

In the Wake of Financial Crisis

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The financial system failed to perform its function as a reducer and distributor of risk. Instead, it magnified risks, precipitating an economic contraction that has hurt families and businesses around the world.¹

Congress passed historic financial reform legislation in mid-2010,² more than two years after the onset of a financial crisis resulting from a housing bubble and bust that rocked the U.S. and world economies and led to a staggering recession, sometimes called the “Great Recession” because of its scope and duration. The Dodd-Frank legislation marks the first major financial reform enacting restrictions on the banking industry since the enactment of Glass-Steagall at the end of the Great Depression and its gradual demise as deregulatory and privatization policies gained sway in the post-Reagan years.

Those years saw the average American worker left with stagnating real wages even though productivity and work hours were dramatically increasing. With lower labor costs and increased productivity, U.S. businesses raked in unprecedentedly high profits that primarily went to managers and owners or were held in business capital accounts (and banks). Tax policies further favored the accumulation of capital in businesses, from accelerated depreciation provisions to other expensing provisions to tax-free accumulated savings accounts especially valuable to top corporate officials. That meant that the U.S. economy was awash with capital at the same time that ordinary workers were facing longer hours and stagnant pay in spite of their continuing expectations of an improving lifestyle. It is not a surprise, in that context, that those years also led to the gradual disintegration of the Glass-Steagall protections distinguishing commercial banks from investment banks and ultimately Congress’s prohibition of regulation of a mushrooming array of financial products that had been developed to provide readier credit to a consumer economy buying beyond its ability to pay in terms of real wages.

The result was the end of a staid, conservative, and robust financial system. An insatiable demand for short-term profits to feed outsized compensation packages fed speculative proprietary trading desks gambling with other people’s money, intertwined with a shadow banking system that was of out sight and out of control. Debt was extraordinarily profitable for the system, but pushing credit on an overworked and underpaid American consumer—with a flood of credit card offers (loaded with hidden fees and high rates) and innovative mortgages (loaded with little understood terms such as negative amortization, interest holidays, variable rates and/or higher interest rates like the subprime loans that

¹ Timothy Geithner & Lawrence Summers, *A New Financial Foundation*, WASHINGTON POST, June 15, 2009, at <http://www.washingtonpost.com/wp-dyn/content/article/2009/06/14/AR2009061402443.html>.

² Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010). The House passed the Conference Report on June 30, 2010, and the Senate on July 15, 2010.

were especially lucrative for banks but extremely risky for overburdened borrowers)—put the entire economy at risk.

In August 2007, American Home Mortgage filed for bankruptcy and short-term credit markets froze after BNP Paribas suspended several of its investment funds.³ In March 2008, the noted investment bank Bear Stearns experienced an inability to get the financing needed to keep going. The Treasury Department and Federal Reserve worked out a sale to JP Morgan.⁴ In September, Lehman declared bankruptcy and Merrill Lynch was sold to Bank of America.⁵ AIG was bailed out,⁶ and Washington Mutual was sold to JP Morgan Chase.⁷ Ultimately, the government provided billions directly and perhaps trillions indirectly:⁸ it funded the largest banks to keep the system afloat, facilitated mergers and expansion of the biggest institutions even while lamenting that they had become too big to fail, and provided funding to AIG to pay off its counterparties in full, much of which went to the same banks already receiving government funds, as well as assisting the national mortgage companies established under federal charters (known as Freddie and Fannie) that had suffered losses by purchasing tranches of “triple-A” debt from Wall Street’s securitizations of subprime loans (the two corporations were not permitted to directly fund the riskier categories of loans), and coming to the rescue of Detroit’s car industry, which had morphed into a part of the shadow banking system with less attention paid to manufacturing excellence. The result was job and home losses for millions of Americans, a huge federal deficit, and an as yet uncertain economic future.

The preceding paragraph describes some of the most obvious events of the financial crisis. But its roots go much deeper. This article explores the causes of the financial crisis, and considers in particular whether or to what extent fair value accounting rules were culpable.⁹ It also briefly reviews measures undertaken to respond. Part I provides an analysis of the financial crisis, delineating the various factors that fomented economic turmoil. In this context, Part II will discuss the relevance of accounting standards to the

³ GEORGE SOROS, *THE NEW PARADIGM FOR FINANCIAL MARKETS: THE CREDIT CRISIS OF 2008 AND WHAT IT MEANS* (2008) (hereinafter, *NEW PARADIGM*), at xiii.

⁴ Suzy Jagger & Siobhan Kennedy, *Bear Stearns Sold to JP Morgan Under Federal Bank Pressure*, *THE SUNDAY TIMES*, Mar. 17, 2008, at http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article3564479.ec.

⁵ Eoin Callan et al, *Lehman Borthers , Merrill Lynch Sold*, *THE NATIONAL POST*, Sept. 14, 2008, at <http://www.nationalpost.com/news/story.html?id=790942>.

⁶ Edmund L. Andrews et al, *Fed’s \$85 Billion Loan Rescues Insurer*, *N.Y. TIMES*, Sept. 16, 2008, at <http://www.nytimes.com/2008/09/17/business/17insure.html>.

⁷ Christopher Palmeri, *JP Morgan Chase to Buy Washington Mutual*, *BLOOMBERG.COM* (Sept. 26, 2008), at http://www.businessweek.com/bwdaily/dnflash/content/sep2008/db20080925_760466.htm?campaign_id=rss_daily.

⁸ *U.S. Government Bailout Summary: Follow the \$8.5 Trillion - Breakdown of the Government’s Rescue Funds*, CLIFF KULE’S NOTES (Dec. 2, 2008), at <http://www.cliffkule.com/2008/12/us-government-bailout-summary.html>.

⁹ This paper was originally presented at a December 3, 2009 panel on accounting developments as part of the International Monetary Fund Seminar on Restoring Financial Stability—The Legal Response. It has been updated to reflect the likely form of financial reform legislation, as reflected in the Conference Report for the Dodd-Frank Bill under consideration in Congress and expected to pass in July 2010.

crisis, in particular the expressed concern that fair value accounting's mark-to-market rules create a pro-cyclical effect that creates panics and insolvencies that would otherwise be nonexistent. This Part will argue that fair value accounting is not the villain it is made out to be, and that proposals to restrict or eliminate fair value accounting are wrong-headed. On the other hand, the off-balance sheet treatment of securitization vehicles was a genuine factor in the crisis, and should appropriately be addressed. Part III will briefly discuss the reforms proposed by the Treasury Department and reform legislation. Part IV concludes.

I. The Financial Crisis

The global financial crisis that began in 2007 resulted in the worst recession since the Great Depression. As described above, the U.S. government (and governments of other developed countries) came to the rescue of the global banking system, temporarily underwriting some collapsing companies and most big bankers.¹⁰ Given the huge outlay of federal dollars and the further commitments via direct and indirect guarantees, it behooves the country to understand the causes of the crisis and to eliminate those causes if at all possible. This Part I considers causation in three major areas. Part I.A. looks at the role of financial innovation. Part I.B. considers the impact of the deregulatory agenda put in place beginning with the Reagan presidency. Part I.C. assesses the overall financialization of the economy. Part II then addresses the relevance, if any, of accounting standards.

A. Financial Innovation: complex mortgage loans, hedge funds, securitizations and credit default swaps

The last twenty to thirty years saw an unprecedented development of financial products and a rapid expansion of the financial markets utilizing those innovative products.

Most critically, financial innovation engineered a range of new financial “derivative” products (products whose values depends on attributes of corporate bonds, corporate shares, or mortgages backed by commercial or residential real estate or similar properties that are referenced by, or underlie, the derivative products). Many derivatives were legitimate hedges for ordinary course-of-business risk. Interest rate swaps, for example, permit end users to limit their exposure to increased interest rates on floating rate borrowings by converting to fixed rates through a swap of periodic payments with a financial intermediary. (In the swap, one counterparty pays fixed rate; the other counterparty pays a floating rate determined under the swap document, such as the London Interbank Offering Rate plus or minus some basis point spread.) Commodities futures allow manufacturers to assure an affordable supply of a necessary raw material.

But financial product innovation also resulted in products used to facilitate tax and regulatory arbitrage.¹¹ For example, banks (and other firms) conducted “repo” deals—

¹⁰ See *infra* note 90 and accompanying text.

¹¹ See, e.g., SIMON JOHNSON & JAMES KWAK, *13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN* (2010), at 80 (“Because the evolution of derivatives has run ahead of regulatory and accounting

purported sales transactions with repurchase arrangements that in reality functioned as financings—to make their balance sheets appear less leveraged. The widespread use of repos for balance sheet window dressing was exposed in the Lehman bankruptcy.¹² Derivatives may also be used by banks to avoid collecting withholding tax on dividends by masking ownership of equities.¹³

Further complicating the matter, many of these derivative transactions were purportedly customized bank-to-bank transactions rather than transactions between a bank and an end user outside the financial industry. Lack of transparency about these over-the-counter products meant that neither banks nor regulators were aware of the extent of derivative exposure taken on by individual financial institutions, the degree of interconnectedness among financial institutions, nor the real riskiness of the products themselves. The amount of unregulated derivatives exploded in a very short period of time, so that the regulated U.S. stock market was only 2 percent of the global unregulated derivatives market by the end of 2008.¹⁴

Financial innovation coupled with lax regulatory oversight¹⁵ permitted financial institutions to greatly expand their risk-taking to leverage themselves to incredible profits (and, commensurately when the markets faltered, enormous losses), becoming “a crazy, man-made money machine, built on flawed mathematical models.”¹⁶ Financial derivatives were central to the spread of the financial crisis from the subprime mortgage loan problems to the broader economy. Mortgage loans initially were issued under regular lending guidelines requiring documentation of income and prudential lending review. But securitization of those mortgage loans into pools that could be sold to third party investors through real estate mortgage investment conduits and, even more profitably, through collateralized debt obligation transactions (CDOs) separated bank profitability from traditional and prudential bank lending standards by separating borrower from lender. Suddenly, banks could push “product” and let others worry about the risks of loss, while the funds from the securitization of earlier mortgage loans were

rules, derivatives can also serve other purposes, such as helping companies smooth their earnings over multiple periods or reduce their tax bills by deferring earnings into the future”).

¹² See, e.g., Alistair Barr, *SEC Quizzing Financial Institutions on Repo Transactions*, MARKETWATCH (Mar. 29, 2010) (noting SEC interest in tracking the extent of use of repo transactions to reduce leverage), at <http://www.marketwatch.com/story/sec-quizzes-financial-institutions-on-repo-deals-2010-03-29>; DealBook, *The Origins of Lehman’s ‘Repo 105’ Accounting*, N.Y. TIMES, Mar. 13, 2010 (tracing the repo transactions used by Lehman), at <http://dealbook.blogs.nytimes.com/2010/03/12/the-british-origins-of-lehmans-accounting-gimmick/>; In re Lehman Brothers Holdings Inc., Chap. 11 Case No. 08-13555, Report of Anton R. Valukas, Examiner (describing the repo transactions), available at <http://lehmanreport.jenner.com/>.

¹³ Lynnley Browning, *Banks’ Derivatives Activity Falls Under I.R.S. Scrutiny*, N.Y. TIMES, Jan. 21, 2010.

¹⁴ *Too Big to Fail but Not Too Big to Sink*, GAMINGTHEMARKET (Apr. 9, 2009), at <http://www.gamingthemarket.com/not-too-big-to-sink.html>. The notional amounts of over-the-counter (unregulated) derivatives outstanding at the time of the crisis were astronomical, as shown in the Bank for International Settlement’s quarterly reviews. See, e.g., Statistical Annex, BIS QUARTERLY REVIEW (Mar. 2009), at http://www.bis.org/publ/qtrpdf/r_qa0903.pdf#page=108.

¹⁵ See infra Part I.B.

¹⁶ Michiko Kakutani, *Investors Who Foresaw the Meltdown*, N.Y. TIMES, Mar. 14, 2010 (reviewing MICHAEL LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE* (2010)).

much more rapidly available for re-lending to new borrowers. That push for product provided a huge incentive to “find” borrowers and to develop new securitization products that would produce even higher returns.¹⁷ Borrowers were easy to find, since wages had stagnated for most American workers in spite of a productivity boom, and debt appeared to be the only way to maintain existing standards of living.¹⁸

The process culminated in two practices carrying extraordinary systemic risk—(i) the issuance of thousands of subprime mortgage loans with little or no documentation, to borrowers who were often unqualified to receive them, in processes that sometimes or even often amounted to abuse or fraud,¹⁹ and (ii) the invention and wide use of complex and risky securitization forms such as the “CDO squared” that re-pooled and re-tranched junk grades of securities from prior securitizations of mortgage loans into new securitizations where they were magically transformed into “triple A” securities (with the assistance of credit rating agencies’ buying into banks’ assumptions about the diversification of risks) and the “synthetic CDO” that merely referenced existing loans but did not have to own them, relying on counterparty bets in the form of naked credit default swaps to provide the periodic payments that would ordinarily have come from owned mortgage loan assets. These securitization devices permitted banks to extract multiple layers of fees and profits from underlying pools of subprime loans while at the same time catering to particular risk appetites of potential speculators in the market. Much of it was done using special purpose vehicles and structured investment vehicles that permitted the banks to keep their own positions in the securitizations off their balance sheets.²⁰ The Securities and Exchange Commission’s investigation of Goldman Sachs in connection with its creation of an Abacus synthetic CDO to include subprime mortgage loans expected to perform very poorly by the CDS protection buyer who selected most of them is the culmination of that process.²¹ The “securitization mania”

¹⁷ See, e.g., *The Anatomy of a Financial Crisis*, in JUSTIN FOX, *THE MYTH OF THE RATIONAL MARKET* (2009) (describing the innovation, securitization, and reduction of prudential standards underlying the subprime crisis).

¹⁸ Richard Wolff, professor emeritus of economics at the University of Massachusetts, presents this narrative of a productivity boom coupled with stagnant worker wages and exploding business profits facilitating the financialization of the economy and the substitution of debt for wages in the film “Capitalism Hits the Fan”, presented in a screening and question & answer format at the New School in March 2009, available at <http://www.youtube.com/watch?v=OHTkEBloxBA>. The film includes a number of graphs tracking productivity, wages, business profits and debt. A transcript is available at the Media Education Foundation, <http://www.scribd.com/doc/31710037/Capitalism-Hits-the-Fan-by-Richard-Wolff>.

¹⁹ See, e.g., James Surowiecki, *Greater Fools*, *THE NEW YORKER MAGAZINE* (July 5, 2010), at 23 (noting that people were “bamboozled into making bad decisions” like refinancing to a higher interest mortgage or buying unnecessary credit insurance).

²⁰ See, e.g., *NEW PARADIGM*, supra note 3, at xv.

²¹ *SEC v. Goldman Sachs & Co.*, S.D.N.Y. No. 10 Civ. 3229 (BSJ) (June 21, 2010) (charging that Goldman made material misrepresentations in connection with the input of Paulson’s hedge fund in the selection of subprime mortgages for the Abacus 2007 AC-1 CDO deal and providing until July 19 for Goldman’s response). As this article was being finalized, Goldman reached a settlement agreement with the SEC on July 15, 2010 for more than \$500 million and agreed not to deduct the payments for tax purposes. See Sewell Chan & Louise Story, *Goldman Pays \$550 Million to Settle Fraud Case*, *N.Y. TIMES*, July 15, 2010, at <http://www.nytimes.com/2010/07/16/business/16goldman.html>. For thorough discussions of the role of naked credit default swaps in the crisis and drives to short the subprime mortgage loan market, see

with its aggressive leveraging of assets “was bound to end badly.”²² As Edmund Andrews has reported, the explosion of financial derivatives played a significant role in moving the subprime problem to a global financial crisis.²³

Furthermore, financial institutions’ development of technological trading procedures threatened the transparency and equality of access to information essential to functioning markets. Financial institutions with significant resources have been able to hire quantitative experts (often called “quants”) and invest in state-of-the-art technology and computerized pricing analysis.²⁴ As a result, they can establish speculative proprietary trading using dark pools (informal, private electronic matching systems that are not reflected in the exchange-traded markets) and flash trading (trading based on computer algorithms to take advantage of slight moves in the market) to make large profits in ways that are opaque and unavailable to ordinary investors and that fragment markets into privileged or run-of-the-mill traders, threatening the markets’ credibility.²⁵

The explosion of derivatives and computerized trading was especially lucrative for Goldman Sachs and the other big Wall Street investment banks, which engage in investment banking for institutional clients (including merger advice and underwriting); trading and principal investment activities for clients; proprietary securities trading and investment for their own accounts; and other asset management and securities services.²⁶ Derivatives essentially doubled or tripled the ability of financial institutions to enter into new deals on which they could make money. And with JPMorgan’s development and

MICHAEL LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE* (2010) (probing the development of awareness about the coming fall of the subprime CDO bubble and those like Steve Eisman and Michael Burry who won by shorting it, and concluding that greed, and the incentives that channeled the greed, were at the heart of the financial system problems and its ability to pass its risk off to ordinary people through extraordinary leverage and aggressive transactions) and GREGORY ZUCKERMAN, *THE GREATEST TRADE EVER* (2009) (specifically about Paulson’s billion-dollar credit default swap gambling win).

²² NEW PARADIGM, *supra* note 3, at xix.

²³ Edmund L. Andrews, *Endgame on Financial Regulation*, May 17, 2010, at

<http://capitalgainsandendgames.com/glob/edmund-l-andrews/1728/endgame-financial-regulation>.

Credit-default swaps tied to subprime mortgages were at the heart of AIG’s immense collapse, and they fueled an immense casino of highly-leveraged bets that all went south at the same time when the housing market tanked. Credit-default swaps amplified reckless behavior because they allowed bond investors to think they had insurance against bond defaults. They also became a multi-trillion-dollar game in themselves, with hedge funds and other institutions buying up swaps even when they didn’t own the underlying bonds. None of this was regulated.

²⁴ See, e.g., PHILLIPP J. SCHONBUCHER, *CREDIT DERIVATIVES PRICING MODELS: MODELS, PRICING AND IMPLEMENTATION* (2003) (covering accepted modeling approaches for pricing credit derivatives).

²⁵ Venkatachalam Shunmugam, *Financial Markets Regulation: The Tipping Point*, May 18, 2010, at <http://www.voxeu.org/index.php?q=node/5056> (providing a description of these practices and a list of SEC and other references on these issues). Companies may also have engaged in front-running, the illegal practice of executing orders based on knowledge of pending client orders. *Id.*

²⁶ Although Goldman’s assets look more like a trading desk than a bank, Goldman Sachs and Morgan Stanley converted from investment banks to bank holding companies on September 21, 2008, in order to take advantage of the cheap funding available through borrowing at the Fed window. See, *Goldman, Morgan to Become Bank Holding Companies*, New York Times DealBook, at <http://dealbook.blogs.nytimes.com/2008/09/21/goldman-morgan-to-become-bank-holding-companies>.

dissemination of a statistical “value at risk” (VaR) model for computerization of risk assessment at a given probability (often 95%), the bankers had an institutional model for measuring risk that all accepted as highly relevant, even though it had significant shortcomings. The model could be gamed, it ignored types of risks such as liquidity risk that hadn’t been an issue in the past, and it relied on historical trends (even when there was little history to use)—all of which tended to deflect attention from the potential for drastic change or the “long tail” probability. The profit machine was up and running, and those profits themselves pushed the concern about risk over the long term to the background as banks pressed to get their share of the manna.²⁷ The stock market and housing bubbles were fed by the banks’ insatiable appetites for transactions that could be securitized and resold to garner multiple layers of fees.

In addition, hedge funds and other non-regulated actors such as company banks became important players in financial markets (often termed the “shadow banking system”). Although not regulated as banks, these shadow banking entities are often owned by banks and engage in risky financial transactions with other financial enterprises. The explosion of derivatives and the computerization of trading was similarly lucrative within this shadow banking system. The interrelationships among the shadow and formal banking entities are obscure, because of the lack of regulation of the shadow banking entities on the one hand and the lack of regulation of the entire range of derivative financial products on the other. Thus, while the hedge fund Long Term Capital Management almost failed at the turn of the century, it was rescued by a group of financial institutions acting under a coordinated plan developed with the federal government out of concerns about systemic risk.²⁸ The ability of the system to learn from the near-collapse, however, was limited because of the lack of systematic information about transactions, ownership and obligations among shadow banks and commercial and investment banks. Instead of leading to much needed reforms, the mere fact that the system survived the hedge fund’s reckless leverage “reaffirmed the prevailing market fundamentalist creed.”²⁹

Moreover, investment banks were also able to exploit the banking laws by taking advantage of the “industrial loan company rules”: the result is that these speculative enterprises have gambled with taxpayer money, taking advantage of the Federal Deposit Insurance Corporation (FDIC) protection and the cheap funding from long-term depositors available through commercial banking business subsidiaries without being subject to the stricter regulation that such banking normally entails.³⁰ Merrill Lynch’s

²⁷ See Joe Nocera, *Risk Management*, THE NEW YORK TIMES MAGAZINE, Jan. 2, 2009 (providing an in-depth discussion of the development of the VaR model and its ultimate institutionalization as the primary risk measurement). See also NASSIM N. TALEB, *THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE* (2007) (discussing the problems of overreliance on quants and their mathematical models in assessing risk).

²⁸ See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *LONG TERM CAPITAL MANAGEMENT: REGULATORS NEED TO FOCUS MORE ATTENTION ON SYSTEMIC RISK* (GGD-00-3 October 29, 1999), at <http://www.gao.gov/products/GGD-00-3>; David Shirreff, *Lessons from the Collapse of Hedge Fund Long Term Capital Management*, at http://elsa.berkeley.edu/users/webfac/craine/e137_f03/137lessons.pdf (noting the high leverage coupled with interconnectedness between the competitive bank and shadow banking sectors).

²⁹ NEW PARADIGM, *supra* note 3, at 116.

³⁰ See, e.g., David Cho, *Bank Loophole for Wall Street Remains in Financial Regulation Bill*, WASHINGTON POST, May 19, 2010, at A14 (commenting on the Industrial Loan Company charters that permitted retail

commercial subsidiary alone reached about \$60 billion in assets in the decade before the financial crisis, more than all of the traditional industrial loan companies combined.³¹

B. Lax regulation

Why this lack of transparency? At the same time that financial innovation was producing new products, a deregulatory approach came to dominate government, encouraged by the Chicago School's economic theory focused on quantifying descriptions of markets. The simplistic theory reduces the chaotic reality of human marketplaces to a concept of rationality where "perfect markets" without transaction costs or information asymmetries achieve an equilibrium between supply and demand; yet this dominant perspective on markets has little to do with the reality of the way markets work.³²

Regulators as well as regulated entities fell into the "perfect market" trap. As Nobel economist Joseph Stiglitz notes, "Our regulatory system failed partly because we had regulators who didn't believe in regulation."³³ That led to a gradual erosion of the Depression-era banking laws that had imposed strong restrictions on commercial banks and prohibited the integration of commercial banking, investment banking, and insurance

firms like Target Corp. to establish in-house banks and the investment banking use of these advantages to establish commercial banking subsidiaries).

³¹ Id. The charter, it turns out, was of most value to the "most reckless" companies. Id. Merrill Lynch had to be taken over in September 2008.

³² See, e.g., *NEW PARADIGM*, supra note 3, at x ("Participants' and regulators' views never correspond to the actual state of affairs; that is to say, markets never reach the equilibrium postulated by economic theory"). It would be impossible here to provide an adequate foundation in the traditional economic theory that has come to be closely associated with the Chicago economics department and its star economists Milton Friedman and Friedrich Hayek. At the core is an emphasis on rational economic decisionmaking based on self-interest and the perfection of free markets. Two economists whose work develops the more traditional theory of John Maynard Keynes provide a friendly assessment, in GEORGE A. AKERLOFF AND ROBERT J. SHILLER, *ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DRIVES THE ECONOMY, AND WHY IT MATTERS FOR GLOBAL CAPITALISM* (Princeton Univ. Press 2009). "According to traditional economics, free market capitalism will be essentially perfect and stable. There is little, if any, need for government interference." Id. at 2. But, the authors note, the theory of economics derived from Adam Smith's teachings "does not explain why the economy takes rollercoaster rides." Id. at 3. In contrast, Keynes sought to explain the volatility of the economy in terms of how humans make decisions—they are not rational, but instead their "animal spirits" come into play. Id. Yves Smith provides a more caustic (and in my view, more revealing) summary of traditional economics' simplistic assumptions.

[Adam] Smith's ideas were cherry-picked and turned into a simplistic ideology This theory proclaims that the 'invisible hand' ensures that economic self-interest will *always* lead to the best outcomes imaginable. It follows that any restrictions on the profit-seeking activities of individuals and corporations interfere with this invisible hand, and therefore are 'inefficient' and nonsensical. ...[I]ndividuals have perfect knowledge, and so they pass their lives making intelligent decisions. Prices may change in ways that appear random, but this randomness follows predictable, unchanging rules. ... It is therefore possible for corporations to use clever techniques and systems to reduce or even eliminate the risks associated with their business.

YVES SMITH, *ECONNED: HOW UNENLIGHTENED SELF-INTEREST UNDERMINED DEMOCRACY AND CORRUPTED CAPITALISM* (2010) (hereinafter *ECONNED*), at 4.

³³ Joseph Stiglitz, *Build Strong Rules for Finance System*, Politico.com, Apr. 12, 2010 (as updated Apr. 15), at <http://www.politico.com/news/stories/0410/35636.html>.

and proprietary trading in a single conglomerate. The erosion was finalized at the turn of the century with the repeal of legal restrictions separating commercial and investment banking and financial services in the wake of the expansion of CitiGroup.³⁴ Brooksley Born's foresighted attempt to bring into the open for regulation the rapidly expanding new credit default swaps at the Commodities Futures Trading Commission was thwarted with the Commodities Futures Modernization Act of 2000, which prohibited regulation of derivatives.³⁵ The result of Congress's action is that derivatives contracts are not dealt with through the normal bankruptcy process, but rather are settled immediately upon counterparty demand when a contractual condition is triggered (such as a default or imminent default on any debt, or thin capitalization or whatever triggers are stated in the particular contract). The lack of regulation and the settling of derivatives outside of bankruptcy put considerable downward pressure on the price of assets.

Further, key officials in a position to act to stem the tide of leverage and risktaking at banks failed to act, in large part due to the way that economic theory about free markets and self-regulation had blinded them to the rising systemic dangers.³⁶ The Washington establishment from Reagan on has been under the sway of a markedly bank-friendly view of the economy—the so-called Washington consensus that treats the Chicago School “free market” ideology as received wisdom.³⁷ Regulators “lacked both an understanding of the real dynamics of the markets and of the concentrations of risk that were developing.”³⁸ Existing theory focused on individual institutions, and not on the system. To the extent officials considered the system, dogmatic reliance on free market theory led to minimization of concerns about risk. The upshot was that credit rating agencies and banking regulators abdicated responsibility, relying on banks' own calculations and risk profile assessments in drawing conclusions about securitization tranches and the likelihood of nationwide market disruptions.³⁹ Lauding the so-called Great Moderation,

³⁴ See, e.g., William D. Jackson, *Mergers and Consolidation Between Banking and Financial Services Firms: Trends and Prospects* (CRS Report RL 30516, as updated Aug. 8, 2003), at CRS-03, available at http://assets.opencrs.com/rpts/RL30516_20030808.pdf (noting that the expansion of Citigroup “anticipated” the laws permitting consolidation).

³⁵ For a good overview of the Act, see Dean Kroner, *Commodities Futures Modernization Act of 2000*, Strook & Strook & Lavan Publ. 134, July 17, 2001, at <http://www.stroock.com/SiteFiles/Pub134.pdf>.

³⁶ “Faith in free financial markets grew into conventional wisdom—trumpeted on the editorial pages of *The Wall Street Journal* and on the floor of Congress.” *Risk Management*, supra note 27. See also RICHARD POSNER, *A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION* (2009) (noting the loyalty of mainstream economists to market theory and the deregulatory movement). The dominance of the simplistic Chicago School approach is discussed in the text at supra note 32.

³⁷ See, e.g., *In Praise*, infra note 54, at 156-57 (discussing the role of market efficiency theory in conflating notions of efficiency with accuracy and perfected markets).

³⁸ Julia Black, *Rebuilding the Credibility of Markets and Regulators*, Jan. 2009 L. & FIN'L MARKETS REV. 1.

³⁹ NEW PARADIGM, supra note 3, at 117 (expressing shock at regulators' “abdication of responsibility” and noting that the Basel II accord permitted banks to rely on their own risk management systems, and that credit rating agencies evaluated the creditworthiness of financial instruments by relying on calculations provided by the issuers).

former Federal Reserve Chair Alan Greenspan decided that banks could regulate themselves. After the crisis broke, he belatedly admitted that he had been wrong.⁴⁰

Lax oversight was due also to the regulatory capture of government agencies by aggressive financial institutions. Moreover, the swinging door between Washington and Wall Street has created an officialdom that naturally allies with Wall Street interests based on shared cultural and investment banking backgrounds.⁴¹ Accordingly, the financial oligarchy exercises enormous power and is able to influence banking regulation at the international arena (Basle accord on capital levels), the domestic tax agenda (the refusal of Congress to include in the financial reform bill a reasonable financial transactions tax or leverage tax to pre-fund future bailout and resolution costs), and domestic banking activities (from accounting standards to proprietary trading to flash trading).⁴² The result is a series of policies (promotion of homeownership, the ready availability of credit through securitizations, low interest rates, policies inviting the influx of funding from China) that both destabilize the economy when pushed to excess and provide rentier profits to the financial institutions at the heart of each of those activities.

The result of innovation, expansion and lax regulatory oversight was a mushrooming of the Wall Street banking business and the overall financialization of the economy. In short, a business that was intended to exist primarily as a service to the real economy of household consumption and business production⁴³ moved into the dominant position of a financially oriented economy centered on transactions among financial intermediaries.

C. Financialization of the economy

Financial innovation and the development of a large “shadow banking system”⁴⁴ reflect a reality that played a significant role in the crisis—the financialization of the economy.⁴⁵

⁴⁰ See, e.g., David J. Lynch, *Former Fed Chief Greenspan: “I was wrong 30% of the Time”*, USA TODAY, Apr. 7, 2010, at http://www.usatoday.com/money/industries/banking/2010-04-07-financial-crisis-commission_N.htm.

⁴¹ One need only consider the many investment bankers (especially from Goldman Sachs) who have played significant economic policy roles in both Republican and Democratic administrations to verify this incestuous relationship: an incomplete list would include Robert Rubin, Henry Paulson, Jon Corzine, Robert Zoellick, Joshua Bolten, and Gary Gensler. See, e.g., Charles Scaliger, *The Government and Goldman Sachs*, THE NEW AMERICAN (July 14, 2010) (discussing the swinging door between Wall Street and DC).

⁴² The term “financial oligarchy” is Simon Johnson’s. See Simon Johnson, *The Quiet Coup*, THE ATLANTIC (May 2009) (hereinafter “*Coup*”) (noting that overreaching and risk-taking of elite business interests are at the root of the US crisis), at <http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/7364/>.

⁴³ See, e.g., Geithner & Summers, *supra* note 1.

⁴⁴ See, e.g., *Causes of the Financial Crisis and the Case for Reform*, Testimony before the Financial Crisis Inquiry Commission, Statement of Timothy Geithner, May 6, 2010 (hereinafter *Causes*) (“A great diversity of financial institutions emerged to provide banking services to individuals and companies, and they were allowed to operate without being subject to the same constraints applied to traditional banks”). Geithner notes that the shadow banking system of repo markets, structured investment vehicles and commercial paper conduits and other specialized finance companies grew to parallel traditional banking in size, with

Financial companies now account for “about twice the proportion of GDP as they did thirty years ago, and up to 40 percent of corporate profits.”⁴⁶ Globally, financial institutions have branched into every region of the world, providing the ability to cherry pick the jurisdiction to reference in cross-border derivatives deals and further weakening the ability of regulators to provide adequate oversight. The difficulty in harmonizing liquidity, leverage and capital requirements across borders results in financial institutions having more flexibility than merited. The Basle II accords were out of date in 2004 when they were promulgated and the Basle III accords, under discussion as the financial reform bill nears finalization in the United States, will be weakened by the clout of the banks in the wake of the financial crisis and can be expected to underregulate on these issues and defer whatever regulation is undertaken during a long transition period. All of these indicators of the power of financial institutions and the importance of these institutions to world economies present troubling questions for appropriate reforms of “too big to fail” institutions.

Further, financial institutions are extraordinarily interconnected, with derivative contracts among banks, shadow banks, and end users, and more complex swaps such as credit default swaps often conducted with a limited group of counterparties considered financially adequate to undertake the task. In the case of the subprime market implosion, the credit default exposure among banks and AIG led to a huge bailout of the insurance firm and payouts by it of tens of billions of dollars to a variety of big bank trading partners such as Goldman Sachs, JPMorgan Chase, and others.⁴⁷ While derivatives were touted as diversifying and reducing risks within the financial system, the interconnectedness among banks and shadow banking entities instead amplified that risk.

Financialization of the economy combined with globalization had three detrimental effects—increasing inequality (which was both cause and effect of financialization); increasing speculation within the banking industry based on Pollyanna assumptions about housing prices, recessions, and economic growth;⁴⁸ and synchronization across economies of the resulting economic downturn. Financialization resulted in soaring incomes among bankers at the top of the income distribution while incomes were stagnating in the middle for most Americans. That inequality made the impact of the crisis more daunting for most Americans as a chilling recession set in when ordinary

\$8 trillion of assets at its peak, “financed with short-term obligations and in institutions or funding vehicles with substantial leverage” and thus “particularly vulnerable to a classic run.”

⁴⁵ For a brief overview of this concept, see Peter Dorman, *Almost All of the Financial Crisis in One Picture*, Econospeak (Mar. 9, 2010), at <http://econospeak.blogspot.com/2010/03/almost-all-of-financial-crisis-in-one.html>.

⁴⁶ Jeffrey Madrick, *Inequality in America and What to Do About It*, 291 THE NATION 21 (July 19/26, 2010) (hereinafter “*Inequality*”). Simon Johnson also provides some insightful charts on the outsized share of profits enjoyed by the financial industry as a share of all U.S. business profits (no higher than 16% prior to 1985, but reaching 41% in the new millennium) and the corresponding outsized pay per worker in the financial sector as a percentage of average U.S. compensation (escalating from around 100% to around 180% after 1983). See also *Coup*, supra note 42.

⁴⁷ *AIG Reveals Biggest Beneficiaries of its Rescue*, DealBook, Mar. 15, 2009, at <http://dealbook.blogs.nytimes.com/2009/03/15/aig-discloses-counterparties-who-received-224-billion/>.

⁴⁸ See *Causes*, supra note 44.

Americans lost their purchasing power, while it abetted a casino attitude among bankers that led to greater risk taking and short-term thinking that shortchanged considerations of long-tail potentials for disaster and its potential impact on the American economy. As Jeff Madrick notes, the banks “pay their people ridiculously well—often two-thirds of their profits. . . . Wall Street paid \$145 billion in 2009, a near record, when the rest of America was mired in the worst recession since the 1930s and one out of six Americans couldn’t find a full-time job.”⁴⁹ That inequality also hints at the enormous political power of bankers and their likely ability to forestall much scrutiny of bank activities, at least so long as the economy appeared to be rolling along. Coupled with the pace of innovation and the supporting economic theory, these trends meant that the financial industry was rushing pell mell down easy-credit street without much insight about risks. The bailout itself provided a means for the system to continue, as the biggest banks raked in profits in 2009 from the cheap funding available due to the government guarantee.⁵⁰

II. The Role of Accounting in the Crisis

There are various views on the root causes of the economic meltdown that began in 2007 as liquidity crises and credit weakness led to the demise or takeover of these major financial institutions. Two key factors that emerged as potential culprits stem from the accounting rules for financial enterprises—off-balance sheet special purpose vehicles and fair value accounting. One, fair value accounting, is a “false villain”⁵¹; the other, special purpose vehicles, is a part of the financial innovation and increased speculative risk-taking that lay at the root of the crisis.

A. A brief overview of fair value accounting

In order to assess the role of fair value accounting in the crisis, some basic review of fair value measurement may be helpful. Although some form of fair value accounting had been in use for particular purposes prior to the 1990s, fair value accounting was adopted in the wake of the savings and loan debacle in 1993. Historical cost accounting had misled investors and regulators by showing solid balance sheets for institutions that were thinly capitalized or even insolvent. As a consequence, the Financial Accounting Standards Board (FASB) promulgated Statement of Financial Accounting Standards 115 (FAS 115), which provided for fair value accounting for investments in equity securities having readily determinable values and all investments in debt securities, including collateralized mortgage obligations and other mortgage-backed securities.⁵² Loans are currently exempt from fair value accounting, however. Under FAS 115, now codified at FASB Accounting Standards Codification Topic 320 (ASC 320), debt securities intended

⁴⁹ *Inequality*, supra note 46.

⁵⁰ Neek Kashkari, a Treasury official under Paulson and then Geithner (and himself a Goldman alumn) freely admitted the advantage to private capital and banks of government funding for the purchase of toxic assets from bank’s balance sheets. See Johnson, *Coup*, supra note 42. The advantage to the taxpayers is presumably the continuation of the financial system intact.

⁵¹ The term is from an article on mark-to-market accounting’s role in the crisis by Nicole Gelinas. See Nicole Gelinas, *Mark to Market: A False Culprit*, 6 J.L. ECON. & POL’Y 145, 145 (2010) (hereinafter *Mark to Market*).

⁵² FAS 115 was superceded by FASB ASC Topic 320 on September 15, 2009.

to be held to maturity are classified as held-to-maturity securities and are accounted for at historical cost, whereas debt and equity securities bought with the intent to sell at near term are classified as trading securities and accounted for at fair value, with changes in value included in earnings. Other debt and equity securities are classified as available for sale and reported at fair value, but changes are not included in earnings; instead, they are reported in shareholder equity.

FAS 157, Fair Value Measurement, issued in 2006 and applicable to financial statements ending after November 15, 2007, provided a definition of fair value and guidance on how to determine fair value for purposes of FAS 115.⁵³ The framework for measuring fair value establishes a hierarchy of fair value inputs, prioritizing “level 1” inputs of quoted prices in active markets for identical assets or liabilities as the most reliable evidence of fair value that must be used when available, but permitting “level 2” inputs of other observable data (such as quoted prices for similar assets in active markets, or quoted prices for identical assets in inactive markets) and, in cases where observable inputs are not available, permitting “level 3” inputs reflecting the entity’s own assumptions about how market participants would price the item. Level 1 inputs are clearly objective measures of actual transactions, whereas Level 3 inputs are essentially proprietary modeling assumptions and offer the most room for manipulation of values to suit the reporting entity’s objectives.

B. The arguments against fair value accounting for financial institutions

Banks, their allies in congress, and some academics and think tank members began arguing as early as 2007 that fair value accounting was responsible for the apparent weakness of bank balance sheets and a primary cause of instability.⁵⁴ As Lehman’s bankruptcy, AIG’s insolvency, and Merrill Lynch’s precarious situation came into attention, some demanded that FASB suspend fair value accounting so that banks would not have to recognize such heavy losses. The argument is that fair value reporting requires them to undervalue their distressed assets, thus lowering their apparent equity, triggering capital provisions, and causing them to appear weak and less solvent than they actually are. This unleashes a parade of horrors related to pro-cyclicality: funding costs escalate as banks cannot as easily access the short term commercial paper markets and liquidity issues ensue leading to sales of assets at a loss.⁵⁵ Blackstone Group’s CEO

⁵³ It also expanded disclosure about fair value measurements. FAS 157 was superceded by FASB ASC Topic 820, September 15, 2009. Fair value is defined as an exchange price, presuming a hypothetical orderly transaction between market participants from the perspective of the market participant that holds the asset or owes the liability, thus focusing on exit price (price received in a sale of an asset or paid to transfer a liability).

⁵⁴ See, e.g., James J. Angel, *In Praise of Mark to Management: The Need for Three-Dimensional Accounting*, 6 J.L. ECON. & POL’Y 153, 154-55 (2010) (hereinafter *In Praise*) (reviewing the efforts in the U.S. House of Representatives to end mark to market accounting).

⁵⁵ These and a range of other critical comments about fair value accounting are reported in the SEC Study, *infra* note 66, at Appendix A. See also Korok Ray, *Do Accounting Measurements Matter?*, 6 J.L. ECON. & POL’Y 219, 222, 225 (2010) (acknowledging that fair value accounting may exacerbate the business cycle but suggesting that the “better approach is to leave the accounting fixed [and] to adjust the capital requirement to guarantee financial stability”); David B.H. Martin, *Disclosure Implications of Fair Value*

Stephen Schwarzman was one of the critics who blamed the accounting rule for “accentuating and amplifying potential losses.”⁵⁶ Similarly, Steve Forbes claimed that the accounting rule was the primary cause of the financial “meltdown.”⁵⁷

An outspoken opponent of fair value accounting in its current form because of its procyclicality is Peter J. Wallison, a Fellow at the American Enterprises Institute.⁵⁸ Wallison makes a variety of additional arguments, noting that it is difficult to categorize financial assets under FAS 115, with the result that banks will tend to categorize assets in the mark-to-market categories of trading or available for sale rather than as held to maturity and suggesting that the “highly conceptual art” of financial accounting provides leeway to choose fair value when focusing on earnings but amortised cost when focusing on stability.⁵⁹ For banks, he argues, stability measures are more important than earnings measurements—banks’ financial statements should not be “distorted” by unanticipated market price moves and banks, which are backed by government directly and indirectly and must deal with the mismatch of short-term liabilities and long-term assets, should not have to compete with securities firms.⁶⁰ Wallison concludes that banks (and probably insurance companies) should be exempted from fair value accounting altogether.

While many critics of fair value accounting do not attribute to it such a central role in precipitating the crisis, they do often see implications for the crisis from fair value accounting that suggest the costs are greater than the benefit gained by investors from increased transparency. Haresh Sapra, for example, focuses on the costs of fair value accounting and its implications for the financial crisis.⁶¹ He suggests that other ways of increasing transparency might be preferable, because fair value accounting gives rise to measurement errors when illiquidity results in overstated losses. Even noted economist and former Federal Reserve Chair Paul Volcker is a critic of fair value accounting for banks in particular. He complains that the accounting standard does not mesh with banks’ business models, which perforce must deal with the long-term/short-term mismatch between deposit obligations and funding sources.⁶²

Accounting and the Subprime Mortgage Crisis (Aug. 2008) (a Covington & Burling presentation setting out arguments for and against fair value accounting’s role in the crisis), at <http://www.cov.com/files/Publication/16b76b09-bbe8-4abd-b925-94363006bf7e/Presentation/PublicationAttachment/79a98677-9f51-44fb-a90a-9acc49d5d147/Disclosure%20Implications%20of%20Fair%20Value%20Accounting%20and%20the%20Subprime%20Mortgage%20Cris.pdf>.

⁵⁶ *Mark to Market*, supra note 51, at 150.

⁵⁷ Steve Forbes, *Op-Ed, Obama Repeats Bush’s Worst Market Mistakes: Bad Accounting Rules Are the Cause of the Banking Crisis*, WALL ST. J., Mar. 6, 2009, at A13, at <http://online.wsj.com/article/SB12363030419804732.html>.

⁵⁸ Peter J. Wallison, *Fixing Fair Value Accounting*, 6 J.L. ECON. & POL’Y 137 (2010), at 142-43 (“We can see how the mark-to-market effect of fair value accounting has caused a downward slide in asset values, and how this decline has evolved into a dangerous downward spiral”).

⁵⁹ *Id.* at 138-39.

⁶⁰ *Id.* at 139-41.

⁶¹ Haresh Sapra, *The Economic Trade-Offs in the Fair Value Debate*, 6 J.L. ECON. & POL’Y 193 (2010).

⁶² See, e.g., *Volcker Heartened by Rulemakers’ Reaction to Crisis; Warns About Dangers of “Isolation”*, DAILY TAX REALTIME (BNA), Oct. 29, 2009 (reporting on Volcker’s comments at an international accounting standards conference).

Others simply have noted the procyclicality of fair value accounting and expressed the need to find some means to address it. For example, the Group of 20 in its review of the financial architecture after the crisis concluded that ways should be found to mitigate the procyclicality of accounting standards.⁶³ Similarly, other academics argue for adjusting accounting numbers for the sole purpose of determining capital requirements.⁶⁴

C. The reasons fair value accounting is not the culprit it is made out to be

In response to pressure from Congress, banks and various other critics to suspend fair value accounting at the height of the crisis in September 2008, the SEC and FASB offered “clarifications” rather than suspension of the rules. They countered (with the support of Federal Reserve Chair Ben Bernanke) that fair value accounting is merely a reporting mechanism *reflecting* market values and not the culprit *causing* low values.⁶⁵ In the economic stimulus act passed in early 2008, Congress nonetheless required the SEC to report before the end of 2008 on whether fair value accounting had caused the financial problems of banks and should be suspended. The SEC Study showed that fair value accounting—and inclusion of the valuation in income—was not a predominant feature of banks’ financial statements: less than 50% of banks’ assets and only about 15% of liabilities were subject to fair value accounting, with only about 25% marked to market in net income. The SEC concluded in its report that fair value accounting was *not* the culprit and rejected any full-scale revision of the accounting rules for banks.⁶⁶

Fair value accounting found friends within business as well. As JPMorgan Chase’s Dane Mott noted, “Blaming fair value accounting for the crisis is a lot like going to a doctor for a diagnosis and then blaming him for telling you that you are sick.”⁶⁷ Or as Nicole Gelinas commented, “fair value accounting did not cause the crisis. The crisis could have only been stopped by the banks themselves. They could have chosen ... to be in the long-term investment business rather than in the short-term exotic-security creation business.”⁶⁸ The problem was not that fair value was being reported, but that investors thought securities were not being written down far enough.⁶⁹

⁶³ Mario Giovanoli, *The Reform of the International Financial Architecture After the Global Crisis*, 42 N.Y.U.J. INT’L L. & POL’Y 81 (2009) (reporting on the April 2009 London G20 summit),

⁶⁴ Giovanni Stramelli, *The IAS/IFRS After the Crisis: Limiting the Impact of Fair Value Accounting on Companies’ Capital*, BOCCONI LEGAL STUDIES RESEARCH PAPER (May 20, 2010), at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1611537.

⁶⁵ See, e.g., Jesse Westbrook, *SEC, FASB Resist Calls to Suspend Fair Value Rules*, BLOOMBERG.COM (Sept. 30, 2008), at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=agj5r6nhOtpM>.

⁶⁶ SEC, REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 133 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: STUDY ON MARK-TO-MARKET ACCOUNTING (Dec. 2008) (hereinafter, SEC Study), at <http://www.sec.gov/news/studies/2008/marktomarket123008.pdf>.

⁶⁷ Quoted in Barry Ritholtz, *Fair Value Accounting & FAS 157*, THE BIG PICTURE (Sept. 30, 2008), at <http://www.ritholtz.com/blog/2008/09/fair-value-accounting-fasb-157/>.

⁶⁸ *Mark to Market*, *supra* note 51, at 150. Other defenders of fair value accounting looked to government subsidies for housing, noting that the housing bubble had begun to burst even before the new guidance on determining fair values using the three-level approach had come out. See Raymond C. Niles, *Eighty Years in the Making: How Housing Subsidies Caused the Financial Meltdown*, 6 J.L. ECON. & POL’Y 165 (2010) (noting that “banks did hold bad loans on their books. Mark-to-market accounting simply revealed

Nonetheless, FASB responded to the ongoing pressure from the American Bankers Association and particularly from Citigroup and Wells Fargo and their allies in Congress like Republican Spencer Bachus by quickly releasing amendments to the accounting rules.⁷⁰ The clarifications permitted more use of judgment (mark to model) even when there are actual reference market prices.⁷¹ FASB Chair Robert Herz made clear that FASB did not view this additional guidance about the application of the fair value standards as a change in the accounting standard, but rather an attempt to clarify when active markets exist.⁷² In his testimony before the House Financial Services Subcommittee on the response to the financial crisis, Herz made clear that the role of accounting is to provide information to investors and markets, while the role of bank regulators is to focus on safety and soundness of banks and the financial system.⁷³ There is no reason that the latter should not use financial statements with adjustments as needed to suit those purposes, but it would be foolish to suspend fair value accounting merely because, as messenger of unwanted tidings, it can have economic consequences.

Trust is critical to financial markets, and uncertainty about the credibility of balance sheets threatens that trust.⁷⁴ It is therefore questionable whether disregard of downward spirals in valuations would in fact more accurately reflect banks' stability rather than earnings potential, as Wallison suggests. Stability is threatened when banks have

it"). While Niles' analysis of the cause of the financial crisis is too narrow, it is certainly correct that fair value accounting is not the culprit.

⁶⁹ Id. at 151 (discussing investors' concern at Lehman's failure to mark losing securities below 70% of original value).

⁷⁰ Ian Katz, *FASB Eases Fair-Value Rules Amid Lawmaker Pressure*, BLOOMBERG.COM (Apr. 2, 2009); Wilhelm Butler, *How the FASB Aids and Abets Obfuscation by Wonky Banks*, FT.COM (Apr. 3, 2009), at <http://blogs.ft.com/maverecon/2009/04/how-the-fasb-aids-and-abets-obfuscation-by-wonky-zombie-banks/>. See also FASB, *IASB Look Back on Actions Taken During Crisis*, 10 Corp. Finance Weekly Update (WG&L) (Apr. 21, 2010) (noting that FASB was "subjected to extreme pressure from politicians").

⁷¹ FASB Issues Proposals to Improve Guidance on Fair Value Measurements and Impairments, <http://www.fasb.org/news/nr031709.shtml> (last visited July 15, 2010) (regarding issuance of Proposed FSP FAS 157-e, *Determining Whether a Market Is Not Active and a Transaction Is Not Distressed* and Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b, *Recognition, Measurement and Disclosure of Other-Than-Temporary Impairments*). The FAS 157 guidance permitted banks to shift assets from Level 2 valuation to Level 3 valuation, thus reducing the likelihood that losses would be reported. The FAS 115/FAS 124 guidance aligned the model for loans more with that for debt securities amid concern that the current model did not recognize that some of the securities' declines in value were temporary and thus did not adequately reflect expected cash flows. It included a much-sought provision to report impairments due to causes other than creditworthiness to be reflected in other comprehensive income rather than earnings. This guidance was fast-tracked and issued on April 2, 2009.

⁷² *FASB Chair Testifies on Global Accounting Standards Convergence Project*, 2010 TNT 99-67 (May 24, 2010) (testimony of FASB chair Robert Herz before the House Financial Services Subcommittee, in which he reviewed the FASB activities addressing the financial crisis).

⁷³ *FASB Chair Opposes Altering Financial Information Reporting*, 2009 TNT 47-43 (Mar. 12, 2009) (testimony of FASB chair Robert Herz before House Financial Services Subcommittee).

⁷⁴ See, e.g., *The Economy Will Not Recover Until Trust Is Restored*, WASHINGTON'S BLOG (Sept. 9, 2009) (quoting Anna Schwartz's views that a major factor in the financial crisis is the lack of credibility of bank balance sheets because of "toxic" assets with uncertain values), at <http://www.georgewashington2.blogspot.com/2009/09/economy-will-not-recover-until-trust-is.html>.

invested in risky assets whose valuations are questionable and likely to be considerably less than original values. To suspend fair value accounting in order to avoid calling attention to such questionable valuations might well *raise* the concern level rather than alleviate it, on the assumption that banks' statements simply are unrevealing about the true state of their finances. In fact, fair value accounting's exposure of banks' balance sheet weakness is ultimately a benefit to the financial system in a context where banks have actually suffered large losses on securities and loan portfolios, since it forces them to "acknowledge the scale of their problems."⁷⁵ It might be that more information—i.e., provision of both historical cost and actual market prices even during market disruptions—could be valuable to investors,⁷⁶ but it is farfetched to think that suppression of bad news about losses through use of artificially high historical cost valuations would be stabilizing for financial markets in the long run.

Policymakers should recognize that economic models generally failed to predict the crisis; on the other hand, analysts who used accounting flow of fund models were more likely to anticipate the problems.⁷⁷ If anything, instead of obscuring material risks, mark-to-market accounting needs to be strengthened to make it harder not to recognize losses, since it is possible that banks' balance sheets appeared too rosy rather than that they were artificially deflated by the procyclicality of mark-to-market accounting.⁷⁸ That suggests that fair value accounting is more useful in foreseeing crises than traditional rules that lock in original value.

The Treasury Department's own report on financial regulatory reform acknowledges the importance of fair value accounting by encouraging standard setters (e.g., FASB and the SEC) to consider how to make loan loss provisioning more forward looking by incorporated a broader range of available credit information. In looking at the criticisms of fair value accounting, Treasury concluded that it would be helpful if accounting rules found ways to provide fair value information to investors as well as more transparency about management's expected cash flows from holding investments.⁷⁹ And FASB has

⁷⁵ *Coup*, supra note 42 (suggesting that banks "don't want to recognize the full extent of their losses, because that would likely expose them as insolvent").

⁷⁶ See, e.g., *In Praise*, supra note 54 (suggesting that new interactive statements using eXtensible Business Reporting Language be utilized to provide historic cost, market value and model values).

⁷⁷ Dirk J. Bezemer, "No One Saw This Coming": *Understanding Financial Crisis Through Accounting Models*, MPRA PAPER NO. 15892 (June 16, 2009).

⁷⁸ See, e.g., Michael Rapoport, *A Comprehensive View on Bank Profits*, WALL ST. J., July 29, 2009, at C14 (reporting that the "relaxation" of fair value reporting standards for other than temporary impairments resulted in better earnings for Wells Fargo and State Street banks); Roderick Hills, Harvey Pit & David Ruder, *Don't Let Banks Hide Bad Assets*, WALL ST. J., Nov. 19, 2009 (responding to the American Bankers Association demand that a systemic risk regulator be able to prescribe accounting standards for banks that banking regulators can adjust capital requirements as desired but should not fiddle with accounting standards, which would be a "dangerous path" for both investors and markets). FASB chair Herz noted that some believed bank assets were overstated because of trades at well below book value. See supra note 73, at 4.

⁷⁹ DEPT. OF TREASURY, *FINANCIAL REGULATORY REFORM: A NEW FOUNDATION* (2009) (hereinafter "TREASURY REPORT"), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf, I.C.5. at 11.

now proposed a requirement that banks mark their loans to market, since original cost is quickly out of date and largely irrelevant information.⁸⁰

In this light, the changes pushed by Congress in permitting banks to use level 3 modeling rather than actual market data in illiquid markets are more than mere clarifications and potentially problematic.⁸¹ Economic substance is at the heart of the current fair value controversy—to the extent banks can disguise their true economic state, they may “last” longer and may cause investors to lose additional funding. Level 3 analysis has frequently been referred to as “mark to myth” accounting because of the concern that banks will manipulate the proprietary modeling to satisfy balance sheet targets.⁸² That is, of course, one reason that ongoing efforts to create greater transparency around Level 3 inputs are especially important.⁸³ Disclosure of inputs, information about the modeling assumptions, and explanation of the reasons for discounting actual market prices should be required, especially for any switching to level 3 inputs in times of market disruptions.⁸⁴

To the extent that fair value accounting’s pro-cyclicality may create higher demands for capital than might need to be required, banking regulators can make that determination

⁸⁰ Michael Rapoport, *Fair Value Plan Could Cost Banks*, WALL ST. J., May 27, 2010, at C1 (noting that most banks have substantial amounts of loans carried at original cost, so that a shift to fair value accounting could result in substantial loss recognition). See also FASB, Proposed Accounting Standards Update on Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815) (May 26, 2010) (providing for both amortized cost and fair value for most financial instruments held for collection but fair value for derivatives and traded securities, with all changes recognized in net income; FASB, Proposed Accounting Standard Update on Comprehensive Income (Topic 220) (May 26, 2010) (requiring that net income and other comprehensive income be presented in a single statement).

⁸¹ See supra note 65 and accompanying text regarding the rapid-fire FASB changes on application of fair value accounting.

⁸² Concerns about the continuing ability of banks to ignore risk and insolvency signals by “marking to myth” reverberate through the blogosphere. See, e.g., Dylan Ratigan, *Wall Street Reform: Politicians Lie, Media Applauds, America Suffers*, HUFFINGTONPOST (June 25, 2010) (complaining that banks are “allowed to ‘mark to myth’ and use off-balance sheet accounting to bonus themselves into the atmosphere, with the taxpayer taking the fall”), at http://www.huffingtonpost.com/dylan-ratigan/politicians-lie-media-app_b_625885.html; Jessica Pressler, *Now Banks Can Just Decide For Themselves What Their Assets Are Worth*, NEW YORK MAGAZINE (Apr. 2, 2009) (complaining that FASB changes to facilitate mark-to-model disguises value as revealed by distressed market prices), at http://nymag.com/daily/intel/2009/04/mark-to-market_accounting.html.

⁸³ See, e.g., Steve Burkholder, *International Accounting: FASB, IASB to Require Sensitivity Analysis Under Rules on Measurement of Fair Value*, 3/29/2010 BBD (BNA) d16; Steve Burkholder, *Accounting: FASB Instruments Proposal Seeks Disclosure on ‘Measurement Uncertainty’ of Fair Value*, 4/1/2010 BBD (BNA) d23 (discussing March FASB decisions on financial instruments).

⁸⁴ See, e.g., Stephen G. Ryan, *Accounting In and For the Subprime Crisis*, 83 THE ACCT REV. 1605 (June 2008) (noting that lack of observable inputs requires considerable qualitative and quantitative disclosure of inputs to the model and sensitivity of the model to inputs). I have argued against accepting fair value accounting as the measure of unrealized gain or loss for tax purposes because of this potential to manipulate in the “mark-to-myth” level 3 valuations. See Book-Tax, infra note 111. This is an area that continues to require increased disclosure, as well as restrictions on modeling parameters. FASB has responded with an exposure draft on disclosure that will require information on reasonably possible alternative Level 3 inputs.

separately from the balance sheet determinations. Accordingly, FASB Chair Robert Herz has urged that regulators should decouple accounting and capital requirements, so that fair value accounting remains as a more transparent window on the current state of a bank's balance sheet but regulatory capital can be increased or decreased countercyclically if required.⁸⁵

One aspect of accounting rules likely did contribute to the crisis—the ability of financial institutions to park liabilities in special purpose or structured investment vehicles, thus removing them from the balance sheet and giving the appearance of less leverage.⁸⁶ FASB moved to revamp these rules immediately after the crisis broke, followed by an extensive SEC release on rules for asset-backed securities.⁸⁷ These consolidation and de-recognition rules should result in more assets should remain on banks' books whenever they retain significant risk in connection with a securitization.

III. Financial System Reforms

The most noticeable attribute of the attempt to deal with this financial crisis is the view that the goal is to “restore” the financial system so that securitizations “work” again, financing “gets done” again, and the banks are seen as in good shape again. In all honesty, the goal should be to ensure that the system as we knew it never can exist again.

A. Working through a crisis

In the immediate aftermath of the 2008 Bear Stearns, Lehman, Washington Mutual and AIG collapses, the government moved to create a rescue program that would “save” the financial system. Specific rescue programs were proposed, modified, and varied as the crisis progressed, from facilitating takeovers (and, through administrative fiat in Notice 2008-83 in October 2008, providing unprecedented ability for acquiring banks to use the merged bank's tax losses in contravention of Internal Revenue Code Section 382's limitation on loss acquisitions) to providing loans, equity investments and purchase of so-called “toxic” assets.⁸⁸ The \$700 billion Troubled Asset Relief Program, signed into law by President Bush in October 2008, provided for government purchases of assets and equity interests in ailing financial institutions. But many other programs provided direct and indirect assistance, including allowing investment banks to become bank holding

⁸⁵ Floyd Norris, *Board to Propose More Flexible Accounting Rules for Banks*, N.Y. TIMES, Dec. 8, 2009, at B5 (reporting on Herz's speech).

⁸⁶ See Ryan, *supra* note 84 (discussing fair value accounting and the accounting rules for securitization vehicles).

⁸⁷ See FAS 166, *Accounting for Transfers of Financial Assets—An Amendment of FASB Statement No. 140* (June 2009); FAS 167, *Amendments to FASB Interpretation No. 46(R)* (June 2009); SEC, *Asset-Backed Securities*, Release No. 33-9117, 34-61858, File No. 57-08-10, RIN 3235-AK37, Notice of Proposed Rulemaking (Apr. 7, 2010) (requiring that the issuer retain a portion of each tranche, repealing the ratings requirement, and requiring information on each asset rather than only on pool data, among other changes).

⁸⁸ See, e.g., Albert Bozzo, *New Terms in Bailout Fund Talks Go Beyond 'Bad Bank'*, CNBC.COM (Feb. 1, 2009) (noting that “things are fluid” in terms of how bailout assistance will work), at http://www.cnbc.com/id/28965410/New_Terms_in_Bailout_Funding_Talks_Go_Beyond_Bad_Bank.

companies with access to the Federal Reserve window, maintaining very low interest rates, and providing implicit and explicit loan guarantees, resulting in federal subsidies to the biggest banks in the form of advantageous cost of funds.⁸⁹ For example, the Public-Private Investment Program announced in March 2009 by Treasury Secretary Tim Geithner permitted private companies to purchase assets with federal funding, where the major rewards from the purchases would be accrued by the private companies, and any losses beyond a minimal amount would be borne by taxpayers.⁹⁰

B. Moving forward to redress system flaws

After the initial shock of the financial crisis and the collapse of Bear Stearns, Lehman Brothers, and Merrill Lynch, the government developed a proposal for financial regulatory reform, issued in 2009.⁹¹ The proposal addressed “five key objectives”:

- i. Promote robust supervision and regulation of financial firms;
- ii. Establish comprehensive supervision of financial markets;
- iii. Protect consumers and investors from financial abuse;
- iv. Provide the government with the tools it needs to manage financial crises; and
- v. Raise international regulatory standards and improve international cooperation.⁹²

Central to the report was the recognition that the various policies in effect at the time of the crisis “did not take into account the harm that large, interconnected, and highly leveraged institutions could inflict on the financial system and on the economy if they failed.” Yet the proposed reforms failed to include two of the most important ideas—bankruptcy modification of residential mortgage loans, to assist ordinary Americans in retaining their homes and neighborhoods, cities and regions from the continuing blight of foreclosed properties sold by banks at fire sales; and fundamental actions to separate risky activities such as proprietary trading and derivatives desks from core, federally protected banking. Paul Volcker, experienced former Federal Reserve Chair, provided blunt advice that the big banks need to be broken up to separate risky activities from what should be staid banking.⁹³

⁸⁹ Dean Baker & Travis McArthur, *The Value of the “Too Big To Fail” Big Bank Subsidy*, CENTER FOR ECONOMIC POLICY RESEARCH ISSUE BRIEF (Sept. 2009) (showing that government support providing lower cost of funds amounted to a subsidy of up to \$34.1 billion to 18 bank holding companies with assets above \$100 billion in the first quarter of 2009), at <http://www.cepr.net/documents/publications/too-big-to-fail-2009-09.pdf>.

⁹⁰ Jessica Pressler, *TARP-Supported Banks Plan to Game the System by Buying Each Other’s Trash*, NEW YORK MAGAZINE (Apr. 3, 2009) (discussing the Public-Private Investment Plan which allows banks to sell toxic assets to taxpayers at a premium price and buy them back at a low price, with taxpayers absorbing the loss spread), at http://nymag.com/daily/intel/2009/04/tarp-taking_banks_plan_to_game.html. For a good overview of the chronology and various embodiments of the TARP program, see *Troubled Asset Relief Program*, WIKIPEDIA, at http://en.wikipedia.org/wiki/Troubled_Asset_Relief_Program (last visited July 15, 2010).

⁹¹ TREASURY REPORT, *supra* note 79.

⁹² *Id.* at 2-4.

⁹³ See Damian Paletta & Jonathan Weisman, *Proposal Set to Curb Bank Giants*, WALL ST. J. Jan. 21, 2010, at <http://online.wsj.com/article/SB10001424052748704320104575015910344117800.html>.

The Treasury proposal provided the basic shape of the financial reform legislation, but its importance and political visibility guaranteed a number of amendments as it wended its way through Congress. After the House and Senate approved differing versions of reform legislation, the conference committee negotiated further changes to accommodate senators needed to reach a filibuster-proof vote.⁹⁴ That inevitably meant a weakening of the most controversial (and arguably most important) parts of the package fought most strenuously by the banks—proprietary trading (the conference report allows ownership of up to 3 percent of a hedge or equity fund) and derivatives desks (the conference report does not require spin off of banks’ derivatives businesses as proposed by Blance Lincoln but merely requires some swaps business to be dropped into a separately capitalized subsidiary).

The Conference Report retained some skepticism about the role of accounting in the crisis, but appropriately refrained from eviscerating fair value accounting. The systemic risk council cannot overturn accounting standards. It is nonetheless charged with tracking accounting developments that may impinge on the financial system and, not unreasonably, it is permitted to “submit comments” to standard-setting bodies “with respect to an existing or proposed accounting principle, standard, or procedure.”⁹⁵ Perhaps of somewhat more concern is the requirement that the council make an annual report to Congress that assesses “significant” regulatory developments, including accounting regulations and standards, for their ability to impact the stability of the financial system.⁹⁶ Latent there is a threat for Congress to renew its browbeating of FASB to ease fair value standards to make losses less conspicuous.

The wide-ranging reform legislation addresses many of the weaknesses in the financial system revealed by the crisis, as outlined in Part I of this paper. Creation of a systemic risk council will hopefully force regulators to pay attention to the system-wide elements of risk, rather than merely considering individual institutions. There are limits, as noted, on the proprietary trading that fueled some of the casino banking mentality. Derivatives transactions will be more transparent, through clearing and reporting requirements, and less risky, through the imposition of margin requirements, even though banks with access to the Federal Reserve window are not required to spin off their swaps desks. This will make it possible for banking regulators to track trades and see systemically risky exposure. The shadow banking system will come out into the open, with SEC registration of hedge funds and private equity funds and the potential for Federal Reserve supervision. Capital and leverage limits may be enhanced by regulators, though much will depend on the outcome of the Basel III discussions among the Group of 20 big economies that were ongoing at the time the Senate took its vote, and transition rules may provide years before full implementation is required. Banks will not be allowed to be less well capitalized than their subsidiaries, and trust preferred securities must be replace

⁹⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong., available at <http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.4173> (House, Senate and Conference Report versions all available).

⁹⁵ H.R. 7213, §112(a)(2)(L).

⁹⁶ H.R. 7213, §112(a)(2)(N) (covering “significant financial market and regulatory developments, including insurance and accounting regulations and standards”).

over time with real capital. Customers can get relief from rating agencies only if they can show reckless failure to investigate, but the bill generally punts on further restrictions by requiring a study of the agencies. Resolution authority resolves some of the concerns about the power and authority of the Federal Reserve that surfaced during the crisis. The consumer bureau, though not perfect because of the auto dealer exemption and the power of the Federal Reserve to undercut its protections, adds much needed protection for consumers who have had little recourse against the powerful financial industry.

Reforms not specifically required, however, weaken the potential impact of the bill. Rather than continue to encourage consolidation of financial institutions, we likely need to revamp our antitrust policies to recognize that concentrated power in an industry that arises from sheer size, leverage, and interconnectedness may merit the trust-busting power of the anti-trust rules. Regulators must take into account that financial innovations are not inherently good: products such as naked credit default swaps (essentially an insurance contract where the buyer of the insurance has no insurable interest in the insured) are too dangerous to permit simply because they facilitate the free flow of credit and the ready profits of venturesome traders. Further, it is likely that it will ultimately be necessary to use a combination of restrictions and taxation to blunt banks' appetites for risk—a tax on big banks based on their leverage ratios would be a disincentive to overleveraging. Contingent convertibles may be a necessary means of forcing executives who enjoy outsize pay to share the losses that their appetite for risk creates. These and other additional measures will undoubtedly be necessary, but it will be some time before the final form of the reshaping of the financial system is known, as required studies and regulatory rulemaking are finalized.

IV. Towards the development of a broader understanding of the relationship of democratic institutions to economic policies

The key regulatory solutions included in the Dodd-Frank bill and likely to be implemented over time in coordination with international developments—prudential banking guidelines on capital and leverage; more transparent trading of derivatives and some limitations on bank holding companies' ability to profit in the speculative derivatives markets and by “casino” gambling through proprietary trading; enhanced transparency and governance provisions; the balance of a consumer protection bureau; augmented regulatory authority to intervene to limit systemic risk—are not meaningless. They all move the financial markets towards a system that may be able to limit the ability of financial players to instigate imbalances that provide short term gains for themselves while socializing larger losses.

These regulatory solutions are not enough in and of themselves, however; and they do not clearly resolve the issues of “too big to fail” institutions. Part of re-regulation is a necessary recalibration of the attitudes towards regulation amongst the regulated entities and regulators. The current approach of regulated entities is one that sees “gaming” the system and “tricking” consumers as part and parcel of the business model.⁹⁷ In the days

⁹⁷ Gaming the system to their advantage is a pervasive problem for powerful financial institutions. See, e.g., Pressler, *supra* note 90 (on the banks' plans to use the Public-Private Investment Fund to buy low-sell

leading up to the final passage of the 2010 Dodd-Frank bill, the biggest banks were already calculating how they could overcome the Volcker Rule (proprietary trading restrictions), and at least one bank was reported to have already transferred its proprietary traders to its client trading desk.⁹⁸ Did that end proprietary trading? Not likely, since there was a view that the rule could be gamed by having traders trade in contemplation of potential trades a client may want to do in order to have an inventory of financial assets readily available. One would expect that the bank's aim would be for the firm to benefit by making the trade ahead of its customer. That approach clearly is contraindicated by the purpose of the proprietary trading restriction and should not be allowed. But just as the Citi-Travelers deal took place in spite of an apparent clear rule preventing such consolidations of banking and insurance businesses, with the result that the transaction led to the demise of the rule preventing such consolidations, so banks will push against the restrictions in the Dodd-Frank reforms that truly limit their speculative endeavors unless and until the regulators reinforce the anti-speculative perspective.

This recalibration is especially needed for industries such as banking where concentrated market power means that the political process is constantly held hostage to the demands of powerful competitors for their favored policies to be enacted.⁹⁹ As more mergers and cross-border acquisitions among big banks take place, the power of the few remaining

high in interbank transactions, essentially improving their balance sheets at taxpayer cost). Noted consumer advocate Elizabeth Warren, head of the Congressional Oversight Panel on TARP, has consistently advocated strong and coherent regulations to help prevent banks' success in gaming the system against consumers by burying "tricks and traps" in the fine print. Ben Frumin, *Fearing Powerful Lobbying from Industry, Financial Reform Proponents Target Key Lawmakers*, TPMLIVEWIRE (Oct. 13, 2009), at <http://tpmlivewire.talkingpointsmemo.com/2009/10/fearing-powerful-lobbying-from-industry-financial-reform-proponents-target-key-lawmakers-before-this.php>; Elizabeth Warren, *Wall Street's Race to the Bottom*, WALL ST. J., Feb. 9, 2010, at http://online.wsj.com/article/SB10001424052748703630404575053514188773400.html?mod=WSJ_Opinion_LEFTTopOpinion. Past experience shows that banks will fight for and use exceptions within an anti-abuse bill to continue "bad" practices that were the basis for the new legislation to the fullest extent possible. See, e.g., Candice Choi, *Credit Card Issuers Still Gaming the System*, SALON.COM (May 18, 2010) (given a loophole that applies new rules only to payments "above the minimum," "standard industry practice" is still to apply minimum payments to the lowest rather than highest interest rate balance), at http://www.salon.com/news/feature/2010/05/18/us_credit_cards_minimum_payments. During the hearings on the financial reform bill, Senators were amazed at Goldman Sachs' position that it was appropriate to sell securities to customers and then take short positions betting against those same portfolios. Market making is one thing; betting against something you just sold your customer is quite another. See Louise Guenin, *Regulating Collateralized Debt Obligations, the Elephant in the Room Untouched by Financial Reform Bills*, HUFFINGTONPOST.COM (June 15, 2010), at http://www.huffingtonpost.com/louis-m-guenin/regulating-collateralized_b_605895.html.

⁹⁸ Aaron Lucchetti & Jenny Strasburg, *Banks Redefine Jobs of "Prop" Traders*, WALL ST. J., July 6, 2010, at <http://online.wsj.com/article/SB10001424052748703620604575349161970563670.html> (noting that the most aggressive banks will likely try to game the system by essentially continuing proprietary trades under the guise of client service, while some clients may be suspicious that traders will push prices against clients by buying or selling ahead of client orders).

⁹⁹ See, e.g., Robert B. Reich, *Everyday Corruption: The Policy-Making Process Has Become An Extension of the Market Battlefield*, 21 THE AMERICAN PROSPECT 25 (July/Aug. 2010) (noting that globalization and deregulation led to more intense competition for consumers, resulting in the corporate competition spilling over into political bodies, where it hinders decisionmaking in the public interest).

players is enhanced. These cross-border mergers are likely to result in even greater risk-taking and access to safety nets from multiple jurisdictions, undermining capital requirements and other controls.¹⁰⁰

Moreover, even if there is an attitudinal shift that avoids regulatory capture, re-regulation can be expected to wane in importance over time, as economic conditions improve and memories of the Great Recession recede. As early an economist as John Stuart Mills recognized that financial systems will tend to have booms and busts. Part of Mills' explanation for this volatility was a psychological framing of events leading to periods of panic when structural flaws predominate and the good times cease; post-panic when all the players are vividly aware of the dangers of unforeseen risk and exercise prudence in their endeavors; revival when the economy seems to have recovered and be operating with a reasonable balance between risky and risk-free endeavors; and then speculation, when caution is thrown to the wind amid perceptions that the good times are here to stay.¹⁰¹ The most recent experience colors expectations for the future and affects the appetite for risk. Although this insight got little coverage for some time, Hyman Minsky in the 1960s revived interest in John Maynard Keynes' "animal spirits" notion of the way attitudes towards risk affect market cycles.¹⁰² Similarly, Nassim Taleb's warnings about the dangers of quantitative assessment of risk focus on a shortcoming to which technologically savvy financial systems are especially prone—the mistake of assuming that quantitative analysis based on some period of historical trends can provide a map for the future, leading analysts to disregard the very severe dangers of "long tail" possibilities.¹⁰³

All of this suggests that we need to rescue the strong precautionary principle from its neoclassical critics.¹⁰⁴ Lasting reform, that is, likely will require a more radical restructuring that takes into account these attitudinal issues by setting in place stronger barriers against the speculative risktaking that fed the crisis—complete separation of risky activities such as derivatives desks and proprietary trading from "regular" banking that benefits from federal guarantees through a modern equivalent of Glass-Steagall and explicit legislative bans on complex and risky financial derivatives that primarily serve the financial casino function (such as banning naked credit default swaps and otherwise imposing regulations on credit default swaps to restrict moral hazards).

More recently, Amartya Sen has set out a theory of justice that argues for a practical approach to eliminating injustices in society.¹⁰⁵ This practical approach demands that we

¹⁰⁰ "Santiago Carbo-Valverde et al, *Evidence of Regulatory Arbitrage in Cross-Border Mergers in the EU*, NBER (Oct. 2009).

¹⁰¹ See, e.g., JUSTIN FOX, *THE MYTH OF THE RATIONAL MARKET: A HISTORY OF RISK, REWARD, AND DELUSION ON WALL STREET* (2009), at 310-11 (discussing Mills' *On Credit Cycles and the Origin of Commercial Panics*, *TRANSACTIONS OF THE MANCHESTER STATISTICAL SOCIETY* (1867)).

¹⁰² *Id.* at 311-12 (discussing Minsky's *The Financial Instability Hypothesis: A restatement*, *THAMES PAPERS IN POLITICAL ECONOMY* (Autumn 1978)).

¹⁰³ TALEB, *THE BLACK SWAN*, *supra* note 27.

¹⁰⁴ See Noah Sachs, *Rescuing the Strong Precautionary Principle from its Critics: The Case of Chemical Regulation* (May 28, 2010), available at <http://ssrn.com/abstract-1617432>.

¹⁰⁵ AMARTYA SEN, *THE IDEA OF JUSTICE* (2009).

identify redressable injustices that actually exist in societies and then take action to remedy them.¹⁰⁶ The aim, according to Sen, is to *accomplish* justice—that is, to enhance the freedom of people to choose the kinds of lives they will live and to develop their capabilities to live those lives.¹⁰⁷ Sen asserts that this can be achieved by looking not to resources but to capabilities—i.e., a person’s “*actual* ability to do the different things that she values doing.”¹⁰⁸ The lesson for financial reforms from Sen’s understanding of justice is that the crisis will not be cured until we redress the injustices at the heart of the crisis—the ability of companies to capture all of the productivity gains while workers languished and the resulting flush of capital in the economy flowing to casino gambling that led to a mushrooming of consumer debt to finance a standard of living no longer attainable on typical wages.

As Robert Dahl notes, how market-capitalism works is fundamentally a question of how democracy can work to protect its citizens from harm that can be produced by unregulated markets.

Competitive markets, ownership of economic entities, enforcing contracts, preventing monopolies, protecting property rights—these and many other aspects of market capitalism depend wholly on laws, policies orders, and other actions carried out by governments. ... [W]ithout government intervention and regulation a market economy inevitably inflicts serious harm on some persons; and those who are harmed or expect to be harmed will demand government intervention. Economic actors motivated by self-interest have little incentive for taking the good of others into account; on the contrary, they have powerful incentives for ignoring the good of others if by doing so they themselves stand to gain. ... When harm results from decisions determined by unregulated competition and markets, questions are bound to arise. ... It is obvious that these are not just economic questions. They are also moral and political questions.¹⁰⁹

To serve the people as a whole rather than merely the elite who hold the keys to primary resources, capitalism “must be supervised within a democratic society and responsive to criticism by outside voices.”¹¹⁰

In this vein, I have argued that economic and political institutions must work together to create a sustainable democracy with a sustainable economy.¹¹¹ Resource allocation

¹⁰⁶ Id. at vii (stating that the “identification of redressable injustice” is “central”).

¹⁰⁷ See, e.g., id. at 18-19, 253-317. See also AMARTYA SEN, DEVELOPMENT AS FREEDOM (1999), preface (suggesting that the “pre-eminent objective” of economic development is the expansion of human freedom, as “social opportunities of education and health care, which may require public action, complement individual opportunities for economic and political participation and also help to foster our own initiatives in overcoming our respective deprivations”).

¹⁰⁸ AMARTYA SEN, THE IDEA OF JUSTICE, supra note 105, at 253 (emphasis in original).

¹⁰⁹ ROBERT DAHL, ON DEMOCRACY (1998), at 174-75. Dahl adds that “in all democratic countries, the harm produced by, or expected from, unregulated markets has induced governments to intervene in order to alter an outcome that would otherwise cause damage to some citizens.” Id. at 175.

¹¹⁰ ECONNED, supra note 32, at 5.

cannot become so distorted that oligarchies are able to demand laws and regulations that shift the lion's share of the benefits to them while leaving others to bear more of the burdens of society. This means that we must recognize the limitations inherent in the financialization of the economy, and the need for restructuring so that the financial system serves the people and the broader economy. The cycle of increasing debt to fund regular consumption is inherently unstable. In addition to the enhanced regulatory regime initiated by the 2010 financial reform act, Congress must also act to ensure that workers acquire an adequate share of productivity gains. That means facilitating unionization as a counterweight to multinational corporate power and corporate officers and boards, maintaining updated minimum wage laws that discourage a "manager takes all" attitude, and providing legal redress that restores a balance between credit consumers and credit providers, such as the ability to modify mortgage loan balances in bankruptcy and the facilitation of consumer-friendly suits against credit card banks for abusive practices in place of arbitration.

In short, a new commitment to fundamental American principles of democratic egalitarianism as a tempering restraint is necessary to achieve any lasting solution to the structural flaws of the deregulated, financialized economy handed down by four decades of laissez faire market capitalism.

¹¹¹ This is an everpresent theme of my weblog, ataxingmatter, which is dedicated to furthering understanding of the concept of democratic egalitarianism, and it is a recurring idea in my scholarly writings. See, e.g., Linda M. Beale, *Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed section 475 Mark-to-Market Safe Harbor*, 24 VA. TAX REV. 301 (2004) (hereinafter *Book-Tax*) (arguing that accepting mark-to-model evaluations for tax purposes was problematic in that it permitted financial institutions to manipulate their valuations to fine-tune their tax liabilities, in contravention of fairness and coherence requirements for a democratically sustainable tax system).