The Moment of Truth

On February 18, 2010, President Barack Obama signed an executive order establishing the bipartisan National Commission on Fiscal Responsibility and Reform, with Erskine Bowles and Allen Simpson as the commission's co-chairs.

It soon became better known as the "Deficit Reduction Commission." In December 2010, the Committee published a 60 page report entitled "THE MOMENT OF TRUTH".

Approximately a year earlier, on May 20, 2009, President Obama signed into law the Fraud Enforcement and Recovery Act of 2009 creating the Financial Crisis Inquiry Commission. The stated purpose was to examine, "the causes, domestic and global, of the current financial and economic crisis in the United States."

Both committees were bipartisan and blue chip, a combination of laymen and elected officials. The commissions were authorized to hold hearings, issue subpoenas for witnesses, testimony or documents, and remain functioning until their work was complete, which was to be late 2010 or early 2011.

These two commissions, along with multiple other inquires by various departments of the government, as well as governmental institutions around the world, were empowered to figure out what happened between the spring of 2007 and the winter of 2009 to cause the greatest financial crisis since the 1930's, a true global crisis. How did it happen, what can we do to prevent it in the future, and how will it be repaired?

Ad hoc committees of inquiry, with vast powers have long been a part of political and social history, as the compulsion to "blame someone" if and as something goes wrong or to thwart a new idea if such does not agree with established culture. Just to illustrate, think how pervasive and frightening committees of this nature, supposed inquiry or fact finding commissions, can be: the Reformation, the Inquisition, the Committee for Public Safety, the

House Un-American Activities Committee, the Kennedy Assassination Inquiry, Watergate, and Iran-Contra.

In 2008 and early 2009, the world was still groping for the proper words to define the financial crisis. Every event needs a title. The United State and the Western World settled on the "Great Recession", as "what to call" the then present economic crisis. This fitted the sound-bite world of instant media, as "great" was meant to mean "a really serious and big event," while "recession" was meant to sound "familiar and fixable," as we had done so often in the past. No one dared use the "D – Word", as nothing comparable to that terrible economic event of the 1930's, still fresh in some minds, could be conceived of, much less its aftermath, the 1940's and the devastation of World War II, which many think was an outflow of the economic sanctions and consequences imposed by the Peace Treaty of Versailles.

Washington, New York, London, Paris, Berlin, Beijing, and Tokyo, all said "solve this damned thing, we are all in the same boat and I don't want to go down because you did something so stupid."

But, just when did "it" start to happen? For that matter, just what was "it"? Economic history does not lend itself well to a beginning, a starting date, any more than it has an end. Just like other parts of history, this evolution does have some seminal events or confluence of circumstance which come together to change a direction, which then takes on an evolutionary life of its own. For modern financial and commercial history, this date was 1971 forty years ago, when then President Richard Nixon ended the convertibility of gold, which had been pegged at $35 an ounce, and freed it to trade openly. The Bretton Woods Agreements, established in 1944 at the end of World War II, were abandoned, although many of the institutions established at Bretton Woods, such as the International Monetary Fund, the World Bank, World Trade and Tariff Agreement Conventions, remained and are important international financial intermediaries to this day.

Whether it was currencies going off the fixed exchange ratio to gold, as many of the inflation hawks or gold bugs believe, or whether it was just a series of political circumstances such as guns and butter, the embarrassing exit from Vietnam, or changing socio-economic structure of the 60's, may be relatively moot in looking back to the events which transpired from 1971 through the present; to the crisis. The change, "it", was in motion.

From the mid 1930's, coming out of the Depression, through the early 70's, commercial banking had been separated from investment banking and most other kinds of financial activity through the Glass-Steagall Act, which was part of the Banking Act of 1933. From that period forward, commercial banking in the United States was fragmented, a large number of community banks, a few relatively large ones, and then a handful of giant banking enterprises, most of which were domiciled in New York or on Wall Street. They were all controlled or supervised by the Federal Reserve Board, the Comptroller of Currency, the FDIC, and various state banking authorities. Other institutions, such as finance companies and the state chartered savings and loans, were also part of this banking picture.

Regulation Q limited the interest rate which could be paid on savings accounts to 4 ¼%. Commercial banks were prohibited from underwriting equity securities and participating in many other financial activities, such as insurance.

In 1971, however, the investment banking and stock brokerage community was pretty much as it had been from the late 1930's. Brokerage firms were partnerships, although there were a few proprietorships, all serving a growing investor public. Business management and organization, mergers and acquisitions, conglomerates, and something called "growth stocks" began to emerge in the 1950's and with them market theories and lore, along with sophisticated investment techniques evolved. The dividend discount model, the Efficient Market Theory, price earnings multiple expansion, quantitative research, growth industries such as computers, new drug products, aerospace, and most exciting of all, instant photography.

After Vietnam and Watergate, the economy in the 1970's moved front and center stage, with runaway inflation and the highest interest rates ever witnessed in the modern United States of America. The goings-on at the Federal Reserve Board were the most popular play in both Washington and New York, if not also in London and Tokyo. In fact, the leading man, the chairman of the Fed, changed as frequently as poorly rated sitcom actor, until one Paul Volker came on to the scene.

There was a bit player in this drama of ever higher interest rates and inflation during the 70's, which in hindsight changed the financial world even more than going off the gold standard. As a result of surging interest rates and inflation, along came a new and revolutionary money game dressed up in mutual fund clothes – The Money Market Fund. Why keep your money in a savings and loan at 4 1/4% when you could get 9, 10 or even 15% in a money market fund at your brokerage house? However, the fund business had to be done by a corporation; it didn't work in a partnership. The New York Stock Exchange was a clubby environment, very prestigious, and it did not permit corporate members. Money being what it is, this changed swiftly, and by the end of the 1970's most if not all brokerage firms became corporations and many of them began to go public in order to raise additional capital to expand into other financial arenas. Quite obviously, this series of events obliterated the savings and loan industry and its philosophy of local lending, neighborhood savings, and the tranquility which surrounded it.

This series of events also brought the "shadow banking system" out of the dark and somewhat into public view. What had formerly been a very sophisticated, large player "side market" of bond shops, commercial paper, and money lenders, all seemed to merge into the new money businesses created on Wall Street and, at the time, most in the shadow world were not even supervised or regulated by the SEC, the U.S. Treasury or the Federal Reserve Board.

The savings and loan industry virtually collapsed and disintegrated during the early 80's and by the end of the decade had taken the real estate industry with it. The stock brokers with their money market funds and the big banks on Wall Street disintermediated the savings and loan industry and many of the smaller banks. In order to stem bank failures, most state legislatures began to allow banks to acquire weak savings or banking institutions in adjoining counties, then getting together with others in contiguous states, and then, of course, it was only a matter of time before something resembling a nationwide banking network began to evolve.

Since the debacle and scandals of the 30's, bankers had generally become a pretty conservative bunch, pillars or their individual communities, and moderately well compensated, but not what one would call "big earners." But, during the 1990's this was changing, and changing rapidly. This charge was lead in the stock market and on Wall Street, but also in some unlikely places such as Charlotte, NC, home of Nations Bank, or Columbus, OH, Bank One. One of the more interesting players in this game of banking monopoly was one Sandy Weill, a tough, active, aggressive, visionary, player. He cobbled together a relatively unlikely series of financial companies, Shearson Hammil, Smith Barney, Traveler's Insurance Company, and, from time to time, he was in and out of other brokerage firms and American Express. Finally, Weill made a bid for and eventually took over Citibank. But, he broke the law. Seems like no one complained, it was too big to fail, and he forced or cajoled Bill Clinton, then President, and Bob Rubin, Secretary of the Treasury, to convince Congress to terminate Glass-Steagall and open banking and financial services to a nationwide, global wide, and all-inclusive money business. Probably not uncoincidentally, Bob Rubin became the chairman of the board of Citibank for a short period and then a special consultant, after leaving government several years later. Weill himself left the executive ranks of Citicorp in 2005, very near the peak of the stock price, and became just another individual entrepreneur, philanthropist, and billionaire.

In 2010, as the two newly created commissions, one on the financial crisis, the other on deficit reduction, one to determine what happened, the other to fix it, it became quite apparent, plain and simple, Wall Street had taken control of the United States over the past 20 years, concluding the evolution started in 1971 by going off the gold standard, the shadow banking market coming into the light with the creation of the money market fund, and the deregulation of the banking or financial services industries. Banking was poised to make big money, money was the fuel of politics, and a financial/political complex evolved to a place of supreme power by the early 2000's. It was an ever so much greater threat than the military-industrial complex feared by Dwight Eisenhower, pointed out in his farewell address 50 years ago. A new epitaph came into being in 2008, "to big to fail," such was the name of the beginning of the end.

This epitaph, however, actually came into being about 25 years earlier, the fall of 1984 with the bankruptcy, rescue, and subsequent sale of Continental Illinois, at that time one of the 10 largest banks in the country. Over the next 15 or 20 years the term became more widely employed with the savings and loan failures, the Texas banks, First City, First Republic, and MCorp, and then the Bank of New England.

In 1991 the Treasury Department described its policy of TBTF as to dealing with "a situation in which the FDIC (with some other governmental unit) is unwilling to inflict losses on uninsured depositors and even creditors in a troubled bank (or bank holding company) for fear of adverse macroeconomic consequences or financial instability of the system as a whole."

As the world of global banking and finance changed during the latter part of the 90's and into the first decade of the 21st century, mergers and acquisitions, virtually in every direction whether horizontal, vertical, or stepping off into the shadow world, huge amounts of money were being made in all kinds of ways on Wall Street. Venture Capital Funds became LBO specialists, then came the hedge funds, and soon they all moved right inside the banks and investment banks as proprietary trading departments, securitization and structured finance departments, and SIV's, Special Investment Vehicles. The best and the brightest from leading graduate business schools all wanted to go to Wall Street, investment banks, or hedge funds.

Over this extended period of time, the last thirty years, while banking was changing and growing, another class, an unlikely partner to Wall Street, burst on to the scene: the economist. Economic theory has long played a part in the development, understanding, and regulation of commerce and finance. Many of today's basic principles have their roots in the likes of Adam Smith and John Stuart Mill, both British economists in the 18^{th} century, who began to deal with the industrial revolution, capitalism, and money, actual currency, as a store-house of wealth. Perhaps most well known 20th century economist was also a Brit, John Maynard Keynes, who gained fame with the concept of deficit financing and government intervention during the Depression. Lord Keynes is still a major influence and his policies are subject to many interpretations and multiple debates.

Economists moved into the United States government with the establishment of the Council of Economic Advisors as part of the Economic Act 1946. The chairman of the Council is the lead economic spokesperson in most presidential administrations, and is often on the road to become chairman of the Federal Reserve Board.

After the White House brought in economists to aide with a growing and economically complex government, it was natural for industry to bring in economists to help them diagnosis trends, banks certainly wanted someone to help with economic theory, forecasts, and interpretation, and as time rolled along, all of this economic theory found its way to Wall Street. However, a theory was entertaining, but application could be enormously profitable.

The stock market has long lent itself to theory, counter-intuitive thinking, trend analysis, forecasts and projections. Many investors believe that having the "right formula" is the road to fame and fortune. The great economists coming out of MIT, Stanford, Harvard, Yale and Chicago began to make money for themselves with their theories; they published in academic and financial journals, and then moved to Wall Street, either inside the investment banking firms or being solicited as partners to form new firms. The big names of the past 75 years are well known, Keynes, Frederic von Hayek, Milton Friedman, Paul Samuelson (he wrote the text book,), Joseph Stieglitz, Franco Modigliani, John Nash, Joseph Schumpeter, and Kenneth Arrow, to name just a few. The economists introduced theories, which became belief, then practice, and then, validation or failure, sometimes even both, as was seen with then Efficient

Market Theory in 2008, or with Myron Scholes, the Nobel laureate, who became a partner in Long Term Capital Management which blew up in 1998.

All of these things came together in the 1980s and held sway for 25 to 30 years, creating bubble after bubble in the economy, financial markets, and the socio-economic structure of the United States of America, perhaps even that of the world.

Six Presidents of the United States presided over this period but only three men held the post as chairmen of the Federal Reserve Board: Paul Volker, Alan Greenspan, and Ben Bernanke. It was said that Paul Volker was the most powerful man in the country in the early 80's, and looking back that was well the case. Alan Greenspan had an unusually long tenure, held a mystical power over Presidents, Congress, and the public with almost a cult-like personality. From the height of popularity, which he once occupied, Greenspan may be viewed as a tragic figure and maybe a failure. Ben Bernanke is very well educated, hard working, and a bright academician, who is probably in over his head. Financial history will probably feel sympathy for Bernanke as he was dealt an impossible hand which he is playing pretty well in unchartered waters.

The Financial Crisis Inquiry Commission was created in May 2009, ten members, with Phil Angelides, the former California State Treasurer, as the Chairman. After developing a plan of inquiry, the committee held its first meeting mid September 2009, just a year after the demise of Lehman Brothers, and held public meetings in various parts of the country from mid January 2010 through the end of July. The commission's final report was initially due to Congress on December 15, 2010, but was delayed until January 2011, amid what appeared to be a public dispute perpetrated by the Commission's partisan divide. The four Republican members released their own "primer" on the full report about what went wrong in America's financial markets; they were unwilling to lay blame. In response to this ploy, the New York Times financial columnist, Joe Nocera, chastised the Republican minority, saying that, "fearing their view would get short shrift, they preemptively put forward a 'cliff notes' version of their theory of the case." There appeared to be some fear in the air as to the findings of the Commission, particularly in mortgage lending and the securitization chain which may have concealed much deeper problems in the mortgage market. Several other newspapers and commentators discussed the minority Republican position and delay as, "very powerful interests seeking to undermine the investigations, Trillions of dollars may be at stake."

The Financial Crisis Inquiry Report was delivered to Congress, the President, and released to the public on January 27, 2011. As noted in December, the minority released as separate report, in fact two minority opinions. The majority or official report was over 500 pages in length and examined a period of over 20 years, diagnosing the financial industry and markets goings on. In previewing their conclusions, the commission spelled out their mission as, "Our task was first to determine what happened and how it happened so that we could understand why it happened." They went on to say, "This was a fundamental disruption – a financial upheaval, if you will –that wreaked havoc in communities and neighborhoods across this country." And the very serious financial nature of the crisis was pointed out by stating, "Nearly $11 trillion in household wealth has vanished, with retirement accounts and life savings swept away." Still further, "The collateral damage of this crisis has been real people and real communities. The impacts of this crisis are apt to felt for a generation. And the nation faces no easy path to renewed economic strength."

The FCIC had six relatively simple points of finding: First, -- We conclude this financial crisis was avoidable, on this key point they waxed poetic by adding, "To paraphrase Shakespeare, the fault lies not in the stars, but in us-- We conclude widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets, and here they added that "regulators had ample power in many arenas and they chose not to use it;' then, -- We conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis; -- We conclude a combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis; next, -- We conclude the government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and the panic in the financial markets, they elaborated by saying “we had allowed the system to race ahead of our ability to protect it;” -- and finally, We conclude there was a systemic breakdown in accountability and ethics. To emphasize this last point, the commission stated, “Unfortunately – as has been the case in past speculative booms and busts – we witnessed an erosion of standards of responsibility and ethics that exacerbated the financial crisis; this was not universal, but these breaches stretched from the ground level to the corporate suites.” These were indeed strong words.

The Deficit Reduction Committee, actually called the National Commission on Fiscal Responsibility and Reform, issued its report on December 1, 2010. However, support for the report was also partisan, along party lines, even though the co-chairpersons, one from each party, supported and voted for the entire plan. In order to require Congress to examine the plan in detail and perhaps propose it into law, the Commission had to have a 2/3 majority approval.

The report, ominously and challengingly entitled “The Moment of Truth”, had pieces of its recommendation supported by many, but not many supporting all of the recommendations. The preamble was inspiring and full of promise, as preambles so often are, with such phrases as, “we cannot play games or put off hard choices any longer . . . , America cannot be great if we go broke . . . , The American people are counting on us to put politics aside, hold together not pull apart, and agree on a plan to live within our means and make America strong for the long haul. . . ., the solution will be painful, there is no easy way out, everything must be on the table, and Washington must lead.

Recommendations of the Commission were straightforward: cut one hundred billion in defense spending, raise Social Security age to 69, raise gas tax by 15 cents per gallon, lower the Corporate tax rate to 26%, rein in Federal Spending on health care, ban Congressional ear-marks, repeal the alternative minimum tax, disallow interest deductions on mortgages over

$500,000, cut the Federal workforce by 10%, cut farm subsidies, tax capital gains and dividends at the higher rate now levied on wage income, to compensate, drastically lower and simplify individual tax rates to 9%, 15%, and 24%. The overall plan would cut the Federal deficit by $3.8 Trillion by 2020, but still not balance the budget.

In mid December 2010, after the mid-term election setback in November for the Democrats, President Obama compromised with the Senate Republicans and agreed to a two year extension of the Bush era tax cuts along with a variety of modifications designed to, in part, close some loopholes, while creating several permanent longer term benefits toward lowering taxes. When the plan was initially unveiled, much criticism was put forth by the liberal Democrats on one hand and the deficit hawks and Tea Party on the other. But the public warmly embraced the idea of a "tax cut" and quickly sent the message to Washington, which silenced partisan bickering and made all sides appear to be winners. The bill, earmarked with Christmas decorations, passed with ease. President Obama declared a victory. None of the provisions in the Deficit Reduction plan were part of the bill, none were even seriously discussed. It seemed as if partisan politics could not and cannot be put aside; so much for the "preamble" of the commission.

And perhaps so much for the Financial Crisis Inquiry as the Commission concluded its report, finally published on January 27, 2011, with the following admonition: "When this Commission began its work 18 months ago, some imagined that the events of 2008 and their consequences would be well behind us when we issued this report. Yet more than two years after the federal government intervened in an unprecedented manner in our financial markets, our country finds itself still grappling with the aftereffects of the calamity. Our financial system is, in many respects, still unchanged from what existed on the eve of the crisis. Indeed, in the wake of the crisis, the US financial sector is now more concentrated than ever in the hands of a few large, systemically significant institutions.

Over a 30 year period of time, from 1981 through 2010, much of the Western world, led by the United States, has gotten into serious financial trouble, no nation or government seems to have been able to cope with its financial problems. Parisian politics trump tough decisions, be it among nations or individual people. Perhaps the words of Winston Churchill, describing a different but similar problem in the late 1930's might apply, "Everybody is feeding the crocodile, hoping he will eat them last!" This time we are feeding that beast with debt!

Yes, in that short 30 year period of time, just a little over a generation, Wall Street brought Main Street down. The moral hazard is not "too big to fail," but to believe that "greed is good." The Moment of Truth has arrived

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