A REPUBLIC NOT WORTH KEEPING: HOW BONDS BETWEEN PRIVATE FINANCE AND PUBLIC SERVICE SUBVERT THE GENERAL WELFARE

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Charles McCarthy, B.A.

Georgetown University
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Charles McCarthy, B.A.

Thomas Kerch, Ph.D.

ABSTRACT

This paper draws upon the chronology of the nation’s most recent financial crisis, the Great Recession, to expose America’s undemocratic governing reality and postulate that its existence rests upon the preferential bonds forged between private money and public service. Over many years, these connections have assumed a dominant role in the body politic, such that they have superceded the Constitution and subverted the collective will of the American people. This usurpation in authority will become apparent through examinations of modern campaign finance, financial regulatory law and its administration, and the operations of the nation’s central bank, the Federal Reserve. As such major reforms are needed to these institutions, alongside a broader effort to educate the U.S. citizenry about its money supply and how it influences the national economy.
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CONTENTS

ABSTRACT ii
ACKNOWLEDGMENTS iii
INTRODUCTION 1
CHAPTER ONE. GRESHAM’S DYNAMIC, CONTROL FRAUD, & THE GREAT RECESSION 5
CHAPTER TWO. A BRIEF MINSKIAN HISTORY OF MODERN AMERICAN FINANCE 30
CHAPTER THREE. PAY-FOR-POWER CAMPAIGN FINANCE, THE REVOLVING DOOR, & REGULATORY CAPTURE 41
CHAPTER FOUR. A DECADE IN THE MAKING – CIVIL SERVICE FAILURES & THE GREAT RECESSION 68
CHAPTER FIVE. THE FEDERAL RESERVE & THE MONEY POWER 100
CONCLUSIONS 117
BIBLIOGRAPHY 131
INTRODUCTION

Do you want to live in a democratic society? Or do you want to live in the society we have, which, remember, is not a democratic society, nor [is] it intended to be.
—Noam Chomsky

The idea that America’s polarized political landscape constitutes the largest barrier to governmental reform and progress may be popular, but it is ultimately misguided. The current ideological terrain is a nothing more than a wasteland of reactionary bravado and bluster, an atmosphere predicated on those foolish and disingenuous allegiances which obscure the ethically unacceptable, morally perverse, and absolutely avaricious relationships between politicians and private interest groups that together subvert the general welfare of the United States. It is a political paradigm that has existed for generations, made manifest by a throng of representatives at the federal level beholden to a legacy, two-party system that is corrupt, perhaps more today than ever before.

This paper draws upon the chronology of the nation’s most recent financial crisis, the Great Recession, to expose this governing reality and postulate that its existence rests upon the preferential bonds forged between private money and public service. Over many years, these connections have assumed a dominant role in the body politic, such that they have superceded the Constitution and subverted the collective will of the American people. This usurpation in authority will become apparent through examinations of
modern campaign finance, financial regulatory law and its administration, and the operations of the nation’s central bank, the Federal Reserve.

For the sake of posterity, a more limited and refined lens will reveal that the unprecedented amount of funds flowing from the sector of the national economy dedicated to finance, insurance, and real estate (FIRE) to federal politicians, especially in the executive and legislative branches, facilitated white-collar crime on an unprecedented scale and provided for its subsequent exclusion from the rule of law. These injustices were primarily perpetrated in the home lending and securities industries. The leaders of commercial banks and other firms offering mortgages to the public committed massive frauds to amass vast personal fortunes over a relatively short period of time. They accomplished this by using modern accounting practices to inflate the value of their corporations through accumulating assets (i.e. mortgages) that they knew would fail over the long run. Investment banks and other brokerages then followed suit, bundling these faulty mortgages with a variety of other mortgages to obfuscate their real value, portraying them as securities that would be safe for institutional investors to buy (i.e. people with a 401k). In effect, corporations were deliberately used as weapons against their prospective customers.

The pervasiveness of this strategy was not a periodic anomaly but the inevitable result of a transition in the FIRE economy from capitalistic enterprises based in the risk-averse, hedge finance of industrial production and its peripheral businesses to speculative, ponzi-like trading in assets purported to appreciate in value indefinitely.
Once payments stopped on millions of mortgages – the balances of which were never meant to be repaid by design – a deflationary sprial began in which the real estate job market collapsed, making even more homeowners subject to foreclosure; empty properties became the norm due to overcapacity in the housing market; and property values declined substantially for many who were able to remain in their homes. Some of those very same citizens, who were investors in the securities backed by fraudulent mortgages, subsequently saw the value of their portfolios plummet.

Such a collapse was only possible because representatives in the federal government, for at least the last 50 years, have presided over deregulatory civil service regimes in which traditional banking and investment firms were permitted to engage in riskier and riskier activities usually reserved for their counterparts in “shadow” finance, eventually to such an extent that their solvency was guaranteed by Uncle Sam. Such an arrangement was the product of record campaign donations by FIRE sector companies – which now surpass hundreds of millions of dollars each election cycle – to members of the House of Representatives, the Senate, and both Democratic and Republican candidates for the presidency in the United States, as well as lucrative employment before and after their terms in office, the latter a sociopolitical phenomenon termed “the revolving door.” In return, America’s elected representatives have ensured the passage of lax laws overseeing the FIRE economy or the repeal of more effective ones; appointed that particular sector’s executives to lead government agencies charged with oversight of many of their former companies and contemporaries (a problematic governance issue that
often results in what is called “regulatory capture”); and made it so those responsible for the Great Recession have faced no criminal prosecutions and no meaningful penalties in civil cases.

Even though the wake of the crisis has propelled new reformative currents into the injustices and inequities stemming from weak campaign finance laws and regulatory legislation riddled with loopholes, there are questions about the efficacy and certainly the legitimacy of these measures. The single promising development, an audit of the Federal Reserve that revealed tens of trillions in secretive monetary rescues of leading FIRE sector corporations, only served to once more lay bare the major operational feature of the nation’s central bank: The leadership structure of the Federal Reserve – and by proxy control of the U.S. money supply – is determined exclusively by the system’s private-sector, commercial member banks.

The Federal Reserve is, therefore, remarkably undemocratic. It represents, by itself, the preferential nature of bonds between private finance and public service, and its actions during the Great Recession undermine the constitutional precept that citizens receive equal protection under the law. But together with the overt corruption that continues to be guaranteed through campaign finance, the revolving door, and regulatory capture, the Federal Reserve and the modern Congress arguably constitute the greatest threats to what is left of American-style democracy and the republican form of government.
CHAPTER ONE

GRESHAM’S DYNAMIC, CONTROL FRAUD, & THE GREAT RECESSION

Investment banking is a business that’s so denominated in dollars that the temptations are great, so you have to have very strong rules. My experience is where there is a one-to-one relation between if I do X, money will hit my pocket, you tend to see people doing X a lot. You’ve got to be very careful about that. Don’t just say: “If you hit this revenue number, your bonus is going to be this.” It sets up an incentive that’s overwhelming. You wave enough money in front of people, and good people will do bad things.

–Former Fannie Mae CEO Franklin Raines, Bloomberg Businessweek

There may be no more pertinent a series of events that demonstrates the inability of the legacy, two-party system to confront the danger of private-public partnerships in the United States than the most recent financial crisis, now called the Great Recession by many journalists and scholars. By now, so much has been said and written in major media outlets on a reactionary or superficial level about who is to blame politically for the Great Recession\(^1\) that the root cause of the crisis – unprecedented levels of private

sector debt primarily originating in the part of the nation’s economy having to do with finance, insurance and real estate (FIRE) – has more often than not only been properly investigated and explained in books found in the nonfiction or reference sections at a local library, in academic or scholarly journals, or in Oscar-winning films.²

Empirically, this massive accumulation of debt in the FIRE economy in the years leading up to the Great Recession has been traced to the proliferation of faulty home mortgages, which were bundled and sold to the public as an investment vehicle known as the mortgage-backed security (MBS).³ According to the U.S. Securities and Exchange Commission, the purpose of the MBS is to create seemingly steady cash flows for investors:

Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization.⁴


A small percentage of MBS are guaranteed (not bought or sold or “issued”) by a single government agency, the Government National Mortgage Association (Ginnie Mae), so long as the mortgage loans originate (are “insured”) with stewardship from handful of complementary government agencies, such as the Federal Housing Administration (FHA).⁵ If a mortgage loan is insured by a qualifying institution like FHA, it is probable that this loan will be guaranteed by Ginnie Mae and “pooled” into an MBS by a list of approved firms, including the likes of Bank of America, Goldman Sachs, J.P. Morgan Chase, Wells Fargo, Ally, Merrill Lynch, and Capital One.⁶ The remaining percentage of MBS, the overwhelming majority, are issued by two government-sponsored enterprises (GSEs) – the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) – and by private institutions, such as brokerage firms, banks, and real estate developers. Fannie

⁵ Per the agency website, “Ginnie Mae does not buy or sell loans or issue mortgage-backed securities (MBS). Therefore, Ginnie Mae’s balance sheet doesn’t use derivatives to hedge or carry long-term debt. What Ginnie Mae does is guarantee investors the timely payment of principal and interest on MBS backed by federally insured or guaranteed loans — mainly loans insured by the Federal Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs (VA). Other guarantors or issuers of loans eligible as collateral for Ginnie Mae MBS include the Department of Agriculture’s Rural Development (RD) and the Department of Housing and Urban Development’s Office of Public and Indian Housing (PIH). Ginnie Mae securities are the only MBS to carry the full faith and credit guaranty of the United States government.…” See Ginnie Mae. Who we are. What we do. Why it makes a difference. Ginnie Mae website, under “About Ginnie Mae,” http://www.ginniemae.gov/about/about.asp?section=about (accessed August 3, 2012). The aforementioned statement actually contradicts information about MBS on the website of the U.S. Securities and Exchange Commission footnoted heretofore.

Mae and Freddie Mac, though not backed by “the full faith and credit of the U.S. government” like Ginnie Mae, also provide limited guarantees and have special authority to borrow from the U.S. Treasury.  

Because of this “guarantee” and the GSEs’ promotion of home ownership for low-income households (so called “affordable housing policies”), there has been a particular, countervailing affinity to blame Fannie Mae and Freddie Mac for the real estate bubble and ensuing financial crisis. But research shows this sentiment to be misplaced for many reasons, including the inability of both Fannie Mae and Freddie Mac to originate mortgage loans, and both institutions’ major losses coming from private-label securities, which were “business lines” established as the subprime market was declining to deal primarily in “Alt-A and interest only mortgages” that had “little to do with low income housing goals.”


As was stated above, MBS issued solely by private institutions are referred to as private-label securities (PLS).\textsuperscript{10} This distinction is somewhat important, relative to the ongoing process of debt deflation associated with the Great Recession, because the rate of default for mortgage loans that supported PLS was significantly higher than the default rate for mortgage loans that supported MBS issued by Fannie Mae and Freddie Mac. This pattern developed, in part, because private institutions have made over 50 percent of securitizations since 2005.\textsuperscript{11} In fact, private firms surpassed both GSEs in insuring (or underwriting) mortgages, as well as securitizing mortgages, in a very short period of time: “By 2006, [private firm] origination of $1.480 trillion [of mortgages] was more than 45% larger than [GSE] origination, and [private firm] issuance of $1.033 trillion [of PLS] was 14% larger than [GSE] issuance of $905 billion [of MBS].”\textsuperscript{12}

It is also important to distinguish between “mortgage lending” and “mortgage servicing” in this process. The mortgage lender can originate and be the steward of individual mortgage loans, but that lender can also sell the rights and benefits – the

\textsuperscript{10} See Federal Reserve Bank of St. Louis, \textit{Housing Policy, Subprime Markets and Fannie Mae and Freddie Mac}. For the sake of clarity, hereafter the term used for mortgage-backed securities issued by GSEs will be MBS, while the term used for mortgage-backed securities issued by private companies will be PLS.


payment of principal and interest – of individual mortgage loans to a third-party firm, or “servicer.” The duties of the servicer can include, but are not limited to, collecting and documenting mortgage payments; calculating fluctuating (variable) interest rates on adjustable-rate mortgages (ARM); making insurance and tax payments from borrowers’ accounts; negotiating modifications of mortgages upon default; and executing or supervising the foreclosure process if necessary. The servicing process occurs simultaneously with the securitization process, and oftentimes the mortgage servicer is the also the firm that securitizes the mortgage loans. From the standpoint of those issuing PLS (and MBS), the mortgage servicer is vital to ensuring the extent of cash flows that return to investors because servicers control the aforementioned collection of mortgage payments. Among the top-10 firms in both subprime mortgage servicing and subprime mortgage securitization in 2005 and 2006 were Countrywide, Option One, and Ameriquest. Other top-10 subprime mortgage servicers included J.P. Morgan Chase, Citigroup, Wells Fargo, and HSBC.

If this system – from mortgages to servicing to securities – seems strange and counterintuitive, it is not coincidence. The complementary processes of making loans and securitizing them with respect to assets in real estate – with the expectation that those


14. Federal Reserve Bank of New York, Understanding the Securitization of Subprime Mortgage Credit.
assets will consistently appreciate over long periods of time – are, in fact, uniquely vulnerable to ethically perverse and morally dubious human behavior, and have come to represent the collective greed and hubris of those employed in one of the fastest-growing sectors of the global economy.\(^{15}\) For many, the prospect of becoming very wealthy – and for some in leadership roles this wealth often would reach ridiculously high levels – spurred one of the most blatant power grabs in the 21st century. Leaders of companies that specialized in faulty mortgages, like Angelo Mozilo of Countrywide, amassed personal fortunes well over $400 million.\(^{16}\) As recent as 2011, when finance stocks plummeted, annual pay for the top-50 CEOs in the FIRE economy rose 20 percent to an average of $12.66 million. Much of this compensation was and is guaranteed. It is not dependent on real gains for many of the companies that made the list.\(^{17}\) Comparatively, the net worth for American families fell from $126,400 in 2007 to $77,300 in 2010.


than $20 trillion was lost cumulatively over the course of four years (in 2010 dollars).\textsuperscript{18} Obviously, much of the loss came from the deflation of asset values across different sectors of the economy. But a significant portion was transferred to the very people who are most responsible for causing the crisis.

How were such failures of character able to pervade the FIRE economy in such a widespread manner? Part of the answer can be understood better in terms of an economic principle called “Gresham’s dynamic,” ably explained by George Akerlof in a 1970 paper about the market for faulty cars called “lemons.”\textsuperscript{19} Essentially, because they are able to gain a competitive advantage through fraud, the behavior of dishonest companies ensures that honest companies are driven out of the market entirely. In Akerlof’s example, buying “lemons” at low cost and turning a high profit via their deliberate misrepresentation and subsequent sale means that the seller exploited “superior information (‘asymmetrical information’) to defraud the customer by misleading him into believing that inferior


quality goods (e.g., cars that are ‘lemons’) are superior quality.”  

Within the context of the Great Recession, the Gresham’s dynamic that developed leading up to the crisis and beyond was the result of the steady institutionalization of a somewhat similar type of fraud among mortgage lenders called “accounting control fraud.”

According to professor of law and economics at the University of Missouri-Kansas City and former federal regulator William K. Black, accounting control frauds “can cause greater losses than all other forms of property crime combined.” They are committed by creating assets (e.g. mortgages) and purposely obfuscating their value so that the originators or underwriters of these assets (e.g. mortgage lenders) can amass vast personal fortunes over a relatively short period of time (e.g. a few years). This is accomplished by exploiting the perverse pay structure that is common at companies within the FIRE economy. The strategy has four stages. First, the lending institution grows extremely rapidly (akin to a Ponzi scheme). Second, loans are made to borrowers who are unlikely to repay their debt. Third, the lending firm employs extreme leverage,


21. Ibid. During what is now commonly called the “Savings and Loan Crisis” (S&L Crisis) in the 1980s, Black became a relatively high-profile civil servant. He was litigation director for the Federal Home Loan Bank Board (FHLBB) from 1984 to 1986, deputy director of the Federal Savings and Loan Insurance Corporation (FSLIC) in 1987, and senior vice president and general counsel of the Federal Home Loan Bank of San Francisco from 1987 to 1989, the collective duties of which included regulating some of the largest thrift banks in the United States. Charles Keating – the same Charles Keating that was linked to five U.S. Senators (the “Keating Five”) accused of corruption for allegedly trying to interfere with the FHLBB’s investigation of Keating’s thrift bank, the Lincoln Savings and Loan Association of Irvine, Calif. – famously threatened Black’s life after he helped expose Keating’s role in defrauding his own company’s bondholders and investors.
which means it operates by borrowing money rather than by raising it through the sale of
stock or reinvesting of profits. And, last, firms maintain severely inadequate loss
reserves, which are funds set aside to pay for future defaults. By forgoing contingency
plans to show a balance sheet continuously in the “black,” this intentional shortage of
loss reserves is just one in an array of accounting strategies that “creates fraudulent
‘income’ or profits in early years,” while masking “catastrophic losses in later years.”

This obsession with income early and often is the heart of the fraud: “The central
fact that must be understood,” Black says, “is that this formula produces nearly
immediate, extraordinary, and guaranteed short-term ‘profits.’ [It] is a sure thing – not a
‘risk’ as we think of that term in finance.” Because of this perceived short-term
certainty by lenders, the strategy is not one of “slightly increasing reported profits,” but
seeking “exceptional profits” instead. Why the emphasis on lending to risky or
“unsophisticated” customers? The answer, again, lies in the dual necessities to grow
quickly and maximize income (through reported fees and high interest rates):

22. Ibid. The concept of “control fraud” has primarily been Black’s to disseminate – with
respect to Michael Lewis Rothman and Stanton Wheeler for their work in 1982, “The
Organization as Weapon in White-Collar Crime” – and this assertion is confirmed by his
scholarship over the last several years. See William K. Black, “Adam Smith Was Right About
Corporate CEO’s Incentives Absent Effective Regulation,” Cato-Unbound (December 2008),
http://www.cato-unbound.org/2008/12/04/william-k-black/adam-smith-was-right-about-
corporate-ceo%E2%80%99s-incentives-absent-effective-regulation/ (accessed August 13, 2012);
and William K. Black “Neo-Classical Economic Theories, Methodology and Praxis Optimize
Criminogenic Environments and Produce Recurrent, Intensifying Crises,” Creighton Law Review
(May 13, 2010),

23. Black, “Epidemics of ‘Control Fraud.’”
The reason that extreme growth optimizes accounting fraud is obvious, but the concept that deliberately making uncreditworthy loans optimizes short-term accounting profits is counter-intuitive. The first two ingredients in the accounting fraud formula are related. Lenders in a mature market such as home mortgages cannot simply decide to grow rapidly by making good loans. Lenders can grow rapidly by making good loans through two means. They can acquire competitors (a strategy that inherently cannot be followed by a very large number of lenders) or they can drop their yields and seek to compete on the basis of price (i.e., their mortgage interest rate in this context). Their competitors are almost certain to match any reduction in mortgage interest rates, so the latter strategy generally fails to provide substantial growth while the lower price leads to reduced “profit” margins.

Lending to the uncreditworthy, however, allows exceptional growth and allows one to charge a higher interest rate. The combination maximizes accounting income.24

Moreover, the pathology of reporting false profits based on fraudulent loans not only expands the span and scope of accounting control fraud, it also has the auxiliary effect of making “subprime” loans to the “unsophisticated” appear similar on paper to “prime” loans to those who supposedly have “worthy credit”:

As more firms emulated the initial accounting control frauds strategy of making subprime and “liar’s loans” to buyers that could not repay the loans, the competition among the lenders reduced non-prime mortgage interest rates. That effect, of course, reduced their accounting profits. “Alt A” loans were, falsely, represented by their issuers as equivalent in risk (through similar interest rates) to (extremely low risk) “prime” loans. They were made without verifying the borrower’s most important representations. In the trade, they were known as “liar’s loans” because failing to verify such information maximizes “adverse selection” and leads to pervasive deceit. The dominant effects of rapidly expanding non-prime lending, however, were to massively expand growth and to extend and hyper-inflate the housing bubble. The net effect of increased competition among non-prime lenders was to substantially increase short-term “profits.”25

24. Ibid.

25. Ibid.
This, in turn, created another corollary set of problems. Mortgages rated as “prime” that were part of PLS were 20 percent more likely to be found “delinquent” than their “subprime” counterparts that were securitized by the GSEs, revealing the prevalence of “adverse selection” at private companies no matter the class of mortgage involved.26 Adverse selection is the practice of using information not available to investors to securitize loans and misrepresent them as less risky than they really are. Once it was determined by lenders that there were profits to be had with “no documentation” loans (“liar’s loans”) in the subprime market, the same mantra expanded to the much larger (and heretofore much safer) prime market.

When profits and accounting income rise, personal compensation from the top down coincides. Accounting control fraud “closely approaches a perfect crime because the large, guaranteed (albeit fictional) ‘profits’ allow the person controlling the corporation to convert its assets to his personal benefit through seemingly normal corporate compensation mechanisms (bonuses, salaries, perks, stock options, and the appreciation in value of stock owned by the CEO).”27 It also allows the leadership of the lending institution in question to avoid detection (and prosecution). The CEO does not have to order, acknowledge, or even be aware of the fraudulent strategy of the firm. All that is required is to announce a desired lending target and to reward those who meet that target: “The CEO simply communicates – by paying large bonuses based on fictional


27. Black, “Epidemics of ‘Control Fraud.’”
profits,” says Black, “that he does not care how they meet the target.” And at many levels within mortgage lenders, these bonuses were not miniscule. For example, after Bank of America faced a lawsuit – Securities and Exchange Commission v. Bank of America Corp. – regarding the payment of bonuses to employees of one of its acquisitions during the financial crisis (Merrill Lynch & Co.), it was disclosed that the remaining average bonus to be paid to roughly 39,000 employees at Bank of America was $91,000.

By putting the onus on low-level officers, leaders of lending institutions were able to establish a chain of minimal or even zero accountability for themselves, making what Black asserts is the signature feature of “control frauds” clear: The corporation can actually be used as a weapon against its own investors, shareholders, and customers. Underwriting protocols for mortgages deteriorated to such an extent during the period leading up to the Great Recession that the major qualifying characteristic for creating a mortgage loan was a borrower’s credit score (FICO). Other important procedures like

28. Ibid.


obtaining documentation showing steady employment and requiring the mortgage to have a reasonable loan-to-value ratio (LTV) – for instance, requiring no down payment on a mortgage of $400,000 is considered a risky LTV – were ignored in favor of pleasing the boss and getting paid:

The most common example of this in the housing crisis was the nearly universal practice among nonprime lenders of paying loan officers bonuses on the basis of loan volume irrespective of loan quality. As their peers see that the worst loan officers who make the worst loans maximize their bonuses (and that the “controls” approve even horrific loans), many of them will mimic the worst loan officers’ practices. The most moral loan officers leave. This is one example of a Gresham’s dynamic in which bad ethics drive good ethics out of the marketplace.  

The “controls” Black refers to above are layers of internal protection within mortgage lenders that are supposed to prevent fraud and abuse. These include the “loan officer, the loan officer’s supervisor, loan underwriters, internal appraisers, the credit committee, the senior risk manager, the internal auditor, the audit committee, the chief operations officer (COO), CFO and CEO, the asset/liability committee, and the board of directors.” Unfortunately, once perverse pay systems are put in place, each layer of internal policing fails “contemporaneously.” Even junior officers, who may have been “whistleblowers” under different circumstances, were compromised by the potential for hefty bonuses, the social threat of being ostracized by their fellow officers, or even the


32. Black, “Epidemics of ‘Control Fraud.””

33. Ibid.
possibility of being fired for refusing to make bad loans. This behavioral dynamic explains the proliferation of tens of thousands of fraudulent loans within a single company, and, more importantly, it explains the plague of approximately two million of fraudulent loans annually across an entire sector of the United States economy in 2006 and 2007. (Again, the Gresham’s dynamic applies: When one fraudulent firm gains a competitive advantage, others will follow or be driven out of business.)

Recall that these faulty mortgages (both “prime” and “subprime”) were “securitized” and sold to investment firms, many of which manage very large pension and retirement funds. Typically, mortgages are securitized categorically (i.e. subprime mortgages comprise a subprime PLS, while prime mortgages comprise a prime PLS). Why “risk-averse” firms would 1) purchase fraudulent mortgages, 2) issue PLS, or 3) invest in PLS without analyzing the underlying assets can again be traced to accounting

34. In a more recent, though not surprising, development, it seems that a handful of “whistleblowers” who collectively brought suit against five of the largest mortgage lenders in the United States (Bank of America, Wells Fargo, J.P. Morgan Chase, Citigroup, and Ally Financial) have been rewarded with “cease and desist” money as part of a settlement between the companies and the Justice Department. The deal, which included $5 billion in fines and supposedly $20 billion more for refinancing and modifying the troubled mortgages of American homeowners, attracted national media attention because it involved the attorneys general of 49 states in an effort to stamp out and paper over the growing tide of lawsuits accusing these companies of fraud and predatory lending on a grand scale, and of so-called “robosigning” practices used by the lenders to foreclose on homeowners illegally. The six “whistleblowers” listed in the settlement received sums totaling over $46 million collectively and up to $18 million individually. See James O’Toole, “Whistleblowers win $46.5 million in foreclosure settlement,” CNNMoney website, http://money.cnn.com/2012/07/02/news/economy/whistleblowers-foreclosure-settlement/index.htm (accessed August 13, 2012).

control fraud, the Gresham’s dynamic it creates, and, additionally, the conglomeration of different services provided by many of the country’s leading financial companies. More specifically, those companies that created fraudulent mortgage loans were also the ones securitizing fraudulent mortgage loans to be sold to their own investors or to third-party firms (e.g. TIAA-CREF, Vanguard, Fidelity, Charles Schwab). The list of companies includes familiar names – J.P. Morgan Chase, Bank of America, Morgan Stanley and the now-defunct or taken-over firms of Bear Stearns, Washington Mutual, Countrywide, and Merrill Lynch were among the top issuers of mortgage-backed securities – both prime and subprime – when the Federal Home Finance Administration (FHFA) sent subpoenas to the 64 companies in its investigation into whether any of them defrauded Fannie Mae and Freddie Mac.  

In other instances, the original lending firm would sell the rights of individual mortgages to a mortgage “servicer,” which would then pool them into PLS or contract the securitizing work out to another firm.

In order for this process to work, the fraud must also extend to external controls – “independent” auditors, ratings agencies, and appraisers – “by suborning them and


37. Black, “Epidemics of ‘Control Fraud.’” Unlike auditors or investment firms or a top-flight ratings agency, appraisers do not have the ability to provide advantages based on reputation to a control fraud because no appraiser has a national reputation. But there are other real benefits. According to Black: “[Appraisers] can appear to provide an independent, expert, and professional opinion of the market value of the pledged real estate. That opinion, if materially inflated, offers two advantages to accounting control frauds. It allows the lender to make a substantially larger
turning them into… valuable allies” through perverse compensation. First, the auditors, who are supposed to evaluate a firm’s accounting practices, are corrupted:

U.S. accounting control frauds typically retain top tier audit firms precisely because these firms’ reputation is so valuable in assisting their frauds. The value of a top tier audit firm “blessing” fraudulent financial statements is obvious. The blessing helps the control fraud deceive creditors, investors, and regulators. It also makes it difficult to prosecute the CEO who “relied” on the outside auditors.38

The spread of control fraud to auditors was so profound that it explains the demise of Fannie Mae and Freddie Mac. Both GSEs were private enterprises with limited government guarantees in the years leading up to the crisis. The companies had private shareholders, and they had executive-level managers who, with huge stock options tied to a public stock price, rewarded themselves with hundreds of millions of dollars in bonuses during the same period. When both Fannie and Freddie began losing market share in MBS as a result of policies against purchasing “Alt-A” mortgages, their leaders, including former CEO Franklin Raines, used the same perverse bonus-compensation system to convince company auditors to overlook the company’s attempt to purchase large amounts of fraudulent subprime PLS.39

The ratings agencies, which have the duty of analyzing the risk of underlying assets (e.g. mortgages) that constitute investment-grade securities like PLS or other larger

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38. Ibid.

39. Black, “Adam Smith Was Right About Corporate CEO’s Incentives Absent Effective Regulation.”
or more diversified collateralized debt obligations (e.g. multiple PLS in their entirety, or even “slices” and separate layers of different PLS combined in a different investment “vehicles”), are arguably more susceptible to capture once a Gresham’s dynamic is realized because of the industry’s oligopsonistic character. Ray McDaniel, the CEO of Moody’s – one of the three nationally recognized ratings agencies, along with Standard & Poor’s and Fitch – confirmed this in an internal company meeting among managing directors in September 2007 and again in a presentation made to the company board of directors a month later in October 2007. At the September meeting, McDaniel admitted that Moody’s was operating at a competitive disadvantage for exercising cautious business acumen: “[W]hat happened was, it was a slippery slope…. What happened in ’04 and ’05 with respect to subordinated tranches is that our competition, Fitch and S&P, went nuts. Everything was investment grade. It didn’t really matter.” The pressure to conform mounted from many sides, and McDaniel’s employees fell in line. During the October presentation, he said: “Analysts and MDs [managing directors] are continually ‘pitched’ by bankers, issuers, investors,” and sometimes “we ‘drink the kool-aid.’”

The ratings that Moody’s, Standard & Poor’s, and Fitch give to mortgages held within different layers of securities (each one called a “tranche,” with ratings from “senior AAA” at the top to “unrated” at the bottom), in large part, determine the

marketability of these securities to investors and the probability (or certainty) of the income coming from the underlying mortgages:

The value of having one of the top three rating agencies give a collateralized debt obligation (CDO) “tranche” backed by “liar’s loans” a “AAA” rating is even more obvious…. The top CDO layer (tranche) has the first claim to cash flows and is the least toxic of an extraordinarily toxic instrument. A tranche rated “AAA” (while the nonprime secondary market was still operating) was considerably more valuable and more liquid. The “AAA” rating also appears to validate the “high” quality of the nonprime assets and demonstrate that the nonprime mortgage lenders must be prudent.41

But documentation from Standard & Poor’s confirms that the ratings agencies – right alongside the commercial and investment banks that made the original fraudulent mortgage loans pooled them into PLS – were not prudent. Ratings agencies did not provide an honest assessment of the loans in question at any point in the process. They didn’t have the records to do so! When a professional credit rater from Standard & Poor’s attempted to – correctly, honestly – do otherwise, he met this response from Richard Gugliada, a senior-level manager at the company: “Any request for loan level tapes is TOTALLY UNREASONABLE!!! Most investors don't have it and can't provide it. [W]e MUST produce a credit estimate. It is your responsibility to provide those credit estimates and your responsibility to devise some method for doing so.”42 Of course, fraud is made easier if the lending institution and the securitizing institution are one and the same, but otherwise the process went something like this: 1) lender creates fraudulent

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41. Black, “Epidemics of ‘Control Fraud.’”

42. House Committee on Oversight and Government Reform, Committee Holds Hearing on the Credit Rating Agencies and the Financial Crisis.
mortgage; 2) securities firm purchases and pools mortgages into MBS without reviewing original loan files; and 3) ratings agency gives fraudulent, “risk-free” ratings to assets bundled in PLS, to lure investors, without ever reviewing original loan files.

A typical subprime PLS can have as many as 4,000 individual mortgages and be valued on its face at $1 billion. Since the ensuing cash flows are supposed to be paid to investors “in order of priority” of the ratings given by ratings agencies to assets within different layers of a PLS or CDO, it becomes increasingly difficult to determine who is entitled to how much and, ultimately, to accurately gauge the overall value of any security that includes one, ten, one hundred, or even one thousand fraudulent mortgages that have phony ratings and no originating documentation. This is why it was disingenuous, in the wake of the crisis and the so-called “bailout” through the Troubled Asset Relief Program (TARP), to conduct “stress tests” on some of the largest banks and financial firms and pronounce them “sound” or “able to withstand another crisis event.” (Other government actions to “stabilize” the FIRE economy were less publicized, such as the “Broad-Based Emergency Programs” conducted by the Federal Reserve.) These companies were the major issuers or secondary buyers of subprime PLS that had virtually no documentation for the mortgages that were the foundation of those securities. Even when one considers the injection of $700 billion (and more by the Fed) onto their balance sheets by the U.S. Treasury, the financial positions of these companies were so severe that Bank of America, Wells Fargo, and Ally Financial, among others, continued to forge

43. Federal Reserve Bank of New York, *Understanding the Securitization of Subprime Mortgage Credit.*

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and backdate paperwork after the aforementioned “robo-signing” class-action lawsuit in order to continue illegal foreclosures on homeowners so that the companies could attempt to resell the homes to “legitimately” reconstitute their balance sheets and stave off insolvency.44

Many of the commercial banks, investment banks, and brokerage firms issuing PLS backed by fraudulent mortgages – or even those firms that purchased PLS in the secondary market – either knew or suspected this, and, ultimately, that what they were selling to investors would collapse (or at the very least be devalued substantially). But because the demand for diversified investments was so great45 – and because the fees levied, premiums charged, and interest accrued for these firms (and the underwriters of their securities) were additional sources of guaranteed income too great to resist – the span and scope of the control fraud was extended into the realm of securities. No fewer than 75 lawsuits filed (and some settled) between 2007 and 2011 attest to this. The cases are against a multitude of firms involved with the sale of securities (mortgage lenders, securities issuers and underwriters, asset management firms, insurance companies, brokers, ratings agencies, and bank holding companies, another others). The plaintiffs include individual persons, government agencies, and insurance companies. At least nine


class-action suits have been settled collectively for more than $3.3 billion. This sum, however, is tiny compared to more than $2 trillion in losses and writedowns alleged by the plaintiffs in all 75 cases.46

To mitigate the future losses that are inevitable when dealing heavily in fraudulent PLS – and in many cases to mask insolvencies so that investors, bondholders, and shareholders did not immediately make a run on firms (and each other)47 – commercial and investment banks, and other securities issuers, engaged in a deceptive two-pronged strategy to transfer the costs of their own reckless behavior to third parties. The first stage of this strategy was to compound the probability that the existing control fraud being


47. See Peter J. Henning, “U.S. Takes Hard Line in Suits Over Bad Mortgages,” The New York Times, September 6, 2011, http://dealbook.nytimes.com/2011/09/06/u-s-takes-hard-line-in-suits-over-bad-mortgages/ (accessed August 25, 2012). For example, in a panic those with outstanding bonds (loans), shares of stock, or investments in a firm’s PLS would attempt to call in their debts owed to them, liquidate their stock, or instruct the firm’s asset managers to sell their stakes in the corrupted securities. However, as has been previously noted, firms that collapsed like Countrywide, Lehman Brothers, and Bear Stearns, alongside companies that have required government rescues like Citigroup and Bank of America, were (and arguably still are) deliberately overleveraged and undercapitalized for the sake of artificially inflated profits and stock values. These companies would not be able to meet all of their liabilities in such a scenario. Even if the firms amassed large “proprietary trading” portfolios, it is likely that these assets would not cover the losses associated with fraudulent PLS. Thus, it is probable that the underwriters who originally insured the market for and purchase of the faulty PLS – perhaps the bondholders or shareholders of company stock at one time or another – would come into conflict with the investors who eventually bought those PLS. The underwriters are merely intermediaries that make a guaranteed return on their capital, so long as they are able to find investors for all of the PLS offered on the market. Lawsuits previously filed by investors allege that underwriters of fraudulent PLS were not forthcoming about the unstable nature of the securities.
committed by mortgage lenders would collapse by purposely assembling *nothing but* fraudulent and risky mortgages into PLS. The second stage was to purchase insurance for these PLS, so-called “derivatives” like the “credit default swap” (CDS). With this scheme, firms could all but guarantee that the securities they were underwriting would fail – many times to the detriment of their own investors – and then collect on the insurance policies.48

Once the mortgage payments stopped flowing in securities like these, chaos ensued. Homeowners were foreclosed upon, houses were vacated and empty properties were the norm because of overcapacity in the housing market as a result of the proliferation of bad loans. By association, many stable homeowners in those same neighborhoods saw their own property values decrease because of the abandoned homes

on their block. They then found themselves “underwater” on their mortgages, paying more for their homes than they were actually worth.49

Many of those very same citizens were likely investors, through their retirement accounts, in the securities backed by fraudulent mortgages and sold by commercial and investment banks. They subsequently saw their investment portfolios lose tremendous value, and banks, securities firms, and insurance companies fail. The lending capacities of the companies that survived either contracted or flatlined, and that dynamic spilled over to core industries and secondary businesses. It is worth remembering that household private debt, which would appear on credit cards and as automobile and student loans, had reached unprecedented levels. During and after crisis events, one of the first actions taken is for household debts to be paid. This accounts for the dramatic slowdown in consumer spending. Subsequently, millions of jobs were lost, more mortgages became delinquent, and the cycle of destruction continued.50

It is also helpful to remember or be made aware of the fact that mortgages (and most other commercial loans, for that matter) are assets created “out of thin air” by banks or lenders that simply add (and subtract) value to the banks’ or lenders’ electronic balance sheets through modern accounting practices. When a bank creates a mortgage loan on its balance sheet, a credit is recorded to indicate the amount of money owed to


50. Ibid.
the bank by the borrower purchasing the house. Simultaneously, a debit is created on the bank’s balance sheet to indicate the same amount of money being paid by the bank to the previous owner or builder of that house (oftentimes another bank). After the borrower pays the balance of the mortgage, both the credit and the debit on the bank’s balance sheet are retired. (What happens to the interest and fees paid by the borrower on that mortgage is a separate issue.)

At the height of the Great Recession in 2008, with the interconnectedness of the national economy in full view and trillions in federal money required to prevent a depression, a central characteristic of modern finance, built on digital balance sheets and credit money, became clear once again: Vast amounts of wealth can be created or destroyed in an instant. In such a fickle system, it must be asked: How was fraud able to go unchecked for years? How was avarice able to prevail on such a large scale?

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51. For more, please see L. Randall Wray, *Understanding Modern Money: The Key to Full Employment and Price Stability* (Northampton, MA: Edward Elgar Publishing, 2006). As will be explained, the “reserve requirement” and “money multiplier” rules that are believed to be the basis for lending money in a fractional reserve banking system have not been observed for at least the last 20 years. The only restraint on a bank’s ability to create assets such as mortgages and record them on its balance sheet is the demand by the public for the “bank money” or “credit-debt money,” called M1 or M2, necessary to pay for those assets, money that banks control. Obviously, there is a manifestation of those assets in the physical world – for example, houses – but the bank’s function, in this instance, is to create and retire credits and debts by acting as a conduit for the Federal Reserve notes that support “bank money”, called “high-powered money” (HPM), to be transferred between two parties.
CHAPTER TWO

A BRIEF MINSKIAN HISTORY OF MODERN AMERICAN FINANCE

Capitalism in the United States is now in a new stage, *money manager* capitalism, in which the proximate owners of a vast proportion of financial instruments are mutual and pension funds. The total return on the portfolio is the only criteria used for judging the performance of the managers of these funds, which translates into an emphasis upon the bottom line in the management of business organizations. It makes the long view a luxury that only companies which are essentially owned by a single individual and which are not deeply dependent upon external financing can afford.

– Hyman Minsky,
“Uncertainty and the Institutional Structure of Capitalist Economies”

To understand how fraud came to flourish during the Great Recession, the history of the Great Depression must be drawn upon for two reasons. First, the Great Depression, like the Great Recession, found the origins of its crisis moment – the stock market crash of 1929 – in fraud, albeit a different variety than accounting control fraud. Second, the Great Depression, like the Great Recession, offered the opportunity for a perceived paradigmatic shift in public policy responses to economic catastrophes by officials in the United States government. However, whereas this “teachable moment” has, in large part, been squandered during the Great Recession to prop up the status quo in the wake of an artificially inflated real estate bubble, the “New Deal” legislation that emerged during the Great Depression, after a stock market bubble fed on the zeal for new economies of scale that had roots in the Industrial Revolution, for a time set the country on very different economic footing.
Because industrial production necessitated complex, capital-intensive technologies, the 19th century bore witness to the advent and domination of the corporation, which replaced individuals, families, and cooperatives as the primary funding source for business. Funding, in part, was facilitated by finance firms (many of which were banks) that pooled capital by selling equity shares of stock in the corporation to investors. At its core, the business model and method of finance for industrial production separated “nominal ownership” of a company (shareholders) from management, leaving the perceived value of equity in a company vulnerable to sporadic and sometimes fabricated sources “of optimism and pessimism.”¹ In fact, fabrication became the trend throughout the Golden Age, as speculators with inside, or “asymmetrical,” information manipulated stocks through “pump and dump” schemes to reap the illgotten rewards of an economy that was fundamentally (and impossibly) operating beyond its own productive capacity:

Indeed, the 1929 crash resulted from excesses promoted by investment trust subsidiaries of Wall Street’s banks. Since the famous firms like Goldman Sachs were partnerships, they did not issue stock; hence they put together investment trusts that would purport to hold valuable equities in other firms (often in other affiliates, which sometimes held no stocks other than those in Wall Street trusts) and then sell shares in these trusts to a gullible public. Effectively, trusts were an early form of mutual fund, with the “mother” investment house investing a small amount of capital in their offspring, highly leveraged using other people’s money. Wall Street would then whip up a speculative fever in shares, reaping capital gains. However, trust investments amounted to little more than pyramid

schemes—there was very little in the way of real production or income associated with all this trading in paper.²

Thereafter, the process of debt deflation began as investors tried sell their stocks while prices collapsed. Spending in the “real economy” then came to a halt and the Depression was on. To recover, the administration of President Franklin Roosevelt used executive orders and acted as a legislative steward of sorts to create a multitude of programs to boost aggregate demand³, but perhaps the most important policy response came when the American financial system was reformed, albeit superficially, by separating institutions according to function. The major piece of congressional legislation that codified it all is popularly referred to as Glass-Steagall (the Banking Act of 1933). Commercial banks, investment banks, savings and loan firms, and insurance companies were each confined to their own economic and legal realms.

This was the beginning of the transition from what economist Hyman Minsky called “money manager capitalism” (or “finance capitalism”) to “paternalistic capitalism”


³ For example, jobs programs like the Works Progress Administration (WPA) and the Civilian Conservation Corps (CCC); a commodity buffer stock program to stop the fall in prices of agricultural goods; labor unions legally protected to prevent wages from falling; and Social Security for income to alleviate inequality to a degree, which as many scholars will attest, was a primary reason that the economy slowed. There were too many people who were mired in poverty, underemployment, and unemployment to consume all that was required for economic stability and growth. With respect to inequality, similar conditions have either become apparent or worsened during the Great Recession. Ignoring the partisan rhetoric against President George W. Bush by a Democratic Congress and instead focusing on the statistical data therein, see U.S. Congress Joint Economic Committee, Income Inequality and the Great Recession, 111th Cong., 2d sess., 2010. http://www.jec.senate.gov/public/?a=Files.Serve&File_id=91975589-257c-403b-8093-8f3b584a088c (accessed August 29, 2012).
(or the “managerial-welfare state” form of capitalism). Followed by a massive spending effort during World War II and a growing postwar middle class, the New Deal financial reforms provided a safer economic platform from which the benefits of industrial capitalism could be enjoyed by broad cross sections of the population. Minsky’s key insight, though – one that is implicit in the policy changes made by the Roosevelt administration during the Great Depression – was to recognize the inherent instability of any capitalist economy, an idea he called his “financial instability hypothesis.” The theory, at its core, attributes to different methods of investing in capitalist production a “boom and bust” dynamic:

The first theorem of the financial instability hypothesis is that the economy has financing regimes under which it is stable, and financing regimes in which it is unstable. The second theorem of the financial instability hypothesis is that over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system.


5. See Federal Deposit Insurance Corporation, Important Banking Legislation, Federal Deposit Insurance Corporation website, http://www.fdic.gov/regulations/laws/important/index.html (accessed August 28, 2012). The provisions of the Banking Act of 1933 were reinforced by the Bank Holding Company Act of 1956, with the latter having been amended and strengthened in 1970. A bank holding company is a private firm that owns one or more banks but does not necessarily conduct any banking operations itself. According to the Federal Deposit Insurance Corporation (FDIC), the Bank Holding Company Act of 1956 “prohibited bank holding companies headquartered in one state from acquiring a bank in another state.” The law, in part, attempted to prevent banks that had established separate bank holding companies from owning both banking and non-banking businesses, like securities and insurance.

The reforms made to American finance during the New Deal were responsible for a period of stability (and prosperity) approaching 30 years. Since the 1970s, however, a series of increasingly global crises – culminating in the Great Recession – have served to destabilize the national economy and in some cases bring it to the brink of collapse. For instance, there were the mortgage real estate investment trust (REIT) busts of the 1970s; debt traps foisted upon developing countries in the 1980s; crises in junk bonds, commercial real estate, and, of course, savings and loans (S&L) in the 1980s; and Long Term Capital Management, the default of Russia on its debt, and the debt debacle in Asian countries in the 1990s.7

Each of these events concluded with some kind of intervention from a central bank or international lending institution (i.e. the Fed, the International Monetary Fund, or the World Bank), and a fiscal rescue (i.e. treasury spending) to prop up demand in the U.S. economy and growth around the rest of the world. What’s more important, each was evidence of the gradual return to money manager capitalism by exhibiting what Minsky identified as the hallmark of a capitalist economy trending toward a protracted crisis event. Namely, the structure of financing ostensibly productive businesses and activities changed from “hedging” to “speculation” (and the “Ponzi scheme”):


Hedge financing units are those which can fulfill all of their contractual payment obligations by their cash flows: the greater the weight of equity financing in the liability structure, the greater the likelihood that the unit is a hedge financing unit. Speculative finance units are units that can meet their payment commitments on “income account” on their liabilities, even as they cannot repay the principle out of income cash flows. Such units need to “roll over” their liabilities: (e.g. issue new debt to meet commitments on maturing debt). Governments with floating debts, corporations with floating issues of commercial paper, and banks are typically hedge units.

For Ponzi units, the cash flows from operations are not sufficient to fulfill either the repayment of principle or the interest due on outstanding debts by their cash flows from operations. Such units can sell assets or borrow. Borrowing to pay interest or selling assets to pay interest (and even dividends) on common stock lowers the equity of a unit, even as it increases liabilities and the prior commitment of future incomes. A unit that Ponzi finances lowers the margin of safety that it offers the holders of its debts.

It can be shown that if hedge financing dominates, then the economy may well be an equilibrium seeking and containing system. In contrast, the greater the weight of speculative and Ponzi finance, the greater the likelihood that the economy is a deviation amplifying system.8

It has taken more than half a century for this “shadow banking” sector to regain prominence, and there have been dozens of laws enacted and court cases decided that have had an impact on the broader state of American finance9, but for the purpose of


9. See Matthew Sherman, “A Short History of Financial Deregulation in the United States,” Center for Economic and Policy Research website, http://www.openthegovernment.org/sites/default/files/otg/dereg-timeline-2009-07.pdf (accessed September 1, 2012). For example, in the case of Marquette v. First of Omaha (1978) the Supreme Court permitted banks to export interest rate policies nationwide, resulting less competition and the elimination of interest rate ceilings in states like South Dakota and Delaware. In 1980, the Depository Institutions Deregulation and Monetary Control Act increased deposit insurance from $40,000 to $100,000, allowed banks to merge, and permitted institutions to pay any interest rate on deposit accounts that they chose. In 1982, the Garn-St. Germain Depository Institutions Act removed restrictions on savings and loan associations and permitted banks to make adjustable-rate mortgage loans. In 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act removed any remaining restrictions on interstate banking that had developed because of
tracing recurring frauds from the Great Depression to the Great Recession, it is instructive to focus on the rise of public and private pension funds, sovereign wealth funds, insurance funds, and university endowments in the second half of the 20th century. When these institutions began accumulating large pools of cash, investment companies in the “shadow banking” sector competed with each other for the rights to manage that money by promising unrealistic, “total returns”\(^\text{10}\) from more risky, complex assets that were not initially legal for traditional commercial banks to sell: asset-backed securities, collateralized debt obligations, and credit default swaps. Instead of evaluating the societal value of these assets, the trend set over the course of multiple decades by dozens of different Congresses has been to accept as truth the industry’s own proclaimed beneficence and supposed productive capacities.\(^\text{11}\)

\(^{10}\) “Total return” equates to the instrument’s yield plus price appreciation.

\(^{11}\) This is not to assert that there has been no examination by government representatives about what has historically been referred to as “the separation of banking and commerce”; rather there has been a short-sighted preference for the successes of American finance no matter the costs. One of the most visible debates occurred in the late 1980s, and a report prepared for the 100th United States Congress effectively summarized the stakes of maintaining or repealing Glass-Steagall and the Bank Holding Company Act of 1956: “The resulting isolation of banking from securities was designed to (1) maintain the integrity of the banking system; (2) prevent self-dealing and other financial abuses; and (3) limit stock market speculation. By half a century later, the “wall” it created seemed to be crumbling, as bankers created new financial products resembling securities, and securities firms innovated new financial products resembling loans and deposits. The ongoing process of “financial deregulation” has evoked calls for Congress to give depository institutions new powers, especially in the securities field. Financial deregulation in the United Kingdom, Canada, and Japan has put additional pressure on Congress to re-examine this Act. Concerns over a seemingly fragile system of depository institutions persist, however, tending to place counter-pressure on Congress to maintain the Act.” See U.S. Congressional Research
Two major pieces of legislation at the turn of the 21st century best epitomize the effectiveness of what was seemingly a public relations triumph: the Financial Services Modernization Act of 1999 and the Commodity Futures Modernization Act of 2000. The Financial Services Modernization Act repealed Glass-Steagall and permitted the consolidation of banks (commercial and investment), bank holding companies, securities companies, and insurance companies. The Commodity Futures Modernization Act specified that transactions outside trading exchanges between two parties in investment vehicles known as “over-the-counter (OTC) derivatives” (swaps, forward rate agreements, exotic options, etc.) would not be subject to the Commodity Exchange Act of 1936, to any applicable federal securities laws, or to oversight from the Commodity Futures Trading Commission (CFTC). Both acts received broad bipartisan support in a divided 106th United States Congress. Republicans controlled the House of Representatives and Democrats controlled the Senate. A Republican, Senator Phil


12. Sherman, “A Short History of Financial Deregulation in the United States.” This served to abolish the differences that existed between traditional commercial banks and the “shadow banks” that had come to gain a substantial market share in private investment vehicles (PIV). The new law, however, was merely a formality. In 1998, the Federal Reserve granted a waiver for the merger of Citicorp, a commercial bank holding company, and Travelers Group, an insurance company, thereby bypassing the restrictions Glass-Steagall (and the Bank Holding Company Act of 1956). This was the logical extension of the Federal Reserve reinterpreting Glass-Steagall in 1996 “to allow bank holding companies to earn up to 25 percent of their revenues in investment banking.”
Gramm, wielded substantial influence in crafting both pieces of legislation, and a Democrat, President Bill Clinton, signed both into law.\textsuperscript{13}

It is a near certainty that the specific “innovative” capacities of those investment companies on the periphery obsessed with trading in “paper” could not have been foreseen by the Roosevelt administration, but by passing the Commodity Futures Modernization Act and leaving purveyors of derivatives to their own devices government representatives from both parties officially endorsed the return to speculation from hedging in the postwar economy that Minsky predicted.\textsuperscript{14} By repealing Glass-Steagall government representatives from both parties provided companies in American finance with the ability to consolidate and concentrate their power, and thereby multiply the disastrous effects of their speculative inclinations and fraudulent actions.\textsuperscript{15} Former federal regulator Black calls these pieces of legislation the spoils of a “competition in


\textsuperscript{14} Minsky, \textit{Stabilizing an Unstable Economy}.

laxity” pitting the public interest against financiers, a deregulatory game in the name of “leveling the playing field” between the traditional banking and “shadow banking” sectors of the FIRE economy.\(^\text{16}\)

It continues today, but the actual desired outcome is to do away with any institutional oversight of American finance piece by piece.\(^\text{17}\) But what good is a game without any rules? It’s only good for fostering the fraudulent, “criminogenic” environments in American finance that played such large roles in causing both the Great Depression and the Great Recession. Since government representatives had the past as a guide, it is confounding to know how little resistance they have shown to the resurgence of “shadow banks” over the last half century, and, in fact, how both legacy parties, Democrats and Republicans, have openly facilitated strategies adopted by these financial


firms to circumvent the provisions of Glass-Steagall and obtain free reign in a derivatives market that somehow has crossed the quadrillion-dollar threshold.\(^{18}\)

The voting record, especially in recent U.S. congresses, completely invalidates the efficacy of the legacy, two-party system and demonstrates its near irrelevance in the face of concerted, monied factions or special interests. To engineer such a disconcerting series of events – to trump ideologies and values and ethics – the supporters of deregulation had to continuously *convince* elected public servants to exclude American finance from the reach of meaningful and just laws. One arena in which to ensure this strategy was realized is campaign finance.

CHAPTER THREE
PAY-FOR-POWER CAMPAIGN FINANCE,
THE REVOLVING DOOR, & REGULATORY CAPTURE

You know, some people think, well, gee, the Congress regulates Wall Street. I think the truth is that Wall Street regulates the Congress.
–Senator Bernie Sanders (I-VT), interview on MSNBC

A day after the Supreme Court’s ruling to uphold George W. Bush’s election as president of the United States on December 14, 2000 (Bush v. Gore), the Commodity Futures Modernization Act was passed under considerably less scrutiny. Buried as a “rider” in an 11,000-page appropriations bill being considered in the last days of the 106th U.S. Congress, it moved through the Senate with a “voice vote” and garnered broad bipartisan support in the House of Representatives (292 yeas, 60 nays). Moreover, the version of the bill eventually signed into law by lame-duck President Bill Clinton was considered by representatives on the floor of Congress in conference for all of four minutes on December 15, 2000, and the final language contained in the 262 pages of the Commodity Futures Modernization Act was only made available to the public 24 hours prior to its passage. It is probable that the majority of congressmen did not even read it.

1. More than 80 congressmen were not present for the vote and recorded on the roll call as “absent.”

Though the passage of the Commodity Futures Modernization Act seems to be indicative of a disfunctional, “broken” legislative process, it is moreso a symptom of a dangerous, corrupting disease that has infected and subverted American democracy, what can appropriately be referred to as pay-for-power campaign finance.³ To begin, consider the relevant years in the campaign contribution histories of the bill’s major congressional sponsors, who were: Senator Phil Gramm, a Republican from Texas; Senator Richard Lugar, a Republican from Indiana; and Thomas Ewing, a Republican member of the House of Representatives from Illinois. Gramm, who served as the chairman of the Senate Committee on Banking, Housing, and Urban Affairs from 1995 to 2000 and acted as the bill’s major steward in Congress, received approximately $2.6 million in campaign contributions from companies in finance, insurance, and real estate (FIRE) over the same five-year period.⁴ Lugar, who served as the chairman of the Senate Committee on Agriculture, Nutrition, and Forestry from 1995 to 2001 (and continues to serve as the ranking member on the Senate Committee on Foreign Relations), received approximately

³ Lawrence Lessig, Republic, Lost: How Money Corrupts Congress – and a Plan to Stop It (New York: Twelve, 2011). Pay-for-power campaign finance (and by association lobbying) is practiced by businesses and firms in virtually all sectors of the economy, from energy, digital technology, and hospital administration to pharmaceuticals, industrial agriculture, and higher education. Hereafter the focus will be limited to the influence of institutions within the FIRE sector of the economy because of the extraordinary impact they have on the U.S. government and the national economy overall. For a more in-depth exploration of the impact of private money on campaign finance.

$800,000 in campaign contributions from FIRE companies over the same six-year period. Ewing, who played a more minor role in the bill’s passage, nonetheless introduced the legislation in the House of Representatives and received about $150,000 in campaign contributions from FIRE companies from 1997 to 2000.

Gramm, Lugar, and Ewing were gatekeepers chosen for their influence and amiable demeanors, but it was not enough to leave to three individual congressmen the fate of a piece of legislation that could have been a hindrance to the FIRE economy and its control of a market in derivatives that has, over time, become so large that its estimated value exceeds $1 quadrillion. No, in truth it seems every person with a potential role or stake in the legislation’s passage was compensated. In conjunction with the Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley), which repealed the Banking Act of 1933 (Glass-Steagall) and allowed companies in the FIRE economy to consolidate and concentrate their power over the derivatives market, the scope of money spent by FIRE companies on political campaigns (local, state, federal)


and lobbying in 1997 and 1998 together exceeded $350 million.\textsuperscript{8} Between 1997 and 1999, $86 million went to members of Congress.\textsuperscript{9} In the year 2000 alone, contributions from FIRE companies exceeded $315 million.\textsuperscript{10}

As has been previously stated, party affiliation was and is inconsequential, really, because the strategy has been one of securing “cooperation” from anyone with the potential to obstruct the sector’s collective avarice. Since 1990, total campaign contributions from FIRE companies have surpassed $3 billion, with 56 percent going to Republicans and 44 percent to Democrats.\textsuperscript{11} However, the voting record of Gramm-Leach-Bliley does make the donation pattern among FIRE companies, though broadcast, appear \textit{pointed} and \textit{instructive}:

\begin{quote}
[O]n average, those lawmakers voting “yea” received about $180,000 in campaign contributions from individuals and PACs in the financial sector during that period. Those who voted “nay” received about $90,000 each, or half of what supporters got.

There was little difference in the money collected by Republicans who supported the bill and those who opposed it; the 255 GOP supporters collected an average of $179,175, while the opponents in their ranks – and there were only five of them – collected $171,890. On the Democratic side, however, there was a wide gulf…. The 195 Democrats who supported the Financial Services
\end{quote}

\textsuperscript{8} Taibbi, “The Big Takeover.”


\textsuperscript{11} Ibid.
Modernization Act had received an average of $179,920 in the two years and 10 months leading up to its passage, while the 59 Democrats who opposed it received just $83,475.\textsuperscript{12}

Perhaps the trend of giving less money to Democrats who voted against an unrestrained FIRE economy was predictable given the party’s brief, postwar proclivities toward legislative “regulation,” but it seems just as likely that a risk-versus-reward ultimatum was implicitly issued in an effort to turn as many potential dissenters as possible.\textsuperscript{13} Of course, the benefits for incumbents who have a substantial advantage in campaign contributions over their opponents have been well documented, and contributions from FIRE companies can certainly change the outlook of electoral contests in this regard.\textsuperscript{14} After all, as data from the Center for Responsive Politics has shown: “The financial sector is far and away the largest source of campaign contributions to

\textsuperscript{12} Ritsch, “Money and Votes Aligned in Congress’s Last Debate Over Bank Regulation.”

\textsuperscript{13} Center for Responsive Politics, “Finance/Insurance/Real Estate: Long-Term Contribution Trends.” Historically, the major institutional fundraisers for Democratic political campaigns in the postwar era were labor unions, but this dynamic was rendered less advantageous beginning in the 1970s when, during the transition back to “money manager capitalism” from what Hyman Minsky called “paternalistic capitalism,” the Republican Party began to secure more campaign contributions from FIRE companies. In the 1990s, the Democrats responded by soliciting more “favorable” attitudes toward the interests of FIRE companies and subsequently were rewarded with more campaign contributions.

federal candidates and parties, with insurance companies, securities and investment firms, real estate interests and commercial banks providing the bulk of that money.”

As large as the amount of money flowing from company “coffers” to campaign “war chests” has been, the benefits of pay-for-power campaign finance for representatives who demonstrate an increased zeal for the interests of companies in the FIRE economy do not stop at the end of a career in Congress. Phil Gramm sponsored the Financial Services Modernization Act and singlehandedly ensured that the Commodity Futures Modernization Act would not be subject to oversight by the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange


16. Since the data from OpenSecrets.org take into account donations as small as $200 from individuals, it should be noted that there is no way to definitively say what are or were the motivations behind every single individual contribution. However, reports from the Center for Responsive Politics also note that substantially larger donations make up the majority of donations from individuals (in gross dollars), remarkably because such donations are “bundled” together (i.e. $30,000-per-plate fundraising dinners) and can provide opportunities for “increased access” to candidates. Additionally, out of the $3 billion contributed by FIRE companies since 1990, more than $1 billion came from political action committees (PACs) and via “soft” or “outside” money (i.e. donations from corporate and union treasuries). It has also been common for FIRE executives to encourage their employees to donate to candidates in significant amounts. For example, see Jamie Dunkley, “Barclays told to stop fundraising for Mitt Romney: Barclays has been accused of fundraising for political candidates instead of working to rebuild the public’s trust in banks following the Libor-setting scandal.” The Telegraph, July 26, 2012, http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9428249/Barclays-told-to-stop-fundraising-for-Mitt-Romney.html (accessed September 9, 2012).
Commission (SEC) by inserting specific language into the bill.\(^\text{17}\) In 2002, after his 18-year career as a senator ended, Gramm was hired immediately as a vice chairman at UBS Investment Bank, the investment arm of Swiss banking giant UBS, to provide “strategic advice to major corporate and institutional clients around the world.”\(^\text{18}\)

Gramm’s move from Washington to Wall Street represents another dimension of pay-for-power campaign finance and one manifestation of what is popularly referred to as “the revolving door,” a symbiotic relationship between civil servants and companies within the FIRE economy in which preferential treatment in government affairs is traded for future rewards from and lucrative employment positions with many of those same companies and the lobbying and consulting firms that represent them (or vice versa).\(^\text{19}\) This dynamic working arrangement has disproportionally affected the republic for decades, and it is not limited to the activities elected representatives. Many who lobby for legislation favorable to the interests of the FIRE sector go on to become Congressional staffers and write bills in the same manner; many who consult with general counsel for

\(^\text{17}\) Sunlight Foundation, “Case Studies: Commodity Futures Modernization Act of 2000 (H.R. 4577).”

\(^\text{18}\) UBS, “Senator Phil Gramm - Vice Chairman, UBS Investment Bank,” UBS website, under “Revitalizing America,” http://financialservicesinc.ubs.com/revitalizingamerica/SenatorPhilGramm.html (accessed September 10, 2012). Although he had earned a graduate degree in economics from the University of Georgia, Gramm had no experience working in banking or finance.

\(^\text{19}\) As will be explained, there are also instances in which employees in private-sector companies, including lobbying and consulting firms, have been elected to office or appointed to senior-level positions at government agencies, which has in the past provided them with opportunities to influence the outcome of any actions that may impact their former employers or clients.
government committees and subcommittees on behalf of private financiers were once lawyers parsing the legal implications of bills coming out of those very same groups; and, perhaps most visibly, many senior-level employees at some of the most wealthy and powerful companies go on to be appointed to the very top position(s) at the government agencies assigned with the duty to oversee the FIRE economy.20

In the early 1990s, for instance, Mark C. Brickell became the leading lobbyist for firms in the derivatives market after having been employed for 25 years at J.P. Morgan Chase; interestingly, he also claims to having been present at the retreat for financiers in Florida at which the idea for derivatives was first conceived.21 That meeting occurred in 1994, the same year that Brickell led a successful campaign to stop four “anti-derivatives” bills in Congress.22 The year prior, in 1993, Brickell aided in the decision-making process of outgoing CFTC Chairwoman Wendy Lee Gramm, who made most over-the-counter (OTC) derivatives exempt from federal regulation.23 (Five weeks after

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23. Lessig, Republic Lost, 72-73.
she resigned, Gramm was appointed to the board of directors of Enron²⁴ and for eight years collected between $915,000 and $1.85 million in salary, attendance fees, stock options and dividends. Enron traded heavily in natural gas and electricity derivatives, and eventually collapsed because of accounting control fraud in 2001.)²⁵ And, finally, in a somewhat surprising though still exemplary development, Brickell was denied a position as the lead regulator at the Office of Federal Housing Enterprise Oversight (OFHEO) in 2003 – which at the time would have given him authority over the mortgage-backed

24. Public Citizen, “Enron’s Web of Influence: The Political Players,” Public Citizen website, under “Our Work” in “Climate and Energy,” http://www.citizen.org/cmep/article_redirect.cfm?ID=7107 (accessed September 11, 2012). The connections between representatives of the federal government and Enron were staggering. President Bush received $312,500 from Enron and its employees for gubernatorial campaigns in Texas, and $413,800 for his presidential campaign and inaugural fund. Vice President Dick Cheney met with former Enron executive Kenneth Lay and other Enron officials six times while formulating the Bush administration’s energy policy, which reportedly contained 17 provisions sought by Enron. Cheney refused to show records of these meetings to Congress. Not long before the company’s bankruptcy filing, Karl Rove sold between $100,000 and $250,000 in Enron stock under advice of White House counsel, having himself participated in energy meetings prior to the sale. Thomas White was Secretary of the Army and an Enron executive for 11 years. He possessed $25 million in Enron stock options at the company’s peak and vowed to privatize military energy services to allow companies like Enron to “win” federal contracts.

securities issued by Fannie Mae and Freddie Mac – after his nomination by President Bush was withdrawn when opponents, such as Senator Paul S. Sarbanes (D-MD) and Senator Jack Reed (D-RI), questioned Brickell’s ability to be an impartial civil servant given his personal role in deregulating derivatives.  

Brickell’s near confirmation by Congress for the position at OFHEO calls attention to another iteration of the “revolving door” and effect of pay-for-power campaign finance,” what scholars call “regulatory capture.” The dictionary definition of “capture,” “an act of catching, winning, or gaining control by force, stratagem, or guile,” could not be more appropriate, but for the sake of utility in the realm of American politics the description of regulatory capture by Kalpana Pai and Thomas D. Tolleson of Texas Wesleyan University is valuable:

[R]egulatory capture occurs because groups or individuals with a high-stakes interest in the outcome of policy or regulatory decisions can be expected to focus their resources and energies in attempting to gain the policy outcomes they prefer, while members of the public, each with only a tiny individual stake in the outcome, will ignore it altogether. Regulatory capture refers to when this imbalance of focused resources devoted to a particular policy outcome is successful at “capturing” influence with the staff or commission members of the regulatory agency, so that the preferred policy outcomes of the special interest are implemented. 


In economic theory, it has long been debated whether “regulations,” in the political-economic sense of the term, are put in place to serve the public interest or whether they are enforced to gradually move markets toward monopolistic conditions. Therefore, regulatory capture is traditionally analyzed from dueling perspectives. It is, alternately, the unintentional byproduct of rules and regulations that some academics say prevent entry into the marketplace, or, as the University of Chicago’s George Stigler argued, the effect of deliberate government decisions to preside over conditions moving toward monopoly in particular industries. In his seminal 1971 article, “The Theory of Economic Regulation,” Stigler contended that governments institute regulations on behalf of corporations who capture the regulatory agency and manipulate its rules and regulations to drive the competition out of business.28 What is perhaps more remarkable, though, is the widespread willingness by ideologically different economists and scholars to admit not only that regulatory capture exists, but also that it is prevalent in many countries around the world, particularly the United States.29 Indeed, Pai and Tolleson may have been understating the capacity for “influence with the staff or commission


members of the regulatory agency” because of the aforementioned likeliness of pay-for-power campaign finance to result in something amounting to overt agency (i.e. leadership) through executive appointments.

To be sure, the appearance of some of the country’s top financiers in positions of power at government agencies extends back to the earliest days of the United States, when the British-born, colonial merchant Robert Morris not only funded the Revolution; he signed Declaration of Independence, the Articles of Confederation, and the Constitution, and went on to manage the American economy as Superintendent of Finance from 1781 to 1784. However, in the absence of a sizable American bureaucracy – with the exception of the Department of the Treasury – the possibility of appointments leading to regulatory capture was inherently limited throughout much of the 1800s. It is only near the turn of the 20th century, with the introduction of new government agencies at the height of industrial production before the first World War, that the influence of American financiers from positions of power within the government became particularly visible.


31. It is also worth reiterating that this period marked the steady transition of from hedge to speculative finance under what Minsky called “prewar money manager capitalism.”
For example, not 40 years after the creation of the Office of the Comptroller of the Currency (OCC),\footnote{During the Panic of 1907, a once-and-future banker, William Barret Ridgely, led the OCC. The Office of the Comptroller of the Currency is a bureau within the Department of the Treasury. Created by the National Currency Act of 1863, the mission of the OCC is to “is to charter, regulate, and supervise all national banks and federal savings associations.” See Office of the Comptroller of the Currency, Mission, Office of the Comptroller of the Currency website, under “About the OCC,” http://www.occ.treas.gov/about/what-we-do/mission/index-about.html (accessed September 15, 2012.)} the Antitrust bombast of President Teddy Roosevelt during the Progressive Era was coupled with the appearance of industrial kingmaker John Pierpont Morgan’s particularly close relationship with Secretary of the Treasury George B. Cortelyou during the Panic of 1907.\footnote{Vincent Carosso, The Morgans: Private International Bankers, 1854—1913 (Cambridge, MA: Harvard University Press, 1987), 528-548.} Several banks in New York would have had to file for bankruptcy had Morgan not personally negotiated a settlement for them with Cortelyou, who ensured $35 million in federal money would be set aside for their rescue – with near zero interest paid.\footnote{Some scholars contend that the Panic of 1907 acted as a catalytic event for the creation of the Federal Reserve through the Federal Reserve Act of 1913. See Robert F. Bruner and Sean D. Carr, The Panic of 1907: Lessons Learned from the Market's Perfect Storm (Hoboken, NJ: Wiley, 2009).}

In fact, Cortelyou was also a lead campaign fundraiser on Wall Street, so much so that in 1904 he reportedly arranged for Morgan to give $150,000 to President Roosevelt’s re-election campaign.\footnote{Morgan denied any impropriety having to do with these campaign contributions in testimony before the Senate. See Boston Evening Transcript, “Morgan gave $150,000 Contributions, in 1904 to the Republicans,” October 3, 1912, in Google News, http://news.google.com/newspapers?nid=2249&dat=19121003&id=J48-} Morgan then personally selected Cortelyou – who was, at the
time, also chairman of the Republican National Committee – to head the newly created Department of Commerce.\textsuperscript{36} Not long after, Cortelyou was appointed to his post at Treasury, and because of the money he issued at Morgan’s behest during the Panic of 1907, troubled banks were able to make $17 million in profits, a return near 50 percent.\textsuperscript{37}

This pattern was repeated in the years surrounding the Great Depression, when one of the premier bankers in America, Andrew W. Mellon of Pittsburgh, served as Treasury Secretary under three presidents: Warren G. Harding, Calvin Coolidge, and Herbert Hoover.\textsuperscript{38} Mellon is said to have received the appointment for personally underwriting $1.5 million of debt from the Republican National Committee’s campaign promoting Harding for president in 1920.\textsuperscript{39} Though scholars disagree whether his policies to cut taxes for wealthy citizens were directly responsible for the prewar move to

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speculative finance credited by Minsky with causing the stock market crash in 1929, Mellon was forced to resign from Treasury in 1932 because of the country’s depressed economy.\(^4\)

In response, President Franklin Delano Roosevelt presided over the creation of the Federal Deposit Insurance Corporation (FDIC) in 1933 and the Securities and Exchange Commission (SEC) in 1934, and appointed a prominent businessman and self-professed manipulator of finance, Joseph P. Kennedy Sr., to lead the latter and reform the securities industry. Though Kennedy coveted the secretary post at Treasury, Roosevelt made the risky decision to install him at the SEC because he said he needed Kennedy’s knowledge to effectively police the industry.\(^4\) Nonetheless, for his presidential bid in 1932, Kennedy made sure that Roosevelt’s campaign was adequately funded by making donations, loaning his own money, and working as a major fundraiser. For Roosevelt’s reelection campaign in 1936, Kennedy even published a book, *I’m For Roosevelt*, detailing his support for the New Deal. In sum, Kennedy contributed $360,000 to Roosevelt’s campaigns.\(^4\)


Although his appointment was counterintuitive and ethically suspect, Kennedy’s performance at the SEC – 2,300 cases of alleged fraud were investigated during his time as chairman\textsuperscript{43} – came to represent a temporary bulwark against the possibility (or probability) of regulatory capture. It was a symbol of the Roosevelt administration’s supervision of the market under “paternalistic capitalism,” and it ushered in a period of approximately 30 years, through a second World War and a Civil Rights movement, in which the general welfare and some semblance of fairness were maintained under new regulatory regimes. Stigler’s theoretical convictions about regulatory capture in the early 1970s foreshadowed the end of this era and, in a sense, drew parallels with Minsky’s prediction of a return to “money manager capitalism.” (Essentially, as the trend of selecting executives in the FIRE economy to lead the very government agencies charged with regulating their own industries escalated, so has there been a resurgence in speculative finance.)

One of the more visible series of events marking the transition occurred throughout the 1980s and into the early 1990s: the “Savings & Loan crisis” (S&L). The causes of the crisis were many and compounding, but for the purposes of describing the shift to a political-economic environment conducive to regulatory capture, it is more

\textsuperscript{43} Kessler, \textit{The Sins of the Father}. 
pertinent to focus on the deregulatory fervor permeating the FIRE economy at the time.\textsuperscript{44} Particularly, under the all too familiar guise of leveling the competition between S&Ls and investment firms in the shadow banking industry, nearly all rules and limitations were eliminated for the former.

Savings and loans – also referred to as “thrift institutions” – accounted for a substantial percentage of traditional, commercial banking institutions offering demand deposit accounts and mortgage loans in the first half of the 20\textsuperscript{th} century. But in the decades that followed, S&Ls became uniquely vulnerable to changes in interest rates set by the Federal Reserve. Specifically, a provision in Glass-Steagall called “Regulation Q,” which provided the Federal Reserve Board of Governors the power to set maximum interest rates for any deposit accounts. President Jimmy Carter repealed Regulation Q, in part, in 1980 when he signed the Depository Institutions Deregulation and Monetary Control Act, which abolished interest rate ceilings for all accounts except demand deposits.\textsuperscript{45} This put thrift institutions at quite the disadvantage. For example, when investment banks introduced vehicles offering higher rates of return on idle cash – such


as money market funds – S&Ls could not match them, and that led customers to move their money, and that led to many thrift institutions becoming insolvent.

The Garn-St. Germain Depository Institutions Act of 1982 was passed to eliminate this disadvantage, but it also provided “expanded powers to federally chartered S&Ls and enable[d] them to diversify their activities with the view of increasing profits”:

Major provisions include[d]: elimination of deposit interest rate ceilings; elimination of the previous statutory limit on loan to value ratio; and expansion of the asset powers of federal S&Ls by permitting up to 40% of assets in commercial mortgages, up to 30% of assets in consumer loans, up to 10% of assets in commercial loans, and up to 10% of assets in commercial leases. 46

After President Ronald Reagan signed the bill into law, there was a rush by state-licensed thrift institutions to obtain a federal charter and exploit their newfound powers. In response, several states – notably California, Florida and Texas – followed the example set by Garn-St. Germain and removed restrictions on the ability of S&Ls to invest their own customers’ deposits in any number of ventures. 47

As has been thoroughly documented, the results were catastrophic for the national economy. Control frauds and other criminal acts were committed on such a scale as to precipitate what was at the time the largest collapse and subsequent rescue of failing financial institutions in U.S. history: “From January 1, 1986, through year-end 1995, the number of federally insured thrift institutions in the United States declined from 3,234 to


47. Ibid.
1,645, or by approximately 50 percent.”\(^48\) At a time when the word “billion” was not quite as normal a part of the national vocabulary, “the thrift crisis… cost taxpayers approximately $124 billion and the thrift industry another $29 billion, for an estimated total loss of approximately $153 billion.”\(^49\)

Before Garn-St. Germain became law, its author, Richard R. Pratt, was hand picked in 1981 by President Reagan (and the bill’s co-sponsor, Senate Banking Committee Chairman Jake Garn [R-UT]) to be the chairman of the agency charged with regulating the thrift industry, the Federal Home Loan Bank Board (FHLBB). Pratt was the former chief economist for the foremost S&L trade association, the U.S. Savings and Loan League.\(^50\) By 1982, the thrift industry was collectively believed to be insolvent by $150 billion, but Pratt proceeded nonetheless to augment his bill’s deregulatory strategy (with support from Secretary of the Treasury Donald Regan, who was a former executive at Merrill Lynch):

Pratt… cut the number of [federal thrift institution] examiners and, at the behest of the Reagan administration, ceased virtually all closures of failed S&Ls. Instead, he merged insolvent S&Ls and used abusive accounting schemes that hid real losses and created massive amounts of fake income and “capital.” He then, ever so modestly, claimed credit for “resolving” hundreds of S&L failures at virtually


\(^{49}\) Ibid., 33.

no cost to the insurance fund. The “resolutions,” of course, were typically accounting shams that led to increased losses.\textsuperscript{51}

In the wake of covering up thousands of instances of accounting control fraud, Pratt then “declared victory,” resigning from the FHLBB early in 1983, and immediately after took a job as president of Merrill Lynch Mortgage Capital, Inc.

Pratt’s successor, Edwin Gray (a Reagan family friend), was also selected by the U.S. Savings and Loan League. Gray, who had previously worked for an S&L in San Diego, “has said that the S&L trade association chose him to be its top regulator because he was a strong supporter of financial deregulation and because they believed he would be friendly to the S&L industry.”\textsuperscript{52} However, he also understood his duties to the American public. Having recognized the ongoing threat of the accounting control frauds consuming the thrift industry, Gray chose to “re-regulate” it by doubling “the number of [federal thrift] examiners and supervisors within 18 months”; ordering “supervisory agents to certify that any violations of law or unsafe conditions or practices found by the examiners had either been fixed or that the supervisor had referred the matter to [law] enforcement to force the S&L to fix the problem”;\textsuperscript{53} and using more than $5 billion from the aforementioned insurance fund at the Federal Savings and Loan Insurance


\textsuperscript{52} Ibid.

\textsuperscript{53} Ibid.
Corporation (FSLIC) to resolve and close failed S&Ls, making sure that depositors were made whole.\textsuperscript{54}

As much money as Gray spent to minimize losses in the thrift industry, it was obviously not enough. When Gray asked for more money to recapitalize the FHLBB’s insurance fund – with $15 billion that would have come directly from S&Ls – members of Congress rebuffed him on behalf of some of their largest campaign contributors, the leaders of fraudulent S&Ls and their associate trade associations.\textsuperscript{55} In fact, representatives delayed the passage of the bill designed to accomplish Gray’s request, the Competitive Equality Banking Act (CEBA), and then forced his resignation before the legislation eventually became law in 1987. The FSLIC went bankrupt, with its insurance provisions being assumed by the FDIC and then the Resolution Trust Corporation.\textsuperscript{56}

The reason Congress and the Reagan administration refused to act – and the reason the S&L crisis spanned so many years – can, again, be traced to pay-for-power campaign finance. While data from the years leading up to the passage of Garn-St. Germain is 1982 is not readily available\textsuperscript{57}, the years in which Gray led the FHLBB have been well chronicled and are revelatory. Having lost their agent of regulatory capture –


\textsuperscript{55} Black, “Why was the S&L Crisis not a Systemic Economic Crisis?”

\textsuperscript{56} Ibid.

\textsuperscript{57} Online data from the Federal Election Commission is sparse and incomplete. A search found no pertinent records prior to 1984.
Pratt – the leaders of the country’s largest S&Ls paid members of congress to make sure their own illegal activities could continue for as long as possible. In 1984, 1986, and 1988, PACs formed by S&Ls donated approximately $650,000, $820,000, and $1 million, respectively, to the campaigns of candidates who were incumbent members of the Banking Committee in the House of Representatives. The Banking Committee was charged with writing CEBA.

The most egregious offenders were the largest donors. In 1985 and 1986, the CEO of the Vernon Savings and Loan Association (Dallas, Texas), Donald Dixon, alongside persons connected financially to the company, donated about $60,000 to the Democratic Congressional Campaign Committee. By 1987, the company was bankrupt, and the FHLBB had filed a $350-million lawsuit against Vernon Savings and Loan and “seven [of its] former officers,” charging them “with looting the organization of hundreds of millions of dollars.” More than 95 percent of the loans made by the Vernon Savings and Loan Association defaulted. In another remarkable instance of the S&L Crisis, David Paul, the head of Centrust Savings Bank (Miami, Fla.), reportedly gave more than


61. Black, “Why was the S&L Crisis not a Systemic Economic Crisis?” The preferred name for Vernon Savings and Loan used by field office regulators was “Vermin.”
$300,000 to lawmakers in the 1980s, including Senate Banking Committee member Bob Graham (D-FL). Centrust failed in 1990, at a cost of roughly $2 billion to taxpayers, with large sums of money ending up in Paul’s own backyard: $3.2 million in Centrust funds were used “to make his $9 million Miami Beach waterfront estate and $7 million yacht more luxurious” and to “expand his house's dock.”

Even more infamous was the case of the Lincoln Savings and Loan Association (Irvine, Calif.), which committed control frauds that cost taxpayers $3.4 billion. Charles Keating, the CEO of Lincoln Savings and Loan’s parent company, American Continental Corporation, attempted to stop Gray’s re-regulatory efforts on multiple occasions. Having donated to the campaigns of Speaker of the House Jim Wright (D-TX) and Senator Alan Cranston (D-CA), Keating called in a “favor” to the two congressmen, who obliged by removing CEBA from the legislative docket until its language was amended to include provisions for “regulatory forbearance.” By allowing the larger, more systemically


65. Wright received $240,000 from S&L PACs in 1986. See Pizzo, Fricker, and Muolo, Inside Job, 355.
dangerous S&Ls to engage in further accounting fraud to make it appear on paper that their capital accounts met (or could in the near future meet) federal requirements, the term basically “ensured that regulators could force only some insolvent S&Ls to close or reorganize.” It basically “relaxed many regulatory provisions” and meant that, for a time, Lincoln Savings and Loan could continue operating with limited restrictions.

Keating’s more publicized role, though, was in orchestrating several meetings between a group of senators – the “Keating five” – and regulators from the FHLBB. From 1984 to the time of the meetings, Keating and associates had given generously to the campaigns of all five senators. John McCain (R-AZ) received $112,000; John Glenn (D-OH) received $200,000; Dennis DeConcini (D-AZ) received $55,000; Donald Riegle (D-MI) received $76,100; and Cranston received $889,000. The first meeting occurred on April 2, 1987, when the senators asked Gray, face to face, to put a halt to the FHLBB’s ongoing investigation of Lincoln Savings and Loan. Gray’s response – that he did not know the details of the case – prompted the next meeting a week later on April 9, in which the Keating five met with three FHLBB branch regulators from San


Francisco, who informed the senators that the case against Keating, and Lincoln Savings and Loan, had *criminal* implications.  

The regulators filed their report in May. It recommended that the government seized Lincoln Savings and Loan. Gray’s resignation, however, prevented the case from moving forward, and left an opening for the leaders of the S&L industry and the FIRE economy to re-establish regulatory capture. Their new man at the FHLBB, M. Danny Wall, did just that. Wall, who was formerly the top congressional aide to Senator Garn, took no action on the regulators’ report, citing “insufficient evidence,” and removed the case from the San Francisco branch in September. In May of 1988, Wall and the FHLBB signed an agreement with Lincoln Savings and Loan that stipulated that a criminal referral against the company would not be filed with the Department of Justice.

In response, FHLBB regulators revolted in open testimony before Congress, exposing Wall’s “sham examination” of Lincoln Savings and Loan in the process and taking advantage of the fact that 1988 was an election year. President George H.W. Bush, who as Reagan’s vice president and chair of the administration’s financial “task force” was “as culpable as anyone in the nation for the deregulation and de-supervision that


70. Ibid.

made the S&L industry a criminogenic environment,” made the politically wise decision in closing the FHLBB and forcing Wall’s resignation in December of 1989.  

The president, having been apprised by those same regulators of the full scale of the losses that were still exacerbating the S&L crisis, appointed Timothy Ryan to lead the FHLBB’s successor agency, the Office of Thrift Supervision (OTS), and shepherded new legislation through Congress that gave OTS effective regulatory powers over failed S&Ls (the Financial Institutions Reform, Recovery and Enforcement Act [FIRREA]).

Ryan’s term at OTS, though a product of political fortune and circumstance, was representative of the effectiveness of career civil servants who respect their duty to uphold the law and serve the public interest. It is stark in its contrast to actions taken by the federal government to combat the frauds that played so large a role in causing the Great Recession. By bringing accountability to the FIRE economy with 10,000 criminal referrals to the Federal Bureau of Investigation and Department of Justice that resulted in 1,000 convictions of individuals who defrauded their own S&Ls, the actions of FHLBB and OTS regulators in during the S&L Crisis saved American taxpayers nearly $1 trillion. There have been virtually no such referrals and convictions in the wake of the

72. Black, "Why was the S&L Crisis not a Systemic Economic Crisis?"
73. Ibid.
74. Ibid.
Great Recession, and, consequently, the losses borne by U.S. taxpayers continue to mount because many have either been hidden from public view or deferred to a future crisis event. These outcomes were by design; they were the inevitable results of deliberate strategies pursued by the beneficiaries of pay-for-power campaign finance and regulatory capture. Having learned from their tactical mistakes during the S&L crisis, concerted and collective efforts were made over the course the following two decades to prevent the possibility of the civil service exacting any appropriate measures of justice after the Great Recession began.
CHAPTER FOUR

A DECADE IN THE MAKING –
CIVIL SERVICE FAILURES & THE GREAT RECESSION

Our bank regulators were not, as they would like us to believe, outside the disco, deaf and blind to the revelry going on within. They were bouncing to the same beat.

–Law professors Susan P. Koniak, George M. Cohen, David A. Dana, and Thomas Ross

Although the politically expedient decisions of the administration of President George H.W. Bush to re-regulate the thrift industry and pursue criminal cases against those who looted it in the late 1980s and early 1990s proved largely successful, the savings and loans that either failed or were defrauded (or both) accounted for a comparatively small percentage of economic activity for companies in finance, insurance, and real estate (FIRE). The leaders of many firms in the rest of the FIRE sector were undeterred, even emboldened, in their efforts to exploit pay-for-power campaign finance in the years after the S&L crisis, and the result has been nothing less than the United States federal government being made rife with overt regulatory capture. And once again the Great Recession is the proverbial “smoking gun,” the contemporary crisis that provides a fresh lens with which to analyze the adverse impacts of partnerships between private finance and civil service that subvert the public interest.

1. Koniak, Cohen, Dana, and Ross teach at Boston University, the University of Virginia, Northwestern University, and the University of Pittsburgh, respectively.
The tipping point was the collapse of Lehman Brothers in September 2008 during the waning days of George W. Bush’s presidency. After Lehman’s bankruptcy, several regulatory bodies that had supervisory officers at the firm – the Federal Reserve (Fed) and the Securities and Exchange Commission (SEC) – were so corrupt that leaders from both lied before Congress about their own institutional policies that essentially permitted Lehman to hide how much debt it held by engaging in complex Ponzi finance. Known internally at Lehman as “Repo 105,” the scheme obtained “new loans to pay off old loans, pretended the new loans were ‘sales,’ and through a complicated series of steps made both the old and new loans disappear just in time for its quarterly reports.” The Fed and the SEC together published the “Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities” in 2006 to provide their implicit approval of “Repo 105,” and made the statement official policy the following year:

What are “complex structured finance” transactions? As defined by the regulators, these include deals that “lack economic or business purpose” and are “designed or used primarily for questionable accounting, regulatory or tax objectives, particularly when the transactions are executed at year end or at the end of a reporting period.”

How does one propose “sound practices” for practices that are inherently unsound? Yet that is what our regulatory guardians did. The statement is powerful evidence of the permissive approach bank regulators took toward the debt-dissolving financial products that our banks had been developing, hawking and using themselves for years. And it’s good reason for Americans to be outraged by

the “who me, what, where?” reaction of [Federal Reserve Chairman Ben] Bernanke and the S.E.C. to the revelation of Lehman’s Repo 105 scam.\(^3\)

The acceptance by SEC and Fed field officers of fraudulent accounting procedures like “Repo 105” is resemblant of Stockholm syndrome. The difference is the source of their psychological inclinations to bond, identify, and sympathize with, and be superseded by, the very FIRE companies that were never supposed to assume the role of captor. The behavior of regulators is not spontaneous, but conditioned and demanded by intermediaries who act on behalf of the FIRE economy: the political appointees that administer virtually all regulatory agencies of the U.S. government. They enabled the frauds that caused the Great Recession and, in addition to the SEC and the Fed, include leaders from the Treasury Department (Treasury), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the Commodity Futures Trading Commission (CFTC), and the Department of Justice (DOJ). Such compromised work environments do not develop overnight, however, and in context those that mattered the most were more than a decade in the making.

Incoming President Bill Clinton faced a recession in 1993 and retained the stigma of a Democrat unwilling to play nice with financiers, especially trailing a reluctantantly interventionist Republican predecessor. To shed this reputation, and to please his campaign contributors – Clinton received more than $800,000 from FIRE companies for

\(^3\). Ibid.
his 1992 campaign— he met with then-Federal Reserve Board Chairman Alan Greenspan to convey his support for a more pro-business monetary policy in exchange for Greenspan’s support for Clinton’s strategy to reduce the federal budget deficit by increasing taxes. He appointed as Treasury secretary former Goldman Sachs Chairman and Chief Executive Officer Robert Rubin. Clinton appointed former Wall Street veteran and chairman of the American Stock Exchange, Arthur Levitt, to lead the SEC. He chose Daniel Zelikow, former managing director of J.P Morgan Chase’s Government Institutions Group, to be deputy assistant secretary for Asia, the Americas, and Africa (within the Treasury Department). Clinton named Roger Altman, an executive in investment banking at Lehman Brothers and vice chairman of financial services giant Blackstone, as deputy secretary at Treasury.


All of these moves by Clinton made the revolving door spin like never before and set the modern precedent for a preferential, “no supervision” approach to the FIRE economy. Altman resigned amid a record-keeping scandal in the mid-1990s, only to return to the private sector and eventually make $46 million from the taxpayer-funded bailout of General Motors in 2009.10 Zelikow led a Treasury task force that administered $20 billion in loans in 1995 to prevent Mexico from defaulting on its bonds, in which Goldman Sachs was heavily invested.11 Afterward, he became executive vice president and chief operating officer of the Inter-American Development Bank, “the largest source of multilateral financing to Latin America,” and now Zelikow leads J.P. Morgan Chase’s International Public Sector Group, which specializes in winning commercial banking contracts from governments in Asia, Africa, and Latin America.12

It was Greenspan and Rubin, however, that best embodied regulatory capture during the Clinton administration. Greenspan feigned ignorance and allowed the NASDAQ-fueled tech bubble to inflate and burst, while also giving his blessing to the subprime (and often fraudulent) adjustable-rate mortgages (ARMs) that helped drive the


more recent housing bubble. Moreover, Rubin’s tenure at Treasury was marked by support for Senator Phil Gramm’s proposed (and realized) repeal of the Banking Act of 1933 (Glass-Steagall). But the duo’s major act against the general welfare – with assistance from Deputy Treasury Secretary Larry Summers and the pushover SEC chairman, Levitt – was in marginalizing CFTC Chairwoman Brooksley Born for her attempt to supervise the over-the-counter (OTC) derivatives industry after her predecessor, Wendy Lee Gramm, made it official CFTC policy not to do so. In March of 1998, Born wanted to release a “concept paper” that would present a series of questions about the potential regulation of the OTC derivatives market, which at the time was believed to be worth between $30 trillion and $70 trillion:

[Her] plan was to have the CFTC oversee these new, often inexplicable financial products. Rubin, Summers,… Greenspan, and… Levitt countered that Born was


out of her depth…. They argued that the CFTC… didn’t have the authority or expertise to regulate complex derivatives in a fast-expanding market.17

Born’s expertise should not have been in doubt because her concept paper actually posited that fraud could become widespread in a deregulated derivatives industry, and, as has been documented, it did.18 But Greenspan still personally invited her to lunch to say that protection against such crimes was not necessary: “He explained there wasn't a need for a law against fraud,” Born said, “because if a floor broker was committing fraud, the customer would figure it out and stop doing business with him.”19

In fact, it was Greenspan and Rubin who took calls from dozens of leaders of FIRE companies, in which the same hollow rhetoric about fraud was echoed and in which pleas were made to the two officials to find a way to end Born’s intransigence.20 Summers then placed a personal call to Born as top financiers met with him in person in


18. Recall, for example, the case of Goldman Sachs’ Abacus derivatives. See U.S. Securities and Exchange Commission, SEC Charges Goldman Sachs With Fraud in Structuring and Marketing of CDO Tied to Subprime Mortgage.


Washington, saying to her, “I have 13 bankers in my office and they say if you go forward with this you will cause the worst financial crisis since World War II.” Of course, Summers only relayed this sentiment because those bankers told him they would each face a bankruptcy-inducing onslaught of lawsuits if Born’s proposed policies were adopted.

After this campaign of fearmongering did not persuade Born, it was Rubin and Greenspan, with the tepid approval of Levitt, who together urged Congress to pass a moratorium on the CFTC’s proposal to regulate OTC derivatives. Even as Long Term Capital Management – a hedge fund heavily invested in derivatives – came to the brink of failure and required a $3.6-billion rescue by a group of 14 private-sector financial institutions in September 1998, Congress agreed to the request. Born then resigned, Rubin left Treasury, and Born’s replacement, William Rainer, joined Greenspan, Levitt, and


22. Using fear as a weapon or an excuse should not be surprising, coming as it does from a part of the FIRE economy where the strategy toward clients can be summed up by the words of a former derivatives salesman for Bankers Trust: “Funny business, you know? Lure people into that calm and then just totally f—— ’em.” Ibid. For the aforementioned quote, see Frank Partnoy, Infectious Greed: How Deceit and Risk Corrupted the Financial Markets (New York: Henry Holt, 2004), 163.

23. Roig-Franzia, “Brooksley Born, the Cassandra of the Derivatives Crisis.”

24. Rubin eventually landed at Citigroup and worked there until 2009 as the company’s executive committee chairman, as well as chairman of its board of directors. “On his watch, the federal government was forced to inject $45 billion of taxpayer money into the company [during the Great Recession] and guarantee some $300 billion of illiquid assets [i.e. derivatives].” Rubin was paid $126 million in cash and stock options for his performance. See Cohan, “Rethinking Bob Rubin From Goldman Sachs Star to Crisis Scapegoat.”
the new Treasury Secretary, Summers, as part of President Clinton’s Working Group on Financial Markets. The group recommended the moratorium become law and it did, albeit in an expanded format — the Commodity Futures Modernization Act of 2000.\textsuperscript{25}

President Clinton signed both the Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley) and the Commodity Futures Modernization Act because he, too, believed the myth that fraud among FIRE companies was impossible and therefore precluded the existence of industry-wide, criminogenic environments in the United States. The same mindset that explains the outright suppression of Born’s whistleblowing on derivatives can moreover be witnessed in Clinton’s decision to put it, a philosophy supporting regulatory laxity, in writing and make it his administration’s formal policy upon the beginning of his second term in 1996. He called it “reinventing government” and dispatched Vice President Al Gore as his enforcer.\textsuperscript{26}

Reinventing government declared that the Clinton administration had a “partnership” with FIRE companies that espoused the following dogma for interacting with them: “cut obsolete regulations”; “reward results, not red tape”; “get out of Washington – create grass roots partnerships”; “allow room for innovation”; and

\footnotesize{25. Johnson and Kwak, \textit{13 Bankers}, 9.}

“negotiate, don’t dictate.”

Gore was so naïve (or calculating, perhaps) that he contended the strategy “increase[d] compliance with the laws of the land.”

Well, aside from the obvious conflicts of interest that can develop when executive branch appointees who once worked for FIRE companies “allow room for innovation” that may or may not be legal, it is, of course, the logical outcome of an inversion in authority that those same companies increase their “compliance” when they can, in fact, “negotiate” what is permitible in the first place. Reinventing government was a policy that completely ignored the lessons of the S&L crisis and implicitly enshrined what scholars and white-collar criminologists have come to call the three “DEs” of government agencies – and, by association, regulatory capture of those agencies – that ensure fraud will not only occur but flourish: deregulation, desupervision, and de-facto decriminalization.

27. Ibid., 41-44.

28. Ibid., 65.

29. An additional, compounding explanation is that the major Congressmen who prolonged the S&L crisis were Democrats, and so any admission of wrongdoing in the midst of keeping campaign contributions from FIRE companies flowing would be politically damaging. Also, after taking office, Clinton was implicated in a federal investigation for his financial dealings with the owner of a fraudulent S&L in Arkansas, Madison Guaranty. He chose to retain Timothy Ryan’s successor at OTS, a Bush appointee named Jonathan Fechter, because Fichter was of like mind toward regulation of the thrift industry and abandoned the more strict underwriting standards instituted by the Federal Home Loan Bank Board before its demise. See Jeff Gerth and Stephen Engelberg, “U.S. Investigating Clinton's Links to Arkansas S.& L.” The New York Times, November 2, 1993, http://www.nytimes.com/1993/11/02/us/us-investigating-clinton-s-links-to-arkansas-s-l.html?pagewanted=all&src=pm (accessed September 27, 2012).

Clinton has been rewarded handsomely for his preferential treatment of the FIRE economy. Months after he left office, Clinton was paid $125,000 for a speech he gave to Morgan Stanley, and another $125,000 for a speech to Credit Suisse.\(^{31}\) In 2004, Citigroup paid him $250,000 to speak; Deutsche Bank paid $150,000; and Goldman Sachs paid Clinton $300,000 for two speeches.\(^{32}\) When the mortgage bubble was at its peak in 2006, the president received $150,000 each from Citigroup (on two, separate occasions), Lehman Brothers, the Mortgage Bankers Association, and the National Association of Realtors.\(^{33}\) In 2007, Goldman came calling again (twice, at $150,000 each), as did Lehman Brothers ($150,000), Citigroup ($150,000), and Merrill Lynch ($175,000).\(^{34}\) Clinton is estimated to be able to make more than $10 million per year in speaking fees, while his net worth is estimated to be between $80 million and $100 million.\(^{35}\) The overwhelming majority of this money has been made after Clinton left office, and that fact informs further the common notion that politicians will do anything to be elected and re-elected: For those elected to office, the more lucrative aspect of pay-for-power.


\(^{32}\) Ibid.

\(^{33}\) Ibid.

\(^{34}\) Ibid.

campaign finance and the revolving door, by far, come from post-election perks and employment.

When George W. Bush became president in 2001, one holdover from the Clinton administration was head of the OCC John Hawke, a veteran lawyer for the banking industry and former general counsel for the Federal Reserve Board of Governors. Hawke took Clinton’s policy of reinventing government to another level while working for President Bush. Amid efforts by state and local officials from North Carolina, Iowa, Georgia, and several other states to curb the use of high interest rates and hidden fees by private-sector lenders, he used authority under the Banking Act of 1863 to prevent attorney generals in all 50 states from prosecuting predatory practices by commercial banks and mortgage companies who did business across state lines, provoking some observers to charge him inflating the housing bubble that burst in 2007 and 2008: “[Hawke’s policy] pushed aside state laws and state law enforcement that would have sent the message that there were still standards in place, and it was a big part of the message to the industry that it could regulate itself without rules.”

Hawke’s time at OCC represents the smooth transition between administrations that were not very different in terms of oversight of the FIRE economy. But where Clinton couched his deregulatory fervor in internal policy documents aimed at getting


37. Ibid.
civil servants to be more on accommodating on the job, Bush actually eliminated jobs altogether in many instances by underfunding and even decreasing agency budgets. For instance, Bush’s choice to lead the SEC was Harvey Pitt, a product of the accounting industry whose avowed “kinder and gentler” approach toward the FIRE economy resulted in record lows in the SEC’s legally sanctioned reviews of company financial records and a particularly sordid episode in which Pitt ignored signs of widespread accounting fraud that destroyed Enron.38

At the time, the SEC’s budget for the 2002 fiscal year was $438 million, and it had a staff of 3,285 (197 investigators) charged with reviewing the financial records of more than 14,000 companies; only 2,280 were reviewed and Pitt actually proposed cutting staff and the budget.39 And although Enron’s demise prompted legislation – the Sarbanes-Oxley Act of 2002 – to not only augment accounting rules but to also increase the SEC’s budget by 77 percent to $776 million for the 2003 fiscal year, Pitt urged Congress to only appropriate $568 million.40 One of the sponsors of Sarbanes-Oxley, Senator Paul Sarbanes (D-MD), couldn’t understand Pitt’s resistance, saying: “We didn’t pull the $776 million out of a hat. The costs of increasing pay, hiring new staff and increasing the volume of their [financial reviews] presents a case for a higher budget that


40. Ibid.
is overwhelming.” Moreover, one of Pitt’s senior-level subordinates at the SEC, Commissioner Isaac C. Hunt Jr., was pleading for more resources to serve the public interest:

I believe the Commission is significantly underfunded and this is and will have a critical effect on the Commission's ability to protect investors. As recently discussed by our Director of Enforcement, Stephen Cutler, our Division of Enforcement is receiving an average of 525 e-mail complaints a day compared to 365 a day a year ago. Last year alone the Division of Enforcement received over 100,000 e-mail complaints. These emails are only one way the Division of Enforcement obtains cases to investigate. Referrals and complaints come from many other sources, including other divisions at the Commission, the NASD, NYSE, and the other Exchanges. Now so you get an idea of how understaffed we are, the Division of Enforcement has only 750 attorneys and 75 accountants to investigate all these complaints. You do the math.

As I mentioned earlier the Division of Corporation Finance is another area where we are severely understaffed. Investors have over $10 trillion dollars invested in the S&P 500 yet resources to permit the level of review that I consider adequate are not available – the Commission should be reviewing a substantial portion of the companies that represent the largest investors' stakes – our largest companies and those which would otherwise appear to merit review. The current review levels are unacceptable…

To be sure, Bush relied on many more once-and-future Wall Street personnel on his staff to help execute his preferred deregulatory strategies. Among them were Carlos Gutierrez, who Bush chose as his commerce secretary and who went on to become vice


chairman of Citigroup’s Institutional Clients Group.43 Bush also chose Faryar Shirzad as deputy national security advisor for International Economic Affairs, who later was hired as vice president and director of International Public Policy at Goldman Sachs.44 Josh Bolten, formerly the executive director for Legal and Government Affairs at Goldman Sachs, was Bush’s chief of staff at one point and his director of the Office of Management and Budget (OMB) at another.45 For his chief economic adviser, Bush selected Steve Friedman, former chairman of Goldman Sachs in the early 1990s and concurrently a board member of the investment bank and chairman of the Federal Reserve Bank of New York during the stock market crash in 2007 and 2008.46 Robert Steel, a former vice chairman at Goldman Sachs and the last CEO of Wachovia, served as Bush’s under secretary for domestic finance at Treasury.47 Bush’s second Treasury


secretary, John W. Snow, went on to be the chairman of Cerberus Capital Management, which managed the Chrysler Corporation after its government rescue in 2007.48

The most infamous was Henry Paulson, the last Treasury secretary during the Bush administration. But for all his storied FIRE-sector connections – after 30 years at Goldman Sachs, he became the company’s CEO and had amassed a personal fortune estimated at $700 million before his government appointment in 200649 – Paulson’s brief tenure at Treasury was quite the passive experience, seemingly more subject to his own private-sector lobbying in years past and the will of new Federal Reserve Chairman Ben Bernanke than any personal deregulatory policy realizations. In 2004, for instance, Paulson led a group of investment bank executives that was successful in lobbying for then-SEC Chairman William Donaldson – a former chairman of the New York Stock Exchange – to remove the SEC’s net capital rule, allowing FIRE companies to shoulder substantially heavier debt burdens without corresponding capital increases, thereby increasing their leverage and exposing them to greater risk.50


The rule change permitted those banks to issue billions of dollars worth of mortgage-backed securities (MBS) and derivatives, which would not be subject to review because their parent bank holding companies were exempted from oversight by the SEC through provisions of Gramm-Leach-Bliley.\textsuperscript{51} Instead, the investment banks were supposed to voluntarily submit records to the SEC for review by a risk management office created by Donaldson, which would examine “firms’ own computer models for determining the riskiness of investments, essentially outsourcing the job of monitoring risk to the banks themselves.”\textsuperscript{52} Perhaps recognizing the futility of this arrangement, Donaldson’s successor at the SEC, Christopher Cox, disbanded the risk management office, only to rescind the program of voluntary regulation for investment banks – dubbed the Consolidated Supervised Entities Program – after Lehman Brothers failed in September 2008 due to accounting fraud committed under its “Repo 105” policy.\textsuperscript{53}

As discussed in Chapter Two, schemes like “Repo 105” were not the exception, but the rule, as much of the debt issued in MBS and derivatives by banks, especially the five largest investment banks (Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman


\textsuperscript{52} Labaton, “Agency’s ’04 Rule Let Banks Pile Up New Debt.”

Brothers, and Bear Stearns), was supported by fraudulent mortgages. The financial status of these assets deteriorated so rapidly in 2007 and 2008 that numerous hedge funds and other investors were able to capitalize on mark-to-market accounting practices by exploiting another regulation lifted by Cox – known as the “uptick rule” – that allowed unlimited short selling on the stock market, essentially guaranteeing them profits by driving down the price of bank stocks that were known to be overvalued because of those poor assets. What ensued was a market crash, with all five of the country’s largest investment banks either failing or bordering insolvency.


55. Mark-to-market is defined as “[t]he accounting act of recording the price or value of a security, portfolio or account to reflect its current market value rather than its book value.” As it pertains to the Great Recession, “[p]roblems can arise when the market-based measurement does not accurately reflect the underlying asset’s true value. This can occur when a company is forced to calculate the selling price of these assets or liabilities during unfavorable or volatile times, such as a financial crisis. For example, if the liquidity is low or investors are fearful, the current selling price of a bank’s assets could be much lower than the actual value. The result would be a lowered shareholder’ equity. This issue was seen during the financial crisis of 2008/09 where many securities held on banks’ balance sheets could not be valued efficiently as the markets had disappeared from them.” See Investopedia, “Mark To Market – MTM,” Investopedia website, http://www.investopedia.com/terms/m/marktomarket.asp#axzz27zUHKLWH (accessed September 30, 2012).


It was a resuscitation of the FIRE economy. But if President Bush’s team is associated with bringing it back to life, it has been the Obama administration that has protected those who brought the FIRE economy, and the national economy, to the brink
of destruction. Amid other injustices in the name stability and safety, President Obama’s appointment to lead Treasury, Timothy Geithner, a protégé of Robert Rubin, refused to negotiate a better deal for taxpayers as head of the New York Federal Reserve after AIG had stipulated that its creditors – among them Goldman Sachs – were to receive 40 percent of the original value for fraudulent derivatives on the company’s balance sheet instead of the full, 100-percent value eventually agreed to by the Fed. In the same time period, he also failed to investigate widespread fraud at Lehman Brothers when it was commonly known that the company’s accounting records were manipulated on a daily basis. In 2008, again as head of the New York Federal Reserve, he covered up frauds to rig LIBOR – the interest rate at which banks lend money to one another – failing to make any criminal referrals, for what amounted to anti-trust violations, to the DOJ. And more recently, as Treasury secretary, Geithner purposefully used bailout funds under a program called the Home Affordable Modification Program (HAMP) to prop up a fragile FIRE


economy at the expense of distressed homeowners, according to former Special Inspector General for TARP Neil Barofsky:

Helping the banks, no home owners, did in fact seem to be Treasury’s biggest concern.

We learned that when, later that fall, we were invited to another oversight meeting with Geithner, GAO [the Government Accountability Office], and the COP [Congressional Oversight Panel]. For a good chunk of our allotted meeting time, Elizabeth Warren grilled Geithner about HAMP, barraging him with questions about how the program was going to start helping home owners. In defense of the program, Geithner finally blurted out, “We estimate that they can handle ten million foreclosures, over time,” referring to the banks. “This program will help foam the runway for them.”

A lightbulb went on for me. Elizabeth had been challenging Geithner on how the program was going to help home owners, and he had responded by citing how it would help the banks. Geithner apparently looked at HAMP as an aid to the banks, keeping the full flush of foreclosures from hitting the financial system all at the same time. Though they could handle up to “10 million foreclosures” over time, any more than that, or if the foreclosures were too concentrated, and the losses that the banks might suffer on their first and second mortgages could push them into insolvency, requiring yet another round of TARP bailouts. So HAMP would “foam the runway” by stretching out the foreclosures, giving the banks more time to absorb losses while the other parts of the bailouts juiced bank profits that could then fill the capital holes created by housing losses.

The efforts by the Obama administration to block any serious criminal investigations of the accounting control frauds in the mortgage lending industry that caused the Great Recession have been concerted and consistent. Since 2009, there have been six different units of an interagency Financial Fraud Enforcement Task Force, a group that, according to the president, was formed to “hold accountable those who broke

the law” and “help turn the page on an era of recklessness.”\textsuperscript{64} The current iteration was created to effectively marginalize New York State Attorney General Eric Schneiderman, the last holdout in a settlement between 49 states and five of the largest mortgage lenders – Bank of America, Wells Fargo, J.P. Morgan Chase, Citigroup, and Ally Financial – in which state and federal prosecutors gave up their legal rights to pursue cases on “chain of title” or robosigning grounds, and admissions of wrongdoing were precluded.\textsuperscript{65} It has only brought one major case, against J.P. Morgan Chase, for securities fraud alleged to have been committed by Bear Stearns before the firm was acquired by J.P. Morgan Chase during the financial crisis.\textsuperscript{66}

One of Schneiderman’s task force co-members is Lanny Breuer, who concurrently leads the Criminal Division of the DOJ. Breuer showed more candor in explaining the Obama administration’s strategy to ignore mortgage fraud (and securities fraud, by association), and in the process provided defense lawyers with explanations to avoid future indictments for past crimes:

To be clear, the decision of whether to indict a corporation, defer prosecution, or decline altogether is not one that I… take lightly. We are frequently on the


receiving end of presentations from defense counsel, CEOs, and economists who argue that the collateral consequences of an indictment would be devastating for their client. In my conference room, over the years, I have heard sober predictions that a company or bank might fail if we indict, that innocent employees could lose their jobs, that entire industries may be affected, and even that global markets will feel the effects. Sometimes – though, let me stress, not always – these presentations are compelling. In reaching every charging decision, we must take into account the effect of an indictment on innocent employees and shareholders, just as we must take into account the nature of the crimes committed and the pervasiveness of the misconduct. I personally feel that it’s my duty to consider whether individual employees with no responsibility for, or knowledge of, misconduct committed by others in the same company are going to lose their livelihood if we indict the corporation. In large multi-national companies, the jobs of tens of thousands of employees can be at stake. And, in some cases, the health of an industry or the markets [is] a real factor.67

This sort of capitulation by Breuer’s is “grotesquely improper,” for many reasons:

1) he actually wanted to “stress” that he will not “always” refuse to pursue justice against FIRE companies that commit felonies; 2) even though he had the example of the S&L crisis to show him otherwise – the federal government put thousands of thrift institutions into receiverships in the 1980s and early 1990s and thereby “made the industry far healthier,” with few liquidations or runs on accounts – Breuer says he finds the testimony by associates of probable FIRE defendants to be “sober” “prediction[s],” when any other “competent regulator” would think otherwise; 3) “innocent employees” are straw men because the “collateral effects” of prosecutions are inevitable, regardless of the color of one’s collar or staff of top-tier lawyers or economists, and do not prevent blue-collar defendants from being indicted; and 4) Breuer’s argument “allows large corporations… 

to escape indictment by holding their innocent employees hostage,” “making them too big to [prosecute].”

But Breuer has not had many opportunities to follow through on his sentiment, which would result in decriminalized arrangements known as deferred prosecution agreements (DPA) and nonprosecution agreements (NPA), and the reason is that indictments must be preceded by criminal referrals. Criminal referrals are most often submitted by federal regulatory agencies like the SEC or OTS or OCC (or even regional Federal Reserve banks) to federal law enforcement agencies like the Federal Bureau of Investigation (FBI) or the Internal Revenue Service (IRS). Law enforcement then works with the DOJ to file criminal charges against persons or corporations. During the years of the S&L crisis, which is estimated to have been 70 times smaller than the Great Recession in terms of taxpayer-funded rescues, there were 1,000 FBI agents assigned to


69. DPA and NPA “are contracts with the government in which a company (or individual) undertakes specified actions in exchange for charges being dismissed or not filed altogether. The terms usually require payment of a fine, continued cooperation with any investigations or trials and a commitment to enhance internal controls. If the agreement is breached, the agreement typically permits prosecutors to restart the case and use any admissions by the company in the a subsequent proceeding.” Furthermore, “[a] significant advantage to these agreements is that there is no judicial involvement, so the Justice Department does not have to worry about a judge second-guessing its terms or questioning the fairness of the resolution.” See Peter J. Henning, “Deferred Prosecution Agreements and Cookie-Cutter Justice,” The New York Times, September 17, 2012, http://dealbook.nytimes.com/2012/09/17/deferred-prosecution-agreements-and-cookie-cutter-justice/ (accessed October 1, 2012).

investigate 30,000 criminal referrals in the thrift industry alleging fraud or some kind of malfeasance, with 1,000 convictions won in courts.\textsuperscript{71} From 2006 to 2010, there were approximately 120 FBI agents assigned to investigate an average of 72 criminal referrals per year against FIRE companies.\textsuperscript{72} As of June 2012, three of the government’s primary bank regulators were all but nonexistent on this front: OTS had made no referrals; OCC had made three; and of the three made by the Federal Reserve, two concerned foreign banks.\textsuperscript{73}

The SEC has, for its part, abandoned criminal referrals and replaced them with spurious settlements in civil cases. Among many deals, Angelo Mozilo, CEO of the defunct mortgage lender Countrywide, escaped admissions of guilt in a suit that charged him with securities fraud in 2010 for $67 million.\textsuperscript{74} Mozilo had already built a personal


\textsuperscript{72} Morgenson and Story, “In Financial Crisis, No Prosecutions of Top Figures.”

\textsuperscript{73} von Hoffman, “Goldman dodges SEC bullet over bum mortgage deal.”

fortune of $600 million.\textsuperscript{75} The SEC settled with Goldman Sachs in 2010 for $550 million in exchange for “a permanent injunction from violations of the antifraud provisions of the Securities Act of 1933,” which would have applied to the firm for its role in orchestrating the infamous Abacus deals in which Goldman’s customers lost $1 billion and only $250 million of the settlement was returned. (Treasury kept the leftover $300 million.)\textsuperscript{76} In a similar deal, the SEC reached an agreement with J.P. Morgan Chase in 2011, in which the bank paid $153.6 million for constructing a fraudulent collateralized debt obligation (CDO) called “Squared” that resulted in the CDO’s counterparty, Magnetar Capital, making nearly $880 million at the expense of investors.\textsuperscript{77}

Each of these settlements stipulated no admission of wrongdoing, but arguably the most lopsided of them concerns Bank of America. After the company deceived its creditors and investors in acquiring the borderline-insolvent investment brokerage Merrill Lynch (with encouragement from officials at Treasury and the Federal Reserve), it

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required nearly $50 billion in taxpayer funds to survive. The ensuing settlement negotiated with Bank of America in 2010, for $33 million, was initially struck down by a district judge who called it “half-baked justice”; as losses from Merrill Lynch were topping $20 billion, the amount was revised upward to a paltry $150 million.

Shirking accountability on such a widespread scale has been the product of a regulatory environment layered with contradictions, perpetuated in name of stability and safety, because the FIRE economy was too fragile to withstand the justice necessary to restore the integrity of government and protect the general welfare. It has been the logical extension of a milieu fabricated by the trappings of pay-for-power campaign finance and the willful disregard of regulatory capture. The current SEC chair, Mary Schapiro, has until recently been a deregulatory stalwart, having worked in the Reagan, Clinton, and both Bush administrations, and under President Obama has done nothing to change the fact that, between 2006 and 2010, “219 former SEC employees filed 789 post-employment statements indicating their intent to represent an outside client before the [SEC].”


Schapiro also continued a decades-long Commission practice of destroying all documents pertaining to thousands of inquiries into potential fraud and malfeasance by companies like Goldman Sachs, Lehman Brothers, Citigroup, and Bank of America, preventing future investigators access to background information on these firms and many others. The SEC’s actions “appeared to violate federal law, which gives responsibility for maintaining and destroying all records to the National Archives and Records Administration [NARA]. Over a decade earlier, in fact, the SEC had struck a deal with NARA stipulating that investigative records were to be maintained for 25 years – and that if any files were to be destroyed after that, the shredding was to be done by NARA, not the SEC.”

Of course, the Obama administration’s collective indemnification of the FIRE economy extends beyond the actions of Treasury and the SEC, and, by precedence, require a broader connection with its leaders. The current chair of the CFTC, Gary Gensler, was formerly a senior partner and head of finance at Goldman Sachs. Michael Froman, a former senior-level executive at Citigroup, is now deputy national security


adviser for International Economic Affairs. Mark Patterson, formerly chief lobbyist for Goldman Sachs, serves as chief of staff to Geithner at Treasury. Larry Summers returned as director of the White House National Economic Council.

Both Breuer and Attorney General Eric Holder worked as white-collar criminal defense lawyers at Covington and Burling, a firm that “has as its current clients Goldman Sachs, Bank of America, JP Morgan, Wells Fargo, Citigroup, Deutsche Bank, ING, Morgan Stanley, UBS, and MF Global…” As it happens, the largest donors to President Obama’s presidential campaigns have been some of those very same FIRE companies and the law firms that represent them. FIRE sector contributions to the Obama campaign totaled more than $40 million for the 2008 election cycle, and $14 million


85. Summers “earned more than $5 million [in 2008] from the hedge fund D. E. Shaw and collected $2.7 million in speaking fees from Wall Street companies that received government bailout money,” including Goldman Sachs, J.P. Morgan Chase, Citigroup, and Lehman Brothers. See Zeleny, “Financial Industry Paid Millions to Obama Aide.”


thus far for the 2012 run. Lawyers and lobbyists donated more than $45 million for Obama’s 2008 campaign, and have given more than $19 million for the 2012 campaign. (Predictably, as a hedge, campaign contributions from the FIRE sector to the Republican presidential candidate, Mitt Romney, have followed a similar pattern during the 2012 election cycle.)

Finally, pay-for-power campaign finance explains the evisceration of the only major regulatory bill to be signed into law by President Obama, the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010. In the year of its passage, FIRE companies spent more than $150 million on lobbying for changes to its 2,300 pages and 240 rule-making procedures. The major stewards of the law, Senator Christopher Dodd


(D-CT) and Representative Barney Frank (D-MA), received $3.8 million (between 2005 and 2010) and $1.3 million (between 2009 and 2010), respectively, in campaign donations from FIRE companies.\(^9\) Predictably, Dodd-Frank does not reduce the size and interconnectedness of those companies, and, consequently prolongs the next crisis rather than preventing it.\(^9\) The law’s most controversial provision – the Volcker Rule, “which prohibits federally insured banks from engaging in proprietary trading, participating in complex securitizations, owning hedge funds or private equity funds, or engaging in any other high-risk activities” that “conflict with the interests of their customers” – was also the target of manipulation, with those congressman “seeking a weaker rule hav[ing] received an average of $388,010 from the financial sector since the 2010 election cycle, compared to an average of $96,897 received by those seeking a stronger rule. Cumulatively, members asking for a weaker rule have received more than 35 times as much ($66.7 million) from the sector as those seeking a stronger rule ($1.9 million).”\(^9\)

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It is clear that such machinations are improper and more pervasive than ever before. New records are set seemingly every year on money spent for lobbying efforts or campaign finance. Their overall purpose, through multiple decades, presidential administrations, and congresses, is not to inform the public, or make civil service better, but to make an end run around the legislative and law enforcement processes when the interests of the FIRE sector are at stake, and thereby profit from their malfunction at the public’s expense. But as great a threat as pay-for-power campaign finance and regulatory capture are to republican forms of self-government, their efficacy is subject to the behavioral flux of democratically elected representatives. The greatest power wielded via the bond between private money and public service was instituted almost a century ago, in 1913, the year that control of the United States’ money supply was taken away from the citizenry by the country’s new central bank – the Federal Reserve – and given to its private member banks.

CHAPTER FIVE
THE FEDERAL RESERVE & THE MONEY POWER

Some people think the Federal Reserve banks are United States government institutions. They are not government institutions. They are private credit monopolies which prey upon the people of the United States for the benefit of themselves… speculators and swindlers, and rich and predatory money lenders…. Every effort has been made by the Federal Reserve Board to conceal its power but the truth is the Federal Reserve Board has usurped the government of the United States.

– Rep. Louis T. McFadden (R-PA), Congressional Record, June 10, 1932

In 1976, the House Committee on Banking, Currency, and Housing conducted a study on the leadership structure of the Federal Reserve (Fed), the government-sanctioned central bank of the United States charged with “conducting the nation’s monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates.”

It revealed a profoundly undemocratic arrangement that favors the preferences of commercial, member banks (and large businesses) over the public interest, prompting the committee’s chairman, Henry Reuss (D-WI), to write: “This Committee has observed for many years the influence of private interests over the essentially public responsibilities of

the Federal Reserve System…. [T]he heavy links to the banking community raise doubts about the ability of the [Federal Reserve] to view… regulatory issues with objectivity.”\(^2\)

The Fed has three primary divisions. The board of governors, stationed in Washington, D.C., has seven members, all chosen by the president of the United States and confirmed by the Senate. Then, there are 12 district banks and 24 branch banks located in 36 cities across the country.\(^3\) Finally, the Federal Open Market Committee (FOMC) – the “monetary policymaking” group – consists of the seven members of the board of governors, and presidents (or first vice presidents) from five of the twelve district banks.\(^4\) The presidents of the Federal Reserve district banks who serve on the FOMC are selected by each district bank’s board of directors.\(^5\)

Traditionally, the members of the board of governors are former presidents or vice presidents of the Federal Reserve district banks, academics, lawyers, or business leaders.\(^6\) While their nomination process is certainly subject to political pressure, subjectively the overwhelming partisanship of the Fed arises from the manner in which

\(^2\) House Committee on Banking, Currency and Housing, Federal Reserve Directors: A Study of Corporate and Banking Influence, 94th Cong., 2d sess., 1976, H. Rep., III.


\(^4\) House Committee on Banking, Currency and Housing, Federal Reserve Directors, 1.


\(^6\) Ibid., 58, 65-113.
the leaders of its district and branch banks are selected. Each district bank has a board of directors with nine members, and each branch bank has its own board of directors that has between five and seven members. 7

At each of the 12 district banks, the 9-member board of directors is divided into three separate three-member classes. Class A directors are, by mandate of the Federal Reserve Act of 1913, commercial bankers “elected by the member banks in each district and they must be bankers while they serve on the boards.” 8 Class A directors are supposed to represent the interests of “lenders,” while Class B directors, “who must not be officers, directors or employees of any bank during the time they serve on the district boards,” represent “borrowers,” a designation which has historically meant executives from large corporations and former directors of major commercial banks. 9

Class C directors are appointed by the board of governors in Washington and supposed to represent the “public interest”; most of the time they are selected from the ranks of “executives or directors of corporations,” “former directors of commercial

7. U.S. Government Accountability Office, Federal Reserve Bank Governance, 20. Within the entire system, there can be up to 290 directors at any given time; 108 are at Federal Reserve district banks, and between 164 and 182 are at branch banks.

8. “[F]or nominating and voting purposes, the member banks in each district are divided into three categories by size [small, medium, and large] with each category nominating and electing one of the three Class A directors.” See House Committee on Banking, Currency and Housing, Federal Reserve Directors, 5.

9. Ibid., 4, 20. Class B directors may own bank stock, and are elected by member banks in each district according to industry. In fact, five of the Federal Reserve district banks channel nominations for Class A and Class B directors through banking trade associations, especially the large banking lobby known as the American Bankers Association. It was, as Chairman Reuss wrote, an “extra-legal nicety.”
banks,” or, occasionally, “university presidents.” The chairman of each district bank’s board of directors is chosen from its Class C directors by the board of governors in Washington. The board of directors at each district bank also appoints the majority of the members of the board of directors at the branch level.

With one exception, all of these electoral procedures and appointment powers have not changed since the Committee on Banking, Currency, and Housing released its study on the Fed nearly 40 years ago. The profiles of those elected or appointed have not changed either: an overwhelming majority of the 274 director positions currently occupied are by executives of banks or large corporations, while companies in finance, insurance, and real estate (FIRE) account for 99 of them. And just as it was in 1976, the

10. Ibid., 34. There are 36 Class C directors that sit on the boards at the 12 district banks.

11. Ibid., 34.

12. Ibid., 58. The other members of branch boards of directors are appointed by the board of governors in Washington.


14. In 1976, “37 of the 108 district bank directors [were] either directors, officers or employees of corporations from the Fortune 500 list of the leading U.S. Corporations,” while many Class A bankers are also directors of “big corporations, oil companies, tool making concerns, insurance firms, mortgage and financial organizations, and large industrial concerns—nine sit on insurance company boards and five serve on Fortune 500 companies.” The contemporary directors of the Federal Reserve district and branch banks include executives (many active, some retired) from Macy’s, The Home Depot, Nissan, Dow Chemcical, Ford Motor Corp., Wal-Mart, AT&T, J.C. Penney, IBM, Costco, Nordstrom, Chevron, Ernst & Young, Boyd
appearance of interlocking directorates, in which a member or former member of the board of directors at a Federal Reserve district or branch bank serves in multiple positions as an executive or board member at different corporations or commercial banks, is so prevalent today that it severely limits impartiality in the decision-making processes at the Fed, and even implicitly indicates collusive relationships between commercial banks to gain at the public’s expense.\(^{15}\)

These features of the Fed have prompted many scholars and civil servants to debate its constitutionality, but there can be no doubt that the operating characteristics of the system are conducive to conflicts of interest that run contrary to the Fed’s stated mission and, more importantly, to the constitutional mandate requiring the United States government to provide for the “general welfare” of its citizenry.\(^{16}\) Moreover, the district


banks “are not federal agencies” like the Federal Reserve board of governors, though they are charged with duties that contradict this nongovernmental designation:

Each [Federal Reserve district bank] is a federally chartered corporation… with member banks [that] are stockholders in the [district banks].… Under the Federal Reserve Act, [district banks] are subject to the general supervision of the [board of governors]. The [board of governors] has delegated some of its supervisory responsibilities to the [district banks], such as responsibility for examining bank and thrift holding companies and… member banks under rules, regulations and policies established by the [board of governors]. 17

It is a quasi-public, quasi-private arrangement that drove the Fed to supercede Congress by allowing the formation of Citigroup through the merger of Citicorp and Travelers Insurance, incapacitating the Banking Act of 1933 (Glass-Steagall) in the process and providing the impetus for FIRE companies that became “too big to fail.” 18 It is an arrangement, previously alluded to in Chapter Two, that permitted accounting control fraud to become endemic in the mortgage industry: Rather than use its authority under the Home Ownership and Protection Act of 1994 (HOEPA) to ban unsound or predatory lending practices by FIRE companies not usually subject to federal regulations, the Fed allowed the largest lenders and member banks – among them Bank of America,

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Wells Fargo, J.P. Morgan Chase, Citigroup, and Ally Financial – to continue making fraudulent loans until 2008.\(^{19}\)

Among many more improprieties, the same quasi-public, quasi-private dynamic provided J.P. Morgan Chase CEO Jamie Dimon, who sat on the board of directors at the Federal Reserve Bank of New York (FRBNY, one of the 12 district banks), the leverage and preferential treatment to acquire a special “bridge loan” from the Fed in the amount of $25 billion to acquire Bear Stearns in 2008.\(^{20}\) The deal was made as a part of the Fed’s “Broad-Based Emergency Programs” at the height of the Great Recession, and Dimon convinced the board of governors to purchase $30 billion of underwater and fraudulent mortgage-related assets from the balance sheet of Bear Stearns (mortgage-backed securities [MBS], derivatives, etc.) during the negotiations.\(^{21}\) The dynamic also proved effective in preempting other regulatory agencies, like the Securities and Exchange Commission, from moving forward with investigations into securities fraud among


\(^{20}\) U.S. Government Accountability Office, Federal Reserve Bank Governance, 76. The FRBNY has a permanent seat on the FOMC, not least of which because it hosts the trading desk that conducts open market operations for the FOMC, purchasing and selling certain types of securities. The $30 billion referenced above was also part of the “Maiden Lane LLC” transactions. There were three “Maiden Lane” deals; the other two were loans made to rescue AIG.

\(^{21}\) Ibid.
investment brokerages.\textsuperscript{22} And, contrary to the FRBNY’s stated duties, the dynamic even prompted its former president, Timothy Geithner, just prior to his appointment as Treasury secretary in 2009, to say, “I’ve never been a regulator, for better or worse.”\textsuperscript{23}

Perhaps the greatest recent display of power by the Federal Reserve, though, lay in its aforementioned “Broad-Based Emergency Programs”; between December 1, 2007, and July 21, 2010, more than $16 trillion was loaned to the likes of Citigroup ($2.5 trillion), Morgan Stanley ($2 trillion), Merrill Lynch ($1.9 trillion), Bank of America ($1.3 trillion), Barclays ($868 billion), Bear Stearns ($853 billion), Goldman Sachs ($814 billion), Royal Bank of Scotland ($541 billion), and J.P. Morgan Chase ($391 billion), among many others, to essentially cleanse the balance sheets of these FIRE companies of illiquid, underwater, or fraudulent assets, because they were so interdependent that if one fell others would follow with speed.\textsuperscript{24} The Fed and its member institutions achieved this objective in a variety of ways, but the primary method was to exchange federal funds for those assets (mortgages, MBS, derivatives); FIRE companies would then use the funds to make money on the spread between the interest rate at which the loans were made (oftentimes close to zero, at what is called the federal “discount window rate”) and the

\textsuperscript{22} Morgenson and Story, “In Financial Crisis, No Prosecutions of Top Figures.”

\textsuperscript{23} House Committee on Financial Services, \textit{Addressing the Need for Comprehensive Regulatory Reform}, 111th Cong., 1st sess., 2009, H. Hrg. 22, serial 111-22, 36.

\textsuperscript{24} U.S. Government Accountability Office, \textit{Federal Reserve System}, 131. There were also fees that the Federal Reserve paid to its member institutions to administer its “Broad-Based Emergency Programs,” totaling over $600 million.
higher interest rates that could be obtained through making new loans with the funds or by using them to purchase government securities that had a higher rate of return.\textsuperscript{25}

It was arguably the largest ill-gotten and unwarranted restitution in the history of the world, and it was only realized after the FIRE economy experienced a credit freeze (and debt deflation) that devastated millions of U.S. citizens. Since so many companies were loaded down with assets that were impossible to value accurately, they stopped lending to each other and most everyone else. But, more importantly, it revealed an ugly truth about the Federal Reserve system: Though the Fed may issue much of the United States’ fiat, dollar-denominated currency – what is referred to as the monetary base (MB) or high-powered money (HPM)\textsuperscript{26} – it does not control the overall money supply; in fact, as the credit manager of the Federal Reserve Bank of Atlanta, Robert Hemphill, said in 1939:

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  \item 25. Phil Kuntz and Bob Ivry, “Fed Once-Secret Loan Crisis Data Compiled by Bloomberg Released to Public,” Bloomberg website, December 23, 2011, under “News,” http://www.bloomberg.com/news/2011-12-23/fed-s-once-secret-data-compiled-by-bloomberg-released-to-public.html (accessed October 7, 2012). The term in modern finance for profits made on the spread between interest rates is also referred to as “net interest margin.” In the case of the Fed’s emergency programs, sometimes the junk assets would reappear on the balance sheets of FIRE companies after they repaid their loans. The profits made in the meantime allowed for losses on underwater or fraudulent assets that previously could not have been withstood. (In other instances, junk assets have remained on the balance sheet of the Fed for indefinite periods of time, as has been the case with the supplemental “quantitative easing” or “QE” programs.)
\end{itemize}
We are completely dependent on the commercial banks for our money. Someone has to borrow [nearly] every dollar we have in circulation…. If the banks create ample synthetic money, we are prosperous; if not, we starve. We are absolutely without a permanent monetary system. When one gets a complete grasp upon the picture, the tragic absurdity of our hopeless position is almost incredible – but there it is.27

Where Hemphill’s contention was once common among bankers and scholars, reality has seemingly been forgotten by the public and mainstream economists, for at least half a century.28 In fact, the Federal Reserve system realizes an “endogenous” theory of money, wherein loans made by commercial banks create deposits and serve to expand the money supply within the economy through added bank or credit/debt money (referred to variously as M1 or M2).29 This refutes that seemingly sacred axiom, “deposits create loans,” which is based on the belief that the Fed controls the money supply “exogenously,” from outside the economy, through correlative fractional-reserve banking mandates like the “money multiplier” and the “reserve requirement.”30

27. Irving Fisher, 100% Money (New Haven, CT: The City Printing Company, 1945), xxii.


30. Paul Krugman and Robin Wells, Macroeconomics, 2 ed. (New York: Worth Publishers, 2009), 390-397. The money multiplier is ostensibly the ratio between M1/M2 and HPM that determines how much M1/M2 can be created for every unit of HPM a commercial bank has on hand (either in its vault or in reserves at the Fed). The reserve requirement ostensibly
While the reserve requirement has been a “voluntary constraint for most banks” for almost 20 years,\textsuperscript{31} the money multiplier is and always has been a myth.\textsuperscript{32} Researchers at the Fed’s board of governors openly admitted this during the administration of its “Broad-Based Emergency Programs” in 2010:

Since 2008, the Federal Reserve has supplied an enormous quantity of reserve balances relative to historical levels as a result of a set of nontraditional policy actions. These actions were taken to stabilize short-term funding markets and to provide additional monetary policy stimulus at a time when the federal funds rate was at its effective lower bound. The question arises whether or not this unprecedented rise in reserve balances ought to lead to a sharp rise in money and lending. The results in this paper suggest that the quantity of reserve balances itself is not likely to trigger a rapid increase in lending. To be sure, the low level of interest rates could stimulate demand for loans and lead to increased lending, but the narrow, textbook money multiplier does not appear to be a useful means of assessing the implications of monetary policy for future money growth or bank lending.\textsuperscript{33}

In fact, reserve balances at commercial banks increased by an astonishing amount, from approximately $15 billion in July 2007 to more than $1.1 trillion in September 2010; yet


bank money only increased by 10 percent, and bank loans were down by almost $200 billion compared to pre-recession data.\(^{34}\)

Contrary to popular belief, this empirically proves that commercial banks are not constrained by reserves. These \textit{profit-driven} institutions will lend to consumers so long as there is a demand for financing, and the Federal Reserve will retroactively supply them with the reserves required for check cashing and clearing if they cannot be obtained through commercial interbank lending.\(^{35}\) So, in essence, loans create deposits, and, in turn, deposits create reserves.\(^{36}\) The primary reason lending stopped during the Great Recession is that commercial banks have \textit{always} been constrained by capital, and, in the midst of a credit freeze of their own making, hoarding truly unprecedented amounts of “Broad-Based Emergency Program” reserves has been the primary method for offsetting the losses that inevitably come from bad capital (i.e. fraudulent mortgages, securities, and derivatives).\(^{37}\)

The extraordinary imposition of commercial banking on total U.S. economic output has been an issue since the birth of the nation, and certainly before the Federal

\(^{34}\) U.S. Board of Governors of the Federal Reserve System, \textit{Money, Reserves, and the Transmission of Monetary Policy}.


Reserve’s inception in 1913. But its practicality changed on August 15, 1971, the day the United States abandoned the gold standard and became a monetarily sovereign nation. Under the gold standard, commercial banks and the population writ large – households, businesses, local and state governments, and the federal government – had to share a more-or-less finite amount of financial wealth because the country’s money supply was supposed to be fixed to the amount of gold possessed by the United States at any point in time. Although commercial banks loaned more money than they had in deposits and reserves – as they continue to do today – the gold standard seemingly acted as a sort of remote bulwark against profligate “lending.” Deposit insurance and all, if

38. Thomas Jefferson and Alexander Hamilton certainly knew it well. Shortly after the Revolutionary War, their debate over what was eventually dubbed the First Bank of the United States – which held a 20-year charter beginning in 1791 – prompted Jefferson, then secretary of state, to say that such an institution was unconstitutional, and ventured into a “boundless field of power, no longer susceptible of any definition.” Jefferson believed “banking establishments [to be] more dangerous than standing armies” and felt credit-debt money should be limited as much as possible. His opponent, Hamilton, the secretary of the treasury, was the national bank’s major architect and supporter. Though his intentions continue to be questioned, Hamilton’s fundamental vision for the bank was “a syndicate of [quasi-private, wealthy] holders of the public debt who were incorporated and granted a monopoly of issuing notes.” See Yale Law School, Lillian Goldman Law Library, “Jefferson's Opinion on the Constitutionality of a National Bank: 1791,” The Avalon Project website, http://avalon.law.yale.edu/18th_century/bank-tj.asp (accessed October 10, 2012); Paul Leicester Ford, ed., The Works of Thomas Jefferson (New York: G.P. Putnam's Sons, 1905), 11:127, http://files.libertyfund.org/files/807/Jefferson_0054-11_EBk_v6.0.pdf (accessed October 10, 2012); and William Graham Sumner, Alexander Hamilton (New York: Dodd, Mead, and Company, 1890), 164, respectively.

39. L. Randall Wray, “Money,” Levy Economics Institute of Bard College website, http://www.levyinstitute.org/pubs/wp_647.pdf (accessed October 9, 2012). Dollars, of course, were still printed (or coined) by the federal government, and the danger lay in the possibility that too much paper currency would circulate relative to the amount of gold that theoretically supported those dollars. If realized, the value of the dollar would collapse and citizens would make a run on banks to convert their dollars to gold, with whatever dollars left over rendered worthless.
banks’ promises to convert fabricated, credit-debt money on balance sheets to paper dollars on demand could not be kept, people might make a run for their dollars and then perhaps even attempt to convert them to gold.\footnote{Ibid., 12.} During the last few years the U.S. operated on the gold standard, this reality began to become overt, as the disparity between gold reserves and dollars in circulation grew. In 1968, only five percent of U.S. paper currency was backed by gold.\footnote{International Monetary Fund, “Money Matters: An IMF Exhibit – The Importance of Global Cooperation. System in Crisis (1959-1971),” International Monetary Fund website, http://www.imf.org/external/np/exr/center/mm/eng/sc_sub_3.htm (accessed October 13, 2012).}

The financial wealth of a monetarily sovereign nation, however, is not fixed. For more than 40 years, the federal government has not been sharing a finite amount of dollars with its citizenry. It has been issuing, \textit{solely}, what is called a “fiat currency,” as it sees fit, and this fiat currency, the dollar, can \textit{only} be created through its sovereign authority.\footnote{Ibid.} And since fiat dollars do not represent a fixed amount of gold, the federal government can theoretically create and issue an infinite amount of them.\footnote{Ibid. Fiat currencies are inconvertible. For example, if a person found a gold nugget while out on a hike in California, that person could obtain dollars by selling it on the open market. But the only reason that the buyer would be able to obtain those dollars to spend on gold in the first place is because the federal government had created them.}

\footnote{Ibid. This is not to say that fiat currencies are not subject to inflation or other monetary pressures, but those are explorations not pertinent to the overall theme and arguments made in this chapter. That is the realm of Modern Money Theory (MMT). Fiat currencies are, however, relevant in a more general sense because they play a large role in how the U.S. economy currently operates and in interacting with the nation’s banking system. For more, see Wray, \textit{Understanding Modern Money}. Also, see Staff reports, \textit{MMT Primer}, New Economic....}
The Federal Reserve system has continually manipulated and exploited this new money paradigm on behalf of its privately-owned, commercial member banks, permitting the creation of steadily rising amounts of credit-debt bank money and retroactively issuing fiat dollar reserves, specifically for the enrichment of the FIRE economy, to the detriment of all in its path.\textsuperscript{44} It is, at its core, the public-relations arm of a cartel acting against the public interest and against its legal mandates. Has the Federal Reserve system, as its leaders claim, \textit{truly} instituted “monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates[?]”\textsuperscript{45} No. It fosters a FIRE economy that unnecessarily and unjustly yields cyclical asset bubbles, causing high unemployment; engages in massive, destabilizing speculation on commodities markets, causing inflation; and utilizes veiled usury through the creation of credit-debt money to enrich traders of paper (i.e. compound interest charged on mortgage loans), thereby sapping the purchasing power of those who work in the \textit{production, service, and tech} economies.\textsuperscript{46}

Did the Federal Reserve “supervis[e] and regulat[e] banking institutions to ensure the safety and soundness of the nation’s banking and financial system and to protect the

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  \item [45] Board of Governors of the Federal Reserve System, \textit{Mission}.
  
  \item [46] Minsky, “The Financial Instability Hypothesis.”
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credit rights of consumers[?]" No. By the admission of some of its own directors and presidents, it did not regulate its own member institutions, but instead knowingly presided over a FIRE economy endemic with fraud and all but abandoned consumer credit needs. Has the Federal Reserve “maintain[ed] the stability of the financial system and containing systemic risk that may arise in financial markets[?]” No. It has maintained the status quo and arguably increased the chance for a future crisis by refusing to advocate for the disassembly of the largest companies in the FIRE sector and instead orchestrating their growth to even larger and more interconnected levels through mergers and acquisitions at the height of the Great Recession, while contemporaneously providing them with $16 trillion in near-risk-free, near-zero-interest, sovereign fiat currency.

47. Board of Governors of the Federal Reserve System, Mission.


The wealth of a civilized society that issues its own sovereign fiat currency is only limited by the knowledge and productive abilities of its citizens. In a civilized society governed as a republic, the formulation and administration of the nation’s currency regime should be decided by all of its citizens, in a democratic manner. Money should be the servant of humanity, not its master. The current Federal Reserve system does not operate on this principle. In fact, the Federal Reserve ensures that the wealth of the United States is largely determined by a small, exclusive group of commercial bankers. It is the most powerful, preferential bond between private finance and public service this country has ever known and it must be broken.


CONCLUSIONS

The economic and financial crisis has been caused by unenlightened self-interest and fraudulent behavior on an unprecedented scale. But this behavior could not have grown so large were it not for the cover given… [by] “Neoclassical Economics.”

–Steve Keen, *The Debtwatch Manifesto*

The bonds between private finance and civil service – the preferential relationships common to pay-for-power campaign finance, the revolving door, regulatory capture, and the Federal Reserve system – cannot be broken by votes alone. The legacy, two-party system has been proven corrupt, hereinbefore and elsewhere. Democrats and Republicans accept, without genuine attempts at reform, the glut of money that produces partisan, lifelong politicians and perpetual electioneering. They actively promote a cancerous professional class that moves between K Street and Capitol Hill, and acts on behalf of whatever special interest propels its members up the lobbying and political ladders. They appoint to senior-level, executive branch positions at regulatory agencies

1. Lessig, *Republic Lost.*

2. The one, more-recent attempt was the Bipartisan Campaign Reform Act of 2002 (McCain-Feingold), which failed to reform campaign finance and stop what its sponsor Senator Russ Feingold (D-WI) called “legalized bribery.” The law, which has had its tepid provisions scaled back on numerous occasions by the Supreme Court, merely accepted some channels of favor-seeking as legitimate while outlawing others. See James T. Bennett, *Stifling Political Competition: How Government Has Rigged the System to Benefit Demopublicans and Exclude Third Parties* (New York: Springer Science+Business Media, 2009), 100-101.

persons whose private lives are littered with so many potential conflicts of interest – before their terms and after – that they should be disqualified from civil service, either altogether or for a substantially long period of time to be determined on a case-by-case basis. And they often accept as infallible the Federal Reserve’s monetary policy prescriptions under a currency regime legitimized not by the citizenry and its democratic due processes but by the profit-driven motives and exclusive electoral machinations of organized commercial banks and Fortune 500 corporations.

To supplant the two-party system as it currently stands, with the expressed purpose of breaking the bonds between private finance and civil service that exist at the federal level, a multifaceted, bottom-up approach is required. It seems an effective first step is to eliminate the gatekeeping powers of the Democratic and Republican national committees. These are the campaign fundraising and electoral strategy arms of the two

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4. For starters, consider Timothy Geithner, Hank Paulson and Robert Rubin. For more, see Matt Taibbi, Griftopia: Bubble Machines, Vampire Squids, and the Long Con that is Breaking America (New York: Spiegel & Grau, 2010).

legacy parties, and they use their surrogates at the state level – legislators from assemblies across 50 states – to erect barriers to entry for federal office.\textsuperscript{6}

But the overall goal with respect to federal elections should be simple: All campaigns, by law, must be publicly financed.\textsuperscript{7} Every candidate able to petition their way onto a ballot should receive the same amount of money, and that amount of money could vary depending on the office being sought. Secondary goals are more complicating and subject to numerous legal hurdles, but could include the elimination of the party primary system – thereby shortening the campaign season – and perhaps even the elimination of

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6. Ralph Nader knows these tactics well, saying: “Article II of the U.S. Constitution, the part where it says ‘No person except a natural born citizen, or a citizen of the United States, at the time of the adoption of this Constitution, shall be eligible to the office of President,’ is disconnected from realpolitik. If it reflected today’s reality, it would read more along these lines: ‘No person who cannot overcome arcane ballot access laws in fifty states and is not a billionaire shall be eligible to the office of president except those nominated by the reigning duopoly and condoned by the \textit{New York Times} and \textit{Washington Post} or the five polling companies that are contracted to provide polls to the bipartisan, corporate-funded commission on presidential debates lest they be thought to clutter the playing field or deprive one of the other candidates of their rightful entitlement to all the votes that the aspiring person might otherwise take.’” The Appleseed Center for Electoral Reform and the Harvard Legislative Research Bureau have suggested appropriate reforms to make ballot access easier for all aspiring candidates for office. See Ralph Nader and Theresa Amato, “So You Want to Run for President? Ha! Barriers to Third-Party Entry,” \textit{National Civic Review} 90, no. 2 (2001): 163-172; and The Appleseed Center for Electoral Reform and the Harvard Legislative Research Bureau, “A Model Act for the Democratization of Ballot Access,” \textit{Harvard Law Journal on Legislation} 36, no. 2 (1999): 451-478.

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political advertisements.\(^8\) With the former, voters would have more choices, and perhaps multiple candidates from the same party, and arguably be made aware of more issues; with the latter, less money would be spent overall, a series of debates could be more effective and informative by using broadcast and internet mediums as temporary, monopolized public utilities, and the candidates would have equal opportunities in terms of free speech because they would have equal time to speak to potential voters.\(^9\)

Eliminating political advertisements would also prevent the disproportionate influence of super political action committees on election issues in the wake of the Supreme Court’s decision on *Citizens United.* The implication from the nation’s supreme judicial body that money is equivalent to speech is a grotesque one, and it deserves the quickest of reversals. And since it seems it does not take more than a week’s time for citizens to

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8. Such a system has resonated with voters in the United Kingdom, although researchers admit the negative impacts of print and internet political campaigns can overwhelm measures taken to limit broadcast advertisements. It may also have the effect of mitigating the influence of media conglomerates, the agendas of which are no longer couched in the mentality of a fourth-estate, watchdog-type of information dissemination, but instead beholden to an advertising model that depends on the enormous purchasing power of corporations determined to see the two parties maintain their power over the American electorate. See Margaret Scammell and Ana Ines Langer, “Political Advertising in the United Kingdom,” in *The Sage Handbook of Political Advertising,* ed. Lynda Lee Kaid and Christina Holtz-Bacha (London: Sage Publications, 2006), 65-82, http://www.sagepub.com/upm-data/11718_Chapter4.pdf (accessed October 15, 2012); and Noam Chomsky, *Manufacturing Consent: The Political Economy of the Mass Media* (New York: Pantheon, 2002).

parse the relevant voting topics and make their decisions, there could even be a common website approved by all candidates that serves to disseminate their policy positions. 10

Public campaign finance, if implemented properly, would preempt pay-for-power campaign finance. Supplementally, it also may have the effect of making lobbying less effective because reciprocity is also preempted between government representatives and private-sector favor-seekers who double as campaign funders. The revolving door could then be stopped and become subject to screenings, a more scrutinized approach conducted on the basis that ideas, not connections on Capitol Hill and K Street, may command more weight by lawmakers not beholden to wealthy, special interests (although the penchant for legislation that disproportionately benefits local and statewide constituents may remain high or even increase). 11

Regulatory capture also seems less likely if public campaign finance became the law of the land, but reinforcing its bannishment from public life is of the utmost

10. There are already multiple models in states for public financing that posit similar benefits, including “(1) reducing the negative influence of large contributions on candidates, officeholders and public policy; (2) freeing candidates from the time pressures of fundraising and increasing the time they have to discuss public issues with the voters; (3) empowering candidates to enlarge the public discussions and general awareness of political campaigns; (4) increasing citizen participation in the electoral process; and (5) increasing the number and diversity of political candidates.” See Center for Governmental Studies, Public Campaign Financing in California: A Model Law for 21st Century Reform, Policy Archive website, http://policyarchive.org/handle/10207/bitstreams/96493.pdf (accessed October 12, 2012). Also, see Frasco, “Full Public Funding: An Effective and Legally Viable Model for Campaign Finance Reform in the States.”

importance. Executive branch appointments to the highest positions at government departments, agencies, commissions, and other groups with responsibilities to protect and enhance the general welfare of the citizens of the United States should be eliminated. The civil service has proven its effectiveness time and again if allowed to perform its duties free of partisan interference, and careerists within it who exhibit strong ethical fortitude and histories of integral law enforcement should lead their respective agencies. This process could be subject to congressional review and confirmation, and the presidential veto, of course, to prevent internal and covertly partisan abuses, but to prevent regulatory capture it is clear the civil service must be cultivated in a way that effectively isolates and augments its vigilance and oversight of the private sector.

Reforming the Federal Reserve system so that it, too, actively and actually works on behalf of all citizens is necessary and could be achieved in various ways. For example, as with campaign finance, directors at Federal Reserve district and branch banks should be selected via publicly funded elections, to limited and performance-based terms. The point is not to ensure that persons with banking or corporate pedigrees are excluded from positions vested with monetary policy powers; rather, it is to re-establish the role of self-governance upon which the Constitution is based. As an auxiliary benefit,

this strategy is likely to increase civic involvement and knowledge of the way money and banking work in the United States.\textsuperscript{13}

A final reform to be undertaken is to increase the public’s understanding of the workings of its national economy. Such an undertaking need not be laden with mathematical models touting the wonders of some fictional, “free” market. The people of the United States live in a mixed economy. The federal government, as economists, sociologists, and philosophers with ideologies as varied as Karl Marx, Adam Smith, and John Stuart Mill knew, interacts with its citizens productive capacities – the measure of wealth in any society – by issuing a \textit{fiat, sovereign currency}. This has been true for much of recorded history and perhaps one of the only unquestioned features of any economy since the dawn of civilization: Money is a creature of the state.\textsuperscript{14}

The members of today’s economics profession, for the most part, fail to understand this reality, and one of the major reasons why concerns the curricula at institutions of higher education. Specifically, a school of thought called “neoclassical economics” dominates the economics departments at an overwhelming majority of colleges and universities in the United States. This is by design: The leading academic

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journals treat neoclassical economics as *orthodox* and beyond reproach; all other
disciplines are preempted from consideration *because* they are *heterodox*:

Up until the early 1970s, non-neoclassical authors were regularly published in the
prestigious journals of the profession… the *American Economic Review*, the
*Economic Journal* and the *Quarterly Journal of Economics*… However, by the
mid-1980s, these and their companion major journals, the *Journal of Political
Economy*, the *Journal of Economic Theory* and many other minor journals had
become bastions of neoclassical thought. Papers that did not use neoclassical
concepts were routinely rejected – frequently without even being refereed.\(^{15}\)

The problems with neoclassical economics stem from its use of *a priori* axioms
that are detached from reality.\(^{16}\) That is, its major models for explaining how economies
work cannot be verified empirically, and in many cases they have been demonstrated to
be impossible.\(^{17}\) They rest on assumptions that stem from a near-fanatical inclination to
construe economics – through a strange combination of principles drawn from Newtonian

\(^{15}\) See Keen, *Debunking Economics*, 8-9; and Howard Goodman, “Students Recoil at
Koch Influence,” Florida Center for Investigative Reporting website, February 1, 2012,
http://fcir.org/2012/02/01/university-students-recoil-at-koch-influence/ (accessed October 17,
2012). To get hired at these schools, publishing in a leading journal is of the utmost importance.
Moreover, many economics departments that teach neoclassical economics are funded by
corporations that have an interest in seeing its influence continue. For more, see Ferguson,
*Predator Nation*, 240-274.

\(^{16}\) Keen, *Debunking Economics*, 7-37. *A priori* translates to “before the event.” The
precepts of neoclassical economics are derived from teleology and suppositions of a system in
which the natural state is equilibrium. It is so beholden to these assumptions about the economy
before anything actually happens within it that, due to its blind faith, it has been called
“theoclassical economics.”

\(^{17}\) Steve Keen, “Behavioral Finance Lectures,” Steve Keen’s Debtwatch website,
lectures/ (accessed October 17, 2012).
physics, political individualism, Cartesian deductivism – as some kind of immutable, deterministic, natural science.\textsuperscript{18}

Economics, however, is a human creation – a social science. It examines anthropological phenomena that are characterized by near-constant fluctuations in behavior, and, thus, it is inherently political. The decades-long movement by colleges and universities to replace what used to be called “political economy” with the seemingly more neutral label of “economics” has been a ruse.\textsuperscript{19} It lends a false credence to the attempts of neoclassical economists to justify ethically bereft worldviews.\textsuperscript{20} And since it is taught at prestigious schools, neoclassical economics also dominates the underpinnings of public policy actions.\textsuperscript{21} Its bogus assumptions about “rational” human behavior – one

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\item \textsuperscript{18} See Hamid Hosseini, “The Archaic, the Obsolete and the Mythical in Neoclassical Economics,” \textit{American Journal of Economics and Sociology} 49, no. 1 (1990): 81-92; and Tcherneva, “Chartalism and the tax-driven approach to money,” 69-71. For example, take the neoclassical version of the origin story for money. It basically exploits an unsound, circular piece of logic wherein “money spontaneously emerges as a medium of exchange from the attempts of enterprising individuals to minimize the transaction costs of barter. The standard story deems money to be neutral – a veil… which lubricates markets and derives its value from its metallic content.” But it is a tale that has virtually no evidence in the historical record, for as much as it describes what money does – act as a medium of exchange – the orthodox theory of money never answers the fundamental question: What is money?
\item \textsuperscript{19} For a brief overview of this trend, see Dimitris Milonakis and Ben Fine, \textit{From Political Economy to Economics: Method, the social and the historical in the evolution of economic theory}, (New York: Routledge, 2009), 1-10.
\item \textsuperscript{21} Warren Mosler, \textit{The 7 Deadly Innocent Frauds of Economic Policy} (Christiansted, St. Croix: Valance, 2010). Multiple high-ranking officials at Treasury in recent years either
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being that fraud is impossible in market economies – most recently facilitated the criminogenic environment that permeated the FIRE economy during the Great Recession.  

Fortunately, alternatives to neoclassical economics do exist, and one that deserves attention because of its real-world observations and their implications for reforming the federal government is called “modern money theory” (MMT, variously referred to as “chartalism” or “neo-chartalism”). The reasoning that underlies the theory is derived from the historical essence of money, “a unit of account, designated by a public authority for the codification of social debt obligations.” In modern sovereign nations, debt demonstrated or readily admitted they did not understand how neoclassical economic theories interact with the real U.S. economy.


23. “Chartalism” is derived from the Latin word “charta,” meaning “ticket” or “token.” “Money is a ‘ticket’ or ‘token’ used as a means of payment of measure of value. The means of payment [i.e. coins, or some material that would be worthless otherwise] is [a symbol]” to which the state prescribes a meaning separate from its material. Money, then, has a “chartal” nature because the state declares a piece of whatever material to be worth so many units of value. See Tcherneva, “Chartalism and the tax-driven approach to money,” 72.

24. Tcherneva, “Chartalism and the tax-driven approach to money,” 69-72. Recall the failure of neoclassical economics to answer the question: What is money? To elaborate, “The function of money as a medium of exchange is incidental to and contingent on its first two functions as a unit of account and a means of payment.” The evidence comes from accounts of the cross-cultural, tribal practice of “wergeld,” an ancient penal system that “instituted compensation schedules of fines… as a means of settling one’s debt for inflicted wrongdoing to [an] injured third party.” Over thousands of years, during civilization’s transition to the nation-state, authorities “transformed this system of fines paid to victims for crimes to a system that generated a variety of payments to the state” (i.e. fees, taxes, rents, interest). For a more measured exploration of the history of money, see Wray, Understanding Modern Money, 39-73; and L. Randall Wray, “Monetary Policy: An Institutionalist Approach,” Center for Full Employment and
obligations between the population and its authorities come in the form of taxes. In the
United States, the dollar is the creature of the federal government, and it is the sole unit
of account designed to retire tax debts. Only it will suffice.\footnote{Wray, Understanding Modern Money, 39-73. Over the course of history, the state used an array of physical objects to act as vehicles for units of account, and in each the objective was to record the account of credit-debt events, usually between it and private citizens. These included tablets, tallies, coins, bills of exchange, and paper notes, among many others. A closer examination of the record even debunks the popular claim that gold is intrinsically valuable. The reason gold was prized throughout history derives from its use to record a weighted unit of account – usually corresponding to grains or produce – cast in the form of coins. The state obtained an advantage from their use because it controlled the mines from which the metal was extracted, making it very difficult to counterfeit coins.}

This is how the nation’s modern currency retains its value.\footnote{Ibid., 18-38. As the U.S. unit of account the dollar has been cast in limited forms (paper and coin, primarily, but also in electronic media), and only it will suffice in payment of taxes. It’s not the fact that it functions as a medium of exchange, or that it has been declared “legal tender.” Legal tender laws do not guarantee the acceptance of currency in all cases, but instead are sanctioned to ensure that certain currencies will be used for restitution in court cases.} It also reveals the crux of MMT: The availability of money is driven by taxes.\footnote{Tcherneva, “Chartalism and the tax-driven approach to money,” 71. Implicitly, the federal government does not have to tax in order to spend. It faces no financial constraints. The same cannot be said for local governments and those at the state level. They do not control the issuance of the nation’s currency.} Once it levies a tax, the federal government can spend its currency into existence in exchange for all the goods and services it requires to operate (and beyond), because citizens will offer those goods and services to acquire government’s dollars to meet their tax requirement.\footnote{Wray, Understanding Modern Money, 74-96. Those citizens also prefer to keep some of this tax-driven money in reserve, as a part of a contingency plan. Thus, the government is free to spend considerably more of its currency into circulation than it taxes out of circulation. Taking}
MMT does not pretend to be some kind of cure-all; it merely uses empirical data to prove the structure of operations as they currently stand with respect to the federal government and its power over the country’s money supply and the national economy. In that respect, however, it does contrast sharply with neoclassical economics, so much so that its concepts could provide the impetus for revolutionary public policy changes in America. Whereas some acolytes of neoclassical economics testify to near hysteria about the immorality and pending disaster of trillion-dollar deficits, supporters of MMT rightly assert that deficits do not constitute money owed to anyone. A federal deficit is simply the amount of money per annum that circulates in the economy by virtue of not being extracted from it through taxes, and, as such, the accumulation of deficits over many years – the national debt – is actually the monetary manifestation of the nation’s wealth and productive capacities.²⁹

²⁹ a sectoral-balance approach to the national economy, it is apparent that one person’s asset (credit) in the private sector is another person’s liability (debt). Therefore, all private-sector transactions are a zero-sum game. Net financial wealth, then, must come from two other sources: 1) the international sector and 2) the federal government. The latter’s issuance of a monetarily sovereign currency accomplishes this because of its primary use as an instrument to retire tax debt. Its value in that regard provides the impetus for its supplemental use as a medium of exchange, and, subsequently, for the affinity to hoard it as a financial asset. Also, see Wynne Godley and Marc Lavoie, “Fiscal Policy in a Stock-Flow Consistent (SFC) Model,” Levy Economics Institute of Bard College website, http://www.levyinstitute.org/pubs/wp_494.pdf (accessed October 17, 2012).

²⁹ Wray, Understanding Modern Money, 74-96. Deficits, then, are and always should be considered standard operating procedure by the federal government. Political arguments against them are mere fodder and not to be taken seriously. Surpluses on the other hand, in which the government extracts more in taxes than it provides in services are to be considered devastating, and necessarily can cause recessions.
Where some neoclassical economists chide the U.S. citizenry for “borrowing” money from China and advocate instead for truly disastrous austerity budgets, modern monetary theorists know that—no matter the rate of interest—the total amount owed for government securities, like U.S. Treasury bonds, owned by any country or its citizens can always be paid because the federal government can simply issue more of its currency.\(^{30}\)

During a downturn like the Great Recession, when unemployment is high and a lack of demand permeates the economy, many neoclassical economists have urged politicians to cut social services, whereas modern monetary theorists know the federal government can (and should) provide citizens with more to boost purchasing power.\(^{31}\)

Taken together, the success of efforts to reform campaign finance, the nation’s regulatory leadership, the Fed, and the economics profession, are of the utmost import. The application of modern monetary theory in the wake of 50 misguided years employing neoclassical economics is vital to the U.S. economy. So long as the population grows and so long as skill sets are broadcast and education levels rise as well, MMT provides

\(^{30}\) Ibid. The notion that the United States borrows its own currency from any other country is absurd. The state never has to borrow that which it creates via monopoly power. In truth, buying and selling bonds provides the federal government, through the Treasury and the Federal Reserve, with a supplemental method to control inflation. The primary method is to tax. When the economy runs beyond capacity—when prices rise because too many dollars chase too few goods—the federal government can implement targeted tax increases to remove currency from circulation and stabilize markets.

\(^{31}\) They know that the neoclassical mantra of unemployment being a “necessary evil” so that price stability is maintained is hollow; the federal government can, theoretically, institute a job-guarantee program. For any citizen willing to work, the federal government could step in and provide employment at a living wage in various professions, thereby achieving full employment and stabilizing the economy during times of crisis. See Tcherneva, “Chartalism and the tax-driven approach to money,” 81. Also, see Wray, *Understanding Modern Money*, 122-154.
intellectual footing from which the federal government can perform its duty to increase
the issuance of dollars to preserve and augment the collective wealth of the citizenry.
Publicly funded campaign finance will purge corruption from Congress and enhance free
speech. Strengthening the civil service and eliminating executive branch appointments
will eliminate regulatory capture, ensure justice is served, and uphold the rule of law.
Finally, the democratization of the Federal Reserve system will return control of the
nation’s money supply to its people.

At their core, these reforms flow from necessary value judgments that aim to
break the bonds between private finance and civil service, restore meaning to the
Constitution, and give these United States a chance to become, once and again, a genuine
republic. But it must be reiterated: If the people of this country do not rise against a class
war waged with commercial debt loads, not military payloads, by traders in paper who
seek fortune above all else; if they continue to choose government representatives who
are not beholden to all, but only to the one percent that pay hundreds of millions for the
privilege; if citizens of this nation do not make it known whether masters of FIRE can or
cannot commit fraud with impunity, so that the nation’s legal system splits further into
tiers; and if they do not come to understand the gross inequities hoisted upon them by the
workings of a currency they do not understand, then tumult will continue to befall them
and America’s experiment will fail miserably.


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