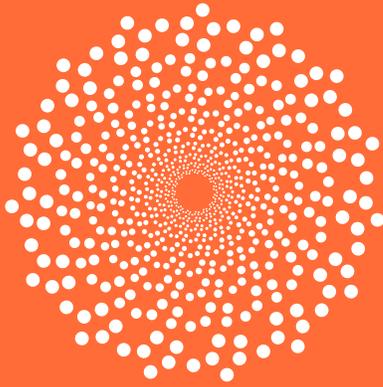




THE CRISIS NEXT TIME.

**Planning for Public
Ownership as an
Alternative to
Corporate Bank
Bailouts**

Thomas M. Hanna
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DEMOCRACY
COLLABORATIVE

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Executive Summary

The next financial crisis is all but inevitable. While its exact timing and severity cannot be predicted, both the accelerating frequency of crises in recent decades and the continued consolidation of the banking sector in an increasingly financialized economy suggest that we should be prepared for a crisis sooner rather than later.

In the Great Financial Crisis of 2007-2008, the US federal government intervened at an unprecedented scale to bailout our largest commercial banks after they became entangled in the mess of risky financial products built on top of an unsustainable housing bubble. The effect of these massive bailouts was, in the end, to preserve the status quo: the modest attempts made to regulate the financial sector to protect consumers and avert further devastating financial crises have largely been rolled back, and the banks that were then “too big to fail” are today even bigger.

Viewed in historical perspective, the ability of the financial sector to use its concentrated wealth to escape or subvert regulations by influencing the political process should come as no surprise; indeed, the sector’s long-term success in lobbying for “deregulation” created the conditions of the 2007-2008 crisis by gutting the safeguards put in place after the crash of 1929 and the

subsequent Great Depression. Similarly, as the disappointing recent track record of anti-monopoly enforcement has shown, attempts to dismantle powerfully consolidated industries are incredibly difficult and at best a temporary fix, with eventual reconsolidation likely to follow any successful attempts to “break them up.”

This working paper presents another way forward, grounded in long-term public ownership of financial institutions. While de-facto temporary nationalization was a key tool in the federal government’s bailout toolbox, at no point during the response to the Great Financial Crisis was the idea that the government should use public ownership for the long-term stability of the financial system and the public good seriously entertained by policymakers. Given the robust success of publicly owned banks both around the world and in the US itself, this was an incredibly misguided decision, one that testifies to the power the big banks have not only over our economy, but over our own imaginations.

During the next crisis, a robust policy response can and should convert failed banks to permanent public ownership, rather than merely using public money to make corporate America whole again, setting up the dominoes for yet another destructive crisis down the road. This working paper sketches the basic contours of legislation that would establish the legal pathways for such conversions, and explains how the resulting public financial system could be structured to meet the financial needs of ordinary Americans and their communities while incorporating innovative processes of decentralization and democratic participation.

As the clock ticks towards the next crisis, it is imperative to begin the conversation **now** about what is possible besides another round of Wall Street bailouts. Public ownership, for the long-term, is a credible path forward, and should by no means be left out of the conversation this time.



Introduction

Ten years ago, the United States' financial system collapsed in spectacular fashion; and took down with it many of the dogmas of the neoliberal era. The myth of the infallibility of free markets and the supposed superiority of the private sector crumbled as governments around the world were forced to step in with every policy tool at their disposal. A decade later, it is difficult to remember just how serious and existential the crisis was. There was genuine concern at the highest levels of government that this could herald the end of capitalism as we knew it. And in some ways, they were correct.

According to standard measures, the economy has largely recovered from the Great Financial Crisis. But we are still experiencing the larger political, economic, and social ramifications of the decisions that were made during the panicked months of late 2008 and early 2009, when a publicly funded rescue plan saved almost all of America's giant financial corporations and the "1 percent" while abandoning tens of millions of ordinary Americans to suffer foreclosure, bankruptcy, and unemployment. The response of policymakers on both sides of the aisle to the crisis demonstrated an inability and lack of will to fundamentally reshape the institutions and practices of the industry responsible for the crisis in the first place. The problems baked into the structure of this industry continue to haunt our political economic system. Financial crises in the



neoliberal era have typically recurred on average every ten years, and we are now due for another one.¹ Every blip or market correction has the more attentive observers of the banking system wondering: could this be the onset of the next financial crisis? Is this the trigger that will bring the increasingly consolidated, interconnected, and still highly leveraged financial system down yet again?

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This paper
argues that
it is time to
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next financial
crisis.
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This working paper builds from the almost universally accepted baseline among credible observers of the system that **there will be another financial crisis**. In agreement with a growing critical consensus, it contends that the weak regulatory reforms put in place after the last crisis (which have subsequently been weakened even further by concerted industry lobbying) will likely be insufficient to deal with the next major one—especially given the growing consolidation of financial firms, continued highly speculative (and in some cases, outright fraudulent) financial activities, and an expanding and highly risky shadow banking sector. It goes on to suggest, based on historical and contemporary experience, that the tremendous political-economic power of these financial institutions makes both strong regulatory and institutional reform strategies (such as “breaking up the banks”) improbable to say the least. Given these two intersecting realities, it appears likely that when the next crisis hits, the public will once again be called upon to step in and bailout Wall Street.

This paper argues that it is time to start seriously planning for an alternative response to this eventuality. More specifically, it contends that, in order to avoid the ill-conceived, ideologically constrained, and messy quasi-nationalizations of the last crisis—replete with backroom deals, devoid of transparency, and lacking democratic control and direction—a plan should be in



place for cleanly and transparently taking failing financial corporations into genuine public ownership. The successful experience of (and growing interest in) public banks around the world means that such public ownership doesn't need to be, and shouldn't be, just temporary. Even the public takeover of a just a few large financial institutions would have salutary effects for the sector as a whole, removing a powerful institutional impediment to real, genuine financial reform efforts, including breaking up those banks that remain too big to fail. A significant expansion of public ownership in the United States could also provide the tools and political-economic preconditions necessary to slow or reverse "financialization" and to begin a process of decentralizing the banking system to support healthy and prosperous local economies. There is an increasingly pressing need to start getting serious about a plan for the next financial crisis, one that can avoid the mistakes and missed opportunities of ten years ago. Public ownership can play a key role in such a plan.



The Crisis Last Time

As 2007 turned into 2008, the first signs of deep problems within the US financial system were beginning to emerge. In April 2007, one of the leading subprime mortgage lenders, New Century Financial Corporation, filed for bankruptcy. In August, American Home Mortgage Investment followed suit. Then Countrywide Financial was downgraded by ratings agencies, and—in an event many people credit with being the official start of the crisis to come—BNP Paribas announced it could not determine the value of three of its mutual funds and was thus suspending redemptions.² What very few people understood at the time was that this was just the tip of the iceberg: below the surface, the entire financial system was dangerously weak. Decades of deregulation, financialization, consolidation, and speculation had left the American financial system—and by virtue of its dominance, the world financial system—stressed and extremely vulnerable. When the housing bubble collapsed, the dominoes began to fall, exposing layers of interconnected and opaque financial instruments, including mortgage backed securities (MBS), tranches (slices) of those mortgage backed securities, credit default swaps, and collateralized debt obligations. Before long, the worst financial crisis since the 1929 Wall Street Crash was underway and the United States had plunged into what is now commonly referred to as the Great Recession. While the full cost of the crisis in terms of lost output is not yet known, experts have suggested it could be anywhere from \$6 trillion to as much as \$25 trillion or more.³



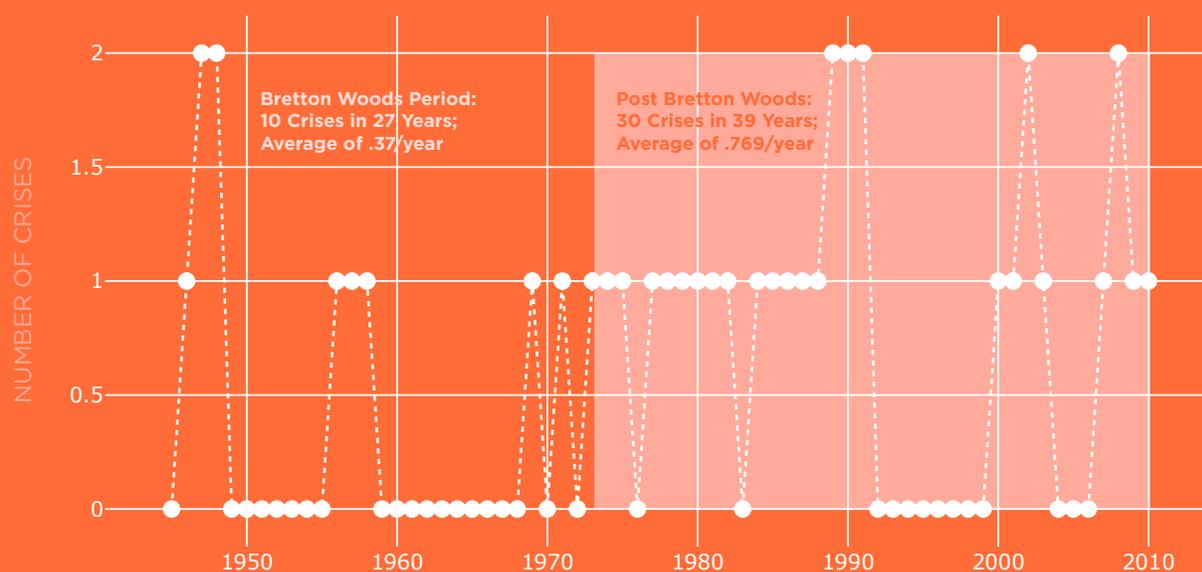
While a small handful of prescient observers saw the crisis coming, for many it was a total shock given the confidence exuded by mainstream economists and policymakers alike. In 2004, for instance, Ben Bernanke, then a member of the Board of Governors of the Federal Reserve System under Chairman Alan Greenspan, gave a detailed speech on what he, and others, had termed the “great moderation.” “One of the most striking features of the economic landscape over the past twenty years or so has been a substantial decline in macroeconomic volatility,” he told the assembled audience.⁴ Bernanke’s remarks were emblematic of a general sense of political and economic optimism that pervaded elite public discourse around the turn of the twenty-first century. Communism had been defeated, the business cycles had been tamed, and privatization and market liberalization were in the ascendant. Less than four years after Bernanke’s speech, this great moderation ended in spectacular fashion with the collapse of the financial system in what L. Randall Wray has called “the biggest scandal in human history.”⁵

In their 2009 best-selling book, Harvard economists Carmen Reinhart and Kenneth Rogoff termed this type of economic hubris “this-time-is-different syndrome.” Its essence is simple, they wrote:

It is rooted in the firmly held belief that financial crises are things that happen to other people in other countries at other times; crises do not happen to us, here and now. We are doing things better, we are smarter, we have learned from past mistakes. The old rules of valuation no longer apply. The current boom, unlike the many booms that preceded catastrophic collapses in the past (even in our country), is built on sound fundamentals, structural reforms, technological innovation, and good policy.⁶

Thus, we should be highly skeptical as to any claims that post-2008 financial regulation has forestalled a re-run of such a crisis. That there will be another financial crisis at some point is practically a certainty—all that is up for debate is when, where, and how severe it will be. Where we lack certainty is

FREQUENCY OF FINANCIAL CRISES



Source: Reinhart, Carmen M. and Kenneth S. Rogoff, "From Financial Crash to Debt Crisis," NBER Working Paper 15795, March 2010; Reinhart, Carmen M., "This Time is Different Chartbook: Country Histories on Debt, Default, and Financial Crises," NBER Working Paper 15815, March 2010

as to the proximate cause. "We need always be aware that the next crisis—and there will be one—will not be identical to the last one," Federal Reserve Vice Chairman Stanley Fischer warned in a 2014 speech.⁷

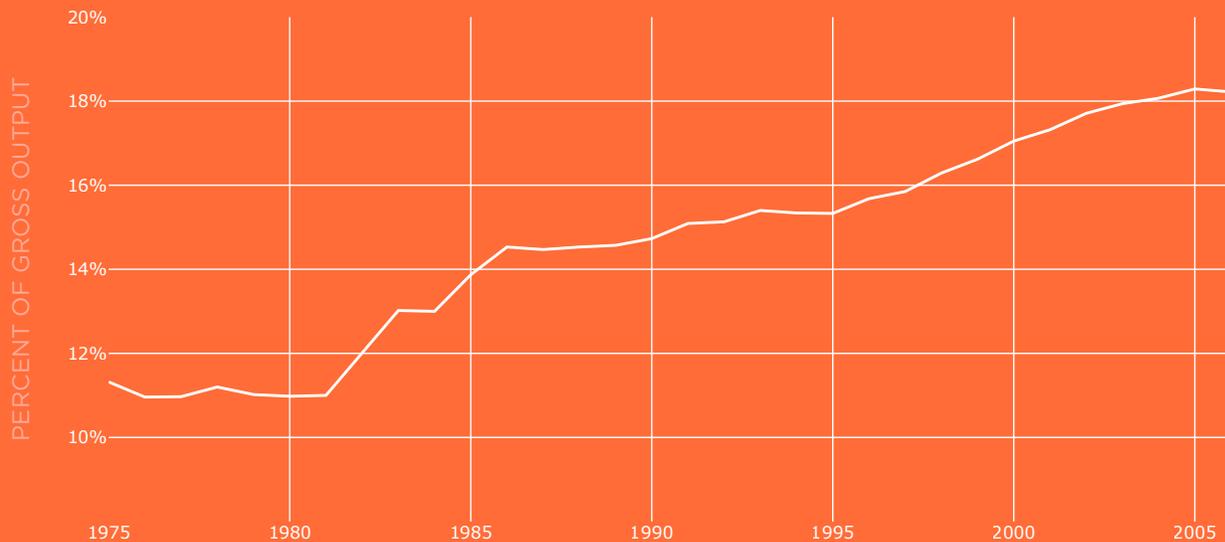
Even more alarmingly, it appears that, contrary to the great moderation theory, the occurrence of financial crises has been accelerating in the neoliberal era. An important 2001 paper by a number of economists from Rutgers, Berkeley, and the World Bank found that "since 1973 crisis frequency has been double that of the Bretton Woods and classical gold standard periods and is rivaled only by the crisis-ridden 1920s and 1930s. History thus confirms that there is something different and disturbing about our age."⁸ Similarly, in 1999, a decade before the 2008/09 crisis, Nobel Prize winning economist Joseph Stiglitz maintained that "over the last 20 years, financial crises have become more frequent and more costly."⁹ And in the 2011 edition of the classic work *Manias, Panics, and Crashes*, the late economic historian Charles Kindleberger and economist Robert Aliber wrote that "despite the lack of perfect comparability across different time periods, the conclusion is unmistakable that financial failure has been more extensive and pervasive in the last thirty years."¹⁰



This increase in systemic volatility is linked with sweeping structural changes in the financial sector and its relationship to the economy as a whole. From roughly 1870 to 1939, broad money (the most expansive definition of the country's total money supply) and credit (bank loans and assets) maintained a relatively stable relationship to each other, and to the overall size of the economy (as measured by GDP).¹¹ However, after the Second World War, money and credit began to rise rapidly and surpassed pre-1940 levels (in relationship to GDP) in the early 1970s. (And "credit itself then started to decouple from broad money and grew rapidly, via a combination of increased leverage and augmented funding via the nonmonetary liabilities of banks").¹² Between 1975 and 2006 the finance, insurance, and real estate (FIRE) sector expanded dramatically—increasing its share of gross output from 11.3 percent to 18.2 percent.¹³ At the same time, finance's share of corporate profits grew from 16.1 percent to 26.9 percent (after hitting a low of 12.1 percent in 1982 and a high of 37.4 percent in 2002).¹⁴ "These figures actually understate finance's true dominance, because many nonfinancial firms have important financial units," Harvard's Gautam Mukunda writes. "The assets of such units began to increase sharply in the early 1980s. By 2000 they were as large as or larger than nonfinancial corporations' tangible assets."¹⁵

"Many observers believe that this expansion of the financial sector comes at a high cost," writes University of South Carolina political scientist Christopher Witko. "Scholars and politicians alike point to the 'financialization' of the economy—and an increased reliance on the financial sector to create growth—as the root cause of many of our economic problems. The list includes income inequality, growing household debt, slow growth and the instability manifested in the 2008 global economic crisis."¹⁶ For instance, the International Monetary Fund has found that when a country's financial system grows too large, it slows growth and increases volatility. It also misallocates resources.¹⁷ In 1984, Nobel Prize winning economist James Tobin wrote that "we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods

FIRE SECTOR AS A PERCENTAGE OF GROSS OUTPUT, 1975-2006



Source: "Gross-Domestic-Product-(GDP)-by-Industry Data; Gross Output," Bureau of Economic Analysis, accessed April 10, 2018, https://www.bea.gov/industry/gdpbyind_data.htm

and services, into activities that generate high private rewards disproportionate to their social productivity.”¹⁸

Within the financial sector, the developing trend has been towards extreme concentration of institutional power. Between 1984 and 2003 more than 7,000 banks and thrift organizations simply disappeared as a result of mergers and acquisitions by larger bank holding companies—and the total assets controlled by the largest banks (those with over \$10 billion in assets) rose from 42 percent to 73 percent of all bank assets. Not surprisingly, the asset share of smaller community banks (under \$1 billion in assets) dropped concomitantly from 28 percent to 14 percent.¹⁹ By 2008 the total number of commercial banks had decreased by 51 percent since 1984—from 14,482 to 7,086; and over the same period, the “average size of U.S. banks increased five-fold in terms of inflation-adjusted total assets.”²⁰ By 2003, the top four banks (Bank of America, J.P. Morgan Chase, Wells Fargo, and Wachovia) held 25 percent of all U.S. deposits. In 1984, the equivalent share was spread across some 42 different banks.²¹ Even more revealing is that in the mid-1990s, the six largest banks held assets equal to roughly 17 percent of GDP;



by 2006, right before the financial crisis, the same handful of banks held assets equivalent to over half—55 percent—of GDP.²²

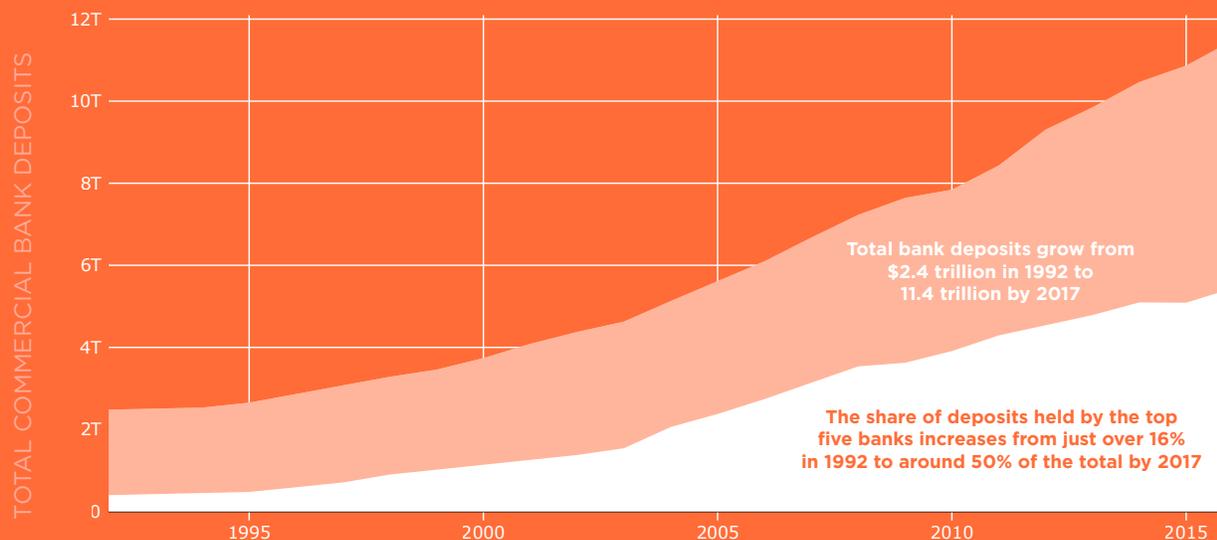
Many of these trends have deteriorated still further since the Great Financial Crisis. In 2017, for instance, the financial sector accounted for 27.1 percent of corporate profits (up 22 percent since 2007).²³ And in 2016, the top five largest banks had deposits equivalent to 28.7 percent of GDP (up from 24.3 percent in 2008).²⁴ “Of the 15 banks that received the most bailout money, 11 are now bigger than they were before the recession, even after adjusting for inflation...” Philip Bump reported in the *Washington Post* in early 2016.

“The recession was a blip on a steep upward climb.”²⁵ The financial institutions that were “too-big-to-fail” ten years ago are now even more so, according to many analyses. In April 2016, the *New York Times* reported that five of the nation’s largest banks “did not have ‘credible’ plans for how they would wind themselves down in a crisis without sowing panic,” suggesting that “if there were another crisis today, the government would need to prop up the largest banks if it wanted to avoid financial chaos.”²⁶ Around the same time, Neel Kashkari, President of the Federal Reserve Bank of Minneapolis, made headlines when he stated: “I continue to think that the largest banks in the country are too big to fail.”²⁷

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Repeated scandals and investigations during the past decade suggest that the financial sector has not yet adequately tackled the internal dynamics and incentives that led to the excessive risk taking, speculation, and fraud that was at the heart of the financial crisis. “The last decade has seen a steady stream of financial scandals and crises: mortgage frauds, insider trading, the illegal fixing of global interest rates, money laundering, and the rigging of the Treasury bond market. This is a partial list,” author

BANK DEPOSITS, TOTAL VS. TOP FIVE BANKS, 1992-2017



Total bank deposits from the end of the third quarter of each year: <https://fred.stlouisfed.org/series/DPSACBW0275-BOG> Deposits of the top 5 banks from December of each year: <http://www.usbanklocations.com/bank-rank/total-deposits.html?d=2017-12-31>

and former hedge fund analyst Sheelah Kolhatkar wrote in 2016. “There were lessons to be found in each of those cases, which revealed flaws and distortions in the financial system and weaknesses in the way that it is regulated and policed.”²⁸ Citigroup—which has a long history of fraud and abuse going back to the 1970s—is emblematic of the industry as a whole, though it is not, as Wells Fargo aptly demonstrates, by any means the only bad actor. Since 2008, Citigroup has paid billions of dollars to settle dozens of allegations and lawsuits (based on activities before, during, and after the crisis). This includes:

- **\$75 million** for misleading investors over its subprime loan exposure;
- **\$285 million** for defrauding investors in a housing market CDO (collateralized debt obligation);
- **a share (with four other banks) of \$25 billion** for loan and foreclosure abuse;
- **\$158 million** for fraudulently getting the U.S. Government to insure risky loans;



- **\$590 million** for deceiving investors about its exposure to sub-prime debt;
- **a share of \$8.5 billion** (with nine other banks) for foreclosure abuse;
- **\$730 million** for misleading institutional investors over the offering of Citi stocks and bonds;
- **\$968 million** to Fannie Mae for misrepresenting the home loans it sold the agency;
- **\$395 million** to repurchase loans it had sold to Freddie Mac (which were not eligible to be sold);
- **\$95 million** for its role in the LIBOR interest rate manipulation scandal;
- **\$97 million** for money laundering (by its Mexican affiliate Banamex);
- **\$1.13 billion** for misleading institutional investors over the sale of mortgage-backed securities;
- **\$7 billion** for packaging and selling toxic assets before the financial crisis;
- **\$668 million** for manipulating the foreign exchange market;
- **\$15 million** for failing to supervise communications between clients and stock analysts;
- **\$1.2 billion** for conspiring to rig foreign exchange rates;
- **\$700 million** for misleading customers into purchasing add-on credit card products;
- **\$175 million** for manipulating interest rate benchmarks (by three subsidiaries);
- **\$25 million** for illegal activity with regards to U.S. Treasury futures markets;
- **\$18.3 million** for overcharging investment advisory clients;

COMMERCIAL BANKS WITH ASSETS GREATER THAN \$15 BILLION (1984-2017)



Source: Average for the year. See: "Commercial Banks in the U.S. with Average Assets Greater than \$15 Billion," FRED Economic Data, February 15, 2018, accessed April 11, 2018, <https://fred.stlouisfed.org/series/USG15NUM>

- **\$28.8 million** for failing to inform borrowers about foreclosure relief options (by two Citigroup subsidiaries).²⁹

That the Great Financial Crisis barely interrupted this pattern of behavior is testimony to the failure to enact meaningful regulation in its aftermath. The Dodd-Frank Act, passed in 2010, was initially hailed as a landmark piece of legislation that would reimpose government regulation and oversight of the financial sector after decades of deregulation. However, Dodd-Frank has proven to be extremely vulnerable to industry pressure and is almost certainly insufficient to prevent the next crisis. Indeed, expert after expert went on record **after passage** of the Dodd-Frank legislation predicting that it was only a matter of time before the next crisis occurred. In 2012, Mark Mobius, Chairman of Templeton Asset Management, stated that "there is definitely going to be another financial crisis around the corner because we haven't solved any of the things that caused the previous crisis...Are the derivatives regulated? No. Are you still getting growth in derivatives? Yes...Are the banks bigger than they were before? They're bigger. Too big to fail."³⁰ Similarly, in 2012, Richard Kovacevich, the former CEO of Wells Fargo, commented that

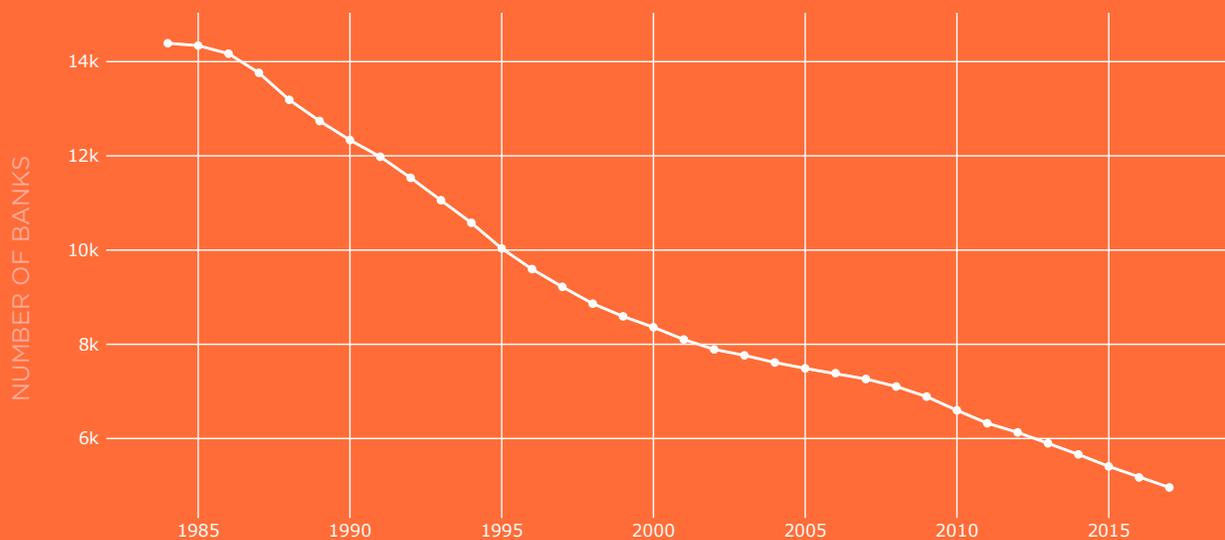


“there’s nothing in Dodd-Frank that would have prevented the last financial crisis, nor will it prevent the next crisis.”³¹ More recently, Neel Kashkari has stated that “over the past six years, my colleagues across the Federal Reserve System have worked diligently under the reform framework Congress established and are fully utilizing the available tools under the [Dodd-Frank] Act to address [too-big-to-fail (TBTF)]. While significant progress has been made to strengthen the U.S. financial system, I believe the biggest banks are still TBTF and continue to pose a significant, ongoing risk to our economy.”³²

Moreover, the legislation itself, and the regulators tasked with writing the rules it authorizes, have been under serious pressure from the financial sector, their lobbyists, and allied politicians ever since it was signed into law. Discussing the successful passage in Congress of two industry supported measures to weaken Dodd-Frank in 2015, the *New York Times* reported that “the continuing assault on the 2010 Dodd-Frank law has achieved remarkable success...”³³ Similarly, in a 2015 *Reuters* investigation entitled “How Wall Street Captured Washington’s Effort to Rein in Banks,” Charles Levinson found that “intense lobbying of regulators, many of them veterans of the industry themselves, helped ensure that practices the Dodd-Frank law was meant to stop would remain in place.”³⁴

That investigation also showed that as a result of such lobbying efforts, the financial sector has managed to protect “private markets” and “off-balance-sheet vehicles” from government scrutiny and oversight. “What’s playing out is exactly what we were worried about,” underscored Sheila Bair, former Chairwoman of the Federal Deposit Insurance Corporation (FDIC). “Most everything is going into these private markets where regulations require little visibility of what’s happening ... I still think there is significantly more risk there than is being reflected on banks’ balance sheets.”³⁵ This risky activity is part of what is now commonly referred to as the “shadow banking system.” According to Federal Reserve Bank of New York researchers Tobias Adrian and Adam Ashcraft:

NUMBER OF COMMERCIAL BANKS IN THE U.S. 1984-2017



Average for the year. See: "Commercial Banks in the U.S." FRED Economic Data, February 15, 2018, accessed April 11, 2018, <https://fred.stlouisfed.org/series/USNUM>

The shadow banking system consists of a web of specialized financial institutions that conduct credit, maturity, and liquidity transformation without direct, explicit access to public backstops. The lack of such access to sources of government liquidity and credit backstops makes shadow banks inherently fragile. Much of shadow banking activities is intertwined with the operations of core regulated institutions such as bank holding companies and insurance companies, thus creating a source of systemic risk for the financial system at large.³⁶

While estimates vary greatly on the size of the shadow banking sector in the United States, at a minimum it accounted for around \$13.8 trillion in assets in 2015—or around 75 percent of the country's total GDP.³⁷ The sheer size of the sector, combined with its complexity and lack of transparency and oversight, raises the prospect of substantial contagion and damage to the rest of the economy when another crisis occurs. "Risks are building in the sector, but they are hard to identify and measure because the shadow banking system is opaque by nature, if not by design..." former Comptroller of the Currency Eugene Ludwig writes. "These companies are inextricably linked with regulated financial institutions because they perform similar functions



and are interconnected—mostly systemically as counterparties in securities and funding markets. A collapse in the shadow banking sector cannot be contained to the shadow banking sector.”³⁸

With ever larger and more complex financial institutions, and no indications that the industry’s behaviors, outlook, or incentive structures have been fundamentally altered by the experience of 2008, when the next big crisis arrives it may well be even more difficult to contain and rectify than the last.

As we will see, a review of the various reform proposals suggested or implemented over the past ten years suggests that the unchecked political-economic power of the large financial institutions has essentially overwhelmed attempts to regulate or constrain the sector. By blocking any serious changes in the industry, these powerful institutions have made it impossible for public authorities to limit the risk of another financial crisis, or effectively mitigate the potential damage such a crisis might inflict.

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Ten Years Of Reform Proposals

By the fall of 2008, the financial system was unraveling and the country was spiraling into a deep recession. With major institutions like Lehman Brothers and AIG collapsing like dominoes and credit throughout the economy frozen, it appeared to many that capitalism itself was on the brink. “The End of American Capitalism?” queried an October *Washington Post* headline, echoing concerns being felt alike by policy makers, economists, and the general public.³⁹ In the end, American capitalism survived—thanks only to the decisive intervention of the government in the form of nationalizations, bailouts, toxic asset purchases, and trillions of dollars in new money creation. As would be expected, an event of this magnitude prompted proposals for change. These can be grouped very roughly into two buckets—regulatory strategies and institutional reform approaches (for want of a better term).

As public anger with the bailouts threatened to boil over into a major assault on the exorbitant privileges of the banking sector, many policy-makers, economists, and even some in the financial industry realized that **some** reforms were going to have to be implemented—not only to create a safer financial system but also to quiet the growing calls for still more radical restructuring. In June 2009, President Obama’s Treasury Secretary Timothy Geithner and Director of the National Economic Council Larry Summers laid out the administration’s



plan for enhanced regulation of the financial system. “The goal is to create a more stable regulatory regime that is flexible and effective; that is able to secure the benefits of financial innovation while guarding the system against its own excess,” they wrote.⁴⁰ The plan included raising capital and liquidity requirements for financial institutions; improving oversight of the shadow banking system—including the traders of asset backed securities and derivative contracts; establishing consumer protection standards for a variety of financial products; establishing a process by which there could be an orderly resolution of failing companies that posed a systemic risk; and working with international partners to improve standards around the world.

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Nearly 30 percent of the 390 regulatory rules required under Dodd-Frank still have not been finalized seven years after the bill’s passage.
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This plan became the basis of the aforementioned Dodd-Frank Wall Street Reform and Consumer Protection Act that passed the House and Senate before being signed into law by President Obama in July 2010. As previously noted, the regulatory reforms that make up the heart of Dodd-Frank were considered by many experts at the time to be insufficient and unlikely to prevent another crisis. Moreover, in the seven years since its passage even those reforms that made it into the final legislation have been systematically stalled, blocked, and dismantled. Nearly 30 percent of the 390 regulatory rules required under Dodd-Frank still have not been finalized seven years after the bill’s passage.⁴¹

“This wasn’t a willful failure on their part,” former Representative Barney Frank says. “They were slowed down by knowing they were going to be sued, and the courts that were going to hear it were unfavorable.”⁴² In addition to slowing down the rule-making process, financial institutions and their political allies have worked tirelessly to repeal regulations that have been finalized. In 2014, for instance, Congress repealed the regulation requiring banks to trade certain risky derivatives contracts in separate affiliates with higher capital requirements and no government protection (the so-



called “pushout” rule).⁴³ The repeal was included in a spending bill required to keep the government operating (causing outrage among Congressional Democrats) and was written almost entirely by Citigroup, the bank that received one of the largest shares of government bailout funds during the crisis.⁴⁴

With the 2016 election of Donald Trump to the presidency, Republicans in Congress have stepped up their repeal efforts. “We expect to be cutting a lot out of Dodd-Frank,” President Trump stated in early 2017. Later that year, in June, the House of Representatives passed the “Financial Choice Act” which would gut some of the key provisions of Dodd-Frank—including the Volcker Rule (which prohibits banks from using customer deposits for risky or speculative securities trading) and the Consumer Financial Protection Bureau (CFPB).⁴⁵ And in March 2018, 16 Senate Democrats voted with Republicans to advance legislation that would significantly weaken Dodd-Frank by easing capital and liquidity requirements and exempting many small and medium-sized banks.⁴⁶ Moreover, in late 2017 President Trump appointed one of the CFPB’s harshest critics, Mick Mulvaney, as interim head of the agency.⁴⁷ In his first report to Congress, the former Congressman (who when in office had introduced legislation to kill the agency) recommended four changes that would dramatically weaken the CFPB.⁴⁸

Former IMF chief economist Simon Johnson has recently commented that the reforms enacted after the financial crisis “were serious; but they did not go far enough, and they can be rolled back without much difficulty. The Trump administration is poised to do exactly that. The big banks will get bigger. Capital levels will fall. And reasonable risk-management practices will again become unfashionable. Powerful people do well from booms and busts. The rest of us can expect deeper inequality and more crisis-induced poverty.”⁴⁹

Dodd-Frank, by many accounts a tepid response to the worst financial crisis in eight decades, is often unfavorably compared to the seemingly strong regulatory reforms instituted in the aftermath of the 1929 Wall Street Crash



and Great Depression, especially the so-called Glass-Steagall Act (otherwise known as the Banking Act of 1933) which separated investment and commercial banking and created the FDIC. The slow demise of Glass-Steagall over the course of the latter half of the twentieth century is worth reviewing briefly because it clearly illustrates the long-term limits of a regulatory approach to financial reform in the contemporary American political-economic system. These selfsame limits are becoming apparent, in accelerated form, in the recent trajectory of Dodd-Frank.

Although the Glass-Steagall Act had been strengthened during the post-war boom era, by 1970 new legislation backed by key groups in the financial industry began to eat away at traditional protections. One of the first changes redefined banks as those that offered demand deposits and commercial loans, thus opening a loophole in Glass-Steagall's prohibition against speculative investment. Soon insurance companies, securities firms, and other investment groups began to acquire banks and then cease either their commercial lending or acceptance of demand deposits in order to avoid restrictions.⁵⁰

By 1987, the Federal Reserve Board had agreed to a "re-interpretation" of key sections of the law, ruling that it would now allow a commercial bank to generate up to five percent of its gross revenues from investment banking. In 1989, the limit on how much revenue could be generated from such activities was raised to ten percent.⁵¹ This was followed, in 1994, by the Riegle-Neal Interstate Banking and Branching Efficiency Act, which further relaxed obstacles to bank consolidation and interstate banking.⁵² In 1997, the Federal Reserve Board essentially gutted the Act by reinterpreting Glass-Steagall's limit on bank activities to now allow bank holding companies to own investment bank affiliates with up to 25 percent of their business in securities.⁵³ Finally, in 1999 the Clinton administration and the Republican Congress repealed Glass-Steagall with passage of the Financial Services Modernization Act (Gramm-Leach-Bliley Act), officially allowing traditional banks to engage in more risky investments.⁵⁴



In the case of both Glass-Steagall and Dodd-Frank, the political-economic power of large financial institutions eventually overwhelmed the capacity of the government to enforce and maintain the regulatory and legislative infrastructure aimed at constraining these institutions. The relentless lobbying, generous campaign contributions, seamless revolving door between government and industry, numerous back room relationships, and overall regulatory capture at play in this interconnected and overlapping process has been extensively documented.

Lobbying: In 2016 and 2017, the FIRE sector ranked second overall in lobbying, behind only the health sector, spending over a billion dollars.⁵⁵ The *New York Times* reported in 2015 that “the current efforts to undermine Dodd-Frank have been textbook lobbying,” and that “proponents of regulation say they are badly outgunned by an army of Wall Street lobbyists.”⁵⁶ In 2012, this amounted to a roughly twenty to one advantage in the number of lobbyists the top five financial sector firms paid to undermine Dodd-Frank compared to those paid by the top five groups defending the law.⁵⁷

Campaign contributions: Financial sector campaign contributions have also paid dividends in the form of big bank friendly legislation. For instance, the Financial Choice Act was introduced by Representative Jeb Hensarling (R-Tex.), Chairman of the House Financial Services Committee and a long-time recipient of substantial support from the financial sector. Hensarling and three of the bill’s co-sponsors are members of the so-called “Banking Caucus,” named for their connections to and campaign contributions from the financial sector.⁵⁸ In total, the four lawmakers have raised almost \$10 million in contributions from the FIRE sector.⁵⁹ “I will not rest until Dodd-Frank is ripped out by its roots and tossed on the trash heap of history,” Hensarling vowed in 2016.⁶⁰

The revolving door: The ties between the financial sector and government are considerably deeper than just lobbying and campaign contributions.



They include the regular transition of personnel between financial institutions and government agencies (including regulatory bodies). Commenting on what has been described as the first empirical study of the deep web of professional interrelationships across the public and private sectors in the industry, the *Financial Times*' Financial Regulation Correspondent Caroline Binham writes "a 'revolving door' between US regulators and banks emphatically exists, according to new statistics published by the Federal Reserve Bank of New York."⁶¹ Economists Elise Brezis and Joël Cariolle note that "the 'revolving door' is a practice quite widely in use in the United States" and that "the revolving door became so widespread in the financial sector that it has been pointed out by the OECD (2009) and NGO's (Transparency International-UK 2011) as a major cause of the 2008 financial crisis."⁶² In recent years, the revolving door between giant financial firm Goldman Sachs and the highest rungs of the federal government has led many to dub the latter "Government Sachs." Thus far, President Trump has brought in, attempting to bring in, and in some cases subsequently let go, several ex-Goldman Sachs employees, including: James Donovan (Deputy Treasury Secretary), Steve Mnuchin (Treasury Secretary), Steve Bannon (Chief Strategist), Anthony Scaramucci (Communications Director), Dina Powell (Deputy National Security Advisor), and Gary Cohn (Director of the National Economic Council). His predecessor, President Obama, also enrolled Gary Gensler (Chairman of the Commodity Futures Trading Commission), Robert Hormats (Under Secretary of State), Diana Farrell (Deputy Director of the National Economic Council), and former Goldman attorney Tom Donilon (Deputy National Security Advisor) from the company.⁶³

Back-room dealing: There are also many other relationships, both formal and informal, between government officials, lobbyists, and the financial sector. In *All the President's Bankers*, Nomi Prins writes that "the political and financial alliances between bankers and presidents and their cabinets defined, and continue to define, the policies and laws that drive the economy."⁶⁴ And in his tell-all book, Jeff Connaughton, a former Clinton Administration official, lobbyist, and then chief of staff to Delaware Senator Ted Kaufman, writes that



“the Blob (it’s really called that) refers to the government entities that regulate the finance industry—like the banking committee, Treasury Department and S.E.C.—and the army of Wall Street representatives and lobbyists that continuously surrounds and permeates them. The Blob moves together. Its members are in constant contact by e-mail and phone. They dine, drink and take vacations together. Not surprisingly, they frequently intermarry.”⁶⁵

Regulatory capture: Last but not least is the problem of regulatory capture. Work on this subject by conservative economist George Stigler earned him a Nobel Prize in 1982.⁶⁶ “As a rule,” Stigler wrote in 1971, “regulation is acquired by the industry and is designed and operated primarily for its benefit.”⁶⁷ Similarly, Richard Posner, an economist and judge associated with the Chicago School, wrote in 1969 that “because regulatory commissions are of necessity intimately involved in the affairs of a particular industry, the regulators and their staffs are exposed to strong interest-group pressures.”⁶⁸ In 2006, right before the financial crisis, an IMF working paper found that “bank regulation may be especially susceptible to capture, and there is some evidence that capture has significantly influenced regulatory and supervisory decisions affecting banks and other financial institutions.”⁶⁹ Regulatory capture takes many different forms. For instance, former FDIC Chair Sheila Bair has stated: “The capture, a lot of people say, is bipartisan. And when I say capture, I’m talking about cognitive capture. It’s not so much about corruption. It’s just listening too much to large financial institutions and the people who represent them and not enough to the people out on Main Street who want this fixed.”⁷⁰ While the details, vagaries, and effects of regulatory capture are hotly debated among academics, the underlying reality—that the financial sector has, through various means, exercised undue influence over the regulatory regime that is supposed to be responsible for overseeing it—is almost impossible to deny.

Neither the specific fates of Glass-Steagall and Dodd-Frank, nor the well-documented weaknesses with the regulatory approach in general, have



prevented various proposals over the past decade to institute or re-institute a stronger regulatory regime. Beginning in 2013, for instance, Senator Elizabeth Warren (D-Mass.) and co-sponsors including Senator John McCain (R-Ariz.) have repeatedly introduced the “21st Century Glass-Steagall Act.” The Act would re-establish the division between commercial and investment banks and prohibit federally insured depository institutions from trading in products such as derivatives.⁷¹ Writing in support of the legislation, former Reagan Administration Assistant Treasury Secretary and *Wall Street Journal*

Associate Editor Paul Craig Roberts contends that “it makes perfect sense to separate commercial from investment banking.

The taxpayer insured deposits of commercial banking should not serve as backing for investment banking’s creation of risky financial instruments, such as sub-prime and other derivatives ... If we don’t re-enact Glass-Steagall, the risks taken by financial greed will complete the economic destruction of America.”⁷²

While this view is not universally shared, especially among Wall Street’s allies in Congress, in 2016 both the Democratic and Republican parties included re-introduction of Glass-Steagall in their party platforms, and various senior officials in the Trump Administration have signaled their support.⁷³ Of course, the tribulations of

Dodd-Frank have demonstrated that the financial sector wields as much political clout as ever, and there is no reason to believe that even if passed, new Glass-Steagall legislation wouldn’t eventually suffer a similar fate. Absent far-reaching systemic change, the regulatory approach to financial sector reform is extremely limited in what it can accomplish.

One of the anticipated consequences of new Glass-Steagall legislation would be to shrink the size of financial institutions (by requiring them to either divest or spin off their investment banking business or, vice versa, their commercial banking business), thus lessening the likelihood that a

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government bailout would be necessary during the next financial crisis. In this, it shares a common goal with the second category of reform proposals—those advocating institutional reform of the industry, or known more colloquially as the break-them-up approach. Over the past ten years, Simon Johnson, for one, has been an unwavering advocate of this strategy. In early 2010, prior to the passage of Dodd-Frank, Johnson wrote in support of the SAFE Banking Act introduced by Senator Sherrod Brown (D-Ohio) and Ted Kaufman (D-Del.) stating that “in the American political system—where the power of major banks is now so manifest—there is no way to significantly reduce the risks posed by these banks unless they are broken up.”⁷⁴ Converted into an amendment, the SAFE Banking Act received the support of 33 Senators but ultimately failed to make it into the Dodd-Frank law.⁷⁵ Reflecting on this two years later, Johnson lamented that “big banks and the Treasury Department both opposed it, and parliamentary maneuvers ensured there was little real debate.”⁷⁶ However, “the issue has not gone away,” he argued. “And while the financial sector has pushed back with some success against various components of the Dodd-Frank reform legislation, the idea of breaking up very large banks has gained momentum.”⁷⁷

That momentum continued into the 2016 Presidential election when insurgent Democratic candidate Bernie Sanders made breaking up the banks a centerpiece of his platform. “We must break up too-big-to-fail financial institutions...” Sanders’ policy proclaimed. “These institutions have acquired too much economic and political power, endangering our economy and our political process.”⁷⁸ Even the Trump Administration has dabbled with the idea of breaking up large banks—although statements to this effect have yet to be followed with any action whatsoever.⁷⁹

However, as Simon Johnson pointed out with regards to the failure of the SAFE Banking Act, the likelihood that such legislation will be enacted is slim given the political power of the finance sector. When discussing Sanders’ plan, the *New York Times* noted that if the legislative route is foreclosed,



either the Treasury Secretary or the Fed may be able to break up the banks using existing authority, but this was “shaky ground” and any such approach would face “serious legal challenges from the financial industry.”⁸⁰ Moreover, of course, such an approach would require a presidential administration unafraid of a major showdown with the powerful financial sector. Bernie Sanders is, perhaps, the only viable presidential candidate in living memory who might have taken this approach—and he was defeated in a bitter and acrimonious Democratic primary which saw individuals and firms associated with finance line up in favor of his opponent, Wall Street favorite Hillary Clinton.⁸¹

An additional challenge with the “break-them-up” approach is the likelihood of eventual re-concentration. Even before the crisis the banking industry was experiencing rapid consolidation. Two main causes for this consolidation are often articulated. The first is deregulation, and specifically the breakdown of inter-state banking restrictions. The second is real or perceived economies of scale—especially as finance has increasingly taken on a global orientation.⁸² In 1998, former Federal Reserve senior economist Steven Piloff and former Philadelphia Federal Reserve president Anthony Santomero wrote that “to a large extent, [bank] consolidation is based on a belief that gains can accrue through expense reduction, increased market power, reduced earnings volatility, and scale and scope economies.”⁸³ There is considerable debate as to the extent to which economies of scale can be used to justify the existence or large, too big to fail financial institutions. On the one hand, for instance, reporting by the *American Banker* in 2013 pointed out that despite exponential growth in bank size, overhead to asset ratios have only fallen slightly or not at all. “So where are the promised cost economies of scale?” the magazine asks.⁸⁴ On the other hand, in 2010 Loretta Mester of the Federal Reserve Bank of Philadelphia and the University of Pennsylvania wrote that “a growing body of research supports the view that there are significant scale economies in banking.”⁸⁵ Based on this research, Mester argued against breaking up large banks.



The point at which economies of scale actually turn into diseconomies of scale may be theoretically important—but is still somewhat irrelevant. As Mester implies, if the market **believes** there are continuing economies of scale, there will be pressure to expand and consolidate. And, given that even in our incredibly consolidated banking sector mergers and acquisitions are still common and the big financial institutions still continue to grow, there is no indication that the market believes that the big financial institutions have reached their limit. Thus, if these institutions were broken up, they would immediately face market pressure to re-group—and would deploy their political power against any regulatory obstacles to that reconsolidation. This can be seen clearly from the earlier, more assertive period of antitrust enforcement. As my Democracy Collaborative colleague Gar Alperovitz documents in *What Then Must We Do?*, in both of the most famous antitrust cases—Standard Oil in 1911 and AT&T in 1982—the companies that were originally broken up eventually regrouped through mergers and acquisitions.⁸⁶

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The historical trajectory of antitrust enforcement is important to consider when analyzing the prospects for breaking up the banks. Even though motivations behind and interpretations of early antitrust law were more expansive, since the 1970s there has been a fundamental reinterpretation of antitrust by the courts and a large decline in successful antitrust prosecutions by the Justice Department. In fact, the last major corporation to be physically broken up as a result of an antitrust case was AT&T in 1982.⁸⁷ Richard Posner, himself a driving force behind these changes, claims that “antitrust has to a great extent been normalized, domesticated. Its political, its ideological, character has receded in tandem with growing agreement on its premises.”⁸⁸ Critics of the recent direction, however, have a different interpretation. American University law professor Herman Schwartz maintains that “the antitrust statutes still



exist, their words virtually unchanged, but their contents have been radically hollowed out and the intent of those who enacted them has been explicitly dismissed.”⁸⁹ “By the 1970s and 1980s,” Harvard political philosopher Michael Sandel writes in *Democracy’s Discontent*, “the ‘antitrust dream’ of a decentralized economy sustaining self-governing communities had given way to the more mundane mission of maximizing consumer welfare.”⁹⁰

The past ten years have shown what happens when you leave the basic structure of the financial sector essentially intact. When powerful for-profit firms operate in an intensely lucrative semi-regulated market overseen by a political system that is highly susceptible to industry pressure, both strong regulatory and institutional reform approaches face a massive, uphill battle. Even when new policy is, with great difficulty, enacted, the sector’s underlying incentives to grow and consolidate, deregulate and capture, and speculate and defraud all but guarantee the eventual unwinding of any hard-won reforms over time. With Glass-Steagall the initial law was relatively strong, and this dismantling process took decades; with Dodd-Frank, the initial law was weaker, and has been gutted that much faster and more effectively. This is testament to, among other things, the degree to which the political-economic power of the financial sector has grown over the past sixty years.

How might America’s over-mighty and crisis-prone financial sector be fundamentally restructured and reimagined in the public interest? Based on real-world experience, outright public ownership is the most immediately viable—and perhaps even the only—effective option.



Restructuring The Financial Sector

Crucially, there are alternatives that would actually alter the underlying structure of America’s financial sector, reducing both the risk of devastating crises and the ill effects of financialization. Some of the early conservative economists associated with the Chicago School had an idea. H.C. Simons, one of Milton Friedman’s teachers, for one, argued that large banks (which at that time were miniscule by today’s standards) with implicit government guarantees against failure implied “an intolerable concentration of power in private hands,” and that “a good case could be made for outright socialization of the banking system.”⁹¹ Socialization, i.e. nationalization, has been one of the default political responses to financial crises around the world for decades, albeit in varying forms and for differing periods of time. In the early 1990s, for instance, Scandinavia experienced a banking crisis resulting from, among other factors, the financial liberalization and deregulation of the 1980s.⁹² In Finland, the government responded by taking over the savings bank group. In Sweden two banks were nationalized by the center right government. And in Norway, the country’s three largest banks were nationalized.⁹³ In 1982, the entire Mexican banking system was nationalized following a debt crisis.⁹⁴ And in 1983, after fraud had collapsed the share price of most major banks, the Israeli government stepped in and took over four or the country’s five largest banks.⁹⁵



Similarly, the Great Financial Crisis that started in 2007-2008 unleashed perhaps the most expansive wave of bank nationalizations in modern history. Among others, Belgium nationalized its largest bank, Dexia Belgium;⁹⁶ Iceland took over all of its major commercial, investment, and savings banks (Kaupthing, Landsbanki, Glitnir, Straumur-Burdaras, SPRON, and Icebank);⁹⁷ Ireland nationalized the Anglo Irish Bank;⁹⁸ Latvia took over Parex Bank;⁹⁹ The Netherlands nationalized portions of the banking and insurance company Fortis (specifically ABN AMRO and ASR) as well as the banking and insurance company SNS REEAL;¹⁰⁰ Portugal nationalized Banco Português de Negócios;¹⁰¹ and the U.K. nationalized Northern Rock, Bradford and Bingley, and the Royal Bank of Scotland, and took a 40 percent share of HBOS-Lloyds TSB.¹⁰²

With the after-effects of the last crisis still being felt, and another crisis possibly just around the corner, more nationalizations may be on the horizon. Commenting on the growing problems in the Italian banking sector in January 2017, John Browne, Senior Economic Consultant to Euro Pacific Capital, stated that:

In aggregate, the problem facing certain European banks is so enormous that even bail-ins could prove politically untenable. A temporary stopgap could be an interim nationalization of Italian and perhaps other European banks. It might dawn gradually on politicians, bankers and even investors as a means of averting a financial and monetary meltdown and thereby help to secure unity within the EU. Furthermore, nationalization would save the banks and their depositors while, at the same time, allowing for much needed banking reforms and a return to more prudent lending practices. The recent rise in Italian bank share prices may indicate this view is gaining credence.¹⁰³

The United States was no exception to this widespread pattern of public intervention to rescue the financial sector. In early September 2008, before the collapse of Lehman Brothers, the administration of George W. Bush ef-



fectively nationalized the giant mortgage companies Freddie Mac and Fannie Mae. Freddie and Fannie, as they are colloquially known, were quasi-public entities known as government sponsored enterprises created to purchase and securitize mortgages (thus allowing banks and other lenders to offer better terms to customers). They were privately organized and listed on the stock market (Fannie Mae starting in 1968 and Freddie Mac starting in 1989).¹⁰⁴ By 2008, they owned or guaranteed around 40 percent of all mortgages in the United States and were heavily exposed to the collapse of the real estate bubble.¹⁰⁵ As the crisis began to unfold, both were on the verge of collapse, and the government stepped in. However, for various reasons, the government chose an unusual (and legally questionable) method to take control of these companies. It received a warrant to purchase 80 percent of their common stock and put the companies into conservatorship (giving the government control). Despite not exercising the warrant, the government has been taking any profits generated by the company ever since to payback their initial bailout.¹⁰⁶ “The reasons were political,” Steven Davidoff Solomon explains. “The government did not want to look as if it owned these two entities, and nationalizing Fannie and Freddie would also have added trillions of dollars in debt to the government’s balance sheet, blowing up the national debt ceiling.”¹⁰⁷ However, most observers, including the Congressional Budget Office, acknowledge that the government is “the effective owner” of both companies.¹⁰⁸ This strange, illogical, and ideologically driven reluctance to conduct what should have been a transparent and straightforward nationalization was a recurring theme during the government’s response to the financial crisis, and one that will be reviewed in more detail below.

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Over the next several months, the government took a 77.9 percent share of insurance giant AIG, a 36 percent stake in Citigroup, one of Wall Street’s larg-



est financial institutions, and a 73.8 percent ownership interest in GMAC (the former financing affiliate of General Motors).¹⁰⁹ And, lest it be forgotten, the Great Financial Crisis wasn't the first time in modern American history that the government nationalized a failing financial company. In 1984, President Ronald Reagan seized 80 percent of the shares in the failing Continental Illinois National Bank and Trust.¹¹⁰ In fact, the government essentially nationalizes failing banks every year through the operations of the FDIC. When a bank is in imminent danger of failure, the FDIC is informed and initiates the resolution process. In most cases this involves selling the assets (along with some of the liabilities) of the failed bank to a healthy bank—a so-called purchase and assumption agreement. However, in order to facilitate this transaction, the FDIC reviews all of the bank's financial information, develops a marketing plan, solicits bids from other companies, approves a buyer and, crucially, acts as the failed bank's receiver in order to transfer various assets and liabilities to the new buyer.¹¹¹ Since 2000, the FDIC lists 555 banks that have gone through this process, and a version of the model is at the heart of the Dodd-Frank strategy to deal with too-big-to fail financial institutions in the future.¹¹²

All this said, the reaction of the United States government to the Great Financial Crisis was relatively unique (both historically and as compared to other countries) in a number of ways. First, the government provided large amounts of capital to banks without demanding much in return (leading it to be termed a “bailout” by almost every media outlet, commentator, and expert). For instance, through the Capital Purchase Program (CPP)—part of the Troubled Asset Relief Program (TARP)—707 banks received capital injections. In return, the government (through the Treasury Department) received preferred securities (a hybrid of stocks and bonds that confer an ownership share, but often have no voting rights) with a dividend rate of five percent for five years and nine percent after five years, as well as warrants to buy common stock equal to just 15 percent of the value of the government's investment.¹¹³



Outside of unusual circumstances, the preferred securities were non-voting, the government could not appoint directors unless an institution missed six dividend payments (and then only two), and half the warrants were redeemable before December 31, 2009. In the AIG case, the government's 77.9 percent ownership stake came in the form of preferred securities (convertible to common stock) that were placed into an irrevocable trust (with the Treasury Department as beneficiary) administered by three trustees recruited from private sector finance appointed by the Federal Reserve.

"The trust instrument provided the trustees with complete power to vote and dispose of the government's shares," Davidoff Solomon reveals. Thus "the government effectively ceded control over both its ownership interest and AIG by placing its shares into this trust."¹¹⁴

This approach has confounded many experts. At the time, Bo Lundgren, the former Swedish Minister of Fiscal and Financial Affairs who had engineered his own government's response to the 1990s crisis in that country, stated "for me, that is a problem. If you go in with capital, you should have full voting rights."¹¹⁵ Moreover, in each of the two cases where the government did retain voting rights—Citigroup and GMAC—peculiarities abounded. In the case of Citigroup, the government contractually limited its ownership rights, agreeing to "vote its shares in proportion to all other shares cast except for certain designated matters."¹¹⁶ One of these was the election or removal of directors, but even here the government never exercised its rights by nominating or demanding the removal of a director. With GMAC, the government was entitled to appoint six of the company's 11 directors, however as Davidoff Solomon explains, "the true control rights the government asserted over GMAC are unknown and the Congressional Oversight Panel (COP) has been particularly critical of the Treasury Department's management of this investment."¹¹⁷

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This strange, illogical, and ideologically driven reluctance to conduct what should have been a transparent and straightforward nationalization was a recurring theme.
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By going to such extreme lengths to avoid any straightforward nationalization, the U.S. government response to the Great Financial Crisis became unnecessarily complicated, totally devoid of transparency, and replete with backroom deals and perverse incentives. It is hard to believe that a pure capital for stock transaction with the government exercising full voting rights would not have been preferable to the messy, hybrid approach the government took.



Long-Term Public Ownership?

The U.S. government also went out of its way to emphasize the time-limited nature of its ownership stake in Wall Street. It explicitly characterized its intervention—a response to the imminent meltdown of the entire financial sector!—as temporary and far from punitive, with a promise to return these companies fully to the private sector as quickly as possible. “The government was more interested in exiting these investments promptly than in earning a return,” Davidoff Solomon writes.¹¹⁸ What the banking industry learned was that there was nothing to fear from the government and everything to gain. The government would do everything possible to provide the sector with capital to bailout their losses with as few strings attached as possible. All the banks had to do was wait out the initial public outcry (until the public had lowered their pitchforks, to extrapolate from President Obama’s phrase), allow the government to retreat from the sector, and get back to business as usual.¹¹⁹

During the financial crisis, almost all commentators who supported these short-term nationalizations were emphatic in their rejection of long-term public ownership. For instance, economist Adam Posen stated in 2009 that “nobody in their right mind wants the government to be in the banking business any longer than it needs to be.”¹²⁰ Such offhand judgments, however, deliberately ignore the extensive, and often highly successful, experience with public banking both in



the United States and around the world. Across Europe, more than 200 public and semi-public banks (those with “public participations” of between five and 49.9 percent), along with more than 80 funding agencies, account for roughly a fifth of all bank assets.¹²¹ In Germany, there are around 400 publicly owned municipal savings banks (*Sparkassen*) with more than €1.1 trillion in assets and approximately 225,000 employees.¹²² (Unlike some of the larger banks, the *Sparkassen*, according to *The Economist*, “[came] through the crisis with barely a scratch.”)¹²³ The Savings Banks Financial Group—an umbrella organization comprised of hundreds of publicly owned entities, including the savings banks, regional public banks (*Landesbanken*), regional building societies, public insurance groups, real estate companies, equity investing companies, and municipal advising companies—employs around 321,600 people and has business volume of some €2.8 trillion.¹²⁴ Despite partial privatization, Japan Post Bank remains the world’s largest public bank and one of the largest banks of any kind in terms of deposits, as well as being one of that nation’s largest employers.¹²⁵ South America, which has been experiencing strong economic performance in recent years, has several, large publicly owned banks, including Banco Nación (Argentina), Banco do Brasil (Brazil), and BancoEstado (Chile).¹²⁶

In the wake of the last financial crisis, much has been written about the nearly 100-year-old publicly owned Bank of North Dakota (BND) in the United States, which has around \$7.3 billion in assets and a loan portfolio of \$4.7 billion.¹²⁷ Formed by the Nonpartisan League (an offshoot of the Socialist Party) in the aftermath of the First World War, the bank survived an early concerted assault by opponents, eventually thriving and becoming institutionalized in the state’s financial and political landscape. Recently, it directly helped North Dakota weather the Great Financial Crisis and Great Recession by backstopping local banks with liquidity (thereby ensuring that the state had the lowest foreclosure rate and lowest credit card default rate in the country, as well as no bank failures for more than a decade), and making loans to consumers while private banks were freezing credit, all while continuing to contribute its revenues to the state’s budget.¹²⁸



Beyond North Dakota, the federal government also operates around 140 banks and quasi-banks that provide loans and loan guarantees for a wide range of economic activities.¹²⁹ In 2009, then Secretary of Agriculture Tom Vilsack commented that if all of the Department of Agriculture's lending activities were accounted for, it would be "the seventh-largest bank in the country."¹³⁰

In the years preceding the financial crisis, with neoliberalism ascendant and seemingly unassailable, the dominant trend in economics and public policy was to see these type of publicly owned banks as a relic of the past and often to advocate strenuously for their privatization.¹³¹ One line of attack was premised on questions of comparative efficiency. The prevailing 'wisdom' was that publicly owned banks would **inherently** perform poorly when compared to private banks. There are at least four problems with this claim.¹³²

First, many studies of comparative efficiency focus exclusively (or almost exclusively) on easily observable financial measures like profits. However, publicly owned banks are often explicitly tasked with other criteria, like providing low or no cost loans to small and medium sized businesses, financing infrastructure or local government needs, supporting certain economic sectors, or providing banking services to lower income populations. Studies that take into account the full socio-economic benefits of these types of activities are much harder to develop and are thus exceedingly rare.

Secondly, because publicly owned banks and privately owned banks are often not operating the same type of business, at the same scale, in the same country, at the same time, it is difficult to accurately pick appropriate benchmarks and make comparisons with private counterparts in many cases.

Thirdly, studies on comparative efficiency do not universally support the theory that publicly owned banks are less efficient than privately owned ones. For instance, in 2014 the OECD summarized a number of studies of



publicly owned German banks, writing that “savings banks appear to be at least as efficient as commercial banks.”¹³³ Similarly, a 2008 study of Russian banks revealed (to the authors’ surprise) that “domestic private banks are not more efficient than domestic public banks.”¹³⁴ And in 2010, researchers in the UK found that:

In their attempt to prevent financial meltdown in the autumn of 2008, governments in many industrialised countries took large stakes in major commercial banks. While many countries in continental Europe, including Germany and France, have had a fair amount of experience with government owned banks, the UK and the US have found themselves in unfamiliar territory. It is, therefore, perhaps not surprising that there is deeply ingrained hostility in these countries towards the notion that governments can run banks effectively. We show in this paper that such views are not well founded. Our empirical findings which utilise cross-country data for 1995–2007 suggest that, if anything, government ownership of banks has, on average, been associated with higher growth rates.¹³⁵

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Since the financial crisis, it has been exceedingly difficult even for the staunchest of neoliberals to argue that privately owned banks are more efficient.
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Moreover, there are many studies going back decades that support the theory that publicly owned banks play a critical role in financial and economic development, helping direct capital to socially beneficial purposes, and correcting for market failures when private banks will not lend to certain sectors or populations for various reasons.

Fourthly, since the financial crisis, it has been exceedingly difficult even for the staunchest of neoliberals to argue that privately owned banks are more efficient when their activities almost brought down the entire capitalist global economy, required massive government bailouts to survive, and caused tremendous economic losses, unemployment, and human suffering—especially



when many publicly owned banks around the world weathered the crisis far better than their privately owned counterparts.

Another common line of attack against public banking focuses on the possibility for corruption and cronyism—the so-called “political view.” The claim is made that publicly owned banks will be used by politicians “to provide employment, subsidies, and other benefits to supporters who return the favor in the form of votes, political contributions, and bribes.”¹³⁶ Like the argument around inefficiency, this claim has its weaknesses. First and foremost, even the authors of one of the most cited papers on the subject (Rafael La Porta, Florencio Lopez-De-Silanes, and Andrei Shleifer) state that “the attraction of such political control of banks is presumably the greatest in countries with underdeveloped financial systems and poorly protected property rights...”¹³⁷ Whether this theory holds in more advanced countries is at best understudied—there is little evidence of it, for instance, in long-established public banks in Germany and elsewhere in Europe. Second, the evidence underpinning this theory (from cross country regressions) is, in the words of Svetlana Andrianova, Panicos Demetriades, and Anja Shortland “fragile.”¹³⁸ Third, there has been little to no comparison of publicly owned and privately owned banks when it comes to the broader implications of “political” connections. For instance, it is well-known that privately owned banks in the United States and elsewhere wield tremendous political power and influence, which can have significant macro-economic effects and cause market distortions, maldistributions, etc. “The financial services industry also has a very high level of a form of distributive activity called ‘rent seeking,’ which involves trying to make a profit by manipulating government policy,” Gautam Mukunda writes in the *Harvard Business Review*. “The economists Kevin Murphy, Andrei Shleifer, and Robert Vishny have shown that as a nation’s most productive workers shift from entrepreneurial to rent-seeking activities, economic growth slows.”¹³⁹ In other words, there are likely some negative economic effects from either form of bank ownership, public or private, but the degree to which this is



the case—and of how it is manifested in the wider economy and society—is dependent on a host of outside factors (beyond ownership), including size and maturity of the financial sector and the democratic strength (or lack thereof) of the political and legal system.

One of the few prominent finance experts who engaged seriously with the question of long-term public ownership during the financial crisis was former Goldman Sachs advisor (now chief economist at Citigroup) Willem Buiter, who wrote in September 2008:

Is the reality...that large private firms make enormous private profits when the going is good and get bailed out and taken into temporary public ownership when the going gets bad, with the tax payer taking the risk and the losses? If so, then why not keep these activities in permanent public ownership? There is a long-standing argument that there is no real case for private ownership of deposit-taking banking institutions, because these cannot exist safely without a deposit guarantee and/or lender of last resort facilities, that are ultimately underwritten by the taxpayer.¹⁴⁰

Such a proposal is not unprecedented. Another was seriously made in the run up to the government bailout of Franklin National Bank in 1974. A year earlier, Democratic Congressman Henry Reuss of Wisconsin, then a high-ranking member of the House Banking Committee, suggested that Franklin National should be nationalized and run as a publicly owned bank. By law, the bank would have focused on making ‘socially desirable loans’ (such as low- and moderate-income housing, local government needs, and “productive investments”) and would have been prevented from speculative loans and currency trading. The company’s board would have been independent, and all profits would have been returned to the public.¹⁴¹ (Unfortunately, Reuss’ proposal went nowhere, and the bank was eventually declared insolvent and its assets acquired by the European-American Bank, which itself was then taken over by Citigroup in 2001).¹⁴²



In summary, governments around the world, including the United States, have considerable practical experience when it comes to both short-term (in conditions of crisis) and long-term public ownership of financial institutions. Moreover, public ownership would convert rent-seeking concentrations of private financial power into public utilities that work for the common good. It holds out the prospect of a way to fundamentally restructure and reimagine the financial sector as something that no longer fuels financialization, speculation, and consolidation, but instead works to allocate funds to real productive investment and decentralizes financial power to support prosperous and healthy local economies everywhere. It goes beyond simply breaking up large banks into smaller banks by changing the ownership structure, incentives, and market dynamics at the heart of the financialized capitalist system.

But given Wall Street's legendary political economic power and demonstrated ability to resist strong regulatory and antitrust strategies, how could public ownership be achieved in the financial sector? One answer, looking back with the benefit of hindsight on 2007-2008, is that when a crisis (either at the systemic level of the financial sector as a whole, or at the firm level) arrives, the big banks will once again become reliant on public support for their survival. In such a moment these banks can be de-privatized rather than simply bailed out. Concrete plans for such an approach should be developed, debated, and refined now—before the next crisis hits.

“
**Public ownership
would convert
rent-seeking
concentrations of
private financial
power into public
utilities that work
for the common
good.**

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Preparing For The Next Crisis

A PLAN FOR PUBLIC OWNERSHIP IN THE U.S. FINANCIAL SECTOR

One possibility would be to put forward and organize for legislation requiring the government to take an ownership stake with full voting rights in any financial institution that has to be bailed out or rescued due to its own fraudulent or speculative activities, which happens with extraordinary frequency—the government has been forced to bailout and/or temporarily nationalize leading financial institutions several times in recent decades, including Franklin National Bank in the 1970s, Continental Illinois National Bank and Trust Company in the early 1980s, the Savings & Loan industry in the late 1980s, and many of the leading Wall Street Banks in the late 2000s.¹⁴³ First and foremost, legislation authorizing a bank rescue approach grounded in public ownership instead of corporate bailouts could reduce systemic risk. The mere threat of nationalization would, if structured appropriately, serve as a powerful disincentive to owners and managers of financial corporations engaging in risky, speculative, or fraudulent business practices.

If and when a public takeover actually occurs, one option is for the new publicly owned entities to be subsequently broken up to separate commercial banking (such as taking deposits and making loans) from investing and other



speculative activities. The former could be kept permanently in public ownership while the latter might be left to private ownership under strict conditions (such as diversification) and oversight.¹⁴⁴ Moreover, all, or some, of the public commercial banks could then be further decentralized into a network of regional and local public banks that could focus on taking deposits from public entities, backstopping small community banks, providing banking services to low-income populations, extending low-interest loans to students, small businesses, and those recovering from disasters, and/or financing the conversion of businesses to worker ownership. Profits would flow to state and local governments, providing a valuable source of revenue to pay for social services, infrastructure, retirement obligations, and other important areas of need. As discussed above, one existing example of this is in Germany where hundreds of small, local publicly owned savings banks—Sparkassen—come together as part of the large Savings Bank Financial Group.

Second, the legislation would clearly establish the legal parameters for the transition to government ownership and governance in the financial sector. Such clarity is important given the multitude of problems that arose from the government's response to the last financial crisis. The long-running legal case brought against the government by AIG's ex-CEO Maurice Greenberg demonstrates that the legal authority used to take over companies during the financial crisis was at best murky, and that new, clear legislative guidelines are necessary. In June 2015, a lower court ruled that the Federal Reserve had overstepped its authority in taking equity in exchange for its bailout, but refused to award damages because the shares would have been worthless if the government had not stepped in. However, in May 2017, an appeals court reversed that ruling stating that Greenberg didn't have standing to bring a lawsuit. The underlying question about the legal authority to take the equity was not decided and Greenberg's lawyers plan an appeal to the Supreme Court.¹⁴⁵ Moreover, the Dodd-Frank legislation actually puts new restrictions on the Federal Reserve's authority to intervene in financial institutions. "The new financial reform bill also limits the ability of the Fed-



eral Reserve to use its section 13(3) power in the manner it did during the financial crisis to provide financial assistance to companies,” Davidoff Solomon writes. “It is thus difficult for the government to find [an existing] statutory hook on which to hang authority to own private enterprise.”¹⁴⁶

Third, the legislation would establish the propriety of longer-term public ownership. Currently, public ownership is seen as at best a temporary expedient, with the goal remaining a prompt transition back to the private sector once the firm or financial system as a whole is stabilized. Such legislation would make it explicit that this is not the only possible option, and that the federal government is authorized to establish and operate (alongside state and local governments) publicly-owned banks for public, not shareholder, benefit.



The legislation could also provide the framework and principles for effective governance of publicly owned financial institutions. This should likely include the following:

- **Establishing a singular government agency, holding company, investment board, or public corporation to exercise the rights and responsibilities associated with ownership.** Examples include Agence des Participations de L’Etat in France (which oversees the government’s ownership stake in around 80 enterprises), the Ministry of Enterprise and Innovation in Sweden (which oversees the government’s portfolio of 48 publicly owned enterprises), or Temasek Holdings in Singapore (which oversees the government’s ownership stakes in Singapore Airlines, Singapore Power, the public transport company SMRT, and dozens of other domestic and international companies).¹⁴⁷



This would also include ensuring that this entity is separate and independent from any agency responsible for regulating the enterprise(s) or the financial sector as a whole;

- **Creating a clear and participatory process to set the overall long-term structure and mission for each of the new publicly owned banks.** For instance, one bank (or network of smaller public banks) could be tasked with financing renewable energy and a green transition, like the successful publicly owned Green Investment Bank in the UK before it was privatized. Another could be instructed to provide banking services to under-banked populations, similar to postal banks in many countries. Another could be charged with buying municipal bonds and supporting local infrastructure projects, and so on. One important area would be financing transitions to worker, community, and public ownership throughout the rest of the economy (especially given rising inequality, on the one hand, and the forthcoming “silver tsunami” of retiring business owners on the other). This would perform a similar function as the “employee ownership bank” that Senator Bernie Sanders and others have proposed via legislation several times.¹⁴⁸
- **Allowing for an appropriate degree of managerial autonomy at the firm level to pursue those missions once established.** This would not only protect against political interference in the day to day running of the enterprises and counter the threat of corruption, but would insulate the publicly owned banks from the short-termism, shifting priorities, and bureaucratic fear that often accompanies regular electoral cycles;
- **Determining a process to establish appropriate metrics of success and efficiency for each public bank beyond pure financial measures.** This would ensure that a full and accurate picture of



each bank's ongoing effectiveness (or lack thereof) is developed, both to guide necessary improvements and to protect against ideologically-motivated accusations of inefficiency and efforts to privatize;

- **Setting accountability, transparency, and participation rules.** Basic open meeting and open records laws, which are common to government agencies and enterprises, are not enough. For publicly owned banks to truly be embraced by and responsive to the population at large they should likely have robust stakeholder participation (probably in the form of multi-stakeholder boards). One real-world example is Banco Popular in Costa Rica (BPDC), that country's third largest bank. Formed by the government to support economic development more than forty years ago, BPDC is now a hybrid publicly owned enterprise and cooperative. The bank has a democratic assembly made up of 290 representatives from among the bank's member-owners (on the basis of representing various economic and social sectors). Any worker holding a savings account for over a year receives an ownership share. The assembly, in turn, advises on the bank's strategic direction and selects four of the company's board members, with another three appointed by the government. Moreover, the bank is committed to a nationwide, popular consultative process when it comes to its strategic direction, requires 50 percent of board members to be women, and directs a portion of revenues to social projects through its Social Bank subsidiary. The bank has also become a leading financier of ecological sustainability in the country in conjunction with its 'triple bottom line' approach seeking economic, social, and environmental returns.¹⁴⁹
- **Enshrining certain rules governing internal procedures, such as limiting executive pay and compensation.** As many stud-



ies have found, financial sector wage premiums (the difference between what comparable workers make in the financial sector verse other sectors) contribute greatly to widening economic inequality (between 15 and 25 percent since 1980).¹⁵⁰ It may also include gender and racial diversity hiring requirements (especially at the senior management level) and gender pay equality.

- **Restricting (if not outright banning) many of the types of speculative activity that are driving increased financialization.**

This might include many derivative contracts that try to generate a profit on the fluctuating price of an underlying asset as well as currency and commodity speculation.

For progressives and others who ultimately want a much more decentralized or localized financial system, such a plan does not preclude ultimately breaking up the banks. In fact, it is almost a prerequisite. In a crisis situation, with banks on the verge of failing, simply breaking them up is not an option. First, they must be saved, which would necessitate either a bailout (like the last financial crisis) or public ownership.



Conclusion

Anyone reading this far will of course ask an obvious question at this point. If we do not have the political capacity to adequately regulate banks (and keep them regulated) or break them up (and keep them broken up), what are the prospects for this type of legislation? The answer is both pessimistic and optimistic. On the face of it, of course, immediate prospects for passage of legislation mandating public ownership instead of public bailouts in a future financial crisis are poor (especially given current Republican control of Washington). However, this is not about now. It is about being prepared for when the pendulum swings. It is about having a plan in place when the next crisis occurs. Even if such legislation has never made it out of committee, when the crisis comes, it could be dusted off and re-introduced—either as a stand-alone bill ahead of any bailout legislation, or modified and attached as an amendment to whatever legal authority the government at the time is seeking to deal with the crisis. It is to our advantage to work out the arcane technical details of such an approach now, in advance of a financial emergency demanding swift action.

As has been demonstrated repeatedly over the past ten years, the American people detest bank bailouts. From the Tea Party to Occupy Wall Street to the presidential campaign of Bernie Sanders, the government's giveaways to the giant Wall Street banks that crashed the economy continue to be a hot-



button political issue. “Americans have always kind of hated bank bailouts, but that hatred seems to be getting hotter with time,” Mark Gongloff wrote in 2012.¹⁵¹ At that time, a poll had found that 84 percent of Americans opposed a future bank bailout. Recently, in 2016, a Rasmussen poll found that 55 percent of Americans believe it was a mistake to bail out the banks during the financial crisis (versus just 23 percent who felt it was a good idea).¹⁵² Moreover, during the crisis, Americans in fact favored public ownership over bailouts. A 2009 *Newsweek* poll, for instance, found that 56 percent of Americans thought it better to have “nationalization, where the government takes temporary control” versus 29 percent who thought “government financial aid without any government control of the bank” was better (11 percent responded “neither” and 4 percent didn’t know).¹⁵³ It is likely that during the next crisis, there will be similar (if not greater) public support for public ownership rather than no-strings-attached corporate bailouts. Such sentiments can naturally be deepened into widespread support for longer-term public ownership in the sector, if a coherent vision is available to pull “off the shelf.” Having a developed, viable, and vetted plan at the ready is essential.

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The next crisis will
be our opportunity
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financial system.
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What has been presented here is a preliminary first step intended to start a discussion. There are countless further details that will be required in areas where financial experts, activists, consumer advocates, and policymakers would need to weigh in and hash out solutions before any plan is truly ready for enactment. But it is imperative that the hard work of developing a viable plan for the next financial crisis start now. We simply cannot know how much time we have. As finance expert Nomi Prins points out, the “banks are still big and bad,” the Trump Administration and Congress are pushing forward recklessly with financial deregulation, and corporate debt has



nearly doubled from pre-crisis levels. “If there is another financial crisis in 2018 or later,” Prins concludes, “it will be worse than the last one because the system remains fundamentally unreformed, banks remain too big to fail and the Fed and other central banks continue to control the flow of funds to these banks (and through to the markets) by maintaining a cheap cost of funds.”¹⁵⁴

The next crisis will be our opportunity to demand a next financial system—and we must develop that vision today in order to be able to fight for it tomorrow. The future of banking is far too important to be left to the bankers.



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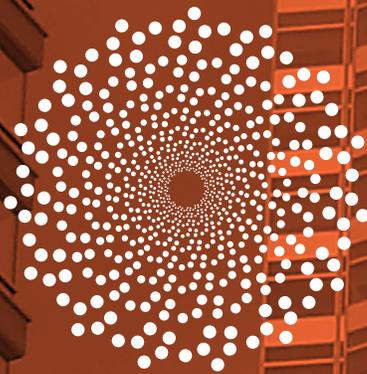
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