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Dodd-Frank and the Great Debate: Regulation vs. Growth

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Abstract: The history of regulation in America is as old as the republic itself. Since colonial times, Americans have struggled with the conflict between the desire for individual freedom and economic growth, and the need for rules and structure in a civil society. The evolution of the United States from a largely agrarian, libertarian society to one with strong industrial and consumer components that are regulated by the federal government has been greatly influenced by Progressive ideas, not only in financial services but in all aspects of economic life. The swing of public policy from periods of strict regulation to eras of greater permissiveness has enormous implications for economic growth. This paper examines the development of regulation in the US from the 19th century up to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in 2010, from both a political and economic perspective.

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Introduction

The Dodd-Frank Wall Street Reform law seeks to prevent future financial crises, in part by placing limits on the risk-taking activities of US banks with respect to consumer lending and issuing securities. Higher capital levels for banks are mandated, protections for consumers are strengthened and other rules and regulations have been implemented to ensure that the subprime crisis never happens again. But seen in historical context, the ostensive goal of Dodd-Frank is a pyrrhic promise. In finance, the cost of “never again” in terms of lost growth and opportunity is too great to represent “victory” and cannot withstand the desire of a free people for opportunity.

In truth, Dodd-Frank represents the latest swing of a political and economic pendulum that goes back centuries. In the first century BCE, Cicero observed: “The sinews of war are infinite money,” reflecting on the relationship between currency debasement and military conflicts. Until 1776, when Adam Smith won praise after publishing a treatise that differentiated “central” banking from “reserve” banking, those brave individuals who openly opposed their rulers’ use of monetary policy to maintain power and fund wars were regularly executed. In the 20th century, the widening use of finance to create new economic opportunities democratized the money game.

In the United States, roots of the subprime crisis of 2008 and the political reaction thereto stretch back to the founding of the republic. In a legal sense, the power of the federal government to regulate finance begins with the 1819 Supreme Court decision establishing supremacy of federal law over conflicting state law. In McCulloch v. Maryland, the Supreme Court settled a dispute that arose when Maryland sought to tax The Second Bank of the United States, which was seen as endangering Maryland’s state banks during the depression of 1818. The landmark Supreme Court decision confirmed that the Government of the Union, though limited in its powers, is supreme within its sphere of action. The Court said that federal laws, when made in pursuance of the Constitution, form the supreme law of the land.

In plain terms, McCullough v. Maryland said that Congress had the power to incorporate a central bank and provided a legal basis for the creation of national banks during the Civil War and the regulation of federally chartered corporations. The establishment of the Federal Reserve System just before World War I (WWI) is yet another example of the federal government using its power to create and regulate financial institutions. Through the 19th century and into the 20th, the role of the federal government gradually expanded, first as an enabler of financial intermediation and the accumulation of leverage, then as a regulator to curb the excesses of a free society. The draconian response to the Great Crash of the late 1920s, including the Glass-Steagall legislation and other initiatives discussed in detail in this paper, provide contemporary examples of
financial excess and the regulatory response.¹ The more recent “swings” of US regulation began in the 1970s with the first major regulatory response to the S&L problems and more broadly to the inflation problem that gave rise to them.

The one continuing truth is that neither a liberal view of better living through government regulation nor a conservative view that deregulation will cure all can be achieved in real life. Moral hazard and financial fraud are only possible (and are made possible) in a free and democratic society. Finding a balance between excessive government regulation and economic freedom and prosperity is a constant and continuing challenge for all who seek to maximize personal freedom and material prosperity.

The Roots of Regulation

When we talk about the role of regulation in American society, there seemingly are two central themes, both of which can claim roots in the work of Adam Smith. We have the libertine, gold rush mentality of the American colonist, on the one hand, and the Puritanical, Calvinist, agrarian tendency, on the other. The former has its origins in the colonial experience and seeks growth and opportunity in a headlong fashion, heedless of the consequences and with complete disdain for efforts to regulate or limit economic growth or personal freedom. Many advocates of growth and expansion tended to support the idea of a strong national government, as with Alexander Hamilton and the Federalist tendency in American politics of the 1800s.

The agrarian, anti-Federalist perspective that prized America’s libertarian, classical liberal philosophy reflected in the Constitution was closer to the views of Founders like Thomas Jefferson and John Adams. Theirs was a more cautious world view, argues Whalen (2010), that sought limits and constraints upon economic growth and the political power of the big urban centers of New York, Philadelphia and Boston. The political struggle over the power of the federal government and the power of the states is illustrated by President Andrew Jackson’s veto of the Second Bank of the United States in the 1830s. His determination to terminate America’s first central bank and the fiscal rules he put in place constrained the actions of the Treasury and the growth of the US economy for decades afterward. After August 15, 1836, the government refused to take anything but gold and silver specie in exchange for purchases of public lands, causing economic panic for years thereafter. By killing the corrupt central bank and restricting the acceptance of paper money for public land sales, the populist Jackson was in a sense a modern regulator, albeit one focused on constraining the power and influence of private interests who controlled the first modern American central bank.

¹ Most of the Glass-Steagall Act applies solely to member banks of the Federal Reserve System. Section 20 prohibits the affiliation of Fed member banks and companies engaged principally in the issue, floatation, underwriting, public sale, or distribution of stocks, bonds, debentures, notes or other securities, Section 32 prohibits officers, directors, or employees of companies primarily engaged in the issue, floatation, underwriting, public sale, or distribution of stocks, bonds, or similar securities, or partners or employees of a partnership so engaged, from serving as directors, officers, or employees of Fed member banks.
The Progressive movement of the late 1800s featured appeals for easy money but also supported the idea of using government as a mechanism for rooting out evil. The libertine aspect of the free silver coinage movement merged with a reactionary, intolerant view of society in general and hostility to wealthy business interests. The Protestant proponents of free coinage of silver also wanted to use the state to stamp out sin and also nonconforming sinners, and create “a new Jerusalem on earth.” They failed, perhaps, to see that it was the conflict between church and state control of money that led Rome to destroy Jerusalem and its inhabitants (Christians and Jews alike) in 70 CE.

Significantly, the members of all of the major political parties active during this period, from William Jennings Bryan to Theodore Roosevelt, exhibited some degree of Progressive tendency in their political platforms. Attacking the Robber Barons and political bosses of the era, it must be remembered, was good politics, even if the Progressive candidate William Jennings Bryan ultimately lost three consecutive elections to the conservative machine of the big city bosses which supported the Republicans. While in political terms the Progressive movement saw its zenith in 1896, when the Republican William McKinley defeated Progressive Party candidate William Jennings Bryan for the presidency by the largest margin of victory since the Civil War, the tendency of Americans to use government and the power of the state to regulate social and economic behavior remained strong. After a banking crisis in 1907, in 1913 the US compromised opposing views and sought to create the Federal Reserve System on Adam Smith’s “reserve” banking model.

The Puritanical side of the Progressive movement eventually led in 1918 to Congress passing the 18th Amendment to the Constitution prohibiting the manufacture, transportation, and sale of alcoholic beverages. The states ratified the Amendment in the following year. But the political corruption and violence spawned by this experiment in social engineering eventually caused Prohibition to lose popular support and it was repealed by another Progressive, Franklin Roosevelt, in December 1933. Yet Bernstein (2012) notes that the failure of Prohibition did not dampen American enthusiasm for using the power of the state to regulate and control the US economy and individual behavior.

Part of the support for using government regulation came because of the enormous political power of the Robber Barons and business interests generally. Around the turn of the 20th century, there was a rising confidence in the efficacy of judicial intervention to vindicate distributive social policies and also a distrust of the institution of the contract, which required private litigation in state courts that few citizens could afford. Glasser and Schleifer (2001) note that “During the Progressive Era at the beginning of the 20th century, the United States replaced litigation with regulation as the principle mechanism of social control of business.”

To explain why this happened, Bernstein (2012) looked at what is known as the “choice of law” enforcement strategy between litigation and regulation based on the idea that
justice via the courts can be subverted with sufficient expenditure of resources. His research suggests that courts are more vulnerable to subversion than regulators, especially in an environment of significant inequality of wealth and political power. As we shall see later, however, regulators are just as easy to sway as elected state officials and court judges. This principle applies not only to issues of financial regulation but to regulation of all aspects of a civil society.

Using the perspective of Glasser and Schleifer (2001), the switch to regulation as a means of achieving positive social outcomes was seen as an efficient response to the subversion of justice by Robber Barons during the Gilded Age. Indeed, even for the wealthy the state courts promised scant justice, since elected judges could be bought and sold readily. When a company partnered with Cornelius Vanderbilt in a Central American enterprise refused to pay him, he famously remarked that suing them in court would take too long, so he would simply ruin them. Such was the lack of confidence in the enforceability of contracts and more generally in the rule of law in the 1800s that the intervention of the federal government and federal courts was often seen by Progressives as the only practical remedy for social ills.

Liberal hostility toward the ancient concept of “liberty of contract” was a key part of the Progressive movement and the growing political support for regulation. Hostility to private contracts was effectively a rejection of the rule of law – at least the law under the control of the political bosses of the latter 19th century. When the Supreme Court occasionally upheld the rights of private citizens to govern their lives via private agreements – as in the Supreme Court’s 1905 decision in *Lochner v. New York* (which invalidated a state maximum hours law for bakery workers), the Progressives howled in rage and demanded that the laws be changed as a matter of “justice.” Bernstein (2011) notes that:

> Progressive critics contended that the [Supreme] Court’s occasional invalidation of reformist legislation was a product of unrestrained judicial activism, politicized judicial decision making, and the Supreme Court’s favoring the rich over the poor, corporations over workers, and abstract legal concepts over the practical necessities of a developing industrial economy. The Supreme Court withdrew constitutional protection for liberty of contract in the 1930s. Since then, a hostile perspective inherited from the Progressives has virtually monopolized scholarly discussion of the Court’s liberty of contract decisions.

It is no surprise that the Progressive movement also drew upon collectivist ideas, much of it reflecting the political models of Europe and became very prominent after WWI. Founders like John Adams, we should recall, did not support the idea of private banks at all and instead wanted a unitary “national bank” under public control.

“The Progressive movement that preceded American entry into WWI also drew largely from classic corporatist theories for its industrial relations policies,” argues Walker Todd (1995), a former Fed official and researcher. “The main unifying principle of classic corporatism was the idea that Marxist or Dickensian visions of class struggle could be
avoided if, somehow, corporate owners and managers, agricultural interests, and urban laborers could be brought together cooperatively under the benign auspices of government.”

Modern Regulation in America

The period leading up to WWI is the major demarcation point for much of the discussion of regulation in the US in the 20th century. Owing in part to the enormous and new role played by the federal government in supporting and financing the European military conflict, the public became increasingly comfortable with a more active role for government in all walks of life. Part of the reason for this acceptance of a greater role for the federal government was weariness with periodic financial economic crises and the concentration of power among the great Money Trusts.

The creation of the Federal Reserve System with a “central bank” located in New York, for example, is widely misunderstood as a great compromise between business and progressive forces. Historians reading the Federal Reserve Act mistakenly conclude that the Fed was a decentralized reserve liquidity model, but what J.P. Morgan’s political “compromise” actually created in 1913 was very different. “By December 23, 1913, when President Woodrow Wilson signed the Federal Reserve Act into law,” notes the history prepared by the Federal Reserve Bank of Minneapolis (2014), “it stood as a classic example of compromise—a decentralized central bank that balanced the competing interests of private banks and populist sentiment.” But this simplification of the political narrative of the time, written a century later, misses key nuances.

The Federal Reserve Bank of New York was, under Governor Benjamin Strong, the nation’s “central bank” while the rest of the system was a “reserve” model for the nation to moderate seasonal/regional liquidity needs. J.P. Morgan thereby guaranteed his ability to still control the “public” central banking system from New York, under his chosen man Benjamin Strong. But Morgan died just after the creation of the Fed and before he could use the system to seize more business in the next crisis. Strong’s death in 1928 completely thwarted Morgan’s intentions. The key point, however, is that the creation of the Fed reflected a willingness by many small banks to see an alternative to the private clearing house system and the House of Morgan for providing liquidity to the markets. It is important to note that the 16th Amendment and the personal Income Tax also arrived in 1913, providing the federal government with an important source of funding to supporting Progressive initiatives.

The agrarian, classical liberal template upon which the US was founded gradually was replaced with the more recent, corporatist models derived from 19th century European philosophies. These authoritarian models would eventually underlie the fascist movements of Benito Mussolini, Adolph Hitler and other authoritarian leaders in the Europe of the 1920s and 1930s. Todd (1995) notes that many of the proponents of the corporatist scheme were drawn to this political economy model precisely “because it appeared to resolve troublesome issues of distributive justice in a way that seemed, at
least at first glance, to be consistent with altruistic doctrines while avoiding strict Marxist egalitarianism.”

By 1918, following the end of the temporary economic boom associated with WWI, the deflation and difficult economic circumstances that had prevailed in the first two decades of the 1900s returned and with a vengeance. The impact of the Spanish Flu pandemic of 1918-19, which claimed some 20 million lives, and the subsequent recession from 1920-21, also wiped out just about all the growth stimulated by WWI. The creation of the Federal Reserve System, itself an example of the enlargement of the federal government, had little effect on the slack employment market and terrible deflation seen in the US agricultural sector.

With the real economy in a bad state, Americans embarked upon a renewed period of financial speculation referred to as the Roaring Twenties. This was possible due to a new development in terms of the widespread use of “off balance sheet” finance. Just as the creation of National Banks added a new layer of financial leverage to the US economy in the period of the Civil War, the rise of the culture of popular investment on Wall Street, fueled by the use of “non-consolidated” pyramids of subsidiaries and trusts, added yet another dimension to the US economy.

The sale of war bonds to support the Great War helped to accelerate the popular culture of investing that began decades before, to fund the Civil War and, in the years after the Civil War, by the issuance of railroad bonds. Finance was no longer merely a means of supporting commerce, but became an end unto itself for more and more Americans. The introduction of the stock corporation as a vehicle for popular investing in the first decade of the 20th century added a new dimension, allowing individuals for the first time to speculate in stocks on a broad basis and creating an alternative means of earning a living outside of the real economy of business and commerce.

Mitchell (2007) argues that “the stock market became the driving force of the American economy in the first decade of the 20th century as a result of the birth of the giant modern corporation.” He contends that the legal, financial, economic and social transformations enabled by the public stock corporation:

- Allowed financiers to collect companies and combine them together into huge new corporations for the main purpose of manufacturing stock and dumping it on the market. Businessmen started to make more money from legal and financial manipulation than from practical business improvements like innovations in technology, management, distribution, and marketing.

Mitchell maintains that while the regulators of the early 20th century were concerned with competition and trust busting, the evolution of the speculative economy became embedded in American economic life by virtue of the growing number of small investors participating in the stock market. The financial markets evolved from the relatively safe investments in railroad bonds to preferred shares in the newly merged industrial giants of the Gilded Age. Through the financial crises of the 1900s, the small investor
gradually built a market for common stocks that would endure right up until the start of WWI in 1913, when the stock markets were closed from August through December. But the US stock markets would subsequently soar virtually uninterrupted until the return to normalcy in 1920, a testament to the enduring American passion for speculation. Again Mitchell describes the scene at the end of WWI:

This was a different market than those that had come before. Brokers were honing their sales tactics and, by 1919, the securities arms of national banks, like “Sunshine Charley” Mitchell’s National City Company, were driving the development of retail brokering into branch offices from Manhattan to Middletown. Individual investors found themselves more comfortable with common stocks as war prosperity brought high returns from companies churning out war materiel. And the Liberty Bond drives of 1917 and 1918 created 25 million new American investors. The brokerage industry watched, salivating, anticipating the day when the Iowa farmer no less than the New York lawyer realized he could do better than to take the bargain-basement interest on his Liberty Bonds and turned them in for a share of the new corporate boom economy. A long year of depression followed Harding’s election and, in 1922, the great bull market of the 1920s began to take flight.

More and more Americans began to participate in the stock market, but there was virtually no regulation or standardization of these markets or the securities sold in that era. The world of American finance in the 1920’s was essentially a pure caveat emptor free market, with no effective legal protection for investors, much less niceties like disclosure requirements or suitability rules. Sellers of securities held an enormous degree of information asymmetry over retail buyers, who often had little in the way of real facts upon which to base an investment decision.

The first wave of regulation of securities coming from Washington in the late 1800s and early 1900s was focused on anti-trust issues. By attempting to prevent concentrations of financial and political power inside the great trusts, but not fraud or other types of skullduggery associated with the investment world, regulators were ineffective in terms of protecting the investing public.

The second stage of early attempts at regulation focused on the issuance of “watered” stock to individual investors as a result of the gigantic mergers that were occurring in the first couple of decades of the 1900s. Acts of fraud and criminality were common in 1920s America, with little in the way of guidance or restraint from the state courts and their elected judges. Again from Mitchell as cited above:

The final development of securities regulation aimed at consumer protection. It began with a model of Wilsonian progressive legislation, proposed after the war by the Capital Issues Committee in a form that would serve as the matrix for the Securities Act of 1933. This was the modern type of mandatory disclosure, grounded in a philosophy that providing information to individual investors would allow them to make self-reliant, informed investment decisions and keep the
market efficient, safe and stable. While the first stages of securities regulation were grounded in the new collectivism of the early Progressive Era, this final phase philosophically was born of the unique combination of individualism within collectivism that characterized Wilson’s brand of progressivism. It was also the stage of securities regulation that institutionalized and legitimated the speculation economy.

The financial shenanigans of the 1920s would eventually spur a response in terms of new regulation every bit as powerful as the political wave that brought Prohibition into being at the end of WWI. One of the early reactions to the fraud and lack of definition prevailing in the US securities markets came with the passage of the Martin Act in New York in 1921, a key antecedent of the federal securities laws that would be adopted a decade later. Another key legal event in that period was the landmark 1925 Supreme Court decision authored by Justice Louis Brandeis, *Benedict v. Ratner*. This decision regarding control over collateral in dispute in a receivership case caused enormous debate in the legal profession and slammed shut the door on fraudulent “incomplete” sales and “pledges” of assets. But the decision by Brandeis also stifled private credit creation in the US for more than three decades afterward. The relevant part of the Brandeis decision follows below:

But it is not true that the rule stated above and invoked by the receiver is either based upon or delimited by the doctrine of ostensible ownership. It rests not upon seeming ownership because of possession retained, but upon a lack of ownership because of dominion reserved. It does not raise a presumption of fraud. It imputes fraud conclusively because of the reservation of dominion inconsistent with the effective disposition of title and creation of a lien.

In plain terms, the paragraph cited above means that any “sale” or assignment of collateral is deficient if the transferor retains “dominion inconsistent with the effective disposition of title and creation of a lien.” Any financial asset transfer, by sale or pledge, that fails this test of a transfer of control “imputes fraud conclusively,” Justice Brandeis concluded. And, in effect, any asset “sale” where the seller retained control over the collateral was effectively a secured borrowing, an important distinction that would come into play during the housing financing bubble of the 2000s. The decision struck down the commercial practice of pledging securities as collateral for loans by making a simple, often vague, common law guaranty without the borrower giving up actual control over the assets.

The Supreme Court’s decision found that a “common law pledge,” by which for example the Bank of England had liquefied markets in crises dating to at least 1866, “imputes fraud conclusively” as a matter of New York law and could, therefore, be unwound for the benefit of unsecured bank depositors in a bank receivership. The full import of this decision did not become clear until after the crash of 1929, when lenders who theretofore had been satisfied with general surety with respect to accounts receivable
finance became suddenly cognizant of the need for substantial security to avoid a transaction being determined to be a state law fraud.2

The Benedict decision was very controversial in legal circles and shook the ground of American finance. It effectively precluded the Federal Reserve’s ability to lend against collateral in the 1929-33 banking crisis. While many economists including former Federal Reserve Chairman Ben Bernanke claim to have studied the Great Depression in great detail, virtually none of them understand finance or specifically the degree to which the Benedict decision constricted the supply of secured credit to the US economy. (Indeed, there is not a single reference to the Benedict decision in the entire Social Science Research Network.) The Brandeis decision stifled private credit creation in the United States until the Uniform Commercial Code, the US Bankruptcy Code and the Uniform Fraudulent Transfer Act established rules for creating security interests that assured the “effective…creation of a lien.” Benedict eventually led to the adoption in the 1950s of Article 9 of the Uniform Commercial Code, which governs the methods used today to create and perfect security interests in mortgages and other financial assets.

But more than merely a decision about commercial law, the Brandeis decision represented a Progressive view of American finance at odds with the business practices of the 19th Century. Janger (1998) notes that “Brandeis's decision in Benedict v. Ratner can and should be seen as an extension of Brandeis's progressive vision of American law. Only then is it possible to see what Brandeis was likely trying to do and what the drafters of Article 9 of the [Uniform Commercial Code] have since missed.” In simple terms, in the Benedict decision Brandeis demanded transparency and accountability in financial transactions, something that the business community of the 1920s found troublesome to say the least.

The decision also stifled financial asset “sales” until the 1970s, when government sponsored entities like Fannie Mae and private issuers like Mortgage Guaranty Insurance Corporation (MGIC), Bank of America and Sears, Roebuck & Co blazed the trail in terms of creating a new legal template for “true sales” of assets that could meet the test in Benedict. But, again, few economists understand the importance of Benedict or how the issue of secured collateral is intertwined with the question of public regulation of financial markets. Again Jagger (1998): “Brandeis had a vision for the appropriate shape of American business law. And, just as he waged guerilla warfare for his view of the First Amendment, he fought for his ideas about private law. Benedict v. Ratner can be viewed as a small piece of this larger Brandeisian agenda.”

There are two other important Supreme Court cases from the 1930s that greatly affected how the courts dealt with financial fraud and, in turn, became part of the legislative agenda of the decades that followed. Both came in 1939, when the Supreme Court finally opined on solutions to the market "gridlock" created by inadequate bankruptcy laws intersecting with rampant pyramids of corporate debt incurred throughout the Gilded Age. They are the two primary cases cited in the legislative history of the US Bankruptcy Code and define the power of the courts to unwind any

2 See Recent Cases, 8 Catholic University Law Review, Rev. 43 (1959), Pg 43
duplicitous scheme, whether concocted by corporate structuring of owners or by moral hazard created via reckless management practices.

The first decision was by Justice John J. Roberts in *Taylor v. Standard Gas & Electric* ("Deep Rock Oil") which involved corporate plundering by a shareholder abusing loan relationships with a subsidiary. The second, *Pepper v Hamilton*, involved a CEO who wrongly claimed a lien ahead of unsecured creditors by having the corporation confess judgment on a suit he filed to support his own employment contract. Together, they establish "the fundamental principles of equity" that underlie all major laws codified thereafter. That phrase is contained in the general principles sections of both the Uniform Commercial Code (UCC) and the Uniform Fraudulent Transfer Act (UFTA).³

The *Benedict* decision effectively shut down the 1920's generation of many new asset-backed securities on Wall Street, and may have contributed to the Great Crash just four years later. For example, the real estate speculation and related financial activity on Wall Street described so vividly by John Kenneth Galbraith in "The Great Crash 1929" (1952) came to a halt after the *Benedict* decision. Two years after the Brandeis opinion, real estate markets in states such as Florida began to unravel, leaving thousands of homes "under water" with mortgage debt that exceeded the value of the house – as is again the case in Florida today. The other Supreme Court decisions mentioned above further constrained the ability of unscrupulous operators to take advantage of bankruptcy to commit acts of fraud against investors and creditors, a practice that had begun in the Gilded Age under the likes of Jay Gould and Jim Fisk.

As a result of market upheaval, court decisions and the rise of regulation, everything and everyone in real estate finance and finance generally simply "froze" in fear from 1929-41. The Second World War disrupted normal economics and the operation of capital finance for another decade. It took until the 1950s and 1960s for population growth to get to a point where "inflation" pushed housing prices up enough to free Florida and other states from the deflationary vise that started to hit it in the late 1920s. Gordon (1964) notes as the amendments to the UCC were being proposed to the 50 states in the mid-1960s for adoption that the changes were needed to end the draconian standard for asset sales and secured borrowing imposed by *Benedict*. "Whether or not there is agreement on retaining the rule in *Benedict v. Ratner* in force," he wrote, "there should at least be agreement that the punishment exacted for failure to exercise the requisite dominion [over collateral] is extremely severe." But, of course, that is precisely what a Progressive like Brandeis wanted to achieve.

³ These advances came about largely because of the work of Professor Frank Kennedy of the University of Michigan Law School who worked with those that wrote the UCC and chaired the committee that wrote what led to the US Bankruptcy Code and chaired the UFTA drafting committee.
The Rise of Modern Regulation

With the great crash in 1929, the era of popular speculation in the US equity markets ended abruptly and private capital formation in the US economy literally stopped. By 1933, banks had failed in droves and existing debt either defaulted or was redeemed without being replaced. Assailed by financial deflation, private investors withdrew from the US capital markets. To avoid a financial “trap” by lending to banks against collateral using transactions that could be unwound by state bank receivers, neither the Hoover administration nor the Federal Reserve Board, then headed by Eugene Meyer, was able to re-liquefy the banking system. No relief was possible until 1933, when President Franklin Delano Roosevelt and Congress created a federal deposit insurance and insolvency regime under the FDIC that precluded the possibility of sacrificing federal funds to support uninsured depositors in defunct state banks. Banks which could not qualify for FDIC insurance were restructured by the Reconstruction Finance Corporation, again to avoid the legal trap created by the Brandeis decision.

The expansion of the regulatory power of the federal government enabled the nation to deal with a serious economic problem. Some argue correctly that the US government resorted to principles of the fascist states of Italy and Germany, ignoring legal obstacles to “reform” and creating a propaganda machine by which FDR pretended that the state capitalism that arose in the 1930s was lawful and Constitutional. President Herbert Hoover complained in 1933:

“We must fight again for a government founded on individual liberty and opportunity that was the American vision. If we lose we will continue down this New Deal road to some sort of personal government based upon collectivist theories. Under these ideas ours can become some sort of Fascist government.”

By the mid-1930s, the US Treasury and the numerous government sponsored agencies spawned under Herbert Hoover and FDR were the only significant source of capital finance in America. Until preparations for WWII led Congress to enact the Assignment of Claims Act of 1940, for example, private contractors could not even finance accounts receivable from the US government. That law allowed contractors manufacturing for the government’s war preparations and fiscal stimulation programs to secure bank borrowings by pledging the government’s payment obligations. It was a cumbersome process, but about the only means for securing pledges that could overcome defects of common law pledges found to be defective by the US Supreme Court.

Passage of the Glass-Steagall laws are the most remembered part of the New Deal regulatory template, but the massive new regulation put in place by FDR to allow the banking system to re-open during the Great Depression could not overcome the many enormous problems that stifled job creation and economic growth until WWII. Investor fear about the political future and the nature of money also helped to retard economic growth until at least the 1950s or 1960s. Todd (1995) notes that FDR also “did away with the gold exchange and bimetallic currency standards, which contemplated the actual redemption of paper currency or silver coin for gold and which dominated the
American political and economic philosophies from 1789 until 1933, became transformed into the present fiat currency regime.” There is, however, no economic argument which would today, at least, suggest that any form of commodity-based financial system works better.

Most important, while securities laws finally imposed effective mandates for greater disclosure and sought to eliminate the ruse of hiding leverage in non-consolidated entities, FDR continued the migration away from individual accountability and personal freedom begun by the Progressives. US law and regulation took a more corporatist, European-style regulatory format where the state was in theory responsible for protecting consumers and business alike and commercial behavior was sharply limited. Today the US has a hybrid system, where federal legislatively empowered regulatory vehicles and the tort system via the state courts operate side by side. Andrew Brady Spaulding of the University of Richmond Law School (2011) notes that:

In discrete but critical ways, the U.S. no longer represents the comparatively laissez-faire approach to federal business regulation. Rather, owing to its origins in the Progressive Era, U.S. federal law directs corporations toward non-economic social goals, particularly combating corruption (e.g. the Foreign Corrupt Practices Act) and promoting human rights (e.g. the Alien Tort Statute or economic sanctions). By contrast, the alternative legal regime to which the U.S. is frequently compared – China – largely allows companies to pursue profits internationally without regard to their impact on corruption and human rights. Though it remains true that the U.S. regime and its principal alternative are distinguished by the extent to which the state restricts business conduct to achieve social goals, the roles are now reversed.

Crushed by an oppressive combination of recovering from excessive speculation, overcoming legal mandates that effectively decimated good and bad leverage, political repression and a swing toward excessive economic regulation under the New Deal, the US economy continued to contract for more than a decade after the 1929 market crash. Many of FDR’s regulatory efforts and industrial initiatives launched during the 1930s may have made the economy perform even worse, but others were essential to re-generate a financial system that collapsed under the burdens of its own excessive frauds. Only with the advent of WWII in Europe and the conflict with Japan did US employment recover, by the massive public borrowing to fuel the war effort. Again, the “stimulus” of spending for war has been understood since Cicero.

Hanke notes (2008) that in the 1930s:

“The money supply in the United States, measured by currency, plus demand deposits (M1), dropped by 25%. And not surprisingly, a sharp deflation occurred, with all major price indices registering significant declines... One of the most significant features of the Great Depression was the collapse of private domestic investment. On a gross basis, it fell from 19.6% of GNP in 1929 to 4.4% in 1933—thanks, in part, to a dramatic drop in business inventories. By 1932, net
private domestic investment was negative, indicating that the economy’s capital stock was shrinking.”

But it was not just Fed action that “caused” the contraction. In the wake of the Benedict decision, no one was going to risk shaky bank capital by making “new” unsecured loans. Nothing was done until 1940 because that was the first time secured lending became safe. And it was World War II (WWII) that got enough Democratic and Republican support in Congress to even begin to fashion a solution. That same contraction of lending caused by the fear of new losses has been our problem since 2008, even with banks that are not in conservatorship. In the 1930s, by the time FDR took office, Every state was in a bank holiday with banks that had closed because they had no capacity or desire to lend.

Regulation in the Post WWII Era

The end of WWII and start of the Cold War marked a period of economic growth and a gradual resurgence of the private sector, albeit one fueled with ample fiscal and monetary stimulus from the federal government. The US sought to win the Cold War conflict with the Soviet bloc the same way it had won WWII, namely with a massive logistical advantage in terms of economic and financial power. But even as the private sector returned, the culture of regulation spawned during the New Deal became institutionalized. Daniel Ernst (2009) provides what he calls a synoptic account of the legal history of the administrative state in 20th century America:

The century saw three cycles in which the creation of administrative structures was followed by their consolidation into durable political "regimes." Each cycle saw innovations in five broad categories of administration: command-and-control regulation, social insurance and provision, fiscal management, state capitalism, and social police. In the state-building phase of each cycle, the emergence of new bureaucracies disrupted an existing political regime by empowering marginal or excluded groups. After the state-building impulse dissipated, the recently empowered and previously dominant actors reached an accommodation. The bureaucracies became part of a new regime, which, for a time, allocated resources, identified feasible goals, and framed ideologies for politically active Americans.

The Banking Act of 1933, also known as the Glass-Steagall Act, established the FDIC as a temporary agency, but it was eventually made permanent. Glass-Steagall separated commercial banking from investment banking, established them as separate lines of commerce and created the Securities and Exchange Commission. For the first time, the business of buying and selling shares in companies was regulated, and the bank accounts of ordinary people were insured. Of note, both FDR and Senator Carter Glass (D-VA) opposed the creation of a permanent FDIC but the political attractiveness of protecting retail depositors with a federal guarantee proved too powerful for a majority in Congress.
The extent to which the New Deal and WWII institutionalized many government functions from the 1930s advanced the cause of regulation and the corporativist state, culminating in a permanent bureaucracy of regulators supposedly looking after the public interest. Private business was now clearly subordinate to the regulatory framework of the federal government. Occasionally business interests would counter-attack via legislation or the courts, but the primacy of regulation advanced by the federal government was largely unquestioned. Coming out of the Great Depression and WWII, the real problem in finance was the resort to “serial monopolies” that from 1933 onward were considered essential to recovery. Yes, there were tens of thousands of private banks in the US at the end of WWII, but only the blanket guarantee on deposits by the FDIC made them viable. The “nationalization cum monetization” theory proved to be the only viable economic response to the collapse of private finance which occurred in the late 1920s and 1930s. This financial reality accelerated the evolution of the regulatory state.

With no obvious basis for constructing a new model for uninsured free enterprise banking without the ability to safely secure loans, the problem of the “New Deal” was that nobody could agree on an alternative to the monopoly model with government at its center. Only in the 1970s was there finally agreement that experimentation with deregulation was better than staying “stuck in concrete” in an economic model that did not really allow for the expansion of private credit. Ernst (2009) describes how the government-monopoly model evolved under the guise of "Progressive" reform:

Administration was consolidated into a political regime in which courts and localistic, bottom-up, patronage-dispensing political parties remained dominant. The Great Depression and World War II provided the impetus for state-building in a second, "New Deal" cycle. It made semi-autonomous bureaucracies a regular feature of the federal government and a vehicle for president-oriented politicians. Social ferment - civil rights, antipoverty campaigns, the consumer and environmental movements - set off the third, "Public Interest" cycle, in which bureaucracies were opened up to previously unorganized populations and new bureaucracies were created to address recently perceived needs.

For the reasons already discussed, both secured lending and crises were relatively unknown from WWII through the 1970s until private commercial banks and companies discovered the ability to sponsor “off-balance sheet” debt. Vehicles such as mortgage REITs and collateralized mortgage obligations financed a construction lending boom, primarily in Southern states where the spread of efficient air conditioning was opening new business opportunities outside the largely unionized “snow belt.” The decade of the 1970s was the start of a process of deregulation and financial expansion that would roll back Depression era restrictions. The first real unwinding of the Depression era restrictions on banks came when the courts and Congress began in the 1970s to loosen the standards that had separated the businesses of banks and of savings and loans. Inflation reached a 20th century peak of over 10 percent, a result that some researchers attribute to a "lack of proper incentives on the part of policymakers who chose to accept
(or even induce) high inflation in order to prevent a recession,” according to Collard and Dellas (2004). The maturation of the Baby Boom generation also seems to be a significant driver of the demand-pull inflation that led to this period being called the “Great Inflation.”

Beginning with the Depository Institutions Deregulation and Monetary Control Act in 1980, Congress eliminated the monopoly created by deposit interest rates under “Reg-Q.” The process would lead to the eventual elimination of Glass-Steagall restrictions on combining commercial lending with securities underwriting. The process began with deregulation of interest rates on time deposits of more than $100,000 and ended with the passage of the Financial Services Modernization Act, known as Gramm-Leach-Bliley after its chief authors, in 1999. Most important, the ability of banks to engage in securities activities and asset securitizations was restored to pre-1929 levels.

The effort to spur economic growth continued in the 1980s with de-regulation of thrifts that had, theretofore, been restricted to home mortgage lending. The de-regulation efforts began under President Jimmy Carter (D-GA) and accelerated as Republican Ronald Reagan won the presidency and the GOP gained control of Congress.

In the early 1980s after the Fed’s attack on inflation under Fed Chairman Paul Volcker, S&Ls got into trouble early on because high interest rates put the entire industry under water, losing money on long-term fixed rate mortgages that had, by tax and regulatory preferences, become the dominant asset class of the thrift industry. As short-term interest rates rose, funding that business model soon cost far more than the returns on the thrifts’ assets.

In response to that crisis, Congress and the Reagan administration enacted a 1982 law to allow thrifts to “grow out” of that crisis. Thrifts were allowed to expand without any effective limit to protect against the risk that loan defaults would leave losses for the government, as their deposit insurer. When President Reagan praised the law, saying it “finally freed the free enterprise system,” his FDIC Chairman William Seidman observed that he didn’t “see any of those thrift managers asking to be freed from government insurance of their deposits.”

The exuberant response of thrift managers and owners caused even bigger problems. The federal government thrift deposit insurer, the Federal Savings and Loan Insurance Corporation (FSLIC), started to forebear with respect to capital, to generate transactions that “manufactured” capital where none had previously existed and also to dismantle the prohibitions on fraudulent transfers of assets that dated back to the 1920s. FDIC Chairman Seidman, after rescuing the government (to the extent that was possible), called the changes in asset sale rules and the phony accounting for thrifts in the 1980s “the biggest mistake in the history of government.”

After the S&L debacle, accounting rules on asset sales were tightened in 1997. Once again, the tough response by regulators to fraud committed by the S&Ls made it impossible for banks and thrifts to sell financial assets except by non-recourse “true”
sales with no continuing involvement—the process FDIC had used for disposing of assets from a bank receivership from 1933 until 1989. In a very real sense, the changes made in rules for asset sales by S&Ls in the 1980s refuted all of the legal and financial changes made from the 1925 Supreme Court decision by Louis Brandeis.

The Republicans provided at least rhetorical support for the American classical liberal model after five decades of varying flavors of corporate statism, but there was no effort to reign in the largest banks. Indeed, the big banks would grow ever larger under the permissive gaze of the Federal Reserve Board and other regulators, who had been transformed from Progressive moderators to enablers of financial misdeeds. ⁴

The Road to Deregulation

Higgs (1997) describes the “Great Escape” of the US economy from the depressing failure of the New Deal era and WWII. Higgs makes the point that the war years were not exactly prosperous and that the pressure for economic growth among Americans was high, this even though unemployment virtually disappeared in the war years under conscription. But the world of finance came out of the 1940s extremely regulated and would remain so for the next 35 years. Private capital did flow back into the US economy, but the entire design of American finance had the government at the top of the credit food chain regulating a system of limited and separated financial monopolies for commercial banking, consumer lending, mortgage finance, insurance, brokerage, investment management and securities underwriting.

George Kaufman (1993) notes that the groundwork for the removal of Depression era restrictions on banks was set two decades before, in the 1960s with a series of industry studies and commissions sponsored to build support for deregulation of financial institutions. The mid-1960s also marked the rise of the Eurodollar market, offshore banking, dollar LIBOR and the negotiable CD, all in response to the misguided “Interest Equalization Tax” sponsored by President Lyndon Johnson – yet another example of the law of unintended consequences. The world of non-bank finance came into play as well, as demands for credit quickly outstripped the ability of banks to finance. Melanie Fein (2013) describes the process:

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⁴ This writer worked as an applications analyst at the Federal Reserve Bank of New York and personally worked on several mega mergers involving Chemical Bank. Starting as early as the 1920s but accelerating in the 1980s and 1990s, Chemical was one of the leading consolidators in the banking industry. It acquired Chase Manhattan Bank, Manufacturers Hanover, Texas Commerce Bank and Corn Exchange Bank among others. Following Chemical’s acquisition in 1996 of the chronically mismanaged Chase Manhattan Bank, the merged bank adopted the venerable Chase brand. In 2000, JPMorgan merged with Chase and the bank added that brand to its name. Four years later, Chase merged with Bank One, the fourth-largest bank in the U. S. and the world’s largest Visa credit card issuer. What had been Chemical Bank is at the core of what today is JPMorgan Chase, including one of the best operations departments in the industry. And the Fed never even suggested any objection to these mergers.
Shadow banking emerged in the regulated banking system in the 1980s and 1990s when the traditional banking model became outmoded. Banking regulators encouraged shadow banking as the only way to preserve banks as viable entities in the financial system. They did not call it “shadow banking,” but rather treated it as part of the evolution of the business of banking and extolled its benefits. Not until the financial crisis occurred did regulators begin the illusion of shadow banking as something sinister outside the regulated banking system.

Sherman (2009) provides some of the significant steps in deregulation.  

- 1996, Federal Reserve reinterprets the Glass-Steagall Act several times, eventually allowing bank holding companies to earn up to 25 percent of their revenues in investment banking.
- 1998, Citicorp-Travelers Merger – Citigroup, Inc. merges a commercial bank with an insurance company that owns an investment bank to form the world’s largest financial services company.
- 1999, Gramm-Leach-Bliley Act – With support from Fed Chairman Greenspan, Treasury Secretary Rubin and his successor Lawrence Summers, the bill repeals the Glass-Steagall Act completely.
- 2000, Commodity Futures Modernization Act – Passed with support from the Clinton Administration, including Treasury Secretary Lawrence Summers, and bipartisan support in Congress. The bill prevented the Commodity Futures Trading Commission from regulating most over-the-counter derivative contracts, including credit default swaps.
- 2004, Voluntary Regulation – The SEC proposes a system of voluntary regulation under the Consolidated Supervised Entities program, allowing investment banks to hold less capital in reserve and increase leverage. The Fed also adopted Basel II at this point allowing much greater bank leverage alongside the greater broker-deal leverage.

Part of the reason that the 1990s were such a difficult period for the US economy and especially the housing sector was the dearth of finance available from regulated

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5 This list, however, misses several significant developments. Walter Wriston’s successful elimination of restraints on banks competing with commercial paper enabled the issuance by major industrial firms. The 1992 adoption of Rule 3a-7 by the Securities and Exchange Commission opened the door to mortgage securitizations for the first time since 1925. The SEC’s allowance of shelf registration opened the lending business to non-bank entities, including major investment banking firms. The deregulation process went on, with advances and errors, from 1968 under both Democratic and Republican presidents and Congresses.
depositaries after the S&L crisis. By 2000, banks were openly making a case for some type of regulatory relief with respect to asset sales. In a 2000 revision to the standard, FDIC adopted a safe harbor that, it later noted, gave banks a pass on legal compliance for asset transfers to be reflected as sales despite the fact that these transactions violated the standard set by the Supreme Court in *Benedict* 75 years earlier. To a great extent, the changes made by the FDIC in 2000 with respect to asset sales, as with the deregulation of the S&Ls in the 1980s, marked the migration of public policy full circle from the draconian limit on credit creation in the 1920s and 1930s.

The Failure of Regulation

Looking at swings in regulation since the 1930s, one important conclusion seems self-evident regarding the regulation efforts of that era, namely the issue of regulatory capture. The assumption of Progressive reformers that regulators are less susceptible to corruption than elected officials is now seen to be false. Not only were regulators and members of Congress corrupted into the cult of deregulation, but some of the key regulatory figures of the period turned out to be enablers of the bad acts which ultimately led to the 2007 subprime crisis. The fact of federal regulators and agencies all being centered in Washington may have actually made the corrupting process easier. As a former legal official of a prominent hedge fund, commented for this paper: “I was once alone in a room with an SEC Enforcement Division official trying to settle a nine-figure securities fraud case when he let it be known that he would be leaving the agency soon and was I aware of any job opportunities in the hedge fund space? I thought I had seen it all by that stage of my career, but I was wrong.”

Many of the worst actors in the deregulation drama, including former Goldman Sachs CEO and Treasury Secretary Robert Rubin, former Federal Reserve Chairman Paul Volcker, and former Treasury Secretary Lawrence Summers, were Democrats. But Republicans, Alan Greenspan, Senator Phil Gramm, Treasury Secretary Paulson, SEC Chairman Christopher Cox, and New York Federal Reserve Bank President Timothy Geithner also contributed to the problem. The supposed regulators turned out to be among the most eager to please and enable the big banks.

Paul Krugman and Robin Wells summarized the Democrats’ situation from a Progressive perspective in *The New York Review of Books* (July 2012):

> The dominance of Rubinites in the new administration shocked many progressives, since for many the Clinton-supported repeal of the Glass-Steagall Act, advocated by Robert Rubin but opposed by Paul Volcker, symbolized the extent to which the financial crisis of 2008 was hatched in the overly friendly relationship between the Clinton administration and Wall Street. It’s true that Glass-Steagall, a Great Depression–era law that forbade the mixing of securities trading and accepting FDIC-insured deposits under the same corporate roof, wouldn’t have prevented the 2008 implosion of Wall Street. Instead, it was extraordinarily high levels of leverage at investment banks like Lehman and Merrill Lynch, as well as the holding of huge portfolios of toxic subprime
mortgages by deposit-taking banks like Bank of America, that were the fuel for the conflagration. But progressives were right to feel that Wall Street had been dangerously under-regulated for too long and that the entire country was now paying the price.

Of course, most everyone says Wall Street leverage was to blame for the 2007 subprime crisis without stopping to ask where the leverage came from. It came from commercial banks via repurchase transactions. Lehman financed with Bank of America, Bear Stearns with JPMorgan Chase, etc. The commercial banks and investment banks worked hand-in-glove. The duplicity of Robert Rubin with respect to his support for deregulation and lack of attention to the problems at Citigroup, where he served as Chairman, is relatively well known. Alan Greenspan is likewise publicly censured for his failure to react to obvious signs of stress in the financial system prior to the 2007 market collapse, but his colleagues at the Fed of New York such as a Timothy Geithner and others are equally culpable.

Less familiar, however, is the role of senior regulators and public paragons like Democrat Paul Volcker and Republican FDIC Chairman William Issac in creating the circumstances for the subprime financial crisis. Their participation in dismantling many of the core restrictions on off-balance sheet finance by banks, as part of an effort to implement new capital rules without disrupting key types of corporate lending is a key part of the deregulation narrative from the early 1980s.

Being the author of the section of the Dodd-Frank law known as The Volcker Rule, which restricts principal risk taking by banks for their own account, is more than a little ironic for the former Fed chairman. Paul Volcker has always been among the many friendly enablers of “too big to fail” banks, yet most Americans are blissfully ignorant of Volcker’s and Issac’s advocacy of looser rules for the “too big to fail” institutions. While the former Fed chief authored an eponymous restriction on bank principal activities that is part of the Dodd-Frank law, much less well known is the role he and Issac played in the 1980s to encourage creation of off-balance sheet structure investment vehicles (known as “SIVs” or “bank conduits”) where some of the worst risk taking by the nation’s largest banks took place. Indeed, in common with the financial catastrophe of the 1920s and the S&L crisis of the 1980s, off-balance sheet finance was the chief cause of the 2007 subprime financial collapse.

Along with Issac, who was the Chairman of the FDIC in the 1980s, Volcker advocated allowing the largest banks to reduce their effective capital ratios and use off-balance sheet vehicles to increase leverage and profits. After the debt crisis of the early 1980s, Fed officials led by Volcker were misled by bank executives who said core bank operations would be rendered unprofitable by new capital rules. They said this despite disclosures in all bank capital-raising prospectuses showing that more capital would increase profits, due to the lower leverage costs. Banks argued that the need to loosen regulatory restrictions such as Glass-Steagall was driven by the need for global competitiveness, but in fact the big banks were destroying investor capital by accumulating moral hazard risk. In terms of risk adjusted return on invested capital or
RAROC, the largest banks have often reported negative returns in terms of their public financial statements. This is one of the reasons that the Fed has often looked favorably upon large bank mergers, because it helps to shield mediocre institutions from restructuring or even failure behind a protective wall of regulation.

Later on, of course, in the 1980s and 1990s, Volcker would argue that the banks did need more capital to prevent the bad acts that led to the accumulation of some $60 trillion in toxic waste by 2007. But for some reason, nobody in the financial media is able to ask Volcker just why it was that he believed back in the 1980s and early 1990s that large banks could manage the financial, legal and reputational risk of off-balance sheet financial vehicles -- entities that were completely unsupported by capital. Volcker talked about the risks of modern finance in a 2002 statement:

The fact is the accounting profession has been hard pressed to keep up with the growing complexity of business and finance, with its mind-bending complications of abstruse derivatives, seemingly endless varieties of securitizations, and multiplying off-balance sheet entities. The new profession of financial engineering is exercising enormous ingenuity in finding ways around established accounting conventions or tax regulations. In the rapidly globalizing world of finance, different accounting standards and methods of enforcement in different jurisdictions present increasing hazards.

Yet Volcker and his contemporaries in the regulatory world helped to enable just such behavior. The high interest rates of the late 1970s and early 1980s caused chaos in the thrift industry and forced disclosure of the incredibly stupid notion that one could “control rates” to eliminate risk of borrowing short-term and lending long-term at fixed rates. That, of course, led to new calls for deregulation. From 1980-1982, statutory and regulatory changes gave the S&L industry new powers in the hope that entering new areas of business would permit them to return to profitability. But no regulation on earth can improve on bad managerial judgment or acts of fraud. Capital requirements were dropped and limits on the use of brokered deposits were eliminated for thrifts. For the first time, the government approved measures intended to increase S&L profits as opposed to promoting housing and homeownership.

In 1982, under the chairmanship of William Isaac, the FDIC issued a “policy statement” that state chartered non-Federal Reserve member banks could establish subsidiaries to underwrite and deal in securities. While the Federal Reserve Board under Volcker did ask Congress to overrule both the FDIC’s and the OCC’s actions, failing that the Fed quietly supported the idea that banks should have broader securities powers and use off-balance sheet vehicles to increase leverage.

By 1987, just as Volcker’s term as Chairman was ending, the Fed approved regulations allowing bank holding companies to underwrite and deal in residential mortgage-backed securities, municipal revenue bonds, and commercial paper. Glass–Steagall’s Section 20 prohibited a bank from affiliating with a firm “primarily engaged” in underwriting and dealing in securities. A little more than three quarters of a century later, Citigroup,
Lehman Brothers, Washington Mutual, Countrywide and other banks would fail because of acts of financial fraud related to underwriting bad securities — securities which were "sold" to off-balance sheet vehicles that were in fact controlled by the sponsoring banks.

True Sales and The Failure of Citigroup

In the early 2000s almost nobody in the regulatory community said a word about true sales, but the courts were looking at the issue. The bankruptcy of LTV Steel is perhaps the most important case in point. The debtor asked that "the court to grant an emergency motion to allow them to use the collections from the securitizations and claimed that the transactions were not “true sales” but rather “disguised financings,” note Mason & Rosner (2007).

From 2000 through September 2010, when the FDIC adopted new rules for asset sales, the largest commercial banks took the “safe harbor” to mean they were given a “get out of jail free” card to commit acts of financial fraud with impunity. Transactions that were clearly “pledges” of assets were instead treated as “true sales,” allowing the largest banks to create tens of trillions of dollars’ worth of bad securities with no capital backing. The overhang of unfunded toxic waste was essentially an involuntary loan from the public, a reality that would cut US stock prices in half and nearly destroy the global economy in 2007-9. Citigroup, American International Group and other banks and commercial firms nearly failed as a result and required a massive government rescue. General Electric, for example, was in such serious trouble due to market fears regarding its financial condition that it was forced to use FDIC guarantees on its corporate debt.

Bair (2012) notes that the Fed, Office of the Comptroller of the Currency (OCC) and other regulators concealed the extent of the problems at Citigroup from the FDIC, which sought to resolve the company’s subsidiary banks on several occasions prior to the government bailout. Many of the off-balance sheet transactions which led to Citigroup’s collapse were facilitated by bank and securities regulators who excluded them from “leverage” tests. Going back to the legal standard set by Justice Brandeis in Benedict, these transactions were clearly not “sales” and instead appeared to be compound frauds that were facilitated by the development of derivatives that actually promised speculators ever-greater gains as the asset quality of insured lenders fell.

The changes made by the FDIC in 2010 to the rules for a “safe harbor” for asset securitizations, combined with the new rules put in place by the Financial Accounting Standards Board ("FASB") regarding the transfer of financial assets, make it impossible today for commercial banks to conduct similar fraudulent asset sales. The changes in the regulatory treatment of off-balance sheet financial vehicles in the 1990s and 2000s were in many respects the proximate cause of the subprime financial crisis. As in the 1920s, the ability of banks to disguise what ought to have been recognized as on-balance sheet financings as supposed “sales” arguably led to the crisis of 2007. These changes, which were encouraged by Volcker and Isaac decades ago, continue to do significant damage today to investors and financial institutions.
While a lack of data and disclosure helps to explain these lapses in the past, for those harmed it is little consolation. The regulatory lapses of the 1980s and 1990s are still the "heart" of the "participation" problem we see on Wall Street today, where unsecured and even subordinate borrowings by banks are reported as "asset sales." The tolerance for securities fraud by regulators is even today growing into the next bubble (along with derivative abuses equal to the "Lehman Repo-105" deal). All of these maladies stem from decisions made by Volcker, Issac and their contemporaries decades ago regarding bank activities, asset securitizations and derivatives.

Dodd-Frank and the New Regulation

The Dodd-Frank law, like the 1930s-era court decisions and Glass-Steagall legislation, places restrictions on credit, capital formation and thus job growth. Combined with the potentially poisonous mixture of Basel III capital rules and the foreclosure abuse settlements, Dodd-Frank represents potentially the most repressive regime for private lending since the 1930s. Whole areas of once private consumer finance have been legislated out of existence by Dodd-Frank and replaced with carefully mandated loan types that are considered to be compliant with Consumer Financial Protection Bureau (CFPB) guidelines. Senator Elizabeth Warren (D-MA), the former college professor turned public policy expert, is personally responsible for cutting off millions of Americans from private mortgage credit via the 2010 Dodd-Frank Wall Street Reform law.

The federal government has asserted new control over a broad new range of activities in the area of consumer lending, from mortgages to credit cards and auto finance to debt collections. The Dodd-Frank Act and the CFPB it created are making big changes in the world of home finance. These changes not only include regulation of consumer transactions, but also intervention in the wholesale market for loans. The net, net effect of the new regulation is likely to be far tighter credit and lower economic growth, risking that we may repeat dangerous experiments of the 1930s through the end of the 20th Century. If you don’t have a credit score above 740 today, don’t bother going to a commercial bank for a home mortgage. As in the decades following the 1920s, banks today are simply not taking any appreciable default risk on their new originations of assets.

Under the Basel III rules, for example, banks must hold more than four times the capital against a private, non-agency loan than the capital needed to hold Government National Mortgage Association (GNMA)mortgage securities guaranteed by Uncle Sam. The entire Basel III hierarchy continues to set government debt at the pinnacle and penalizes private assets financed by the “too big to fail” banks. The converse of Cicero’s observation that “the sinews of war are unlimited finance” is that by securing unlimited finance governments have, historically, turned to war as the means for generating growth. The combination of regulatory constraints and risk aversion by the largest banks is causing mortgage lending volumes to fall dramatically, especially for loans that cannot be government guaranteed. Loan applications measured by the Mortgage Bankers Association in 2013 have fallen to about half of 2012 levels, but this
is largely due to a decrease in applications for mortgage refinance. Some two-thirds of all applications for new mortgages are to refinance an existing loan, however, and not for a new home purchase.

Moreover, between 20 and 30 percent of all US homes remain under water, meaning that the house is worth less than the mortgage. The fact that many homes remain under water vs. the mortgage debt on the property is constraining supply, another near-term positive for home prices, but a negative for the US economy. Indeed, it can be argued that the still large percentage of homes that lack at least 20 percent positive equity – the minimum required for a voluntary sale without forcing the debtor to write a check at the closing – is a major obstacle to the Fed’s efforts to reflate the housing sector via low interest rates and “quantitative easing.” This is perhaps the single most important reason why the housing market’s recovery is slowing as 2014 begins. In October 2013, for example, the Case-Shiller Home Price Indices were up just 0.2 percent.

The Mortgage Bankers Association (MBA) expects to see $1.2 trillion in mortgage originations during 2014, a 32 percent decline year-over-year from the $1.7 trillion in mortgage loans in 2013. While MBA expects home purchase originations to increase nine percent, it expects mortgage refinance originations to fall 57 percent in 2014. Until Congress and the Obama Administration accept that we have, perhaps, gone too far with Dodd-Frank, Basel III and the various other legal settlements and regulations, the housing sector is not likely to continue its recovery. Indeed, while a number of housing analysts are looking for a single-digit increase in home prices in 2014 after the 12 percent gains in 2013, in many markets home prices may actually start to fall in the next year.

While commercial banks and government-sponsored entities such as Fannie and Freddie cater to high-income, prime borrowers, the FHA is the only game in town for the rest of the market. Close to half of all FHA loans originated in 2013 were for credit scores of 620 to 679, about a quarter of the loans were for 680 to 719 and roughly a quarter were for 720 and higher, according to data from the FHA. Banks simply will not originate below-prime credits unless they can sell them to investors – a difficult proposition in the current market. Regulation is the chief reason for this reluctance to lend by banks and purchase assets by investors.

Add to this reluctance the end of the safe harbor for “true sales” of asset-backed securities by the FDIC in 2010 and it is possible that no FDIC-insured commercial bank will underwrite a nonprime, non-QRM loan or securitization ever again. In the past, when mortgage markets have shrunk, origination spreads rose and new market sources eventually developed. But there is a painful lag time in that process.

Despite the extraordinary monetary policy put in place by the Fed since 2008, the US economy continues to show signs of deflation after the last major financial boom with the housing sector. The Fed board seems stuck in precisely the same debt deflation trap of which Irving Fisher warned in the 1930s, yet the role of Dodd-Frank is not widely
It seems self-evident that increased levels of regulation and government intervention in the consumer credit markets are not likely to prove to be positive factors for the economy. With activity in the equity markets muted and volumes in housing way off from peak levels, the rest of the economy feels the weight of deflation in these sectors.

Ominously, the volume of spending on all financial transactions generally is still anemic, even falling, and is now at post WWII levels in terms of broad measures of money flows. Consider this chart from the Federal Reserve Bank of St. Louis showing the velocity of money, which has been falling rapidly since 2007 and is now at the lowest level since the Great Depression.

“The velocity of money is the frequency at which one unit of currency is used to purchase domestically-produced goods and services within a given time period,” notes the St. Louis Fed. “In other words, it is the number of times one dollar is spent to buy goods and services per unit of time. If the velocity of money is increasing, then more transactions are occurring between individuals in an economy. The frequency of currency exchange can be used to determine the velocity of a given component of the money supply, providing some insight into whether consumers and businesses are saving or spending their money.”

It needs to be said that the US Constitution gave Congress power to create a Fed and to give it the discretion to ruin the economy by making mistakes. This fact proves the need for Congress to act with even greater caution when it elects to step in and replace free enterprise—either in favor of or opposition to prudent regulation. If America is to
provide the stable growth and opportunity our people demand, we need more punishment of fraud and also more freedom to experiment with new types of financial products.

Conclusion

In the debate over Dodd-Frank, the Basel III capital rules for banks and other regulatory strictures put in place since 2008, the overriding assumption has been that we need to rein in the risk taking activities of banks to prevent another financial crisis. The many hundreds of thousands of pages of new laws, regulations and comments that have been issued since the start of the subprime bust are all designed, in theory at least, to protect us. But by limiting risk taking we also limit economic growth. In many respects Dodd-Frank and the regulations adopted since go too far. Instead of merely focusing on financial fraud, Dodd-Frank instead attacks all risk taking.

While you may argue that the Dodd-Frank regulatory regime is not as severe as the strictures put in place during the Great Depression, the fact remains that the US is in the midst of a periodic increase in regulation of finance following a major speculative bust. The increase in oversight and audit in the consumer finance industry is massive and much of it for no apparent purpose. The net impact of all of the regulations put in place since 2008 is to restrict consumer access to credit and to make federally insured banks much more reluctant to lend in general. The non-bank financial sector is also under far greater regulation than ever before, including credit cards, auto finance and other areas of consumer lending that have previously not been subject to federal oversight.

Seen in a long-term perspective, the Depression-era laws and court decisions we refer to generically as “Glass-Steagall” represent both an effort to resolve a prior period of massive fraud and an attempt by a then-ascendant liberal political class led by FDR to limit private risk taking. The New Dealers sought to embed a Progressive culture of regulatory bureaucracy in Washington because they did not comprehend an alternative. The 2010 Dodd-Frank reform law is another political reaction to excesses in private risk taking, although with the difference that this time we are adding yet another layer of Progressive-style regulation led by the CFPB atop the existing failed regulatory regime comprised of the Fed, SEC and other agencies. The regulators have become simultaneously both the problem and the solution.

Dodd-Frank attacks credit creation by the private sector, including the quasi-public commercial banks, but places no limits on public credit growth. The whole Basel III framework has for decades been built around the idea of government debt at the top of the food chain. The net effect of the Fed’s low rate regime is felt in terms of financial inflation visible in asset bubbles in the US (housing, stocks) and around the world, but no significant job growth. Or put another way, the radical monetary policy pursued by the Fed with quantitative easing and low interest rates is, perhaps, being thwarted by the new financial regulations imposed since 2008. Households can only reflate if consumers have access to credit. The central bank is printing money, but only certain parts of the economy – banks, non-banks, leveraged investors – are being helped by
low rates. Until US policy makers come to the realization that over-regulation is thwarting real economic recovery based on private sector growth, the outlook for jobs and consumer spending in the US is likely to remain very cautious. If the Progressive objective of a century ago was a just society that was accountable and transparent, surely the Dodd-Frank law and other regulatory initiatives put in place since 2007 have failed in achieving that noble goal.
References

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