NEOLIBERALISM IN CRISIS:
REGULATORY ROOTS OF
THE U.S. FINANCIAL MELTDOWN

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ABSTRACT

Social scientists have long been interested in how political institutions affect economic performance. Nowhere are these effects more apparent today than in the current U.S. financial meltdown. This article offers an analysis of the meltdown by showing how government regulation among other things helped cause it. Specifically, the article shows how regulatory reforms closely associated with neoliberalism created perverse incentives that contributed significantly to the increased lending in the mortgage market and increased speculation in other financial markets even as such behavior was becoming increasingly risky. The result was the failure of mortgage firms, banks, a major insurance company, and eventually the market for short-term business loans, which triggered a general liquidity crisis thereby thrusting the entire economy into a severe recession. Implications for future research are explored. The article also offers a few policy prescriptions and an assessment of their political viability going forward.
Social scientists have long been interested in how political institutions affect economic performance. Nowhere is the importance of these effects more apparent than in the meltdown that occurred in the U.S. housing market and quickly spread to the financial services sector in 2008 thereby precipitating the worst economic catastrophe in America since the Great Depression. I explain how the meltdown stemmed from a variety of regulatory policies stretching back to the 1970s – policies associated to a significant degree with the rise of neoliberalism, a loose bundle of conservative ideas and policy prescriptions including less government regulation, lower taxes and more. In other words, the financial meltdown is the manifestation of a broader crisis of neoliberalism.

The theoretical and political stakes here are high. Since the late 1970s national politics in the United States has been dominated increasingly by neoliberals who have argued that less government regulation is better for the economy. They have also argued that markets in the United States – one of the most lightly regulated economies in the OECD to begin with – are too tightly regulated and ought to be freed to a large extent from the state’s grip. This, of course, is a view that is rooted in the classical writings of Friedrich Hayek (1944) and Milton Friedman (1962) who argued for free markets and against any form of state planning or state intervention into the economy other than for purposes of rectifying the most serious market failures or negative externalities. The largely unbridled pursuit of self-interest, they believed, facilitated the most efficient market behavior and, in turn, the most effective route to economic development and prosperity. This view came to political fruition in the United States with the election of Ronald Reagan as President in 1980 and has been pursued since then in varying degree by all presidents through George W. Bush.

Economic sociologists and historians disagree with this view. They have argued that market activity is always embedded in and constituted by political rules and regulations – that is, formal and informal political institutions including property rights (Campbell & Lindberg, 1990; Carruthers & Ariovich, 2004; Fligstein, 2001; North, 1990; Schneierberg, 1999). Indeed, these institutions are the essential fabric on which markets depend (Campbell, 2004; North, 2005). Without such regulatory institutions, they argue, markets are eventually doomed to failure and even collapse (Abolafia, 1996; Polanyi, 1944). Financial markets in particular require the state to deploy regulations in order to check excessive risk taking that could lead to speculative booms. They also require the state to serve as the lender of last resort in order to contain collateral damage when speculative booms turn into busts (Kindleberger, 1978; Minsky, 1986). In the end there is no such thing as a truly free market. Following this line of reasoning I will show that the financial meltdown in 2008 stemmed not from too much regulation but too little. The inadequacy of regulation in the financial services industry encouraged the development of an ever more abundant supply of credit in the housing market in ways that sowed the seeds of the financial meltdown.

Some readers might wonder why I want to make this argument against neoliberalism now. After all, Barack Obama won the presidency in large part because he presented a clear alternative to neoliberalism. And since the financial meltdown occurred many have called for Washington to beef up its regulatory oversight of the financial services industry – including such previously staunch neoliberal advocates as Alan Greenspan, former chairman of the Federal Reserve Board, and Arthur Levitt, former chairman of the Securities and Exchange Commission (SEC). Yet, as I will explain, there are still powerful forces arguing and lobbying hard against regulatory reform in this industry and who want to preserve the neoliberal status quo. In my view, if they win, then the chances for another crisis will not have diminished significantly. That is why my argument needs to be made.

This is a story about what some might call deregulation – a shift toward a lighter regulatory burden. There is much debate about whether neoliberal reform involved deregulation. Some argue instead that it entailed only a reconfiguration and not a reduction in the overall regulatory burden on business (Brathwaite, 2009; Schneierberg & Bartley, 2008; Vogel, 1996). In the financial services industry, as we shall see, regulatory reform involved three things since the late 1970s. In a few cases state oversight and responsibility for financial markets was dramatically reduced although not eliminated entirely in a manner akin to deregulation in the conventional sense. More often, however, regulations were revised or reconfigured – not reduced. And on rare occasions as new markets were developing in the first place regulations were not imposed on them at all. But even then it turned out that the state was prepared to move swiftly into these as well as other financial markets as the lender of last resort when they began to collapse and threaten the rest of the economy.

Market regulation is a highly contested political process. The regulatory and other institutions in which market activity is embedded are political settlements born from power struggles, negotiation and compromise. They reflect the balance of political power. When that balance shifts, too may the rules and regulations that govern markets (Campbell, 2004; Campbell, Hollingsworth, & Lindberg, 1991; Fligstein, 2001; Knight, 2001; Schneierberg, 1999). I will not discuss the politics involved in the many regulatory and other reforms described in this article. My intent is to focus on the
effects – not the causes – of these reforms. But as several articles in this volume make clear neoliberal reform was always a politically contested process that involved powerful actors inside and outside the state – including members of the financial services industry and their political allies whose influence was especially pronounced on several very important occasions that contributed to the financial meltdown (e.g., Krippner, 2010; Mizruchi, 2010).

The causes of the meltdown are complicated. Some regulatory factors were more proximate to the meltdown than others. Moreover, the meltdown was not entirely due to regulatory policies (Jickling, 2009). For instance, technological advances in securities trading and risk assessment contributed to the story. I am not, however, arguing for some sort of regulatory or political determinism. The regulatory policies discussed here created incentives and constrained behavior such that the probability of a financial meltdown occurring was significant. But it was not inevitable. People may choose to do things other than what these regulatory incentives would encourage. In the end, however, these incentives and constraints were strong enough to contribute in important ways to the meltdown.

The causes of the meltdown are complicated for another reason too. Beginning in the late 1970s a variety of regulatory reforms occurred that contributed to the ultimate crash. Some were more important than others. And their effects accumulated slowly over time. Not all of them spelled disaster immediately because it was only after they were combined with particularly risky lending practices in the housing market that their collective effects began to emerge. In other words, it is impossible to point to a single cause of the meltdown. There were a considerable number of regulatory and other institutional reforms involved. This was a crisis that was long and complex in the making (see also Fligstein & Goldstein, 2010).

I begin by briefly reviewing the events of 2008 that constituted the financial meltdown. This story is well-known but is only the tip of a much more complicated regulatory iceberg that requires explanation. To provide that explanation I turn next to the regulatory underpinnings of the events of 2008. These include a variety of government policy decisions – some longstanding, others more recent. They also include a few decisions in the private sector but decisions that were still facilitated by or otherwise connected indirectly with regulatory policies of various sorts. Among the myriad regulatory reforms and practices in question, three stand out as being especially central to the financial meltdown: banking reforms that facilitated the development of a tightly coupled shadow banking system through which financial problems reverberated with alarming speed and damage in 2008; the absence of regulation of over-the-counter markets for asset-backed securities, which enabled firms to create and sell high-risk investment products at will; and lackadaisical oversight of the credit rating agencies whose extremely rosy assessments of these asset-backed securities convinced investors that these products were much safer than they turned out to be. Finally, I discuss the story’s implications for future research and public policy going forward. I call for new regulations to separate commercial and investment banking; to regulate over-the-counter securities trading; and to establish new forms of payment and new rating practices in the credit rating industry.

THE FINANCIAL MELTDOWN IN BRIEF

As is now well-known, the catalyst for financial meltdown in late 2008 was the collapse of a bubble in the U.S. housing market and a rapid decline of housing prices beginning in late 2006. Driving the growth of this bubble in the first place was the increased availability of inexpensive mortgage credit, thanks in part to the Federal Reserve Board’s low interest rates. But it was also due to the increased availability of subprime mortgages. When the housing bubble burst people began to default on their loans in record numbers. This was especially true for those with subprime mortgages (Gwinner & Sanders, 2008; Standard and Poor’s, 2009).

In turn, rising delinquencies set off a chain of events that reverberated through the mortgage, banking and insurance industries and eventually brought the entire financial system to the verge of collapse. First, mortgage companies failed including the New Century Financial, Countrywide, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Mortgage Corporation (Freddie Mac). The latter two are government-sponsored entities with access to a credit line from the U.S. Treasury and an exemption from SEC oversight. Countrywide was bought by Bank of America in a deal orchestrated by the federal government. Fannie and Freddie were put into conservatorships by the federal government, which took over nearly 80% of their stock.

Second, banks failed. Because many of these risky subprime mortgages were frequently bundled with other types of loans as structured asset-backed securities and sold to banks and other investors, the collateral damage was unprecedented. In March 2008, Bear Stearns was taken over by the Federal Deposit Insurance Corporation (FDIC) and sold to J.P. Morgan Chase. A similar fate awaited Washington Mutual a few months later. That fall
several other large banks failed, including Merrill Lynch and Wachovia, and were bought by other banks. Finally, Lehman Brothers went bankrupt after the federal government decided not to bail it out for fear of creating perverse moral hazard incentives for other banks in the future. As a result, the markets for mortgages and bundled mortgage-backed securities began to seize up as concerns about the risky nature of these financial instruments started coming to light. In turn, mortgage firms and banks began to tighten their lending practices. Credit markets began to contract (Bank for International Settlements, 2008).

Third, the American International Group (AIG) faced collapse. Just prior to the meltdown it was the world's largest insurer. Many banks had purchased insurance called credit default swaps from AIG just in case the mortgage backed securities they held turned sour as a result of mortgage defaults. So when the housing bubble burst and mortgage defaults mounted, AIG was faced with the calamitous possibility of an unprecedented number of payment claims being filed all at once against the swaps that it had sold. As a result, AIG's credit rating was downgraded and it found itself unable to raise enough new capital to cover its potential losses. Its stock value plunged. Concerned that AIG's failure would bring down other banks and investment firms, in September 2008 the federal government provided an initial $85 billion bailout loan in exchange for a 79.9% equity stake in the company. As AIG’s situation continued to deteriorate, the government put up more money bringing the total to $182 billion by March 2009.

Fourth, the crisis spread and the general credit market failed. AIG's problems sent shock waves through the financial community. Because many subprime mortgages had been bundled with other forms of debt and sold to investors many times over, nobody really knew where all of the subprime mortgages were, who owned them, or how many of them were in danger of default. And now nobody could be sure that the insurance (i.e., credit default swaps) that they had purchased in the event of default would cover the losses that they might incur. Without complete knowledge about how many of these potentially toxic assets they were holding or whether their swaps would actually cover the losses they might suffer, banks and other lenders further tightened their lending practices trying to keep as much capital on hand as possible.

The demise of Lehman Brothers amplified all of this. Lehman's bankruptcy undermined confidence in some of the safest investments – money market funds – and, in turn, the commercial paper market. Money market funds invest mainly in commercial paper, which are very short-term loans that businesses frequently take out to finance things like inventories and payrolls while waiting for payment from customers. The commercial paper market greases the day-to-day operation of the economy. One of these very large money market funds, the Reserve Primary Fund, had invested about $785 million of its investors' money in Lehman Brothers debt. So after Lehman collapsed people's investments with Reserve Primary began to lose value and they started pulling their money out of Reserve Primary and then similar mutual funds (Bruno, 2008). Concerned that such a run on the money markets could imperil the commercial paper market and bring the entire economy to its knees, the Fed intervened by providing liquidity to money market investors thereby ensuring existing money market deposits much like the FDIC guarantees bank deposits. Nevertheless, money market fund managers had been spooked and grew exceedingly cautious in lending. As a result, businesses began to see their lines of credit dry up as a general liquidity crisis suddenly gripped the entire economy. The economy had already been in recession since late 2007 but now it began to deteriorate rapidly.

The federal government moved swiftly to contain the damage. In October 2008, Congress passed the Troubled Asset Relief Program (TARP), which was intended to ease the credit markets by injecting them with $700 billion. In December, the Fed lowered its benchmark interest rate to nearly zero. In February 2009, Congress passed a $787 billion package of tax cuts and spending designed to stimulate the economy. A few days later the president announced another plan, which, if passed by Congress, would provide up to $275 billion more in direct spending to homeowners as well as additional financing to Freddie and Fannie to stabilize the mortgage market. The Treasury also announced in February a plan to muster as much as $2.5 trillion from the Fed and private investors to remove the toxic assets currently owned by the banks and to inject additional money into the financial system. All of this was designed to ease the credit crisis and get capital flowing again.

It is important to note that the key theoretical point in all of this detail. In the sense that the state was poised to intervene as the lender of last resort when the financial markets got into serious trouble these markets were never free markets at all. Federal agencies moved into the mortgage and banking markets rescuing several lenders including Bear Stearns, Washington Mutual, Fannie Mae, and Freddie Mac. They moved into the insurance market rescuing AIG and thereby protecting all of the investors in the asset-backed securities market who had purchased AIG swaps. They moved into the commercial paper market rescuing the money market funds by guaranteeing investors that their money market deposits were safe.
And they provided hundreds of billions of dollars to the banks through TARP to ease the liquidity crisis in the credit markets overall – an effort that was supplemented by the Fed dropping interest rates to an historic low. This was matched eventually by Congress, which provided several hundred billion dollars more in economic stimulus to pull the economy out of recession. Finally, the government planned additional moves to bail out troubled homeowners in the mortgage markets and help banks clear toxic assets off of their books. It is an open question whether the financial markets faith in the state’s capacity and willingness to serve as the lender of last resort created moral hazards that contributed to the meltdown. But the fact is that when the chips were down, the state moved swiftly as the lender of last resort.

There is, however, a second sense in which the financial markets were not free markets. A variety of regulatory moves by the state affected how they were organized and how they performed in the first place. Much of this had the effect of aligning incentives among market actors so as to reinforce what we now know to have been excessive risk taking. These moves helped facilitate the disastrous chain reaction discussed above. To understand how this happened, we need to look closer at these regulatory moves.

REGULATORY ROOTS OF THE MELTDOWN

As noted above, the financial meltdown was triggered by a collapse of the housing market and its follow-on effects. The long-term economic roots of precarious mortgage debt – and consumer debt more generally – stretch back to the mid-1970s. As is well-known, wage stagnation since the 1970s pervaded the middle class and lower classes (Mishel, Bernstein, & Allegretto, 2005, p. 42). This made it increasingly difficult for families to maintain the standard of living that their parents’ generation had enjoyed (Levy, 1998, Chapter 2; Mishel et al., 2005, p. 102). One way for them to do this was by borrowing money. Household debt rose from just under 80% of disposable income in 1986 to 140% by 2007. Much of this increase was due to rising mortgage debt (The Economist, 2008, p. 12; Leicht & Fitzgerald, 2007, Chapter 3).

But why were American families able to borrow so much money when, given their increasingly more tenuous earnings stream, their ability to repay that debt would seem to have become ever more questionable? The answer is twofold. First, the supply of consumer credit increased. And, second, the reason for this was that the financial services industry was engaging in increasingly risky investment behavior. Both were influenced by regulatory reform.

Supply of Mortgage Credit Grows

To be sure, an important factor contributing to rising consumer debt had little to do with regulatory change. This was monetary policy. During much of the 1990s until 1999 the Federal Reserve Board maintained low interest rates. It also did so in the aftermath of the 2000 dot-com stock market crash and subsequent recession during which time it cut the federal funds rate to 1%, leaving it there for a year and then raising it only timidly after that. So as consumers were turning increasingly to the credit markets to help maintain their standards of living, the price of credit was kept especially low. Nowhere was this more evident than in the housing market where mortgage rates were very low. When combined with unconventional mortgages, such as sub-primes, the government in effect enticed families to incur more debt. Beyond monetary policy, however, several regulatory changes were also involved.

To begin with, the market for subprime mortgages soared in part after 2004 because the two government-backed mortgage giants, Fannie Mae and Freddie Mac, began buying up huge swaths of subprime mortgages. They did so in response to political pressure from Washington where politicians wanted to expand the financing for housing for the middle class. Fannie and Freddie’s move to buy up subprime mortgages institutionalized the congressional will to help people buy homes. And it created additional incentives for mortgage lenders to make subprime loans because they knew that they could turn around and sell the mortgages to Fannie and Freddie. In effect, then, Fannie and Freddie began to regulate albeit informally how much money was available in the mortgage market. This in combination with the Fed’s low interest rates and speculative building contributed to a booming housing market, rising property values and a housing bubble that finally burst in 2006. Sales fell off, housing prices dropped, and the housing industry began to experience a recession. This was compounded by the fact that in 2004 the Fed began raising interest rates to check inflation. This move increased adjustable subprime mortgage interest rates to a point where many homeowners could no longer afford to pay them and faced foreclosure (The Economist, 2008, pp. 10-20). And the decline in housing prices dashed many homeowners’ hopes of refinancing these mortgages at lower rates.

A second factor contributing to the booming subprime market were regulatory reforms that helped encourage the development of a market for
so-called nonconforming mortgages outside the model specified by Fannie, Freddie, and other government-sponsored enterprises (GSEs). Following problems with accounting and governance at these organizations, the GSE’s capacity to expand lending was capped by new regulatory limits from the George W. Bush administration. This was also due to the administration’s desire to reduce the dominance of GSEs in the mortgage market and foster more competition among private companies—a clear move in a neoliberal direction. The reform created an opportunity for private lenders to go into the mortgage markets in greater numbers, which they did. New entrants included large investment banks operating through recently acquired mortgage lending subsidiaries. At the same time, however, mortgage lending was becoming less profitable due to a wave of refinancing at low interest rates during the early 2000s. In other words, more private lenders were moving into a market whose profitability was declining. In order to compensate for declining profits these lenders began relaxing requirements in order to qualify more borrowers and sell more mortgages. These included new but riskier types of mortgages such as subprimes. For instance, second mortgages became easier to obtain and were often hidden from the originator of the first mortgage. In 1999, less than 1% of all subprime first mortgage loans had a so-called “silent second” attached to them but by 2006 more than 25% did (Ellis, 2008; Gramlich, 2007).

A third policy change—the 1986 Tax Reform Act—was complicit in this. The federal tax code has long permitted homeowners to deduct from their income taxes the interest paid on their mortgages. This was done in order to stimulate private home ownership after the Second World War. The tax code also let them deduct interest for other forms of consumer debt. However, the 1986 Act eliminated the latter interest deduction but allowed an unlimited interest deduction for mortgages on both first and second homes (Conlan, Wrightson, & Beam, 1990, p. 265). This created additional incentives for people to take out second mortgages on their homes. Why? Second mortgages provided a way to finance their spending and still benefit from an interest deduction.

A fourth part of the story involved the incentives institutionalized within mortgage companies that encouraged loan officers to lend to risky borrowers in order to boost profits and salaries. For example, at Washington Mutual, a bank deeply engaged in subprime mortgage lending, underwriters, who approved loan applications brought to them by brokers, faced intense pressure from management and brokers to approve mortgages despite concerns about the quality of the loans. According to one senior underwriter, volume was paramount and risky loans were pushed through because they were profitable to the company. As discussed in the next section, this was because even the riskiest mortgages could be easily packaged as asset-backed securities and sold to investors leaving the company free of losses if there was a default. And brokers pushed the mortgages hard because they could make hefty commissions. If underwriters resisted pressure to approve risky mortgages, they were punished and in some cases fired (MacKenzie, 2008; Morgenson, 2008).

Fifth, although these lending practices were devised by actors in the private sector they were embedded in a wider set of regulatory policies that facilitated shoddy mortgage lending practices. To begin with, thanks to regulatory reform independent lenders—that is, nondepository entities—were under much less regulatory authority than traditional mortgage lenders, such as commercial banks. For instance, in 1982 the Alternative Mortgage Transactions Parity Act became law allowing nonfederally chartered mortgage companies to write adjustable mortgages, such as those with interest-only payment and balloon payment schemes that were sold to subprime customers. These riskier mortgages eventually replaced many conventional fixed rate mortgages that had long been the norm in the conventional banking industry. Furthermore, in 2004 the Office of the Comptroller of the Currency (OCC) passed rules by which federally regulated lenders were exempted from state regulations, which were often stricter than federal regulations. Some of the practices banned under some state laws but that were now legal under the OCC ruling included mortgage prepayment penalties and balloon payments that tend to increase the risk associated with such loans and raise default rates (Ellis, 2008). In hindsight, the Obama administration recognized that at the root of shoddy lending practices had been a breakdown in mortgage underwriting standards enabled by lax or nonexistent regulation and a broad relaxation of discipline in the mortgage market (The New York Times, 2009, p. 41).

In sum, several factors conspired to provide a greater supply of credit to consumers in the housing market. Almost all of them involved state regulation demonstrating again that the organization and functioning of markets is heavily affected by the state even in liberal market economies like the United States. These factors included Fannie and Freddie’s move to buy up more subprime mortgages; regulatory limits to the activities of GSEs that created an opportunity for more private lenders to enter and compete in the mortgage market; changes in the tax treatment of interest on consumer loans; insufficient oversight of mortgage lending practices; regulatory permission to write riskier adjustable-rate mortgages; and regulatory exemption of some lenders from more rigorous state-level regulations.
In other words, the state helped create a set of institutional conditions that aligned incentives toward riskier and more competitive market behavior. However, this story of reckless mortgage lending was facilitated by another set of very widespread innovations in the broader financial services industry that put increasing sums of money at the disposal of mortgage lenders in the first place. These changes also encouraged riskier behavior, particularly among large investment banks and insurance companies that stood behind mortgage lenders. Among the most important were banking reform, a decision not to regulate derivatives markets, and lackadaisical oversight of credit rating and risk assessment.

Risky Behavior Grows in the Financial Services Industry

Banking Regulation
One of the most important sets of regulatory reforms that laid the foundation for the financial meltdown involved the banking sector. To begin with, interstate banking had long been effectively prohibited by state law. But Maine passed legislation in 1978 that permitted out-of-state banks to operate in the state. Other states eventually followed suit. In 1994, the federal government passed the Interstate Banking and Branching Efficiency Act, which mandated interstate banking by 1997 unless a state explicitly chose to opt out, which only two did. Banks based in one state could now operate branches in other states without explicit permission from these state regulatory authorities. This allowed banks to move to states that permitted higher interest rates on loans of various sorts. In turn, this triggered competition among state governments to relax their usury laws or risk losing banking business as banks moved to states with higher interest rate ceilings. Additionally, the U.S. Supreme Court ruled in its “Marquette” decision of 1978 that banks and other lenders could charge interest rates whose ceilings would be limited only by the usury laws in their home state regardless of which other states they might be operating in even if the usury laws in these other states were more restrictive than in the home state (Ellis, 1998). Two years later Jimmy Carter signed the Depository Institutions Deregulation and Monetary Control Act, which phased out interest rate ceilings altogether and effectively eliminated state usury ceilings for residential mortgages and other bank loans (Federal Reserve Bank of Boston, 1980). Thus, thanks to regulatory reform lending became more profitable and so banks began offering more and more credit—often in new and riskier ways like giving credit cards to college students and selling subprime mortgages.

(Leicht & Fitzgerald, 2007, Chapter 4; Strahan, 2002). The turn toward riskier lending practices was reflected not just in rising consumer debt, but also in a quadrupling of bankruptcies between 1978 and 1996 (Ellis, 1998).

More important still, the Glass-Steagall Act, which had separated most insurance, commercial and investment banking services since 1933, was repealed in 1999 by the Gramm–Leach–Bliley Financial Services Modernization Act—legislation that was driven politically by a desire to let banks diversify and grow in order to compete effectively in international markets. The banking and insurance industries strongly supported the new law. Its chief sponsor, Senator Phil Gramm (R-Texas), was an avid neoliberal and long-time advocate of banking deregulation. But Democrats supported it too like Robert Rubin, former cochair of Goldman Sachs, who actively supported the repeal when he was Treasury Secretary in the Clinton administration (Stiglitz, 2003, p. 160). Following its passage several huge mergers occurred (e.g., Bank of America’s merger with Fleet Bank of Boston) or were solidified after having received temporary waivers to Glass-Steagall before it was repealed (e.g., the Citigroup conglomerate formed through the combination of Citibank, Smith Barney, Shearson, Pramerica, and Travelers Insurance).

One important ramification of the growth of these huge financial institutions was an increase in their access to capital through means other than traditional bank deposits, such as borrowing. This raised the possibility for them to develop a wide range of elaborate, complex, and potentially risky financial instruments for investment purposes. The fact that this risk might be significantly greater than investors initially anticipated was reflected in the costs to investors of insurance against such risk—credit default swaps—which skyrocketed beginning in early 2006 (Bank for International Settlements, 2008).

In short, the Gramm–Leach–Bliley legislation facilitated the rapid growth of the so-called “shadow banking system,” which was populated by increasingly large nonbank financial companies that channeled funds from investors to corporations through new securities, such as asset-backed securities and credit default swaps. Examples of organizations in the shadow banking system include investment banks (e.g., Goldman Sachs, Morgan Stanley, Lehman Brothers, Bear Stearns, Merrill Lynch), hedge funds (e.g., Long-Term Capital Management), money funds (e.g., Primary Reserve Fund), and other nonbank financial companies. Arguably, the development of the shadow banking system was one of the root causes of the financial meltdown because it was responsible for creating and selling asset-backed securities in the first place. The sums involved in the shadow banking system
by 2007 were staggering. The five largest investment banks, for example, had combined assets worth about $4 trillion and U.S. hedge funds had assets worth about $1.8 trillion. The shadow banking system did not accept deposits like a commercial bank and, therefore, was not subject to the same safety and soundness regulations as traditional banks, such as capitalization requirements. During the 2000s the assets held by the U.S. shadow banking system grew to exceed the $10 trillion held by the traditional banking system (The Economist, 2009a, p. 18; Geithner, 2008; Wolf, 2009b).6

**Securities Regulation**

Several changes in securities regulation helped open up new and riskier credit markets for the shadow banking system. First, the SEC issued regulations that fostered the development in the 1990s of booming markets for asset-backed securities. About 70% of this market, which was comprised of $6.6 trillion of tradable securities in 2002, involved mortgage-backed securities issued primarily by government-backed lenders, notably Fannie Mae and Freddie Mac. A substantial portion of the rest involved credit card debt. The securitization of credit card debt through asset-backed securities was introduced in the mid-1980s by Banc One Corporation and laid the foundation for what is now a $400 billion asset-backed securities market in credit card debt alone. The development of the asset-backed securities market contributed directly to the explosion in consumer debt in the United States. Issuing mortgages and other loans became more attractive as traders could buy and sell bundles of these securities in ways that could be very profitable. In turn, this created incentives for lenders to make more credit available to those who wanted to borrow — even if the borrowers were willing to shoulder more debt than may have been financially prudent for them. In some cases, lenders bent over backwards to extend credit, such as by offering extremely low interest rates for the first year or two of the loan. And, as we have seen, consumers took the bait in order to borrow as a way to compensate for their faltering earnings and savings (Leicht & Fitzgerald, 2007, Chapter 5).

Second, and of paramount importance, once the asset-backed securities market began to flourish, the government decided in classic neoliberal fashion not to regulate it. As discussed above, asset-backed securities are financial derivatives — that is, financial instruments whose value is derived from the value of something else. The value of the derivative, such as a bundle of mortgages, is derived from the presumed value of the group of securities that constitute it. As the complexity of these instruments grew concerns mounted that they involved substantial risk, but risk that was exceedingly difficult to evaluate given their complexity. This is why in 2003 multibillionaire financier Warren Buffett described them as financial weapons of mass destruction. Why they were not regulated requires some explanation because the unbridled operation of the derivatives markets was another root cause of the financial meltdown.

In 1982, Congress banned trading stock-futures because the SEC, which regulates stock trading, and the Commodity Futures Trading Commission (CFTC), which regulates commodities futures trading, could not agree who should have regulatory jurisdiction over them. However, political pressure to permit their trading mounted because there was demand for these instruments and they were being traded profitably in Europe. Eventually, legislation was passed by Congress and signed by Clinton in 2000. The Commodity Futures Modernization Act, as it was called, was again cosponsored by Phil Gramm and other neoliberals among others. It removed the trading ban on stock-futures. But it also did something else particularly germane to the financial meltdown.

In 1998, Brooksley Born, Chair of the CFTC, proposed that asset-backed securities and other over-the-counter derivatives, particularly credit default swaps, should be regulated. Over-the-counter trades are privately conducted between two parties rather than on an exchange, where they would be subject to regulation and much greater transparency. During the booming stock market of the 1990s, these and other new but unregulated financial instruments were emerging and proving to be extremely lucrative.7 The sort of regulation Born proposed would have dampened the ability of lenders to make so much credit available to consumers in the first place because it would have required holders of asset-backed securities to increase the capitalization of their firms in order to cover the risks associated with these investments, which would have reduced the amount of money they had to lend. However, the idea went nowhere as it ran into strong opposition from Federal Reserve Board chairman Alan Greenspan, SEC Chairman Arthur Levitt, and Treasury Secretary Robert Rubin, who all warned that regulation would undermine the efficiency with which they believed these new, exciting and profitable markets were operating (Wade, 2008, p. 14). The Commodity Futures Modernization Act officially preempted derivatives like these from government oversight. It also excluded from regulatory oversight credit default swaps for which by late 2008, there was a $60 trillion market (Cox, 2008). This was extremely important. It is reasonable to assume that without such swap insurance, prospective buyers would have been much less likely to have purchased asset-backed securities. So the decision not to regulate swaps made it even easier for companies to issue
them and therefore contributed further to the growth of the asset-backed securities market. All of this meant that credit continued to flow more and more easily and especially to the housing market.

The importance of credit default swaps cannot be underestimated. As discussed previously, banks, securities firms, hedge funds, and others bought swaps from insurers like AIG in order to absolve themselves of responsibility for the financial risks associated with asset-backed securities investments. Insofar as banks were concerned, which were regulated and faced capitalization requirements, buying swaps also saved them from having to put capital aside to cover such risks as the regulations required. Hence, what would have been lower-rated securities were converted into higher-rated securities because they were covered by credit default swaps. This, of course, gave further impetus to the drive to invest in these complicated and, as it turned out, quite risky investments (The Economist, 2009a, p. 20). As Mitchell Abolafia (2010) argues at length, poor regulation of this sort created opportunities and incentives for extreme opportunism in the financial services markets.

**Capitalization Requirements**

SEC regulatory reforms contributed further to the availability of consumer and mortgage credit as well as riskier investments by securities firms and investment banks by easing in 2004 the capitalization requirements of these organizations. The rule allowed these firms to shift capital from safer to riskier and potentially more profitable investments. Under the old rules, securities firms had to reserve a set percentage of every dollar of capital at risk to ensure solvency in the event of a market collapse or failure of a major client. Under the new rules, reserves are determined according to a more complex and nuanced calculation of risks including things like adverse market movements or changes in legislation. More important for our purposes, the new rules also let firms use noncash assets, such as derivative contracts, to offset risk. This freed up more capital to use as collateral in order to borrow money for leveraging investments. All of this was done to keep Wall Street firms competitive with their European counterparts by allowing these firms to shift capital from traditionally safe investments to riskier ones. The large investment banks lobbied hard for the ruling. Prior to the change the leverage ratio for these firms was typically about 12 to 1 but afterwards it shot up to about 33 to 1 for the industry. The five biggest Wall Street firms increased their leverage to nearly 27 to 1 by the end of 2005 as they began adjusting to the new rules (Blinder, 2009b; Onaran, 2007).

Additionally, the 2004 SEC ruling established a program whereby investment bank conglomerates (e.g., Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns) need only agree voluntarily to SEC oversight of their capitalization, liquidity, and leverage positions. In order to avoid having their European operations regulated by the European Union they needed to be regulated in the United States, which is one reason why they pressed for the ruling. It turned out that voluntary regulation did not work because investment banks could opt in or out of supervision voluntarily and because they were not subject to specific legal authority of any other government agency. Hence, the SEC eventually shut down the program in September 2008 after it became clear that its lack of oversight was a contributing factor to the financial meltdown (Cox, 2008). But by then it was too late.

**Risk Assessment**

Underlying much of the shift toward riskier and more highly leveraged investments was a problem with evaluating the risk involved in the new and more complicated financial instruments like asset-backed securities and other forms of derivatives, which were exceedingly complicated to value. This was a major problem that government regulators left almost entirely to the private sector much to their explicit regret later. Had it not been for the lackadaisical and highly misleading risk assessment investors would likely have been much less eager to purchase the risky asset-backed securities being offered in the derivatives markets by the shadow banking system.

Investment firms have risk managers who are responsible for evaluating the risks associated with their firm’s various investments. At most firms risk managers were not viewed as profit centers. Although some of them began warning about the risky nature of the investments being made, they were largely ignored. They lacked the clout of the traders who were making fortunes for their firms (and for themselves) by dealing in these complicated securities. Trader’s livelihoods depended on finding new ways to make money as did the competitive advantage of their financial firms. So as incentives to engage in these new and extremely lucrative financial instruments mounted the warnings of risk managers were often ignored (Dash & Crewsell, 2008; Nocera, 2009b).

Moreover, it became easy to ignore these warnings because firms that had created these financial instruments developed complicated mathematical models to assess the risk involved. The most widely used model was Value at Risk (VaR), developed by J.P. Morgan in the early 1990s and then distributed to anyone who wanted to use it. Eventually, the SEC began to
worry about the amount of risk that derivatives posed and mandated that financial firms disclose the amount of such risk to investors. But the SEC left it up to the private sector to figure out how to do this. Hence, VaR became the de facto standard that almost everyone used for doing this. It turned out, however, that there were several problems with the model. Its projections were based on short two-year data histories. It ignored the slim possibility of giant losses, which could only occur through a catastrophic event, such as a 20% fall in house prices. It did not account for falling mortgage underwriting standards or certain kinds of leverage that might be involved with derivatives. Hence, unbeknownst to most people who used the model, it underestimated some of the low probability/high cost risks involved. Because it did so most corporate managers and regulators remained sanguine about the perils of derivatives, asset-backed securities, credit default swaps, and the like. In turn, because regulators used VaR to determine how much capital banks needed to put aside, it also contributed to the under capitalization problem (The Economist, 2009a, p. 13; Nocera, 2009b).

As Bruce Carruthers (2010) has detailed, independent credit rating agencies like Moody’s, Standard and Poor’s, and Fitch exacerbated these problems in very important ways. They assessed the credit worthiness of various financial instruments and the firms issuing them. They encouraged the proliferation of asset-backed securities like mortgage-backed securities by publishing what turned out to be overly optimistic assessments of their quality. In hindsight, this may not be surprising. For one thing, they struggled to keep up with the proliferation and increasing complexity of asset-backed securities and similar instruments during the 2000s. Few rating agencies had specific, comprehensive, written procedures for evaluating them (Casey, 2009). They also used extremely complicated albeit flawed risk assessment models to determine credit worthiness (Tett, 2009). These models typically failed to account for the effects of the U.S. housing bubble, the growth of mechanisms for transferring credit risk like asset-backed securities, and the increased appetite for risky debt in the U.S. housing market. Furthermore, these agencies faced a conflict of interest because they were paid by the issuers of the securities that they were rating. These conflicts were not always managed properly in part because there was no government oversight. This is one reason why in late 2006 Congress passed the Credit Rating Agency Reform Act, which ended a century of self-regulation by the credit rating agencies and gave the SEC jurisdiction over them (Casey, 2009). Prior to that, however, most investor’s knowledge of the properties of asset-backed securities and similar products was extremely superficial. It was based chiefly on the ratings, which were assumed to be trustworthy, rather than on a real understanding of the intricacies of the instruments themselves or their risks (MacKenzie, 2008, p. 6). Indeed, these financial instruments were so complicated that they were beyond the comprehension of most bankers, investors, and regulators (Tett, 2009). Hence, markets, regulators, and even the managers of many of the financial firms that were issuing these securities put increasing blind faith in the high credit ratings that these agencies issued (Dash & Crewsell, 2008; MacKenzie, 2008; The Economist, 2008).

**Investment Bank Public Listing**

Of course, the financial meltdown cannot be blamed just on regulatory decisions. For instance, another factor contributing to the propensity for risky behavior among investment banks was repeal by the New York Stock Exchange in 1970 of a rule preventing investment banks from going public – that is, to sell shares of the company on the exchange. Prior to that investment banks were private firms structured as partnerships that relied on the capital provided by the partners to finance operations. In those days investment banks were smaller and their business was more straightforward. Partners were liable for each other’s mistakes and the resulting losses. Hence, partners were strongly motivated to monitor each other’s behavior and they were more risk averse. But by the end of the 1980s virtually every large Wall Street firm was incorporated and publicly owned – the notable exception being Goldman Sachs, which went public in 1999. Incorporation and public listing lifted the burden of responsibility from the partners’ shoulders and enabled them to take advantage of soaring stock prices. In other words, they could now begin to play with other people’s money.

Going public also created an opportunity for their executives and top-level managers to be paid in stock options, although traders were still paid overwhelmingly in cash. The turn toward stock options as a key form of executive compensation and the need to keep shareholders happy by boosting daily share-price movements, total shareholder returns and quarterly results created strong incentives for bank executives and the traders and analysts who worked for them to maximize short-term profit even if this entailed taking risks that could have serious downside repercussions in the long term (The Economist, 2009a, p. 16; Guerrera, 2009). This too exacerbated the incentives for riskier but potentially very lucrative investment decisions (Stiglitz, 2003, Chapter 3; Surowiecki, 2008). Some of these investments were in new types of securities like the asset-backed securities that were being invented and that were subject to only
modest, if any, regulation. Moreover, the amount of money these firms could borrow to leverage their investments increased now that they could increase their capitalization by selling company stock on the exchange. As a result, the aggregate debt of the U.S. financial sector jumped from 22 to 117% of GDP between 1981 and late 2008. Financial sector debt was the fastest growing component of private sector debt since the late 1990s (The Economist, 2009b; Wolf, 2009b).

To be sure, going public was a private decision. Yet the Obama administration acknowledges the problems that stemmed from the short-term incentive structure that it created and admits that there should have been more regulation by the state. It has recommended new regulations to align the compensation incentives of brokers and others involved in the securitization process with the long-term performance of the securities they issue, such as by changing accounting practices to better reflect the long-term performance of these securities. The government also wants to peg the fees firms charge to the long-term performance of these securities and reduce them if underwriting or asset quality problems emerge over time (The New York Times, 2009, p. 42).

To review briefly, whereas the actual meltdown of the financial services industry illustrates how important the state is for financial markets as the lender of last resort when things turn sour, the factors contributing to the crisis described in this section illustrate how important the state is as a regulator of these markets and how significant its role is in preventing – or causing – the booms that can initially create serious problems. On the one hand, regulatory decisions affected how much risk originators of various securities and the investors who bought them were able to take. For example, exempting over-the-counter derivatives from regulation helped allay concerns about trading asset-backed securities like bundles of subprime mortgages. The SEC’s decision to ease capitalization requirements allowed firms to make a larger number of riskier investments. The absence of regulation of the credit rating agencies contributed to inadequate risk assessment of the new derivative securities, which is why Congress eventually imposed SEC oversight on them. On the other hand, regulatory decisions also encouraged the formation and development of some of these markets in the first place. Notably, regulatory reforms in banking facilitated the development of the shadow banking system, which invented many of the risky investment instruments central to the story. SEC securities regulation reform also helped spawn these markets. So did the Commodity Futures Modernization Act, which gave rise to a lucrative market for credit default swaps. Put differently, the state created a number of incentives that fostered ever-riskier market behavior. Not all of the factors contributing to the meltdown involved the state, but many did, especially as they stemmed from deep-seated beliefs in the virtue of relatively free and unfettered markets as the best way to organize an economy. And this brings us to the role of neoliberalism.

THE ROLE OF NEOLIBERALISM

If we stopped the story here it would appear perhaps that the crisis was simply the result of a number of isolated regulatory decisions and reforms and lacked any kind of overarching explanation. I do not believe that this is the case. Instead, many of these reforms were rooted in the rising prominence of neoliberalism as the guiding light for U.S. regulatory policy. The rise of neoliberalism was driven in large part by the financial services industry, especially those on Wall Street, and their powerful allies in Washington (Krippner, 2010). A full-blown and systematic discussion of how each of these regulatory moves stemmed from neoliberalism is well beyond the scope of this article. Nevertheless, some discussion is in order.

According to the National Bureau of Economic Research, the overall level of financial regulation in the United States dropped sharply between 1980 and 2009 (Wolf, 2009a). Nowhere was this more obvious than in the regulatory reform of the banking industry where the Carter administration phased out interest rate ceilings for residential mortgages and various other bank loans and where the Clinton administration supported repeal of the 1933 Glass-Steagall Act – a move that was pushed hard by neoliberals in Congress. Neoliberalism was also evident in the Clinton administration’s decision not to regulate over-the-counter derivatives and credit default swaps because various influential members of the administration believed that doing so would stifle the efficiency of emergent markets for these things. Neoliberalism also influenced the Bush administration’s SEC decision in 2004 to allow self-regulation of the investment bank conglomerates capitalization, liquidity and leverage positions. And neoliberalism was at the heart of the Bush administration’s decision to reduce the dominance of GSEs, like Freddie and Fannie, in the mortgage market by capping their ability to expand lending thus creating new opportunities for private mortgage companies to compete in the market.

But neoliberalism is often about reforming the tax code as well as regulatory structures per se. In this regard, the 1986 Tax Reform Act,
which eliminated the interest deduction for consumer debt other than
mortgages, is important. This legislation was designed to do two things.
First, it was intended to reduce tax rates in accordance with neoliberal ideals
about limiting the role of government in the economy by limiting the
resources available to it in the first place. Second, it sought to simplify the
tax code by eliminating many of the so-called tax expenditures (i.e., loopholes)
that had been inserted into the code over the years. This is why the interest deduction for consumer debt was removed.
This too was inspired by neoliberalism to the extent that another of its
tenets is the simplification of government — including its tax code — in order
to make government more efficient. Neoliberalism was also at work insofar
as broadening the tax base through loophole reduction was intended to
avoid budget deficits that might otherwise result from reduced tax rates.
Deficits, of course, are anathema in principle, if not always in practice,
to liberals.

The fact that the government permitted much self-regulation in the
financial services industry is another example of neoliberal ideas. Of course,
neoliberalism does not advocate the complete elimination of all regulatory
oversight in markets. Enforcement of property rights, for instance, is
something liberals believe the state must do. But the preference is often
for some form of self-regulation by market actors whenever possible,
premised because they would recognize that it is in their collective self-
interest to police themselves rather than have the state do it for them. This
assumption was put to the test by the financial meltdown. For instance,
Washington reined in aggressive regulation by the SEC as part the neoliberal
reform movement. This took pressure off self-regulatory associations on
Wall Street, such as the National Association of Securities Dealers, which
became so passive that traders in some markets were either ignorant or
indifferent to its activities. A culture of tolerance resulted, which observers
believe was inadequate for inhibiting the sort of opportunism in the markets
that we now know caused such havoc (Abolafia, 1996, p. 34–35).

Neoliberal tendencies toward self-regulation also appeared in the area of
risk assessment. For example, the troublesome effects of regulatory reform
were compounded by the creation of and blind faith in fancy statistical
models for estimating risk, credit assessment algorithms, and other cognitive
deVICES that enabled mortgage lenders, financial services companies, inves-
tors, borrowers and others to ignore the mounting risks associated with
the development of increasingly complicated financial instruments. The
 adoption of the VaR model as the de facto standard for estimating the risks
associated with asset-backed securities and credit default swaps mystified

not only the private sector but also government regulators. Here again the
state assumed in classic neoliberal fashion that firms would behave
responsibly — in this case by developing accurate risk assessment models
and heeding the warnings of their own risk assessors when serious risks were
detected. Neither of these things happened. Furthermore, the state
permitted the credit rating agencies to police themselves even as they faced
a conflict of interest in rating securities issued by the same firms that paid
them, and even as they struggled to keep pace with the rapid evolution of
increasingly complex and hard to understand investment products.

Recognizing that the credit rating agencies had failed to police themselves
adequately, the Obama administration called for the SEC to tighten
its regulatory oversight over them by requiring tougher standards of
disclosing and managing conflicts of interest, explaining the methodologies
involved in rating different types of securities, and informing investors
of additional risks that might not be evident from the ratings. The
administration also noted that regulators themselves had relied too heavily
on the credit ratings of these agencies in their own regulatory and
supervisory practices and should now refrain from doing so (The New
York Times, 2009, pp. 42–44). In short, the administration called for an end
to neoliberal self-regulation.

To adequately defend the argument that neoliberalism was behind all of
the regulatory reforms that I have identified as contributing to the crisis one
would have to develop case studies of all the reforms in question, identify
the key supporters of these reforms and demonstrate that their neoliberal
beliefs motivated their actions. This would require a book-length treatment
of the events in question. Yet there is enough prima facie evidence here that
I bet that such an exercise would support my claim.

CONCLUSION

I have argued that many roots of the financial meltdown stemmed from a
number of regulatory decisions taken over the years that facilitated the
creation of a large and ever riskier supply of credit into the housing market.
Many of these decisions echoed the neoliberal prescriptions that policy-
makers in Washington embraced increasingly since the 1970s. The result was
a massive market failure that sent the financial services industry and
eventually the entire economy into a tailspin as economic sociologists and
historians would have predicted.
Implications for Future Research

The most obvious implication of my argument for future research, as suggested earlier, is that more attention needs to be paid to how the emergence of a neoliberal paradigm of policymaking influenced the events in question in the financial crisis. Scholars have spent much time trying to explain the rise of neoliberalism (e.g., Campbell & Pedersen, 2001; Hall, 1993; Prasad, 2006). They have also attempted to show how neoliberal ideas pushed by powerful actors from the political and business communities affected various isolated episodes of macroeconomic, monetary, fiscal, and regulatory policy (e.g., Blyth, 2002; Schmidt, 2002; Vogel, 1996). But to my knowledge nobody has examined how neoliberalism affected such a wide range of policy decisions over such an extended period of time in one sector of the economy like financial services. If this could be done, then we would have a comparatively exhaustive analysis of how time and again neoliberalism turned out not to be a blessing but a curse.

Another important avenue of research would be to take the sort of analysis I have developed here and push it in a cross-national direction. To date, virtually all of the work that has been published in the United States on the financial crisis has focused only on this country, such as how the Fed failed to handle the emerging housing bubble, how Lehman Brothers slid into bankruptcy, how hubris on Wall Street led to the collapse, and so on (e.g., Lachter, 2009; Madrick, 2009). To my knowledge no comparative cross-national research has been published on the subject. I would be curious to know, for instance, why the United States and Britain experienced a more severe crisis than Canada. Was this because the regulatory infrastructures of the United States and Britain were more similar to each other than to Canada? Was this because neoliberalism held political sway to a much greater extent in the United States and Britain than it did in Canada? Or what? Research along these lines can better pinpoint exactly what sorts of regulatory infrastructures financial markets ought to have in order to avoid such crises in the future. There is certainly precedent for this sort of work in comparative historical and institutional analysis but it focuses on crises long past, such as the Great Depression (e.g., Gourevitch, 1986).

Several articles in this volume argue that the crisis stemmed from the tightly coupled nature of interorganizational relationships in the financial services industries (Guillén & Suárez, 2010; Palmer & Maher, 2010) – couplings that were facilitated in part by the small clique-like interpersonal networks of actors in these industries (Pozner, Stimmler, & Hirsch, 2010). From my perspective, the question that needs further investigation is how state regulatory reforms contributed to the development of such tight coupling. Repeal of the Glass-Steagall Act is the most obvious example of how a regulatory reform can tighten the relationships among organizations. In this case, the firewall separating commercial and investment banking was torn down thereby enabling the intermingling and merging of various formerly independent firms such that some became too big to fail and received massive government bailouts. In other words, one wonders whether most of this tight coupling was solely the work of private actors on Wall Street or whether it also involved much cooperation from Washington. Economic and organizational sociologists have often argued that politics and policymaking affect interorganizational relationships in corporate America (Fleisig, 1990; Perrow, 2002). The financial meltdown provides an opportunity to expand on this line of research.

I also find it interesting that on some occasions leading up to the financial crisis courageous individuals stood up and warned that too much risk was being taken and was likely to be disastrous. Brooksley Born was one who confronted some of the most powerful politicians in Washington and argued for regulation of the derivatives markets only to be shouted down by them. Risk managers inside investment banks were another group of individuals who sounded alarms only to be told to be quiet. As is well-known, Max Weber was among the first economic sociologists to pay attention to the sometimes conflicted relationships that organizational leaders have with the staff that work for them and occasionally challenge their authority. Such theoretically diverse scholars as Talcott Parsons, Alvin Gouldner, Peter Blau and Richard Scott, and William Kornhauser among others extended this line of research (e.g., Campbell, 1987, p. 151). The financial crisis seems to present a wonderful set of cases by which researchers could compare such challenges in both public and private organizations in order to better understand their dynamics and why they succeed or fail.

Policy Implications

So far the Obama administration has proposed several regulatory reforms. These include, among other things, increasing the capitalization requirements of banks; mandating that any firm issuing derivatives be obliged to purchase at least 5% of them itself; establishing a Financial Services Oversight Council to assess emerging risks in the industry; setting guidelines to better align the interests of corporate managers with long-term
shareholder interests; setting up a consumer finance protection agency; and regulating all over-the-counter derivatives markets. All of this is intended to mitigate excessive risk taking and avoid new crises in the future.

While all of these make sense, given the preceding analysis it seems to me that there are three sets of reforms that are especially urgent. The first is to separate commercial and investment banking by reinstituting a regulatory firewall between the two. Among others, Paul Volker, former chairman of the Fed, has urged the Obama administration to do this. As I have shown, repealing the Glass-Steagall Act permitted these two types of banking to be combined in ways that created a shadow banking system, which contributed significantly to the financial meltdown. Separating commercial and investment banking again would also help to reduce the tight interorganizational coupling that others have pointed to as another cause of the meltdown.

Another especially important reform is regulating over-the-counter derivative markets. The ability of firms to create and sell asset-backed securities over and over again with no government oversight was one of the most important causes of the financial meltdown. Indeed, former President Bill Clinton has acknowledged that signing the Commodity Futures Modernization Act was a serious mistake and that he should not have let himself be swayed by Greenspan, Rubin, Levitt, and others who pushed the legislation. He especially regretted that his administration did not put derivatives under the jurisdiction of the SEC and require more transparency in their trading. But he also believed that the Republicans in Congress would have overridden a veto anyway (Baker, 2009, p. 80). We will return later to the issue of whether regulatory reform like this is politically feasible.

A third step that Washington could take to guard against similar catastrophes in the future would be to resolve the conflict of interest that credit rating agencies face when they are paid by the same companies whose investment products they are hired to evaluate for risk. One way to do this would be to require investment firms to contribute annually to a general pool of funds from which credit rating agencies would be paid when rating derivatives and other financial products. This way rating agencies would be paid from the collective pool of funds not by a particular firm with a personal stake in a rating. The idea of a credit rating payment pool is similar to what happened in the commercial nuclear power industry after the Three Mile Island disaster. Utility companies with nuclear facilities and industrial trade associations agreed to contribute to a new private organization designed to monitor and identify generic problems in utility operation, management, construction, and quality assurance practices. The basic idea was that by pooling their resources, industry members could facilitate better oversight of their operations and share important information among themselves (Campbell, 1989). The amount of money contributed each year to a credit rating payment pool could be based on how much money was spent the previous year by the industry on credit rating. Similarly, contributions could be prorated for each firm based on how many securities they had rated by agencies the previous year.

To ensure an additional degree of independence from the financial services industry the federal government could contribute to the payment pool. Moreover, in exchange for that contribution government representatives, perhaps from the SEC or FDIC, could participate in the rating process to ensure that ample caution and objectivity characterized the ratings being issued. That is, government credit rating officers trained professionally in investment credit rating techniques could serve along with traditional workers from the credit rating agencies as they conducted the research and calculated ratings for various offerings on the market. So credit rating would be a team effort consisting of public and private actors where at minimum a government official would have to sign off on all ratings issued by the credit rating agencies. This is a significant step beyond what the House Financial Services Committee passed recently – a bill that simply calls for more SEC oversight of the credit rating agencies (Nocera, 2009a).

My idea would bring government credit rating specialists into the credit rating process itself rather than have them watch the process from the outside. In addition to the benefits described, this would infuse the credit rating system and thus the derivatives markets with an additional degree of transparency that might help mitigate excessively risky investing.

Prospects for Meaningful Regulatory Reform

As of this writing, virtually none of the Obama administration’s reform proposals have been written into law. And I am not optimistic that these proposals will pan out as planned. Why? To begin with, enormous political forces have mustered against these proposals. Large and small banks and their trade associations in Washington have already waged a major lobbying campaign to kill or water down various parts of the administration’s proposals (Labaton, 2009). Notably, Goldman Sachs, the large Wall Street investment bank, successfully lobbied the House Financial Services Committee to substantially dilute efforts to regulate over-the-counter derivatives markets (Kuttner, 2009). Special interest lobbying is built into
the very institutional fabric of U.S. politics and will only accelerate moving forward in this area.

Beyond this, however, there are other factors that are likely to impede effective reform. One of the most important may be the often contradictory nature of new and old regulations themselves. For instance, under the federal Helping Families Save Their Homes Act of 2009, mortgage companies that agree to modify the terms of a mortgage in order to help financially distressed homeowners avoid foreclosure, such as by reducing their monthly mortgage payments, receive protection from liability arising from these loan changes. But in a suit brought against Countrywide, the big mortgage company now owned by Bank of America, a federal judge ruled that the firm must uphold its original contractual pledge to buy back loans from investors if it modifies those loans for troubled borrowers. The ruling is a win for holders of mortgage-backed securities who would typically see the value of their investment drop were mortgages renegotiated. Such institutionalized conflicts of interest are likely to bloom in the future (Morgenson, 2009a). The point is that new and old policies and laws may contradict one another such that the Obama administration’s reforms may be hampered by the political-institutional legacies it has inherited, such as the edifice of contract law as this case illustrates.

Another looming obstacle to meaningful reform is bureaucratic infighting stemming from a regulatory architecture governing the financial services sector that is a complex patchwork of overlapping jurisdictions and laws at the state and federal levels. As reform plans unfold various government agencies are scrambling to protect or expand their regulatory turf. Notably, other regulatory agencies do not want to lose influence to the Fed, and the Fed does not want to relinquish its consumer protection responsibilities to a new agency although the Treasury Department has proposed both things (Blinder, 2009a). Obstructionist turf wars like this are to be expected because institutional fragmentation has caused similar problems in the past, such as when the SEC and CFTC vied for control of the stock-futures trading industry and ended up doing nothing (Paulson, 2009).

Other obstacles to reform are more ideational. For example, expertise in matters relating to the intricacies of how the financial markets and their complicated investment instruments operate lies squarely with the industry, not the government. This gives the industry an advantage in shaping whatever legislation is eventually passed as the government depends on the industry for advice on how to prevent such crises in the future. But Wall Street still seems locked into its old mind-set and remains devoted to the old way of doing things. Notably, investment banks are already devising new exotic investments that are reminiscent of those that got us into trouble in the first place. They are beginning to bundle and securitize life insurance policies as bonds and sell them to investors. And some firms are repackaging their money-losing securities, including real estate mortgage investments, into higher-rated ones. These innovations are simply a variation on the old asset-backed securities model and are fraught with some of the same risks (Anderson, 2009). Ideas on Wall Street about what constitutes appropriate risk-taking behavior do not seem to have changed much.

What all this points to is the strong possibility that, despite initial discussions among policymakers about rather bold regulatory change, we are likely to see something much less profound. This would not be surprising. Despite theoretical arguments about moments of crisis triggering radical institutional change, many scholars now recognize that political-institutional change tends to be much more incremental even at historical junctures like this one thanks to political resistance and other mechanisms of institutional path dependence (Campbell, 2004; Streeck & Thelen, 2005).

What is also troubling in the long run is that even many prominent economists continue to suffer from cognitive blind spots. For instance, Amartya Sen (2009), Nobel Prize winner in economics, wrote recently about the need now to remember the lessons of classical economists like Adam Smith, who stressed the importance of values and trust for efficient market performance, and Arthur Pigou, who theorized about the need for social welfare provisions to compensate for market failures. Sen’s point was that we need to fortify the underlying institutions of capitalism as part of the fix for the current situation. Unfortunately, he provided no concrete suggestions about how to do that.

Similarly, in his latest book Paul Krugman (2009a), another Nobel Prize winner, argued that the crisis is largely a monetary and demand-side problem requiring a return to Keynesianism. He devoted only two pages to discussing the “prophylactic measures” for reforming the system so that a similar crisis does not happen again. Here he mentioned the need for regulatory change with a single guiding principle — anything that needs to be rescued during the crisis should be regulated in the future when the crisis is over (p. 189). But he offered only two specific ideas along this line: require more capitalization by banks and shadow banks, and beef up capital controls to prevent international currency crises (p. 184).

Krugman is an optimist. And his optimism is telling. As he put it: “I believe that the only important structural obstacles to world prosperity are the obsolete doctrines that clutter the minds of men” (p. 190). But might not the choice that he poses between Keynesianism and neoliberalism also
constitute obsolete doctrine to a degree? Granted, there is need for Keynesianism at the moment to help resolve the current recession. But what about something new that is more appropriate for understanding the roots of the current situation, such as political–institutional analysis along the lines suggested by economic and political sociologists and historians? Economists are often at the ideational center of any paradigm shift when it comes to reforming economic regulation, which is why economic ideas matter so much (Fourcade, 2009). Hence, there is cause for concern that most economists – including Keynesians – have so little to say about political–institutional reform or institutional theory more generally. To be fair, although Krugman remains adamant that Keynesianism is our best framework for making sense of the current crisis, since his book was released he now calls for more attention among economists to some of the ideational factors that were involved in the crisis, such as those theorized in behavioral economics (Krugman, 2009b). This is a move in a more institutionally oriented direction. But more can be said.

For economic sociologists maintaining adequate state oversight in the financial markets is absolutely necessary to ensure that they operate properly. Similarly, economic historians have argued that the state must permanently engage the financial markets in order to mitigate their tendency toward booms and busts. For instance, Hyman Minsky (1986) theorized that financial markets are subject to slow movements from stability to crisis as speculative bubbles form and then burst causing banks and other lenders to tighten credit even to the most credit worthy companies and individuals. Recession follows immediately. He believed that without adequate state oversight through regulation, central bank intervention and other means the economy will be subject to severe business cycles. Similarly, Charles Kindleberger (1978) argued that financial crises occur when investors develop excessively optimistic expectations (i.e., irrational exuberance) and over estimate the future profitability of certain firms or markets. This leads firms and investors to devise and sell more securities than is prudent and take on more debt than they should. When their inflated expectations are not met, debt and stock values collapse, and markets for their heavily promoted financial assets dry up. Insolvency and economic recession or depression follows. The only way to avoid this, he argued, was for the state to intervene as the lender of last resort. All of this, of course, is evocative of the 2008 financial meltdown.

The point is that there are disciplines that take the political–institutional fabric of markets seriously. Economic sociology is one. Economic history is another. And institutional economics is a third (e.g., Hodgson, 1988).

However, they are all marginal to conventional economics in the United States. This is too bad because they warn of things that mainstream approaches miss – namely that markets are fragile and can only be protected from self-destruction through the state's supervision and protection. For markets to remain stable and avoid extreme booms and busts the state must limit how much risk market actors can take and when necessary intervene as the lender of last resort. This involves much more than a return to Keynesianism. The financial meltdown shows that when the state does not effectively manage risk taking it will eventually have to ramp up its lender of last resort function to fix the damage. This insight escaped neo-liberals who sought to roll back or avoid financial market regulation. They failed to take seriously enough that state and market must always be intimately connected and that without the state markets cannot function properly. Because these insights are not central to mainstream economic thinking, and because the ideas of mainstream economics often inform economic policymaking, I worry that whatever regulatory reforms we see coming out of the current crisis will only be ad hoc and not sufficient to prevent more crises later on.

Indeed, skeptics have already charged that the administration’s proposals for regulatory reform are not enough. For instance, they say that it fails to restore the separation of commercial and investment banking and it does not limit the possibilities of creating and selling new and ever more risky forms of derivative securities that carry with them the grave possibility of nasty spillover effects (Morgenson, 2009b; Rich, 2009). The Obama administration won office campaigning on a theme of hope. We must now hope that it will fully appreciate the lessons of economic sociologists and others as well as the errors of the neo-liberals as it tries to prevent future meltdowns.

NOTES

1. As is the convention among political sociologists and political economists, when I refer to the "state" I do not mean to imply that it is a monolithic whole. Rather it is a complex organization that consists of a number of branches, agencies, and departments.

2. Subprime mortgages are those typically made to borrowers with poor credit scores, histories of delinquent payments, foreclosures, or bankruptcies, poor debt-to-income ratios, and limited ability to cover monthly living expenses. Such easy credit often enticed prospective homeowners to buy houses that they would be unable to afford.

3. An asset-backed security is a financial instrument that is tradable like a stock or bond and whose value and income payments are derived from and backed (i.e., collateralized) by a specified pool of underlying assets. The pool is typically a group of small and illiquid assets that are unable to be sold individually. These might
include, for example, common payments from credit cards, auto loans, and mortgage loans, aircraft leases, royalty agreements, and movie revenues. Pooling the assets allows them to be sold as a bundle to general investors, a process called securitization. It allows the risk of investing in the underlying assets to be diversified because each asset-backed security will represent a fraction of the total value of the diverse pool of underlying assets. In short, an asset-backed security involves the bundling, underwriting, and selling of pieces of loans and other types of receivables as tradable securities. One incentive for banks to create and sell an asset-backed security is to remove risky assets from their balance sheets by having other investors buy them and, therefore, assume the credit risk, so that they (the banks) receive cash in return. This also allows banks to invest more of their capital in new loans or other assets and have a lower capitalization requirement. An asset-backed security is typically underwritten by an investment bank, which selects the portfolio of assets that constitute the security, sizes the pieces (or tranches), and works with credit rating agencies to establish the desired credit rating for each tranche.

4. Swaps are another type of security that is traded in the asset-backed security market. They are insurance policies against the possibility that an asset-backed security, including a securitized bundle of mortgages, or other derivative might default.

5. Some have argued that shoddy lending was facilitated by yet another institutional factor. Unlike many countries the U.S. legal system allows credit reporting to be widely shared, such as the well-known FICO score, which represents a numerical assessment of an individual’s overall creditworthiness. These scores were initially developed to guide lending in credit card and other types of short-term debt markets, not mortgage markets. But because it is cheaper to rely on these scores than to do your own credit report on a prospective borrower, mortgage lenders became less likely to do their own in-house credit assessments and more likely to rely on these generic scores for evaluating the creditworthiness of prospective borrowers. The problem was that these scores were not always reliable indicators of long-term credit worthiness for large loans like mortgages (Ellis, 2008).

6. Years later former President Bill Clinton admitted that signing the Gramm–Leach–Bliley Act likely enabled some of these firms to become bigger than they otherwise would have been the case and, thus, harder to manage (Baker, 2009, p. 80).

7. Over-the-counter derivatives involve much larger sums than do traded exchanges. In December 2005, the amount outstanding on all organized exchanges worldwide for both futures and options contracts was around $58 trillion. In over-the-counter markets, the sum was $248 trillion. Over-the-counter derivatives are often traded internationally. They are subject to a modicum of private self-regulation through the International Swaps and Dealers Association (ISDA). The problem with ISDA was that its standards were unconnected in any way with sanctions and hard law at the national and international levels (Morgan, 2008).

8. The regulation is known as “Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities” (RIN: 3235-A196).

9. The Act did not take effect before the largest rating agencies issued the ratings that contributed significantly to the financial meltdown. It was not until August 2007 that the SEC initiated an investigation of the large credit rating agencies and it was not until December 2008 that it adopted regulations governing credit rating agency transparency, competition, and accountability (Casey, 2009).

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