Boston University School of Law

Scholarly Commons at Boston University School of Law

Shorter Faculty Works

4-4-2010

# How Washington Abetted the Bank Job

Susan P. Koniak

George M. Cohen

David Dana

Thomas Ross

Follow this and additional works at: https://scholarship.law.bu.edu/shorter_works

Part of the Law Commons

The New York Times

**April 4, 2010**

OP-ED CONTRIBUTORS

# How Washington Abetted the Bank Job

**By SUSAN P. KONIAK, GEORGE M. COHEN, DAVID A. DANA and THOMAS ROSS**

A FEW weeks ago, two Republican House members asked Ben Bernanke, the chairman of the Federal Reserve, whether the Fed knew — before Lehman's bankruptcy examiner revealed it — about the bookkeeping scam at Lehman known as "Repo 105." This scam allowed Lehman to disguise how much debt it was carrying, right up until it collapsed. Lehman got new loans to pay off old loans, pretended the new loans were "sales," and through a complicated series of steps made both the old and new loans disappear just in time for its quarterly reports.

Mr. Bernanke said the Fed had known nothing about this. After all, he explained, the Fed wasn't Lehman's regulator — the Securities and Exchange Commission was. The Fed had placed some people at Lehman — not as many as the S.E.C. had — but they were there only to ensure that Lehman paid back money it was borrowing from the government. Can't lay this on him.

Meanwhile, the S.E.C. insists that it could not have known what Lehman was up to because it was "understaffed" and "ill-suited" to run a voluntary oversight program. But, the commission says, since the Lehman bankruptcy examiner's report it has sprung into action, investigating whether other banks might also have cooked the books.

Any minute now, expect to hear that the Treasury, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation — our other federal bank regulators — were just as shocked that Lehman used make-believe sales to hide its ocean of red ink.

Well, the truth is this: The collapse of Enron back in 2001 revealed that the biggest financial institutions, here and abroad, were busy creating products whose sole purpose was to help companies magically transform their debt into capital or revenue. At the time, there were news reports about Merrill Lynch pretending to buy Nigerian barges from Enron, JPMorgan Chase dressing up its loans to Enron as commodity trades and Citigroup disguising Enron debt as profits from Treasury-bill swaps.

This went well beyond Enron. Our banks had gone into the business of creating "products" to help companies, cities and whole countries hide their true financial condition. Consider the recent revelations about how Goldman Sachs and J. P. Morgan helped Greece hide its debt. Now we discover that our banks not only were raking in huge profits helping others hide debt, they also drank their own Kool-Aid. As a chief executive of Citibank said in 2007 about financing dangerously leveraged deals, "As long as the music is playing, you've got to get up and dance."

Our bank regulators were not, as they would like us to believe, outside the disco, deaf and blind to the revelry going on within. They were bouncing to the same beat. In 2006, the agencies jointly published


Electronic copy available at: https://ssrn.com/abstract=2554601

something called the "Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities." It became official policy the following year.

What are "complex structured finance" transactions? As defined by the regulators, these include deals that "lack economic or business purpose" and are "designed or used primarily for questionable accounting, regulatory or tax objectives, particularly when the transactions are executed at year end or at the end of a reporting period."

How does one propose "sound practices" for practices that are inherently unsound? Yet that is what our regulatory guardians did. The statement is powerful evidence of the permissive approach bank regulators took toward the debt-dissolving financial products that our banks had been developing, hawking and using themselves for years. And it's good reason for Americans to be outraged by the "who me, what, where?" reaction of Mr. Bernanke and the S.E.C. to the revelation of Lehman's Repo 105 scam.

•

Since the financial crisis struck in 2008, many have bemoaned the supposed inability of bank regulators to coordinate their efforts. That assumes a joint effort would somehow have helped. In fact, our regulators could coordinate, and did, and thereby contributed to the crisis.

Their cooperation began in the early 2000s, when the regulators decided they had to say something about how our banks helped Enron conceal its debt through complex transactions and how financial institutions were devising ever more complex instruments. In 2004, the agencies issued their first proposed statement on these practices.

This proposal was not quite "regulation" (in the sense of a set of new binding rules), but rather more like a position paper that set forth safeguards the regulators thought the banks should adopt. Mild really, given what Enron had exposed.

Still, the plan included significant hurdles that the regulators wanted banks to clear before selling or using potentially dangerous financial instruments. The focus of the 2004 proposal was complexity itself; it would have applied to all new complex products developed by banks.

That focus was right. Complexity was what made it possible to hide debt, avoid capital requirements and evade taxes. Thus the statement said that banks should document their reasons for concluding that each complex instrument developed and sold would be used for a legitimate purpose and not to evade the law. It also said that financial institutions should ensure that the buyers of complex instruments understood how they worked and what risks they entailed.

The financial industry would have none of that. It bombarded the agencies with comments denouncing the proposal. Banks did not want the responsibility of explaining to customers the risks inherent in these instruments. And, while banks couldn't say it directly, how they could document that products that were valuable specifically because they could get around laws were not being bought for that purpose?

MOREOVER, the banks understood that the statement threatened the virtually regulation-free zone they had won for other forms of complex structured finance, particularly collateralized debt obligations. So the


Electronic copy available at: https://ssrn.com/abstract=2554601

industry condemned the 2004 proposal, and the regulators caved. They agreed to think it over — for two more years.

Hence the interagency statement on "sound practices" of 2006 we described earlier, which was greeted with effusive praise from bankers, their lawyers and accountants. Gone was the requirement to ensure that customers understood these instruments and that the banks document that they would not be used to phony-up a company's books.

The focus on complexity was also gone, as was the concern over transactions "with significant leverage" — that is, deals with little real cash underneath, another unfortunate deletion because attending to excessive leverage would have served us well.

Instead, the only products that the banks were asked to handle with special care were so narrowly defined and so obviously fraudulent that suggesting that they could be sold at all was outrageous. These included "circular transfers of risk ... that lack economic substance" and transactions that "involve oral or undocumented agreements that ... would have a material impact on regulatory, tax or accounting treatment."

Just as troubling, at least in retrospect, the new statement specifically exempted C.D.O.'s from the need for any special care because they were akin to other "plain vanilla" derivatives, in that they were "familiar to participants in the financial markets" and had "well-established track records" (yes, the same C.D.O.'s backed by bundled mortgages that financial firms and the government are now stuck trying to value and absorb, the infamous "toxic assets").

•

Only two years later, these same regulators were explaining that the complexity and opaqueness of instruments like C.D.O.'s had contributed significantly to the economic collapse. And it is now common wisdom that many of the bankers themselves did not understand the risks of these "familiar" instruments.

Moreover, the collapse was characterized by institutions supposedly healthy one day and on the verge of collapse the next, due in no small part to their extraordinary debt burdens — debt burdens that complex instruments magically removed from the books.

To this day, that final interagency statement (which was adopted in 2007) has not been repealed or replaced. It can still be found on the S.E.C. Web site, along with the letters from industry representatives praising the 2006 draft.

The site also has a single letter begging the agencies not to adopt that draft statement — a letter the four of us wrote. Our position was simple: products having no economic purpose except to achieve questionable accounting, tax or regulatory goals; or that raise serious concerns that customers will use them to issue materially misleading financial statements; or that meet any of the other bullet points in the 2006 statement's list, should, at a minimum, be labeled presumptively prohibited.

The final statement notes and rejects our plea, saying that if any firm determined that its participation in a complex financial transaction "would create significant legal or reputational risks for the institution," it


Electronic copy available at: https://ssrn.com/abstract=2554601

could “take appropriate steps to manage and address these risks.”

As Congress now considers reforming the financial industry, it needs to take into account how abysmally our regulators performed when they coordinated their efforts and how insular their decision-making has been on matters that affect the entire economy. Congress needs to recognize that “regulatory capture,” in which an agency becomes a pawn of the industry it is supposed to oversee, is real.

Ideas like the proposal by Paul Volcker, the former Fed chairman, to prohibit traditional banks from trading on their own accounts, will do little to improve the situation so long as enforcement is left up to regulators’ discretion. Passing piecemeal fixes to outlaw each fraud-inviting instrument — like the provision slipped into the recent jobs bill that outlaws a derivative that had been designed by the industry to allow individuals to evade paying taxes on their stock dividends — will never be a substitute for restoring civil liability for abetting securities fraud. Innovation can too easily outstrip specific rules.

Yes, we can lay Lehman’s Repo 105 and the proliferation of dangerously complex instruments at the feet of the Fed, the S.E.C. and the other signatories to the watered-down interagency statement. Years earlier, after Enron collapsed, they learned all they needed to know about the bogus structures banks developed to conceal financial instability. Yet by backing down and giving in, the regulators encouraged them. We are paying for those mistakes today.

*Susan P. Koniak is a law professor at Boston University. George M. Cohen is a law professor at the University of Virginia. David A. Dana is a law professor at Northwestern University. Thomas Ross is a law professor at the University of Pittsburgh.*

Copyright 2010 The New York Times Company

Privacy Policy | Terms of Service | Search | Corrections | RSS | First Look | Help | Contact Us | Work for Us | Site Map



Electronic copy available at: https://ssrn.com/abstract=2554601