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What the Big Banks Have Won

Regulatory Capture

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Global Research, June 26, 2009
CounterPunch 26 June 2009

Region: USA
Theme: Global Economy

The trouble started 24 months ago, but the origins of the financial crisis are still disputed. The problems did not begin with subprime loans, lax lending standards or shoddy ratings agencies. The meltdown can be traced back to the activities of the big banks and their enablers at the Federal Reserve. The Fed's artificially low interest rates provided a subsidy for risky speculation while deregulation allowed financial institutions to increase leverage to perilous levels, creating trillions of dollars of credit backed by insufficient capital reserves. When two Bear Stearns hedge funds defaulted in July 2007, the process of turbo-charging profits through massive credit expansion flipped into reverse sending the financial system into a downward spiral.

It is inaccurate to call the current slump a "recession", which suggests a mismatch between supply and demand that is part of the normal business cycle. In truth, the economy has stumbled into a multi-trillion dollar capital hole that was created by the reckless actions of the nation's largest financial institutions. The banks blew up the system and now the country has slipped into a depression.

Currently, the banks are lobbying congress to preserve the "financial innovations" which are at the heart of the crisis. These so-called innovations are, in fact, the instruments (derivatives) and processes (securitization) which help the banks achieve their main goal of avoiding reserve requirements. Securitization and derivatives are devices for concealing the build-up of leverage which is essential for increasing profits with as little capital as possible. If Congress fails to see through this ruse and re-regulate the system, the banks will inflate another bubble and destroy what little is left of the economy.

On June 22, 2009, Christopher Whalen, of Institutional Risk Analysis, appeared before the Senate Committee on Banking, Housing and Urban Affairs, and outlined the dangers of Over-The-Counter (OTC) derivatives. He pointed out that derivatives trading is hugely profitable and generates "supra-normal returns" for banking giants JP Morgan, Goldman Sachs and other large derivatives dealers. He also noted that, "the deliberate inefficiency of the OTC derivatives market results in a dedicated tax or subsidy meant to benefit one class of financial institutions, namely the largest OTC dealer banks, at the expense of other market participants." As Whalen testified:

> "Regulators who are supposed to protect the taxpayer from the costs of cleaning up these periodic loss events are so captured by the very industry they are charged by law to regulate as to be entirely ineffective….The views of the existing financial regulatory agencies and particularly the Federal Reserve Board and Treasury, should get no consideration from the Committee since the views of these agencies are largely duplicative of the views of JPM and the

large OTC dealers."

Whalen's complaint is heard frequently on the Internet where bloggers have blasted the cozy relationship between the Fed and the big banks. In fact, the Fed and Treasury are not only hostile towards regulation, they operate as the de facto policy arm of the banking establishment. This explains why Bernanke has underwritten the entire financial system with $12.8 trillion, while the broader economy languishes in economic quicksand. The Fed's lavish gift amounts to a taxpayer-funded insurance policy for which no premium is paid.

Whalen continues:

> "In my view, CDS (credit default swaps) contracts and complex structured assets are deceptive by design and beg the question as to whether a certain level of complexity is so speculative and reckless as to violate US securities and anti-fraud laws. That is, if an OTC derivative contract lacks a clear cash basis and cannot be valued by both parties to the transaction with the same degree of facility and transparency as cash market instruments, then the OTC contact should be treated as fraudulent and banned as a matter of law and regulation. Most CDS contracts and complex structured financial instruments fall into this category of deliberately fraudulent instruments for which no cash basis exists."

No one understands these instruments; they are deliberately opaque and impossible to price. they should be banned, but the Fed and Treasury continue to look the other way because they are in the thrall of the banks. This phenomenon is known as "regulatory capture".

Credit default swaps (CDS) are a particularly insidious invention. They were originally designed to protect against the possibility of bond going into default, but quickly morphed into a means for massive speculation which is virtually indistinguishable from casino-type gambling. CDS can be used to doll-up one's credit rating, short the market or hedge against potential losses. CDS trading poses a clear danger to the financial system (The CDS market has mushroomed to $30 trillion industry) but the Fed and other regulators have largely ignored the activity because it is a cash cow for the banks.

Whalen again:

> "It is important for the Committee to understand that the reform proposal from the Obama Administration regarding OTC derivatives is a canard; an attempt by the White House and the Treasury Department to leave in place the de facto monopoly over the OTC markets by the largest dealer banks led by JPM, GS and other institutions….
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> The only beneficiaries of the current OTC market for derivatives are JPM, GS and the other large OTC dealers…. Without OTC derivatives, Bear Stearns, Lehman Brothers and AIG would never have failed, but without the excessive rents earned by JPM, GS and the remaining legacy OTC dealers, the largest banks cannot survive and must shrink dramatically." (Statement by Christopher Whalen to the Committee on Banking, Housing and Urban Affairs, Subcommittee on Securities, Insurance, and Investment, United States Senate, June 22, 2009)

The Geithner-Summers "reform" proposals are a public relations scam designed to conceal the fact that the banks will continue to maintain their stranglehold on OTC derivatives trading while circumventing government oversight. Nothing will change. Bernanke and Geithner's primary objective is to preserve the ability of the banks to use complex instruments to enhance leverage and maximize profits.

The banks created the financial crisis, and now they are its biggest beneficiaries. They don't need to worry about risk, because Bernanke has assured them that they will be bailed out regardless of the cost. Financial institutions that have explicit government guarantees are able to get cheaper funding because lending to the bank is the same as lending to the state.

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The original source of this article is CounterPunch

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