American University Business Law Review

Volume 1 | Issue 1 Article 2

2011

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Brooksley Born

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Recommended Citation

Born, Brooksley. "Financial Reform and the Causes of the Financial Crisis." American University Business Law Review 1, no. 1 (2011): 1-6.

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KEYNOTE ADDRESS

2011 AMERICAN UNIVERSITY BUSINESS LAW REVIEW SYMPOSIUM: LAW, FINANCE AND LEGITIMACY AFTER FINANCIAL REFORM*

"FINANCIAL REFORM AND THE CAUSES OF THE FINANCIAL CRISIS"

BROOKSLEY BORN†

I congratulate the American University Business Law Review in holding this symposium on the important subject of financial regulatory reform. The recent financial crisis and the economic crisis that has followed it have demonstrated how vital financial regulatory reform is to the welfare of the American people.

These crises have been devastating. Trillions of taxpayer dollars have been spent to rescue large financial institutions and to support the financial system. Millions of Americans are out of work, cannot find full-time work or have given up looking for work. About 4 million families have lost their homes to foreclosure, and another 4.5 million are in the foreclosure process or are seriously behind on their mortgage payments. Nearly $11 trillion in household wealth has vanished, with retirement accounts and life savings swept away.

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*Symposium was held at the American University Washington College of Law in Washington, D.C. on April 8, 2011.

†Brooksley Born was a Commissioner on the Financial Crisis Inquiry Commission from mid-2009 until February 2011. She is a retired partner of Arnold & Porter LLP and served as Chairperson of the Commodity Futures Trading Commission, the federal independent regulatory agency for futures and options, from 1996 to 1999. In that role she warned about the dangers of unregulated derivatives.

We all need answers to why these crises occurred. Unless we find those answers and respond appropriately to what we learn, the country and the global economy may well face recurrent crises.

I recently served as a Commissioner on the Financial Crisis Inquiry Commission, which was created by statute in 2009 to examine the causes of the financial and economic crisis in the United States and to report to the President, Congress and the American people on those causes.[1] The Commission issued its report on January 27, 2011 after 18 months of investigation, including 19 days of public hearings, interviews with about 700 persons and review of millions of pages of documents. We found that profound failures in financial regulation and supervision along with failures of corporate governance and risk management at major financial firms were the prime causes of the financial crisis.

Let me outline for you our major conclusions.[2]

First, the Commission concluded that the financial crisis was avoidable. It was the result of human failures, mistakes and reckless behavior. Even though we heard a great deal of testimony by senior regulatory officials and executives of financial services firms that the crisis could not have been foreseen, we found that there were clear warning signs that were ignored or discounted. Among other things, there was an explosion in risky subprime lending and securitization, an unsustainable rise in housing prices, widespread reports of egregious and predatory lending practices, dramatic increases in household mortgage debt, and exponential growth in financial firms' trading activities, in unregulated derivatives trading, and in short-term lending markets.

The Commission concluded that widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets. Policymakers and regulators failed in their responsibilities to protect the public in large part because of a widely accepted belief in the self-regulating nature of financial markets and the ability of financial firms to police themselves. Former Federal Reserve Board Chairman Alan Greenspan championed deregulation and was joined by policy makers in successive Presidential Administrations and successive Congresses in supporting widespread deregulation of financial markets and institutions. As a result, gaps in government oversight of key parts of the financial system were created, including the enormous shadow banking system and the over-the-counter derivatives market. Moreover, supervision of financial firms was weakened, and firms were able in many cases to

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[1] Fraud Enforcement and Recovery Act of 2009, Section 5, Public Law 111-21, 123 Stat. 1617 (May 20, 2009).

[2] *See* Financial Crisis Inquiry Report, pp. xv-xxviii (Jan. 27, 2011).

select among supervisors, leading to a regulatory race to the bottom. The financial sector effectively pressed for this deregulation, spending almost $4 billion in federal lobbying expenses and campaign contributions in the decade leading up to the crisis.

The Commission concluded that dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of the crisis. Too many of these firms acted recklessly, taking on too much risk with too little capital and too much dependence on short-term funding. The largest investment banks and bank holding companies focused increasingly on risky trading activities. Many of these companies took on enormous exposures by acquiring or supporting subprime lenders and creating and selling trillions of dollars in mortgage related securities. Firms expanded in ways that left them too big to manage as well as too big to fail. They placed undue reliance on mathematical risk models, and their compensation systems imprudently rewarded short-term gain and ignored potential downside risks.

The Commission concluded that a combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis. Financial firms and American households borrowed too much and left themselves susceptible to financial distress if the value of their investments declined even modestly. National mortgage debt almost doubled in the six years leading up to the crisis. The five major investment banks in the U.S. had leverage ratios in 2007 as high as 40 to 1. They also relied heavily on short-term borrowing in the overnight repo market, which dried up during the crisis. The two enormous government-sponsored enterprises, Fannie Mae and Freddie Mac, had combined leverage ratios of 75 to 1. Moreover, many systemically important firms took on large positions in risky mortgage loans and securities. With the growth of the shadow banking system to a size rivaling the traditional banking system, large portions of the financial system were opaque, including the repo lending market, off balance sheet entities, and the over-the-counter derivatives market. When the housing bubble burst, the lack of transparency, extraordinary debt levels and risky assets created large losses and panic.

The Commission also concluded that the government was ill-prepared for the crisis and that its inconsistent response added to the uncertainty and panic in the financial markets. The Treasury Department, the Federal Reserve Board, and the Federal Reserve Bank of New York were caught off-guard as the events of 2007 and 2008 unfolded. The lack of transparency in key markets meant that they did not have a clear grasp of the financial system in all its complexity and interrelationships. They believed, for example, that securitization of mortgage assets and the use of over-the-counter derivatives had resulted in safely spreading risk when in

fact risk had become dangerously concentrated in systemically important financial institutions. Senior public officials did not recognize that the bursting of the housing bubble could threaten the entire financial system. They also had little or no information about the interconnections among firms via the over-the-counter derivatives market. The inconsistency of the government decisions to rescue Bear Stearns and to place Fannie Mae and Freddie Mac into conservatorship, followed by the decisions to let Lehman Brothers collapse into bankruptcy and then to bail out AIG, stoked uncertainty and panic in the markets and exacerbated the financial crisis.

The Commission also concluded that there was a systemic breakdown in accountability and ethics. Examples include borrowers who defaulted on their mortgages so rapidly after taking out a loan that it appeared that they never had the capacity or intention to pay. Mortgage brokers worked with lenders to put many qualified borrowers into higher-cost loans so brokers would reap bigger fees. Subprime lenders wrote loans that they knew the borrowers could not afford. Major financial institutions securitized such toxic loans and sold them to investors without full disclosure of the poor quality of the loans. The Commission placed special responsibility for these failures on public policy makers charged with protecting the financial system, those entrusted to run the regulatory agencies, and the chief executives of companies whose failures drove us to the crisis.

The Commission examined certain components of the financial system that it concluded had contributed significantly to the financial meltdown. For example, it found that collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis. Many mortgage lenders became so eager to originate loans that they took borrowers' qualifications on faith, often willfully disregarding the borrowers' inability to pay. The Federal Reserve Board was aware of this increase in irresponsible lending, including predatory and fraudulent practices, but failed to exercise its statutory responsibility to restrict such behavior. The securitization process led lenders and securitizers to believe that they were able to pass the risk of these toxic mortgages to investors in mortgage-backed securities and collateralized debt obligations or CDOs. However, the financial crisis revealed that in fact a number of systemically important institutions remained significantly exposed to them and were brought to the brink of failure with the collapse of the housing bubble.

The Commission concluded that over-the-counter or OTC derivatives contributed significantly to this crisis. After being fully deregulated by federal statute in 2000, the OTC derivatives market grew exponentially to almost $673 trillion in notional amount on the eve of the crisis in June 2008. This unregulated market was characterized by uncontrolled leverage, lack of transparency, lack of capital and margin requirements, rampant speculation, interconnections among firms, and concentration of risk in

systemically important institutions. Derivatives known as credit default swaps fueled the securitization frenzy by encouraging investors in mortgage-related securities to believe they were protected against default. Credit default swaps were also used to create synthetic CDOs, which were merely bets on real mortgage securities. Such bets significantly amplified the losses from the collapse of the housing bubble. Insurance giant AIG's sale of credit default swaps without adequate capital reserves brought it to the brink of failure and necessitated its rescue by the government, which ultimately committed more than $180 billion because of concerns that AIG's collapse would trigger cascading losses throughout the financial system. In addition, the existence of millions of OTC derivative contracts of all types created interconnections among a vast web of financial institutions through counterparty credit risk, exposing the system to contagion and helping to precipitate the massive government bailouts.

The Commission also concluded that the failures of credit rating agencies were essential cogs in the wheel of financial destruction. Without the high ratings issued by credit rating agencies, the mortgage-related securities at the heart of the crisis could not have been marketed and sold in such vast quantities. The credit rating agencies issued top ratings to tens of thousands of mortgage securities, which reassured investors and allowed the market to soar. Then they downgraded them, wreaking havoc across markets and firms. These rating failures resulted from pressure by the securities issuers that paid for the ratings, the use of flawed computer models, the desire to increase or maintain market share and the absence of meaningful government oversight.

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We must ask ourselves whether financial regulatory reform has effectively addressed the problems that the Financial Crisis Inquiry Commission has reported. As the Commission found, some problems, such as concentration in the financial sector, have gotten even worse since the crisis. As a result of the government rescues and consolidations of our largest financial institutions through failures and mergers during the crisis, we have a few even larger firms which are too big and too interconnected to fail and which may well also be too big to manage and too big to supervise or regulate.

The financial regulatory reforms contained in the Dodd-Frank Act[3] passed last year certainly are a step in the right direction in addressing this and other problems. However, the Act's provisions must be fully implemented by the adoption of regulations and must be fully enforced if the Act is to be effective.

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[3] Public Law 111-203, 124 Stat. 1376 (July 21, 2010).

There is now a concerted effort by some large financial institutions and their trade associations to prevent full implementation and enforcement. Alan Greenspan is warning about dire consequences of some provisions of the Act.[4] Bills are pending in Congress that would repeal or weaken the Act. Efforts to persuade agencies to issue watered down regulations or otherwise fail to fully implement provisions of the Act are underway. Moreover, Congressional threats to cut the funding of key regulators imperil regulatory reform. For example, the SEC and the CFTC, the agencies with responsibility to impose needed regulation on the over-the-counter derivatives market, are threatened with cuts that would significantly impair their operations.

The political power of the financial sector is still enormous, but our policy makers must have the political will to resist these efforts to derail regulatory reform. If they do not learn from the financial crisis and insist on regulatory reforms addressing its causes, we all will be doomed to repeated financial crises. The American people deserve better, and I urge readers to consider how they can contribute to the country's adoption of truly effective financial regulatory reform.

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[4] Alan Greenspan, *Dodd-Frank fails to meet test of our times*, FINANCIAL TIMES.COM (March 29, 2011, 06:31 PM) http://www.ft.com/cms/s/0/14662fd8-5a28-11e0-86d3-00144feab49a.html.