



## **CPEG Fact Sheet: Regulating Finance**

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### **1. What caused the financial and economic crisis? Why didn't the Federal Reserve (the Fed) and economists see it coming and take action?**

Our financial crisis was caused by banks and other financial institutions such as hedge funds, mortgage brokers, and insurance companies trying to maximize short term corporate profits and salaries/bonuses for executives and traders without regard to the long term impact of their actions. Instead of doing what the financial sector is supposed to do—channel savings into investment that drives the real economy—banks and other financial institutions tried to increase profits by trading paper claims to existing assets and creating new, complex products instead of helping businesses grow and develop new assets or those seeking homes gain affordable houses.

### **2. What impact did regulation have on our financial crisis? Did we have too much regulation? Too little?**

We had too little regulation. And we had too little regulation because banks and bankers, as well as other finance leaders, worked to destroy the financial protections that served us well since the 1930s, such as the Glass-Steagall Act, which separated different kinds of financial activity. Banks could engage in either commercial or investment activities but not both. Commercial banks took deposits (and were insured by the FDIC) and made loans—for residences, small business, commercial real estate, etc. Investment banks, in contrast, underwrote and traded stocks, currencies and debt. Insurance companies were also separated from banks. In 1998, bankers and financiers succeeded in repealing these safeguards.

### **3. What happened as a result of the repeal of the separation provisions of Glass-Steagall?**

Banks like CitiGroup went on a merger binge and became one-stop shopping financial superstores. You could get a mortgage, buy and sell stocks, and buy life insurance from Citi and its various subsidiaries.

As investment banks entered the traditional fields of commercial banking they developed new products to attract customers and increase profits. These included subprime loans and various derivatives (instruments whose value is determined trading in another market).

As banks grew they became intertwined with other large banks as well as hedge funds, mortgage brokers, and insurance companies such as AIG. The risk to the entire financial system from the failure of a large financial superstore such as Citi increased. Thus some banks became 'too big to fail'—the potential impact of their failure was too frightening to allow it to happen.

As banks and other financial institutions became bigger and bigger, their influence over our political system also grew so they were able to resist efforts to exert increased regulatory control.

#### **4. What can be done to change this, how can we restore stability to our financial system? Do we need another Glass-Steagall?**

A. The business separation provisions of Glass-Steagall worked for 60 years; there is no reason to think they couldn't work again. But reinstating separation provisions is only the start.

B. While the Fed's intervention in 2008-09 prevented the collapse of the "too big to fail" banks, it has done nothing to reduce the risk to our financial system and the real economy posed by these big institutions. We need a ceiling on the size of financial institutions to insure that no financial institution becomes so big and so intertwined with the rest of the financial system that the Fed or the Treasury is unwilling to let them fail.

C. One of the primary reasons for the failure of the investment firms Bear Sterns and Lehman Brothers and near failure of others was too much leverage. That is, they controlled a large amount of assets with a very small amount of actual capital. When the meltdown happened, they lacked the capital to cover their risk. There should be limits on the extent of leverage investment firms can have. (Commercial banks already have limits.)

D. We live in an age of financial engineering. Bankers and brokers are inventing new products, many of which are difficult for most people to understand and are usually inappropriate for most people. Just as we established protections for food and drugs, we need a Consumer Financial Protection Agency (CFPA) to oversee the introduction and use of new financial products. Such an agency could have limited subprime mortgages; it could control fees imposed by banks and credit card companies.

E. During the past 20 years there has been a proliferation of new financial institutions that often function much like banks because they extend credit but are exempt from the more stringent regulations that govern commercial banks. All institutions that extend credit should be regulated similarly..

**5. Would all of this regulation discourage some financial activity? Would the U.S. become less competitive in the world financial markets?**

“Competitiveness” should not promote pursuit of profit at the expense of financial soundness. If we lose the financial engineers (with their salaries and bonuses) to off-shore venues with little or no regulation, we will be better off. We don’t need more derivatives or complicated financial instruments. We do need a return to the fundamental business of finance: raising capital and channeling to the needs of the real economy so that jobs are created and people can afford to buy homes, send their children to college, and take vacations.

**6. Would these reforms be sufficient to return finance to its appropriate role of aggregating and allocating capital? Isn’t there a risk that, just as bankers and other found ways around Glass-Steagall and other regulations, so they would find ways around this regulatory structure?**

It is certainly the case that financial firms and the people who work at these firms will not like these regulations and will actively seek to evade and dilute them. For that reason we also believe that the social role of finance needs to be recognized and institutionalized. This means:

- A. At a minimum, the public, through democratic decision making, should be able to control the aggregate level of investment and the returns to ownership of capital.
- B. This goal would be enhanced by competition, the establishment of publicly controlled credit institutions (North Dakota’s state bank is an example). By offering real competition to private financial institutions, these public credit providers would both distribute credit to sectors of the economy that are underserved today and would effectively compete away the abnormally high returns to private sources of credit and thus the outrageous compensation that individuals who manage these private firms receive.

- C. Ultimately a democratic society needs to exert control of the commanding heights of the economy. It has become increasingly clear that delegating finance to the private sector produces dysfunctional, suboptimal, and self-serving, financial gambling. Credit and money are publicly created and guaranteed. They should be publicly controlled at least in terms of broad economic goals.