

Six Banks Control 60% of Gross National Product

Is the U.S. at the Mercy of an Unstoppable Oligarchy?

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BILL MOYERS: Welcome to the JOURNAL. With all due respect, we can only wish those tea party activists who gathered this week were not so single-minded about just who's responsible for their troubles, real and imagined. They're up in arms, so to speak, against big government, especially the Obama administration.

But if they thought this through, they'd be joining forces with other grassroots Americans who will soon be demonstrating in Washington and elsewhere against high finance, taking on Wall Street and the country's biggest banks.

The original Tea Party, remember, wasn't directed just against the British redcoats. Colonial patriots also took aim at the East India Company. That was the joint-stock enterprise originally chartered by the first Queen Elizabeth. Over the years, the government granted them special rights and privileges, which the owners turned into a monopoly over trade, including tea.

It may seem a stretch from tea to credit default swaps, but the principle is the same: when enormous private wealth goes unchecked, regular folks get hurt - badly. That's what happened in 2008 when the monied interests led us up the garden path to the great collapse.

Suppose the Tea Party folk had dropped by those Senate hearings this week looking into the failure of Washington Mutual. That's the bank that went belly up during the meltdown in September 2008. It was the largest such failure in American history.

WaMu, as we were reminded this week, made sub-prime loans that its executives knew were rotten, then packaged them as mortgage securities, and pawned them off on unsuspecting investors.

SEN. CARL LEVIN: And that was your responsibility to make sure that the securities which went out to the investors were following notice to the investors of everything that they needed to know in order that the information be complete and truthful. That's what your testimony was, under oath.

DAVID BECK: It's a very real possibility that the loans that went out were better quality than Mr. Shaw laid out.

SEN. CARL LEVIN: And you don't -

DAVID BECK: A very real possibility.

SEN. CARL LEVIN: And there's a very good possibility that they were exactly the quality that he laid out, right? Is that right?

DAVID BECK: That's right.

SEN. CARL LEVIN: Okay. And you don't know, and apparently you don't care. And the trouble is, you should have cared.

BILL MOYERS: Then there's Lehman Brothers. During those black September days a year and a half ago, the Feds decided to let Lehman go. This led to America's biggest bankruptcy ever. In an admirable work of journalism this week, the New York Times reported that Lehman secretly controlled a company called Hudson Castle and used it to borrow money as well as to hide bad investments in commercial real estate and sub-prime mortgages.

But the week's award for sheer gall goes to a Chicago-area hedge fund called Magnetar, named after a kind of neutron star that spews deadly radiation across the galaxies. Thanks to the teamwork of the investigative reporting website "ProPublica," NPR's "Planet Money" project and "This American Life," we learned Magnetar worked with investment banks to create toxic CDO's - collateralized debt obligations - securities backed by sub-prime mortgages the management knew were bad. And then Magnetar took that knowledge and bet against the very same investments they had recommended to buyers. Selling short and making a fortune.

And late this week the Securities and Exchange Commission charged the godfather of Wall Street, Goldman Sachs, with fraud in earning a fifteen million dollar fee involving those complex CDO's, a hedge fund, and the housing market.

But, since we know all this, why is it so hard to hold Wall Street accountable? Even as we speak the banking industry and corporate America are fighting against financial reform with all the money and influence at their disposal. Their effort is to preserve a system that would enable them to ransack the country once again.

So even if the Tea Party folks saw the light, what can ordinary Americans do?

That's the question I want to put to my guests, Simon Johnson and James Kwak. They have written this new book, *13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN*. It's a must read - already a best seller - and it couldn't have come at a better time. This book could change the debate over financial reform by tipping it in favor of the public.

Simon Johnson is a former chief economist at the International Monetary Fund. He now teaches at MIT's Sloan School of Management and is a Senior Fellow at the Peterson Institute for International Economics.

James Kwak is studying law at Yale Law School - a career he decided to pursue after working as a management consultant at McKinsey & Company and co-founding the successful software company, Guidewire. Together James Kwak and Simon Johnson run the indispensable economic website BaselineScenario.com

Welcome to you both.

Let me get to the blunt conclusion you reach in your book. You say that two years after the devastating financial crisis of '08 our country is still at the mercy of an oligarchy that is bigger, more profitable, and more resistant to regulation than ever. Correct?

SIMON JOHNSON: Absolutely correct, Bill. The big banks became stronger as a result of the bailout. That may seem extraordinary, but it's really true. They're turning that increased economic clout into more political power. And they're using that political power to go out and take the same sort of risks that got us into disaster in September 2008.

BILL MOYERS: And your definition of oligarchy is?

SIMON JOHNSON: Oligarchy is just- it's a very simple, straightforward idea from Aristotle. It's political power based on economic power. And it's the rise of the banks in economic terms, which we document at length, that it'd turn into political power. And they then feed that back into more deregulation, more opportunities to go out and take reckless risks and- and capture huge amounts of money.

BILL MOYERS: And you say that these this oligarchy consists of six megabanks. What are the six banks?

JAMES KWAK: They are Goldman Sachs, Morgan Stanley, JPMorgan Chase, Citigroup, Bank of America, and Wells Fargo.

BILL MOYERS: And you write that they control 60 percent of our gross national product?

JAMES KWAK: They have assets equivalent to 60 percent of our gross national product. And to put this in perspective, in the mid-1990s, these six banks or their predecessors, since there have been a lot of mergers, had less than 20 percent. Their assets were less than 20 percent of the gross national product.

BILL MOYERS: And what's the threat from an oligarchy of this size and scale?

SIMON JOHNSON: They can distort the system, Bill. They can change the rules of the game to favor themselves. And unfortunately, the way it works in modern finance is when the rules favor you, you go out and you take a lot of risk. And you blow up from time to time, because it's not your problem. When it blows up, it's the taxpayer and it's the government that has to sort it out.

BILL MOYERS: So, you're not kidding when you say it's an oligarchy?

JAMES KWAK: Exactly. I think that in particular, we can see how the oligarchy has actually become more powerful in the last since the financial crisis. If we look at the way they've behaved in Washington. For example, they've been spending more than \$1 million per day lobbying Congress and fighting financial reform. I think that's for some time, the financial sector got its way in Washington through the power of ideology, through the power of persuasion. And in the last year and a half, we've seen the gloves come off. They are fighting as hard as they can to stop reform.

SIMON JOHNSON: I know people react a little negatively when you use this term for the United States. But it means political power derived from economic power. That's what we're looking at here. It's disproportionate, it's unfair, it is very unproductive, by the way. Undermines business in this society. And it's an oligarchy like we see in other countries.

BILL MOYERS: And you say they continue to hold the global economy hostage?

JAMES KWAK: Exactly. Because what's happened- what we learned in 2008 were certain institutions are so big and so interconnected that if they were to fail, they would cause systemic shocks throughout the economy. That's essentially what happened in September 2008 when Lehman Brothers collapsed. And what's remarkable, and I think what essentially proves the point of our book is that almost two years later, nothing has changed.

Or the only thing that has changed is that these banks have gotten larger, more powerful, both economically and politically. And they've been flexing their muscles in Washington for the last year and a half. So Neal Wolin, the Deputy Treasury Secretary gave a blistering speech to the U.S. Chamber of Commerce in which he said, look, the financial sector has been spending more than one million dollars per day lobbying against the reforms we need to fix the financial system. Now, Simon and I think those reforms that the Administration has proposed do not go far enough. But we think they're certainly better than nothing. What Wall Street wants is they want nothing. They want to stop this in its tracks and go back to where we were five years ago.

SIMON JOHNSON: It's amazing, Bill. But this is this is politics and this is money. And you know, there's a ground game, which is campaign contributions, which are surging in. I'm sure on both sides of the aisle. And there's also the ideological space. It's amazing. The Chamber of Commerce that claims to represent the broad cross section of American business is siding with six big banks, who favor policies that are directly contrary to the interests of most of the membership of the Chamber of Commerce. And that's just not just me saying that. That's Neal Wolin. That's Treasury. That's the White House saying that now. Calling fortunately, they've come to the point where they're willing to call the Chamber of Commerce on that. But I don't know if that message is getting through to people.

JAMES KWAK: You see what the bankers have done is they have taken a basic principle which is more or less true. Which is that free financial markets do enable money to go to the places where people need it. But on top of that, they've erected a system that is indescribably complex. And gives many opportunities to make money at the expense of their customers, at the expense of their counterparties. Even at the expense of their own employers. So, one of the things that has happened has been that Wall Street finance has become so complex and the internal systems of Wall Street banks has become so complex that if you are a smart banker, who is out to maximize your own income, you can find the loopholes in the system and you can exploit them, even if it means taking money from your own- from your own company

BILL MOYERS: You've been writing this week on your website- about this hedge fund in Chicago that's made a lot of money. In effect, betting against the American Dream. What was that?

JAMES KWAK: Magnetar is a hedge fund which means that other people gave them money to invest. And their job is to make as much money as possible. And these were the smart guys in the room. They saw that the system was broken. And they found a specific way to exploit it. And they knew that they could go for example, they could go to Wall Street banks and the banks would collaborate in making these extremely toxic securities. Because they knew what the bankers incentives were. They knew that the banker's incentives were to do the deal, to do the transaction, to get the fees up front. And they knew that there was nobody watching out for the investors. There was nobody watching out to make sure that securities

they manufactured were actually good securities. But essentially what they were doing is they wanted to short the housing market. And they shorted the market in such a way that they actually made the problem worse, because what they did is they encouraged they tried to create these very toxic securities explicitly so that they could then short those securities. And that's why in a sense, they were they were shorting the American Dream. But what the real story of Magnetar, I think, is that they were exploiting a system that was deeply broken.

So, we like to think that the financial system we have in Wall Street are set up so that as people try to make lots of money they are they are indirectly helping the economy by making sure their capital goes where it's needed most. What the Magnetar story shows us that this is a casino, where you can make money you can make money exploiting the weaknesses in the casino. And it has nothing to do with the American Dream. It has nothing to do with making sure that capital goes to the places where it's needed most. I have to say that we owe a great debt to ["ProPublica"](#) and ["Planet Money"](#) and ["This American Life"](#) for uncovering this story

BILL MOYERS: Public radio's excellent program, "This American Life", did a terrific broadcast on this subject, based upon the ProPublica investigation that you talked about. And there's a song in it that I have to play for the two of you and for my audience. Take a listen.

UNIDENTIFIED MAN: Step one. You write a check for 10 million dollars. Hand the check to a Wall Street bank, and ask them to make us a CDO. Step two: they create the CDO, using risky stuff, very risky stuff, extremely risky stuff. Step three: other investors commit hundreds of millions of dollars to the CDO. Step four: we bet against the CDO, using a credit default swap. Step five: the housing market crashes. The CDO's value goes to zero, our bet pays off and we make hundreds of millions of dollars and before you can say step six, we're rich! We're going to bet against the American Dream, we're going to be on the winning team, purchase risky debt on a massive scale. Then place a bet that the debt will fail. Hundreds of millions for Magnetar, the economy collapsing like a dying star. No one will know till it's on NPR, and who cares? It's time to hit the town, this sucker could go down. The housing market's losing steam. And all we got to do to make our dreams come true is bet against the American Dream!

BILL MOYERS: You're smiling, James, but is it really that funny?

JAMES KWAK: Well for decades, we've been told that Wall Street and financial innovation were promoting the American Dream. And what they've I think what the show and the song have really hit the hit the nail on is that in fact, you can make even more money betting against the American Dream. And that's the kind of system we have today.

SIMON JOHNSON: My bumper sticker from this and I hope it does become a bumper sticker is, "Trust me, I'm a banker."

I mean, you need to break through there's a level of progress here, Bill. Which is when people can laugh about it. When people can break it down into pieces. When you've got the 60-second version. And you can hammer that. And people understand it. Then you're starting to fight back. This is about ideology. This is about belief. This is about these guys are smart. These guys are well paid. So they must know what they're doing. And that's wrong.

BILL MOYERS: You wrote on your website this week about how JPMorgan Chase lost \$880

million on one of these kind of whacky obscure deals? But the executives still paid themselves millions of dollars in up front fees. And you conclude that bankers placed a ticking bomb on their own bank balance sheet. It exploded and personally they still made money.

JAMES KWAK: Exactly. Because this is an example so, this is from the “ProPublica” investigation of Magnetar. essentially the bankers at JPMorgan Chase involved in the transaction created a new CDO. A new collateralized debt obligation. Which was very, very toxic. And either they knew at the time that it was toxic, or they should have known, I have no way of knowing. JPMorgan decided to hold onto most of this toxic product they- they had built. A billion dollars worth of toxic product. And then when the market collapsed, it turned out they lost \$880 million on that position.

So, if we think about it, there are really two possibilities here. The bankers involved in the transaction either really thought that this was a good product and a good investment, in which case they’re incompetent. Or they had- they may have doubts, they may have thought it was toxic, but they knew that the way the internal systems at JPMorgan Chase worked, they could get the fees front, they could get bonuses based on those fees, and leave the bomb for later.

BILL MOYERS: Somebody wrote on your blog this week, “If I were to buy an old house. Make some cosmetic improvements that mask an underlying rot. Got my insurance company to write an exorbitant homeowners policy exceeding any leans against the property. Then burned it down, wouldn’t that be fraud?” Did you answer this guy?

JAMES KWAK: I haven’t. That would

BILL MOYERS: Would you?

JAMES KWAK: That would be fraud.

BILL MOYERS: That would be fraud. So, explain to me how you manage to lose \$880 million on your own company’s money to make a quick buck for yourself and you get away with it?

JAMES KWAK: Well, I think that there are laws in this area. So, for any securities, there has to be- for this type of security, there has to be a document which explains those securities. And that’s a document that you give to the investors who might buy them. And there are laws governing those. And if you put in facts in there that that are materially false. That you know to be true, that is fraud. But I think the problem is that in many of these cases, I don’t think that many of these people are criminals. I get a lot of criticism for saying that I don’t think these people are criminals. But I think it’s relatively easy to write these documents in such a way that you’re not saying anything you know to be false. And so, they pass through, they pass through any kind of you avoid any possible criminal liabilities there. But yet, they can be misleading in a way that encourages people to buy them.

SIMON JOHNSON: I think it’s actually worse in some instance, Bill. Certainly for offshore activities. Goldman Sachs was involved in hiding a lot of Greek government debt. They then sold new Greek government obligations to people in the United States as far as far as we understand it. And didn’t reveal that they’d hidden the levels of the true levels of government debt. Now, that is withholding material information. That’s a violation of rule 10B-5. and where is the legal process, you should ask, that holds them accountable for that?

I've talked to lots of very good lawyers about this. And there are many complicated stories about why Goldman Sachs won't face any civil action or criminal action. There are huge loopholes in our legal system with regard to financial services that need to be closed.

BILL MOYERS: There were some interesting hearings, as I know you saw, before the Financial Crisis Inquiry Commission. And some of the first, some of the most interesting testimony came from the former honchos at Citigroup. Mr. Prince and Mr. Rubin. Take a look.

CHARLES PRINCE: Let me start by saying I'm sorry. I'm sorry that our management team, starting with me, like so many others, could not see the unprecedented market collapse that lay before us.

ROBERT RUBIN: My role at Citi, defined at the outset, was to engage with clients across the bank's businesses, here and abroad. Having spent my career in positions with significant operational responsibility at Treasury and, prior to that, at Goldman Sachs, I no longer wanted such a role at this stage of my life, and my agreement with Citi provided that I would have no management of personnel or operations.

ROBERT RUBIN: But almost all of us, including me, who were involved in the financial system, missed the powerful combination of factors that led to this crisis and the serious possibility of a massive crisis. We all bear responsibility for not recognizing this, and I deeply regret that.

PHIL ANGELIDES: The two of you, in charge of this organization did not seem to have a grip on what was happening. I don't know that you can have it two ways. You were either were pulling the levers or asleep at the switch.

BILL MOYERS: How can it be that a Robert Rubin, former Secretary of the Treasury, pulls down \$100 million as a senior advisor to Citigroup and claims he doesn't know the risk that was involved in what he was trying to sell to clients and foreign officials? How can that be?

JAMES KWAK: I think there are two things. There's a narrow and a broad view of this. The narrow view is I think Rubin is actually not lying. I think it is true that Rubin did not know what the risks were. Although he certainly should have known what the risks were. And that's because he was fully subscribed to this ideology that free markets are good. That the market will take care of itself. That, he also suffered from a lot of the blindness that corporate officers and directors have. Corporate officers and directors manage these enormous organizations with tens of hundreds of thousands of people. They have very little idea what's going on. They're getting their information from subordinates, who are giving them a filtered view of the world. On the other hand, when he says, no one could have foreseen this. This is what I call an intellectual cover up. And I say that because it's very disingenuous. Over the past 20 years, these banks used their economic power and their political power to engineer an unregulated financial environment in which precisely this sort of thing could happen. And in that sense, I think that this was not an accident. It was not a natural disaster. It was not unforeseeable. It was the product of the efforts by the sector over the past 20 years to reshape Washington and to engineer an environment that would allow them to make as much money as possible. Simon talked earlier about money. And we know that the financial sector, especially Wall Street, has been, has made enormous contributions to both campaign contributions and lobbying expenses. But I think there were,

there were two more potent weapons in their arsenal. One is the revolving door. So, we've seen an enormous number of people passing back and forth between Washington and Wall Street over the past 20 years. This is not a new phenomenon. It happens in every industry. But there are certain things that make it especially pernicious when it comes to finance. One is that, one is a question of incentives. So, compared to other industries, Wall Street can simply offer enormous amounts of money. I'm not saying that everyone did that. I'm not saying that even the majority of people did that. But that is, that is very clear.

BILL MOYERS: The New York Times has a story this week saying that 125 former members of Congress and staffers are now working for the financial industry in Washington. One of them is Michael Oxley, whose name is on one of the most important pieces of business legislation in the last 20 years. The Sarbanes-Oxley bill, which was designed to impose some very strict accounting rules after Enron on all of this. And there he is now, he's a lobbyist for the securities industry.

SIMON JOHNSON: But Bill, it goes even further and deeper than that. Robert Rubin was Secretary of the Treasury in the 1990s. He oversaw the deregulation. He fought hard against Brooksley Born, the only regulator in living memory who tried to prevent derivatives from getting out of control. He then went to Citigroup. He presided over this nonsense and this mess. He's now and he was he's clearly *éminence grise* of this administration. Mr. Geithner and Mr. Summers are his protégés. But that's, that's not all. Next week, the Hamilton Project, a project of the Brookings Institution founded by Mr. Rubin, will have a big public event. Probably Mr. Rubin's most prominent Washington appearance since the crisis broke. The headline act at this event will be Vice President Joe Biden. Now, maybe Mr. Biden will be taking on the view of finance that we all should fear greatly. But I'm not so optimistic.

BILL MOYERS: You know, I don't get it. Recently when "Newsweek" wanted to give big space to somebody to explain how we get out of this, who wrote the piece? Robert Rubin. I mean, are they locked into this worldview so that they cannot see the consequences of their own actions?

JAMES KWAK: Well, I think there are a couple things going on. One of the things we talk about in the book is how the Democratic Party became taken over by this Wall Street friendly view in the 1990s, which is, you know, extremely important, because in the 1980s, we had a deregulatory administration that was largely opposed by a Democratic Congress. And it became very convenient for Democrats, because if you believed in the ideology of finance, you could sincerely think, I am a Democrat, I am a servant of the poor and the working class. And yet, I can take campaign contributions from Wall Street, because I sincerely believe that Wall Street is doing what's best, what's in the interest of the country.

I think it's been exposed in the last year and a half that a lot of what Wall Street did was not in the best interest of the country, not in the interest of the people getting these subprime loans, not in the interest of the taxpayer who was paying for the immense fiscal costs of the financial crisis and the recession. But it's, there's a curious time lag going on in the, in the Wall Street, intellectual and political establishment, where they think they're still in 2005.

SIMON JOHNSON: As I travel around the country, Bill, I'm really struck by the fact that while people in Washington talk about populist anger in the country, most of what I encounter is legitimate, sensible anger. People actually understand what happened. They understand what went wrong. And they want to stop it. And the banks don't get this. The belief system on Wall Street is the same. Jamie Dimon, head of JPMorgan Chase, one of the most powerful

men in the country. If you don't know his name, you should look him up because this is a man to fear.

BILL MOYERS: Very close to the President. Has dinner- lunch with the President.

SIMON JOHNSON: The President called him a savvy businessman, recently. Jamie Dimon told his shareholders, we just had probably our best year ever. They didn't have their best year ever. They went through crisis. They were saved like the rest of the financial system by the government, by the taxpayers, but that's not how they see it. That's not what they believe. That's really important. That belief must be shaken if we're to make any progress at all.

BILL MOYERS: But we can't compete with those lobbying dollars. We can't compete with this interlocking oligarchy that you say. That's a fact.

SIMON JOHNSON: Bill, in 1902, when Theodore Roosevelt took on the industrial trusts, nobody knew what he was doing. Nobody thought he could win. The Senate was called the Millionaires Club for a reason. And it wasn't even any theory. The antitrust theory, everything we know and believe about monopoly, why monopoly is bad for society, didn't really exist, certainly not in the mainstream consensus, when Roosevelt decided to take on J.P. Morgan, okay?

Ten years later, the mainstream consensus has shifted completely. People understood from the debate and from the struggle, from the fact- from the way the trusts fought back and the way they spent their money, they began to understand this was profoundly dangerous, politically and socially. 1912, everyone agreed that breaking up Standard Oil was a good idea. Had to be done. They broke into 35 companies, most of them did well. The shareholders actually made money. It's a very American resolution, Bill. And it's very clear that we've had this confrontation before in American history: Andrew Jackson against the Second Bank of the United States in the 1830s, Jackson won, barely; Theodore Roosevelt, the beginning of the 20th Century; FDR in the 1930s.

The American democracy was not given to us on a platter. It is not ours for all time, irrespective of our efforts. Either people organize and they find political leadership to take this on, or we are going to be in big trouble, okay? Now, I agree, we don't have Theodore Roosevelt. I agree. The only Senator who speaks complete truth and clarity on this issue is Ted Kaufman from Delaware, who's an appointed Senator, he got- he was appointed to Joe Biden's seat, and he's not running for reelection. He therefore doesn't care about the money. I take that point. But there are others. There must be others. We must find them and we must fund them, individually, sufficiently, to fight against this nonsense from the corporate sector.

I would like to emphasize, Bill, I'm a professional entrepreneurship, James is a successful entrepreneur. We're not anti-finance. We have many people endorsing the book, backing us, and you know, they, we put their blurbs in the book for a reason, who are from finance. Who really appreciate and understand this key point. Which is the complexity has gone too far. It's become dangerous. And we need to return our financial system to a simpler, more direct, easier to manage way.

BILL MOYERS: You both paid attention last week, to the hearings in Washington, on the Financial Crisis Inquiry Commission. Was there a theme that you heard emerge there?

JAMES KWAK: I think the biggest theme that I heard emerge was that this was an innocent mistake. So, what I mean by that is-

BILL MOYERS: You mean the collapse of 2008? All of this? What- was-

JAMES KWAK: Exactly.

BILL MOYERS: An accident?

JAMES KWAK: Yes, an accident in the sense that-

BILL MOYERS: Natural disaster?

JAMES KWAK: As we heard Chuck Prince say and Robert Rubin say, we couldn't see it coming. These were, there were risks that build up in the system, and our models didn't account for it. We're sorry that it happened. Not even, we're sorry that we did it. We're sorry that it happened.

And I think that this is, I mean, it's unfortunate if they really believe this. Because again, if we just take a very small example, one of the things that clearly went wrong is these banks were not able to manage their own risk. They did not know what positions they had. They did not know what market forces they were exposed to. You would think that should be the first job of a bank. And I don't think this was an innocent mistake. And I say that for this reason. It was in the bank's short term financial interest to underestimate their risk. Because if they had estimated their risk accurately, they should have had to set more capital aside, they would have been less profitable.

So, yes, it's possible that the CEOs of these banks honestly did not understand their risk positions. But that mistake- there was an incentive behind that mistake. You know, banks never overestimate their risk. These mistakes always only go in one direction. Because that's the direction they have an incentive to make the mistake in.

BILL MOYERS: What do you mean they have an incentive to make a mistake?

JAMES KWAK: So, in the short term, a bank's profitability is going to depend on how much capital it has to set aside. So, in banking, if I have a certain position, I have to set aside a certain amount of capital to protect myself from that position going bad. If I think the position is less risky than it actually is, I'm going to set aside less capital to cover that position, and that's going to give me a higher profit margin.

If I'm the head of this bank, that means that in the short term, I'm going to have higher profits, higher stock price, more money for me, but I'm underestimating the risk of something blowing up several years down the line. But we know that the, essentially, the incentive systems within these banks favor short term profits over long term solvency.

SIMON JOHNSON: The most profound thing, observation, on this structure, inadvertent, I would say, observation, was by Chuck Prince, the former head of Citigroup. In July 2007, right before the whole structure began to crumble. He said, "As long as the music is playing, you've got to get up and dance." And that's a statement about the incentive structure. Saying, well, everybody's doing it. That's how we all make money. We've got to do it, too. I'm just a bank doing what all the other banks are doing. That's absolutely the heart of the problem. I would also say and tell you, and emphasize, these people will not come out and

debate with us. The heads of these companies or their representatives, they will not come out. They're afraid. They don't have the substance. They don't have the arguments. We have the evidence. They have the lobbyists. And that's all they have.

BILL MOYERS: They've got the power, the muscle, the money.

SIMON JOHNSON: They have money.

BILL MOYERS: You just have the arguments. You just have the facts. On your side.

SIMON JOHNSON: Absolutely. That's exactly what it comes down to.

BILL MOYERS: Let me show you one of my favorite moments of the week. The commission on the crisis is looking into two former executives of the big mortgage giants, Fannie Mae and Freddie Mac. And the Fannie Mae guy tries to say, what happened was Congress made us do it.

BILL THOMAS: Was there an opportunity, perhaps, to reprioritize your charter and focus on those things that were most relevant in the marketplace that would have made the institution more sound?

ROBERT J. LEVIN: That wasn't done at my pay grade.

BILL THOMAS: My understanding is, between 2000 and 2008, you made \$45 million. So only people above 45 thousand- 45, excuse me, million dollars, between two and 2008, could answer that question?

ROBERT J. LEVIN: What I meant by the, what I was addressing was the question of, could we have affected the charter act-

BILL THOMAS: Right. And it was above-

ROBERT J. LEVIN: Of the company-

BILL THOMAS: Your pay grade.

ROBERT J. LEVIN: Yes. And my language was sloppy, and-

BILL THOMAS: No, it wasn't sloppy.

ROBERT J. LEVIN: And what I meant by that-

BILL THOMAS: It was flippant, if you want that as a choice.

ROBERT J. LEVIN: What I meant by that, sir, was that that was in the purview of the Congress, not the company.

BILL MOYERS: You're laughing.

SIMON JOHNSON: So, look, what I say to my, to all my Republican friends: on Fannie Mae and Freddie Mac, you were right. They became too big to fail. They captured Congress. They were known as some of the most formidable financial lobbyists in the 1990s. They argued for the rights to take on these kinds of risks, okay?

And the Republicans were right. The Republicans called them on this. But now it's the big private banks that have the same incentive structure. That have bulked themselves up so big that you can't let them fail. That's what we saw in September 2008. Hank Paulson looked at his options. And they are all pretty awful. And I'm not a big fan of Hank Paulson, but I think the moment where he looked at it, he was right. That if you let JPMorgan Chase or Goldman Sachs fail, the consequences would have been devastating, because they're so big. It's a Fannie Mae and Freddie Mac structure come to Wall Street, come to the top guys on Wall Street. And our Republican colleagues and friends should recognize this, they should acknowledge it. And then we can all fix this together.

BILL MOYERS: Well then why is Mitch McConnell, the Senator from Kentucky, who is the Republican Leader in the Senate saying what he said this week? Let me show you from his statement.

SEN. MITCH MCCONNELL: If there's one thing Americans agree on when it comes to financial reform, it's that it's absolutely certain they agree on this: never again, never again should taxpayers be expected to bail out Wall Street from its own mistakes [...] This bill not only allows for taxpayer-funded bailouts of Wall Street banks, it institutionalizes them. The way to solve the problem is to let the people who made the mistakes pay for them. We won't solve this problem until the biggest banks are allowed to fail.

BILL MOYERS: He seems to be saying what you say, right?

SIMON JOHNSON: It's a clever piece of political manipulation. It's not at all what we say. What he says is dangerous and deliberately misleading.

BILL MOYERS: How so?

SIMON JOHNSON: He says let the biggest banks fail, go bankrupt, don't do anything, leave the situation as it is now and when they get in trouble, let them fail. If you do that, you'll have catastrophe. The bankruptcy system clearly and manifestly cannot deal with the failure of a complex, global, financial institution. And we have the evidence before us in what happened after Lehman Brothers failed. That was bankruptcy. It caused chaos around the world, Bill. That's what the Republicans are advocating. Is we just leave things as they are and next time we'll take that chaos and we'll get a second Great Depression. We're arguing for reform. We're arguing for change. We're arguing for ways to make those biggest banks smaller and safer. If they were small enough to fail, that's a very different story. And that's a much safer place to be.

BILL MOYERS: What do these big six banks think about what Senator McConnell is saying?

JAMES KWAK: Well, the big six banks don't want any reform at all, essentially. So, I think that they are, and there's some evidence that Senator McConnell has been talking to the big banks and to other people on Wall Street.

BILL MOYERS: There have been published reports that he attended a fundraiser with hedge funds and other Wall Street poobahs just last week, before he made this statement. And the reporters, knowing that he had been at this big fundraiser for hedge fund and Wall Street tycoons a week before, begin to press him in an unusual, and actually promising way. Take a look at this.

REPORTER: How do you push back against this perception that you're doing the bidding of

the large banks? You know, there was a report that you guys met with hedge fund managers in New York. A lot of people are viewing this particular line of argument, this bailout argument as spin-

SEN. MITCH MCCONNELL: You could talk to the community bankers in Kentucky.

REPORTER: I'm not asking you about the community bankers-

SEN. MITCH MCCONNELL: But, I'm telling you about the community bankers in Kentucky. This is not, everybody-

REPORTER: Have you talked with other people other than community bankers?

SEN. MITCH MCCONNELL: Well, sure. We talk to people all the time. I'm not denying that. What's wrong with that? That's how we learn how people feel about legislation. But the community bankers in Kentucky, the little guys, the main street guys, are overwhelmingly opposed to this bill.

REPORTER: Well what would you say to folks who say that this is just spin to deflect attention from the fact that you're representing the large banks?

BILL MOYERS: So, he deflects their questions about being at this meeting with the large banks, the oligarchs, as you called them. And talks about community banks back in Kentucky. What do you make of that?

SIMON JOHNSON: Well, two things, Bill. First of all, he's embarrassed, as he should be, and that's good. I don't think they used to be embarrassed. I think- I hope Vice President Biden is somewhat embarrassed by the event he's going to attend next week with Robert Rubin, unless he criticizes Rubin and goes after Rubin's view of the world. In which case, I'm okay with that.

JAMES KWAK: This other part of the problem which Simon and I talk about more in the book, and that we don't think is fully solved by the legislation in the Senate, is why do you have to have these too big to fail banks in the first place? So, we think that's the obvious and simplest and almost unarguable solution that you should simply not have banks that are too big and too interconnected to fail.

SIMON JOHNSON: There are no benefits to society, Bill, from having banks that are larger than \$100 billion in total assets. This is a well-established fact. The evidence does-

BILL MOYERS: You make the case.

SIMON JOHNSON: There's nearly 100 pages of footnotes for a reason.

BILL MOYERS: But don't let the facts get in the way.

SIMON JOHNSON: I understand. But there's no evidence, okay? We've let our banks get to \$2 trillion- Citigroup when it almost failed or did fail in fall 2008 was a \$2.5 trillion bank. Jamie Dimon runs a \$2 trillion bank at JPMorgan Chase and says, if we're big, it's 'cause we're beautiful and efficient. And we should be allowed to get bigger. It's not true. They're big because of the government subsidy, right? That's what gives them the profits at this level. If they get bigger, they'll become more dangerous. That's, those are the costs. On the

benefit side, there's no economy of scale or scope or anything else to support the case that banks bigger than \$100 billion. That's on a pure cost/benefit basis.

JAMES KWAK: So, there's no way that Jamie Dimon, who according to many observers is perhaps the savviest bank CEO, the best one out there, there's no way that he can know what's going on within his organization. There's no way he can even have an information system that will let him know, efficiently, all the things that he needs to know. So, why is JPMorgan Chase so big? One reason is that it's in the interest of CEOs to have large banks. Because if you have, the larger your bank, the bigger your salary. But then at the same time, it creates this incentive among the traders, the people who really make the money or lose the money in these banks. It creates an incentive to the traders to essentially exploit the management failings of the company.

BILL MOYERS: The toughest hearing in Washington this week was conducted by Senator Carl Levin in the Senate, looking into Washington Mutual. That's the largest bank ever to go under in our history, and there are some friends of mine in Washington say there's some possible criminal indictments going to be coming out of this. Let me show you Senator Levin laying out some of the evidence.

SEN. CARL LEVIN: To keep that conveyor belt running and feed the securitization machine on Wall Street, Washington Mutual engaged in lending practices that created a mortgage time bomb...WaMu built its conveyor belt of toxic mortgages to feed Wall Street's appetite for mortgage-backed securities. Because volume and speed were king, loan quality fell by the wayside and WaMu churned out more and more loans that were high risk and poor quality.

Destructive compensation schemes played a role in the problems just described. These incentives contributed to shoddy lending practices in which credit evaluations took a back seat to approving as many loans as possible.

BILL MOYERS: He goes on, you know? There's evidence that WaMu knowingly sold fraudulent loans to investors in the form of securities. That loan offices were falsifying documentation in order to churn out as many lousy loans as they could. And that senior management was putting pressure on the loan officers to do just this. And he claims, what we were talking about, that destructive compensation schemes were part of the problem.

JAMES KWAK: I think that some people may go to jail. I think that falsifying loan documents, I think there's a good chance people could go to jail for that. I think that if there are- you know, when you get the emails of people at midlevel managers at these banks saying, you know, falsify the loan documents. They might go to jail as well. I don't think anyone who's high up in these banks is going to go to jail for this reason.

I think that, for example, these loans were eventually sold on to investment banks which used them to manufacture new securities. Those investment banks were getting documents from Washington Mutual. These are like representations and warranties. So Washington Mutual is saying, you know, these loans meet these criteria. And the investment bank is going to say, I got this document from Washington Mutual. They told me the loans were good. You can't send me to jail.

And he's absolutely right. So, you've got investment bankers who must have known. Who should have known that a lot of these loans are bad. But they've got a piece of paper from

the person selling them the loan saying they meet these criteria. He's pretty much Scott free when it comes to criminal liability. So-

BILL MOYERS: Mistakes were made, but not by me, right?

JAMES KWAK: Exactly.

BILL MOYERS: I mean, that seems to be the mantra that came through all these hearings this week: mistakes were made but not by me.

SIMON JOHNSON: Or, no, I think they also say, Bill, well, everyone made mistakes, Bill. You know, we're just human. This was beyond our control. And that's not true, these are systems they controlled, they designed. Mr. Rubin designed this, right? And I want to point out there's something very interesting in this WaMu conversation.

It's only when a firm collapses that you get full discovery. Now, Senator Levin is a great voice on this. And I think he's absolutely nailing this. But he only has the ability to get at this level of detail and documentation from a company that failed like WaMu. For the people who were able to keep going. The Goldman Sachs of this world, you'll never know what they were really up to.

These are incredibly smart people. They're very well paid. They have every incentive. The regulators are totally outgunned. It's not an accident that this complexity allows them to get away with it. It's by design. That's the system. Not a conspiracy, Bill. Don't say that.

BILL MOYERS: I wouldn't.

SIMON JOHNSON: It's a system of-

BILL MOYERS: A system.

SIMON JOHNSON: It's a system of beliefs and incentives, much more profoundly dangerous than a conspiracy.

BILL MOYERS: Why?

SIMON JOHNSON: Conspiracies you can unroot. Conspiracies you can have, you know, a couple of hearings. People can understand it on TV. You get the sound bite. This is very complex. This is about what many, many PhDs and specialists in finance have cooked up over 20 years with the active participation of the people who were supposed to oversee that in Washington.

BILL MOYERS: Is this what the blogger meant when he posted on "The Baseline Scenario" this week, "Unnecessary complexity just creates rich opportunities for systemic corruption"?

JAMES KWAK: That is certainly one of the things he meant.

BILL MOYERS: What should be the purpose of reform? Should it change the behavior of Wall Street, or should it change the regulation of Wall Street? And there is a difference, is there not?

SIMON JOHNSON: Absolutely. Look, I don't know if this will work or not. I don't know if at the end of the day, we will end up supporting the bill. I hope we will, okay? But whatever

happens, this is one legislative cycle. Theodore Roosevelt did not change the mainstream consensus in this country with regard to power and monopoly and the dangerous side effects of big business overnight.

He didn't do it in one year or two years. It was a ten year process. The consensus has to change, Bill. And regulation, the role of regulation or understanding of regulation with regard to finance has to change. The regulation is there to limit the downside to society and to make sure that all of these activities have as much as possible of the positive effect on the economy without generating these massive negative shocks. And we're a long way from that point.

JAMES KWAK: I think the distinction you made is a very good one. Between changing the regulation of Wall Street and changing Wall Street itself. I think the bill does a lot of things that will improve the regulatory system.

I think it does not do a lot to change Wall Street. Certainly, better regulation will change Wall Street a little bit, but some of the basic fundamental issues, I think, for example, the fact that in many realms, Wall Street banks knowingly make money by finding, because they want to put on a trade, they find a sucker to take the other side of that trade.

They're making money directly off of their customers. You can't really have it any other way when you're engaged in proprietary trading. These, this is not going to change. The fact that we have these enormous banks that are too big to manage and that have a competitive advantage, because they're big. That's not going to change.

And that's one reason I think why it's not going to satisfy the many people in America right now who are upset and frustrated about what's happen. Because they're going to see that what we've done is we've made Washington a little bit better at regulating Wall Street. We haven't changed the fundamental causes.

BILL MOYERS: Well, I've seen one regulatory agency after another taken over by the very industries they were supposed to regulate.

SIMON JOHNSON: This is absolutely right, Bill. And, you know, the person who nailed this intellectually a long time ago was from the University of Chicago. George Stigler. Not a man of the left. He got a Nobel Prize for his observation. All regulated industries end up with the industry capturing the regulators.

And what's happened to us is a Stigler, exactly what Stigler warned against on a massive scale. And you have to think very hard about this. The Administration still argues that we should delegate responsibility, going forward, for lots of things around finance. Like how much capital you should have. Delegate that to the regulators.

Now, that's crazy. That's not acceptable. That is not what they should do. Particularly because, and any Democrat should say, well, wait a minute, next time a free market President who doesn't believe in regulation comes in will gut the system. And any person from the right who's read Stigler should say, Well, these regulators are just going to get captured. You've got to put it in legislation. You've got to design the legislation. You've got to go after the things that can be legislated. Congress must not abdicate this responsibility.

BILL MOYERS: So, you would break up the banks. That's what you would do, right?

SIMON JOHNSON: We would set a hard size cap on the banks. And the banks, in order to comply with that, would have to break themselves up. So, take a bank like Goldman Sachs, for example. It's about ten times bigger than what we would be comfortable with. And, you put that cap in- they have to figure out how to do it. They have a fiduciary responsibility to their shareholders not to lose value as they comply with this law, not a regulation, law, right? Our book is called "13 Bankers" because it was 13 bankers who were pulled into the White House last March, and they were saved completely and unconditionally in the most amazing deal ever: their jobs, their pensions, their board of directors, their empires. But the title is also an echo of a remark made forcefully in 1998 by Larry Summers, who was then Deputy Treasury Secretary to Brooksley Born, who was trying to regulate over the counter derivatives.

And she was way ahead of her time, by the way. None of this nonsense existed. But she had- she saw this coming in a very profound sense. And she wanted to act in a preemptive and preventive way. Now, Larry Summers called her up. This is according to the public record and it's not been disputed by any of the protagonists here.

He called her up and he said, Brooksley, if you do what you want to do, which is regulate the derivatives. Over- regulate all this over the counter derivatives, you- I have 13 bankers in my office who say you will cause the greatest financial crisis since World War II., right? That was what he believed. That was the prevailing philosophy of the Rubin wing, the Wall Street wing of the Democratic Party.

That was Alan Greenspan's view. That is what brought us to this point. The idea that if you regulate, in any fashion, in any form, you will cause problems, you will prevent growth, you will cause crisis. That view is profoundly wrong. It has been manifestly and repeatedly demonstrated to be wrong. And the people who hold that view must change their minds or they should be voted out of office.

BILL MOYERS: If Wall Street's behavior doesn't change, can we have another financial catastrophe like the one in 2008?

JAMES KWAK: The definition of insanity is repeating the same thing over and over again and expecting a difficult result. And I think one of the core messages in our book is that the fundamental conditions of the financial system today are the same as the ones we had leading up to this crisis. And it would be folly to expect a different outcome.

Now, the legislation will help in certain ways. It will certainly, you know, it'll bolt the barn door after the horses have fled. The Consumer Financial Protection Agency will make it much harder to have a bubble built on subprime mortgages. But we'll have a bubble built on something else. And it may even be on a market or a product that doesn't even exist yet.

And that's why, again, legislation is helpful, but if you're going to have the same kind of incentive structures on Wall Street and the same degree of concentration, the same degree of political power, it's likely that we'll have another financial crisis.

The financial world has gotten much more dangerous in the last 30 years. We had this one. We had the stock market bubble of 2000. We had the long term capital management crisis. We had the S & L crisis. We had the Latin American debt crisis. And the question is, are these crises going to- are we going to somehow figure out a way to have fewer of them, or a way to make them less damaging? And I'm not sure I've seen that.

SIMON JOHNSON: The structure of the system is such that people will take these egregious risks. That's what they're paid to do. They will mismanage their companies. That is absolutely in their incentive. And they get the upside, remember? Goldman Sachs just helped Geely Automotive, a Chinese car company, buy Volvo from Ford.

Now, that's an interesting investment. It's a very risky investment. If that goes well, Goldman will get tremendous upside. If it goes badly or if Goldman's other investments go badly, who gets the downside? Well, Goldman Sachs is a bank holding company now. They were allowed to become that in September 2008 as a way to rescue them. They have access to the Federal Reserve discount window. Okay? If Goldman Sachs gets into trouble, that's the responsibility of the Federal Reserve and the downside is for society. That is an untenable, unacceptable position in America today.

BILL MOYERS: We are moving now toward the decisive moment in this fight for reform, sometime in the next two or three weeks, we may well have a vote in the Senate. But what are you going to be looking for over the next two weeks that will convince you there is some possibility of true reform?

JAMES KWAK: Well, it's going to be a little bit difficult, because right now a lot of the action is in the fine print. As often happens in the last phase of bills. But I think there's going to be an attempt to weaken the Consumer Financial Protection Agency. Even more than it's been weakened already.

And essentially, what will happen is opponents will try to make the C.F.P.A. subordinate to some other regulators, who can veto it. I think that on derivatives, there's going to be a lot of action, essentially on this issue of exemptions.

So, the derivative legislation looks quite good if you read the first page and look at the headlines. But then there are exemptions inside it. And the question is how big are the exemptions. The thing that we care about most is on the too big to fail issue. So, are we going to have real constraints on the size and scope of these banks? Things that the Obama Administration unveiled in principle to great fanfare in January.

They had a press conference with Paul Volcker and said we're going to have these Volcker rules. Those rules have been considerably watered down in the legislation. And I think that, you know, what we would most like to see are serious constraints on the scope and the size of these banks. Those are the main issues that I'll be looking at.

SIMON JOHNSON: So, the second Volcker rule was proposed in January was to put a size cap on our largest banks at their current size. Now, that-

BILL MOYERS: \$2 trillion?

SIMON JOHNSON: Yes.

BILL MOYERS: 2 trillion-

SIMON JOHNSON: Now, a size cap is a good idea. Obviously, the current size makes no sense at all, because that's how we got into this mess. There will be amendments brought forward to the floor of the Senate, if this process has any integrity at all. For example, Senator Sherrod Brown has a very good draft amendment.

BILL MOYERS: Ohio, right?

SIMON JOHNSON: Absolutely. And he will, in that amendment, press for a hard cap on the size. And I think also restrictions on the scope. And they'll give a lot more restrictions in legislation, which regulators will have a hard time getting out to, in terms of what can be allowed in our biggest financial institutions.

For me, at least Bill, that is going to be the critical moment. How many people support that amendment or that kind of amendment. Does the Democratic leadership come out in favor of it? Where does the White House stand on this? If the White House steps back and the White House says well, it's all up to the Senate, we're staying out of this. I think you know what's going to happen. You're going to get mush, right? Nothing really meaningful will come of it.

If the President takes the lead, the President takes this one, if the President takes this to the country, takes on the Chamber of Commerce, goes directly to people. And explains why you need to make our biggest banks smaller. As one way, that's not a sufficient condition for financial stability, but it's necessary and it gets at the heart of their political power. Take on the big banks. Take them on directly. That's what Jackson did. That's what Theodore Roosevelt did. That's what Franklin Roosevelt did, too.

BILL MOYERS: Simon Johnson, James Kwak, thank you for being with me. The book is 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN. We will link this conversation with your website, BaselineScenario.com.

JAMES KWAK: Thank you.

ROBERT J. LEVIN: Few, if any, predicted the unusually rapid...

DANIEL H. MUDD: I did the best that I knew how...

ROBERT J. LEVIN: In hindsight, if we and the industry as a whole had been able to anticipate...

CHUCK PRINCE: Regrettably, we were not able to prevent the losses that occurred...

ROBERT RUBIN: I was not involved in the interactions between the company and the regulators...

DANIEL H. MUDD: Although I was not in the room — it was executive session [...] I don't, but I just don't know what the number was.

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