Introduction

Make Markets Be Markets

Robert Johnson

Eighteen months after the most devastating financial crisis since the Great Depression, our financial system remains critically flawed. The United States has not yet enacted the financial reforms necessary to repair the broken financial system.[1]

We have a financial system that continues to be sustained by taxpayers through the fiscal side door of the Federal Reserve's balance sheet. All legislative proposals offered by the Administration, House and Senate fall far short of what is needed for proper reform. Independent experts across the political spectrum have clearly identified the dangers of large complex financial institutions that are intertwined through the proliferation of derivative instruments. Those experts have also prescribed remedies that are concise, clear and well developed. Many of the fault lines in the current system and their remedies were well known long before this latest crisis unfolded.

The crisis of 2008 was predictable. Unless we go far beyond current legislative proposals the next crisis is inevitable.

The structure of our current financial markets does not reflect the critical market principles that once allowed our economy to flourish– principles like transparency, competition, and free flow of information. And it has not been subject to the most important principle of all — the opportunity for market participants to fail. We all know the result. Financial sector CEOs have relied on taxpayer support. They have benefitted from express taxpayer bailouts as well as secret "back door" deals. They continue to lead companies that seem to make profit but actually only thrive because of government subsidies and taxpayer support.

Make Markets Be Markets: Restoring the Integrity of the U.S. Financial System is the result of months of discussions among the country's leading financiers, market experts, academics and former regulators. These discussions, on issues ranging from 'theory failures' to 'regulatory incentives,' have culminated in the development of a concrete plan for a financial system that can manage the flow of capital, price risk appropriately, reduce fraud and collusion, protect taxpayers, and provide liquidity – all without compromising innovation or stability.

The purpose of this report is to present a comprehensive plan for what must be done to fix our broken financial system. It provides a set of recommendations that together serve to prevent, detect, and credibly resolve financial crises. Making markets work as a system is the focus — emphasizing transparency, competition, and the important discipline of failure. The goal is to restore the integrity of the market system with a realistic, rather than romantic, perspective on the role that government must play in the making and enforcing of the laws and regulations that are essential support for the market system.

Without the reforms outlined in this report, we cannot restore confidence in the U.S. financial markets, in the role of New York as an international financial center, and in the continuing use of the dollar as the primary reserve currency of the world economy. Ultimately we cannot ensure our national budgetary soundness, because we cannot rule out the wasteful and unnecessary budget burden of another crisis and bailout. If unaddressed, we will likely spiral into the amplifying "doom cycle" described by Simon Johnson in the first chapter.

Topics are addressed in the spirit of putting the markets back on sound footing. They include: the reform of GSEs dependent on an unhealthy open spigot of government capital and guarantees; the reform of ratings agencies; the importance of regulatory incentives in determining rules versus discretion in the design of the government's oversight role; the establishment of a strong consumer protection system that will stop toxic instruments and incomprehensible documents from fouling our economic bloodstream; the reform of the shadow banking system that exposed our financial system to runs; reform of the securitization process through which over 50 percent of capital flows were intermediated in the years prior to the crisis but which now lies largely dormant; the ending of deceptive and damaging off balance sheet practices that were revealed and not reformed by the Enron scandal; the move away from the dark mark to model world of OTC markets to a world in which well-designed derivatives function in transparent, properly-cleared and settled markets where information flows freely; and finally, perhaps most importantly, the ability to credibly resolve Large Complex Financial Institutions whose current government guarantee serves as a illegitimate burden on the American people and a moral stain on the legitimacy of the market system.

This set of topics by no means exhausts the terrain of important reforms. Other critical themes will be developed as part of this project in subsequent reports, including the definition of the appropriate scope and scale of guarantees of financial institution liabilities; mortgage foreclosure modification; the governance of the central bank and its role in financial resolution; the registration and systemic monitoring of the aggregated positions of hedge funds and private equity funds; the role of executive incentives and corporate governance; and the important role of venture capital and small capitalization equity markets in transforming the structure of the economy and providing new paths to employment.

The purpose of setting out the recommendations put forth in the present report is twofold. First, they provide a roadmap for financial reform and as such can help advise efforts already underway. Second, they provide a critical litmus test for citizens and the media can use to measure the progress of our political system. This report defines the minimum we must do before we can restore the integrity of the U.S. financial markets. By defining that threshold of reform, we also illuminate the vast gap between what is happening in Washington D.C. and what reasonable, un-encumbered experts believe is necessary.

Our government leaders have shown little capacity to fix the flaws in our market system. Admittedly the issues involved are complex, even for finance professionals. Yet the complexity of the subject is no reason to defer to those who cloak themselves in a mantle of expertise in order to clandestinely advance their gross self-interest.

The pressure from industry groups is enormous – and the money at stake for the Large Complex Financial Institutions is measured in billions of dollars of earnings each year. They have powerful incentives to impede reform at every turn – and are willing to invest enormous sums to block reform and keep their dangerous money making structures alive. Forces that protect dysfunctional businesses, rather than ensuring competitive markets, are rampant. As University of Chicago Professor Luigi Zingales put it, "most lobbying is pro-business, in the sense that it promotes interests of existing business, not pro-market, in the sense of fostering truly free and open competition".[2,3] The $400 million dollars financial institutions spent on lobbying last year, and their successful effort to stymie reform is convincing evidence of this.

When businesses rely on government bailouts instead of on innovation and investment, they are weakened. Once upon a time, the American auto industry was the best in the world. But years of using political muscle instead of intellectual or creative muscle - relying on lobbying rather than R&D and productivity improvements – took its toll. Wall Street despised manufacturing protectionism. Yet now Wall Street is seeking protectionism of its own. It is trying desperately to maintain an opaque and unsustainable system that imposes heavy costs on the rest of society. The leaders of these institutions are hiding behind the skirts of the American taxpayer.

The toxic side effects for society of Wall Street protectionism are substantial. Detroit's automakers embraced government for protection, and they ended up bankrupt. Ironically, it will require the tough love of proper reform from Washington and the American people to save Wall Street from going bankrupt a second time.

With the reforms suggested in this volume, another crisis is preventable. Without them, another crisis – a bigger crisis that weakens both our financial sector and our larger economy – is more than predictable, it is inevitable.

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Endnotes

1. It may well be that the improvisation by the Federal Reserve was necessary given the ill-formed regulatory system and resolution structures that existed at the onset of the financial crisis. At the same time the massive fiscal role that the Federal Reserve has played, the extensive and inconsistent use of their Section 13(3) powers to bail out institutions that were not banks at the end of 2007, and the unacceptable structure of Federal Reserve governance, particularly the governance of the New York Federal Reserve Bank which is thrust into the primary fiscal/bailout role, combine to reveal a resolution process that is badly designed and crying out for reform. Public confidence in the Federal Reserve has plummeted since the onset of the crisis. For more on this theme and

Gallup poll data see, "Unmet Duties in Managing Financial Safety Nets" by Dr. Edward J. Kane, February 10, 2010. Available at http://www2.bc.edu/~kaneeb/

2. Capitalism After the Crisis, *National Affairs*, Issue 1 Fall 2009. http://www.nationalaffairs.com/publications/detail/capitalism-after-the-crisis
3. See the illuminating collection of writings on the history of struggles between business interests and the politics of American society contained in Thomas Ferguson's extraordinary book entitled *Golden Rule*, University of Chicago Press, 1995.

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