

Issue: Ethics and Financial Services

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Has the industry learned from the global crisis?

Executive Summary

Seven years after subprime mortgage lending and Wall Street investment maneuvering precipitated a global financial crisis, managers, lawmakers, regulators and law enforcement officials continue to debate the reasons for the 2008 debacle and the lessons still to be learned. Observers disagree about who was to blame, with bankers, regulators and homeowners all attracting censure. It is widely agreed, however, that ethical lapses in the financial services industry were an important cause. "Greed," as one expert noted, "overran peoples' ethical foundations." In response, a Democratic Congress passed the Dodd-Frank Act to protect consumers and to more closely regulate Wall Street. Republicans, however, now control Congress, and anti-regulatory champions are attacking the constraints put in place since 2008. A host of questions remain about ethics and the financial services industry. Is the industry behaving more ethically since the crisis? Can regulation compel ethical behavior? Should top executives be held personally responsible for their companies' mistakes? One skeptic put it succinctly: "Ethics and financial services— isn't that an oxymoron?"

Overview



A Citibank branch near Citigroup's headquarters in New York City. The bank, one of the world's biggest financial firms, touts its commitment to ethics, but it also has faced problems stemming from missteps related to the 2008 global financial crisis. (Scott Eells/Bloomberg via Getty Images)

The notice of Citigroup's annual stockholders' meeting last year featured an unequivocal commitment to improved training, stronger controls, zero tolerance for malfeasance and a renewed focus throughout the company on responsible finance and adherence to a code of conduct.

"The board and management are conscious of the pervasive public perception that many members of this industry do not behave ethically," Citi declared in that March 2014 notice. "This perception undermines trust across the financial services sector and in our institution. The board and management are committed to addressing this industry issue head on. ... We have no higher priority than ensuring that we hold everyone at Citi to the highest ethical standard."¹

Evidently, not everyone was paying attention. In December 2014, Citi announced that it was setting aside \$2.7 billion to cover costs stemming from multiple investigations into alleged foreign exchange violations, Libor-related violations and anti-money-laundering and related compliance investigations.² This followed a whopping fine earlier in the year, when Citi agreed to pay \$7 billion to settle long-standing mortgage-related violations dating back to before the 2008 global financial crisis.³

Seven years after Wall Street firm Bear Stearns collapsed in March 2008, one of the early failures of what would become a full-blown crisis, managers, lawmakers, regulators and law enforcement officials continue to debate the reasons for the debacle and the lessons still to be learned. Observers on the left,

middle and right of the political spectrum apportion blame differently among bankers, regulators and homeowners. It is widely agreed, however, that ethical lapses in the financial services industry were a root cause.

"There was mortgage origination fraud, securitization fraud, appraisal fraud," says banking expert Art Wilmarth, a law professor at George Washington University who was a senior adviser to the Financial Crisis Inquiry Commission (FCIC), a congressionally appointed panel that examined the causes of the crisis. "Where wasn't there fraud?"

Those ethical breaches that led to the 2008 crisis, plunging millions of U.S. homeowners into foreclosure and hobbling the world financial system, just won't fade away. Neither will concerns that ethical problems continue to challenge the financial services industry. In the immediate aftermath of the crisis, U.S. and international regulators imposed new constraints on the banking system. In the ensuing years, regulators have slapped banks with approximately \$150 billion in fines, and each month seems to bring more. And many ordinary people hold the industry in low esteem.

"The pattern of bad behavior did not end with the financial crisis but continued despite the considerable public sector intervention that was necessary to stabilize the financial system. As a consequence, the financial industry has largely lost the public trust," William C. Dudley, president of the Federal Reserve Bank of New York, said in an October 2014 industry speech. Problems can't be blamed on "isolated rogue traders," he said, but rather on the culture of financial services firms.⁴

In early February, Standard & Poor's Ratings Services agreed to a \$1.4 billion fine to settle allegations that it knowingly inflated the grades of mortgage bonds before the crisis. Supposedly independent and objective ratings "played a central role in the crisis that devastated our economy by giving AAA ratings to mortgage-backed securities that turned out to be little better than junk," said the Justice Department.⁵



Activists protest outside the U.S. Justice Department in Washington in 2013. The economic stagnation and wave of foreclosures following the subprime mortgage lending bubble fueled public distrust of the financial services industry. (Alex Wong/Getty Images)

settle claims arising from federal investigations into mortgage bond sales.

Almost all punishments have come in the form of civil penalties levied years after the original violations, rather than criminal penalties. That has led many to question whether consequences have been sufficient to discipline wrongdoers or deter future transgressions.

Although the crisis came to a head in September 2008, it took time to build, and reverberations continue. For years, mortgage bankers and brokers pushed loans to eager U.S. homeowners and homebuyers who wanted to share in the soaring real estate market. Many of these mortgages were classed as subprime—loans to borrowers with less-than-perfect credit, or with inadequate documentation or income. In many cases, predatory lenders signed people up with terms they didn't understand. And many loans were

structured so that monthly payments were low at first, but would balloon after as little as a year.

Mortgage originators resold the loans to Wall Street, a process called “originate to distribute.”⁷ Investment banks packaged these mortgages into complex securities. They sold them to investors around the world who, comforted by optimistic reports from ratings agencies, thought they had purchased safe, high-paying paper. But home prices peaked in 2006 and then plummeted.⁸ Rising unemployment left borrowers without the means to make mortgage payments. Nor could homes fetch higher prices in a sale. Borrowers defaulted in unprecedented numbers. Losses spread, eventually bringing markets and the highly interconnected global financial system to the edge of collapse. To preserve the wobbling integrity of the system, governments around the world stepped in to bail out institutions deemed “too big to fail.”

“Greed overran peoples' ethical foundations,” says former Federal Reserve Board Vice Chairman Donald Kohn, now a fellow at the Brookings Institution in Washington. “They pursued short-term profits in a way that was not consistent with their own firms' long-term interests or the interests of their customers.”

At the simplest, ethical business conduct is the same as general ethical conduct, with an emphasis on not lying, cheating or stealing. But some questions are more nuanced. How does a company balance the needs of shareholders and society? Should a lender provide a mortgage to an eager would-be homebuyer who might not be able to afford payments? How far should an investment banker go to protect the interest of a customer who wants a piece of a seemingly profitable deal?

“‘Do no harm’ is always a good starting point,” says Mark White, chair of the philosophy department at the College of Staten Island in New York. And then it gets cloudier. Any trade, policy or regulation reflects in some measure someone's interests. “Ideally, the legal and regulatory system governing financial transactions would be designed so that actors could do what benefited them without worrying about wrongfully hurting others,” White says, “but no system is that perfect.”

“The problem in today's world is we don't have bright lines that say this is when something is unethical,” says John Blank, chief equity strategist at Zacks Investment Research.

“Ethics and financial services— isn't that an oxymoron?” asks Nell Minow, an activist investor and longtime corporate governance watchdog.

Addressing the Institute of International Bankers in March, Timothy Massad, chairman of the Commodity Futures Trading Commission, defined the challenge his agency and others face. “Sensible regulation is needed to prevent fraud and manipulation, as well as systemic risk,” Massad said. “Sensible regulation can help ensure integrity and transparency. And sensible regulation can help make sure our markets continue to thrive and that they work for the many businesses that need them.”⁹

One of the thorniest ethical problems highlighted by the crisis, known as “moral hazard,” challenges the overall financial and regulatory system, rather than individuals. Moral hazard is created when institutions such as banks are considered too big to fail—that is, governments cannot let them collapse because that would endanger the financial system. Bankers then have an incentive to take risks they otherwise might not. Bankers keep the winnings; taxpayers pick up the tab for their mistakes. (See Short Article, [“Too Big to Fail Hangs On.”](#))

“Moral hazard is changing our notion of who is responsible,” Minow says. “Fault shifts from financial institutions that sell toxic products to customers who are not equipped to evaluate risk.”



Sen. Chris Dodd, left, and Rep. Barney Frank, the two Democrats who championed the financial regulatory overhaul, confer during a 2009 meeting. (Chip Somodevilla/Getty Images)

Policymakers have tried to codify ethics and reduce moral hazard by tightening oversight. In the United States, the 2010 Dodd-Frank Act, named for sponsors Sen. Chris Dodd, D-Conn., and Rep. Barney Frank, D-Mass., set a sweeping financial industry regulatory agenda that is still unfolding. As the short preamble to the 849-page law states, Dodd-Frank aims “to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices” and more.¹⁰

In Basel, Switzerland, global banking regulators shored up standards. After two earlier rounds of rulemaking, they embarked on reforms aimed at bolstering the world financial system. In June 2011, Basel III modified rules governing the risk of loss caused by changes in the market value of counterparty credit risk. In January 2013, Basel III tightened regulation to ensure that banks have sufficient assets

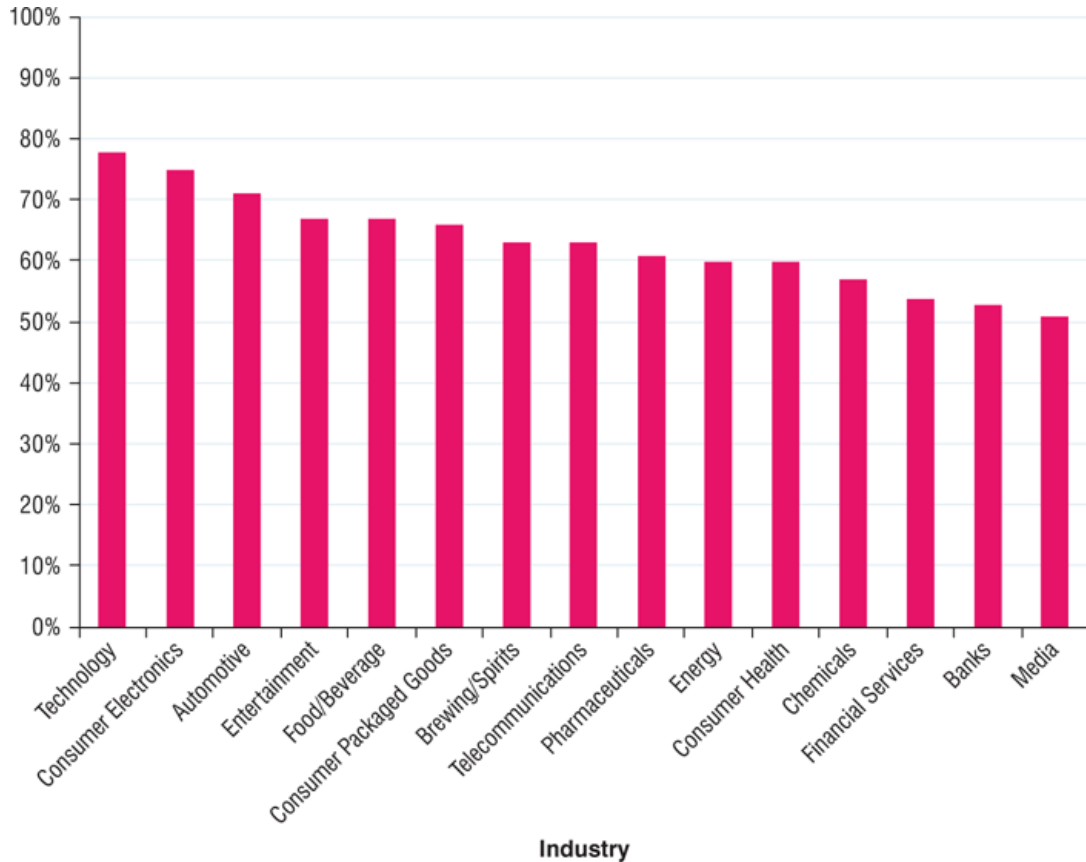
convertible to cash under economic duress.¹¹

Financial firms argue that regulation creates burdensome compliance costs. Critics look at costs but draw a different conclusion when, for instance, JPMorgan Chase alone has paid \$25 billion in fines over about two years, yet remains profitable.¹² “How can you say you are being ethical when you have \$25 billion” in fines? Blank says.

Reforms notwithstanding, firms that manage capital, facilitate payment transfers and sell insurance rank close to the bottom of a list of 15 industries in an annual survey of trust in business by Edelman, a global public relations firm.¹³

Survey: Banks, Financial Services Among Least Trustworthy Industries

Percentage of respondents who trust industry sectors, 2014



Note: Based on online interviews with 27,000 people in 27 countries

Source: "2015 Edelman Trust Barometer Executive Summary," January 2015, p. 7, <http://tinyurl.com/o9gzm4p>

Just slightly more than half of respondents said they trust the banking and financial services industries, just above the bottom-of-the-list media and below the chemicals industry in a global survey by public relations firm Edelman. Technology was the most trusted industry at nearly 80 percent.

To gain trust, financial services firms must change their cultures, Dudley said. "For the economy to achieve its long-term growth potential, we need a sound and vibrant financial sector. Financial firms exist, in part, to benefit the public, not simply their shareholders, employees and corporate clients. Unless the financial industry can rebuild the public trust, it cannot effectively perform its essential functions. For this reason alone, the industry must do much better," he said.¹⁴

Ethics have become detached from brand image, an overriding concern in executive suites, says research fellow Norbert Michel at the conservative Heritage Foundation. "If we are really concerned with brand image, it's probably a bad long-term strategy to push ethics out the door," Michel warns. Market trading algorithms and scripted interactions with clients should not diminish the importance of ethics, he says.

Ethical behavior will remain a perpetual concern, says former Goldman Sachs Vice Chairman Robert S. Kaplan, now a professor of management at the Harvard Business School. "If you think ethical issues are behind us, they're not," he says. "This is an ongoing battle, like losing weight or getting in shape. You never arrive; you will never get there; you need to work at it for the rest of your life."

Progress requires constant reexamination. "In my career we never lambasted people because they didn't have an answer," says Kaplan, who was with Goldman from 1983 to 2005. "We did lambaste people because they didn't ask questions."

Investors on the wrong side of a securities trade known as "ABACUS 2007-AC1" may wish Goldman had asked tougher questions on behalf of its customers. The firm eventually paid a \$550 million Securities and Exchange Commission (SEC) fine for keeping some investors in the dark about a deal that was stacked against them. "In the humiliating settlement with the Securities and Exchange Commission," The Guardian reported in July 2010, "Goldman accepted the largest fine in the commission's history and accepted that the marketing materials it issued to investors for the Abacus transaction at the heart of the regulator's case gave 'incomplete information.'" ¹⁵ Goldman acknowledged it made mistakes but didn't admit or deny wrongdoing. ¹⁶

Humiliating, maybe, but far from crippling. The fine amounted to less than a tenth of the gain in Goldman's stock price after the deal settled



Robert S. Kaplan: "This is an ongoing battle."

uncertainty about consequences—or two weeks of profits, according to investigative reporting organization ProPublica.¹⁷

The finance sector loses credibility when actions appear to clash with statements about ethics. "The danger with ethics is the same as the danger with risk management. It becomes a gesture rather than reality," says Thomas H. Stanton, a former federal regulator and the author of the book, "Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis."

News that former House Majority Leader Eric Cantor, R-Va., headed for a Wall Street job after a primary defeat in 2014 fueled accusations that politicians who need cash are too close to financial firms. In the 2013–14 election cycle, the securities industry was Cantor's biggest donor, contributing \$1.3 million, according to the watchdog Center for Responsive Politics.¹⁸

"How wrong can this be that basically what's happening here is that people work in Washington and, man, they hit that revolving door with a speed that would blind you and head straight out into the industry," Sen. Elizabeth Warren, D-Mass., a frequent financial industry critic, said in a 2014 interview.¹⁹

Cantor is only one in a long list of Republicans and Democrats who have tapped Wall Street for campaign donations or drifted between jobs in the financial sector and the government. Current U.S. Treasury Secretary Jacob Lew has served as managing director and chief operating officer for two different Citigroup business units.²⁰ His recent predecessors at Treasury include former top executives of Citigroup (Robert Rubin) and Goldman Sachs (Henry Paulson). Reform advocates bristled in January 2013 when Lanny Breuer, the Justice Department official charged with bringing financial crisis culprits to justice, left for the private sector. As the vice chairman of law firm Covington and Burling, Breuer reportedly will earn more than \$4 million a year to represent financial services firms and other clients.²¹

As bankers, policymakers, academics and regulators attempt to draw lessons from the ethical failures of the past, these are among the questions under debate:

Weighing the Issues

Is the financial services industry behaving more ethically since the crisis?

Revenue, profit and stock prices in the U.S. financial services sector have rebounded in the years since the crisis. Whether attempts to improve banker and broker behavior have succeeded remains unclear.

"We are much better off today, because we couldn't get much lower than in 2008," says Dennis Kelleher, a former Democratic Capitol Hill staffer who is president of Better Markets, a Washington group that lobbies for scrutiny of financial services and steeper penalties. (The group has received most of its funding from founder Michael W. Masters, who runs an Atlanta hedge fund.)²²



Dennis Kelleher: "We couldn't get much lower than 2008."

Many individuals in the industry tried to help mortgage-lending victims in the aftermath of the meltdown, according to Faith Schwartz, former executive director of HOPE NOW, a nonprofit coalition of counselors, mortgage companies, investors and other mortgage market participants. "People from big financial institutions that were awful during the crisis worked 24/7," says Schwartz, who now heads the government solutions unit at real estate data provider CoreLogic. "The work force was remarkable."

At HOPE NOW, Schwartz worked closely with banks and federal agencies to assist strapped borrowers facing foreclosure. In November 2014 alone, HOPE NOW estimated that 34,000 homeowners received permanent, affordable loan modifications through government-backed programs and lenders' proprietary programs.²³ However, the mortgage modification process has faced vocal criticism from borrowers and advocates who say lenders and servicers continue to mistreat people in trouble.²⁴

Schwartz thinks those in the lending industry and those who oversee it have learned from the past. As markets improve, "we all hope we won't see as much complacency," she says.

The 2010 Dodd-Frank Act was the most sweeping U.S. attempt to rein in industry excess. The law, enacted over the objections of anti-regulation members of Congress, tightened oversight of many of the arcane financial niches where problems had festered. The law gave the CFTC more authority over swaps, which are one-on-one trades of interest rates or other contracts; pushed derivatives trading out of the shadows and onto exchanges; imposed capital requirements and risk safeguards on financial institutions; compelled the largest banks to file liquidation plans in case they went bankrupt; restrained credit rating agencies and executive compensation; and created the Consumer Financial Protection Bureau (CFPB), an agency charged with protecting consumers from lenders who skirt rules and flout ethical standards.

CFPB actions, some jointly with state attorneys general, show regulators are keeping a close eye on consumer interactions with financial services. The bad news: Regulators still find ethical and legal problems. CFPB has brought actions against mortgage servicers, banks

and a variety of nonbank lenders, among others, for actions it claimed cheated consumers.²⁵

“In terms of regulation, I would say that we are clearly better off, but in terms of ethics, I would say we are nowhere,” says economist Dean Baker of the Center for Economic and Policy Research, a left-leaning economics research group based in Washington.

For instance, some see evidence of a possible new lending problem. “Borrowers who took out auto loans over the past year are missing payments at the highest level since the recession,” The Wall Street Journal reported in January. Chief economist Mark Zandi at Moody’s Analytics said, “It’s clear that credit quality is eroding now, and pretty quickly.”²⁶

Bill Himpler, executive vice president of the American Financial Services Association, a trade group that represents auto lenders, defended standards. “Auto loans continue to perform well, as they did during the recession,” he said. “Concerns about a spike in delinquencies have not been substantiated by evidence.”²⁷

Baker says lenders are making high-interest auto loans to borrowers who clearly can’t afford them, an unethical practice. “They then sell them off to investment banks to securitize them, just like in the housing bubble days,” Baker says.

Subprime lending by nonbank auto finance companies is not regulated at the federal level.²⁸ Thus, it provides a window into the financial services sector when no one is watching, Baker says. “This lets us see what happens when people in the financial sector are guided by their own ethics rather than restricted by government regulation. It isn’t pretty.”

Can regulation compel ethical behavior?

From home mortgages sold without regard for credit quality to Wall Street banks betting against institutional clients—actions that later brought those huge financial penalties—regulation failed to prevent the financial crisis. In the years that followed, the Dodd-Frank Act and Basel III tightened bank oversight in the United States and abroad.



Donald Kohn: “I don’t see how a law can ensure ethical behavior.”

Laws and regulation can alter the boundaries of what is legal and thus make the system more resilient when inevitable lapses occur, says Kohn, the former Federal Reserve Board vice chairman. Laws also can make rule-breaking less attractive by monitoring activity, shutting down rewards for bad actors and clawing back rewards after the fact. However, regulation alone cannot rescue an ethically tarnished system, Kohn says. “Behaving ethically has always meant being honest in what you did and treating the other person with respect,” he says. “I don’t see how a law can ensure ethical behavior.”

Mark Calabria, an economist and regulatory analyst at the Cato Institute, a libertarian think tank in Washington, sees value in some regulation but warns against overreach. Instead of making the system safer, Calabria says, over-regulation hampers profitability and weakens financial institutions. More regulation might produce better behavior in the short term, he concedes. But new bubbles will develop in unforeseen ways. Meanwhile, the wrong regulations will cut profits that can sustain banks in lean times, he says.

Calabria prefers market self-regulation. Short sellers and hedge funds with profit motives, he says, not government regulators, exposed massive fraud at energy company Enron in 2001 and by investment adviser Bernard Madoff in 2008. “I just don’t think that we can put a lot of weight on thinking that regulators will be [the] ones to lean against the wind next time,” Calabria says. “I hope I’m proven wrong, but I don’t think I will be.”

A \$968 million settlement between mortgage lender and servicer SunTrust and federal and state regulators provides an example of how regulators can attempt to curb harmful activity. Sued over mortgage origination, servicing and foreclosure abuses, SunTrust promised to do better. The settlement included \$500 million for consumer relief, including modifying mortgages for some borrowers to make them more affordable.²⁹

“This settlement holds a major mortgage servicer accountable for its unacceptable past practices, and it provides direct relief to Kentucky borrowers,” Kentucky Attorney General Jack Conway said in one announcement of the settlement, which involved 49 states, the District of Columbia and several federal agencies. “Additionally, SunTrust must treat its borrowers much more fairly because of the settlement’s tough servicing standards.”³⁰ The July 2014 settlement was closely modeled on a 2012 settlement between state and federal regulators and several of the largest mortgage servicers, which had been accused of mistreating borrowers.³¹

Efforts to regulate must make room for irrational behavior contrary to a borrower’s or an investor’s best interests. That’s expecting a lot. For instance, bubble-era homebuyers who ignored the downside in a major financial decision did so, most thought at the time, in their own best interest.

Weighing the wrong things can leave naïve consumers and investors open to dubious tactics and unrealistic expectations. In one demonstration, researcher Roy Zuckerman at Tel Aviv University’s Faculty of Management probed the link between personal appearance and trustworthiness. “We found that the ‘trustworthy’ managers tended to make less money for investors and more money for themselves by leveraging the way they looked and how they presented themselves,” Zuckerman said.³²

No oversight body can police all daily transactions by millions of Americans who base financial decisions on professional advice. In 2008,

as the system was fraying, researchers from Harvard and elsewhere set out to measure the value of financial guidance. In a working paper for the National Bureau of Economic Research, they reported that, by a wide margin, investment advisers steered customers toward investments with high fees, which are more apt to enrich the advisers than boost return on investment. Of 284 brokers contacted for the study, only 21 recommended index funds that match broad market performance and charge low fees.³³

When questioned by Sen. Warren at a 2014 Capitol Hill hearing, New York Fed Chairman Dudley dismissed any expectation that the Fed can track all activity by large institutions in real time. "What you're proposing is something that I think would be very difficult to do in practice, which is evaluating every transaction ... the bank does on a transaction-by-transaction basis, and I just don't think that's practical," he told Warren.³⁴

Should top executives be held personally responsible for their companies' mistakes?

As statutes of limitation for prosecuting bad actors in the financial crisis expired, the roster of top bankers sent to prison for mortgage securities misdeeds boiled down to one name: Kareem Serageldin, ProPublica investigative reporter Jesse Eisinger, who has covered the aftermath of the crisis in depth, reported in April 2014.³⁵

Bankers, brokers, mortgage salespeople and investment advisers who rode roughshod over consumers, misled investors, bankrupted financial institutions and landed taxpayers on the hook slipped through the prosecutorial net, save for Credit Suisse trader Serageldin. Inflating the value of mortgage bonds in a crumbling housing market drew a two-and-a-half-year sentence at the Moshannon Valley Correctional Center in Philipsburg, Pa.³⁶



Kareem Serageldin, a former Credit Suisse executive, was sentenced to 30 months in prison for his role in concealing hundreds of millions of dollars in losses on mortgage-backed securities. (Andrew Cowie/AFP/Getty Images)

This contrasts starkly with prosecutions following the earlier savings and loan crisis. "The savings and loan regulators made over 30,000 criminal referrals, and this produced over 1,000 felony convictions in cases designated as 'major' by the Department of Justice," former bank regulator William Black, who was instrumental in jailing high-level S&L executives, said in a 2013 interview.³⁷

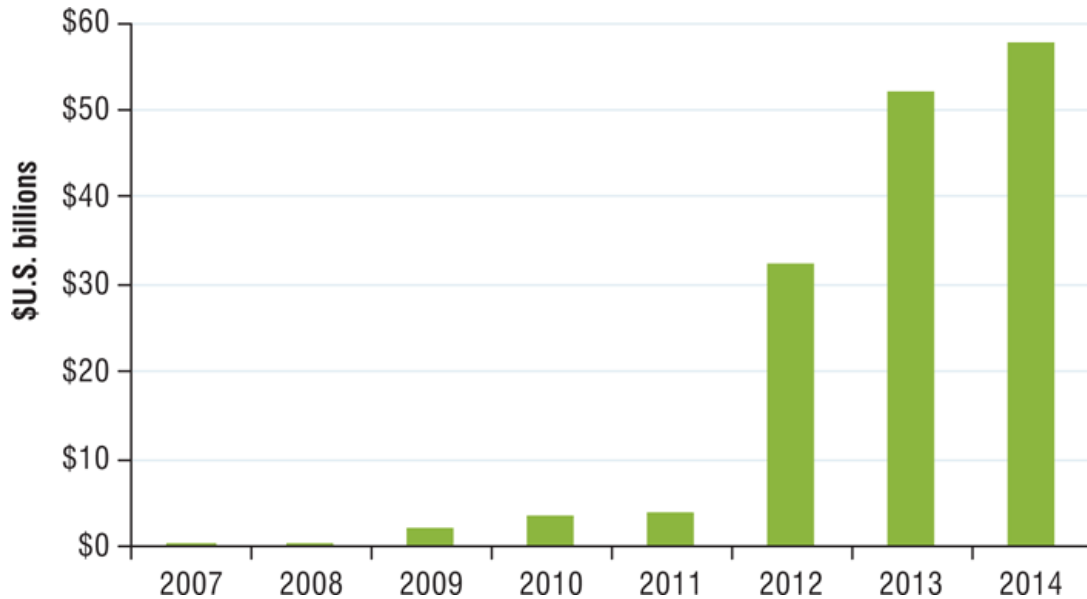
Meanwhile, the Justice Department has secured guilty verdicts in smaller cases unrelated to the financial crisis. In February, a court sentenced Kevin G. White of Texas to eight years in prison for misappropriating \$1.7 million in a \$7.4 million commodity pool investment scam.³⁸

In lieu of criminal prosecutions since 2008, authorities have meted out punishment mostly in the form of big civil penalties against corporations. Fines levied

on the banks since the crisis far exceed \$100 billion, New York Fed President William Dudley said in October 2014.³⁹ According to a database of federal and state fines maintained by the Financial Times, that figure has reached \$150 billion.⁴⁰

Bank Fines Top \$150 Billion Since 2007

Fines, penalties and settlements paid by banks to U.S. regulators, in \$U.S. billions, 2007–14



Source: Original graphic by Aaron Stanley, Kara Scannell, Tom Braithwaite, Gina Chon, Tom Pearson; data from Martin Stabe, "Bank fines get the data," Financial Times (blog), updated Nov. 12, 2014, <http://tinyurl.com/pz255r4>

Banks paid more than \$57.5 billion in fines and legal settlements to U.S. agencies in 2014, a \$5 billion increase from 2013, according to data compiled by the Financial Times. In total, regulators have fined banks more than \$150 billion since the beginning of the 2008 financial crisis for legal violations and penalties related to money laundering, unethical lending and mortgage investment fraud.

Regulators who bring these civil suits say the penalties act as a deterrent. Robert S. Khuzami, former SEC director of enforcement, lauded the 2010 \$550 million settlement with Goldman Sachs over fraudulent representations of risk to its customers in the mortgage securities deal known as ABACUS 2007-ACI. "This settlement is a stark lesson to Wall Street firms that no product is too complex," Khuzami said, "and no investor too sophisticated, to avoid a heavy price if a firm violates the fundamental principles of honest treatment and fair dealing."⁴¹

However, reliance on fines instead of convictions rankles reformers such as Kelleher at Better Markets. When perpetrators don't go to jail, that sends a dangerous signal to bankers mulling ethical and legal indiscretions, he argues: Maybe transgressions are worth the risk.

Cash settlements, even those in the billions of dollars, serve mainly as cover-ups, he says. Executives who cause, abet or close their eyes to gigantic transgressions remain behind the curtain until statutes of limitation expire. Settlements "ensured that there has been virtually no public transparency or disclosure of who did what to cause the crisis and who engaged in illegal conduct," Kelleher says.

He points out that big banks continue to err, and continue to be fined rather than criminally prosecuted. For instance, in November 2014, six banks agreed to pay \$4.3 billion to settle claims that they manipulated foreign-exchange markets between 2008 and 2014. "Still No Real Punishment When The Too-Big-To-Fail Banks Break The Law," Kelleher's newsletter proclaimed.⁴²

Some culpable institutions have vanished, but responsible individuals have scattered—"a total lack of accountability for the crash at the individual and institutional level is where seeds have been laid for the next crash and crisis," Kelleher says.



Mark Calabria: "Few executives actually pay."

In the settlements, executives seldom dig into their own pockets. "Few executives actually pay," says Calabria at Cato. "It's the shareholders."

Simon Johnson, a former chief economist at the International Monetary Fund who is now an economic and management professor at MIT, drew a parallel between punishments of bankers and athletes. When athletes break rules, wrist-slaps show that regulatory bodies aren't serious about discipline, he said. Johnson, who has been a vocal banking critic, pointed to a minimal penalty imposed on the captain of an Australian cricket team who violated rules against moves that risk serious injury to other players. "Cricket Australia was making it clear that such behavior merited only a symbolic punishment," he wrote.⁴³

A \$13 billion fine against JPMorgan Chase, for instance, sounds like enough to alter behavior.⁴⁴ "But, just like Cricket Australia, the message is clear: There will be no change to business as usual," Johnson wrote.⁴⁵

A fine so large is less than meets the eye, says a securities analyst who follows JPMorgan Chase and spoke on the condition that neither he nor his firm be named. Not all of it was cash, he points out. Some was consumer relief. Also, a lot already had been recorded on the bank's books in write-downs of losses in the loan portfolio. "Over time, if you're earning five or six billion dollars a quarter, you have a pretty big capacity to absorb these charges," he says.

Kaplan, the Harvard professor and former Goldman Sachs vice chairman, cautions against a rush to judgment against individuals. "If I wreck someone else's car in an honest mistake, I'm accountable as a driver," Kaplan says. "It does not mean I did something illegal or unethical and that I should go to jail."

Kaplan attributes the financial crisis mainly to critical errors in judgment, not to deficient ethics. "Everybody on Wall Street and around the world went by the assumption that house prices don't go down all at once," Kaplan says. "A lot blew up because home prices went down [all at once]."

Top financial executives failed to take ownership of the potential cost, and this might make them culpable, Kaplan says, but not necessarily criminal or liable for the economic upheaval that followed.

"I wish the whole story was just about ethical lapses," Kaplan says. "It would be so much easier to fix."

Background

New Mandates

Companies once aspired routinely to the "punctilio of honor," lawyer-talk for taking the high road to preserve reputations. Ethical lapses imperil reputation, or did in Adam Smith's day. "A prudent dealer, who is sensible of his real interest," the Scottish moral philosopher said in 1763, "would rather choose to lose what he has a right to, than give any ground for suspicion."⁴⁶

Thomas Jefferson embraced a universal definition of ethics. "I have but one system of ethics for men and for nations," he wrote in 1790 to the Duchesse D'Auville, "... to be faithful to all engagements under all circumstances, to be open and generous, promoting in the long run even the interests of both."⁴⁷

Jefferson opposed big banks, preferring an agrarian economy based on honest farmers. "Banking establishments are more dangerous than standing armies," he wrote in 1816.⁴⁸

His economic philosophy famously lost to that of colonial financier Robert Morris and Alexander Hamilton, who established the first U.S. central bank. Still, two centuries later, Jefferson's fears resonate. Modern U.S. banking and securities regulation has roots in the Great Depression, with laws aimed at curbing bankers' excesses. Poor judgment and criminal acts caused bank failures and investment debacles then—with no insurance for bank depositors who lost their savings. A web of post-Depression financial laws, including the Glass-Steagall Act, largely prevented a recurrence for the next eight decades.

Glass-Steagall, also known as the Banking Act of 1933, aimed "to provide for the safer and more effective use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations, and for other purposes."⁴⁹

The law separated banking functions. Commercial banks would cater to depositors, and investment banks to investors. Insurance companies would operate separately.

In subsequent decades, advocates fought to strengthen or relax regulation, with both sides arguing that they were on the side of taxpayers and the U.S. economy. By 1970, a confluence of financial innovations and mounting demand for homeownership began chipping away at Glass-Steagall.

On Wall Street, in the fixed-income division of then-prominent Wall Street firm Salomon Brothers, trader Lewis Ranieri and his colleagues pioneered mortgage securitization. They bundled thousands of home mortgages and resold the resulting bonds, transforming interest payments into fixed-income securities. Ranieri's work, which built on similar securitization created to resell government-insured mortgages, created a gigantic market tied to residential mortgages.⁵⁰

By 1983, "Ranieri's mortgage finance group at Salomon Brothers accounted for close to half of Salomon's \$415 million in profits," journalists Bethany McLean and Joe Nocera wrote in "All the Devils Are Here," their account of the financial crisis. "Along with junk bonds, mortgage-backed bonds became a defining feature of the 1980s financial markets."⁵¹

For mortgage lenders, who previously tied up their capital in 30-year mortgages, the secondary market was key to liquidity. By reselling mortgages via Wall Street to investors rather than holding them to maturity, lenders could raise cash to write new mortgages. As the principal issuers of home mortgages in the United States, small thrifts, also called savings and loan institutions, stood to profit, or so it seemed.

Meanwhile, financial engineers also had created a new market that invested in very short-term securities that were, in theory, impervious to risk. These “money market mutual funds,” intended originally as a way to hold escrow before closing home sales, grew into a new category for Wall Street: retail checking accounts that competed with banks for checking and savings customers.



President Franklin D. Roosevelt, seated, jokes with Rep. Henry Steagall, right, as he signs the Glass-Steagall banking law in 1933. Sen. Carter Glass is at left of the group of onlookers. (Library of Congress)

In 1977, the Community Reinvestment Act, enacted with stellar intentions, added another element to the mortgage mix. Aimed at making homes affordable for low and moderate-income families, the legislation provided aggressive lenders with a putative justification for pushing mortgages to consumers who could not afford them.⁵²

Climate Change

The oil crisis and economic stagflation of the 1970s pushed interest rates up along with prices. The prime rate—the interest rate that banks charge their best customers—topped 20 percent at several points in 1980 and 1981.⁵³ In October 1981, home mortgage rates hit 18.45 percent.⁵⁴

Banks and thrifts were still legally barred from raising rates they paid depositors on many types of accounts. Wall Street institutions, though, could lure customers with high-interest money market mutual funds and other products. Under pressure from commercial banks and thrifts, Congress soon loosened regulation of these institutions, notably with the 1982 Garn-St. Germain Depository Institutions Act, which lifted

interest rate caps and relaxed lending rules.⁵⁵

But deposits continued to flow to Wall Street. The thrifts in particular were saddled with old long-term, low-rate loans, especially home mortgages. “When interest rates rose, these mortgages lost a considerable amount of value, which essentially wiped out the S&L industry’s net worth,” wrote Kenneth Robinson at the Federal Reserve Bank of Dallas.⁵⁶

Commercial banks hung on, but thrifts foundered. “The rates they had to pay to attract deposits rose sharply, but the amount they earned on long-term fixed-rate mortgages didn’t change.” Robinson wrote. “Losses began to mount.”⁵⁷ In the early 1980s hundreds of thrifts failed.

To lure deposits, S&Ls still standing took riskier and riskier bets, heavily skewed to Texas real estate during its oil boom. But the oil boom fizzled along with construction nationwide. When loans went bad, S&Ls ended up owning vast tracts of residential and commercial space that developers never completed.

As insurer for accounts at defunct thrifts, the Federal Savings and Loan Insurance Corp. (FSLIC) was saddled with a huge portfolio of bad assets, including unfinished condominiums financed by a bankrupt Texas S&L that were cheaper to tear down than to sell.⁵⁸

In 1989, the federal government bailed out the S&L industry, setting up a new agency, the Resolution Trust Corp. (RTC), to take over the assets of failed thrifts and dispose of them. The agency was charged with getting rid of about \$400 billion worth of assets, largely real estate and loans.⁵⁹

Subprime Debt to the Rescue

The RTC had five years to complete three goals: (1) manage and resolve all cases involving accounts of depository institutions insured by the FSLIC; (2) maximize the return of value from the sale or other disposition of depository institutions or their assets with minimum impact

on taxpayers; and (3) maximize the availability and affordability of residential real property for low- and moderate-income individuals.⁶⁰

The agency's portfolio included a huge number of commercial real estate loans. It also included what are known as nonconforming home mortgages—loans that don't meet plain-vanilla underwriting standards, such as those with high loan-to-value ratios or deficient documentation.⁶¹

The agency's main strategy for getting rid of its portfolio was to transform the bad assets into securities. The agency seized failed institutions and packaged loans, mostly on commercial properties, into pools. The pools were then sold to investors in tranches—slices—divided by risk into interest-bearing securities, as Ranieri had pioneered, but now with much riskier underlying loans. Fixed income pools feature bonds with multiple layers that vary in credit quality, called tranches. The tranches most likely to pay investors earned top investment-grade ratings; the RTC kept the riskiest tranches. The strategy succeeded and proved to Wall Street that a market existed for previously unattractive assets.⁶²

In Washington, financial market deregulation accelerated. In 1999, the Gramm-Leach-Bliley Act repealed key elements of Glass-Steagall, knocking down the walls that separated banks, securities firms and insurance companies.⁶³

Blaming the crisis on deregulation is misguided, according to Peter J. Wallison at the American Enterprise Institute, a conservative group in Washington.⁶⁴ Many observers differ, including Kelleher at Better Markets. After Gramm-Leach-Bliley, says Kelleher, “it took the financial industry just seven years to crash the global financial system and almost cause the second Great Depression.”

Low mortgage rates and rising home values seemed to open homeownership to everyone. Low interest rates also sent investors in search of higher yields, despite risks. And the riskiest home mortgages paid the highest interest rates. The appetite on Wall Street for high-paying loans that could be securitized seemed insatiable. Mortgage brokers could not originate and distribute fast enough, collecting origination fees and keeping none of the risk on their books.

In the 2000s, subprime securities, always an area for risk takers, attracted new buyers and sellers who blurred the lines between investing and gambling. Investment banks peddled an alphabet soup of exotic paper: credit default swaps (CDS), collateralized mortgage obligations (CMOs), collateralized debt obligations (CDOs) and instruments as arcane as CDOs squared. (Explaining how each of those investments works would take a book, and many have been written about them. In hindsight, many analysts say that even the most sophisticated investors didn't really understand what they were buying.)

Where securities once had been backed by actual mortgage payments, financial engineers began creating securities with thinner and thinner ties to underlying cash flows—until in some cases, there was no relationship other than gambling on the prospect that some securities would lose their value. “The people on the short side of the subprime mortgage market had gambled with the odds in their favor,” financial journalist Michael Lewis wrote in his best-seller, “The Big Short: Inside the Doomsday Machine.” Investors on the short side of a deal were betting prices would drop. “The people on the other side—the entire financial system, essentially—had gambled with the odds against them.”⁶⁵

In its examination of events leading up to the crisis, including mortgage securitization, the Financial Crisis Inquiry Commission concluded that there was “a systemic breakdown in accountability and ethics.” The commission said, “We witnessed an erosion of standards of responsibility and ethics that exacerbated the financial crisis. This was not universal, but these breaches stretched from the ground level to the corporate suites.”⁶⁶

View From the Top

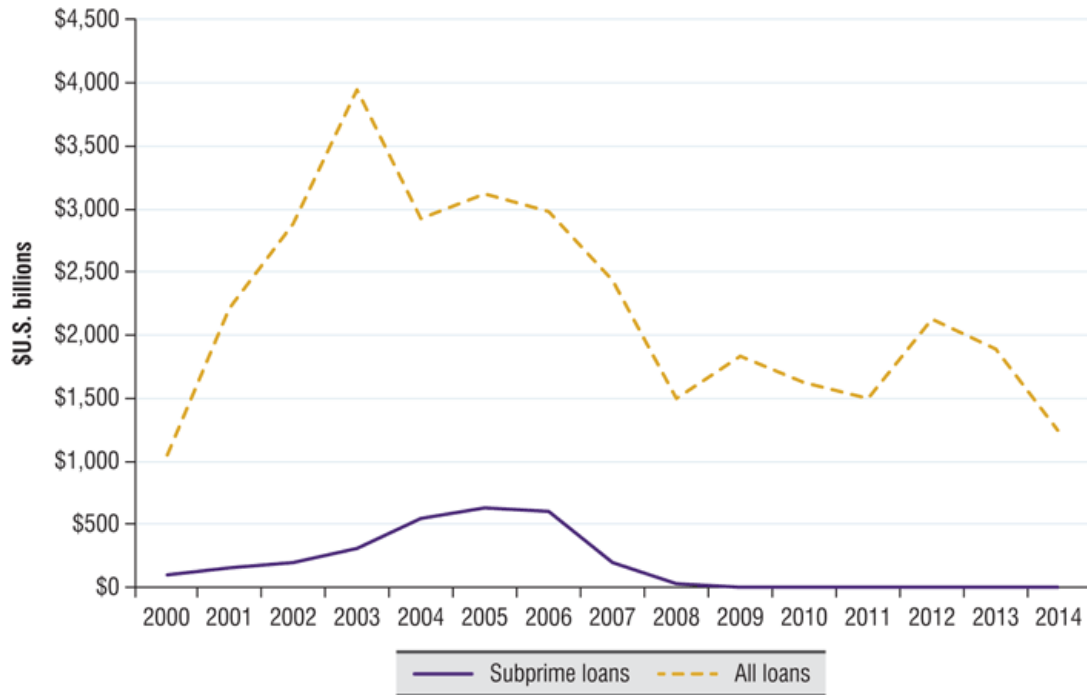
In the first decade of the 21st century, home construction and the stock market zoomed to record levels. Lenders extended exotic mortgages to borrowers with weaker and weaker credit. Rating agencies fell in line by certifying that mortgage bundles made up of subprime loans passed muster as top-grade triple-A investments, a lucrative deal for them.

Mortgage originators scrambling for borrowers enticed existing homeowners to treat their houses as ATMs. In a 2007 report, former Federal Reserve Board Chairman Alan Greenspan and Fed economist James Kennedy estimated that home equity loans extracted \$743.7 billion in net equity in 2005—up from \$229.6 billion in 2000 and \$74.2 billion in 1991.⁶⁷

Subprime loans—mortgages for borrowers with less-than-ideal credit scores—totaled just \$100 billion in 2000, about 10 percent of the \$1 trillion in mortgages that year, according to industry data provider Inside Mortgage Finance. In 2005, lenders originated \$625 billion in subprime loans, or 20 percent of the \$3.12 trillion mortgage total, plus another \$380 billion of what are known as “Alt A” loans—often those with little documentation.⁶⁸ The volume of mortgage-backed securities (MBS) collateralized by subprime and Alt A loans increased from \$98 billion in 2001 to \$798 billion in 2005 and \$814 billion in 2006.⁶⁹

Subprime Lending Ballooned in Mid-2000s

U.S. mortgage originations, in \$U.S. billions, 2000–14



Note: Subprime loans are defined as those made to borrowers with subprime credit scores.

Source: Inside Mortgage Finance

Mortgage lending to borrowers with below-prime credit increased each year from 2000 to 2005, when the volume of subprime loans peaked at \$625 billion. Subprime mortgages accounted for one-fifth of all U.S. mortgages originated in 2006, when the housing bubble popped, leading to the 2008 financial crisis. Since the crisis, subprime lending has remained flat at \$4 billion per year.

Investigators later found numerous emails reflecting the wild investment climate. “The market is not pricing the subprime (residential mortgage back securities) wipeout scenario,” an employee of the hedge fund Paulson & Company wrote in one email. “Rating agencies, CDO [collateralized debt obligations] managers and underwriters have all the incentives to keep the game going, while ‘real money’ investors have neither the analytical tools nor the institutional framework to take action before the losses that one could anticipate based [on] the ‘news’ available everywhere are actually realized.”⁷⁰

National home prices peaked in April 2006; defaults began to rise later that year, and continued to increase in 2007, especially in hard-hit states such as Arizona, California, Florida and Nevada.⁷¹ Cracks in the subprime market became fissures. Two investment funds under the aegis of Bear Stearns, their portfolios packed with high-risk assets of crumbling worth, imploded in mid-2007. Investors lost \$1.6 billion. The fund managers eventually faced criminal trial over charges that they repeatedly lied to investors about how much money they personally invested; they also were accused of concealing information about investors taking funds back. In November 2009, a jury acquitted them.⁷²

Former federal prosecutor Robert Mintz, who was not directly involved in the case, speculated that the government failed to persuade jurors that the brokers acted fraudulently. “While prosecutors argued that the case was about lying to investors, jurors seem to have found that the government was trying to unfairly hold these defendants responsible for predicting the impending collapse of the economy at a time when even economists were uncertain as to where the world markets were headed,” Mintz told CNNMoney.⁷³

Dominoes Start Tumbling

Worse than sitting on big quantities of shaky subprime securities, Wall Street firms had razor-thin equity to absorb problems. At the end of 2007, \$11.1 billion in equity supported \$395 billion in assets at Bear Stearns, the fifth-largest investment bank in the United States, according to a case study former U.S. bank regulator William Ryback prepared for the Toronto Leadership Centre, which trains financial regulators globally.⁷⁴

In March 2008, as the price of subprime securities crumbled, lenders balked and cut off the short-term loans Bear Stearns needed to fund operations. Over a weekend, federal regulators negotiated the sale of Bear Stearns’ assets to JPMorgan Chase for \$2 a share (although the final price was \$10 a share). The company’s stock had been worth \$70 per share a week earlier.⁷⁵

Wall Street wondered who would be next. Speculation centered on Lehman Brothers, an investment bank with a huge portfolio of subprime loans and counterparty relationships with investors around the globe.

The financial crisis reached a crescendo over a series of weekends in the fall of 2008. The federal government took over mortgage market giants Fannie Mae and Freddie Mac. The government pushed Bank of America to buy brokerage firm Merrill Lynch. And then, after frenzied negotiations over the weekend of Sept. 13–15, 2008, the government declined to bail out Lehman, instead letting the investment bank go into bankruptcy. The next day, as world financial markets teetered, the government stepped in to save insurance company American International Group (AIG). When Congress rejected a version of the Troubled Asset Relief Program (TARP), a financial industry bailout package, panicked traders sent the Dow Jones industrial average plunging 778 points. Credit markets froze, and an already-shaky economy was on the way to what has become known as the Great Recession.⁷⁶

Sounding like a captain who faults the iceberg, Lehman's CEO cast blame elsewhere for his firm's failure. "Bear went down on rumors and a liquidity crisis of confidence," Richard Fuld told the FCIC. "Immediately thereafter, the rumors and the naked short-sellers came after us."⁷⁷

A less charitable perspective blames a Lehman board of directors ill-equipped to challenge poor decisions. "They had an actress, a theatrical producer and an admiral, and not one person who understood financial derivatives," activist investor Minow told the FCIC. The Corporate Library, which Minow co-founded, gave a D grade to Lehman's governance in 2004 and an F in September 2008.⁷⁸

After the Crisis

As the dust was still settling, Congress passed the Dodd-Frank Act and an \$800 billion economic stimulus package, on top of \$475 billion earmarked for the TARP bailout.

Republicans decried the stimulus as a peril that would burden future generations with debt. Liberal Democrats bristled at bailing out banks. Because Democrats controlled Congress, opposition within the party posed more of an obstacle than did Republicans. "Being able to speak fluently about why, for example, helping the banks with TARP was the unavoidable price for preventing another great Depression did not help [Rep.] Frank with the liberals who viscerally detested bailing out banks," Washington Post journalist Robert Kaiser wrote in "Act of Congress," a book about passage of Dodd-Frank.⁷⁹

Dodd-Frank tackled ethics and financial services head-on. It imposed regulation in sectors where the worst problems occurred. "The Wall Street reform bill will—for the first time—bring comprehensive regulation to the swaps marketplace," said then-CFTC Chairman Gary Gensler. "Swap dealers will be subject to robust oversight. Standardized derivatives will be required to trade on open platforms and be submitted for clearing to central counterparties. The Commission looks forward to implementing the Dodd-Frank bill to lower risk, promote transparency and protect the American public."⁸⁰

Complex only begins to describe implementation. At the end of 2014, a total of 277 of nearly 400 Dodd-Frank deadlines for final rulemaking had passed, the law firm Davis Polk reported. Of these 277 deadlines, regulators missed about a third.⁸¹

While legislators wrangled over funding of implementation, financiers continued to demonstrate the need for supervision. A trader in a unit of JPMorgan Chase, Bruno Iksil, staked out a position in credit derivatives of such size that he became known as the London Whale. Eventually, his ill-timed investments forced JPMorgan to announce a whale-size \$5.8 billion trading loss in July 2012. Nonetheless, the bank reported a \$5 billion profit that quarter.⁸² In 2013, the bank agreed to pay U.S. and U.K. regulators \$920 million in fines for improperly overseeing the trades.⁸³

Current Situation

Risk-Taking Remains

Republican control of both houses of Congress following the November 2014 election has invigorated legislators hostile to many aspects of Dodd-Frank. "Republicans have launched a new effort to weaken, bit by bit, a law that dramatically expanded oversight of the financial system after the Great Recession," according to the Los Angeles Times.⁸⁴

Restrictions in place since the crisis are loosening elsewhere, too. Aiming to revitalize a sluggish mortgage market, Fannie Mae and Freddie Mac are relaxing loan restrictions. Low down payments—shunned for years as risky—will let buyers borrow 97 percent of the price of a new home.⁸⁵ The goal is to put consumers with sufficient income but minimal assets into their own homes. Strings are attached. Borrowers must attend a homeownership counseling program. Attendance will reduce default risk, said Melvin L. Watt, director of the Federal Housing Finance Agency, which oversees Fannie Mae and Freddie Mac.⁸⁶

Attempts to enforce ethical standards continue. For instance, every member of the National Association of Mortgage Brokers (NAMB) must undergo continued ethics training. NAMB President John Councilman says the requirement has paid off. His profession has come

along in three decades, ethics-wise, he points out. When he entered the business in 1985, there were no licensing standards. Now, mandatory annual training and state licensing requirements drive home a similar message: no bait and switch, no misleading ads, no misrepresentation.

He concedes that every large group can have bad apples. "I can't say you will never have someone flagrantly say, 'I don't care what the law says; I will do this anyhow,'" Councilman says.

Maintaining financial stability requires vigilance, according to the Office of Financial Research (OFR), an arm of the U.S. Treasury that Dodd-Frank established to improve quality, transparency and accessibility of financial information.⁸⁷

In its December 2014 annual report, OFR noted good news. Loan delinquencies, default rates and debt overhang have eased. Delinquency benchmarks at commercial banks for non-mortgage loans are close to record lows. Dangers to the financial system are generally low, according to OFR Director Richard Berner. However, he named three lurking threats: "excessive risk-taking in some markets, vulnerabilities associated with declining market liquidity, and the migration of financial activities toward opaque and less resilient corners of the financial system."⁸⁸

Case in point: Subprime mortgage risk-taking has resurfaced. Hedge funds are buying up loans to borrowers with low credit scores, foreclosures in their past or hard-to-document income that rules out conventional mortgages, according to Bloomberg Business. They plan to reissue these loans as securities.⁸⁹

Faster Times

Much of Wall Street trading today occurs between computers programmed with sophisticated algorithms. Depending on who is asked, high-speed trading is either a boon to market liquidity or a dubious means to skim profits ahead of investors who do not trade multiple times in a single second.

But computers don't make ethical decisions, whether trading securities at high speed or launching new ones derived from mortgages, says former Fed Vice Chairman Kohn. "I don't agree that slicing and dicing of securities and algorithms have made ethics unimportant or unnecessary," he says. "Ethics and the perception of being ethical and having customers' best interests in mind is still critical."

High-speed trades look unethical to Blank, the chief equity strategist at Zacks. "When risk is under a millisecond, you are taking no risk. You are just milking the system," he says.

Other than suspicious market machinations, Blank asks, how can anyone explain steep and sudden downswings in a company whose earnings are climbing and shares have been upgraded?

Algorithms extend now to short sales, a practice as old as financial markets. In a short sale, investors who expect the price of a stock or other security to fall borrow shares and sell them. When time comes to replace the borrowed stock, if prices are down, the short seller wins. If prices go up, short sellers lose—the opposite of buying low and selling high.

Blank questions the ethics of banks that lend to short sellers who then make deals with borrowed money. It's OK when short sellers put their capital at risk with honest convictions that stocks are overpriced, Blank says. Banks cross an ethical line, in his estimation, when they furnish cash to short sellers whose short-term actions jeopardize the long-term value of stock in the bank customers' portfolios.

Looking Ahead

Sea Change

Predictions for how the financial service industry will evolve in coming years run the gamut from cautious change to revolutionary alterations in the way consumers connect with financial services. Far from restoring personal connections in lending, credit decisions may be even more impersonal.

For instance, institutions given ordinarily to incremental change have embraced mobile services. In the Chicago area, Wintrust Financial allows customers to use a mobile banking app rather than a physical card to get cash at the ATM, American Banker reported. Radius Bank, in Boston, uses smartphone cameras to input data when opening accounts. Eastern Bank, also in Boston, has an innovation lab for experimenting with technology that could revamp underwriting, branch formats, marketing and other facets of banking, according to American Banker.⁹⁰

Technology and better use of big data could also allow banks to use nontraditional standards for lending. "When bankers of the future decide whether to make a loan," The New York Times speculated in January, "they may look to see if potential customers use only capital letters when filling out forms, or at the amount of time they spend online reading terms and conditions—and not so much at credit history."⁹¹

Ethical implications are hard to guess. Nonetheless, based on the long history of boom-and-bust cycles, dating back before the Dutch tulip

bubble culminated in 1637, experts agree that some other financial crisis lurks. ⁹² “I’m fairly sure we will find ourselves in this situation again,” says Calabria at Cato. He questions the ultimate value of regulation applied selectively. Regulators treated Bear Stearns one way, Lehman another, AIG a third way and other banks other ways. “That seems ad hoc,” he says.

Calabria instead seeks more reliance on monitoring and less on regulation. Limited regulation supplies one leg of an ethical stool. A second leg would end the originate-to-distribute mentality, where lenders wash their hands of risky loans. The third leg would incentivize financial institutions to monitor each other because self-interest properly applied is powerful.

“If I lend you \$1 million I have a strong incentive to care what you do with it; that’s more incentive,” Calabria says. “If the government says, ‘I’ll make you good,’ that’s less incentive.”

In 2012 remarks to a forum on homeownership, Bank of America CEO Brian Moynihan shared his expectations for banking in the future. “How does everything we have learned during the crisis and recovery apply?” he asked.

Lessons underscore the need for a system that keeps borrowers out of homes they cannot afford and will lose, rather than trying to expand homeownership for poorer Americans. “It means shifting the conversation,” Moynihan said, “from what percentage of Americans own homes to what is the right solution at the right time for each individual or family.” ⁹³

Kaplan, the former Goldman executive, sees ethics in the context of the entire capitalist system. “As long as wage and wealth inequality are big societal issues, business in general and financial services in particular will be under severe scrutiny for their business practices,” Kaplan says. “The issue won’t be about what is legal. It will be about the right thing to do.”

About the Author

S.L. Mintz covers personal finance, corporate finance, banking and financial regulation, and public policy. His articles have been published in Barron’s, Institutional Investor, The Economist, Bloomberg Personal Finance, Knowledge@Wharton and other print and online venues. Book credits include “Five Eminent Contrarians” and “John Neff on Investing.” He co-wrote the eight-part PBS Television series “Beyond Wall Street: The Art of Investing” and a companion book with the same title. He served as a staff writer on the best-selling Financial Crisis Inquiry Commission report that probed reasons for economic upheaval triggered by collapsing home prices and excess on Wall Street. He lives in Montclair, N.J.

Chronology

1930s	Early ethics reforms begin during Great Depression.
1933	Commercial banking system collapses; President Franklin D. Roosevelt declares bank holiday Banking Act, also known as Glass-Steagall , authorizes actions to rehabilitate banking system and promote transparency by separating commercial banks, investment banks and insurance companies from each other to protect depositors.
1938	Former New York Stock Exchange President Richard Whitney is convicted of fraud and sent to Sing Sing prison ; he is paroled in 1941 after serving less than half of his sentence. ... Government forms Fannie Mae as ultimate lender in housing, giving the federal government a stake in homeownership.
1970s–1990s	Seeds of 2008 financial crisis are planted.
1970	Money market funds, which were developed to hold escrow money in real estate transactions, morph into retail checking vehicles, posing a new competitive threat to banks and savings and loans.
1975	Lewis Ranieri and team at Salomon Brothers unveiled mortgage-backed securities, an achievement that will eventually land him on Time’s list of 25 people who caused the 2008 crisis.
1977	Community Reinvestment Act spurs lenders to make home loans to less credit-worthy borrowers.
1981	Thirty-year home mortgage interest rates peak at 18.45 percent.
1982	Garn-St. Germain Depository Institutions Act attempts to level playing field for thrifts competing with Wall Street for depositors, but fails to head off a thrift crisis caused by bad loans and poor judgment.
1989	President George H.W. Bush signs the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) that disposes of “toxic” assets thrifts had accumulated. Act establishes the Resolution Trust Corp., which completes its job ahead of time and demonstrates investor appetite for subprime assets. Wall Street takes note and subprime securities linked to real estate start to proliferate.

- 1999** Congress passes the [Gramm-Leach-Bliley Act](#), “to enhance competition in the financial services industry by providing prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers.”
- 2000s–Present** **Wall Street and the economy collapse, prompting new round of reforms.**
- 2002** Falling interest rates boost appeal of homeownership; subprime residential mortgages skyrocket.
- 2004** [Homeownership in the U.S. reaches record high.](#)
- 2005** Funding available through short-term lenders in the shadow banking system widens its margin over funding from traditional banks. ... Subprime residential mortgage lending accounts for 20 percent of all mortgage lending.
- 2006** Home prices peak in April. ... Subprime mortgage defaults begin to rise.
- 2007** Meltdown accelerates; securities firm Bear Stearns closes two high-flying hedge funds littered with subprime mortgages. ... On July 10, S&P places 612 securities backed by subprime residential mortgages on [negative credit watch](#), and Moody’s downgrades 399 mortgage-backed securities backed by subprime collateral.
- 2008** Bear Stearns collapses. In a rescue orchestrated by the Federal Reserve, JPMorgan Chase buys assets in a fire sale. ... Financial services firm Lehman Brothers goes bankrupt. ... Government takes over Fannie Mae and Freddie Mac; bails out AIG and banks. ... Financial panic spreads around the globe; markets crash. ... The Emergency Economic Stabilization Act creates the Troubled Asset Relief Program (TARP) to bail out more banks and eventually auto companies. ... Authorities arrest Bernard Madoff on charges of running a \$50 billion Ponzi scheme; he later pleads guilty and is sentenced to 150 years in prison for defrauding investors.
- 2009** President Obama signs the Helping Families Save Their Homes Act, aimed at assisting people in danger of losing their homes to creditors. ... The number of [failed banks reported](#) by the Federal Deposit Insurance Corp. surges more than fivefold in one year and nearly matches the number of total bank failures in 2001–08.
- 2010** The [delinquency rate on single-family residential mortgages](#) peaks at 11.27 percent.
- 2011** President Obama signs the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#). Its key aim: “to promote the financial stability of the United States.”
- 2012** Securities and Exchange Commission (SEC) settles civil suit with two Bear Stearns high yield fund managers, Ralph Cioffi and Matthew Tannin; they are fined and barred from working for several years in industries the SEC regulates.
- 2013** As regulators develop rules under Dodd-Frank, the House of Representatives votes repeatedly to amend or repeal the act. ... International banking authorities continue to roll out [Basel III](#), a set of rules governing asset allocation that banks must maintain to weather trouble.
- 2014** Conviction of former [Credit Suisse executive Kareem Serageldin](#) leads to the only prison sentence over actions related to mortgages during the financial crisis. ... [Judge dismisses a lawsuit](#) against banks over securities sold before the 2008 crisis.
- 2015** Civil settlements from financial crisis continue, with Standard & Poor’s and Morgan Stanley agreeing to billions of dollars in fines.

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Organizations

Bank for International Settlements

Centralbahnplatz 2, 4051 Basel, Switzerland
(+41 61) 280-8080

Switzerland-based organization that acts as a bank for central banks globally and a hub for financial information; supports the international banking standards procedure known as the Basel Process.

Better Markets

1825 K St., N.W., Suite 1080, Washington, DC 20006
202-618-6464

Group established in 2010 that lobbies for tighter oversight of capital and commodity markets.

Consumer Financial Protection Bureau

1700 G St., N.W., Washington, DC 20552
202-435-7000

www.consumerfinance.gov

Federal agency established by Dodd-Frank Act to oversee consumer financial products and services, including many mortgage originators.

Securities and Exchange Commission

100 F St., N.E., Washington, DC 20549
202-942-8088

www.sec.gov

Primary U.S. federal agency with oversight of financial markets; its Office of the Whistleblower (www.sec.gov/whistleblower) collects tips about possible securities laws violations.

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