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Unfinished Business

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Unfinished Business: by Tamin Bayoumi (2017). Yale University Press. 286 pp. (Amazon $33.18 hardcover). ISBN: 978-0-300-22563-1

In the aftermath of the 2007-2008 financial crisis, scores of books presented thoughtful insights and compelling narratives explaining the crisis, the government response to the crisis, and unpleasant truths in the aftermath of the crisis. Despite similarities, it is the dissimilarities observed by authors writing from various vantage points that raise unsettling questions regarding what is known about human behavior, the effectiveness of institutions, and the prevailing integration of financial markets and the interconnectedness of the global economy. In *Unfinished Business*, Tamim Bayoumi deviates from the familiar emphasis on failed domestic policy and greed to offer an explanation that accounts for the global scope of the crisis. Even within the subset of explanations that acknowledge the international extent of the crisis, *Unfinished Business* is unique.

Hennessey, Holtz-Eakin and Thomas (2011) author one of two dissenting views included in *The Financial Crisis Inquiry Report* produced by the Financial Crisis Inquiry Commission. The authors argue that capital surpluses accumulated by developing countries during the 1990s suppressed interest rates in the U. S. They contend that lower interest rates encouraged demand for houses and investment in new housing construction resulting in a bubble. Conspicuously absent is any mention of monetary policy. During this time, in the aftermath of the collapse of the dot-com bubble in the late 1990s, the Federal Reserve maintained an accommodating monetary policy. This narrative evokes concerns expressed by the Noble Prize winning Austrian economist, F. A. Hayek, who warned that Central Bank intervention to promote economic expansion necessarily leads to *malinvestment* (Hayek, 1939/1975). In short, in creating a boom, the central bank plants the seeds of the inevitable bust. Interestingly, the Financial Crisis Inquiry

Commission (2011, p. xxvi) identifies low interest rates as a prerequisite rather than as a causal factor in the crisis.

In a review of *Reckless Endangerment* by Morgenson and Rosner (2011), John Tamney (2011) reports that nominal housing prices increased dramatically around the world, not only in the U. S. To explain the global phenomenon, he refers to periods when devaluation of currency instigated nominal price increases in commodities and housing. Tamney indicts the administration of George W. Bush for reversing the strong dollar policy of the Reagan administration. Both the dissent and Tamney present a singular cause for the financial crisis, which seems overly simplistic and disingenuous given the extraordinary complexity and interdependence of economies.

In *Unfinished Business*, Tamim Bayoumi provides a comprehensive accounting of the dynamic interplay between policy makers and market participants in the U. S. and Europe. He refers to the North Atlantic Crisis to acknowledge the interdependence of financial markets of advanced economies. A compelling attribute of this book is the presentation of the historical context for the series of events that culminate in a global crisis. Bayoumi asserts that the crisis was an inevitable outcome of "benign neglect" that undermined international policy cooperation and accommodated ill-fated policy decisions in the U. S. and Europe. At one level, *Unfinished Business* is a detailed accounting of painful consequences resulting from the uncoordinated efforts of well-intentioned idealists, which is ironic given the pervasive condemnation of greed inherent in capitalist economies that is nearly universally identified as a significant causal factor of the crisis. Alternatively, *Unfinished Business* reflects hubris, as "Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist" (Keynes, 1936/1964, p. 383).

"Benign neglect" is a generous euphemism to explain how and why the crisis surprised and overwhelmed financial markets and governments around the world. Nearly one century ago, Thorstein Veblen (1923/2009) observed that rules change but that industry advances beyond the rules. Veblen identified the *drift of habituation* to describe how laws and customs continually adapt to guarantee that laws and customs are outdated. Although Veblen wrote in regard to the heavy industries of his time (e.g. manufacturing, mining, and the railroads), his insights are transferable to the financial sector leading to the crisis. Heavily influenced by Darwin's (1859) *On the Origin of Species*, Veblen is identified as the founder of evolutionary economics. *Unfinished Business* seems to fit in that tradition.

To contextualize the nuance of the causality of the crisis, Bayoumi likens the incubation of the crisis to the events leading up to WWI. The metaphor illustrates the interconnectedness and unpredictability of events culminating in the unwanted and unexpected. Using the outbreak of devastating war as a metaphor to describe the conditions leading to crisis is not unique to *Unfinished Business*. In the Forward to William M. Isaac's (2010) *Senseless Panic*, the venerated former Federal Reserve Board Chairman, Paul Volker, submits a similar metaphor. Previewing the criticism that Isaacs presents in his book, Volker asserts that government officials failed to learn the lessons from the Savings & Loan crisis of the 1980s. Volker refers to the failure to the Treaty of Versailles as a contributing factor to the inevitability of WWII. While the two books reflect a shared appreciation of the complexity and nuance of the crisis, the commentaries quickly diverge.

Unfinished Business was published years after many books offering explaining the crisis. The subtitle, *The unexplored causes of the financial crisis and the lessons yet to be learned*, suggests that the author embarked on the project in response to the absence of a satisfying explanation. To address the deficiencies, *Unfinished Business* explores the underlying conditions that accommodated the behaviors typically identified as causes for the crisis. Bayoumi presents the sequence of regulatory changes and government policies that motivated market behaviors culminating in crisis.

In contrast to many of the books concerning the crisis, Bayoumi stresses the role of institutions rather than assign blame to individuals. While *Reckless Endangerment* by Morgenson and Rosner (2011) and *The Big Short* by Michael Lewis (2010), and *Homewreckers* by Aaron Glantz (2019) identify and condemn villains, Bayoumi contends that the system rather than specific individuals failed. Rather than denounce scoundrels or celebrate heroes, he refers to "sleep walkers" unaware of their movements and the consequences of their actions. Among the "sleepwalkers" are Francois Mitterand, Jacques Delors, Alan Greenspan, Christine Cummings, Christopher Cox, and William McDonough. Given how few names he includes in the book and the dearth of references to each name, often only a single mention, one wonders why he mentions anyone at all.

Evoking the imagery of "sleep walking" is an appealing deflection of individual responsibility. However, it is difficult to ignore that well-placed individuals contributed to the crisis while others exacerbated the crisis. William M. Isaac (2010) and Shelia Bair (2012) offer contrasting accounts of effectiveness of key institutions, notably the Federal Reserve and the FDIC, and Aaron Glantz (2018) provides extensive evidence contrasting the response of the U.S. government to the Great Depression and the Great Recession. In all these accounts, individuals are singled out. Similarly, Morgenson and Rosner (2011) weave a compelling narrative implicating many individuals in deception, malfeasance, and greed. In contrast, Bayoumi emphasizes a sequence of regulatory changes and market responses involving various institutions and individuals over an extended period to convey his allegation of system failure.

The North Atlantic Crisis was the outcome of a series of policy decisions and market responses transpiring over two decades. The Single European Act and Maastricht Treaty were intended to advance peace and prosperity, yet inadvertently established the context for the crisis. The Single European Act formally introduced the free flow of goods, labor, and capital within the European Community; however, banking remained fragmented by country.

Bayoumi's causal narrative essentially begins with the EC's response to the fragmentation of the banking sector. The Second Banking Directive (1989) established universal banking (no separation between commercial and investment banking) in the EC. Bayoumi notes that national regulators adapted quickly to ensure that banks were not disadvantaged. The regulatory race-to-the-bottom facilitated creation of mega banks in northern Europe. Twelve mega-banks located in the core of the European Union controlled nearly 25% of banking assets in the EC. The emergence of the northern European mega banks served as the driving force in the North Atlantic Crisis.

In 1996, the Basel Committee issued the Market Risk Amendment (RMA) to address difficulties created by the Second Banking Directive. Familiarly known as Basell II, the RMA afforded large banks to use internal risk models to calculate capital buffers for market risk. The adoption of the RMA reflected the growing belief that market discipline would contain risky behavior. Federal Reserve Chairman, Alan Greenspan, argued in favor of "counter party surveillance" believing that government intervention created moral hazard as financial institutions relying on government regulation abdicated risk assessment responsibility. In retrospect, it is clear, that allowing banks to use internal risk models resulted in the reduction of capital the committee was formed to avoid.

The banking sector in the U. S. was more fragmented than in Europe. Interstate and branch banking were not permitted in the U. S. prior to 1980. In addition, Regulation Q of the Federal Reserve Board Act (1933) limited the interest rate banks could pay on deposits and charge for loans. These interest rate caps were intended to curtail risky behavior however, "Reg. Q" motivated formation of "shadow banks." With the inflation of the 1970s, large depositors exited the insured banks in favor of uninsured shadow banks able to offer higher returns through the creation of money market accounts and repurchase agreements. In order to meet capital buffer regulations due to reduction of the deposit base, banks sold securitized debt composed of routine loans like mortgage loans to shadow banks. As Veblen noted one century prior, rules lagged practice. Shadow banks grew out of the dynamic market conditions created by and ultimately constrained by outdated regulation.

In 1980, the Depository Institutions Deregulation and Monetary Control Act (1980) removed the constraints. With the introduction of interstate and branch banking, formation of national banks began. As in Europe, the regulation intended to curtail risky behavior actually facilitated creation of institutions engaged in riskier behavior. Shadow banks were beyond the reach of government regulation and regulators argued that denying the shadow banks deposit insurance imposed greater incentives to monitor and to control risk. Indeed the regulatory environment continued to peel back depression era regulations. In 1987 and 1989, key provisions of the Glass-Steagal Act were repealed. By 1999, when President Clinton signed the Graham-Leach-Bliley Act to completely repeal Glass-Steagal, the legislation was largely ceremonial as the legislation was already gutted. National banks in the US now resembled the mega banks in Europe.

In contrast to the web of regulatory changes and market responses presented by Bayoumi, Morgenson and Rosner (2011) identify the Clinton Administration's National Homeownership Strategy (NHS), launched in 1995, as the catalyst of the explosion in subprime lending that fueled the financial crisis. Mortgage origination exploded as credit worthiness, income verification, and down payment norms were relaxed to promote homeownership. Originators of the loans did not hold the loans but rather bundled and sold the loans, initially, to government sponsored enterprises like Fannie Mae and Freddie Mac or, eventually, directly to the shadow banks. Largely because the originators did not plan to retain ownership of the loan, traditional lending criteria were ignored. The bundles of loans contained higher and higher proportions of loans that would not be repaid.

The familiar story emphases that demand for the securitized loans drove loan origination, which was only possible in light of the removal of lending standards. Bayoumi reveals that the U. S. repo market funded the acquisition of the securitized debt instruments. Quickly, the frenzy approached a collateral constraint in the repo market. In April 2003, the Securities Exchange Commission (SEC) widened the collateral that could be used in the repo market to include foreign paper such as sovereign bonds and highly rated non-governmental debt and securities associated with the US housing market. In July 2005, the Basel Committee loosened capital requirements for the repo market. With these changes, demand for securitized debt composed of real estate loans was assured.[1]

[1] In February 2000, in his testimony to the Securities Exchange Commission, Goldman Sachs CEO, Hank Paulson, urged the SEC to revise net capital rules to accommodate higher leverage ratios. In 2004, the Consolidated

The rapid expansion of mega banks in Europe and national banks in the US was possible due to razor thin capital requirements required by regulators. The single currency in Europe facilitated trade however; there was no mechanism in place to respond to crises. Each European country was responsible in the event of bank failure. In contrast, in the US the FDIC and the Federal Reserve represent backstops to bank failure. Isaac (2010) and Bair (2012) offer interesting opposing perspectives regarding the role of the FDIC during the crisis.

The title, *Unfinished Business,* refers to the ongoing need to establish coordinated international regulations in the financial sector. This is an unsatisfying conclusion given the inherent lag and failure of regulation in general. Moreover, the national focus by legislators and regulators will be influenced by a well-financed industry uninterested in global well-being but focused on profit and the resulting bonus. Regardless, *Unfinished Business* is well researched and entirely accessible to a general audience. The book is an outstanding resource for anyone interested in the conditions leading to the financial crisis.

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Supervision of Broker-Dealer Holding Companies legislation permitted *certain* broker-dealer to calculate net capital requirements relating to credit risk. Paulson would be confirmed as Secretary of Treasury in 2006 and oversee the bailouts of the surviving broker-dealers afforded permission to determine their net capital requirements (Lenzner, 2011). This is an instance when it might be appropriate to acknowledge how the role of an individual may bias the response of a governmental institution.

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