Instead of Real Financial Reform, Obama's Plan capitulates to Wall Street

By Prof Michael Hudson
Global Research, June 22, 2009
22 June 2009

Region: USA
Theme: Global Economy

The story is worse than just "Pres. Obama labored, and brought forth a mouse." He is morphing into Joe Lieberman in reaching across the aisle for Republican support – and no doubt future campaign contributions from the financial sector. There also is a touch of Boris Yeltsin in sponsoring a financial "reform" disturbingly similar to what advisor Larry Summers backed in Russia – relinquishing government power to a banking elite (the notorious "Seven Bankers" in post-Soviet Russia). The Financial Regulatory Reform proposal promotes Wall Street's "product," debt creation, at the expense of the economy at large, and lets financial chieftains continue to self-regulate the debt industry – and by the way, to keep all their gains from the past decade's worth of fraudulent lending, scot-free.

Confronting the wreckage of a debt crisis worse than any since the Great Depression, Mr. Obama has achieved what no Republican could have: rescuing the Bush Administration's pro-creditor policies that fostered the Bubble Economy in the first place. "Most of the financial sector lobby community is happy with what has emerged," the Financial Times summarized. A spokesman for the Financial Services Forum, a major Wall Street lobbying organization, called the proposals "careful and balanced." With such endorsements, victims of predatory lending have good reason to worry. The Obama plan is just the opposite from reforming the financial system along lines that progressive Democrats and other critics have urged.

The plan's six most fatal flaws are apparent in its preamble, which lays out a false diagnosis of the financial problem in a way that whitewashes Wall Street (in contrast to Mr. Obama's nice televised populist speech giving verbal criticism to "culture of irresponsibility"). A false diagnosis must lead to wrong-headed cures – rarely by accident. There invariably is a financial beneficiary who gains from blind spots in a legal "reform" package.

1. Regulatory capture. Preparing the ground for future Alan Greenspan "free market" ideologues

The most serious problem is "regulatory capture": control of the public regulatory process by the special interests being regulated. Mr. Obama's speech introducing his reform was forthright in acknowledging that "some companies shop for the regulator of their choice … That is why, as part of these reforms, we will dismantle the Office of Thrift Supervision [OTS] and close loopholes that have allowed important institutions to cherry-pick among banking rules. We will offer only one federal banking charter, regulated by a strengthened federal supervisor." It was the OTS, after all, that AIG and Washington Mutual chose as their regulator, as did GE Capital. The most incompetent, most ideologically opposed to serious regulation, its idea of a "free market" in practice was one free for fraud-ridden subprime lenders to do whatever they wanted.

One could go down the list of non-enforcement agencies – the Securities and Exchange Commission (SEC) not responding to warnings about Bernie Madoff, and the most deregulatory agency of them all: the Federal Reserve under Bubblemeister Alan Greenspan. Traditionally, the Fed has acted as lobby for the commercial banking system and indeed for Wall Street as a whole. (Its shares are owned by the commercial bank members of its system.) The Fed's refusal to intervene to stop the subprime mortgage bubble, fraudulent lending and other elements of the Greenspan Chairmanship does not give much faith that it will take actions that will interfere with Wall Street's money-making at the expense of the rest of the economy. Even today, the Fed is stonewalling Congress by refusing to release details on its $2 trillion "cash for trash" giveaway to favored Wall Street institutions.

It is supposed to be the Treasury's role to represent the public interest. Unfortunately, appointing Treasury Secretaries from the ranks of Wall Street management – or giving Wall Street veto power over the nominee – undermines this mission. Elsewhere in what is supposed to be the regulatory system of public-private checks and balances, the simple tactic of underfunding the criminal justice system, the FBI, state and local prosecutors – or actively blocking them, as George Bush did – leaves the economy without adequate protection against financial fraud and predatory credit. Putting the Congressional financial committee heads up for sale to the highest campaign contributors caps the process of transforming economic democracy into oligarchy.

Britain affords a horror story that serves as a case in point. The management guru John Kay wrote a column in the Financial Times this week tracing how bank lobbyists managed to de-tooth meaningful regulation. The moral is that "self-regulation" by finance has become a universal tendency these days, and is utterly ineffective – by design!

Meaningful regulation should start with the premise that the right of banks to create credit out of thin air (actually, out of strokes on a computer keyboard, as long as bankers can find borrowers to sign IOUs) is a public utility. Mr. Obama and his Treasury do not agree. They treat credit creation as a private Wall Street monopoly, to be regulated more in name than in practice. The result is a Thatcherite giveaway to the banking sector – and as Tim Geithner noted, Wall Street institutions of all stripes, from brokerage houses to automobile lenders and retail stores are now declaring themselves "banks" in order to get government handouts to anyone who is a credit (but nothing for their debtors). This is part of the New Class War that the Bush-Obama administration has sponsored to polarize the economy between creditors and debtors.

The politically astute way to deregulate a public utility – especially in the wake of a financial crisis that has much of the population up in arms – is to shed crocodile tears over Wall Street's "culture of irresponsibility," as Mr. Obama did on Wednesday, and then claim that you are "centralizing" regulation to make it stronger rather than weaker. If you are going to block future bank regulation, of course you promise that your act will provide greater public oversight. Mr. Obama has tapped the Federal Reserve for this role. But this is precisely what exacerbated the Greenspan Bubble.

The problem is what has now become a tradition throughout the world, not only in the United States itself. Presidents Bush Sr., Bill Clinton, George W. Bush and Mr. Obama all appointed deregulators drawn from the Wall Street's managerial ranks or those of its lobbyists. This is the path of least political resistance in blocking meaningful regulation. All that is needed is for "regulators" to do nothing, OTS, SEC or Fed style. It is the same with the Federal Drug Administration and other regulatory agencies whose officials come from the managerial ranks of the industries to be regulated. The Japanese have a long experience in such matters. The retirement of Bank of Japan heads is called "descent from heaven": They return to the banking sector to reap their just rewards, or at least to get a lifetime of exorbitantly paid dinner speeches.

The deregulation-by-centralization ploy peaked when Pres. George W. Bush used it to nullify attempts by state attorney generals to prosecute Countrywide Financial, Washington Mutual, Citibank and other financial crooks as criminal enterprises for making fraudulent subprime mortgage loans. The ruse Mr. Bush used to block their lawsuits was an obscure small-print rule from the 1864 National Bank Act giving Washington the power to overrule local states in bringing criminal charges. The motivation for this Civil War law was clear enough: Local governments and their courts tended to be venal and corrupt. Washington asserted its oversight so as to prosecute "wildcat banking" in an era when bankers issued their own bank notes, many of which were worth much less than their face value when their holders tried to spend them.

Pres. Bush turned this law on its head, blocking eleven state AGs from prosecuting financial fraud. Taking matters out of their hands, he assigned the complaints to the Washington national bank regulator – who refused to prosecute, claiming that fraud was all part of America's wonderful free market. This has cost the U.S. economy over a trillion dollars so far. Washington has preferred to let the banks make their fraudulent loans, and then pay them in full (along with the financial companies they've victimized, but not the personal debtors of course) for their bad loans that defaulted, so as to "save the system."

The moral is, let the fraudsters do what they want, let the appropriate congressional committee heads take enough campaign contributions from Wall Street to ensure their safe re-election, and end up using taxpayer-funded "cash for trash" swaps to make sure that crime (now rechristened as the "free market") pays. This is what happens when a criminalized class achieves "regulatory capture." And of course, nearly the same objective can be served by permitting financial affiliates to operate out of unregulated offshore tax-avoidance centers.

Mr. Obama's reform does not propose repealing or qualifying this clause of the National Bank Act so as to permit any prosecutor to prosecute (but not to allow prosecutions of financial fraud to be blocked). Placing regulatory power in the Fed has the potential to sterilize any serious fraud prosecution to make an industry behave whose slogan these days should be "Frauds 'R Us." This is the Robert Rubin and Larry Summers-style free market – free for criminalized finance to proceed unchecked. And if Mr. Summers is to become the next Fed Chairman … well, you can guess where this will lead on the regulation/deregulatory spectrum between creditors and debtors!

2. Failure to give meaningful teeth to fraud reduction

Sound regulations against fraud are on the books, many of them from the New Deal. But as the Bubble Economy saw levels of financial fraud unprecedented since the 1920s, officials who wanted to prevent abuses found their departments un-funded. Mr. Obama's proposal fails to address this problem. "There are … millions of Americans who signed contracts they did not always understand offered by lenders who did not always tell the truth," he acknowledged in introducing his plan on June 17. Soft language compared to that of New

York State Attorney General Eliot Spitzer in his heyday. Mr. Obama promised “enforcement will be the rule, not the exception.” But where is the funding for the FBI’s criminal fraud division? Where is effective consumer protection from insurance companies that don’t pay, from crooked contractors and mortgage companies using property appraisers, lawyers and collection agencies, or from stockbrokers packaging junk mortgages into junk securities? They’ve been given a fortune in recent years – and can keep it to set themselves up to make yet a new killing. It looks as if as little will be done to financial fraud as will be done to the Guantanamo torturers and the high-ups who condoned their actions.

Much attention has been given to the Consumer Financial Products Agency, whose role has been defined largely by Elizabeth Warren of the Harvard Law School. Its main aim is to enforce truth-in-lending laws on credit-card companies and mortgage lenders. (Weren’t these laws already on the books?) This is progress, but surely much more is needed. One way to make credit-card rates more economic would be for the government to provide its own rival service. After all, credit cards have become a major form of payment today. Isn’t electronic payment really a public utility? The difference is that unlike electric and gas utilities or railroads, there is no regulation to keep fees in line with economically necessary basic costs to the card issuer. It is fine to hear that one finally will be able to read clearly how much one is being exploited. But why not stop the exploitation in the first place?

Larry Kudlow said on MSNBC that he expected Congress to reject the “liberal” agency, but Republicans may simply try to make it only “advisory,” without real regulatory power. So even if Congress doesn’t kill the proposal, Mr. Obama doesn’t have to worry too much about offending his number-one donor constituency. Serious regulation over Wall Street will have about as much effect as the corporate “social responsibility” desk to which companies assign employees on their way out. At the Senate hearings on June 18, Sen. Robert Menendez of New Jersey asked Mr. Geithner “whether the council that would watch over the financial regulators has any power to do anything other than make recommendations. Mr. Geithner [said] they may not have gotten the balance exactly right, but he didn’t want the council to have the authority to unilaterally force changes on the regulators it oversees.”

Mr. Obama’s aim in introducing the consumer protection agency may have been to hold out hope among liberals that his plan was more than just a go-ahead for Wall Street to continue doing what it has been doing. In any case, it’s easy to de-tooth the proposals like this simply by turning implementation over to do-nothing administrators given the seal of approval by the Wall Street lobbyists who have veto power over all government regulatory positions.

To really protect consumers, why not counter extortionate credit-card practices by re-introducing anti-usury laws? They were evaded initially by companies incorporating themselves in states with “race to the bottom” laws. If Washington can override state prosecutors to prevent punishment of financial fraud, why can’t it override such ploys by the usury industry? Here’s where centralized federal law really should count for something.

3. Failure to reverse the shift to pro-creditor bankruptcy laws

The Obama plan aims at enabling Wall Street to keep on selling its product – debt, growing at exponential rates (“the magic of compound interest”) – as if finance were an “industry” like manufacturing. (In this spirit the Dow Jones Industrial Average now contains the leading financial-sector firms, although it dropped Citicorp when its shares dropped below the $1 cutoff point.) The reality is that tax favoritism for finance and debt leveraging is largely responsible for de-industrializing the economy. More and more income is being diverted away from buying goods and services in order to pay lenders on debts run up in the past. What is needed to free economies from such debt is to repeal the reversal of America's traditional bankruptcy law – the pro-creditor reversal that Congress passed in 2005 in response to lobbying by the credit card and banking industry. Making it harder for personal debtors to go bankrupt, this law blocked courts from rolling back debt to the population's ability to pay.

Obama's plan fails to rectify matters. It treats the financial "services" issue in isolation from the economy's debt problem and general economic welfare. FDIC head Sheila Bair has proposed limiting mortgage interest to 32% of the debtor's family income. The alternative is for home foreclosures to continue, expropriating many recent buyers and also owners who have borrowed against their homes to pay off their higher-interest credit-card debt or simply to keep up their living standards that their paychecks no longer cover.

Ever since colonial times, New York State has had the Fraudulent Conveyance Law on its books. This wise legislation states that if a bank makes a loan to a borrower without knowing how the debtor can reasonably meet the terms of the loans out of normal income, the loan is deemed fraudulent and therefore null and void.

4. Failure to re-introduce Glass Steagall or otherwise limit lenders "too big to fail"

In presenting his program, Mr. Obama misrepresented a major cause of the Bubble Economy. It all seemed to be caused by the impersonal force of technology. "A regulatory regime," he claimed, "basically crafted in the wake of a 20th century economic crisis – the Great Depression – was overwhelmed by the speed, scope, and sophistication of a 21st century global economy." Well, not exactly. The capstone of FDR's New Deal was the Glass-Steagall Act separating commercial banking from investment banking. This blocked the financial conflict of interest between serving retail bank customers and investment-bank profiteering.

One consequence of Glass-Steagall was to make the merger between Citibank and Travelers Insurance illegal. To save Citibank officials from suffering the consequences of breaking the law – and in the process, to open the doors to the conglomerate movement that brought down the economy – President Clinton took the advise of Messrs. Summers, Greenspan and their fellow free enterprise ideologues and signed into law the repeal of Glass-Steagall in 1999. Banks were permitted to buy insurance companies real estate and stock brokers and law firms to package junk mortgages into junked collateralized debt obligations (CDOs), insure them with junk-insurance policies written by A.I.G. and other companies taking fees for promising to pay money they did not have (they paid it out to themselves in exorbitant salaries and bonuses), and get bailed out with trillions of dollars of "taxpayer" money in the form of the Federal Reserve and Treasury's "cash for trash" swaps.

Mr. Obama earlier made a point of bringing in Paul Volcker as an economic advisor for his reforms, and indeed the former Fed Chairman (Mr. Greenspan's predecessor) gave some good advice: reverse the repeal of Glass-Steagall. Given Mr. Summers' current position as advisor to Mr. Obama, people asked who would win: the reasonable Mr. Volcker, or Mr. Summers, who had urged repeal of the act in the first place? It proved to be no contest. There is no thought of breaking up the seemingly obvious conflict of interest between commercial banking and investment bank "casino capitalist" functions.

5. Failure to deter credit default swaps and other “casino capitalist” gambles

On Mr. Summers’ watch under the Clintons, the word “reform” came to mean what it meant in Russia, where he had a free hand in the 1990s: a giveaway of public assets to financial insiders. In the United States this involved stripping away the true reforms put in place from the Progressive Era to the New Deal. Among the excuses being cited is the need to free “innovation.” But financial innovation is not like that of manufacturing. Instead of raising productivity to produce more with less labor (and hence at falling prices), financial innovation aims at extracting more from debtors and from money-management clients and funds. Under free competition, for example, modern electronic technology enables banks to clear checks in a single day. But “financial engineering” has gone hand in hand with political engineering, permitting the banking monopoly to adhere to old pony express schedules – and keeping depositors’ money as “float,” that is, as an interest-free loan.

The main achievement of financial engineering has been to create mathematically opaque derivatives. As no less a speculator than George Soros has noted: “Financial engineers claimed they were reducing risks through geographic diversification: in fact they were increasing them by creating an agency problem. The agents were more interested in maximising fee income than in protecting the interests of bondholders. … Custom-made derivatives only serve to improve the profit margin of the financial engineers designing them.” Mr. Obama acknowledged: “We’ve seen the development of financial instruments, like many derivatives, so complex as to defy efforts to assess their actual value.” But they simply will be “regulated” and standardized, not banned. Mr. Soros warned that this would not go far enough to cure this problem. The only cure is to ban credit default swaps outright. But they have become Wall Street’s leading profit center. Mr. Obama’s reform does not interfere with that cash cow.

As for the “technology” of credit evaluation, modern web searching should enable any creditor or hapless buyer of packaged bank mortgages to easily check the estimated price of any home or building on-line – or any credit reporting score on individuals, for that matter. Banks have no interest in doing this when it interferes with their fraudulent rip-offs. “We’ve seen a system that allowed lenders to profit by providing loans to borrowers who would never repay,” Mr. Obama explained, “because the lender offloaded the loan, and the consequences, to someone else.” Much of today’s institutionalized financial irresponsibility indeed stems from the fact that banks today are a different kind of institution from what they were throughout history until quite recently: banks which held the mortgages they originated. The idea of “offloading” their loans based on other peoples’ misplaced trust led them to give bonuses to officers based on their loan volume without any consideration for loan quality or reality. This was Mr. Greenspan’s free market at work. It used to be called fraud, and be prosecuted.

Mr. Obama proposes that originators keep a token 5 percent on their own books. Critics point out that this hardly will deter junk-mortgage practices, and suggest that the required proportion at least be doubled or raised even further, along with blocking off-balance-sheet vehicles, especially in tax-avoidance zero-oversight offshore banking centers. In view of the almost universal condemnation of this practice, Mr. Obama’s delicate steps suggest that the plan was formulated with a view of “How little do we have to yield to popular and Congressional anger at the trillions of bailout dollars we have given to financial crooks?”

This is not real reform. Pres. Obama was elected with a mandate for change. He could use his office as a bully pulpit to propose real reform, urging that recalcitrant politicians in the pockets of the financial lobby be removed from their positions on the grounds of conflict of interest, unethical behavior and outright bribery for being the largest recipients of campaign contributions from the sectors their congressional committees are charged with regulating. Alas, America's desire for change is far ahead of Mr. Obama's when it comes to defending the public interest against those of his leading campaign contributors.

6. Failure to reform the tax system that has distorted the financial system to promote predatory extractive debt, not productive industrial credit

The "product" that the banking "industry" sells is debt – loans which, under today's financial circumstances and tax favoritism for Wall Street, are extended in a way whose main effect is to inflate asset prices, not fund tangible capital formation. Rising prices for housing and commercial property, stocks and bonds, are taken as justification for yet more lending, backed by collateral being bid up in price. By loading the economy down with debt, this seeming "wealth creation" becomes a vicious circle increasing the economy's financial carrying charge.

Mr. Obama's "reform" plan is that it seeks to sustain this dynamic, not reverse it. The plan does not acknowledge the symbiotic relationship between fiscal and financial policy. Cutting property taxes leaves more real estate rent, monopoly rent and asset-price gains "free" to be pledged to the banks for yet larger loans – pledged to pay more interest on the rising debt taken on to buy assets being inflated by the credit bubble.

The resulting financial "enterprise" is different from industrial innovation. It consists largely of capturing congressional tax legislators so as to write small-print tax "loopholes" and more glaring tax breaks that shift the fiscal burden onto productive labor and industry. That is the essence of today's "pay to play" democracy. Financializing the economy in this way has gone hand in hand with de-industrialization.

The most regressive tax is FICA wage withholding for Social Security and Medicare. Only wages below about $102,000 are subject to this tax, not higher incomes. And Wall Street speculators only pay a low "capital gains" rate on their trading. By shifting the tax burden onto the "real" economy, this tax shift polarizes income and wealth at the top of the economic pyramid while increasing the cost of living (taxes are a cost, after all). This squeezes family budgets and shrinks spending on goods and services. And as a result of tax subsidy for debt leveraging, industrial cash flow is diverted to pay interest and dividends rather than being reinvested in new means of production and being liable for income taxes.

More bank lending – that is, more debt – is the heart of today's economic problem, not the solution. Finance capitalism is undercutting industrial capitalism, replacing the production of goods and services with predatory extraction of rent and interest via economic "tollbooths," from parking meters in Chicago to roads in New Jersey. States and localities are facing fiscal shortfalls obliging them to sell off their roads, parking meters and public enterprises to buyers on credit (making their income tax exempt) who erect expensive tollbooths and extract yet more income from the shrinking "real" economy, which is being Thatcherized.

As Leona Helmsley explained, "Only the little people pay taxes." Between debt and taxes, many people are so strapped that they must run even further into debt or suffer lower living standards. Borrowing more leads even more people into bankruptcy, subject to the 2005 law that Congress wrote to favor creditors. The economy is heading toward debt peonage as it polarizes between wealthy patrons and a work force reduced to patron-client dependency relationships.

Do we need a new beginning for meaningful financial restructuring?

Debt bubbles never survive for long. But their collapse can be the most dangerous stage of all. Mr. Obama is obliging debtors run down their lifetime savings in an attempt to carry their debt overhead. Meanwhile, investors at the top of the economic pyramid are foreclosing on the property of debtors, and "vulture funds" are looking to pick up assets on the cheap.

America's financial problem thus requires deeper solutions than have been discussed to date. Paul Krugman in his Friday column (June 19) complained about two obvious lacunae in the Obama plan. "To live up to its own analysis, the Obama administration needs to come down harder on the rating agencies and, even more important, get much more specific about reforming the way bankers are paid." The securities ratings agencies certainly have an inherent conflict of interest in being paid by their clients to give a review – which usually turns out to be rave AAA revues for junk securities. But beneath this problem lie much deeper ones, so it is understandable that when Mr. Geithner was asked about better regulation of the ratings agencies in his Senate testimony on Thursday, he said that this would have to wait for another day. As Mr. Obama explained: "we are proposing a set of reforms to require regulators to look not only at the safety and soundness of individual institutions, but also – for the first time – at the stability of the system as a whole."

But this is just what is not being done. The plan is silent when it comes to the reported 25% of U.S. real estate sunk into a state of negative equity and 1/8 already I arrears heading for foreclosure as the mortgage debt attached to it exceeds its (falling) market price. Commercial real estate looks like the next big sector to topple. Debt service meanwhile is crowding out consumer spending on goods and services, shrinking the domestic market and aggravating unemployment.

The economy needs an FDR but has got the opposite. Mr. Obama promised change, but is defending the status quo as far as financial and debt trends are concerned. In due course he will discover that past trends cannot long persist, requiring the status quo to be replaced. For the time being it looks like he is simply trying to prevent losses for Wall Street by un-taxing finance and sacrificing debtor interests – the majority of Americans – to creditor interests at the top of the economic pyramid, not renewing the economy by de-leveraging. Will his historical role be to have made a failed attempt to sustain growth in America's debt overhead? Eroding Progressive Era checks on financial dynamics has been the political and economic trend for the past thirty years. It is advisor Summers' idea of "reform." When he and his neoliberal cohorts had a free hand in Russia in the mid-1990s, the result was to endow a kleptocracy imposing poverty on the population at large, stripping away industrial capital even while making Russia the world's hottest stock market for awhile. America seems to be getting a Yeltsin, not a Roosevelt.

The trends we are seeing today do not constitute industrial capitalism as classically understood. Under the euphemism of creating a "post-industrial society," the economy is being de-industrialized, as if that were a way forward rather than a lapse back into a pre-industrial extractive economy. Mr. Obama's financial "reform" aims at sustaining casino capitalism by rolling back a century's worth of progressive tax and financial legislation. After his speech the DJIA rose on Thursday, mainly because most "industrials" are now financial companies, reflecting the degree to which financial engineering has replaced industrial engineering.

Banks have not done well with their credit-creating privilege. Instead of funding tangible capital investment to raise living standards, the financial system has focused on lending against property already in place (mainly land, followed by buildings, monopoly rights, and personal income). The effect is to inflate asset prices while deflating the market for goods and services, by diverting spending away from the purchase of commodities to pay debt service.

The plan has no real teeth to shape the financial environment in the happy-face way that Mr. Obama and Mr. Geithner promise. It is like the proverbial software demo version, better on paper than what turns out to be the reality. The disconnect is not accidental. Its rhetoric follows the strategy of a stage magician whose patter talk serves to divert attention away from what his hands actually are doing. Like B'rer Rabbit in the Uncle Remus story telling his captor, B'rer Fox, "Please don't throw me in the briar patch," the banks will complain about the Obama plan (really the Paulson Plan) to centralize financial regulation in a strengthened Federal Reserve. But of course that's just where they want to end up, under a compliant Chairman (Mr. Summers himself?) appointed with Wall Street's advice and consent. "Born and bred in the briar patch," crowed B'rer Rabbit triumphantly after being thrown there. Saved from future Eliot Spitzers!