to the people who work at the upper levels of those institutions or who own stock in them.

Possibly our average family has a child, and perhaps more than one, who is ready for college. Our society has told young people and their families over and over that college is a necessity if they want to have any kind of respected and reasonably paid job; they are considered irresponsible if they opt out of higher education. But very few families have enough money to pay for college expenses without borrowing. One of the more sobering statistics about credit cards is that around one-third of college students pay all or part of their tuition this way.[6] They will only be able to make partial payments on these cards for years.

Most students also take out some combination of federal loans with interest of 6.8% and private loans with varying interest rates. Students often have all three kinds of debt by the time they graduate, and the amounts they owe are truly extraordinary: average student debt at the time of graduation is around $27,000,[7] but students who have attended law school, medical school, or other graduate programs often owe many times that much.

In generations past, college graduates could usually find a job and begin paying a reasonable amount on their loans each month. Now the situation is very different. Not only is there high unemployment or underemployment for recent graduates, but the amount they must pay on their debts each month is insupportable. Everyone knows graduates who have moved back home to live with their families after college because, even if they have been lucky enough to find work, they can't pay off their college loans and also pay for a place to live and a car. These young people are not saving to buy a home or to start a family or a business; at the beginning of their adult lives, they are struggling just to get by.

What Happened To The Benefits?

In 1980, two out of three American workers were in defined-benefit pension plans provided by their employers, with guaranteed lifetime benefits.[8] By 2011, that number had shrunk to fewer than one in five workers, and it is continuing to go down. Now workers are expected to enroll in 401(k) plans through their employers or set up an Individual Retirement Account (IRA) on their own. There are four big problems for a family trying to provide for retirement through one of these financial instruments:

- The money in these funds is at much greater risk than money in traditional pensions, as we all saw during and after the financial crisis of 2008. A family can lose an enormous amount of retirement savings overnight.
- A family with no particular financial expertise has to figure out how to invest. Just as the markets and finance are becoming more complicated and less transparent, regular people are forced to gamble with their future.
- Families often ask financial advisors to help them sort through the various possibilities. But of course these advisors must be paid, with money that could have gone into the retirement account.
- In a crisis, a family sometimes withdraws money from these accounts and pays steep penalties — not only the taxes that had been deferred, but also an additional fee of 10%.

So our average American family, with mortgage debt, car debt, credit card debt, and student loan debt, also has no idea of how much will be in their retirement fund when it is time to retire — assuming they have not withdrawn the funds before that time for an emergency. They could be lucky — the stock market could be up and their mix of stocks and bonds could be performing well -or they could be wiped out. Ultimately, they have virtually no control over the outcome.

The other benefit that workers relied on was employer-provided health insurance, not just for themselves but also for their families. After World War II, because of wage controls, employers offered health benefits in order to compete for workers. The number of employers offering this benefit grew until the early 1980s. However, as health care costs increased, employers cut back on various benefits, health care among them. In 2010, only 55.3% of American workers had employer-based health insurance, and workers were paying more for it.[9] This means that almost half of all working people don't get access to health care through their jobs. Even when they do have such benefits, coverage is often seriously inadequate and the deductible — the amount the family must pay before they receive any insurance assistance — is very high.

A 2009 study in The American Journal of Medicine reported that, of people who declared bankruptcy because of medical bills, 75% were covered by health insurance.[10] And employers, particularly non-union employers, can change the coverage they offer at will, as can the health insurance corporations. Walmart, which had been heavily criticized for not providing health insurance and for paying workers so little that they were actually eligible for Medicaid, announced that it was improving its health insurance policies in 2006.[11] However, by 2011 Walmart rescinded most of those changes, particularly those which covered part-time workers. As we know, many companies deliberately keep workers' hours below the number at which they would be eligible for benefits. In other words, they intentionally add more part-time workers rather than increase the hours of the workers they already have in order to avoid paying for benefits. If our average family is fortunate, at least one breadwinner has employer-provided health insurance which also covers the spouse and children, but there is a one-in-two chance that this is not the case.

Historically, pensions and health insurance were offered to workers in lieu of pay raises. Now, the productivity of Americans has increased, but their salaries have not gone up and their benefits have been seriously eroded. What, we hardly need to ask because we already know the answer, has happened to the money that could have paid higher wages and decent benefits?

Blood From A Stone

So far we have been discussing the increasing financial burdens on an average American family. But what about the burdens on the millions of families that survive on less than $30,000 a year, sometimes much less? Their situation is truly desperate — but not so desperate that various businesses cannot make money from their distress. The general name for this sector of the economy is Alternative Financial Services, which covers everything from check-cashing stores to payday loan providers. What is most interesting about these “alternative” services is how closely they are connected to regular, mainstream institutions like JPMorgan Chase.

Unless a bank depositor maintains an average monthly balance, usually of more than $1,000, he or she will be charged a monthly fee and various additional fees for checking and other services. Many people who are unable to maintain a large enough balance are therefore driven to use check-cashing services, for which the fee is usually 1.5% to 3.5% of the face value of the check. They also have to figure out how to pay their bills without a bank account, often using money orders or other expensive options. Walmart and Kmart now offer check-cashing services at their stores, illustrating how “alternative” quickly becomes normalized when there are profits to be made.

Since the Credit Card Act went into effect in 2010, placing some restrictions on credit card issuers, the use of prepaid cards has exploded. These cards are most often used by people who can’t get regular credit cards. They are not yet regulated in the same way as regular credit cards, so, naturally, charges and fees that are not initially disclosed to the buyer are common. The buyer of a General Purpose Reloadable (GPR) card purchases the card which has a certain amount of money on it — but of course the card, and the service, comes for a fee. Other fees include monthly charges, a fee to activate, balance inquiry fees and dormancy fees, among others. A different kind of card, issued by the government to pay benefits, is the Electronic Benefit Transfer (EBT) card. We are not surprised to learn that the banks that are contracted to service these cards charge a variety of their own fees.

People who live paycheck to paycheck sometimes cannot quite make it through the week or two weeks between checks, and so they take out payday loans. Everyone, including the people asking for these loans, knows that they are a terrible, last-ditch option, but sometimes getting such a loan is a necessity. They can carry annual interest rates of over 500%. There are now many Internet-based payday lenders that can automatically withdraw payments from a borrower’s checking account. JPMorgan Chase, Bank of America, and Wells Fargo, among others, permit this practice. If the payday lender tries to withdraw money and it is not in the account, a fee is charged. So the borrower is paying not only extraordinary interest charges, but also excessive bank fees.

These are only some of the ways in which our largest institutions bleed money out of our most vulnerable citizens, and surely right now, at this very moment, new and ostensibly legal possibilities for turning some people's debt into other people's investment opportunities are being created. Exploitation never sleeps.

Is One Person's Profit Another Person's Loss?

We are used to thinking of ourselves as a rich country — rich in land, rich in natural resources, rich in the creativity and willingness of our people to work hard. Perhaps because of this, we have allowed ourselves to believe that large fortunes can be made by a few people and no one will be the worse for it. We refuse to make the connections between how money is made and what is happening in our society. How has great wealth affected our values and what is important to us in life? How has it affected our politics? How has it affected our environment? And most important, how has it affected not only our citizens but also other people in other countries?

We have slid, at first slowly and then rapidly, into making wealth our only measure of value, and we have encouraged our financial sector in its drive to find more and more ways to turn the necessities of life into profits. But there is a price to be paid. Some people are paying now and paying dearly. For the rest of us, the cost may be delayed — but the bill will come due.

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2. The Bailout: It Didn't Work, It's Still Going On, and It's Making Things Worse

"We're not that fussed about safety because, if we have an accident, it's you who pays."

John Lanchester[1]

The $700 billion bailout of the banks in 2008 is the most grotesque example of the how the financial system has been consistently shielded from its mistakes while citizens have paid the price of those same mistakes. Despite the narrative we all hear from the Obama Administration about how successful the bailout was and how it will never need to happen again, the truth is different: the bailout didn't work, it's still going on, and it's making things worse.

In this chapter we'll investigate how the bailout was intended to work, why the outcome wasn't even close to what was promised, and how the bailout morphed into our current system: the continual drip-feed of taxpayer money and obligation to an increasingly unstable financial system, a system that is, in many ways, more dysfunctional than it was before the financial crisis.

The Bailout Didn't Work

The Situation at the Time of the Bailout

In the summer of 2008, banks were in full-bore crisis mode, especially when Lehman Brothers was allowed to fail. The extensive interconnectivity of contracts between the banks, as well as the complexity of the legal and financial obligations among so many massive institutions, meant that the failure of the mortgage-backed securities market on the one hand and Lehman, one of the largest players in the mortgage and credit default swap (CDS) markets (see more about CDSs in the insert titled *CDOs, CDSs, and Magnetar Capital*), on the other hand, was freezing all sorts of very short-term financing markets, putting all the institutions on the brink of illiquidity and insolvency at the same moment.

What are short-term financing markets and why are they so critical to the financial system? As was explained in *The Bankers' New Clothes,*[2] over the past few decades the banks slowly evolved out of many kinds of long-term agreements between each other — on the scale of years or decades — and into short-term agreements — on the scale of days and weeks. This was a way of reducing the presumption of trust and the expectation of long-term solvency among them, and it allowed for more and more risk-taking by each individual bank. The new mindset was something like this: "I don't have to trust this bank to be around forever, just that it'll survive another week".

Rather than trying to understand the impenetrable accounting of the big banks (which would be needed for long-term investments), the system evolved to the point of depending crucially on overnight loans and very short-term financing by the time the financial crisis erupted in 2008. Indeed, the entire market hinged upon this fragile system of minimized trust to function, and once it failed, it came completely undone.

It's still a convincingly terrifying memory to recall: if something wasn't done immediately, we were at real risk of a situation in which businesses couldn't meet payroll, so people couldn't get their paychecks cashed, and possibly couldn't even withdraw cash from their savings. Since we no longer live in a local community where, by reputation alone, we can borrow or write IOUs until the system starts up again, this was indeed a menace to the citizens as well as to the politicians in this country. Have no doubt about it: when the Federal Reserve Bank or U.S. Treasury Department tells politicians "Do this or the financial system will collapse", there's real power behind that.

So the largest private financial institutions may in fact have been too big to let fail entirely, and we were quite right to prevent a very short-term emergency situation as outlined above. However, that doesn't mean we couldn't have implemented it in a very different way, a way that was fairer and would have encouraged better conduct in the future. To name a few obvious possibilities:

1. We could have nationalized the banks since there was never any moment when the need for "banking as service" was more obvious. That this was never seriously considered is a testament to how

strongly the Bush Administration, and since then the Obama Administration, have trusted the expertise of economists with a passionate belief in the “free market” when it comes to banks, except when bankers need help.

2. Since we are supposedly such free-market thinkers, we could have allowed real losses for the bondholders of the institutions, which is to say the banks could have defaulted on their loans. Presumably the bondholders knew about the risk they were taking when they bought the debt in the first place. That’s what’s supposed to happen in the free market after all. And yes, some of those bondholders were pension funds, but bailing out pension funds directly would have been more honest, forthright, and palatable than not letting insolvent banks fail. The fact that we didn’t do this is evidence that our free-market ideologies only go so far.

3. At the very least, we could have negotiated a change of management for the banks we were bailing out. We could have fired all of the CEOs, CFOs, and CROs who got us into these outrageous messes and had them replaced.

We didn’t do any of these things. Why? Because these bankers used to work for the Fed and the Treasury and were being protected by their friends in high places who were orchestrating the bailout.[3]

We didn’t even ask the banks to explain what they were doing with the money. The terms of the bailout were virtually devoid of any accountability.

Whenever you hear someone wax poetic about moral hazard for dead-beat borrowers, people who owe large sums on their credit cards (often due to medical debt), through their mortgages (possibly through predatory loan practices), or through their student debt (quite probably through inflated tuition at a for-profit institution or because the college in question simply had to hire another set of assistant deans), remind that person about the analogous moment in the bailout when dead-beat banks were given money with no strings attached, with no accountability. Where’s the real moral hazard?

Think, for a moment, about why things had come to this. Over a 40-year period we permitted the retail and investment banks to capture a disproportionate piece of our economic lives. They did so with outrageous and unregulated markets in derivatives (see chapter 4), including the overgrown mortgage derivatives market, Wild West accounting games played with repos,[4] and enormous interconnected counter-party agreements that inextricably tied each individual institution's fate to the fate of the larger market. Even the so-called boring and huge money market was at risk of collapse as the Treasury felt compelled to guarantee over $2 trillion in funds.[5]

To make a comparison between banks that played this game and a deadbeat individual, we'd need to create that rare character who had filled out every credit card offer ever mailed to him, had bought and flipped 15 homes and was in the process of doing that with 20 more, and was borrowing student loan money to satisfy a cocaine habit. That's the type of guy we gave our bailout money to.

How Big Was the Bailout?

The scale of the bailout that banks received is literally incomprehensible. This is painfully evident when we get confused between the words "billion" and "trillion". Just to have one solid reference point, the total current student debt just surpassed 1.1 trillion dollars, and it also recently surpassed the total credit card debt in this country.

Because the bailout was so massive, it's difficult to measure how big it ended up being. Given this, we'll rely on two different sources. According to the New York Times, the total bailout *commitment* was over $12 trillion, with about $2.5 trillion already spent. [6]

But let's be conservative and use the Bloomberg account from August 2011 which calculates that the total outflow of the bailout at that time was 1.2 trillion dollars.[7] Numerically, that's $1,200,000,000,000!

Specifically, **the bailout** consisted of the $700 billion TARP program, which had an **actual** outflow of over $605 billion, and which we will describe in the next section, as well as other programs **intended** to boost lending and to provide emergency "liquidity".

As the Bloomberg article notes, there were actually six different federal programs intended to keep the private credit markets–which allow for day-to-day financing of the economic system — functioning with taxpayer money in the fall of 2008 after the private lending markets had shut down. While we were being told that the ten largest financial institutions had borrowed about $160 billion from the Treasury Department, we weren't being told that the same ten firms were also borrowing an additional $669 billion in emergency funds from the Fed. For example, Morgan Stanley borrowed $107 billion, Citicorp borrowed $99.5 billion, and Bank of America borrowed $91.4 billion.

Almost half of the Fed's top 30 borrowers were European — not American — firms, including Royal Bank of Scotland, which borrowed $84.5 billion, and UBS AG, which borrowed $77.2 billion. A few European institutions required emergency federal loans from the Fed to stay liquid well into 2010.

Given all of these facts, we'll make the case that the Financial Sector used the opportunities presented by a crisis of their own making to secure even greater public advantages at taxpayer expense.

What We Were Told the Bailout Would Be Versus What it Actually Was

TARP was originally voted down by Congress. There wasn't much support at the time for saving bankers from their own mistakes. Then the market went down by 9% in one day and Congress, under pressure from the Treasury and Fed, capitulated to the banks and approved the $700 billion bailout program.

There were a few stipulations. One of them was to have a Special Inspector General (SIGTARP) in charge of overseeing the allocation of funds and making sure TARP wasn't defrauded and that the banks were held accountable. The second stipulation was that the banks would only get the first half — $350 billion—and would then have to come back for a second Congressional vote to get the second half.

The only real mistake the bankers and their lobbyists made in orchestrating the bailout came when they allowed Neil Barofsky to become the SIGTARP. Barofsky, formerly an assistant U.S. Attorney in the Southern District of New York, had just spent years prosecuting cases against Colombian drug lords that resulted in the indictment of the top 50 leaders of the Revolutionary Armed Forces of Colombia (FARC) on narcotics charges, the largest narcotics indictment filed in U.S. history. Barofsky was also a member of the Securities and Commodities Fraud Unit, where he prosecuted white collar crimes, including the accounting fraud case that led to the convictions of the top officers at Refco Inc.

In other words, Barofsky was just too honest and too tough to capitulate to Timothy Geithner, even when Geithner told Barofsky that was his job. In particular, Geithner wouldn't allow Barofsky to require the banks to explain what they were doing with the bailout money, essentially threatening Barofsky with the collapse of the financial system if he tried.[8]

Neil Barofsky's book, titled *Bailout: An Inside Account of How Washington Abandoned Main Street While Rescuing Wall Street*, was published in July

2012. It is an excellent account of the bailout from the inside. Barofsky explains that when the time came, Congress was reluctant to give Treasury access to the second half of TARP funds unless it was earmarked directly to help people stay in their homes. After all, the "TA" in TARP stands for "Troubled Assets," and the program was sold to Congress and the public (a) to prop up the mortgage market directly so that the investments people had made in their homes wouldn't be lost and (b) to renegotiate predatory or unrealistic mortgages directly, so that people could remain in their homes.

One of the first efforts the Obama Administration made towards cleaning up the financial mess was called the Home Affordable Modification Program (HAMP). Sadly, HAMP was nothing more than a token nod towards helping homeowners take advantage of the second half of the TARP money. It has been a failed project, to date only helping 1.1 million people stay in their homes [9] and denying millions more, although the program was originally intended to help four million homeowners.[10] Indeed, it is possible that HAMP was more harmful than helpful because of the perverse incentives it created for banks to string homeowners along without ever actually remediating their mortgages.

The way HAMP worked ultimately made more profit for banks if they got desperate homeowners to try to qualify for the program while, at the same time, foreclosing on those same homeowners and accruing fees. Why? Because the fee structure set up through HAMP was perverse: if, at the end of the HAMP application process, a homeowner's application was denied, the bank got to collect all the accrued late fees. If the application went through, it didn't.[11]

If this all seems completely crazy, there's one last kicker: it was intentional. Members of Congress may have been earnest when they said they wanted the second half of TARP to go towards keeping people in their homes, but Geithner, the Treasury Secretary, once admitted to Barofsky that the real goal was to "foam the runway for the banks"[12] (see Barofsky's Bailout). In other words, he wanted to slow down the entire process for the sake of the banks — ignoring the pain of homeowners entirely.

Specifically, the plan was to compare rates of profit and loss: the profit that banks would make through cheap Fed loans versus the losses that they would realize as they slowly acknowledged the true depleted value of their mortgage-related investments. If they could lower the rate of losses enough, on the one hand, while keeping the rate of profit high on the other, then the banks would avoid failing. That's what Geithner's plan had been all along.

But Didn't the Banks Return the Money?

Lots of people argue that the bailout "worked" and that the banks paid back the money, so no harm was done.

This is nonsense. We've already argued that the bailout was utterly misrepresented to Congress and to the American people, with disastrous consequences for desperate homeowners and millions of people who lost their jobs and are living under the weight of debt while the economists and bankers responsible for this mess are being honored as national heroes.

As for the actual money, it's true that the largest banks have returned the money, with some interest. But, as it turns out, this comes with a bunch of caveats, and whether or not the banks have returned the money is actually the wrong question to ask. These are the caveats:

1. Many people have argued (sometimes in satire [13] and sometimes with rigorous analysis [14]) that we didn't get nearly enough of a return on our investment. In other words, we gave the money to the banks at extremely low interest rates, much like you might loan your daughter money to go to college and tell her to pay it back when she has a good job and can afford it, at little or no interest.

Indeed it would be very difficult to measure the correct level of risk that was present at the time of the bailout and to infer what the appropriate interest rate should have been, because there were simply so few institutions or individuals other than taxpayers that could have lent the money to the banks. Improbably, some combination of China, rich oil guys from the Middle East, and Carlos Slim *(the richest man in the world)* might have gotten together eventually to loan money to the banks, but they certainly would have charged a lot more interest than we did.

2. Fannie Mae and Freddie Mac haven't paid back all the money, nor has AIG. So it's incorrect and unreasonable to say "We got our bailout money back" unless we consider every institution we bailed out.

3. The banks paid back the money primarily for the sake of appearances, and in collusion with Treasury. For the same reason that the so-called "stress tests" have been orchestrated to make it seem like the banks are sturdy and solvent, the banks returned the TARP money in part to look strong for PR purposes, and in part so they could go back to giving huge bonuses to their risk-takers, which was unacceptable under TARP. So the money was returned before it was actually available — in other words, before the banks could truly afford to pay it back — with the undercover agreement that the bank could always borrow it from Treasury or the Fed again if it were needed.

Given all of this, it's clear that when people bring up the "They paid back the money" argument, we shouldn't be talking about the money, we should be talking about the risk.

What really happened when the taxpayers bailed out the banks — and what didn't stop happening when the banks "paid back the money" before they could actually afford to do so — is that we, the taxpayers, have taken on the risk of the banks. We are firmly on the hook for that risk, and any money which happens to be attached to that risk, whenever the time comes. And although risk is harder to measure than money, it's much more dangerous. You can print money and you can destroy it at will, but you can't create or destroy risk at will.

Next time someone says to you, "They paid back the money," tell them, "Yeah, they gave us back our money but we didn't give them back their risk."

What Did We Save?

Another important thing to remember when people talk about the so-called success of the bailout is that our current financial system is borderline dysfunctional and may not have been worth saving.

There are fewer banks now and they are bigger than before. Their power is massive and their lobbyists are incredibly powerful and act as information conduits to politicians. Indeed the complexity of the financial system acts in favor of the big banks in more than one way: first, because it allows more trickery and imprecise risk measurements, and second because it makes it difficult for smaller banks to compete.

What we have now is an international system of intensely confusing and complicated legal and financial rules that no one person can possibly understand, regulators that don't have the resources or political power to force simplicity or transparency, and a political system that is afraid to push back.

What even happened to the original goal of banking, anyway? Wasn't the financial system originally intended to help grease the machine of commerce? How can that case be made when small and medium-sized businesses still have trouble getting loans and when people are being disenfranchised from their own money?

Next time we go all-out to save the financial system, let's do ourselves a favor and get rid of the complicated, corrupt, and/or greedy aspects that do more harm than good.

The Bailout Is Still Going On: Backdoor Bailouts

In additional to skewed incentives, the financial crisis and ensuing bailout gave birth to a series of backdoor bailouts for the banks. These are settlements that, on the surface, look like they take the banks to task for improper or illegal behavior or are neutral to banks, but they actually serve to inflate bank profits at the expense of taxpayers. Examples of backdoor bailouts are as follows:

Mortgage Settlements

As Yves Smith[15] anticipated months before the rest of the world caught on, the recent mortgage settlements, in which the banks were supposedly fined $35 billion to correct mistakes from their shoddy paperwork and foreclosure process, was actually a backdoor bailout for those banks. Indeed the amount of actual money they needed to hand over was only $5 billion, and they managed to "pay off" their debt in part by writing down other people's debts.[16]

What's also unsettling is that the banks were excluded from liability from those with whom they settled (such as state Attorneys General, the Department of Justice, and the U.S. Department of Housing and Urban Development) on the practices named in the settlement, although this still allowed for private rights of action.

As for the future, there are "threshold error rates" which dictate the servicing standards and allow for a minimum threshold of the same conduct up to and including foreclosing with false documents.

In reality, if there have been new illegal foreclosures — and there have been — any federal prosecutor worth his or her salt could ignore the threshold error rates and sue under a new case, and, if need be, open up the terms of the original settlement. There's ample precedent for that in cases where the guilty party goes back to the same illegal conduct after settling out of court.

So it's really a question of will. And there is none.

SEC "Do Not Admit Wrongdoing" Settlements

It doesn't make sense to make a financial penalty so minor that the expected profit from the crime, if discovered, is still positive. But that's exactly what the SEC has done with its recent settlements with the megabanks. For example, the SEC settlement for the HSBC decades-long facilitation of money laundering to drug cartels and terrorists, at $1.9 billion, is only a small fraction of the firm's profits. There were no prosecutions, either of the firm or the individuals who allowed it to happen, despite their admission to serious crimes. In addition to not having to pay a financial price, there seems to be no political price either: the former CEO and chair of HSBC, Lord Stephen Green, is now UK Minister of Trade, and there seems to be no pressure on him to resign.

This means that there will be even less hesitation in the future when megabanks pursue a profitable criminal activity because they now face nothing more than a "regulatory wrist-slapping fee" as a consequence.

Inflated Markets

Given our disappointment in Treasury's ability to use HAMP to help homeowners threatened with foreclosure, we might have held out some hope that, through its monetary policies, the Fed would somehow have been able to revive our economy and people would have been able to get back to work.

That hasn't happened. And it's not totally the Fed's fault. They've lowered the interest rates to essentially zero, but the banks have been hoarding money and still don't make loans. Indeed the discrepancy between what banks charge for loans and what they pay has never been wider, which is one reason we can see the Fed policy as yet another bank bailout.

"Cheap money" has created a very bad value proposition for the investing class. People who might have invested in U.S. Treasury bonds are now investing in junk bonds and stocks in search of a return. Fed policy has had the obvious effect of bailing out the banks and of inflating stocks and junk bonds. Nevertheless, both are at risk of falling and, while smart money insiders have made considerable profit on these investments, little has been done to help the average person.

The Bailout Is Making Things Worse: Skewed Incentives

The narrative that we hear from most mainstream media goes like this: The banks got themselves into a huge pickle by dint of their interconnectivity and patently stupid assumption that housing prices would always go up.

It's time to point something out. Namely, it wasn't a stupid assumption at all, but rather a calculation made by each individual banker that going along with the market in this respect would earn him more bonus money than going against it. In truth, there were not many bankers on the inside who thought housing prices would continually go up and there weren't many credit rating agency experts who thought the mortgages were all getting paid, either.

The truth is, "the market" isn't a person and banks aren't people (whatever the Supreme Court may claim about the personhood of corporations). If we think about them as people, we will get the wrong impression. For instance, fining a company won't have a deterrent effect if the people in that company can benefit from the illegal acts for which they were fined. For example, in the LIBOR scandal, many traders manipulated interest rates to increase the profits of their trading desks. It is far from clear this benefited the banks as a whole, but it certainly did increase the traders' bonuses — which is all they cared about.

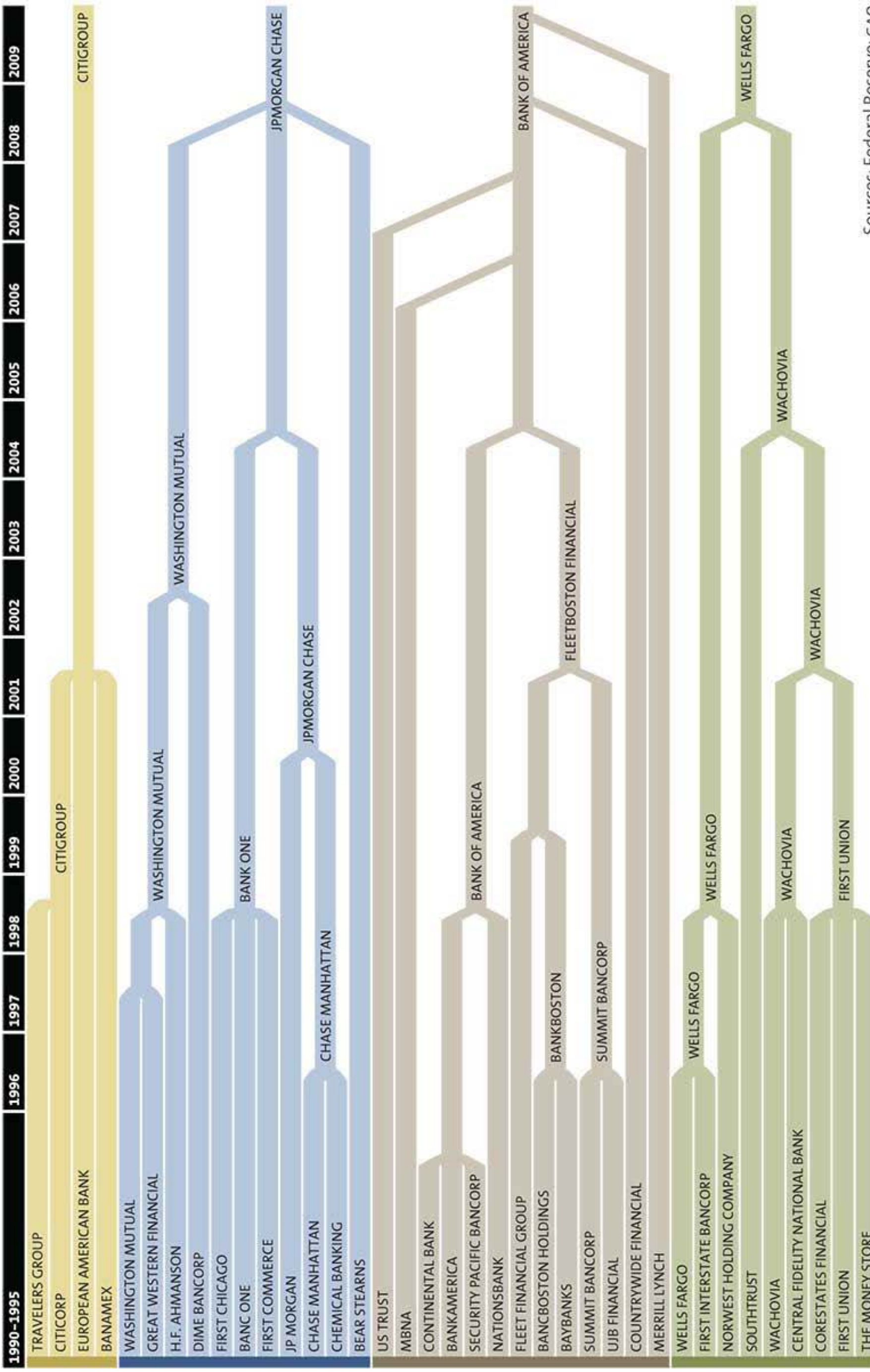
Assumptions about the market are, in this case, used as a front for something far more sinister. In reality, the financial system is a big complicated web of people who are each trying to make money for themselves. Once in a while they *seem* to work together, if their agendas align as they did with inflating home prices. But keep in mind that it can happen again, in a different setting, that aligned agendas and greed will distort the markets to the detriment of investors and/or homeowners.

Of course, a few smart bankers figured out how to make money by timing the bursting of the bubble, but don't feel too sorry for the ones that lost money in the end because most of them are still rich.

The housing prices narrative is just one example of skewed incentives. What's important to understand, here, is that the much ballyhooed "markets" are replete with such bizarre foibles and fronts that — far from driving us towards a promised land of recovery and stability — incentive the kinds of conduct that are most likely to lead to another crisis. And many of these fronts are the product of the bailout itself. Note the the following examples of skewed incentives:

1. **The financial sector has used the crisis as a growth tool.** The number of big banks has dramatically decreased in the aftermath of the crisis and bailout, as the graphic shows.[17] From the perspective of a given survivor like JPMorgan Chase, the disaster which it helped create has been perversely rewarded — it is now the biggest bank in the U.S.

It's not just about growth in the size of the banks, but also in the relative amount of power and influence the heads of the banks have over Congress and the regulators. Judging from the recent JPMorgan "whale trade" fiasco,[18] where the London CIO office lost more than $6 billion through a risky and hidden trade, there doesn't seem to be much power regulators can reasonably wield over too-big-to-fail bankers.



Sources: Federal Reserve; GAO

2. **Increasing risk from artificial protection.** Just as today's carbon dioxide emissions bring about global warming, today's bailout assumptions are seeding future bailouts by allowing and incentivizing banks to increase their risk rather than diminish it.

One way to see that banks are being given extra room for risk is by examining their credit ratings. Moody's rating agency makes it clear that it now definitively expects governments to bailout megabanks should the need again arise. It has actually given the banks substantially higher ratings than it would have had it looked only at the banks' *actual* credit-worthiness, not counting implicit government support. In addition to being an unfair government subsidy, this perversely encourages the megabanks to take even more risks.[19]

Future taxpayer support is assumed to be open-ended. For instance, Moody's assigns "standalone" ratings of Baa3 to Bank of America, to Citigroup, and to Morgan Stanley. Baa3 is the lowest "investment grade" rating; an evaluation below that is termed "non-investment grade" or "junk." However, Moody's assigns ratings of A3 to the FDIC-insured bank subsidiaries of Bank of America, Citigroup, and Morgan Stanley, citing future taxpayer support as the rationale for this whopping three-notch "rating uplift" over the evaluations afforded to the "standalone" entities.

With higher ratings, banks borrow more money, book more derivative trades, and post less collateral than would be the case without the future-bailout assumption. In turn, those activities enable banks to *self-cannibalize*, *i.e.* book profits today against derivative risk that will persist for 10 years, 20 years, 30 years or more. It's a tricky accounting method that allows bankers to pocket bonuses today and then leave the (crumbling) building.

And with the five largest U.S. banks controlling 90% of the U.S. derivatives market, these dodgy self-cannibalization strategies occur right where they pose the most risk to the stability of the system as a whole.

3. **Implicit subsidies.** In a series of recent Bloomberg editorials, a price has been put on the current annual taxpayer subsidy of the too-big-to-fail banks. The price was estimated to be $83 billion. Although various other parties, including Dean Baker arrive at different figures,[20] one thing is clear: the majority of people believe that the government will bail out the megabanks, if needed and that is lowering the megabanks' borrowing cost and saving them billions.

4. **Too big to jail.** The too-big-to-fail status has translated into something even more perverted: too-big-to-jail. This was evident last year when HSBC was slapped on the wrist for large-scale money launder-

ing on behalf of drug lords and terrorists. Even Attorney General Eric Holder admitted the "too big to jail" problem recently, although he's backtracked under pressure, no doubt from bank lobbyists.

Conclusion: Shifting the Blame, a Threat to Democracy

One disturbing trend coming out of the financial crisis and ensuing bailout is how we've seen the narrative of blame gradually shift from the bankers to the public. This shift threatens to lead to a dramatic increase in the privatization of public goods, such as through municipal bankruptcies.[21]

Sequestration, austerity, attacks on public sector employees, and the dismantlement of pensions (both public and private) can all be traced back to the fact that we raided the public piggy bank when we bailed out the financial system, and the bailout is just continuing.

One goal of this book is to give you, the reader, the ammunition to fight back against that shifting narrative of blame and remind people of what actually happened and what is still happening.

If you think about it, in spite of the pride we take in living in a free democracy, none of this bailing-out was done democratically. To some extent, when Congress initially voted against the bailout, we were witnessing the democratic process in action, but then when the market responded badly, Congress capitulated, and that was kind of the end of that. To see how democracy could have worked differently, consider the recent history in Iceland where they forced banks to default and prosecuted bankers.

One can look elsewhere in Europe, Greece in particular, to see how far the politicians have strayed from the democratic process. When is the last time the public was asked how to deal with ultimatums from some group of unelected economists or given the opportunity to understand and choose one policy initiative over another?

The bailout has taken a heavy toll on the democratic process in the U.S. and globally. The current and growing aggregation of wealth in America's Financial Sector is a large part of that story as, indeed, is the heightened indebtedness and wealth-dissipation affecting the 99%. It's hard to address cause and effect here, although we can absolutely point to one smoking gun, namely the Supreme Court's decision in *Citizens United*, which pretty much equated spending on politics with political activity. If we want to address too-big-to-fail, we are going to have to address the waves of money the financial sector pours into politics, which means addressing *Citizens United*.

Notes

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19. In Moody's words of June 21, 2012, "Moody's systemic support assumptions for firms with global capital markets operations remain high, given their systemic importance…

While Moody's recognizes the clear intent of governments around the world to reduce support for creditors, the policy framework in many countries remains supportive for now, not least because of the economic stress currently stemming from the euro area and the potential systemic repercussions of large, disorderly bank failures and the difficulty of resolving large, complex and interconnected institutions.".

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3. How Banks Create Money … and Keep It

"Of all the many ways of organizing banking,
the worst is the one we have today."

"Change is, I believe, inevitable. The question is only whether we can think our way through to a better outcome before the next generation is damaged by a future and bigger crisis."

Sir Mervyn King,
Governor of the Bank of England, *October 25, 2010* [1]

Because the Financial Sector keeps growing as a portion of our economy, it is important to ask ourselves, "What do banks do?" Most of us think (to the extent that we think about it at all) that commercial banks serve some pretty basic functions like holding our money, making it easier to use, and lending to customers. If I buy a pack of gum at my local bodega, I'll probably pay in cash. But having a bank account that allows me to make easy ATM withdrawals, write checks, and have a debit or credit card makes it easier to spend money more often and in bigger chunks. Similarly, if I need money to buy my first home or open a small business, the bank is a good place to go for the loan.

These are, in fact, functions of banks, but this is certainly not the whole story. Perhaps the most critical and often overlooked thing that occurs via these seemingly ordinary processes is that banks are creating pretty much all of our money, and that is a really powerful function. As one of our more under-appreciated Presidents, James Garfield, once correctly observed, "he who controls the money supply of a nation, controls the nation."

Some Common Misconceptions about the Source of Our Money

We often think of American money as being made at the U.S. Mint by craftsmen mixing special dyes while large machines engrave metal plates.

In fact, because the Mint gives banks new coins and bills in exchange for old ones or transfers of digital money, the kind of work that goes on at the Mint doesn't have much to do with the overall money supply. Hard currency, like bills and coins, is the most traditional *form* of money, but it is hardly the only one or, at this point, even the most common. For example, because the *purchasing power* represented by the numbers on our ATM screens is pretty much the same as that of the bills and coins in our pockets, we don't usually even think of the cash form of money as having priority over the increasingly predominant electronic forms money takes. We tend to move our money back and forth between these two forms without much thought, our main consideration being what it is we are looking to do. For instance, if we are headed for a cash-only restaurant, we want our money in that form; but if we anticipate buying a sandwich on a flight that only takes credit or debit cards, we prefer the electronic kind.

And note—there is no stockpile of bills and coins in banks' basements or anywhere else equivalent to all of the electronic dollars and cents shown on all of our bank account web pages. The Treasury Department runs the Mint and the Federal Reserve then makes sure enough bills and coins are available for us to engage in the kinds of transactions that require them. The Fed lets the rest of the money exist in purely digital form. The Federal Reserve's decision about how many bills and coins to have in circulation is not driven by concerns about the overall money supply. Rather, the Fed's interests are so mundane that it focuses on problems like making sure there is adequate cash available on weekends (when we apparently tend to use more of it) as opposed to weekdays (when we seem to use more plastic). The mint and the Fed are just trying to keep the right amount of old fashion bills and coins around to facilitate the kinds of transactions that need hard currency; neither is the hub where money is made.[2]

It would also be a mistake to assume that the Federal Reserve has other tools by which it creates all of our money. There is no doubt that the Federal Reserve has extraordinary powers to influence the amount of money circulating in the economy, and, as will shortly be explained, at times **it** creates money out of thin air. However, the notion that the Fed is the main engine for our money's creation is also wrong. Before explaining more about the kinds of things the Federal Reserve regularly does to influence the supply of money, let's first explain how the real creators of our money, private commercial banks, get it done.

How Commercial Banks Create Money

We know how bank loans basically work, but it takes a little thinking to realize that money is created in the process. If Jill has $100 in a jar of coins she is saving to open her first bank account, before she goes to the bank those coins represent 100 units of the total U.S. money supply. Jill (correctly) feels the coins could be used to buy $100 worth of goods and services in society; that is, the coins have $100 worth of *purchasing power*. And, as suggested above, when she goes to the bank, gives the coins to the teller, and checks her ATM a moment later to see an account balance of $100, we might think that nothing much has changed.

But, in fact, things immediately change because the bank does not just leave Jill's money sitting there; it loans a large portion of it (for big banks, up to 90%) to someone else. So assume that the bank increases its total portfolio of loans by $90 based on Jill's $100 deposit by extending a $90 loan to Jack, for example. There is now literally more money in society because of the $100 deposit. Jack is going around understanding that he has $90 in purchasing power that was not there before. At the same time, Jill (oddly, perhaps) does not feel any poorer for having put her money in the bank with the full knowledge that someone else (Jack) is effectively going to have access to "that money" as well. This is really no different than if we were in a position to lend a friend $90, and, having done so, continued to walk around a mall feeling as if it was still in our pocket. Make no mistake about it, it's good to be a bank. A bank license enables a bank to participate in this genie-like "fractional reserve" system whereby you can credit accounts with money while at the same time giving a high fraction of that (same) money to someone else by way of a loan. In the process, this is how almost all of our money is created. In our example above, Jill's deposit of her $100 worth of coins and the bank's resulting $90 loan to Jack created 90 units of new money, increasing the money supply from $100 to $190.

There are a number of things to understand about these transactions. First, obviously, is that whether this new money stays in the economy or shrinks back to the original $100 (or less), is going to have something to do with what Jack *does* with it and, specifically, whether he can pay it back. But before we go there, it is important to stress that in a fractional reserve system, the mere fact of both the deposit and the loan immediately creates money, regardless of what Jack does with it. Because even if Jill or Jack (or both) do not use the money, the money supply is greater while the loan is outstanding, as reflected by adding up all the "money" shown on their respective ATM screens. Jill is showing that she has $100 to spend (or more if she has overdraft privileges) while Jack sees that he has $90 which he can, and probably will, use too.

Second, it is hardly the banks' practice to make loans, have them paid back, and then shut down their lending practices. To the contrary, banks are in business to make loans with interest, so while Jack's individual loan will come due and have to be paid back, it is extremely likely that so long as Jill keeps $100 on deposit, someone—be it Jack by rolling over the loan or someone else by getting a "new" loan—is going to have additional *purchasing power* (money) because of Jill's deposit. In other words, we don't expect the bank's business to simply shrink because a creditor pays back a loan. Banks are in business to lend, and they will continue to do so after Jack pays back his personal loan.

And third, if Jack pays the loan back *with the required interest,* the bank is actually going to have more money under its control at the end of the loan than before. Suppose, for example, the interest charge over the term of the loan was 10% and, at the same time, Jill kept her $100 on deposit. This means that when the loan is paid back, the bank is now going to have reserves of $109 (Jill's $100, plus the $9 in interest the bank earned from the loan to Jack). So now the bank can lend $98 of its deposits and investments and still be compliant with the Federal Reserve rule to hold at least 10% in reserve,[3] meaning the money supply will grow even more in the next round of lending. Jill still sees $100 on her ATM screen as available for spending; the holder of a second loan (let's say it is Jack again), now has $98, and the bank has held in reserve one additional dollar taken from the interest it received from Jack's first loan, meaning the total money supply went from $100 when the money was in the form of Jill's initial coins to $190 during the term of the first loan and finally to $199 during the term of the second loan. And the process is obviously unlikely to stop there. As long as the loans are being paid back, the money supply will grow, and grow, and grow, all as a result of the traditional practices of commercial banking.

This hardly completes the story of what banks do. For example, it leaves open the critical question of how a society comes up with the money to pay interest under such a system. But before going there, let's return for a moment to the activities of the Federal Reserve.[4]

What the Federal Reserve Does

The Federal Reserve is, after all, a bank, too, so it should come as no surprise that it also has genie-like powers of money creation. For example, it recently used these powers on the tremendous scale of up to $85 billion a month through its "Quantitative Easing" program.[5] The way Quantitative Easing basically works is that the Federal Reserve purchases either U.S. Treasury bills or mortgage-backed securities (the complex packages of individual mortgages that were at the heart of the 2008 crisis), in either case using "money" the Fed just literally brought into existence by pushing buttons on a computer. You might find this outrageous, sort of like the way medieval kings paid off their creditors by minting new coins. But in the context of what we now know about how most money is made, perhaps this should no longer seem so troubling. If private banks are permitted to call money into existence by tapping on key-boards with the (thin) justification that they have some reserve deposits (like Jill's) backing it up, why shouldn't the Federal Reserve be allowed to do something similar? At least the Fed has *some* claim to being a public institution, even if the extent of its control by banks and insulation from democratic processes is a whole other (very worthwhile) story.

What is probably just as telling is that, historically, the Federal Reserve most often tries to influence the money supply in ways that explicitly recognize the private banks' privilege as society's main money creators. So rather than create money by just pushing its own computer buttons, the Fed will more often adopt policies that make it more or less attractive for banks to be aggressive private lenders, that is, to be aggressive money creators.

The principal strategy most of us have heard about concerns the Fed's setting key interest rates, known as the "Discount Rate" or the "Federal Funds Rate." These rates address a critical feature of bank practice we have not yet discussed, namely, what happens when too many people like Jill want their money back all at once so that the bank dips below the 10% reserve ratio the Federal Reserve requires that it maintain? Or worse, what if all the people like Jill (the depositors) cumulatively withdraw more than 10% of their money so that the bank (which, remember, has lent 90% of Jill's deposit to Jack) is forced to tell them, "Sorry, there's no money, we're out of cash," in which case we'd have a run on the banks.

The Discount Rate is one of the Federal Reserve's main "solutions" to this problem. It is a special loan, at a very low interest rate, with little to no screening, which the Fed makes available to certain preferred private banks when they find they have loaned out too much of depositors' money and need to boost their reserves back up to a point where they represent at least 10% of their balance sheets. Similarly, through the Federal Funds Rate, the Fed facilitates banks borrowing cheaply from one another for this same purpose. The Fed constantly evaluates and often modifies these rates in an effort to exercise some influence on the banks' money-making frenzy, but the fact that these rates exist at all, the fact that the Fed is attempting to control the money supply by moderating the *degree* of money-making banks engage in, is not a fact to be accepted lightly. Unlike the days when kings inflated the currency by engraving new coins to pay private soldiers, our monetary authority inflates or deflates the currency mainly by modifying how much it privileges the most wealthy "private" sector participants in our economy, the banks, to generate money.

Why Would Anyone Want Such a System?

Before concluding (perhaps reasonably) that this whole system is nuts—private commercial banks creating the bulk of our hard currency through lending—it is important to at least try to understand why anyone would want such a system.

In attempting to understand this, it is first useful to consider what basic purposes money *ought* to serve. In other words, if the banks' principal role is to create our money through fractional reserves, then to be even-handed in evaluating this, we need some criteria for what it means to do a good job of introducing money into an economy. Some traditional ingredients for what constitutes well-functioning money are the following (in no special order):

1. The money should serve as a predictable "measure of value." That is, if two frequently used household items cost, respectively, one and two dollars last year, and nothing significant happened to the demand for them or the means by which they are produced, money is working well if the relative, and preferably actual, cost of the items stays about the same next year.

2. If groups or individuals in society have good ideas about how to make their communities better —perhaps because they come up with innovative products, needed services, or better ways to support each other—it would be nice if new money could be promptly introduced to facilitate these additional possibilities. In other words, money should be readily available as a "means of exchange."

This last point is really critical and goes to the heart of some of the problems the 99% has with the current system. Whether we like it or not, money helps us interact with one another. It helps us essentially enter into cooperative ventures with people we do not know, but with whom—with the help of money—we can become engaged in common projects that can result in significant human achievements like airplanes, sewer systems, and pencils (no joke, there is probably no one out there who knows how to make a pencil by herself; it happens in no small part because of money).[6] In fact, a main complaint—perhaps *the* complaint—we should have with the current financial system is that it is failing, abysmally, to introduce money into our communities for such socially-responsible and community-building purposes.

We need not imagine highly complex monetary relationships to refocus—or perhaps focus for the first time—on this critical function of money. So let's keep it simple. Imagine that Athos and Porthos are members of a far more basic monetary society than ours in which (for the moment) the whole system consists of a single fifty dollar bill. Athos and Porthos, having poor memories, move the fifty dollar bill back and forth between one another to help them remember whose turn it is to get water from the nearby well. One day Athos gets it and Porthos gives him the bill; the next day Porthos gets it and Athos gives him back the bill; and so on. They know whose turn it is to get water the next day by checking who doesn't have the bill.

But if all of a sudden D'Artagnan seeks to join the monetary system by initiating a similarly cooperative cycle of retrieving firewood from the forest, there will be a problem. The three of them could still make use of the bill to keep track of their patterns of doing favors for one another, but the availability of only *one* bill would mess things up. Athos might, for example, be holding onto the bill to keep track of the fact that yesterday he brought Porthos water and it was Porthos's turn to do so for him tomorrow, but D'Artagnan is now asking Arthos to give him the bill if he (D'Artagnan) brings Arthos firewood. Unless the three can find a way to fairly introduce new money into the system, the insufficiency of their "money supply" is going to create confusion, slow things down, and generally result in less reciprocally cooperative behavior.

Now you might be thinking, "Wait, just make change and use $25 to facilitate the water retrieval and the other $25 for the wood retrieval." But that won't work because then the money will have stopped being a good "measure of value" (which, as we mentioned earlier, is important). Under this solution, the "price" of getting water just went from $50 to $25 without any change in the demand for, or cost of, getting it. In an ideal world— assuming having firewood and water are of approximately equal value and take about the same amount of effort and skill to accomplish—the addition of another fifty dollar bill into the economy would keep the price of water retrieval the same, while allowing the wood retrieval to proceed at the same "price."

Which is why it is nice to envision a really great bank operating under a well-functioning fractional reserve system. So imagine D'Artagnan went to such a bank with his wood chopping idea. The bank recognizes wood retrieval as a great initiative, and, perhaps because other banks know about it too and are prepared to compete for the opportunity to fund this new business, the bank offers D'Artagnan a $50 bill at a negligible interest charge for a long period of time. Under these circumstances, we are unlikely to be too offended by the fractional reserve system. The fact that we know from our encounters with Jack and Jill that this bank loan is predicated on some other person's earlier deposit and thus is an act of money creation probably does not bother us here given the good result. In fact, if we had a way of being assured that banks would only create money for purposes like this, we probably wouldn't be so offended if an entity like the Fed frequently created money out of thin air to facilitate good ideas like D'Artagnan's.

Which finally gets us to the point of being able to consider why it is important *what* D'Artagnan (or earlier, Jack) or any other debtor *does* with borrowed money. Assume, having gotten the $50 loan, D'Artagnan's, Athos's, and Porthos's simple exchange grows into a more complex operation in which the three partners are able to bring more wood to town than they need. This would lead people from other towns to come offer their bills in exchange for this service (assuming their towns had similar rudimentary economies), which, in turn, causes our three partners to accumulate extra money. We can refer to the aggregation of all of these behaviors and the resulting money accumulation as 3Musketeers Enterprise, Inc. Once we do, we can start asking questions like how much should it be worth today for someone to get a share of the future flow of extra bills 3Musketeers will generate? And does it change the amount of "money" in society if we create a document that represents such a claim?

Assume that the three original partners "financialized" their operation by creating a piece of paper that gives each a 1/3 claim on all future 3Musketeer's excess dollar bills. We now have a new tangible representation of the business' future money-flow, known as a stock certificate, that has no independent use (*e.g.* it makes an unattractive wall hanging), more or less maintains its value, and can be traded for other things. In fact, it might even be traded for wood itself! In short, while the stock certificate is not traditional currency—and, given its likely price fluctuation, not Grade A money—it is hard *not* to think of it as another *form* of money. For example if a 1%'er looks at his stock portfolio and sees a large monetary value associated with it, he will probably correctly tend to think of this as money. On the other hand, if he is running a start-up company that has not yet generated profit, but looks like it eventually will, he may think of himself as in some sense "richer" because he owns the company, but the value of the business is nowhere reflected in the national monetary supply. Only once the expected flow of future profits of the business is represented in a stock certificate that can be traded (by going public) does its newly "securitized" value snap into the monetary system.

It's critical to the health of the fractional reserve system that a form of money can be added to the economy through "securitizations" that represent and make tradable the value of new businesses, property, or basically anything of quantifiable worth as financial instruments. It means that not all interest on loans has to be paid back by the total amount of lending in society endlessly chasing its own tail to satisfy the interest obligations it creates. Think about it: if money was only created by private banks accepting deposits and extending loans, where would the money come from to pay for the interest on these loans? If virtually all money comes from new loans, there is only one possible answer: still more loans issued just to pay off the interest obligation on the earlier ones.

If this sounds like a first-rate Ponzi scheme, that's because it is. While there is good reason to believe that a lot of what fuels financial bubbles and busts is exactly this kind of behavior, there is at least some sense in which loans used to create things of real economic (and securitizable) value are less prone to drive the economy into rapidly destructive spirals. Although we may not often think about the system this way, it is thus the securitization *of things of real and quantifiable value* which acts as a major moderating financial force to temper the otherwise exponentially expanding system of loans, chasing loans, chasing loans … with each providing the funds needed to satisfy the interest obligations on its predecessors.

Going back to 3Musketeers Enterprise in order to finish the tale: if D'Artagnan's newly securitized share of the company is of equal or greater value to what he owes the bank in principal and interest, the securitized money (representing the "value" D'Artagnan created in his woodcutting initiative) will be available to pay the bank the principal and interest owed, which sounds a lot more palatable than if the system had to generate the additional money by D'Artagnan, Athos, or Porthos taking out yet another loan just to cover the interest charges on the first loan.

In our 3Musketeers' fairy tale scenario, the fractional reserve system has worked great. It increased the money supply at the loan stage based on the anticipation of D'Artagnan generating something of societal value, the promise of which was then fulfilled at the securitization stage when the value of 3Musketeers Enterprises snapped into the money supply through the issuance of the stock certificate with sufficient market-value to pay the debt with all the accumulated interest. And because the bank was paid back with interest, it has even greater deposits on-hand to start its next round of loans, which will mean it will likely issue loans in even higher amounts, which will in turn mean the money supply is going to keep growing (and, if the system keeps working like this), growing, and growing. Within the (perhaps peculiar) logic of the fractional reserve system, things are running on all cylinders. But, as we now know, the strong interrelationship between banks' money-creation through fractional reserve lending and the activity of financial firms in creating money through securitizations more often plays out in ways that are utterly destabilizing to society and impoverishing for the 99%.

Where Things Go Wrong

The first and perhaps most important thing to recognize is that this whole system has a lot of similarities to a car engine or other constrained dynamic system. You have lots of actors participating who have no interest in the positive outcome the system is supposed to generate. Nevertheless, as the theory goes, their self-interested behavior is still going to yield a good result because the rules of the system pit them against one another in just such a way as to make it so. In other words, the last thing individual commercial banks want is either fierce competition among one another (cartels are far more profitable) or full responsibility for bad loans (it's much better to have someone else bear the loss while you pocket the gains). Likewise, the last thing individual investment banks want is securitization opportunities that are tightly regulated to avoid the introduction into the system of devilishly clever new forms of money that are prone to blow the system sky-high. But these kinds of restraints are precisely what *the system* requires to succeed. Just like a car engine needs to be made out of strong metals to contain the activity of the heated gas that drives it, so, too, should we expect that a system (like our financial one) that relies for its "success" on very powerful people acting in blind pursuit of rabid self-interest is going to need very strong structures to contain it, which we surely do not have.

Since so much of this book is about how this system has failed, it will hopefully suffice, for now, to consider what signs, akin to those we would see in a failing car engine (such as over-heating, bellowing smoke, fire, and explosions), we should expect to see in a failing financial regime.

Here are a few examples:

- Competition among banks is so weak that six banks have 64% of all U.S. banking assets.[7]
- Dehumanizing rules have been imposed to insulate banks from the risk of losses that would otherwise impose discipline on their lending practices (*e.g.* the crazy rights banks obtained under the 2005 amended bankruptcy law to make it harder for the 99% to discharge some of its most common forms of indebtedness, like credit card bills and student loans).
- Banks are playing a "heads I win, tails you lose" game with our money. Note the vile success they have had resisting even minimal requirements that they should use their *own* money when placing risky financial bets, despite the obvious fact that, when they blow the deposits of people like Jill, there is a much higher chance of the government (and thus us) footing the bill (think bailout), but when they occasionally get lucky with Jill's money, it exponentially increases bankers' rates of returns, which they do not have to share.
- Securities firms (which, since the repeal of the Glass-Steagall Act, *are* often banks), are so pressured to find securitization opportunities to keep the money-creation spiral from too quickly going bust (again) that they search to securitize not just good new businesses, but practically anything: formerly public schools, pensions, water systems, prisons, all forms of higher education (ever hear of a Student Loan Asset Backed Security, literally known as "SLABS"?), Detroit, New Orleans … you name it.
- Financial sector capture of both the regulatory and electoral processes to such an extent that there is, as in the car engine example, virtually no more metal confinement of the heated gas; rather, the heated gas and the metal that would surround it become one and the same. Note the appointment of financiers like Robert Rubin and Hank Paulson to hold the highest financial regulatory offices. Also note the Supreme Court's 2010 *Citizens United* decision, ruling that the thing we now know banks produce – money – enjoys the full mark of First Amendment constitutional sanctity so that it can be expended without restraint in political contests to essentially defend its own means of creation.
- Finally, the grossly high compensation of financial sector executives, often for ephemeral short term results, which indicates that, in the most basic sense, this industry's work has become divorced from its function of providing money as a means of exchange in

> our communities in an appropriate manner. Instead, the financial sector uses its money-creating powers for self-enrichment, leaving the communities of the 99% cash-starved, awaiting securitization of their remaining communal assets. The financial sector is living in Richistan — where we are not welcome.

And if we nonetheless maintain lingering doubts about whether this is what is going on, then we should just ask ourselves this question: if a small clique of private individuals had achieved virtually unregulated power to make money, what do we really think they would do?

Notes

1. Mervyn King speech at the "Buttonwood Gathering" conference, October 25, 2010 http://www.bankofengland.co.uk/publications/Documents/speeches/2010/speech455.pdf
2. There are excellent explanations of the Fed's relationship to the supply of currency on both the Federal Reserve Board and Federal Reserve Bank of New York web pages. See http://www.federalreserve.gov/faqs/currency_12626.htm and http://www.newyorkfed.org/aboutthefed/fedpoint/fed01.html
3. 1-[98/109] is just over ten percent.
4. One of the best discussions of this process can be found in Geoffrey Ingham, The Nature of Money Polity, 2004. See also the response of Ann Pettifor in "The power to create money 'out of thin air" January 2013 http://www.primeeconomics.org/wp-content/uploads/2013/01/The-power-to-create-money-out-of-thin-air5.pdf
5. Dunstant Prial "Bernake Offers Possible Timetable for Tapering", June 19, 2013, *Fox-Business* www.foxbusiness.com/economy/2013/06/19/fed-decision-on-tap/
6. Matt Ridley, "Humans: Why They Triumphed", *The Wall Street Journal* May 22, 2010.
7. See FDIC Table of "Top 50 Holding Company by Total Domestic Deposits" as of June 30, 2012; http://www2.fdic.gov/sod/sodSumReport.asp?barItem=3&sInfoAsOf=2012

What Is Securitization?

Part of the difficulty ordinary citizens, even well-informed citizens, have in coming to grips with what has happened within international finance is the vocabulary used to discuss money matters. Not just the regular guy on the street, but elected representatives, bureaucrats, and even employees paid to oversee municipal and pension fund investments have widely varying levels of understanding of what, exactly, a particular investment consists of and how risky it is. And adding to this complexity is the fact that very smart people — what a BBC documentary termed "The Rocket Scientists of Finance" — continually create new financial instruments and give them new names, sometimes intentionally obscure names.

"Securitization" is one such term. It refers to a process that is so fundamental to our current system that it is worth spending time clarifying and, admittedly, simplifying what it is. Most of us learned that a security is a stock or a bond, and many of us retain a very basic, textbook idea of what stocks and bonds are.

Let's start with the most basic financial instruments and work our way forward one step at a time. A stock is a security, and if you have one then you own a share (a tiny little piece) of a company. You might receive a dividend if the company does well, although not all stocks provide dividends; or you might lose money if the company does poorly because your little piece of that company would now be worth less.

A bond is also a security, and if you own a bond, you have given a loan to a company (or the government). You don't own a share, but you are promised a certain rate of interest for the loan. You can sell your stock or bond, but of course that will be difficult if the company is not doing well at the time of sale or if a lot of other people want to sell the same security at the same time.

Similarly, if you borrow money from a bank, it owns the contract you signed promising to pay back the debt. You've agreed to pay back the loan little by little, possibly over the course of, perhaps, 30 years. From the bank's perspective, this is an asset that they own and which they hope will be paid back. But, of course, 30 years is a long time to wait, and, after all, you might declare bankruptcy and not pay it back at all. In the meantime, the bank is still waiting around for those 30 years to go by, hopefully collecting your monthly payments. At least that's how it used to work.

Modern securitization involves finding ways to turn one kind of financial product into another; it is a process of repackaging assets so that they can more easily be sold to investors. In the case of modern mortgage backed securities, it was invented so that banks don't have to sit around for 30 years to see if you actually pay off your mortgage. Instead, financial firms put together bunches of mortgages in what is called a "pool", and then they make a statistical guess as to how often people in that particular pool will pay-off their mortgages and how regularly.

More generally, today, Wall Street securitizes different kinds of debts, which, individually and collectively, are viewed as assets. When many debts are pooled together, the expected regular payments by the debtors can be looked at as a source of income for investors.

Let's look into the mortgage debt and securitization example some more. An individual goes to a bank and takes out a 30-year home mortgage with specified monthly payments; but so do a lot of other people.

In our high-speed, pressured-to-maximize-all-possibilities society, the concept of mortgage repayments happening over 15 or 30 years, with limited opportunities to make still more money, seems incredibly stodgy to a bank or other financial firm. So banks will sell a whole group of mortgages, sometimes thousands of them, to another financial firm. That firm then divides the mortgages up into what were called "tranches". These are then marketed as investments, or securities: the mortgages have thereby been securitized.

Moreover, these new securities are divvied up relative to their risk. Some tranches would absorb losses first if borrowers defaulted on their mortgages; these would be the riskiest and, accordingly, have lower credit ratings—more on this in a later insert titled "CDOs, CDSs, and Magnetar Capital".

The people at the bank who sell the mortgages to the financial firm like this new "securitization" process because they make money on the sale and then have none of the risk of mortgage-holders not being able to pay.

The people at the financial firm that securitized the mortgages are also pleased because they, in turn, sell the new securities to investors, make money doing so, and also don't have to worry about not being paid back by homeowners.

The investors who are the ultimate buyers of the securities are also pleased because they believe that they are assured of a regular stream of income from those mortgage holders who are dutifully paying off their debt each month.

Historically, these investors have, for the most part, been convinced that, while a few mortgage-holders might not be able to pay in any given month, it is extremely unlikely that a lot of them will not pay and thereby risk losing their homes. Unless, of course, something really crazy happens.

A few things need to be understood about this kind of securitization.

First, no particular person or group of people feels terribly responsible for making sure that the mortgage loans are repaid in a timely manner. The bank sells the mortgages and gets rid of them; next the financial firm packages them and gets rid of them; and the end investor knows nothing about the individual loans and is betting on how well the whole conglomeration of mortgage loans will do. As a result, mortgages were sold with little concern for the possibility that borrowers might eventually be saddled with unpayable debts on depreciated properties.

Second, the original loan can end-up quite far from the place of origin. A firm in Germany may hold investments in mortgages that started out facilitating home-purchases in West Virginia.

Finally, there is little access to information about the loan once it's been securitized. A family with questions or difficulties with a mortgage often has great difficulty finding out who to contact about the issue.

Mortgages are not the only debts that are often securitized. Credit card debt, student loan debt, auto loan debt — all of these debts and lots of others have been securitized. So one person's debt becomes another person's investment opportunity, which may be why our society does not encourage us to live as debt-free as possible.

The complexity increases when additional financial innovations like Credit Default Swaps (CDS) get combined with our Mortgage-Backed Securities (again, see the later insert titled "CDOs, CDSs, and Magnetar Capital" for more on these financial instruments and their misuse).

Note that we are deep in the weeds and need a trusty guide to get us out. But there is a terrible shortage of trusty guides, likewise a shortage of laws to regulate the use of various financial instruments. Most importantly, there is an unwillingness to imagine the consequences as each individual Wall Street player tries to maximize his or her own money-making opportunities. The result of that is described in the next insert.

4. A Little History to Explain a Lot of Tragedy

"This bill will also, in my judgment, raise the likelihood of future massive taxpayer bailouts. It will fuel the consolidation and mergers in the banking and financial services industry at the expense of customers". [1]

Senator Byron Dorgan
Expressing opposition to the bill that removed
Glass-Steagall restrictions in 1999

Our recent and current crisis was the worst economic downturn since the Great Depression and has been aptly named the Great Recession. Experts and talking heads have credited a wide variety of factors as causes of the crisis. But there are three key dates that actually tell much of the story. Those are 1933, when the Glass-Steagall Act ("Glass-Steagall") was passed, 1999, when it was repealed, and 2000, when Congress effectively banned the regulation of derivatives. Sometimes, history does come darn close to repeating itself.

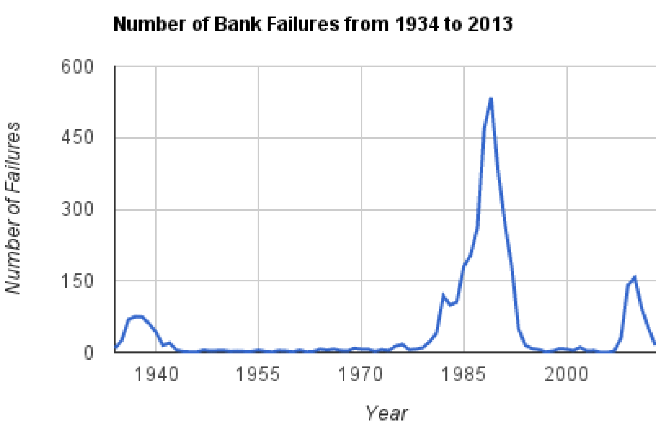
The 1929 Crash and Glass-Steagall

The stock market crash of 1929 was arguably the worst disruption ever of American financial markets, and it soon led to the catastrophic Great Depression, in which unemployment ballooned from 3.2% in 1929 to 25.2% in 1933.[2] The capital markets similarly floundered after the market crashed, when issuance of corporate securities shriveled from $9.4 billion in 1929 to a mere $380 million in 1933.[3]

In 1932, Congress commissioned Ferdinand Pecora to lead a thorough investigation of the 1929 crash, with the hope of providing guidance to lawmakers on what kind of legislation might avert similar outcomes in the future. One of the Pecora Commission's key findings was that, leading up to the crisis, investment banks were precariously involved in speculative securities, effectively using the deposits of the ordinary people and businesses who were their customers. Rather than keeping depositors' money in a vault (or at least in a safe financial instrument), banks were essentially gambling with it and keeping the profits for themselves.

The Commission's conclusion that the conflict "between the business of marketing securities and the business of protecting depositors' money" was a key support for the cause of reform,[4] which, not long afterward, led to the passage of the Glass-Steagall Act of 1933 (Glass-Steagall). Generally speaking, the Act restricted commercial banks (*i.e.* banks that take deposits and issue loans) from engaging in securities dealing as investment banks do (*i.e.* trading securities for profit).

Glass-Steagall was an unqualified success. From 1797 to 1933, the American banking system crashed about every 15 years. In contrast, during the first half-century after Glass-Steagall, there were barely any bank failures at all.[5] And yet despite this unprecedented financial stability, Glass-Steagall continually provoked fierce detractors who pined for access to the trillions of dollars of depositor money that was sitting in relative safety at commercial banks. In addition, these detractors jealously eyed the flood of capital flowing to banks through the Federal Reserve's discount window and other monetary programs. At the same time, commercial banks became bored with the incremental profit margins that they could earn from traditional banking and craved the higher earnings that riskier investments offered. But, of course, it was precisely *to prohibit* such mixing of bank speculation and depositors' capital that Glass-Steagall had been enacted.



Source: Federal Deposit Insurance Corporation (FDIC)

Undeterred, banks kept pushing, and in the 1980s, with the advent of President Reagan's pro-business supply-side economic policies (known as "Reaganomics"), the bankers began to get their way. Reaganomics brought widespread financial deregulation, including, perhaps most significantly, the financial lobby's success in convincing the nation's banking regulators to puncture Glass-Steagall with numerous loopholes and exemptions. As a result, commercial banks began engaging in riskier activities, and, not surprisingly, the late 1980s brought a sharp spike in bank failures. This trend can be seen in the chart above, which chronicles the number of bank failures since 1934, as reported by the Federal Deposit Insurance Corporation.

This data plainly shows a long period of financial stability following Glass-Steagall's passage, which then reverses once financial deregulation sets in. It also shows a period of "quiet before the storm" leading up to 2008, with zero recorded bank failures in 2005 and 2006.

The steady gutting of Glass-Steagall continued from the 1980s until its final death knell in 1999, which is when the Gramm-Leach-Bliley Act officially repealed Glass-Steagall, allowing investment banks and commercial banks to once again merge, pool assets, and co-mingle the monies of ordinary depositors with speculative trading operations, as in the pre-Great Depression days. Banks could (and did) return to the good old days of treating assets they held in trust for common depositors as resources available to underwrite higher yielding, riskier securities transactions, with no obligation to share the upside. The problem was that, once again, all the risk on the downside would be *everyone's* problem because we are still likely to be called on to bail them out if needed. Freed from the regulatory shackles of Glass-Steagall, banks took risks of increasing magnitude and complexity. And just in case more cheap (virtually free) cash was needed, the Federal Reserve, under the Chairmanship of Alan Greenspan, made absolutely no effort to pushback against the growing speculative tide. Instead, the Fed fueled speculation by lending to banks at very low rates.

Deregulation, Derivatives, and Brooksley Born

Perhaps needing to shield a more sophisticated public from the degree of risk associated with its behaviors (after all, perhaps folks still remembered some of the lessons from 1929), the banks' betting strategies increasingly relied on "financial innovations" which mainly served to conceal what they were up to.

As has been discussed in previous chapters, the concept of a mortgage changed from a relatively simple two-party contract into a multi-party apparatus involving layers upon layers of transactions, pass-through entities, and servicers. Bundles of mortgages were pooled together, forming the collateral for new "mortgage backed securities" (MBS). These, and various other instruments that "derived" their value from other financial arrangements, became known as "derivatives." The risk associated with these and other new-fangled financial products could often be sold in the form of credit derivatives, which further shifted risk away from the original mortgage lender to unknown, distant parties.

Needless to say, the more complex the transactions grew, the more lucrative this was for the investment banks, such as Bear Stearns and Goldman Sachs, which had created them. Like the cost of any highly technical thing, banks charged higher commissions for each level of added complexity. While there is a story that bankers liked to tell about how these products grew the economy by lowering the risk of individual bad loans through their "pooling" with hundreds of other good and (even more) bad ones, a comprehensive survey of empirical economic data has revealed little evidence of such a benefit.[6]

Paul Volcker, the former head of the Federal Reserve Board, may have expressed it best when he quipped that the most important innovation in finance over the last twenty years was actually the ATM. Volcker lamented: "I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth—one shred of evidence."[7] And the nation's leading private investor, Warren Buffett, memorably labeled the new derivative instruments "weapons of mass destruction."

Much, but not all, of the risk of derivatives came from the fact that banks had virtually no obligation to disclose how many of them they held. As a result, they were able to massively shield their financial health from their many creditors. Derivatives are typically traded off the market, in an agreement between two parties that remains known only to them. This is known as "over-the-counter trading." These derivative trades are not on exchanges and, typically, nobody (except, just maybe, the parties) knows who owns what or how much anything is currently "worth." In short, there is absolutely no transparency.

These off-exchange transactions began accounting for an increasing percentage of all trading done by major banks and other financial entities like AIG. Since nothing about them has to be reported, it becomes impossible to know how heavily involved a particular bank or hedge fund might be in a risky deal.

It was not just Paul Volcker and Warren Buffett who recognized the potential for systemic disaster lurking in these hidden trades. In the late

1990s, Brooksley Born was the Chairperson of a small federal agency, the Commodity Futures Trading Commission (CFTC). She had an understanding of derivatives from her work as a lawyer in the financial world and believed that the sheer volume of derivatives trades coupled with the government's complete ignorance of what was taking place presented a serious problem. Indeed, it lay at the heart of the unexpected 1998 collapse of the hedge fund, Long Term Capital Management.

Brooksley Born proposed that the CFTC, which regulated other derivatives, create regulations which would permit authorities to at least know what was happening and outlaw certain practices which contributed to instability. In a remarkable narrative of power overcoming good faith and reason, the story ended poorly. She was set upon by the biggest guns of the governmental financial establishment, most notably Robert Rubin and Lawrence Summers, then Secretary and Deputy Secretary of the Treasury, respectively, and Allen Greenspan, then Chairman of the Federal Reserve. Her proposal was decisively defeated.

Born resigned in June 1999. Not long afterward—and with the staunch support of the just-mentioned Clinton-era financial gurus—Congress, as if responding to a national emergency, hastily passed The Commodity Futures Modernization Act of 2000. The CFMA is a remarkable piece of pro-business legislation that virtually bans government regulators from gathering information on, investigating, or making rules pertaining to, derivatives. The law essentially mandates a complete "Hands Off" approach to these transactions despite the fact that a core principle of Wall Street free-market champions is that only with full and free information can markets ever be expected to function productively in the first place!

Indeed, only a few years later derivatives, and the inability of financial institutions to assess the risk posed by them were main contributors to the freezing of international credit markets and the resulting economic meltdown of 2008. And yet even today, the derivative market remains opaque and largely unregulated.

Thus, in the run up to 2008 — with Glass-Steagall gone and the effort to create even a modest regulatory structure for derivatives crushed—banks were engaging in more complicated, riskier, and less transparent behavior than ever before.[8] And so, in retrospect (as understood by a very small community of economists), the crisis was not just the kind of thing that is going to happen now and again as a result of the haphazard economic forces in a capitalist society. Rather, the gutting of the Glass-Steagall Act and other deregulatory maneuvers would be equivalent to the blind mismanagement of a forest system left to grow dense fire-sensitive ground cover. We might not know just when the spark is coming, but can we really act surprised when it hits or feign shock at the extent of the catastrophe it unleashes?

Recent Attempts to Approximate the Glass-Steagall Standard

In 2010, in response to the crisis, Congress did do something: it passed the Dodd-Frank Act (Dodd-Frank) to implement *some* restraints on banking and financial activities. We should point out the Dodd-Frank fell far short of what many felt was needed. Nonetheless, there were useful parts to and a key provision was Section 619, commonly known as the "Volcker Rule," named, yes, after the same former Fed Chairman, Paul Volcker, noted above.

Volcker had been one of the most prominent critics of the repeal of Glass-Steagall, perhaps because he had been around long enough to live the history we just described. Volcker began working as an economist at the Fed in 1949, led the organization during the tumultuous stagflation days of the 1970s, and, in his old age, had become a "wise man" of sorts on Wall Street (however oxymoronic that may sound). In an uncharacteristic choice of someone outside the core community of the revolving door group of "bankers-today-regulators-tomorrow," Obama brought Volcker to the White House during his first term to serve as the head of his Economic Recovery Advisory Board.

In 2009, Volcker presented Obama with a two-page white paper that outlined a modern-day version of Glass-Steagall. The proposal involved placing limits on proprietary trading (*e.g*, self-interested securities trading, or speculation) by regulated commercial banks. Obama actually adopted Volcker's idea in January 2010 and christened it the "Volcker Rule." It is vital to note that neither Glass-Steagall nor the Volcker Rule ever put limits on securities trading by traditional broker dealers or investment banks. Rather, these laws only sought to address the glaring conflict of interest recognized by Ferdinand Pecora eighty years ago: a bank that benefits from public money (whether in the form of customer deposits or Federal Reserve loans) should not be permitted to gamble with that money in the highly speculative manner characteristic of investment banks or securities traders.

By the time the Volcker Rule made its way from the President to Congress in the summer of 2010, deregulatory interests had already prevailed in riddling it with numerous loopholes and exemptions. As a result, the final version of the Rule that was passed as Section 619 of Dodd-Frank in July 2010 bore little resemblance to the simple proposal that Volcker had originally presented. For instance, while the Rule prohibited proprietary trading by commercial banks, it permitted such banks to engage in "market-making," which involves taking the opposite position on a customer's securities order in order to prop up the market for that security. Unfortunately, the market-making exemption can be easily exploited, especially in cases of highly illiquid over-the-counter (OTC) securities that have no real market. For such securities, a purely speculative trade by a bank can be easily disguised as an attempt at "market-making." The Volcker Rule's exemption for "hedging activities" presents a similar problem.

The five federal agencies charged with implementing the Volcker Rule—the Fed, the SEC, the CFTC, the OCC, and the FDIC (the Agencies)—issued proposed regulations in October 2011, shortly after the inception of the Occupy Wall Street movement. Under the Administrative Procedure Act (APA), any "interested party" affected by a federal agency's proposed rule can submit a public comment to the agency, and, by law, the agency is required to consider such a comment before finalizing the rule. A significant amount of corporate lobbying exists at this level of would-be lawmaking, which, given the obligation of the Agencies to consider everything submitted to them, can pretty much drown the process in paperwork. As recently reported in *The Nation*, the flood of such comments from the financial industry, along with the crushing flow of financial sector lawsuits the government has had to defend (at taxpayer expense) has pretty much thwarted implementation of the 2010 law.[9]

One Occupy group, Occupy the SEC (OSEC), has recognized the inordinate lobbying pressure that was being placed on the Agencies (from banks, politicians, and even foreign countries) to gut the Volcker Rule, so it decided to fight fire with fire by submitting its own 325 pages of comments, which were submitted in February 2012. Those comments took issue with loopholes and exemptions that could be found in the proposed regulation and suggested regulatory changes that would strengthen the Volcker Rule's containment of bank excesses. As of this writing, the Agencies have yet to issue final rules implementing Section 619, which means that banks continue to pose many of the same systemic risks that caused the 2008 crisis. In addition to submitting comments, OSEC brought a federal lawsuit in the Eastern District of New York against the Agencies (and also the Department of the Treasury) for their delay in finalizing the Volcker Rule.[10]

If implemented in a form that is similar to the proposed version that came out in October 2011, the Volcker Rule would merely be a middling half-step towards reinstituting the sweeping safeguards that Glass-

Steagall originally imposed. That is, the Rule would certainly improve the *status quo* because many types of overt proprietary trading would be prohibited, but it would not be the case that we have successfully re-learned the lesson of the 1929 crash and kept banks from betting widely with consumer deposits and the essentially public monies made available to them at the Fed's discount window. Given the breadth of the Rule's market-making, hedging, and securitization exemptions, many unsafe banking practices would still continue unabated. Of course, as noted, even the watered-down text of 2010 financial reform legislation has come to naught because of massive bank obstructionism, led by none other than Eugene Scalia, son of Supreme Court Justice Antonin Scalia, and a Washington DC partner at the global law firm of Gibson, Dunn & Crutcher. Unfortunately, we stand hardly better protected today than we did before the 2008 collapse.

Senator Elizabeth Warren has tried to address the Volcker Rule's deficiencies by proposing a new version of the Glass-Steagall Act. Remarkably, Republican Senator John McCain is a co-sponsor of her bill.[11] As of this writing, the bill seems very unlikely to pass, despite tepid support from some Wall Street veterans like Sanford "Sandy" Weill, former Chairman of Citigroup, who is widely credited as the mover-and-shaker behind the repeal of Glass-Steagall during the late 1990's.

The nation's financial system continues to be at risk so long as the Volcker Rule—Section 619—is a weak substitute for Glass-Steagall and, even in that watered-down form, remains unimplemented. Unfortunately, even if the Volcker Rule eventually becomes law in a form vaguely resembling the 2010 Congress' intent, banks will, to a considerable extent, still be able to engage in speculative trading funded by public money. Only a full return to the Glass-Steagall standard originally championed almost a century ago would appropriately safeguard the interests of depositors, average investors, and the public generally as the true intended beneficiaries of Federal Reserve lending activities. Such a return seems unlikely at this stage, which means that the 99% has yet to adequately express its indignation and outrage about the regulatory work that needs to be done to avert the next Great Recession.

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5. The Dirty Dozen Legal Outrages

"If serious prosecutions of fraud by Wall Street firms are never brought, the public's suspicion about Washington's policies toward bankers will only grow, as will cynicism about the rule of law as it is applied to the rich and powerful."[1]

Jeff Madrick and Frank Partnoy

The past decade has seen a broad assortment of legal outrages. Wall Street firms have flagrantly violated the law. Often they are not prosecuted at all. When they are, they typically receive a slap on the wrist that will not deter future wrong-doing. At the same time, Congress has passed laws and regulators have written regulations that further entrench Wall Street's interests. The following are some of the worst.

1. HSBC Laundering Money for Terrorist Organizations and Drug Cartels

Hongkong and Shanghai Bank Corporation (HSBC) laundered billions of dollars for Al Qaeda, Iran, Mexican drug cartels and similar "clients." When warned by regulators or reported by news media, HSBC alternately denied the activity or said they would stop it. Instead, they allowed it to continue for at least a decade. In fact, an HSBC whistleblower claims it is still going on.[2] (see Chapter 2).[3]

2. 2005 Bankruptcy Law

In 2005, Congress revised the bankruptcy law to make it much more "creditor-friendly." This is to say, good for the banks, bad for the borrower. To give one example, judges are no longer allowed to reduce amounts owed on student loans to private lenders, even if the schools are scamming, for-profit "degree mills".[4] Lo and behold, in 2010, student loans pulled ahead of credit-cards as a form of 99% indebtedness. [5]

3. LIBOR Manipulation

Although it is obscure, the London Interbank Offered Rate (LIBOR) is crucial to trillions of dollars of financial instruments — quite possibly including your mortgage, your credit card or your city's borrowing. Despite its incredible importance to rates around the world, LIBOR is set through casual communications among banks, and traders routinely adjusted these "communications" to benefit one another. They basically skewed the entire international financial system for personal gain.

This episode epitomizes two things about Wall Street. First of all, this was done by traders without apparent oversight. It is not clear that the banks involved actually benefited. But, the traders did increase their own bonuses. A trader has even been quoted as saying, "It's us against the bank."[6] The bank in question was his employer. Clearly, the megabanks are unable to govern themselves. Second, this behavior happened at many banks in several countries. It was so common that traders felt no compunction about putting damning statements in e-mail messages. For traders, their bonus is paramount, obligations to their employer are secondary, and consideration of other people is not even on the radar screen.

4. Repeal of Glass-Steagall

After the Great Depression, reforms were put in place to restrict banks from taking risky positions with depositors' money or with funds borrowed from the Federal Reserve. This reduced the frequency of bank failure for fifty years. But beginning in the 1980s, many of these restrictions were removed, with the capstone being the Gramm-Leach-Bliley Act of 1999. More specifics of this sad history are discussed in Chapter 4.

5. Too Big to Fail / Too Big to Jail

There is a widespread belief that failure of one of the largest banks or other financial institutions could have catastrophic consequences for the economy. Rather than trying to address this threat, the fear of these consequences has been used as justification for bailing out these institutions when they get into trouble (see Chapter 2). President Obama and his administration will claim that this problem was addressed by the Dodd-Frank Wall Street Reform Act. But even the Fed does not believe it. In a major speech on the topic, Federal Reserve Board member William Powell noted, "Success is not assured."[7] This is Fed-speak for "we have our fingers crossed." Richard Fisher, President of the Dallas Federal Reserve

Bank, is more forthright; he says the banks are still too big, practice crony capitalism, and need to be broken up.[8]

Even worse, too big to fail has been used as an excuse not to prosecute banks even when they admit to a long history of criminal activity (see point 12 below, "Lack of Accountability").[9]

In addition to the injustice of all that, because the megabanks are deemed too big to fail, they can borrow at lower interest rates — in essence, this is a subsidy worth tens of billions of dollars to the banks every year.[10]

6. Special Tax Break for Hedge Fund and Private Equity Managers

Hedge fund managers and private equity executives get a big break on their personal income tax. They pay about half of the ordinary tax rate because their income is deemed to be long-term capital gains subject to a preferential rate — even if it really isn't.[11]

This is called "carried interest" treatment.[12]

7. Commodity Futures Modernization Act of 2000

In the 1990s, instruments called "derivatives" were traded outside of public view and often without regulatory oversight, in volumes representing more money than the entire world economy. Brooksley Born, then head of the agency with authority to regulate most derivatives, tried to include these within the agency's scope. This effort was squashed first through the combined efforts of Treasury Secretary Lawrence Summers and Fed Chairman Alan Greenspan, and then by Congress in this so-called "Modernization" Act (see Chapter 4).

8. Privatization of Fannie Mae and Freddie Mac

Fannie Mae was created as a government agency in the 1930s to foster the issuance of long-term fixed-rate mortgages. It served this purpose well for nearly 50 years. But in the 1970s, Congress decided to privatize it. They did the same with Fannie's brother "Freddie Mac" shortly afterward. As private companies, they paid their shareholders tens of billions of dollars in dividends by taking enormous risks. But, when the risks turned sour, Fannie and Freddie were deemed "too big to fail" and considered "government sponsored enterprises" and so we, the taxpayers, got to absorb their hundreds of billions of dollars in losses.

9. Fiduciary Obligations of Pension Trustees

Trustees of pension funds might appropriately be concerned not just about the financial returns on investments they secure for participating employees — but also on whether the industries the employees work in survive, or for that matter, whether the world they live in survives. Which means the trustees may want to avoid investing in companies that are engaging in unsavory labor practices, war profiteering, or are contributing to climate change. The plan beneficiaries might in fact agree with these criteria. But, fiduciary obligations have been interpreted to pretty much prevent trustees from considering such "non-financial" factors. This means that the financial criteria that are generated by Wall Street to evaluate investments are effectively all the trustees are allowed to consider when investing trillions of dollars of the 99%'s savings. The harm that may be done by the companies invested in is considered irrelevant.[13]

10. Robo-Signing and the Settlement

After the collapse of the housing market, banks had many mortgages in default. When they took the bail-out money, the banks assured the government that they would work with the borrowers to make the best of the situation. Working with the borrowers would also have been good for banks, in many cases, because it is often more profitable to adjust a mortgage of an existing borrower who is behind than to try recouping the money on the delinquent loan by selling the house in foreclosure.

Because of the extensive securitization of mortgages, it often wasn't clear which institution had title to the loans. The law required the banks to work through the documentation and figure it out. But many banks decided neither to work with borrowers nor to go through the pains-taking process of lawfully foreclosing on them. Instead, they hired unqualified people to sign documents without reading them so that foreclosures could proceed quickly. This came to be called the robo-signing scandal.

When the robo-signing scandal came to light, the banks were let off with light settlements and no prosecutions.

11. Companies Are Just Like People … Until They Owe Money

Another not sufficiently discussed, but sadly entrenched, outrage in the law is the use of corporations as a means to run from commercial debts. In a very real sense, that is what the law understands corporations *are for*. As we have discussed, especially since the 2005 bankruptcy amendments, the ability of human beings to get out from under their debts, especially loans to pay for college, is almost non-existent. Mitt Romney (and the Supreme Court in its *Citizens United* decision), have told us that "corporations are people," but it turns out that this is not entirely true. People get stuck with the consequences of their promises (at least the 99% does); corporations do not.

Consider, for example, the fact that a human (as opposed to a "corporate") person can pretty much give away all of his future earnings by signing papers that obligate him to a huge student loan or a home mortgage that he can't really afford. Say what you may about whether someone should sign such documents, a signature on a loan or a mortgage means what it means: you are obligated to repay.

This is not so for corporations. Because they are really not things at all, but just names on registries, they can easily go out of business, leaving whomever they owed money to, such as their workers, in the lurch. Indeed, when principals of companies (in rare cases) try to back-up the promises of the companies they create by saying they will be personally liable for the corporate debt — courts often won't let them, even when the language they have signed agreeing to do this is crystal clear.

Similarly, companies will almost never be found responsible for one another's debts even if it is overwhelmingly clear that they are run by the same people, using the same phone numbers, and sharing the same office. Again, the motivation here is that companies are entities that are *designed* to run-up debts. Absent extraordinary circumstances, courts will not undermine that purpose by doing something so "inefficient," so "socialistic," as holding the humans behind the companies responsible for the damage to society that their corporate creations inflict, even though we know it is these same human principals who stand to benefit on the upside if their companies succeed. If only it were so easy for the broke students who never got the benefit of a good job after graduation to get out of the bet they took in going to college.[14]

12. Lack of Accountability and Prosecution

After running up billions of dollars in losses in their companies and trillions of dollars in "collateral damage" to the economy, the megabanks were not required to replace their CEOs or other senior executives. Not only did the CEOs keep their jobs, they even kept their bonuses, their stock options, and their corporate jets.

In many cases, the CEOs should have been prosecuted. Although some people admit that there were regrettable acts, they still argue that few of these acts were actually illegal. This is not true. Despite extensive law-breaking, there were actually fewer criminal prosecutions after 2008 than after the comparatively tiny 1980s savings and loan scandals (see Chapter 4). In many cases since 2008, no prosecution was brought at all. In others, there was a settlement on terms that amounted essentially to a slap-on-the-wrist. What's worse, *none* of the senior executives was prosecuted.

Although some try to justify the inaction or light penalties by arguing it would have been hard to prove the crimes, this is not an adequate excuse. First of all, as former prosecutor Neil Barofsky noted when he met with Alternative Banking, it is a prosecutor's job to try hard cases. But secondly, it shouldn't have been so hard. After the bubble in Internet stocks of the 1990s, Enron's massive book-keeping fraud, and other corporate accounting scandals, Congress passed the Sarbanes-Oxley Act specifically to make senior executives liable for crimes committed by their companies.[15]

The salt in the wound has been that after seeing the bankers get away with all this, we now get to hear the U.S. Attorney General, Eric Holder, explain why. Holder noted that "I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them",[16] specifically because their immensity means any harm to them will harm the economy. They are just too big and too important to be bothered with having their crimes punished. They are literally "too big to jail." Lack of prosecution, or inadequate prosecution, only encourages continued law-breaking.

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CDOs, CDSs, and Magnetar Capital

Manipulating internal risk models

One way people make money in the finance industry is by taking intelligent risks. You get your "edge" through figuring out that things are mispriced and betting on that knowledge.

Of course, every bet involves risks, and not all bets will be correct. You will sometimes get burned, but over time, you hope, the wins will exceed the losses, and what really matters is that, relative to the risk you take on, your profits are good. That is in fact how traders are measured and how bonuses are awarded, so there's a lot on the line.

Instead of understanding each bet individually, a bank or hedge fund, generally speaking, tries to keep track of only the risk that each of their trading groups is taking on as a whole. Each group is required to have a risk model which measures their risks in various ways. Each group is also given a "risk limit" which they are expected not to exceed and which they divvy up among individual traders inside the group. All of this is a way to keep things reasonably safe for the firm. But since there's such a strong connection between risk and reward, the individuals in each trading group always want the group's risk limits, and their individual risk limit, to be higher.

Leading up to the financial crisis in 2008, there was a pretty well-known (and widely-used) method of working around the pesky requirements for having a risk model and paying attention to risk limits in one's group. Namely, the group would let a "risk guy" into the group for a while, just long enough to for him to create a half-decent risk model, and then the group would say, "Thanks but we don't need you any more, we'll run with this". Then the risk guy would be kicked out of the group. The group would then spend the next few years learning how to "game", or manipulate, the risk model.

For instance, traders would figure out exactly what kind of trades to make so that the risk model wouldn't be able to "see" them. No model is perfect so every model has blind spots, namely risks that are ignored, overlooked, or underestimated. By taking these positions, they could potentially make more money while remaining technically within the risk limit. Even better for risk takers and common at the time, the market would change and new instruments would be created. So the risk model would be applied to instruments it wasn't even meant to measure.

The game went like this: it was important to always stay within the preset risk limits – as measured by the risk model – even while the group took larger and larger bets on things that were invisible to the risk model. As long as the world didn't blow up, this method returned higher-than-expected profits, so the group's profit versus its stated (but not actual) risk looked great.

Individual members of the group would get rewarded for this. In the meantime the company they worked for took on the risk and, typically, didn't see it as coming from any specific trading group but rather as some type of systemic risk. Or, because the instruments didn't have publicly available prices, the traders would make up prices or get their friends at dealers to make up prices that made the positions look less risky than they really were or that were more stable than they should be, so the risk wouldn't show up at all.

It's not clear how many people or how high up were those who participated in this scam, but it seemed pretty clear that they enjoyed the ride as long as it lasted. As Citigroup CEO Chuck Prince said in July 2007, as things were starting to fall apart, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." [1]

The Collateralized Debt Obligation (CDO) market

One really enormous and tragic example of how people can game the risk model is described in Yves Smith's brilliant book ***Econned*** [2], in the chapter describing the CDO market and Magnetar Capital's involvement. One can argue that CDOs were the reason the housing bubble turned into a full-blown global economic crisis, so it's important to understand them at least at a basic level.

What are CDOs anyway? The CDO market is complicated, and you can learn a lot about it by reading Smith's book. What follows is a very simplified version.

In the late 1980s through the mid-to-late 1990s, there were not that many securitizations outside of the federal arena (namely Freddie Mac, Fannie Mae,and Ginnie Mae), and they were pretty useful because they made pools of mortgages more predictable and tradable than individual mortgages.

Recall from the previous insert titled ***What is Securitization?*** that, after being created, securities were sliced into groups called "tranches" depending on how they would be treated if the underlying mortgages defaulted. Back in the 1980s, the pieces at the top of the securitization pile were given the highest possible rating, AAA, by Moody's and S&P (later joined by Fitch and dubbed the "big three rating agencies"), because they had a big cushion of loss protection beneath them. The lower tranches had lower ratings such as BBB and were harder to sell, which limited the size of the overall market.

Starting around 2003 the lower-rated, harder-to-sell tranches started getting re-securitized into new instruments, which were called Collateralized Debt Obligations, otherwise known as CDOs.

So, just as the mortgage-backed securities took questionable mortgages and converted them into securities that people were willing to buy, CDOs were the next step: they took the very worst mortgage-backed securities and repackaged them into new securities. To sell these profitably, they needed the stamp of approval from the rating agencies who are supposed to be independent, objective evaluators of the credit-quality securities. However, as securitization became widespread, the agencies became severely compromised. Issuers pay the rating agencies to rate their securities. This creates a conflict of interest, but it wasn't too harmful when they were rating bonds from many different companies and no one set of issuers were dominant. But with securitizations, massive amounts of securities were being issued by the banks.

In addition, rating agencies are low in the food chain and so pay less compensation than the banks and hedge funds. So employees of rating agencies would see the banks as potential employers and so would be particularly disinclined to ask questions. Everyone at the rating agencies had large incentives to please the banks by putting the highest ratings on the securities.

They were convinced that because many mortgages, or CDOs, were being pooled together, they would benefit from the magic of diversification and the risk would go away. If it seems that they really believed this, remember Upton Sinclair's dictum that "It is hard to get a man to understand something when his livelihood depends on his not understanding it."

Once the securities had gotten the rating agencies' stamps of approval, the banks could find willing buyers of them who were happy to buy AAA-rated securities that yielded more than others. If this again seems naïve, it was. But the decisions were being made by people who were managing other people's money. They would not personally take the losses. And AAA-rated securities had been safe in the past.

In fact there were even riskier CDOs, called mezzanine CDOs, which consisted mainly of the BBB tranches, and so-called "high grade" CDOs consisting mostly of old A and AA tranches. These mezzanine CDOs were again securitized, with around 75% of them getting an AAA rating.

Yes, you read that right: if you bundled together a bunch of easy-to-imagine-they'd-fail low-rated mortgage bond tranches – even though you knew the terms of those mortgages and how much they depended on the housing market to continue its climb — most of the resulting package would be deemed AAA. The riskiest securities received the highest rating.

It made no sense then and it makes no sense now.

The Credit Default Swap (CDS) market

Enter the credit default swap (CDS) market.

First, what is a CDS? People have correctly described it as an insurance contract on a bond. So, for some quarterly fee, you can insure the value of a bond you purchased against the risk of default.

Say, for example, that you own a 5-year bond issued by a large company like Sears. Then you might be worried about the possibility of Sears having financial problems and defaulting on this bond. If you buy a 5-year CDS to protect your bond, then if Sears does default, you'll get back your lost money from whoever wrote the CDS – as long as that insuring entity hasn't gone bankrupt itself.

But the amazing thing is that, unlike normal homeowner's insurance, you don't actually need to own the Sears bond (the "underlying bond") to buy CDS "protection" on it. In other words, you can buy insurance on a bond you don't own. That is, you can bet that Sears will default on its bond, since you can pay a quarterly fee for the chance to make a bunch of money in the case of default.

Also, you could buy CDSs for financial instruments other than bonds. It was also possible, and common, to buy CDSs to protect the tranches of securitized products, like mortgage-backed securities or CDOs.

Remember the discussion about how risky these investments were, standing by themselves? Now a product had been invented to remove the risk from these financial time bombs. Well, actually not to remove it but to pass it on to someone else. Who ended up with this risk? Read on.

So how did traders use CDSs in their bets surrounding the mortgage market?

Hedge fund traders bought CDS protection on higher, less risky tranches while selling protection on a lower tranche of that same CDO. Because the higher tranche was supposed to be less risky, protection on it was cheaper and so they could buy more protection than they sold without actually having to pay any money. The traders were betting that "if things go bad, they will go really bad", while limiting their overall exposure.

In other words, if all the tranches failed, then the traders would be paid more money on the higher tranche than they lost on the lower tranche, so they would end up far ahead. The only situation where they lost money is when the lower tranche went into default but the higher tranche didn't, which they thought unlikely. Remember, all those tranches were made from super shaky mortgages, so there's no reason to think some of them would go bad but others wouldn't — they'd probably all go down together.

Moreover, the income on the lower rated tranche, i.e. the money coming from those risky mortgages, would be sufficient to pay for the CDS fees on the higher rated tranche. In finance this is called a "self-financing bet," which means that traders at banks and hedge funds could do this a whole lot. Which they did.

The synthetic CDO market

Recall that a CDO is a re-securitized security. The money paid out from a mortgage-backed CDO comes from a bunch of mortgages somewhere, even though it takes a few twists and turns to get there.

But what if the demand for CDOs outstrips the supply? In the mid 2000's, investors became hungry for ever more bets on the mortgage market. In fact there was more demand than could be sustained by the large but finite mortgage market at the time.

The demand for more CDOs (and for more CDSs to play the game described above) led some clever traders to figure out that they could create CDO-like instruments, which they called "synthetic CDOs," from credit default swaps rather than from actual bonds. The money coming from synthetic CDOs wasn't paid by mortgage holders, but rather from premiums the traders were paying on the CDS contracts.

Once synthetic CDOs were invented, the banks could create more CDOs (synthetic ones) without even going to the trouble of issuing more mortgages. Moreover, traders could bet against the same crappy BBB bonds again and again and have them packaged up with most of the value of the "synthetic" CDO rated AAA, again with the collusive help of the ratings agencies.

The first mortgage-backed synthetic CDO was issued in 2005. By 2006, the synthetic CDO market was by some estimates bigger than the actual CDO market.

Who was doing this stuff?

At first, the big protection sellers in the CDS market were insurance behemoth AIG and other insurers. This makes sense since CDSs are like insurance. But the insurers only wrote CDSs on the least risky AAA CDO tranches.

Later, after AIG stopped being involved – not soon enough, as we later saw – that side of the CDS market was entered into by all sorts of unsophisticated investors with help from the complicit ratings agencies who kept awarding AAA ratings because they were being well paid to do so.

Magnetar

Even so, there was still a problem for this re-re-bundled heavily synthetic CDO market. Namely, it was hard to find people to buy the so-called "equity tranche", which was the tranche that would disappear first, as the first crop of the underlying loans defaulted. This tranche contained mortgages that no sane person expected to pay out, which is why it was considered toxic.

That's when hedge fund Magnetar Capital, and others, got into the act. They set up deals that were designed to fail so they could profit by betting against them. Banks were willing to allow anyone willing to buy the equity tranche to design the synthetic CDO themselves. By agreeing to buy the equity tranche, Magnetar got to create CDOs designed to fail. Why would they do this? Because they could make much bigger bets against the AAA-rated tranches. Also, the equity tranche, because it was risky, paid out a lot of cash quickly. If they were lucky, they could get enough cash out to pay for their bets. In any case, they would win big as long as the CDOs failed catastrophically — which they did — exactly as they had been designed to do.

The CDOs that Magnetar designed to fail were then sold by banks to pension funds and other global investors. The banks selling them did not consider it relevant to tell the buyers that the deal was designed by a hedge fund that was making a huge bet on their failing. How big was this? Magnetar Capital accounted for the majority of the synthetic CDO issuance in 2006, which was one of the biggest years in this market. And everything they did was legal, although the banks committed fraud when they sold the deals without mentioning who designed them and why.

Conclusion

If this seems immensely complicated and confusing, it's because it is, and it was designed to be that way.

Let's go back to the groups manipulating their internal risk models from the beginning of this insert. The same thing happened here, except instead of individual traders fooling the company they were working for, Magnetar was fooling the entire market. Instead of one risk guy, there was a combination of the rating agencies, AIG and naïve investors.

In the end, it was the investors who'd been duped into buying this stuff and ultimately the United States and various European governments who were on the hook, which is to say, ***us***.

How predictable was this whole scheme? Some people at Goldman Sachs and Deutsche Bank knew exactly what was happening and what was likely to happen. They made a very intelligent bet that if and when the housing market went under, AIG would be backed by the government.

In essence this entire market was an enormous bet on a government bailout. Not everyone knew this, of course, especially the guys who were still betting on the mortgage market when it collapsed, but lots of people knew. These are some of the same people who, right now, are lobbying against reasonable financial regulation.

This story argues for, at the very least, the treatment of CDS as insurance with the associated regulations. Any thinking human being should recognize that you first need to own something in order to buy insurance protection on it, just like with home and fire insurance. Imagine it this way: Magnetar identified buildings they didn't own, where they saw arsonists enter with gallons of gasoline and matches, and then bet everything on the probability of fires in those buildings.

Notes

1. Michiyo Nakamoto in Tokyo and David Wighton, "Citigroup chief stays bullish on buy-outs", Financial Times, July 9, 2007

http://www.ft.com/intl/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html

2. Yves Smith, ***ECONned: How Unenlightened Self Interest Undermined Democracy and Corrupted Capitalism***, Macmillan 2011

6. New Civics: Feasting on the Commons

"I see in the near future a crisis approaching that unnerves me and causes me to tremble for the safety of my country. . . . corporations have been enthroned and an era of corruption in high places will follow, and the money power of the country will endeavor to prolong its reign by working upon the prejudices of the people until all wealth is aggregated in a few hands and the Republic is destroyed."

U.S. President Abraham Lincoln, Nov. 21, 1864
(letter to Col. William F. Elkins)

Before moving on to some possible responses to the host of problems the financial sector has wrought, there is one more set of related issues to address. These concern what the rise of the financial sector has done to our governments, to our sense of certain places or functions as being "public", and to our core notions of democracy.

Predatory Public Finance

First, it should come as no surprise that with local and state governments collecting billions of dollars from various tax streams, Wall Street was not going to leave this taxpayer money alone. Some of the most outrageous stories concern what happens when local governments — the ones we rely on to provide services like road maintenance, education, and policing — have had to turn to Wall Street for capital. Because of the Wall Street-induced recession, our municipal governments have suffered both a decline in tax receipts and an increase in social service spending. They have been battered by years of corporate fueled anti-government campaigning and they often lack the financial sophistication necessary to win negotiations with bankers. At times, Wall Street banks have employed methods, when dealing with our towns and cities, that are only a bit — and just sometimes — more nuanced than those the 19th Century Tammany Hall gangsters used to rob New York City. In short, the mixing of the worlds of public service and high-finance has, as you might expect, been disastrous for the 99%.

It is probably most interesting to first review some of the flat-out robberies. Municipal bonds are a 3.7 trillion dollar industry in the U.S. To understand how big that is, the Gross National Product for the whole country was about 15 trillion dollars in 2012. So a smart thief should not be looking to steal a lot from every town or county bond offering. A little should do to make him very rich.

This is what some GE Capital traders figured out, namely how to rig the bidding for municipal investments. They ultimately went on trial and were convicted for it in *U.S. v. Carolla.*[1]

Here's what happened. GE Capital was competing with the likes of Bank of America and Chase to invest the money of various municipalities that were collecting revenue from the issuance of bonds meant to support new or renovated libraries, schools, roads, and such things. The towns did not immediately need the money coming in from the bonds, probably because whatever projects they were funding were not yet ready enough to necessitate major expenditures. So the towns retained middlemen to supposedly get "competitive" bids from financial firms to temporarily invest the money.

Remember, the towns wanted to get *high* interest rates on this money, because they were investing it, and so they wanted the competing firms to bid up the interest rate. Unfortunately, the GE Capital guys and their colleagues in these supposedly competitive auctions figured out that if they tipped one another off about the bids (*i.e.* engaged in bid-rigging), then the interest rates they ultimately needed to offer to get their hands on the municipalities' money would come in a bit lower each time. But over ten plus years, that still really adds up, even after you take into account having to pay off the middle-men with some of the "savings".

Exactly how much skimming this all added up to is either too big or too complicated to fully calculate, because we still don't know for sure. But some of the banks' settlements to resolve the resulting claims have veered towards the high nine-figures, which gives you a sense of the proportions. As you can see, it is a kind of subtle thievery. That is, you don't have to break into any vaults, but the extra money you end up with is just as green, and it comes just as much out of the pockets of taxpayers as if it was robbed from the county safe at gunpoint.

If you prefer an example of more old fashioned skullduggery, consider, too, the tale of how JPMorgan recently milked corrupt Jefferson County Alabama administrators to such an extent that the entire county government ended up in bankruptcy.[2]

In the late 1990s, Jefferson County was required to do some infrastructure work that should have cost about $250 million, but after the work got going and construction firm pay-offs of municipal officials started flowing, the county went wild trying to build and repair more stuff. Where better to go for funding than Wall Street? The bank of choice here was JPMorgan, and this deal got so good for the bank that at one point JPMorgan actually paid Goldman Sachs $3 million to stay the heck out of Jefferson County and let it continue to serve as the sole financier of this money-laundering pay-off scam extraordinaire.

It all came crashing down for the really crooked town officials, but not so much for JPMorgan, which paid a mere $25 million fine and handed over another $50 million to help workers displaced as a result of the County's financial collapse.

These are not the only stories of this kind, but rather than recite one horror story after another, let's think a little more about the less extreme examples, just to get a better sense of how widespread the problem of Wall Street's relationship with local governments is. Let's look at Philadelphia.

The Philadelphia school district is the eighth-largest in the country, with a $2.3 billion operating budget for 242 schools serving 150,000 children, over 80% of whom are poor. Beginning in 2003, the district (and the city of Philadelphia itself) turned to big financial players like Wells Fargo, Morgan Stanley, Citigroup, and Goldman Sachs to try getting some certainty on their growing debt obligations.

The parties entered into a series of "interest rate swaps", which means they basically agreed to pay one another's debt. The Philadelphia school district agreed to pay the fixed-rate obligations the banks held, and, in exchange, the banks agreed to pay the floating-rate obligations of the schools. Philadelphia's intent was presumably to make budgeting more predictable and possibly to save some money. Accounts of the motivation differ, however, because things went very wrong.

As interest rates plunged after the onset of the 2008 financial crisis (and have remained at historically low levels ever since), the fixed rate payments Philadelphia owed on the debt it assumed did not fall (Philadelphia, you will recall, opted for the "certainty" of a fixed rate, rather than an adjustable rate).

Philadelphia's tax-base and support from the State were cut because of the Recession, and the school district was in no position to keep paying interest on the swaps it was locked into way above market rates. These total "costs" have exceeded $300 million based on the combined effect of the interest rate swings and the cancellation fees the municipalities incurred to avoid having to enter into still more such swaps under the terms of the now horrible-looking original deals.[3]

While Philadelphia has recently sued many of these banks on the grounds that their manipulations of interest rates through LIBOR[4] (see chapter 5) had a lot to do with these unfortunate "swings", you might still say that this sounds nothing like the above examples: after all, the banks did not steal this money, they just tremendously benefited from the plunge of interest rates and may have also tremendously out-negotiated the municipal parties (which happens a lot in these cases).

But, we'd argue, think for a moment about what is going on now in Philadelphia.

The banks entered into these "great" deals before 2008. But in 2008, their other not-so-great deals (the ones related to mortgage-backed securities) sent them into what was probably technical insolvency and almost collapsed the American economy. And *that* was what caused the interest rates to swing against Philly school kids: bad economies mean less demand for money and lower interest rates.

Yet in the midst of this, who gets bailed-out? In any sane society, you would say… the kids, of course. But that's not what happened. As we know, the banks got the bail-out, funded, in part, by the tax dollars of the parents of the very same Philly school kids to whom the banks had shown no mercy.

These days governments need banks. Bankers know it and frequently use that advantage to make deals which, in retrospect (and probably often in advance, too), demonstrate the negotiating imbalance between them. Financial transactions involving governments are often complex. A bond sale, for instance, can involve a small legion of bankers and lawyers and take several steps to execute. This offers a maze of nooks and crannies into which fees can be tucked and costs hidden. Middlemen are often retained to arrange transactions, and, remarkably, they don't owe the municipalities or taxpayers any fiduciary obligations in handling public monies. There are also many transactions, like the Philadelphia ones, which are intended to transfer risk (always for a fee) and risk is notoriously hard to quantify. So even when cases are not as obviously corrupt as in the earlier examples of auction-fixing and county-official-bribing bankers, we need to press the issue and not let the questioning and analysis just end there.

Philadelphia made a bad bet, just as a large percentage of the American public did when they bought houses during the Wall Street-induced real estate bubble. But if we are going to teach our kids in Philly and other school systems about the democratic ideals of equal opportunity and civil rights, we also ought to be explaining to them the other dynamic of modern American civics, *e.g.* how interest rate swaps between cash-starved, financially naive municipalities and Wall Street banks are ubiquitous because they are necessary to maintain basic services, but they almost always end up unbalanced against the governmental party.

They should similarly learn that when things go terribly wrong, when massive market shifts result in real or potential collapses of basic public services like elementary school education, what *this society's* civic considerations call for are not terribly consistent with the stated ideals of equal opportunity and civil rights . . . they call for the bailout of the banks.

Privatization and the Securitization of What Was Previously Public

Stealing from and getting the better of local governments is not all Wall Street is doing to undermine our civic institutions. Under the guise of bringing us the "efficiencies" that come with "running it like a business", an ever-increasing part of the enterprises, spaces, and services that we traditionally have thought of as "public" are being taken over by corporations.

In any individual case, this can seem benign. For instance, the New Jersey town of Bayonne is facing a credit downgrade, so it enters into a deal with KKR's "energy and infrastructure fund" to turn over management of its water system to the legendary private equity firm "in what bankers say may become a U.S. model." [5]

New York City is looking to save some money on needed park space, so it enters into an arrangement for a corporation to build a park in exchange for the City modifying the zoning rules that affect a different project the company has a stake in. The result is a privately owned "public" park (such as Zuccotti Park) made accessible to us only by virtue of the terms of the commercial agreement between its private proprietor and the City.

When these kinds of things happen, there is a problem. Something we all would otherwise hold in common, something with respect to which we would maintain rights as *citizens* rather than as *customers*, disappears. It is critical to remember that the rights we most value in our Constitution are about, *and only about*, our relationship with a government. In the sphere of things "private", the Bill of Rights has no bearing.

Even if a shopping mall is the center of our community, we have no right by virtue of our citizenship to enter it and express our views about things like the so-called War on Terror or the Bush Tax Cuts, just as we have no right under the First Amendment to tell our boss we think he is a bigot or a lecher.

Once spaces and functions are privatized, our rights with respect to them get defined by leases, bills of sale, and other commercial agreements that turn them over to private parties — because the Constitution has precious little to say about the terms on which we serve as customers of companies performing once-public functions.

So when you hear a Congressman reading the full text of the U.S. Constitution to open a Congressional session, remember (and be careful): there is more than one way to erode the Constitution. The hard way is to go right at it and change what it says or means, but the easier way is to pretend you love it (perhaps by reading it aloud in a public forum) but then shrink the only things to which it ever applied, *e.g.* our governments and the functions and spaces they provide.

Let's assume for a moment that we don't buy into the argument that such privatizing efforts bring wonderful "efficiencies" to formerly lackadaisically performed government services. What, we might then ask, does any of this have to do with the financial system, which is, after all, what this book is all about? The answer is: quite a lot.

Recall the basic argument from Chapter 3 regarding the mechanics of the fractional-reserve banking system. If the financial system is, at its core, the mechanism by which our money is made, we learned that two basic ingredients have to be present to make it work "well". First, banks need to lend, and then they need to have at least some of those loans get paid back with interest earned from borrowers' successful creation of things of real value.

Second, the financial system's securitization of some of the new enterprises — either through the issuance of shares in them or the extension of credit based on their perceived "value" — snaps "new money" into the nation's money supply (broadly construed). Given this, the financial system avoids the tail-chasing death spiral of having to extend new loans just to endlessly pay interest on the old ones — which, by the way, is the hallmark of a Ponzi Scheme.

But for the second part of the cycle to work (let's call it the securitization part), it turns out that loans don't actually need to be used to create "new" businesses. They can just as well be made to individuals to capture, in the present, substantially all of their future earning capacity. For example, this is what happens when credit cards, student loans, or mortgages indebt us and are packaged into tradable bundles of things like mortgage backed securities, "MBSs", and student loan asset backed securities, "SLABSs".

In addition, loans can fund the purchase of existing public functions, which however valuable to society when they were public, were not contributing to the above-referenced money-creation cycle.

For example, the American public school system — whatever you may think about its quality relative to some foreign ones — is a thing of real value in our country. Without it, we certainly would not have one of the world's highest literacy rates nor would pretty much the whole population know enough basic math to "break a twenty".

But prior to the advent of charter schools and the massive use of corporate service providers to develop and prepare kids for "achievement" tests, the public school system did not play a real role in money creation. Sure, teachers and janitors got paid for their services, but this did not create money, it was just a means by which existing money could circulate.

Once a school district, like that of Chicago or New York City, decides to let private entities run previously public schools, all of this changes. Suddenly, the process described in "What Banks Do" regarding the 3Musketeers woodcutting operation is (sort of) at work, only instead of something really new being created from the loans, credit is being extended just so that private businesses can displace public operations.

For example, if the sort of company that administers charter schools, known as an "Educational Management Organization" (EMO), takes over the back-office support for a charter school that has attracted 1,000 kids from a public one Rahm Emanuel or Michael Bloomberg recently shut down as "failing", then regardless of whether the kids get a better education at XYZ charter school, one thing is for sure: the monetizable value of the EMO will rise. This is going to affect the value of some 1%er's holdings, which means he will have more "money" available to pay interest on a loan that might be supporting a different one of his various financial ventures.

So, regardless of what is happening in the much-debated contest of educational test scores in Chicago and New York, one thing will be certain: the shift from public to private schooling will matter to the financial system and it will provide the "securitizing fodder" that is so necessary in the second part of the money-creation cycle to keep the system from too quickly reverting into pure Ponzi-like dynamics.

In other words, as far as the financial system is concerned, cannibalizing us and our existing public institutions, regardless of whether they were previously working well, is actually just as good a money-making strategy (and takes much less imagination) as funding something new that has societal value.

Given this, it should come as no surprise that the extraordinary rise we have seen in the size of the financial sector over the past 25 years has been contemporaneous with a similar rate of increase in the extent to which things we previously held in common have been privatized and securitized. Without the plundering of our previously public enterprises, it's safe to say that the financial system could not have experienced — nor continue to experience — its meteoric growth.

For example, while we have become accustomed to thinking of our medical system as private compared to that of Europe or Canada, as recently as the 1970s most hospitals were non-profit or public institutions. But the largest for-profit hospital company, Hospital Corporation of America (HCA), was only founded in 1968 (by, among others, Dr. Thomas F. Frist, the father of later U.S. Senate majority leader Bill Frist), and experienced its exponential growth in the 1970s and 1980s as it acquired hundreds of American hospitals, at one point owning 255 facilities and managing another 208.[6]

To give you a sense of how much freshly securitized "value" this added to the monetary base, consider that the company was re-acquired by Thomas F. Frist, Jr. in 1988 for $5.3 billion and in 2006 was purchased by Kohlberg Kravis Roberts (KKR), Bain Capital, and Merrill Lynch for a total of $31.6 billion, all despite having been mired throughout the 1990s and early 2000s in a series of criminal cases that resulted in, among other things, the company admitting to fraudulently billing Medicare and other health programs by inflating the seriousness of diagnoses and giving doctors partnerships in the business as a kickback for referring patients to HCA. Wall Street has recently been looking for the next big, previously public, enterprise to cannibalize. The push has been relentless and thus too varied to entirely capture here, but consider the following two notable ongoing examples.

K-12 Education.

Sometimes we just have to thank the 1% for telling it like it is. In a 2007 article about the privatization of K-12 education, *Harpers Magazine* profiled Nations Bank Montgomery Securities, whose prospectus (according to the magazine's summary) explained that:

> [T]he education industry represents, in our opinion, the final frontier of a number of sectors once under public control that have either voluntarily "opened" or "been forced to open" up to private enterprise. The education industry, the bank concluded, represents the largest market opportunity since health care services were privatized during the 1970s. While college education can offer "attractive investment returns, the larger developing opportunity is in K-12. EMOs [… are] the Big Enchilada." [7]

Until recently, the need to maintain charter schools' (thin) veneer of "good works" meant that most were registered as non-profits. Almost all of them, however, are administered, in whole or in part, by these for-profit EMOs, a name Wall Street apparently coined with uncharacteristic appropriateness to (dismally) recall the Health Maintenance Organizations (HMOs) that led the 1970s charge to health care privatization based on a model of skimping on care.

EMOs are often not the public face of charter schools, but they hold contracts to do all, or substantially all, of the actual work of running a school, from leasing space, to paying teachers, to managing the operation in its entirety. With Obama's Secretary of Education, Arne Duncan, and the mayors of the nation's two biggest (traditionally Democratic) cities, New York and Chicago, now solidly in the charter school camp, EMOs, and charter-schools more generally, are moving fast to exceed even the robust predictions of the 2007 Nations Bank prospectus. As of 2011, there were 5,400 charter schools in the U.S. educating about 1.7 million students, with the market growing by over 14% a year.[8]

Securitization of this new-found "value" has come more slowly, perhaps because the country has not been so quick to embrace the entanglement of stock-tickers and kids' math grades. In addition, the nation's once leading EMO, Edison Learning (founded as "Edison Schools" by Presidents Reagan's and Bush I's Assistant Secretary for Education), fell on its face after it went public. At one point, it was trading at a mere 14 cents per share after the NASDAQ charged that it had over-stated its earnings by as much as 41 percent.[9]

But no worries, other forms of securitization are rapidly evolving to fill the gap. In 2011, Canyon Capital Realty Advisors — a $20 billion real estate fund which had previously partnered with Magic Johnson to fund a so-called urban-improvement project in Brooklyn which used shell entities and cheap labor[10] — partnered with Andre Agassi to establish a charter school investment fund, the goals of which are charmingly described as:

> Provid[ing] investors with current income and capital appreciation by responding to the growing demand for quality charter school facilities in the nation's burgeoning urban centers and by capturing the opportunities arising out of the current dislocation in the real estate market.[11]

And don't forget about the other important source of K-12 education privatization, the one happening in public schools themselves. Over the past 15 years the insane rise in the "need" to test our kids, as pushed by the Bush II "No Child Left Behind" Act and other laws, has utterly changed what children actually *do* when they come to class in the morning. The development of virtually all of this testing and "ingenious" technologies to prepare kids for the (same) testing does not come from our school boards or governments, but rather from corporate giants like McGraw Hill and Houghton Mifflin.[12]

Private Prisons.

The privatization of prisons in the United States might go all the way back to 1868 when, after the Civil War, southern farmers and businessmen turned to convict-leasing because they needed a replacement workforce for their freed slaves. However, it took the 1980s to really get this business revving.

The U.S. prison population exploded in the 1980s due to, among other things, the "War on Drugs" and, soon enough, the first true U.S. corporate-run prisons went on-line in 1984 when the Corrections Corporation of America (CCA) took over facilities in Tennessee and Texas.

CCA and its competitors have dramatically expanded since then. Today, about 8% of the total U.S. prison population is housed in privately operated state prisons, mainly in Southern and Western states (although there are private federal facilities too). [13]

Securitization of this "value" has required another stroke of corporate good luck to get moving, namely 9/11 and the resulting mass increase in the detention of immigrants. Since those attacks, CCA stock has gone from a meager $4.75 a share to its price as of this writing of $33.37, a tidy 702% increase. The company now has a total market value of $3.86 billion. GEO Group (formerly Wackenhut Securities) began publicly trading in February of 2002, and its stock has similarly risen from about $5.40 a share to its current price of $33.00 a share, with a market capitalization of $2.36 billion.

This means that in the last 13 years or so, these two companies alone have added around $6 billion of newly securitized "value" to our monetary base by displacing pre-existing public institutions and actively lobbying to increase the national rates of incarceration (see the discussion below regarding ALEC). Both companies are now actually shamelessly classified for tax purposes as "Real Estate Investment Trusts". Yes, they no longer even pretend to be working towards the rehabilitation of criminals; they just provide "real estate" services to tens of thousands of "customers" who are involuntarily residing in their depressing facilities. [14]

The above stories demonstrate, once again, that to keep the money-making engines primed, it turns out that 1%ers don't have to extend loans to innovators set on improving people's lives. Instead, they can just give it to people set on encroaching into once-public spaces.

The Financialization of Politics and De-Politicization of Finance

Money and Politics

As you would expect, all of this plundering of public functions does not happen without corporate lobbyists who pressure and pay our legislators to adopt policies that undermine public functions. Once the cannibalizing industries are in place, the early revenue they generate can be used to pay corporate lobbyists to push for further legislative changes to grow these "fresh" markets, such as stiffer criminal penalties to benefit private prison owners, and the dictatorial powers given to mayoral-appointed heads of school systems to close down struggling inner-city public schools. As a result, our nation's politics become financialized.

Money has long been part of the diet of American politics, but with the job of a Congressman increasingly over the last 25 years entailing fundraising rather than legislating, the issue reached a point of such severity in 2002 that our federal government (shockingly, perhaps, in retrospect) actually did something about it by passing the McCain-Feingold campaign finance law. The U.S. Supreme Court's 2010 decision in *Citizens United* striking down key parts of that law has become the symbol of the present era of utterly financialized politics, in a way similar to how the court's 1954 decision in *Brown v. Board of Education* became the symbol of the (far prouder) Civil Rights era. In *Citizen's United*, the Supreme Court nauseatingly concluded that spending money on political propaganda is on par for constitutional purposes with acts of actual political *engagement*, in part because corporations are treated for such purposes as "persons" entitled to the same constitutional protections as us human sorts of "persons". The result has been the formation of Super PACs extravagantly funded by the 1% of the 1% through their personal and corporate treasuries, all for the purpose of propping up their ever-beholden favorite candidates.

Political financialization has also been dramatically revealed in the workings of the corporate-supported American Legislative Exchange Council (ALEC), which, functioning under the guise of a tax-exempt non-profit organization, has crafted cookie-cutter bills for adoption by sympathetic (and well wined-and-dined) member-legislators.

The bills rolling off ALEC's conveyor belts are skillfully crafted to benefit the bottom lines of its corporate sponsors such as gun manufacturers (*e.g.* the "Stand Your Ground" laws), the energy-sector (the Koch brothers are huge supporters), and the previously discussed private prison operators and EMOs. ALEC similarly drafted Wisconsin's law that gutted public-sector collective-bargaining rights, and Michigan's law preventing unions from including provisions in their contracts that dis-incentivize workers from enjoying union representational services for free, *i.e.* "Right to Work" legislation.

Just as financialized politics happens when the 99% lack the financial means to compete with this kind of "political engagement", it happens too when the staggering increases in the amounts of personal debt the system has laid upon the necks of ordinary Americans works to psychologically and socially isolate and disempower them.

There seems to be a surprising scarcity of well-publicized research on the correlation between personal indebtedness and activities like voter participation and civic engagement, but it probably does not take an advanced degree in sociology or psychiatry to figure out that heavily indebted people are frequently depressed and socially isolated, and these traits don't make any of us model public citizens.

The contributors to this book have had enough experience with heavily indebted folks (who are included among our ranks) to know that they are frequently socially isolated and often too busy dealing with their own personal miseries to "waste time" thinking about how their predicament might be generalized to the larger society.

In addition, desperation can make people unreliable co-workers when they are pressed by bosses not to unionize. Terrific recent studies by academics like Daniel Dorling, Kate Picket, and Richard Wilkinson have explained the tight correlations between economic inequality and a wide array of personal and social ills, ranging from worse health (among both the well-off and not), higher crime rates, and general morbidity.

Given this, it is not much of a leap to see that when the financial system uses the 99% as the fodder for its securitization efforts, this not only makes money for the 1%, but also commences a negative feed-back loop, the result of which is to sap the 99% of their will to fight back.

De-politicized Money

What is also under-discussed but critical to the dynamics of the current state of affairs, is the extent to which the inverse of financialized politics is also true: issues concerning how our money is made, cycles through the system, and ultimately flows back to us (or doesn't), have become divorced from politics.

Back in the day, populist champions like Andrew Jackson (who no doubt had plenty of faults too) and William Jennings Bryan achieved wide support expressly campaigning on issues like the merits of having a national bank and the extent to which alternate currencies should, or should not, be permitted to proliferate.

It should thus strike us as intensely odd that, although we are told by pundits that historical levels of discord between the major parties undermine democratic institutions, the fact is that on the issue that might matter most — *money* — a Martian who knows nothing else about us, but who reviews the pedigrees, policies, and identities of the people at our financial controls, would be hard-pressed not to conclude that it was visiting a single-party autocracy.

The likes of Lawrence Summers, Tim Geithner, Alan Greenspan, Robert Rubin, Ben Bernanke, Jack Lew, and other Wall Street revolving-door wizards and friends have been manning the financial ship for at least 25 years. Their push for free trade agreements, suppression of financial regulations, bail-out of banks, and use of the Federal Reserve solely to manage bank credit (as opposed to facilitating full employment, which its charter also permits)[15], has not varied one bit depending on which of the two (supposedly) competing parties has held the presidency.

Come to think of it, it is hard not to get suspicious that all the public acrimony between the political parties might be best explained as a shared preference for government to *be* dysfunctional so that we are all pushed ever further towards the "private solutions" about which they seem to be in such accord.

We are not suggesting here that all feuding in Congress is strictly for show or that all of the points about which legislators disagree are unimportant. We are suggesting, however, that sometimes participants in a complex system (think of ant colonies or birds flying in a V-formation) find ways of acting in a manner that furthers the system's logic and true purposes, even if the individual actors are barely cognizant of the *real meaning* of the roles they play.

And as a last warning of things to come that might really sound conspiratorial (but it's true, we swear), beware of the tremendously underpublicized Trans-Pacific Partnership Agreement (TPP). It's a free trade deal that has been in the works for a long time and is allegedly still under negotiation.

The Obama administration has veiled TPP in secrecy, hoping to submit it to Congress on a "Fast Track" basis that would only allow legislators an up-or-down vote, and apparently (from what little the 99% can glean so far) stands to more fully than ever prohibit national legislation that interferes with the flow of capital across international borders or otherwise impedes corporations' efforts to seize profit-making opportunities with such cross-border investments. Andrew Jackson would be turning over in his grave.[16]

Finally, please realize that none of this uniformity of mainstream opinion on the rules governing finance and money is possible without *our own* unjustified acquiescence to it.

The 1%'s demands that finance be treated as natural science and thus left for the sole consideration of specialists with "successful" investment banking pedigrees (*i.e.* they made a truck-load of money on Wall Street) or advanced degrees in falsely scientific-sounding fields like "Quantum Finance".

If you take nothing else from this book, let it be this: *that's bull*. Money, throughout history, has always been intensely *political*. Remember, the same people who want you to treat finance as hard science utterly failed to predict the 2008 collapse! Putting them on a pedestal is like hailing the guys who, before Einstein, thought light travelled through an undetected medium called "The Ether" — guys whose "theories" led to demonstrably false conclusions.

Perhaps even worse, the makers of the present apolitical culture surrounding finance want you to believe that they have learned objective laws regarding the creation and dynamics of money, like those regarding gravity, quantum mechanics, or other sub-specialties of the physical sciences. They have not. Money is neither created nor flows *naturally*, but does so according to the rules and contours that we (the people) establish for it.

Notes

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7. Old Bankers' Tales... and Why We Should Reject Them

"The greater the wealth, the thicker will be the dirt."

John K. Galbraith

Myth: *"The 1% earned it, so the government should let them keep it."*

Earning money. Let's tackle this head on: what does it mean to earn something?

There is, floating around in the American zeitgeist, the idea of demigod entrepreneurs who create the products and companies that make us all better off. These rare, special creatures ought to be compensated for sharing their talents with us in a way that makes us all better off via innovation! Heroic individuals of genius and talent generate enormous social wealth and so "earn" whatever they are paid!

A typical, yet flawed, example of this myth is Steve Jobs. Steve Jobs is an atypical example of the 1% — most of whom are finance or C-class (so CEO, CTO, and the like) executives – because, arguably, he created real value for people.

But note that this narrative depends on two questionable assumptions. The first assumption is that the market worth of an individual's economic contributions is a measure of the net social wealth they have generated – their "marginal product" in economics-talk. The second assumption is that the market price commanded by an individual is a fair and just way of distributing income.

Let's pick apart that first assumption. Where does social wealth come from, actually? Is it really wholly manufactured by a few geniuses? Even expressing it this way makes it absurd on its face. It's much more likely, in fact, that society itself is the real source of wealth: see Elizabeth Warren's "you didn't build that" speech[1] for example.

To paraphrase Warren, lucky you if you were able to take advantage of the way society has been set up, but you are not the sole source of value here. The economy depends on a huge number of institutional and social realities that have no price tag.

Consider this: how much of what Apple did was really because of China opening up and allowing U.S. factories? How many Chinese and Vietnamese lifetimes went into each iPhone? How much of what Apple did was because of government investment in the Internet? Also, since Jobs didn't have a great engineering background, intellectual property was "negotiated" between him and Steve Wozniak. In other words, it wasn't a one-man-against-the-world situation. If we plopped Steve Jobs in medieval Germany, he would likely wind up plowing some farmland, just like everyone else.

In other words, once you take into account the basically social nature of the background conditions for market success, Steve Jobs doesn't look like an amazing genius, but rather one individual (kind of jerky and potentially replaceable) in a process that included many factors.

Even if we concede that there is a general, albeit noisy, correspondence between pay and social value, it's still arguable whether the particular 1% in our society is producing any social value. Today, most of the extremely rich are not creating consumer products like Steve Jobs. They are doing things like running a hedge fund profiting from the mortgage meltdown like John Paulson, making bad loans like Angelo Mozilo, causing climate change (and influencing the political process so the government doesn't get in their way) like David Koch or doing "God's work" like Lloyd Blankfein. Those maniacs blew up the economy, after all! We have an elite that is paid by organizations that fail to internalize huge externalities, from environmental costs to financial fragility. To the extent that they are making a profit by ignoring these costs, their resulting pay is not even remotely related to helping society.

Let's face it: earning doesn't necessarily mean that we are making society better off, but rather that someone is willing to pay us for our labor and capital. It's just as likely that individuals are paid really well because they came up with fancy new derivatives to fleece people as it is that they were making the world a better place. To the extent that the system allows you to make money by screwing people over rather than by improving society, there will continue to be a discrepancy between earning and the betterment of society.

Let's move on to the second assumption, namely that people earn their market value and that such a system is both fair and just.

One overriding element of the Steve Jobs success story is luck. Indeed, luck is one of the features that make markets work — the right person at the right time can make the right trade, product, or innovation.

How does the element of luck square with the concept of justice? If you think of the sheer amount of luck and arbitrariness that is inherent in market rewards, it's difficult to believe that it corresponds closely to justice, since we generally think of justice as fixed, or, at most, a slowly evolving and emerging concept.

Hold on, though. Maybe there is a loose correspondence after all. Maybe the market implements some form of meritocracy. Those frugal and thrifty people, or those talented and risk-taking people, are the ones that the market rewards.

But at some level this possibility can't be reconciled with the intrinsic dynamism and random shocks that the market brilliantly delivers. Merit is essentially backwards-looking ("I'm investing time and money to build the widgets that our country already needs"), whereas the free market generally rewards what's coming up ("We've disrupted the field of widgets by creating new, virtual widgets at a fraction of the cost!"). This kind of technological jump is great, in general, but it also means that the people thinking the hardest about what society already needs might not anticipate the next disruption. So capitalism is constantly pulling the rug out from under even the most thrifty, frugal, and talented people. In other words, the extent to which someone "earns" their pay is continuously disrupted by serendipity and noise.

Keeping money. Now that we've talked a bit about the concept of "earning" money, let's talk about the concept of "keeping" money. That is, should the government let people keep "their" money rather than taxing and transferring some of it?

As we discussed above, it's possible to make the case that lots of currently rich people made their money by a combination of luck and screwing people over. If that is the case, it was never "their" money to begin with. Heavily taxing rich guys is therefore arguably the simplest way just to smooth-out some of the noise we discussed, and also to create better incentives when our cockamamie legal system dumps tons of riches in the hands of a few folks who obviously are not engaged in the most societally beneficial behaviors.

If that sounds extreme, consider this: we have an enormous number of talented scientists going into finance, even after the financial crisis. In the 1950s and 1960s, their counterparts sent people to the moon, but nowadays our most talented people are leaving scientific fields, getting jobs in finance, and then figuring out how to invent complicated and opaque financial products. That is not because society is now getting a lot more value out of finance and less out of science. It is much more likely because some of the totally unprincipled legal rules we mentioned are resulting in a misallocation of resources, which a more progressive tax system would go a long way towards straightening-out.

Also, when, as we have earlier discussed, there are fewer and fewer goods and services in society that we hold in common, that necessarily means people are starting off their lives from vastly different baselines. Taxes alone cannot fix that. Other countries address inequality in various ways: allocating public goods (such as schools, universal daycare, excellent public transportation) and changing the structure of the labor market.

The lowest mobility places in the U.S., for instance, are still the black belt and the plantation delta, two regions in the South. This suggests that the current structure of American inequality runs a lot deeper than just tax and redistribution policy. Whether someone has any money to "keep" when he starts off will have a heck of a lot more to do with what part of our lumpy geography of wealth distribution he is from, than with any moral entitlement he may claim.

Finally, strong unions might do more to fix inequality than taxes, while eliminating the (false) perception taxes cause that something is being "taken away" from the rich guy that was already "earned". Why? Because when we're in a union, the bargaining clout that comes with standing up to the boss together means the revenue "the company" (*i.e.* the broad community of people that constitute the firm's workforce) generates will be distributed more evenly. So the issue of "correcting" an uneven distribution becomes besides the point. And, of course, unions create a political voice for workers to balance out the over-sized modern political voice of corporations.

Myth: *"Things that hurt the private sector are bad for job creation."*

First, things that the business community perceives as bad for individual businesses might often actually be good for the overall private sector.

For example, standard Economics suggests that firms will hire workers to the extent that doing so increases their net- revenue, meaning the cheaper the worker, the more hiring a firm will do. Higher taxes and more stringent regulations are bad on this view because they make it harder for the revenue vs. cost spread of the next hire to come out positive. But thinking about it this way is like saying — because I got my sandwich faster by cutting to the front of the deli-line, everyone should do it. In other words, breaking down an individual firm's decision-making calculus about its next hire tells us nothing about what kinds of policies might benefit *the system* of private sector employment.

There are a lot of reasons to think, for example, that policies that set living wage standards at practically double the current federal minimum wage would eliminate race-to-the-bottom pricing of labor. And a more fairly compensated private-sector workforce would actually be in a better position to go out and buy the products and services its employers sell so *the system* of private sector employment would actually do better. When the wages of Walmart workers are at or near poverty levels while the wealth of Walmart's founding family is so extraordinary that they could not spend it in several life-times, is that really good for private sector business? When money pools and gets stuck in nooks and crannies of the system, leaving most economic-participants little choice but to turn to public assistance or crime — it is bad for business, private and public.

Second, private job creation does not account for all jobs — there are plenty of government jobs too. We have more control over them and nothing *per se* makes a private sector job better than a public one. So to the extent (god forbid) Rahm Emanuel were to shut-down a charter school and give its teachers jobs at a resuscitated public institution, why would those jobs be worse? They would arguably be better because governments don't run from their debts and vanish as frequently as start-up companies do.

Let's think even a bit more about public employment. That is, let's be open to the idea that a national public employment program – an army of workers for creating things instead of destroying them — could reduce a lot of unemployment while building parks, cleaning up the environment, making public art, and the like.

Even just in NYC alone, we owe so much to the Works Progress Administration (WPA) that created public sector jobs in the late 1930s — take a look around. It makes you realize that there's a lot of labor that society needs for creating things — like parks, bridges, schools, roads, museums, zoos, and airports—that the private market won't provide. We should be pretty darn proud of the work our public sector employees and other employees working on public projects do; they build and service most of what we take pride in as a society.

Myth: *"Entitlements and government waste, like the stimulus, have created too much government debt, which is what brings us down."*

By government waste, which one of the wars does this refer to? Or does it refer to the NSA surveillance budget or the Pentagon drone budget?

Let's face it, government waste is in the political eye of the beholder. In other words, when a politician says "waste of our tax dollars", we might say "vital government program", referring to the same thing. A description of "waste" often has more to do with a view about the objective the government program seeks to fulfill than with the way the government is carrying it out.

The stimulus is often thrown out there as the classic example of government waste, so let's tackle it directly. It's piddling in the gross domestic product (GDP) scheme of things: a one time cost of $1.2 trillion vs. $14 trillion annually. And parts of it did valuable things like helping cities avoid laying-off teachers or improving the energy efficiency of our electric grid. We really could have used more of it and spent it better.

In addition, we might want to worry about climate change at least as much as government budgeting and debt. Why compare two different things like climate change and budgets? Because of their similar time horizons. In other words, we ignore certain pressing issues like climate change which lie on that same time horizon as the deficit — let's say 2030 — so why the current obsession with the government's alleged waste and debt?

Even so, let's admit that an overly indebted government will have trouble borrowing at reasonable rates, which would be bad. It gives bondholders too much clout and makes the government timid when it comes to projects that might prevent debt rollover. It is also no substitute for a more thorough taxation scheme and a functional political system that can raise taxes when needed for important projects.

If we decided to stop depending so heavily on government debt, what are the basic steps we'd need to take to get out of it?

As far as Social Security is concerned, we don't actually have a problem. While there's a bit of a short-term squeeze, there are no problems we can't fix in the medium term, first by raising the Social Security payroll "cap" (currently $113,700) up to some higher cap of our income, and, second, by making the Social Security payroll tax more progressive.

Next let's consider healthcare. There have been lots of projections about a severe crisis in healthcare because medical expenditures are rising at an enormous rate. To the extent that government pays those costs, this is a rapidly increasing part of the budget. There are a few reasons for this; some of them give us reason to be hopeful, and others have nothing to do with government waste.

First, it looks like cost growth has slowed in the past year, partly because of how companies have anticipated the onset of Obama's Affordable Care Act (ACA). Based on extrapolation, it's not certain that the rising cost of medical care will hold true going forward.

But even ignoring this possible slowdown, healthcare is expected to constitute 25% of the national budget by 2025. Is that actually such a bad thing? If we think about it, it's a totally civilized society in which the government is an efficient insurance company and, at the same time, a reluctant army (armies cost a lot), especially if you compare this to the current situation in which we pay a large fraction of economic output to the finance sector.

After all, as people get richer, the value of extra "stuff" becomes less meaningful but the value of an additional year of life or additional sense of security always remains high. Seen in this light, the expected continuing increase in healthcare expenditures and social insurance is possibly reasonable in a rich country. Ideally, we would want to hold down cost, but if people are actually demanding more healthcare, then so be it.

And lastly, it is becoming pretty well understood that the inefficiencies in our health care system are not on the government side. They come mostly from private practitioners who have financial stakes in all sorts of procedures sick people undergo, so a lot of doctors do well when we are (and stay) sick, rather than by making (and keeping) us healthy.[2] Remember, almost all government employees get serviced by private doctors. It is only the insurance which the government supplies.

So Social Security is not a big deal and healthcare is a big deal, but it might be reasonable, and to the extent it is a mess, it is largely a mess of the private sector's making stemming from all the privatization that happened to that field in the 70s and 80s. That leaves things like wars, defense, and the unconscionable government subsidies of pet industries like big pharmaceuticals (Bush II made it illegal for the government to bargain for better prices for Medicare Part D drugs) and the Finance Sector (the ongoing bail out) to name but two.

A final point about the myth that governments are inherently wasteful and that too much debt is dangerous: at what point is the bond market, as a whole, going to freak out and stop lending to the profligate inefficient U.S. government? There would have to be something better, safer, and more liquid than the U.S. for this to ever happen. Clearly, this is not happening, and does not look like it is going to happen any time soon.

Myth: *"The current structure best allocates capital, and, in any event, if we suppress it, it will just go elsewhere and the U.S. economy will suffer."*

Let's first dig into the assumptions embedded in the first part of this statement. If we peek under the covers at what "best allocates capital" means, we'll see that it assumes that we are doing something especially clever right now which makes our current system "the best". What would that be? If anyone responds by claiming — our markets are free — then get them to give you an address to a "free" market, and it better not be Wall Street or the "The Merc" (the Chicago Mercantile Exchange). Those markets are not only heavily (if inadequately) regulated; they were created as a result of regulation. As Bernard Harcourt has wonderfully explained in his book *The Illusion of Free Markets*[3], the commodities exchanges in Chicago were created out of a multi-decade public-private partnership bent on suppressing "bucket-shops" and other "off market" trades. All markets are regulated; indeed, without heavy regulation all you have is people conspiring to set prices and grab things away from one another without paying for them. The only question therefore is whether the current set of regulations is any good, and for all the reasons we have discussed earlier, it is not.

Further, even if we concede that the financial system is doing an adequate job of allocating capital to "profitable" businesses, do we think that profit is really a good proxy for social well-being? Recent history ought to give us precious little solace that dumping capital in the most "profitable" firms is going to put money where it will do the most good.

Let's move on to the second part of the myth, namely that capital might move to other countries if the U.S. has strong regulation.

First, investors all over the world want to invest in the U.S. It is hard to believe that will change any time soon, but it is even harder to believe they are coming here because we have lax capital regulations. They are coming here because despite the financial hits the 99% has taken over the past 25 years, we still have a lot of educated, reasonably well-off people living here who together create a vibrant society compared to many other places in the world. The economic dynamics this book has spent a lot of time exploring are doing tremendous damage to that vibrancy, and, if not checked, will ultimately make the U.S. a poor place to invest (and live). But it is certainly not loose money that brings investors to our shores; and it is certainly no time soon that reasonable capital regulations are going to drive them from these shores.

Our competitors on the regulation front are also the likes of the Cayman Islands, Singapore, and Switzerland. Is that where all the money is going to go? Keep in mind that Europe is no less regulated than the U.S., and although England is a soft spot, it is also under political pressure by its public to restore sensible regulation.

Given this, let's not worry so much about regulation of capital, but, on the other hand, let's go ahead and worry about tax havens. The European Union is currently trying to pass laws about tax havens to make them less available.

On the scale of the world's money, tax havens are having a pretty serious effect, and they're even tilting our perception of which countries are net debtors versus creditors. Come to think of it, they don't generate a lot of jobs for the 99%, so we probably should not worry too much about winning the race to the bottom of that garbage heap.

NOTES

1 Elizabeth Warren's "You Didn't Build That Speech"
http://www.youtube.com/watch?v=i-P-CoSNYaI

[2] For a seminal (but fun) article on this see Atul Gawande, "The Cost Conundrum", *The New Yorker,* June 1, 2009 www.newyorker.com/reporting/2009/06/01/090601fa_fact_gawande

[3] Bernard Harcourt, "The Illusion of Free Markets, Laissez faire and Mass Incarceration", *University of Chicago Law School Podcast Lecture Series*, May 11, 2011.

8. Starting to Re-Build What's Ours

"The existence of a free market does not of course eliminate the need for government. On the contrary, government is essential both as a forum for determining the "rules of the game" and as an umpire to interpret and enforce the rules decided on."

Milton Friedman

Sports leagues rely on rules and officials to assure fair competition. When the National Football League tried to break the referees' union by bringing in inexperienced refs, fans quickly discovered the results of poorly enforced rules. The replacement refs made one glaring mistake after another. Teams that should have won lost. The public outcry led to a quick restoration of capable officials.

Poor financial regulation gets less attention than poor refereeing, perhaps because it is not broadcast on TV, but we have all suffered from the effects of both bad rules and bad enforcement. As earlier chapters have described, bad regulation contributed greatly to the recent financial crisis and its aftermath. Even when the terrible effects became obvious, the regulations were not adequately fixed. In fact, the abuses are continuing. Clearly, those in government are not willing to do what is needed to hold the abusers accountable for their actions. Why? Because the status quo serves the interest of Wall Street and the banks' influence on politicians and regulators is pervasive.[1] So we need public outrage to demand better regulation.

Many people, both in Occupy Wall Street and outside, believe that our current financial/governmental/regulatory system is beyond repair and something very different must replace it. But even those with that ultimate goal must not, in the meantime, simply accede to whatever rules the corporate interests and lobbyists impose. In this chapter, we outline a framework for regulatory reforms that will move toward a system where the rules are enforced fairly, powerful miscreants are brought to justice, and the 99% have a representative voice in the political and regulatory processes.

The suggested reforms are by no means a complete fix of our economic arrangements. But they illustrate that, even within the existing system, the rules could be much fairer, predatory practices could be much less prevalent, power could be much more equitably distributed, and violators could be punished even if they are rich and powerful. These are useful steps toward getting we, the people, involved in deciding what needs to be done and how it should be done. It is a reclaiming of the people's power.

The current problems with financial regulation are not inevitable. The financial system used to be better regulated and it can be again. There are also examples of good regulation that prove it is possible. For instance, those of us who live in Los Angeles or New York City will be familiar with the letter grades A, B, or C prominently displayed on restaurant windows. This simple measure has improved restaurant hygiene and reduced severe food-borne illness.[2] As the Consumer Financial Protection Bureau has shown, better rules and regulation of the financial industry are also possible.

This chapter proposes a framework for what we call "Popular Regulation". We call this approach "popular regulation" because it will make regulation more transparent, effective, and protective. But, more fundamentally, it will make the people's interests and the people's voices more prominent.

Principles of Popular Regulation

Popular regulation is defined by four principles:

<u>Responsible and accountable:</u> Society must expect the regulators and the regulated to behave responsibly. When they don't they must be held accountable. There are three significant aspects of responsibility:

- At the most basic level, companies and people must be held accountable when they break the rules or abuse the public trust. As described in chapter 5, there have been too many examples of law-breaking going unpunished. In addition to being unfair, this also encourages future misdeeds. But the rules should demand responsible behavior well beyond abiding by the letter of the law. Many financial relationships inevitably involve unequal positions or asymmetric information, such as those between financial adviser and client. The more powerful or well-informed advisers should be prevented from using that information to exploit their less knowledgeable customers.

- In addition, for regulation to work, regulators must act in the public interest. Their incentives and career opportunities should support such behavior, not undermine it as these opportunities do today.
- Finally, social norms are also important. For too long, society has lionized selfish behavior in the corporate sector and demonized government regulation. We need to appreciate the need for and the value of good regulation.

Simple and consistent: In general, simpler rules are better because they're commonly less subject to gaming. Simpler regulations make it harder to embed loopholes or special privileges. Simpler regulations will facilitate democratic involvement in the process, because regular citizens will be able to understand and critique them.

Fair and comprehensive: The rules must be fair and enforced in an equitable manner. Regulation also should be comprehensive. All too often, regulation is fragmented and inconsistent. This has allowed for abuse of the process and/or avoidance of oversight.

Democratic and transparent: our government is intended to be "of the people, by the people, for the people". This principle should apply to regulation as much as to any other governmental activity. The financial regulatory process today is open in structure. New or revised regulations are available for public comment. But in practice it is all-but-impossible for people, or even their representatives, to have meaningful involvement in the process. We present some ideas to change that.

In the remainder of this chapter, we illustrate these four principles and how they could be applied by proposing some examples of better regulations and improvements to the regulatory process.

Responsible and Accountable

When we visit a physician, we have reason to expect that the doctor will give us advice and treatment that is in our best interest. Doctors know more than we do about medicine and health, and we expect them to use that knowledge for our benefit, not to make a profit from us.[3]

Fiduciary obligations

Financial companies and the professionals who work for them also have informational advantages over most of their customers. There should be similar expectations for them to put their clients first. In finance, this is called a "fiduciary obligation". As discussed in chapter 1, financial companies currently sell products. The burden of determining which of these products are attractive or beneficial and how to use them is shouldered almost entirely by the individuals who invest, take out a mortgage, use a credit card, or engage with other financial products. But most individuals do not have the expertise to make those decisions well. And, increasingly, many financial products contain traps in terms of hidden fees, adjustments to payment requirements or other features that can make them toxic to customers. Financial products are supposed to serve a useful purpose but instead, all too often, they are used to take advantage of individuals for the benefit of the company selling the product.

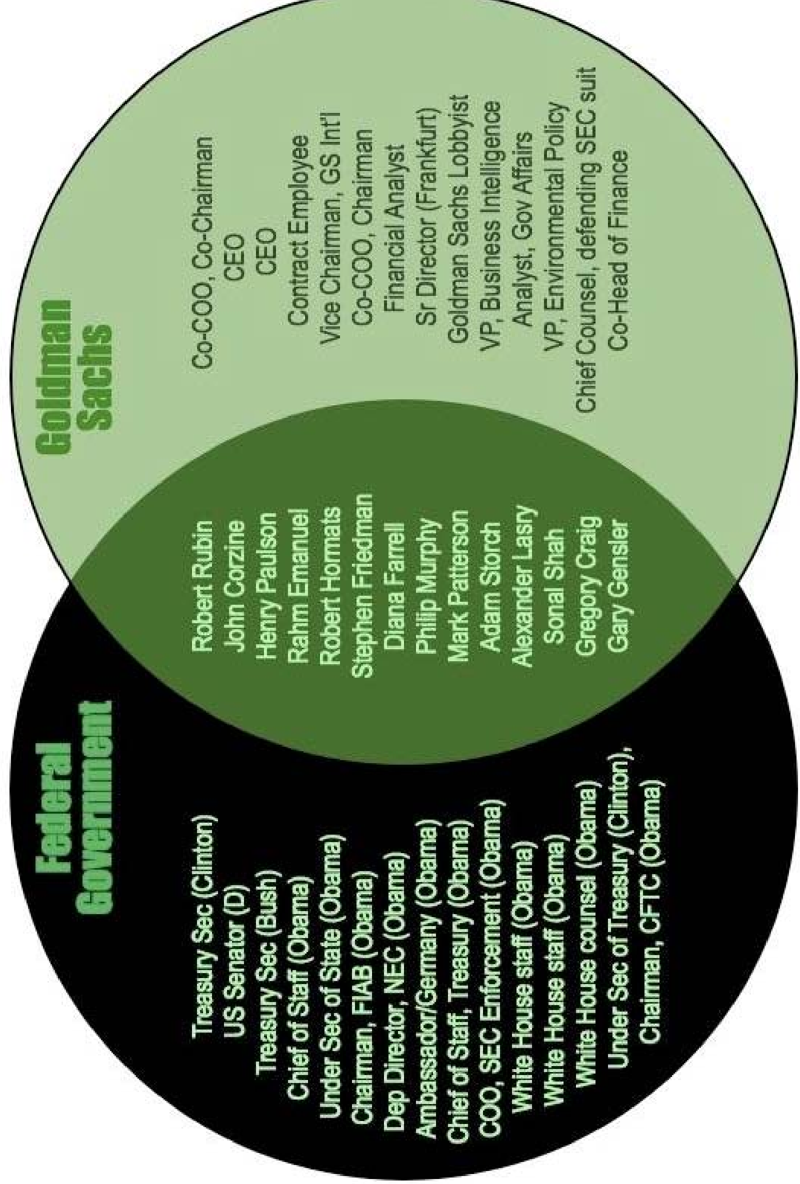
Things do not need to be this way. Financial practitioners should be held to standards as doctors are. They should offer products and advice that are truly helpful to their customers or clients or risk being sued for "malpractice". Higher minimum standards for behavior need to be enacted legally and via regulation. Fiduciary obligations need to be extended more broadly. For example, mortgage brokers should be legally prevented from selling high-cost products to a borrower who would qualify for a lower-cost alternative. In addition, mortgage brokers should be responsible for fully disclosing all aspects of the loan agreement, including the compensation that they will receive, directly and indirectly, for selling different products.

Lock the revolving door

Financial professionals now move seamlessly between regulatory agencies and financial firms as well as the law firms that represent financial interests. This is insidious in both direct and indirect ways. When regulators see the industry representatives lobbying them as potential employers, it undermines efforts for regulation in the public interest.

Perhaps worse, since many of the staff at regulatory agencies such as the Securities and Exchange Commission (SEC) and at the U.S. Treasury Department previously worked on Wall Street and have friends who still do, their mindset is similar as well. The awful consequence of this system has been described by former regulators Sheila Bair and Neil Barofsky in their excellent books *Bull By The Horns* and *Bailout.*

The graphic portrays the revolving door between Goldman Sachs and Washington. Similar charts can be made for all of the major financial firms and the lobbyists and law firms that represent them.



Source: Chartporn.org

This problem should be attacked directly. Sheila Bair has proposed that regulators should be permanently banned from working for the companies they regulated.[4] While a permanent ban may sound onerous, Bair spent most of her career in government, ultimately as Chair of the FDIC, so we respect her judgment that this would be feasible. We also think it can be implemented in ways that will be effective while still attracting capable regulators.

Bair's point is that locking the revolving door would cause a culture change. People going to work for the government would see it as a career. A permanent ban would attract people who would find government employment a rewarding mix of good compensation and public service–just the sort of attitude we would want in regulators–rather than what we have today, where working for regulatory agencies is viewed as a stepping stone to a more lucrative job on Wall Street.

Junior regulators need only be subject to a temporary ban of perhaps one year. As people gain tenure and rise in rank, the bans should be lengthened to a few years, and those at the highest levels should be permanently banned from entering private industry. In conjunction with this, the regulatory agencies should be encouraged to hire from within government so that career prospects for regulators would be improved.

There are many insidious effects when people move from Wall Street to Washington. This is particularly true at the highest levels. We were shocked to learn that when Treasury Secretary Jacob Lew left Citicorp to return to Washington, Citigroup paid him a handsome bonus.[5] The bonus specifically rewarded him for moving into a high government position – yet another way for corporations to bias the system in their favor. This is unseemly and should be forbidden

After all, public servants in other parts of the government truly do behave as public servants. The diplomatic corps seems quite professional. Federal judges usually act honorably. Judges have explicit life tenure and foreign service officers hold government posts for long periods. We need to promote similar professionalism in financial regulators. Locking the revolving door would be an important step toward achieving popular regulation.

Punish wrong-doing.

When malfeasance occurs, those involved need to be held accountable. As described in chapters 2 and 5, there were many crimes during and after the subprime crisis that were not prosecuted. Even when there was clear evidence of wrongdoing, the SEC, the Department of Justice, and/or state Attorneys General made agreements with Wall Street firms that permitted these firms to "neither admit nor deny" wrongdoing. The fines that were imposed were typically woefully inadequate to discourage future misbehavior, and in fact did little more than establish the fee for criminality. [6]

In addition, fining companies is generally ineffective because it doesn't sufficiently punish the executives who committed or condoned the wrong-doing and personally benefitted from it.

The SEC has begun, in some cases, to demand that financial firms actually admit to the crimes they have committed. But this is still the exception when it should be the rule. Even in extreme cases, such as HSBC's admission to years of money-laundering for drug cartels, no criminal charges are pursued. This must change.

Change the culture

Finally, statutory restrictions and prosecutions are necessary but not sufficient. Social and industry norms also play an important role. When Michael Lewis described outrageous behavior on Wall Street in the 1980s in the book *Liar's Poker*, he thought it would embarrass people on Wall Street into acting better. Instead, the book was taken as a "how-to" manual! Wall Street became even more brazen in taking advantage of clients, the government, the public, and anyone else they can make a buck from. Society is partly responsible for this since, in addition to money, Wall Street executives get public accolades even when they are caught committing wrongful acts. For instance, JPMorgan Chase CEO Jamie Dimon continues to be respected despite a Senate report that shows he lied to Congress and shareholders.[7] Ina Drew, who headed the JPMorgan Chase unit involved in this deceit, was honored as a respected Barnard alumnus and "one of the most successful women on Wall Street" even after the report became public.

The LIBOR scandal is a window into the corruption in the culture of finance.[8] Hundreds of people, working for dozens of banks around the world, routinely colluded to manipulate interest rate indices for several years. They did this to increase their bonuses, and were profoundly indifferent to the impact this would have on the public and even on the companies they worked for. In fact, this practice was so well accepted that the perpetrators openly discussed it in e-mails.

How could this go on for so long? Ironically, it is the natural outcome of the "rational actor" model [9] taught in business schools[10] – namely, that the LIBOR manipulators were acting in their own best interest given the incentives they faced and the lack of effective oversight or enforcement.

We need to reject the myth that market forces ultimately work for the common good and that selfish behavior is "doing God's work" [11]. We should recognize that hedge funds that exploit regulatory loopholes or front-run other investors do not produce any social value but that good regulation does. In order to understand this better, we recommend reading *23 Things They Don't Tell You About Capitalism* and *What Money Can't Buy* (see chapter 9, "Resources").

Simple and Consistent

Simplicity is another crucial element of popular regulation. Simpler regulation would reduce the potential for inserting loopholes or special provisions. It would also encourage broader participation in the regulatory process.

We originally advocated for the Volcker Rule to prohibit banks from speculating with depositors' money. In principle, we still endorse the idea. But in practice the regulations to implement the rule are thousands of pages long and the process is mired in bureaucracy. What's worse, the megabanks are manipulating them to their advantage.

Occupy the SEC (OSEC), our sister group within the Occupy movement, has done extraordinary work in an attempt to insure that the regulations are written well and implemented.[12] But its effort is not sufficient because there are dozens of rules being proposed; OSEC is only able to comment on a small fraction of them.

Let's face it: regulatory complexity serves the interests of the largest banks. First, it provides opportunities for Wall Street lobbyists to insert special provisions and loopholes. Even when the rules are not written specifically to provide advantages to Wall Street, the regulatory burden works to their advantage. The cost and expertise needed to deal with the regulation acts as a barrier to entry for smaller firms and encourages industry concentration.

Require more bank capital

There is a much simpler alternative to the Volcker Rule. In their compelling book *The Bankers New Clothes: What's Wrong with Banking and What to Do about It,* Professor Anat Admati and Dr. Martin Hellwig argue for requiring banks to rely much less on borrowed money and to have a larger cushion against losses. Andrew Haldane, Executive Director of the Bank of England, has also called for greatly simplified rules in his "Dog and a Frisbee" speech.[13]

Admati and Hellwig's proposal is simply to require that banks have a larger cushion between what their assets are worth and what they owe. This would reduce both the risk and the consequences of bank failure. It would go a long way toward ending "too big to fail" and stabilizing the financial system. In addition, as Admati and Hellwig show, the only true costs to the banks would be reducing the "too big to fail" subsidy and the exploitation of tax preferences given to debt, which provide them with unfair advantages. That would be costly to the banks but beneficial to society.

They also argue for drastic simplification of the rules. While we agree that a simple measure of assets would have done much better in managing the past crisis, it is far from clear that it would be more effective in the next one. No single measure is perfect. What's more, Goodhart's Law, proposed by a member of the Bank of England's Monetary Policy Committee, states that any measure used as a policy tool will lose its effectiveness because banks will configure their assets in ways that exploit the measure's flaws.

We think the only solution is a belt-and-suspenders approach. That is, there should be multiple and different measures to lessen the banks' ability to game any single one. While we like the Admati/Hellwig/Haldane proposal for a simple measure, we also think more sophisticated measures should be maintained because any one measure is imperfect, and increasingly so as Goodhart's Law comes into play. In addition, regulators should have the tools to apply their judgment to address problems as they are recognized.[14]

The approach we recommend should not be burdensome to the banks. As Admati and Hellwig note, many of the banks' arguments against these proposals have no more substance than the Emperor's New Clothes. What we recommend is similar to the current regulations except with much higher standards.[15]

As more capital would allow for easing of what the banks consider more intrusive regulations such as the Volcker Rule, it could reduce the overhead of the banks while making the regulation both more effective and more "popular".

Simple retail products with clear disclosure

Another example of the benefits of simplicity is the progress that the Consumer Finance Protection Bureau (CFPB) has made toward protecting individuals. Anyone who has received a credit card privacy statement may have noticed that they are much clearer. As opposed to many pages of fine print, the salient aspects are now on the first couple of pages in bold type. It makes clear what the company does with your information, when you can restrict their sharing of your data, and how to do so. While we might want more privacy protection, at least people are made aware of what is being done and can, to a degree, opt out if they wish.

Other credit card and mortgage disclosure language is also being greatly simplified. As the Center for Plain Language has shown, it is possible to write a credit card agreement that a fourth-grader can understand – if you want to. This level of clarity should go a long way toward helping individuals avoid the traps that currently exist in all-too-many financial products.

We also applaud efforts to restrict the use of complex financial instruments. Here too, the CFPB is leading the way. The Qualified Residential Mortgage designation that is applied to simple mortgage structures will encourage their use. While it is still legal to offer the more complex mortgages that created such havoc during the latest crisis, the hurdles to using them are higher compared to using simpler instruments. This should discourage their use.

While we have mixed opinions about the Volcker Rule, we do agree with former Fed Chairman Paul Volcker's statement that the only useful financial innovation of recent decades is the ATM[16] — and as noted in Chapter 1, even that is a mixed blessing. Promoting simpler financial products, simpler regulation, and clearer disclosure is an important part of popular regulation.

Simpler, more open markets

Markets should also be simplified and made more transparent. Forty years ago, most trading was in stocks and took place on public exchanges. Today, derivatives dominate the financial system and trade in opaque over-the-counter markets. Even many products sold to individual investors have become very complex.

Trading should be required to be more public. In addition, there should be review of financial products before they are used. Two professors have proposed an agency that would review products for financial safety and effectiveness, similar to what the Food and Drug Administration does for pharmaceuticals.

Why the parallel? Some financial products are so complex and contain so many hidden traps that it seems clear that they are designed to confuse potential buyers. Creators of new instruments should be required to justify that they serve a useful purpose other than making money for the originators. The "Financial FDA" could outlaw instruments, or it could rule that, like prescription drugs, they can only be used in specific circumstances, or it could allow them to be used more generally.[17]

Fair and Comprehensive

Clearly, fairness is another essential pillar of popular regulation. As part of that, the rules must be comprehensive. For example, it is unjust that practices that are outlawed for credit cards can still exist for pre-paid cards that are foisted on some of the poorest and least powerful members of society.[18]

No off-balance-sheet entities

There are many other areas where incomplete or inconsistent regulations hurt society. One egregious example is the use of "off-balance-sheet" entities. Banks contorted the accounting rules to enable themselves to hold large amounts of mortgage securities and other assets that proved toxic but not to list them on their balance sheets. To accomplish this, they created entities called "Special Investment Vehicles, or "SIVs", which are close cousins to the "Special Purpose Vehicles" used extensively by Enron. SIVs misled regulators and investors about the true risk the banks were taking and also circumvented the regulatory controls. While rules for these entities have been tightened up, that is not enough. SIVs should be abolished.

End "regulator shopping"

Another serious problem is the fact that multiple regulators cover similar activities or the same entities. As a result, banks and other financial institutions can often choose their own regulator. It should come as no surprise that they choose the one that is most lax. Even worse, the agencies' budgets are often, in part, determined by how many companies choose them. This leads to competition among agencies for who can be the most "attractive" regulator—meaning the most lax!

One of the worst cases was the Office of Thrift Supervision (OTS), which was supposed to be regulating savings and loan companies, actively promoting itself as being "industry-friendly".[19] As a result, AIG, which was primarily an insurance company, was able to choose the OTS to oversee its London-based Financial Products unit. That is the unit that wrote trillions of dollars in credit guarantees that lead to billions of dollars in losses that were absorbed by U.S. taxpayers in the bailout.

While the OTS has, thankfully, been abolished, there is still enormous regulatory confusion. Both the SEC and the Commodity Futures Trading Commission (CFTC) regulate derivatives. The financial industry is playing these agencies off against each other in order to delay and weaken the rules being implemented as part of Dodd Frank. These two agencies should be combined in order to avoid such practices.

In general, rules need to be written that apply across the board. It is unfair if similar activities are treated differently from a legal, regulatory or tax standpoint. What's worse, it is an opportunity for what Wall Street calls "regulatory arbitrage" and we call "gaming the system".

Democratic and Transparent

Democracy is the final pillar of Popular Regulation. Regulation, like all of the U.S. government, is intended to be "of the people, by the people, for the people". While this may not be practical in its purest form, we believe that important steps are nonetheless feasible to move closer to this ideal.

We know all too well how the regulatory process is biased toward the financial industry. The banks have billions to put into lobbying, campaign contributions and other efforts to influence the process. The Nation magazine recently described this in an article titled "How Wall Street Defanged Dodd-Frank".[20] The article noted that the top five organizations lobbying in the public interest, such as Americans for Financial Reform and the Center for Responsible Lending, were out-resourced by more than 20:1 by the top five industry groups.

But even this drastically understates the imbalance. While the top five public-interest groups constitute basically all of the lobbying on behalf of the 99%, there are dozens of corporations and industry groups that are actively lobbying for Wall Street. Between the imbalance of funding and the complexity of the regulatory process, people have been deprived of the right, guaranteed by the First Amendment, to petition the government.

People's lobbies

We have a simple proposal to address this. The government should create a fund equal in size to the money industry spends on lobbying to be allocated by the people. Each American resident would be entitled to vote on which organization they want to represent them and the money would be allocated pro rata in accord with these votes. While we recognize that much of this money would go to organizations that we might consider either wasteful or objectionable, we'd counter that waste is part of democracy, as we see already in election campaigns.[21] The result would be a large increase in funds going to organizations lobbying on behalf of the people.[22]

Direct public involvement

Public involvement in the regulatory process should not be entirely delegated to the peoples' lobbyists.

There are many other ways that people can participate in, or influence, the regulatory process. People should be more outspoken when they see behavior on the part of regulators or industry that they find outrageous. They should demand that abuses such as Jacob Lew's payment from Citigroup or HSBC's being let off for money-laundering be addressed. It may seem that the people's voice is not heard. Certainly it is given less weight than it should receive. But there are times when it does have an impact.

One example is the "Crowdsource the Fed" twitter campaign that called for nominations to the Federal Reserve bank boards. Most of the directors of the New York Federal Reserve Bank, and other regional Fed banks, are intended by law to represent the public. But the process had been corrupted.

Simon Johnson and others publicly called attention to this matter[23] and there was a call to "Crowdsource the Fed" via Twitter.[24] While we cannot make a direct connection, the subsequent appointments were a vast improvement on their predecessors. When JPMorgan Chase CEO Jamie Dimon left the board he was not replaced with another megabanker. And the latest class of appointees includes the founder and director of the Freelancers Union. This is a big step forward from the previous class that included the President of the Metropolitan Museum of Art, whose main credential seems to be the ability to toady to bankers and other NY elite.

There is a very long way to go, but this is evidence that public outcry can have an impact. Entrenched interests always win when the public is silent. We can't allow that. When the people speak out, there is a possibility for progress.

Popular Regulation

We agree with many on the political right that the current state of regulation is woeful, but we reject their conclusion that regulation should be reduced. Banks can threaten the entire financial system. They can mislead customers. They have been supported by the government even when they made disastrous decisions. Regulation is needed, but not the regulation we have today. Instead we need popular regulation that would protect the 99%.

Our solution is not to get rid of regulations but to fix them. Bringing responsibility, simplicity, fairness and democracy to regulation would go a long way toward making it more effective and equitable. These principles would be mutually-reinforcing. Simpler regulation would facilitate broader involvement in the process. Responsible regulators would be more open to the people's lobbyists. Comprehensive regulation would be more effective.

Applying these principles would create "popular regulation". This would be more effective in serving the people's interest and would not be subject to the disdain that the current regulatory regime both deserves and receives. Most essentially, it would be regulation "of the people, by the people, for the people".

The task of fixing the financial process is daunting. None of these proposals will be implemented unless the people demand them. But we should not, under any circumstances, accept the status quo. As long as we struggle, there is hope.

Some people believe that it will take another crisis before the public is sufficiently outraged to pressure public officials to do what is needed. They may be correct, but we think it is a mistake to assume that. There are more than enough financial outrages already to provoke action. Even if it will take another crisis, it is better to start the movement now to lay the groundwork for when the time is ripe.

All we need is the political will. That is why all of us are needed. We must demand that these steps are taken to repair financial regulation and the financial system.

Notes

1. As Daron Acemoglu and James Robinson discuss in "*Why Nations Fail*", Crown Publishers, 2012, countries sometimes follow policies that are very adverse to the overall economy if doing so benefits those in power. We reluctantly believe that the U.S. may

be on that path.

2. Ginger Zhe Jin and Phillip Leslie, The Effect of Information on Product Quality: Evidence from Restaurant Hygiene Grade Cards *The Quarterly Journal of Economics* (2003) 118(2): 409-451 doi:10.1162/003355303321675428, Available at SSRN: http://ssrn.com/abstract=322883
3. We recognize that doctors are far from perfect and this expectation is being eroded. But, it is still considered unethical for doctors to put their own interests ahead of their patients.
4. Chapter 26 of Sheila Bair, "*Bull by the Horns*", Free Press, 2012
5. See "Citigroup's man goes to the treasury department", *Bloomberg News*, February 21,2013 http://www.bloomberg.com/news/2013-02-21/citigroup-s-man-goes-to-the-treasury-department.html.
6. See mathbabe.org "Dissolve the SEC" October 6, 2012 http://mathbabe.org/2012/10/06/dissolve-the-sec/.
7. Steve Schaefer, "Senate Report Slams JPMorgan For London Whale Debacle" *Forbes*, March 14, 2013 http://www.forbes.com/sites/steveschaefer/2013/03/14/senate-committee-takes-jpmorgan-to-task-for-london-whale-debacle/.
8. LIBOR (the London Interbank Offered Rate) is an obscure interest rate but it is extremely widely used in derivatives and other financial agreements. So widely it is thought to be in $350 Trillion worth. This is larger than the entire world economy. See http://en.wikipedia.org/wiki/Libor_scandal
9. The "rational actor" model underlies most economic theory. It assumes that people have all the relevant information and act perfectly rationally. As a non-economist, you might think it is self-evident that this is false and not in need of study but it took decades for this to be accepted by many economists. Even today most economists assume rational behavior in their models. This is not so much because they believe it but that it makes it much easier to build models.

   George Akerloff and Robert Shiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*, Princeton University Press, 2010
10. Long Wang, Deepak Malhotra, J.Keith Murnighan, "Economics Education and Greed", http://bit.ly/12R9sop.
11. John Carney, "Lloyd Blankfein Says He Is Doing 'God's Work'", *Business Insider*, Nov. 9, 2009 http://www.businessinsider.com/lloyd-blankfein-says-he-is-doing-gods-work-2009-11
12. Josh Harkinson, "In a 325-Page SEC Letter, Occupy's Finance Gurus Take on Wall Street Lobbyists", *Mother Jones*, February 14, 2012

http://www.motherjones.com/mojo/2012/02/occupy-sec-letter-volcker-rule.

13. Andrew Haldane and Vasileios Madouros, "The dog and the Frisbee" Speech given at the Federal Reserve Bank of Kansas City's 36th economic policy symposium, August 31, 2012. http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf. The title refers to the fact that anticipating the path of a Frisbee is a complex physics problem but that dogs can learn to do so using simple strategies.
14. This structure is already in place with the leverage ratio, risk-weighted capital requirements and stress tests. But the leverage ratio and capital requirements are much too low and the stress tests are flawed (especially in Europe). What we recommend is basically to make the current structure more effective.
15. Another proposal we are sympathetic to is to reinstate the restrictions on banking that were in place under Glass-Steagall from the 1930s until the 1990s. Senators Warren, Cantwell, King and McCain have introduced a bill to do so. However, we are concerned that implementing this will be difficult and that there are systemic risks outside the banking industry that it would not address. Overall, while we don't object to rein-

stating Glass-Steagall, we believe that it is essential to reduce leverage throughout the financial system, as increased capital requirements would do.

16. Joseph B. Treaster, *Paul Volcker: The Making of a Financial Legend* , John Wiley & Sons, Inc., 2004.
17. A similar idea was proposed here: Eric Posner and E. Glen Weyl "An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to 21st Century Financial Markets", Social Science Research Network, June 4, 2012 http://ssrn.com/abstract=2010606 but our proposal is more truly analogous to the FDA.
18. Jessica Silver-Greenberg and Stephanie Clifford, "As Pay Cards Replace Paychecks, Bank Fees Hurt Workers", *New York Times*, June 30, 2013 http://www.nytimes.com/2013/07/01/business/as-pay-cards-replace-paychecks-bank-fees-hurt-workers.html
19. Simon Johnson and James Kwak, *13 Bankers*, Pantheon Press, 2010, chapter 4.
20. Gary Rivlin, "How Wall Street Defanged Dodd Frank", *The Nation*, April 30, 2013
21. We realize this is far from perfect. To paraphrase Winston Churchill in a very similar context, it would be the "worst system, except for the one we have now." We would be happy to hear other suggestions to achieve the same goal.
22. We call this the "People's Lobbies" not the "People's Lobby" to recognize the diversity of voices it would represent.
23. Simon Johnson, "Institutional Flaw at the heart of the Federal Reserve", *New York Times, Economix blog*, June 14, 2012. http://economix.blogs.nytimes.com/2012/06/14/an-institutional-flaw-at-the-heart-of-the-federal-reserve/.
24. Jonathan Reiss, "Crowdsource the Fed Bank Boards", *Huffington Post*, June 14, 2012 http://www.huffingtonpost.com/jonathan-reiss/crowdsource-the-federal-r_b_1598487.html

9. Resources: Thinking Outside the Corporations

"A man will be imprisoned in a room with a door that's unlocked and opens inwards — as long as it does not occur to him to pull rather than push."

Ludwig Wittgenstein

In a poor city a large number of neighborhoods were littered with garbage. Rats spread diseases. The water was contaminated. Kids played among trash and got sick. The local government didn't have the money to fix the problem. One of the few scarce resources that the local government had was an unused municipal bus system.

How could buses help to deal with the horrible trash problem? The city mayor had an idea. Large bins were placed along the streets near places with piles of garbage, and people who lived nearby were shown how to sort trash. Those who collected and sorted the trash were given tokens to ride buses.

Thousands of kids started collecting the trash and teaching their parents how to do it. In no time people started riding buses using tokens. Often they went downtown to find jobs. Pretty soon local food vendors started using tokens as a form of payment. The neighborhoods became clean. This radiated into the other social sectors: creating green areas and providing housing, as an example.

This happened almost 25 years ago and the city is Curitiba — the capital of a southeastern state in Brazil, which now tops some of the best quality-of-life charts in the world.[1]

By this chapter in the book, we hope it has become clear how our financial system created the credit crisis of 2007-2008 and the ensuing Great Recession.

The sad part is that it is being rebuilt — or more accurately, patched up — with the same set of tools and by the same people who have failed to place value on social and environmental risks. The same people who benefited from the complexity of financial markets and steered them away from socially useful purposes.

In many respects, we find ourselves lost and paralyzed, not knowing where to start and what to do — possibly much like the people of Curitiba.

Change can come from three different directions:

1. It can be imposed by the government and regulators if there's enough of a public outcry,
2. It can come from insiders changing the way they operate, or
3. It can come from new ways of doing business and rebuilding the financial system from the bottom up.

In the case of Curitiba, both the local government and the people of the city were willing to change, maybe because they had no other options. Similarly we can do it by recognizing collective human potential, our own potential, and ingenuity. That will give us courage to imagine alternatives and build a different financial system from the bottom up.

Join a group or a community-based organization that matters to you, or start one if none exists. Make waves and become part of the Occupy Wall Street movement in your community.

Educating Ourselves

There has never been a better time to learn more about the banking system, finance, and regulations. The same economic catastrophe that has overwhelmed many of the world's economies has called forth an extraordinary outpouring of analyses and commentaries. This truly is a Golden Age of writing about finance, from many different perspectives. Here are just a few suggestions:

Film and Video:

Moyers & Company with Bill Moyers

Notably: John Reed on Big Banks' Power and Influence, March 16, 2012

Matt Taibbi on Wall Street's Campaign to Loot Public Pensions, Sept. 30, 2013

Robert Reich's Plan for Fixing America's Economy, Sept. 16, 2013

Inside Job by Charles Ferguson

Money, Power and Wall Street — Frontline/PBS

Secret History of the Credit Card — Frontline/PBS

The Retirement Gamble — Frontline/PBS

Rich People Didn't Create Jobs TED Talk by Nick Hanuer [2]

Articles:

"Let's Consider Kate" by John Lanchester, *The London Review of Books*

"The Quiet Coup" by Simon Johnson, *The Atlantic Monthly*

"How Wall Street De-fanged Dodd Frank", by Gary Rivlin, *The Nation*

Books:

Beyond Outrage by Robert Reich

13 Bankers by Simon Johnson and James Kwak

The Bankers' New Clothes by Anat Admati and Marin Hellwig

Bull By The Horns Fighting to Save Main Street from Wall Street and Wall Street from Itself by Sheila Bair

Bailout An Inside Account of How Washington Abandoned Main Street While Rescuing Wall Street, by Neil Barofsky

I.O.U.: Why Everyone Owes Everyone and No One Can Pay by John Lanchester

The 23 Things They Don't Tell You About Capitalism by Ha-Joon Chang

Econned by Yves Smith

What Money Can't Buy by Michael Sandel

Debt: The First 5,000 Years by David Graeber

The Debt Resistors' Operations Manual by Strike Debt/Occupy Wall Street

The Little Book of Ideas by Occupy London's Economics Working Group

> "We recognize that everyone deserves adequate housing, meaningful work, short hours, fair wages, access to health care and a truly liberating education. We can't fulfill these obligations if we continue to cooperate with the system as it currently exists. Why keep paying our money to the Wall Street mob? We know our resources could be better spent."

Source: The Debt Resistors' Operations Manual[3]

Another very useful source is online courses. If you don't have access to the Internet, go to your local public library and use its computers to watch tutorials about the financial system on sites like KhanAcademy.org, Coursera.org, and OpenYale.com.

Move Your Money Project

The "Move Your Money" campaign is a decentralized project to convince people to move their banking accounts from too-big-to-fail banks to smaller community banks and credit unions. The "Move Your Money" project was partly a result of people's dissatisfaction when Bank of America announced plans to increase its fees. Within 90 days, 5.6 million adult Americans changed banks.

The Independent Community Bankers of America association said that a poll of its 5,000 members indicated that about 60 percent of community banks are gaining customers who no longer trust the big financial institutions. [4] You can find more information and a list of small community banks on the association's site (*www.icba.org*).

Credit Unions

Credit unions are an alternative for many people, although they each have a charter which restricts who is allowed to be a member. An exception to that rule, which allows anyone to open an account after joining a group with a free membership, is the NASA Federal Credit Union.

You can think of credit unions as a parallel financial industry. They are depository not-for-profit institutions created to serve their members' financial needs. They are accountable to all of their members, not to a limited number of owners.

Credit unions offer many of the same services as banks: mortgages, car loans, personal loans, small dollar loans, credit cards, savings and checking accounts, international money transfers, retirement planning, and budgeting. Accounts at both banks and credit unions are insured for up to $250,000 (by the FDIC for banks, and by the NCUA for credit unions). However, there are very important differences. Credit unions generally have missions to serve their local communities. This means that the money deposited by members often (but not always) stays local.

Credit unions are governed democratically; each member has one vote, regardless of the size of the member's deposits. There is a member-elected board of directors who are volunteer-based.

There are over 70 credit unions in New York City alone and 8,000 nationwide, and the industry has been around for more than 100 years. Many provide their members with access to extensive surcharge-free ATM networks. Community Development Credit Unions (CDCU) have a specific mission to serve low-income communities. CDCU have the ability to fund-raise, offer affordable terms with low minimum balances, promote financial literacy, and provide financial counseling. Find more information by contacting The National Federation of Community Development Credit Unions.

Social (Peer-to-Peer) Lending

We want people to be informed about another kind of parallel financial industry as well. It is called peer-to-peer lending. This is an industry that brings together individual savers and lenders on online platforms. Social lending bypasses banks and credit card companies and claims to deliver better interest rates directly to both borrowers and savers. There are a lot of options, but the sites listed below have been in the social lending space for a while and seem to have found a working business model.

- Kiva
- Lending Club
- Lending Tree
- LoanBack
- Prosper
- Zopa (UK)

Note that some sites act as a contract administrator, only creating loan documents for you to use with people you already know. With those sites, the idea is to create a legally binding contract that helps preserve friendships and families by letting everyone know where they stand upfront.

A couple of words of caution are due. First, while peer-to-peer lending might be a great option for some people, the current approach can be seen as a way to get around regulations, in particular the FTC's Equal Credit Opportunity Law,[5] by using models that judge people's credit risk by their browsing history or their social network.[6] This is problematic and can be seen as yet another example of regulators not keeping up with so-called financial innovation.

Having said that, peer-to-peer lending is filling a vacuum left behind by the banks, at least for now.

Rotating Savings and Credit Association

A Rotating Savings and Credit Association or ROSCA is a group of individuals who agree to meet for a defined period of time in order to save and borrow together. "ROSCAs are the poor man's bank, where money is not idle for long but changes hands rapidly, satisfying both consumption and production needs."[7]

ROSCAs are essentially a group of individuals who come together and make regular cyclical contributions to a common fund, which is then given as a lump sum to one member in each cycle. A member will lend money to other members through her regular monthly contributions. After having received the lump sum amount when it is her turn to borrow from the group, she then pays back the amount in regular monthly contributions. This explains the name for such groups: rotating savings and credit associations. Depending on the cycle in which a member receives his lump sum, members alternate between being lenders and borrowers.

Of course, any system like this can be set up and can work well in good times. It's the question of what happens during financial crises or other hard times that tests such a system.

Public Banking

The common assumption has been that we all benefit from the free market operations of big banks. But as it has been pointed out multiple times throughout this book, the current system is no longer able to address many of our financial and social problems. One idea that might help is to familiarize ourselves with ideas that worked in the past and came from public banking.

After the First World War, there was a drastic tightening of credit in the U.S.. In the Midwest, farmers were having a tough time. In response to the plight of its citizens, the state of North Dakota formed a public bank in 1919. All state funds — state tax collections and fees and the funds of state institutions — are deposited with the Bank of North Dakota.

It has successfully been in business for almost 100 years and has generated more than $300 million dollars in revenue in the last 10 years.[8] That's about $1,200 per family in North Dakota. Moreover, it has been widely supported by all political parties, which in itself is a rare occurrence in our political climate [9].

Other great examples of state banking are:

- One PacificCoast Bank
- Bremer Bank

Since 2010, twenty states have considered or are considering legislation to form a state bank. In Colorado, people put forward a citizen's initiative to do the same thing. For more information on these and other state initiatives see the Public Banking Institute[10] It is a great source for citizens to learn and enact ideas about public banking not only at the state level but also in cities and towns. San Francisco and Portland are on the front lines of changing the status quo. Here are some more references for specific cities:

- Portland: see Rich Goward and Jennifer Yocom, "Draft for Public Discussion — Responsible Banking," Office of the Mayor of Portland.[11]
- San Francisco: see Jonathan Nathan, "Supervisors Hear from San Franciscans About City Finance Options." [12]
- Kansas City, MO: Communities Creating Opportunity, "City Council Passes CCO-Supported Responsible Banking Resolution"[13]

To see more examples go to www.community-wealth.org.

There are more examples of this quiet change happening in our neighborhoods, but they go mostly under the radar of the mass media. We should look around and find people like ourselves who are dissatisfied with the status quo and are willing to roll up their sleeves and work hard to change it. Their ideas and their implementation of them are diverse and vary from community to community.

There is no universal answer to this question, of course, so we should try to find out which approach will work in our respective communities. For that matter, one vital attribute of a working system is to have many different functional banking institutions; we've seen what happens when the financial system is monopolized by one type of thinking and structure. Namely, it becomes unstable.

> "…yes, it may take longer than we might hope for the point to sink in nationally, but the buildup of experience, state by state, community by community — as in the prehistory of the New Deal — is also ultimately likely to help put a truly refined model in place nationally" [14]
>
> Gar Alperovitz

Consumer and Business Tech Applications

Internationally, there are surprisingly flexible and widespread solutions to the problem of access to money systems, especially in Africa where the infrastructure for what we consider normal banking is especially weak. Mobile banking, in particular, is essentially universal: people can exchange units of currency freely by phone, which is how they pay for things and how they get paid. Considering how developed a system it is in some countries, it's surprising indeed that no such system has been introduced in the United States.

Here are some specific companies that are trying to break into or create such a market:

- Mobino: believes that each citizen of the world should be able to effortlessly send and receive money with their phone, no matter where they live, which telephone company they use, and whether they have a bank account, a credit card, or just cash in their pocket, no matter how much they earn and what they buy.
- Square: makes a small credit card reader that plugs in to the headphone jack of an iPhone and lets any user take credit card payments via an app. It has allowed thousands of merchants, from taxi drivers to businesses big and small, to take card payments where previously it was impossible because of high charges and embedded vested interests.
- WePay: allows businesses and merchants to accept credit cards, similar to Square.

Worker Cooperatives

More than 130 million U.S. citizens are involved in one or another form of co-ops, which is an institution where each person has equal voting rights, e.g. in one-person one-vote organizations.

We have previously described one form of this type of institution in credit unions, for example. The main idea is to democratize the means of ownership. However, when it comes to implementation, each group of individuals decides specifically what approach will work for them.

There are 10,000 worker-owned companies operating in the U.S. and 4,000-5,000 neighborhood owned corporations[15]. They are present in multiple sectors of the economy: agriculture (land trusts), utilities (electrical co-ops which are more common in rural areas), retail co-ops (ACE and REI), health care, arts and culture, and many more.[16]

Worker-owned companies are not the only forms of democratized ownership developing without broad recognition by the mass media in the United States. Indeed, there are many strategies the media simply doesn't cover. Moreover, as the social and economic pain of the new era we have entered intensifies, most worker coops are developing in numbers, scale, sophistication, and reach.

Land Trust

Like other democratized forms of ownership, today's land trusts are also the benefactors of early experiments that planted innovative seeds — the heart of any long-term evolutionary reconstruction process.

Some of the first serious modern efforts, for instance, were begun in the 1960s and 1970s in western Massachusetts by Robert Swann and in southwest Georgia by Charles and Shirley Sherrod. All three were deeply involved in the Civil Rights movement and saw cooperative land ownership both as an answer to systemic problems and, in the case of the Sherrods, as a way to help poor black farmers forced off the land by mechanization and political retaliation for their civil rights activities.

At the time the early trusts were conventionally seen as interesting utopian experiments signifying hard work and idealism, but essentially not going anywhere serious. However, hundreds of such efforts now exist, and new land trusts are being established on an expanding, ongoing basis in diverse contexts and cities.

Social Enterprises

There are also thousands of "social enterprises" that use democratized ownership to make money and use both the money and the enterprise itself to achieve a broader social purpose. One of the most impressive is Pioneer Human Services (PHS) in Seattle, Washington, an organization that provides employment, job training, counseling, education, and housing to recovered alcoholics and drug addicts.

PHS was established some fifty years ago as a nonprofit corporation dependent upon donations and grants. Its $67 million annual budget is now in significant part funded by revenues from businesses it created as part of its overall strategy. Among other things, PHS runs a full-service precision sheet metal fabrication and machining shop, produces thousands of aerospace parts for Boeing, and, through its catering services, prepares and distributes more than fifteen hundred meals a day to hospitals, care centers, and nonprofit and government facilities. PHS's social enterprises employ nearly a thousand theoretically impaired and unemployable people.

At the other end of the continent, Greystone Bakery in Yonkers, New York, was founded by a Buddhist teacher to employ his students, but the organization's mission quickly expanded to provide jobs for neighboring inner-city residents [17.]

Another direction in social enterprise development is illustrated by Southwest Key Programs in the heavily Latino East Austin section of Austin, Texas. Presently the fourth largest Hispanic nonprofit organization in the country, Southwest Key Programs has an annual budget of over $74 million and a staff of more than thirteen hundred employees. Following a path similar to that of Pioneer Human Services, it decided to expand into business development both to support its projects and to offer work to trainees. Start-ups include Café del Sol and Southwest Key Maintenance & Janitorial [18.]

By far the most common social enterprise is the traditional community development corporation (CDC). Nearly five thousand CDCs have been in operation in almost every U.S. city of significant size for a long time. For the most part, CDCs have served as low-income housing developers and incubators for small businesses. Early on in the fifty-year history of the movement, however, a different, larger vision was in play — one that is still present in some of the more advanced CDC efforts, and one that suggests additional possibilities for the future.

New Community Corporation (NCC) in Newark, New Jersey, is a large-scale neighborhood nonprofit that employs roughly thirteen hundred neighborhood residents, manages two thousand housing units, has $500 million in assets, and has an approximately $200 million operating budget. Though modest in the total picture, proceeds from NCC businesses — including a shopping center anchored by a major supermarket — help support day care and after-school programs, a nursing home, and four medical day care centers for seniors. NCC also runs the School of Practical Nursing and Gateway to Work programs, both designed to train young residents for future careers. [19]

The list can go on and on. Innovative things are happening and there is time for us to start challenging the status quo by asking what is the right thing for each of us to pursue and for our families and communities to do. We can decide what can be done on the practical level and not simply engage in rhetoric!

NOTES

1. Alicia Fazzano and Dr. Marc Weiss, "Curitiba, Brazil—Economic Strategy Report",*Global Urban Development Organization*, July 2004.
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3. *The Debt Resistors' Operations Manual*, Strike Debt/Occupy Wall Street, September

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4. Michael Winship, "Giving Up Your Bank For Lent", *Moyers & Company-On Democracy*, March 15, 2012 (www.billmoyers.com).

5. http://www.consumer.ftc.gov/articles/0347-your-equal-credit-opportunity-rights

6. Hamza Shaban , "LinkedOut", The New Inquiry, July 19, 2013
http://thenewinquiry.com/essays/linkedout/

7. F.J.A. Bouman, "Indigenous Savings and Credit Societies in the Developing World" in von Pischke, Adams and Donald (Eds.) Rural Financial Markets in the Developing World, *World Bank*, 1983.

8. Stacy Mitchell, "How State Banks Bring The Money Home", *Institute for Local Self Reliance of the Bank of North Dakota*, September 15, 2011 (www.ilsr.org)

9. ibid.

10. http://publicbankinginstitute.org

11. www.portlandonline.com/shared/cfm/image.cfm?id=384250

12. Jonathan Nathan, "Supervisors Hear From San Franciscans About City Finance Options", BeyondChron, February, 9, 2012
www.beyondchron.org/articles/Supervisors_Hear_From_San_Franciscans_About_City_Finance_Options_9884.html) or Luke Thomas, "Supervisor Avalos Declares Re-Election Bid," Fog City Journal www.fogcityjournal.com/wordpress/3494/supervisor-avalos-declares-re-election-bid

13. "City Council Passes CCO-Supported Responsible Banking Resolution", *Communities Creating Opportunity*. http://myemail.constantcontact.com/A-CCO-Victory--City-Council-Passes-Responsible-Banking-Ordinance.html?soid=1101339995598&aid=KbY9HXioUy8

14. Gar Alperovitz, *What Then Must We Do*, (White River Junction, VT: Chelsea Green Publishing, 2013).

15. Gar Alperovitz, "Worker-Owners of America, Unite!", *New York Times*, December 14, 2011 (www.nytimes.com).

16. For more information, see the work of Gar Aperovitz and also Green Worker Cooperatives.

17. John Golden, "The Zen of Brownies", *Westchester County Business Journal*, May 11, 2009.

18. Social Enterprises Overview www.swkey.org/about/

19. New Community Corporation www.newcommunity.org/about

10. And Now…

"Never doubt that a small group of thoughtful, committed citizens can change the world. Indeed, it is the only thing that ever has."

Margaret Mead

We are thrilled that you have arrived at the last chapter of *Occupy Finance*, but we are somewhat concerned that you, like us, might be suffering from "well-informed futility syndrome". We learned about this syndrome from Sandra Steingraber on *Moyers and Company*. Her response to this is as follows:

> "I try to take well-informed futility as my starting point and let people know that there is a way out of this. But because we can't — I can't honestly tell you that the problem is less bad than it is — the response has to be that we scale up our actions. So the problem is huge. And so our actions have to be huge as well."

Huge actions can be composed of millions of small actions, but rather than a small group, we need a large one. **We need you!** Small actions can not only have an effect on their own, but, more importantly, they inspire others to take action. This book is one of our small actions — not enough, but a step in the right direction.

We in the Occupy Wall Street Alternative Banking Group — the authors of this book — believe that change is possible but that it will not come from within the system. We have been told this by people who were themselves within the system, like Sheila Bair of the FDIC and Neil Barofsky, former prosecutor and head of the Federal government office in charge of monitoring bailout funds. Much to our surprise, when they spoke to us at meetings of the Alternative Banking Group, they looked to us as the agents of redress and renewal! We recognize that many people across the political spectrum share our outrage. We are not alone in thinking that our current form of crony capitalism is corrupt and failing. There is even agreement on many of the specific issues like "Too-big-to-fail" banks.

Because our outrage is shared and our cause is just, we are confident that we will ultimately succeed. Though we recognize that fundamental reform will, of necessity, take years, we know it is imperative to start now. The financial system will only change if we change it. If not us, who? If not now, when?

Join us!

We meet every Sunday from 3-5pm at Columbia University.
Email Alt.Banking.OWS@gmail.com *to join our mailing list*

"If there is no struggle there is no progress.
Those who profess to favor freedom and yet deprecate agitation
are men who want crops without plowing up the ground."

Frederick Douglass