Zsuzsánna Biedermann

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The History of American Financial Regulation

SUMMARY: From 2007 onwards, the United States has been confronted with the most severe economic recession since the Great Depression. The root causes of this crisis lie on one hand in the "erroneous" operation of the American financial markets; abundant financial innovations prior to the outbreak of the crisis led to a less transparent and thus riskier financial market. On the other hand, the system of financial market regulation itself was unable keep pace with the development of markets, and market players — exploiting the economic boom — successfully pushed for deregulation. This study outlines the major financial regulatory changes in America that created the context for the crisis; furthermore, it also details the repeal of the 1933 Glass-Steagall Act and its consequences. The Gramm-Leach-Bliley Act significantly contributed to changing the rigid logic of the originate-and-distribute model, the basis of the American economy. Several economic actors who could have signalled the mounting risks participated in the creation of a sort of "boom frenzy" (or as Raghuram G. Rajan put it "a cyclical euphoria"), the exaggerated optimism of which ultimately led to massive irresponsible financial behaviour and crisis. The study points out that the new Dodd-Frank Act passed in 2010, aimed at strengthening supervision and protecting consumers from abusive practices in the financial sector, is in itself insufficient to avert another financial crisis. The United States will have to face an even graver crisis unless it manages to find a lasting solution for regulating its financial markets in a flexible and effective way.

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The causes responsible for the crisis of the American economy are deeply rooted in its economic history.

From 2007, the United States has struggled with an economic recession not seen since the Great Depression, in spite of an economy that has flourished for decades; the Asian financial crisis and domestic financial troubles had no negative impact on economic growth in the long-term and thus faith placed in the flexibility and adaptability of financial markets and firms grew and grew.

The Glass–Steagall Act was enacted in America after the 1929 stock market crash with the goal of controlling speculation by, among other things, separating investment and commercial banking activities[1] and creating a wall between banks and brokerage firms[2]. The Act was meant to prevent banks from drifting near bankruptcy by foolhardily risking clients' money, since if a bank catering to small depositors is having liquidity troubles; the state often undertakes to help out financially in order to protect the interests of the aforementioned small depositors. The Act was signed by *Franklin Roosevelt* in 1933 and was in force up until 1999.

The financial lobby attacked the Glass–Steagall Act from the onset, mainly on the grounds that it restricts growth through the over-regulation of economic players. Before 1999, there were heated debates on whether the Glass–Steagall Act is really necessary. In these debates, increasing the competitiveness of American financial markets was juxtaposed with the need to maintain investor

E-mail address: zsbiedermann@vki.hu

confidence as people will only trust their money to banks whose activities they do not consider risky.

The research service of Congress published a report in 1987 (Jackson, 1987) which collected arguments for and against the Glass–Steagall Act. The report calls attention to the fact that the objective of the Glass–Steagall Act was to maintain the integrity of the banking system, to prevent financial abuses and to limit excessive stock market speculation. It also goes on to state that the banks have created several new forms of investments and financial products since 1933 that resemble securities, while securities firms have innovated new financial products resembling loans and deposits. Even in 1987, therefore, the players of the financial sector tried in every possible way to circumvent the wall erected by the Act between banks and brokerage firms. The financial deregulation sweeping the world (cites the examples of the United Kingdom, Canada and Japan) has put additional pressure by financial players on Congress to ease regulations.

THE IMPACT OF THE GRAMM–LEACH–BLILEY ACT ON THE AMERICAN FINANCIAL SYSTEM

"An act [...] to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers ..." (quote from the Act)

"I think we will look back in 10 years' time and say we should not have done this, but we did because we forgot the lessons of the past, and that that which is true in the 1930's is true in 2010." (Senator Byron Dorgan after the repeal of Glass–Steagall)

The provision of the Glass–Steagall Act (Financial Services Modernisation Act) according to which banks cannot own companies that conduct other financial activities was effectively repealed by the Gramm-Leach-Bliley Act on 12 November 1999 (Barth, Brumbaugh, Wilcox, 2000). The financial lobby worked long and hard to abolish certain achievements of the Glass–Steagall Act and to ease the financial regulatory environment.

Since, among other things, strict regulations guaranteed the more-or-less reliable operation of the securitisation-based originate-and-distribute model and mortgage lending, this was probably one of the first steps towards the development of today's crisis. Countless renowned economists share this view, among them *Paul Krugman* for instance (Krugman, 2008). One of the main reasons for the wave of deregulation is so-called "cyclical euphoria" (Rajan, 2009) which at a time of economic boom makes it difficult (as recession seems so far off) for decision makers to build checks into the regulatory system in the interest of stability. As *Rajan* puts it: faith in draconian regulation is strongest at the bottom of the cycle – when there is little need for participants to be strictly regulated. By contrast, at the top of the cycle – when the chance for market players' sense of danger to ease up and for them to become careless is the greatest – everyone has faith in the ability of markets to regulate themselves.

The amendment of the Act greatly eased the operation of American financial service providers. It facilitated the establishment of financial mammoth corporations that were able to combine previously separate financial activities: insurance, portfolio management, underwriting and commercial banking. The Financial Services Modernisation Act allowed for the establishment of financial conglomerates, parts of which belonged to the insurance sector, while one or more others to the investment or banking sector. It was, among other things, due to the Gramm–Leach–Bliley Act that 'too big to fail' financial institutions came to be - insti-

tutions that required government bailouts and capital injections during the crisis. Afterwards, several analysts criticised these 'too big' institutions; it constitutes moral hazard that these goliaths build their positions in the secure knowledge that due to their size the government will not allow them to fold, and that potential losses arising from excess risk-taking will be paid for with taxpayer money. It is a fact that such giant banks can rely on government support even if they manage their affairs badly and during market declines are less adamant on solving liquidity problems on their own account than the smaller banks.

In spite of the aforementioned moral hazard, this change was considered necessary by legislators in the US because demand for financial services has changed considerably over the past few decades (for instance pension savings-related investment demand increased), and as a result the scope of operations of institutions dealing with traditional financial activities expanded worldwide to include activities traditionally performed by other institutions of the financial sector. The conglomerates created as the result of cooperation between banks and insurance companies became key economic players in several countries (Belgium, Netherlands, Australia) (Szüle, 2006) and large American banks felt at a competitive disadvantage due to strict regulations.

The Act distinguished so-called financial holding companies (FHC) which were authorised to perform the whole range of financial activities, provided they have appropriate capitalisation, risk management and credit rating (these conditions were also valid for branch institutions, and the transactions between holding banks and subsidiaries were also restricted).

The Act organised the supervision of financial institutions on a functional basis, i.e. depending on the scope of activities, supervision was conducted by the Federal Reserve, the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC) and the State Insurance Supervision, while the Federal Reserve was responsible for the comprehensive supervision of financial holdings. Functional regulation also extended to the activities of banks, i.e. securities trading as well as investment service activities were overseen by the SEC, while insurance activities were supervised by state insurance authorities.

The positive attribute of this Act, which blurred the lines between investment and commercial banking activities, was that after this point, American financial service providers were able to keep up with financial conglomerates on international markets.

However, during the intense competition, merging service providers entering new financial activities lost sight of caution and transparency with increasing frequency. On top of it all, commercial banks 'learned the ropes' of riskier investment banking activities.

As a diverse range of activities were conducted within the walls of the same institution, mutual interests inevitably led to conflicts of interest and in the long-term it was investors who suffered. When stock analysts and investment bankers work at the same firm, they might offer stocks and shares of companies in trouble to their clients as first-rate investments and bankers might begin to cooperate with the executives of problematic firms (Marján, 2003, p. 65).

The problems of financial system supervision were already augured by the scandal surrounding Enron's collapse. At the beginning of October 2002, a committee investigation by the United States Congress made public certain irregularities it uncovered at the SEC, also holding credit rating agencies, auditing firms and analysts responsible. Due to these irregularities, in November 2002 both *Harvey Pitt*, Chairman of the Securities and Exchange Commission and his chief accountant, *Robert Herdman* stepped down (Marján, 2003, p. 66).

In my opinion, the legislation, with all its negative consequences, and its amendment in 1999 cannot be solely held responsible for today's crisis, nor is it simply the result of the merging of commercial and investment banking activities. The 1999 amendment greatly contributed to the 'atmosphere' of crisis; grave ethical issues, intrigue and conflicts of interest emerged due to insider activity. What is more, the creation of financial conglomerates was just a prelude to the *'too big to fail'* problem set. These institutions, with respect both to ownership structure and activities, were 'too intertwined with one another' and constituted a complex system where it became impossible to distinguish individual players. In other words, if any of the players lost their balance, the others followed like dominos.

In the next section, I will be discussing investment banking activity and the related sector, and will attempt to shed some light on how the proliferation of mortgage-backed securities and collateralised debt obligations are connected to the development of the crisis.

DAMAGE TO THE ORIGINATE-AND-DISTRIBUTE MODEL

Mortgage lending has a long tradition in the U.S. While a large portion of society typically finances all major expenditures (education, home buying, children's education, etc.) from loans, economic players entering a later stage of their career as well as various insurance companies and funds usually have savings. One of the main tasks of the financial products market is to satisfy the investment demands of both of the groups mentioned above. This is realised during the securitisation process originally applied in 1970. The literature on the subject offers several definitions; *Nádasdy* captures the essence of the phenomenon as follows: "During the process of securitisation, a group of financial claims are separated in a legal and economic sense, and using this as collateral, so-called asset-backed securities (ABS) are issued in the market." (Nádasdy, 2004, p. 32)

During securitisation, banks – as the originators of the process – finance the long-term loans of American households (which are typically real estate mortgage loans) using the funds of American long-term investors (for instance households, pension funds or insurance companies with savings). This is beneficial for them because they exchange long-term claims for money in the short-term; essentially raising funds, and thus theoretically making it easier to avoid liquidity problems. As the *Király – Nagy – Szabó* trio of authors put it in their article entitled "Egy különleges eseménysorozat elemzése – a másodrendű jelzáloghitel-piaci válság és (hazai) következményei" ["The subprime mortgage lending crisis and its (Hungarian) consequences"]: "*They transformed illiquid assets into liquid assets: long-term, difficult to move mortgage loans became securities with significant and deep markets, i.e. securities that were easy to liquidate (…) The cash-flow that is the subject of securitisation has three basic qualities that are worth transforming in order for the end-investors to receive a product most appropriate for their taste: maturity, interest and credit risk*" (Király – Nagy – Szabó, 2008, p. 586).

The term 'distribute' in the name of the model refers to the fact that the institution initially providing the loan spreads its risk among investors. The originate-and-distribute model, which is based on securitisation, was profitable for all participants. It was beneficial for banks because it lowered the concentration risk of loans; it eased capital burdens and ensured liquidity for mortgage lenders, generated surplus profit for securitisers, and offered a diversified financial product market to institutional and individual investors (Király – Nagy – Szabó, 2008).

The originate-and-distribute model is not a specifically American feature; it is present in all countries where the financial market is suitably complex or where the various stages of the career model are characterised by different financial situations and attitudes (at a young age we take out loans; as we become older we try to save).

The model worked fine as long as ensuring the quality of created securities was a priority; the credit-creator was only able to find refinancing if it packaged high quality loans (i.e. loans of carefully selected, first-rate debtors) into securities. So-called private-label mortgage-backed securities first appeared on the dynamically developing securities market as early as the 1970s, whose underlying loans neither the government nor the institutions operating with quasi government guarantees were willing to refinance (the mortgage banks Fannie Mae, and Freddie Mac [3], effectively the cornerstones of the American housing market, operated as limited corporations, with Articles of Association and a purpose specified in accordance with the Act, and the government guaranteed to make a credit line available to them).

Article 20 of the Glass–Steagall Act stipulated that commercial banks could not conduct any activities primarily related to securitisation; however, the greats of the financial world lobbied to conduct different types of financial activities within a single institution since the sixties. By 1986, they acquired the right to generate a maximum of five per cent of the total revenue of commercial banks from investment banking activities. In 1989, under pressure from money market players, this limit was raised to 10 per cent, and in 1990 J. P. Morgan even secured the Fed's explicit consent for securitisation. As of 1996, bank holdings were allowed to generate maximum of 25 per cent of their income through subsidiaries dealing with securitisation. This measure in essence completely overrode Article 20 of the Glass–Steagall Act, and commercial banks began to pass on their mortgage loans to various investors wrapped in securities with increasing frequency.

In 1999, the repeal of Glass–Steagall officially permitted banks to step into the lucrative arena of the mortgage market. They were able to cooperate with companies creating mortgage loans, provide loans to clients who did not have sufficient collateral and were able to pass these loans on to other investors in the form of structured financial assets. The loans were grouped and mortgage-backed securities and collateralised debt obligations were created.

After the Gramm–Leach–Bliley Act was enacted, banks paid even less attention to the quality of the mortgage loans they repackaged, as part of their portfolio was moved to investors and thus removed from the bank's balance sheet (simply put, it was not the banks' concern whether debtors paid or not). Banks were hoping for more and more profit from the seemingly less and less risky loans (as in theory, the risks were spread among players). More and more frequently, they provided loans without proper due diligence, pushing risks off the balance sheet during securitisation. Quantitative aspects preceded qualitative considerations, and the originate-and-distribute model was no longer distributing only the loans of reliable debtors on the market.

The sharp increase in low quality loans was also nourished by real estate investment campaigns and the home-buying fever. The latter was also encouraged by social factors and the government itself.

SUBPRIME DEBTORS AND INCREASINGLY COMPLEX FINANCIAL PRODUCTS; THE END OF THE ECONOMIC BOOM

At the same time, from the beginning of the 1990s, there was a boom in the subprime mortgage market related to subprime debtors

(debtors who have no or dubious credit history). Starting in the 1980s, many American companies shifted production to countries with cheaper labour, leaving thousands of American employees without work. The middle-class slowly started to fall behind financially, and political pressure to solve problems by easing access to loans increased. "The low-income home buyer can have just as nice a house as anybody else" – emphasised then – President *Bush* in 2002 (George W. Bush addresses the White House Conference on Increasing Minority Homeownership at The George Washington University, 15 October 2002). Due to the simplified borrowing process, low interest rates and constantly increasing real estate prices, an increasingly large ratio of subprime borrowers were present on the mortgage market. In 2001, subprime loans made up only 5 per cent of all US mortgage loans; however, by 2007 this ratio jumped to 15 per cent (Király – Nagy – Szabó, 2008).

MBS-holders – similarly to government-sponsored enterprises – implemented credit-enhancement measures; they took out credit insurance with specialised insurance companies and had their papers rated by large credit rating agencies. Parallel to the subprime mortgage market boom, an increasing number of private securities based on subprime loans appeared among securitised products, and due to similar ratings investors found it increasingly difficult to distinguish good quality, first-rate papers from lower quality securities on a progressively more polluted market. As if that was not enough, the originators of securitisation had a penchant for so-called "*ratings shopping*", i.e. they selected from available agencies and ratings (Móra, 2008).

Seeing clearly on the increasingly complex financial markets was made difficult not only by subprime debtors, but by financial innovations as well. Experts well-versed in finance developed countless new and complex investment opportunities, the goals of which were to spread risk and increase the complexity (number of investment opportunities) of the financial market. During securitisation it often happened that mortgage loans possessing quite varied characteristics were bundled, and later even different types of loans and bonds could also be included in these 'packages', which were then transformed into collateralised debt obligations. These combinations were limited only by imagination. These obligations were increasingly difficult – even for a financial expert – to realistically rate. More and more frequently, the expert originally compiling the collateralised debt obligation was the only one able to clearly judge the rate of risk.

In spite of all this, credit rating agencies kept applying risk analysis methods tried and tested with corporate bonds to collateralised debt obligations. The constant economic growth preceding the crisis covered up the risks connected to collateralised debt obligations, and while yields were high, investors tended to overlook the potential illiquidity of financial innovations. Securitisers kept a lower than required capital ratio (multiple leveraging accumulated in the system, allowing multiplied profit, but unfortunately multiplied losses as well) as their primary concern was maximising liquidity and commissions (Szanyi, 2009).

Another typical investment type related to leveraging that has gained popularity over the last 25 years is the derivative *(forward, swap, futures, option)* deal, which is derived from a basic product (for instance, the basic or underlying product of a futures contract on Goldman Sachs with a December 2013 maturity is the Goldman Sachs share). Derivatives are rather opaque financial instruments as underlying risks, and as a result the actual market value of products, are difficult to assess due to their derivative nature. On top of this, a flourishing market of derivative products developed out-

side the stock exchange (over-the-counter – OTC), under significantly more 'unregulated' conditions, which made seeing clearly in a sea of increasingly murky transactions all the more difficult. The lack of appropriate regulation of OTC derivatives transactions greatly contributed to the development of the global financial crisis.

Derivatives were created as a result of striving for increased yields and lower financing costs. Derivates products generally ensured much higher yields before the crisis than deposit interest, and offered a wide range of investment opportunities with high returns compared to the amount invested. This, however, was due not to the 'risk-free' nature of derivatives transactions, but to the overly optimistic speculations related to them. Due to high leveraging, if they take up an unfavourable speculative positions investors can lose multiples of their original investment.

Making the market of complex financial innovations more transparent was on the agenda several times during the *Clinton* presidency; however, no progress was made on the matter. In an April 2010 interview, Clinton admitted to making a mistake by not trying to regulate this particular segment of the financial market in-depth (*ABC News,* Jack Tapper's interview with former US President Bill Clinton), but at the same time he emphasised that it was Bush and his financial experts who "let go" the SEC and the whole regulatory apparatus.

Product innovations did not only involve securities; loan arrangements also underwent several changes. In many cases, loans with variable interest rates and low initial repayment instalments appeared on the market and in many cases these were taken advantage of by subprime debtors themselves. As Király – Nagy – Szabó also emphasise in their article entitled "Egy különleges eseménysorozat elemzése – a másodrendű jelzáloghitel-piaci válság és (hazai) következményei" ["The subprime mortgage lending crisis and its (Hungarian) consequences"]: *"within this clientele, the ratio of loans provided with looser conditions, through agents, with low initial instalments, was higher than average"* (Király – Nagy – Szabó, 2008, p. 580).

As long as external circumstances were favourable, no one questioned how the system actually worked. One of the reasons no one called this into question was that everyone seemed to benefit from the system. Debtors received the loans they wanted (perhaps due to a lack of objective underwriting procedures), and banks churned out more and more loans,[4] which allowed them to generate enough profit not only to pay handsome dividends to their shareholders, but also to finance the bonuses of their executives. Those packaging securities pocketed their commission and savers realised significant profit without perceiving the risk involved.

This ideal state lasted only as long as the market was on the up. However, as soon as the Fed, looking to decelerate the overheated economy, raised interest rates (from 1 to 5.25 per cent, in 17 steps from June 2004 to June 2006), many subprime debtors became insolvent, unable to pay their loans due to rising loan interest rates. As interest rates increased, the appreciation of real estate prices came to a halt, then began to plunge drastically. This is why in many cases the real estate serving as collateral became unsellable or alternatively the sale price did not cover arising solvency problems. In the meantime, investors who bought collateralised debt obligations before 2007 – with every right to be concerned about potential losses – attempted to divest themselves of their securities, which, however, in many instances also proved unsellable.

Defaulting mortgage loans started an avalanche which led to the subprime mortgage crisis and ultimately, through the events known to the reader, to the global economic crisis.

THOSE WHO COULD HAVE WARNED OF DANGER

How could it have happened that neither credit rating agencies or auditors, nor supervisory bodies warned investors and the markets of the imminent danger of collapse? Even if an uninformed investor– due to a lack of information– was unable to realistically assess the situation of a bank or a brokerage firm, how could such warning signs have gone unnoticed by organisations specialised in the field? How could financial institutions on the verge of bankruptcy and later requiring government assistance and securities soon to be devoid of any value have received positive ratings immediately before the crisis?

Moreover, this was not the first time market players were not correctly oriented; two of the largest corporate collapses in history, that of Enron and WorldCom were also not indicated in advance.

Credit rating agencies

The market is currently dominated by three large credit rating agencies, which have already erred in their forecasts on a number of occasions before and at the beginning of the mortgage crisis, and have rated securities and credit products, among other things, as excellent which soon lost their value. Moody's, Fitch and Standard & Poor's gave premium category ratings even to those collateralised debt obligations, the underlying subprime mortgagors of which were already insolvent. The first securities to go under were exactly the ones that were backed by subprime mortgage loans, which then led to the collapse of the securities market relying on them, taking down several financial institutions with them in the process. Credit rating agencies played a considerable role in deepening the crisis; the determination (or possibly redetermination) of ratings is not very common; therefore, if there is indeed a change in rating, it is usually late, wide-ranging and significant. This is how it could have happened that in the second half of 2007 and the first half of 2008 the rating of several securities changed from AAA (obligation will be met with a very high probability) to CCC (significant credit risk) over the course of a single day (in the period in question, mortgage-backed securities were downgraded in a total value of USD 1.9 trillion) (Morris, 2008). Many institutions, required by law, were only allowed to have a certain ratio of low-rated investments and as a result were forced to start selling. Those who could have purchased were unable to do so due to strict regulations (as financial institutions are only allowed to keep a certain percentage of their assets in high-risk investments as previously mentioned). It was therefore the system itself which reinforced negative feedback and elevated panic.

The damage to the originate-and-distribute system, the increase in the ratio of subprime debtors, and the proliferation of structured forms of investment, difficult to categorise in terms of risk, seemed to have escaped the attention of credit rating agencies for quite some time.

But did they really not see that the risks were increasing, or were they effectively interested in handing out positive credit ratings, or did they, perhaps, mislead investors on purpose?

Credit rating agencies have been present in financial life for close to a century; their role became more significant in the US after the SEC recognised the three largest rating agencies as Nationally Recognised Statistical Rating Organisations[5], thereby making their roles official in the world of finance. One of the goals of the decision was to make it easier for investors to judge the risk of a given portfolio or financial institution. Later on, however, legislators made credit rating agencies indispensa-

ble; if a market player wanted to sell a share basket or to bundle up a few mortgages into a security, a rating was absolutely essential. It is true that these credit rating agencies are private companies, yet in the decades preceding the crisis, their opinion was practically tantamount to the force of law. This is how it came to pass that financial market funds were required by law to keep no more than 5 per cent of their assets in low-rated securities.

One of the gravest problems in connection with the credibility of credit rating agency activity is that even though they are private companies, ownership structures are opaque and could also include investment funds or banks that from time to time need to be rated. Moreover, despite the fact that in theory the three firms are independent of each other, there are considerable overlaps at an ownership level. Moreover, ratings are paid for by those whose products are to be rated in terms of risk (Bánfi – Kürthy – Bánfi, 2010). As *Miklós Iván Szegő* so aptly put it in one of his articles: credit rating agencies on the financial market are like foxes guarding the henhouse.

Each player of the financial system is aware that the influence of the three rating agencies on the market is too great; their credibility is dubious to say the least and it would be very difficult to eliminate them from the system. In theory of course, a AAA (i.e. near risk-free) rating does not necessarily mean that investors will immediately purchase the product in question. This could be no more than an element of investor decisions. Practice, however, shows that the state guarantee hovering above the activities of credit rating agencies as well as the regulatory environment that is openly based on rating agency ratings both encourage market players to attribute an exaggerated significance to these ratings. The most obvious example of the exaggerated influence of credit rating agencies is the assessment of country risks; the worse a country's rating, the more difficult and expensive it will be for it to continue to finance its sizeable debts on the market, and the surcharge of insurance premiums taken out on insolvency will begin to rise.

Despite their bad, recently somewhat notorious reputation credit rating agencies are necessary, because very few investors have the patience, competence or time to establish the risk factor involved in an investment. The conditions of their operation, however, require obvious changes; they should be separated from government guarantees and regulation. The market players must be made aware that any sense of false security engendered by a AAA rating is no excuse to forego individual assessment and responsibility when making a financial investment. On the other hand, credit rating agencies must be reminded of the dire consequences of misleading investors, which can have serious repercussions for the global financial system as a whole.

Auditing firms

Auditing firms have played a similarly important role in the crisis. Listed companies must have their annual and business reports audited every year. In principle, independent audits are designed to check the rating of investments and the 'emergency reserves' generated on the basis of that rating. In practice, however, realistic assessment of the risks in the world of structured financial investments requires exceptional professional knowledge and competence, and auditors should have kept up with the advances of the financial field.

Another doubt often raised in connection with the professional competence of auditors concerns the nature of the audit market. Ninety per cent of quoted companies are audited by one of the Big Four, (that is the four largest audit companies Deloitte, PwC, Ernst & Young and KPMG), meaning that the entire

audit market is shared by these four audit firms. Currently, although registered auditors are periodically rotated within audit firms, audit companies are usually not rotated or only to the extent that one of the Big Four changes places with the other. Consequently, audit firms have a rather symbiotic relationship with the companies they audit (Bánfi – Kürthy – Bánfi, 2010), an arrangement that benefits both parties. Moreover, it often happens that financial institutions require companies to hire one of the Big Four to carry out their audits as a pre-condition to giving them loans. This level of market concentration carries system-level risks, and the collapse of any one of these companies could drag the entire market with it. In addition, audit firms have already proved that these concerns are justified in cases such as the Enron scandal, which resulted in the downfall of Arthur Andersen. That is because it is still the case to this day that the Big Four perform auditing and tax consulting –at the same company. Effectively, this means that they provide tax advice to a company, whose balance sheet they certify. Moreover, it is also often the case that the majority of their income comes from tax consulting.

In the Enron case, the audit firm Andersen published misleading, fraudulent reports on behalf of its corporate client. These types of cooperation are usually rooted in the fact that corporate executives are increasingly expected to generate more profit every year and ensure that stock prices continue to rise, prompting these companies to expect solidarity, business partnership and good advice from their auditors. Although these companies adamantly assert that their auditing and tax consulting divisions operate in complete separation from each other, the situation in practice is somewhat different. This does not guarantee the neutrality and independence of the auditor's report.

The solution on the one hand concerns the complete separation of tax consulting and audit activity, and the reduction of market concentration through official intervention.

Management of financial institutions

Besides credit rating agencies and auditors, the management of financial institutions also played a key role in hushing up problems.

According to the FDIC,[6] "*corporate governance generally can be defined as the process of managing an organisation's affairs or ensuring accountability. It can include a range of activities, such as setting business strategies and objectives, determining risk appetite, establishing culture and values, developing internal policies, and monitoring performance. Corporate fairness, transparency, and accountability commonly are viewed as goals of corporate governance. To some, corporate governance simply means more active and involved participation by the board of directors; others emphasise corporate »democracy« or broader shareholder participation.*" (Gup, 2007, p. 2, quoting Basinger et al.)

If we take this definition as the basis of American corporate governance ethics, then it can objectively be established that the management of several financial institutions erred in terms of the transparent and fair operation of companies and the definition of their risk bearing capacity in the period leading up to the crisis.

In theory, executives represent the interests of owners and conduct their activities in their interest. However, in recent years most large companies have introduced bonus-based remuneration systems in which long-term agreements made with the executives set out a fixed salary to which variable incentives are linked. There are many companies in the financial sector, where the base salary only represents a fraction of the total attainable income, the rest depends entirely on the performance of the employee. Performance, of course, is a highly

relative term. *Mihály Erdős'* and *Katalin Mérő's* article entitled "The subprime crisis and the supervision of financial organisations" mentions the following very informative case: „There were even cases, where the bonus of the executive in charge of the asset management company depended on the number of external contracts, regardless of the actual profitability of the business conducted" (2008, p. 516)

Members of corporate managements strive to retain their jobs and related prerogatives and to earn as much money as possible. In many cases incentive systems in the long run prompted financial institution executives and employees alike to undertake short term risks instead of taking into consideration the interests of their depositors/shareholders and maintaining sustainable profitability in the long term. That is because most of the rewards were tied to how successful the given company was on the market. The indicators of success in this field usually involved market share figures (number of policies, income, profit), increase in client numbers, and quick gains in market share. As a result, lending became more and more irresponsible and contracting volumes became exaggerated (clients were talked into well rated, but rather risky deals) in the hopes of attaining higher bonuses. After the crisis, the bonuses that were paid out were not demanded back from the executives that "gambled" with depositors' money. The top five executives of Lehman Brothers between 2000 and 2007 made more than 1 billion USD, which they were allowed to keep after the company collapsed. Moreover, excessive severance payments to resigning or dismissed company executives, so-called "golden parachutes", became the norm rather than the exception. *Stan O'Neal* received a severance payment of USD 161 million when he resigned as the CEO of Merrill Lynch. After the company was bailed out by the government, executives were paid bonuses in the billions of USD.[7]

Many executives tried to conceal the company's liquidity problems, with the help of auditors and credit rating agencies, until the last minute, rendering attempts to avoid a government bailout to save the company from default futile.

CHANGE WE CAN BELIEVE IN[8]

"The financial system (...) is still operating under the same rules that led to its near collapse" (Obama's speech of 21 January 2010).

Before the crisis, unethical and irresponsible business conduct permeated American financial life. Financial regulation could not keep up with the new products and services generated by money markets. In hindsight, it seems obvious that successive administrations should have done more to solve the problems that jeopardised the stability of the financial system, and should have developed a new regulatory framework to deal with financial innovations and fraud resulting from insider activity.

In his speech of 17 June 2009 *Obama* announced his intention to carry out comprehensive reform of the American financial sector. The President admitted that the regulations implemented in the first half of the 20th century in the wake of the Great Depression are outdated. Before the subprime mortgage crisis erupted, the global economy instituted money market innovations that the regulatory environment was ill-equipped to regulate. The short-term results based bonus systems and rewards of company executives also contributed to a marked jump in clients' willingness to assume higher risks. Instead of responsible business conduct, business life has become overly permeated by recklessness; unethical behaviour proved profitable, which, according to Obama, was a system error and not the fault of individuals.

The American President emphasised that the financial regulatory environment needed to be fundamentally reformed in order to restore market and consumer confidence. The role of the new regulations was, among others, to eliminate any structural errors that led to the crisis.

Naturally, the pressure exerted by the public could not be ignored either. As a result of the series of government bailouts directed at the banking sector, trust in the invisible hand of the markets has diminished and many more have come to support more stringent regulation.

In order to realise his objectives, Obama would have had to take several difficult steps; he should have had to break large financial institutions down to smaller units, bring the entire process of securitisation and derivatives transactions under regulation, eliminate financial conglomerates that gave way to insider trading and conflicts of interest, more thoroughly regulate the activities of credit rating agencies and auditors, and raise the mandatory capital reserve ratios of banks in a flexible manner (Becker – Posner, 2010).

However, if we read the Dodd-Frank Act on Wall Street reform and consumer protection which Obama signed more than a year after announcing his reform plans, it is obvious that the original objectives changed considerably during the course of political feuding.

Even the basic tenet of the Act is dubious. It focuses on consumer protection, when in fact the crisis was not caused by lack of consumer information; rather it was induced by the irresponsible, self-interested behaviour of the financial sector. It is true, however, that clients in many cases were taken advantage of and misled. Consumers, however, even if they are well-informed financially speaking, are usually not in a position to dictate the terms of certain banking services (for instance when they are looking to take out a loan). The relationship between service providers and clients is mutual but not equal. Insider fraud could be curbed by, in addition to raising consumer awareness, implementing a system of checks and incentives and subjecting these activities to regular audits.

MAIN POINTS OF THE LEGISLATIVE PACKAGE

"An Act [...] to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes..." (quote from the Act).

The following is a summary of the main objectives of the legislative package and the eventual impact of the changes envisaged by the Act.

To break the vicious cycle of "too big to fail"

Excessively large banks and financial institutions represent system-wide risk. As Obama put it in one of his speeches: Banks regarded as too big to fail have virtually taken American taxpayers hostage, simply because the government could not afford to let them fail. If they are allowed to fail, the whole financial system as well as the real economy would be put into harms way. As a result of the billions of dollars spent on bailing out financial institutions of key importance US government debt reached USD 14 580 billion in August of 2011; i.e., it exceeded the entire USD 14 526 billion GDP of the United States in the preceding year.[9] America cannot afford to spend more on bank bailouts. As a result the Act applies stricter rules than before on the operation of financial

institutions deemed too big. Banks regarded as "too big" are required to set up a regulatory board to supervise their operation. On the other hand, the Act requires banks to set aside funds to prepare for eventual default (in order to avoid risking taxpayers' money once again).

Defining what should be considered "too big" is quite problematic, because size is not always an indicator of importance. Smaller banks can also have a set of wide-ranging relationships that could wreak considerable havoc in the financial system. Until now, however, not many steps have been taken to break up large financial institutions; moreover, several smaller banks have gone out of business or been acquired by larger banks. Many financial institutions merged as a result of the crisis.

Giant corporations performing combined activities such as Goldman Sachs or Morgan Stanley, simultaneously give financial advice to clients and sell them various financial products as well as trade on their own accounts. These activities represent a conflict of interest that calls into question the integrity of these companies.[10] From the entry into force of this Act brokerage firms are required to put the interests of their clients first. It is doubtful, however, whether this can actually happen, considering that they are still allowed to carry out both of the above mentioned activities (consulting and trading on their own account). If the Act were to address the root of the problem, then such mammoths engaged in wide-ranging financial activities would need to be divided up into smaller units. This would both reduce their size and eliminate the possibility of a conflict of interest.

The Volcker Rule

The Volcker rule, named after former United States Federal Reserve Chairman *Paul Volcker*, originally wanted to restrict banks from trading on their own accounts as well as making speculative investments into higher risk funds. Pursuant to the Act, however, banks are allowed to make higher risk investments, but are only allowed to do so with up to 3% of their shareholders equity. This might seem like a miniscule figure, but it is still a step back from complete prohibition. Moreover, banks can ask for a temporary deferment, meaning that they only have to fully comply with some parts of the Volcker rule by 2022.[11]

The Volcker rule is in fact none other than the updated version of the Glass–Steagall Act; i.e., its main goal is to separate commercial and deposit banking activities and to protect taxpayers and clients from excessive risks taken by banks. There is a debate in the relevant literature about the extent to which the combination of the two activities contributed to the crisis we are experiencing today. It is a fact that the proliferation of financial innovations and the globalisation of money markets happened roughly at the same time as the merging of the commercial and deposit banking activities. Engaging in both activities within the same institution definitely increases the possibility of insider trading, the risk of misusing information and misleading clients.

Transparency reforms

Making the derivatives market – whose estimated worth is 600 billion USD – more transparent is another important objective and it would bring real change to the disorder of today's securities trading. The Act only allows standardised derivatives contracts to be made on the open market, specifying the prices and quantities concerned. The contracts would be guaranteed by a third party, who would warrant the business (i.e. if the contracting party were to default, the third party would still pay back the investment made by the investors).

The Act also specifies that securities trading companies must have a minimum, pre-defined shareholders' equity and that banks are to separate their derivatives deals from their commercial banking activity.

The original proposal also included a measure whereby banks would have been required to outsource all of their swap transactions, but the Act now only includes a watered down version of the original idea; swap transactions linked to interest rates, stock prices, gold and silver trading are allowed to stay within the bank. Banks will only be required to outsource swaps that are considered very high risk, such as the ones linked to agriculture, the metal industry and the energy sector. This means that the regulation is going to leave roughly 80 per cent of the derivatives business line in the hands of the banks (based on the statistics provided by the Bank for International Settlements).

The Act will presumably improve the transparency of the business line, but these provisions will not be able to do away with the system of securitisation and excessive leverage, even though both had a significant role to play in the overheating of the economy.

Consumer protection

The financial reform establishes the Consumer Financial Protection Bureau. Previously, the Fed was responsible for consumer protection and the security of national financial institutions, often placing emphasis on the latter category.

The new agency will be entitled to amend the regulations of credit counseling, the mortgage market, the credit card market as well as other banking products. Furthermore, it will also be charged with educating clients in financial matters, to develop a form of financial literacy. The establishment of the Consumer Financial Protection Bureau decreases the chance of consumer interests being harmed when signing agreements or purchasing financial products than before the enactment of the Act. The Bureau will ensure that each and every mortgage and credit card agreement is drawn up in language that is clear and comprehensible and that there are no hidden fees or increasing interest rates.

Since even the establishment of the Bureau is proving to be cumbersome, it is doubtful that its operation will be able to create a consumer-friendly atmosphere in the US. According to Obama's opposition, the Republicans who gained a majority in Congress in November 2010, the Dodd-Frank Act restricts growth and reduces America's competitiveness. They have made hindering the setting up of the Consumer Protection Bureau one of the focal points of their actions directed against putting the Act's provisions into practice. Among other things, they proposed the termination of the 'soft' Volcker rule that has made it into legislation (i.e. they would not limit banks' high-risk investments), but have also objected to recommendations as to the head of the bureau.

It is, therefore, doubtful how the new institution will be able to perform its commissioned tasks in the face of such opposition.

Shareholder vote on executive compensation (bonuses)

Voting could help resolve the problem of distributing massive and unreasonable compensation. Pursuant to the Act's provisions, in their proxy statements joint-stock companies shall, not less frequently than once every three years, request shareholders to take a vote to approve the compensation of executives. The result of the vote, however, will not be binding for management.

The vote on compensation also requires that in case shareholders are asked to approve an acquisition, merger, proposed sale, etc., the

person making such solicitation shall also disclose how much compensation corporate executives will receive due to the given transaction. At this time separate shareholders may vote separately to approve such compensation; however, vote results will still not be binding. [12] In the US, even this 'soft' proposal has a great number of opponents.

The system of bonuses favouring short-term business success remains in essence unaffected by the Act; moreover, financial executives are not obliged to take shareholder votes into account.

Changes affecting credit rating agencies and audit firms

The Act allows consumers to sue any credit rating agency that "intentionally or due to negligence issues erroneous credit ratings"; furthermore, it restricts the number of cases where a positive rating from such institutions is required to conclude a transaction. These changes are aimed at forcing credit rating agencies to be more cautious in their activities and suppressing the significance and influence of such agencies. Over the course of the year that passed since the signing of the Act, no appreciable decrease in the influence of credit rating agencies could be observed. Moreover, in many cases world markets have reacted more sensitively to the down or upgrading of certain countries.

Confidence in auditing firms had already dwindled at the beginning of the 2000s (as a result of repeated scandals, see the section entitled Auditing firms), and the Sarbanes–Oxley Act, enacted in 2002, was meant to rectify this. After the Act entered into force, auditing firms reviewed internal control procedures and reported the related results. The Dodd-Frank Act changed this situation in that it facilitated the exchange of information for the Public Company Accounting Oversight Board with foreign supervisory authorities and further reinforced the control of brokerage firm audits.

THE FINANCIAL LOBBY

Lobbying has traditionally had a key role in the US system; this legal method of convincing and influencing politicians is also a tried-and tested tool of money market giants. Following the signing of the Act, those with a stake in amending the Dodd-Frank Act also jumped into action through various lobby groups. In the first three months of 2011, Wall Street spent nearly USD 52 million on lobbying. According to the head of one of the lobby groups, the goal is not to dismantle the Dodd-Frank Act, but to "reform the reform" (Protess, 2011).

The critics of lobby group activities, however, do not share this view. According to *Barbara Roper*, Director of the Consumer Federation of America (an organisation protecting consumers), banks have exploited the bailouts, and are now doing everything in their power to hinder the measures taken to prevent financial crises of the future. The Director is of the opinion that Wall Street should have realised that the business principles applied have nearly pushed the world economy to the brink, but regardless, they have already reverted to their old ways.[13]

Among other things, due to intense lobbying activity, the practical implementation of the Act's provision is progressing very slowly. The legal firm Davis Polk & Wardwell posts the so-called Dodd-Frank Progress Report on its website every month, and according to the survey published on 1 July 2011, not even a tenth of the 400 regulations pursuant to the text of the Act have been finalised.

It makes no difference that reform objectives are appropriate; they cannot be imple-

mented with the Dodd–Frank Act. Though the reform does change a few Wall Street factors, it does not effect any fundamental transformations in the operating model of the financial system. As Obama himself has acknowledged, the unethical behaviour of people working in the financial sector is not attributable to individual persons, but to the nature of the current system. Until the perverse logic of the system is transformed, we cannot talk about true reform.

SUMMARY

The history of American financial regulation is not a success story. Based on the above, it is very obvious that in times of economic growth legislators are inclined to loosen regulations, and in times of crises the issue of stricter frameworks arises once again. Since the eruption of the subprime mortgage crisis in 2007, a new chapter has begun in the tug-of-war between the political elite trying to reform the financial sector and financial market players.

Appropriate regulatory responses given to recurring crises are persistent problems of capitalism. In the period of economic upturn preceding the current crisis, money markets seemingly worked with incredible efficiency and flooded American consumers with cheap loans and investors with easy money. This created the moral foundation for deregulation. The nightmare of recession seemed but a mirage, and the stringency of the regulatory environment started to ease up amidst general optimism.

However, the crisis proved that the processes of recent decades - the increasing complexity of financial markets and the proliferation of the originate-and-distribute model based on securitisation - did not bring increasing profits with decreasing risks as the experts of financial institutions led us to believe. The risk management illusion related to financial innovations (i.e. that with the development of the mathematical basis of modelling and risk management, risks will become more predictable) greatly contributed to the development of these problems.

Therefore, the two key reasons of the crisis are markets turning opaque due to the proliferation of financial innovations and inappropriate regulatory environment.

It is the author's opinion that problems leading to crisis could clearly be rectified through the appropriate regulation of financial sector activity. The question is what regulation would be appropriate. US President Barack Obama did make an attempt to create a more strictly regulated financial system; however, his ideas were not met with clear enthusiasm either by the political and economic elite, or by the general public. What we need is probably not stricter regulation, but more flexible regulation that adapts better to economic cycles (see for instance Raghuram Rajan's idea of so-called 'cycleproof regulation').

One thing is for certain, the US and the world cannot avoid another, potentially more deadly financial and real economy crisis if it fails to recognise that in exchange for safer operation, the scope for action of financial markets will probably decrease. It seems a greater shock is needed in order for markets to cooperate with decision makers in the interest of creating a more efficient regulatory system. Since the circumstances leading to the crisis remain present in the US economy, this shock could come sooner than we expect.

Notes

[1] Commercial banking activity: deposits, lending money, guarantees, discounting, cash-free payments, warranty
Investment banking activity: asset financing, hedging transactions, asset management, securities trading
Corporate Finance: securities trading, hedging, forward transactions, options, enterprise financing with stock exchange assistance, initial public offering
Asset Management: asset management, portfolio management
Mergers and Acquisition: mergers and consulting

[2] American classification of institutions

- Depository institutions
  - Commercial banks
  - Savings banks
  - Savings and loan associations
  - Credit unions
- Non-depository institutions
  - Finance companies
  - Insurance companies
  - Investment banks, brokerage firms
  - Mortgage banks
  - Pension funds

[3] Fannie Mae, i.e. FNMA (Federal National Mortgage Association), Ginnie Mae, i.e. GNMA (Government National Mortgage Association) and Freddie Mac, i.e. Federal Home Loan Mortgage Corporation; in brief their task is to ensure financing for mortgage lending. They buy up mortgage claims from lending financial institutions, then issue derivative products based on these – mortgage-backed securities – thereby ensuring and increasing the capital funds for prime mortgage lending.

[4] "Financial institutions in the United States lent not only 80% of the sales price of new housing, but 100% and then (…) even 120%, because new homes had to be equipped with new furniture and new household appliances" (Bánfi – Kürthy – Bánfi, 2011).

[5] Nationally Recognised Statistical Rating Organisations

[6] Federal Deposit Insurance Corporation

[7] Charles Ferguson's documentary entitled *Inside Job* on the causes and consequences of the crisis.

[8] Barack Obama's election campaign slogan

[9] The last time the government debt ratio (as a ratio of the GDP) of the United States exceeded its gross domestic product was in 1947, in the wake of the Second World War, whereas by 1981 it dropped to 32.5 per cent. In 2007, it was still only at 64.4 per cent, but when the global economic crisis hit the indicator spun out of control.

[10] The SEC, for instance, started proceedings against Goldman Sachs in connection with one of its financial products. The essence of Abacus, the product in question, was that it protected banks against the adverse effects of a drop in the price of certain real estate bonds, while the bank in the meantime advised clients to invest in these bonds (all the while taking up an opposing position on the stock exchange). The SEC, however, after imposing a 550 million USD fine (equivalent to two weeks' worth of profits for the bank, or 3 per cent of the bonuses paid by Goldman Sachs in 2009) on the bank, did not ask any more questions (Warde, 2011).

[11] Several financial institutions must reduce their share in so-called in-house hedge funds. This may take quite a while according to the justification provided by those concerned, explaining the somewhat distant 2022 target deadline.

[12] The so-called 'golden parachutes'.

[13] Ibid.

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