Protecting The Public From Another Financial Crisis

The 2008 financial crisis led to the loss of almost nine million jobs in the worst economic collapse since the Great Depression. Close to ten million people lost their homes through foreclosure, and retirement savings were devastated.

The financial collapse was driven by the irresponsible and greedy practices of Wall Street insiders who turned away from serving the real economy to pursue risky short-term profits. When the bill came due for the irresponsible risks they took, the big banks were bailed out by taxpayers, and top executives kept almost all of the bonuses they had received.

Bank actions before the crisis were enabled by a regulatory system that let Wall Street insiders write the rules that governed their actions. In response to the catastrophic effects of big bank self-regulation, after the crisis Congress and regulators took steps to address some of the worst kinds of bank actions that led to the crisis. These changes are designed to reduce risks to the economy, refocus financial practices on supporting the real economy, and ensure that in the future financial institutions and top executives bear the consequences of their own actions.

Below are some of the most significant new guard rails put in place after the crisis. Many of them have been under attack by Wall Street since they were passed, and now the new Administration has explicitly called on regulatory agencies to eliminate them. This will put all of us in danger of suffering the consequences of another financial crisis.

Taking on "too big to fail": During the financial crisis we saw that the U.S. government was afraid to let the giant Wall Street firms fail, even when these firms were effectively bankrupt. That fear allowed Wall Street to hold up the public for hundreds of billions of dollars in bailout money and trillions in loans. In response, Congress required big banks to prepare themselves for a safe bankruptcy and established a new government resolution process that empowers regulators to shut down a failing firm, fire management responsible for the failure, and protect the economy from the resulting fallout. While the "too big to fail" problem will not be fully solved until the largest banks are restructured more aggressively, these measures make real progress in making it harder for the biggest banks to hold us all hostage.

Limiting dangerous and excessive levels of bank borrowing: Before the financial crisis, big banks were borrowing as much as $40 for every dollar of their own investors' money. That level of borrowing multiplied their profits in normal times. But when banks were called on to quickly pay back their borrowed money, they couldn't, which led to the spread of financial panic, with disastrous consequences for all of us. After the crisis, regulators stepped in, limited the amount banks could borrow, and forced them to raise additional investor capital. More capital and less borrowing lets financial institutions to withstand reasonable market losses using their own money, without defaulting on loans, triggering wider market panic, or reducing real economy lending. Big bank borrowing is still too high, but some of the worst excesses we saw before the crisis are being addressed.

Requiring big Wall Street banks to focus on customer service and stop acting like hedge funds: Banks should serve their customers, rather than acting like hedge funds and making their own trading bets on the market. Some of the failing investment banks in the financial crisis, such as Bear Stearns, were brought down by their hedge fund investments. All of the big Wall Street banks bailed out by the public held enormous internal trading inventories stuffed with subprime mortgage securities, which amounted to a hedge-fund like market bet that eventually created enormous bank losses. Big banks used their privileged position at the center of the financial system not to serve customers but to exploit them, for example by designing and selling their own toxic securities which banks themselves knew would fail and harm investors. After the crisis, Congress passed the Volcker Rule and other measures which require banks to focus on customer service rather than gambling on the markets.

Controlling risks in markets for complex financial derivatives: Derivatives are complex financial instruments that were crucial parts of the "toxic assets" that helped to crash Wall Street in 2008. Big banks are central players in the multi-hundred trillion dollar global derivatives market, which was effectively unregulated prior to the 2008 financial crisis. Because derivatives commit financial institutions to hard-to-predict and potentially enormous risks, they have been called "financial weapons of mass destruction". After the crisis, Congress empowered regulators to establish rules of the road for these previously unregulated markets, requiring banks to hold more money against potential derivatives losses and to significantly improve risk management and trading practices for derivatives. Without strong regulation, these "weapons of mass destruction" could again bring down our financial system.

Stopping giant non-bank financial institutions from avoiding the rules: Before the crisis, financial regulation focused most on commercial banks with large amounts of government-insured deposits. Regulators effectively ignored major risks emerging in non-banks like AIG, an insurance company that insured hundreds of billions of dollars in subprime toxic assets, and in big Wall Street investment banks. When the financial system started to crash these hidden risks surfaced and the government gave AIG the biggest taxpayer bailout in American history. After the crisis, regulators acted to establish a council that could designate giant non-banks for enhanced supervision and make sure that these kinds of risks were never ignored again.

End "take the money and run" Wall Street pay practices: Pay rules at major financial institutions allowed key executives and traders to keep the multi-million dollar bonuses they had received, even when it was revealed that their decisions had brought the world financial system to the brink of collapse. Top executives at Bear Stearns and Lehman Brothers took home over $2 billion in bonus payments over the years prior to the collapse of those two giant banks, and never had to pay back a dime. After the crisis, Congress required regulators to ban these destructive bonus pay practices, a crucial task they have not yet completed.

Reversing or significantly weakening these measures will harm the economy and open the doors to another Wall Street meltdown. The failures created by such deregulation may not come immediately, and not all problems will be on the scale of the 2008 crisis. But giving in to the demands of giant banks and allowing "too big to fail" Wall Street firms to once again take irresponsible and dangerous risks will have severe economic costs.