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The Powerful Bank Lobbies
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I was struck by a piece in the *Financial Times* on May 6 to the effect that the originators of subprime mortgages spent almost \$370 million in a lobbying campaign in Washington to prevent tighter regulation of their industry. Unfortunately for the rest of us, they succeeded. The *FT* article was based on research by the Center for Public Integrity, a nonprofit journalism organization. A point brought out by the research was that most of the top 25 originators of the loans were owned or heavily financed by the nation's largest banks, Citigroup, Goldman Sachs, Wells Fargo, JP Morgan, and Bank of America. These are precisely the banks that received the bulk of the government's bailout funds.

The more we learn about the events that led to the disastrous economic collapse that continues to beset most of the world, the more incomprehensible the actions of the banks and mortgage companies look. We are being told by the same banking experts that brought on the current problems that we should not dwell on the past but, rather, look to the future; yes, we must look to the future, but the actions of the past are still affecting us in the present. Spokespersons for the big banks are quoted almost daily in the media that they wish to repay their bailouts from the federal government to escape the onerous conditions that go with these loans. "Onerous conditions" apparently refer primarily to limits on compensation to bank managers and senior professionals. Nothing is being said about who repays the companies forced out of existence, or people who lost their jobs, or those who lost much of their retirement savings as a result of the actions of the banks.

Some of the "givens" that took place in the lead-up to the financial collapse, such as the lobbying to limit oversight of bank actions, are the following:

1. Subprime mortgage lenders and the institutions that bought these mortgages took on large risks because the profits were extraordinarily high. Part of the backdrop to this was the Bush administration campaign to make the

United States an ownership society—to convince people to buy houses and apartments. Pseudo-ownership (ownership with unpayable mortgages) was extolled and affordable rentals were disdained.

2. The risky mortgages were packaged into notes sold to unwitting buyers, presumably on the ground that this would permit the process to go on indefinitely. It is hard for a layman in this field, like me, to understand whether there was a well-thought-out rationale for the procedures—issue billions (trillions) of dollars of subprime mortgages, drastically raise the interest rates after an initial period, sell these defective mortgages to packagers to incorporate in securities that were widely marketed—or was each step taken by the banks and mortgage companies when they realized that inordinately high profits would follow. The designers of these measures surely realized that putting families into houses they could not afford could not endure unless housing prices rose forever. I had always thought of bankers as cautious, people who knew that if something cannot endure, it will not endure.

3. By now just about everybody not personally involved understands that the willingness to take risks by actors in the financial sector stems from the compensation incentives. Compensation was based on short-term profits, and taking risks increases these profits. One can understand why intelligent young people flocked to the financial sector, especially the investment banks, because the compensation was outsized compared with other professions. It is harder to reconcile acceptance of the self-evident risks by the senior management of these banks other than to conclude that they too enjoyed the exceedingly high compensation they received. A little gray hair should have inculcated some caution about their management of their institutions, but on the whole this was not the case.

4. The issuance of trillions of dollars of credit default swaps was again an operation built on greed, on the

conviction that income can be generated without fear of having to meet any or much the insurance obligation inherent in these complex derivatives. The managers of AIG, the insurance company that issued so many of these instruments, did not take Milton Friedman's caution to heart—that there is no such thing as a free lunch. What was free—or profitable—for the bankers has been immensely costly for the rest of society.

It remains uncertain what banking structure will emerge after the United States and much of the rest of the world comes out of the current recession. The leaders of big banks have made it clear that they oppose compensation limitations that might affect their institutions. Their argument is that such limits would make it difficult for them to recruit and retain talented people. Lobbying along these lines is now pervasive. As we know, many bonuses were paid to personnel of institutions that received government bailouts—another indication of the difference in mindset between bank insiders and the general public. A future regulatory structure as lax as that which preceded the financial meltdown is unlikely, but it is hard to know how strict new regulations will be and what will be targeted. We learned from the stress tests that the data published on capital shortfalls of the banks examined were calculated only after much give-and-take between the banks and the examiners making these determinations.

Many observers, including me, were intrigued by the fact that Canadian banks did well financially even as the market value of large U.S. banks collapsed. Canada's economy is about one-tenth the size of that of the United States, but (according to a Bloomberg report) 4 of the top 10 banks in North America are Canadian. Canada did not have a housing bubble and its banks did not finance subprime mortgage lending, although the central government did provide a relatively modest mortgage purchase program in 2008. The six largest banks in Canada were profitable in 2008. They are less leveraged than U.S. banks. And, getting to the heart of the matter, the regulatory structure in Canada is far more stringent than that faced in the United States before the financial meltdown. According to Marie-Josée Kravis of the Hudson Institute, the home ownership rate in Canada is similar to that in the United States at about 60 percent.¹ However, a commentary by Pietro S. Nivola and John C. Courtney published by the Brookings Institution states that almost half the households in the lowest income quintile in the United States own their own homes, whereas the comparable

figure in Canada is about 38 percent.² Much of U.S. subprime lending targeted lower income families.

The Bank of Canada, Canada's central bank, issued a "Financial System Review" in December 2008 that includes the following: "The housing and mortgage market excesses seen in the United States and in several European countries do not have a counterpart in Canada." And "...a greater proportion of loans (made by Canadian banks) remain on the balance sheet of the originator...and lowered the sensitivity of bank capital to fluctuations in the market price of assets."

Much has been written about the cultural differences between the United States and Canada. The most widely read of these analyses is probably Seymour Martin Lipset's 1990 book *The Values and Institutions of the United States and Canada* (Routledge), and this is worth reading again in light of the different approaches to banking in the two countries. On this, Canadian banks and regulators were clearly more risk averse than their U.S. counterparts. Canadian culture seems to give greater weight to collective well-being and less to individual prerogatives than in the United States.

In the end, the cultural mores that led to the intertwined mortgage and banking crises were those of the United States. Compensation to managers of large banks is high in just about all countries, but they are probably higher in the United States than anywhere else. All countries have banking lobbyists, but few in other developed countries have been as successful in achieving their goal of minimal regulation as those in the United States. Housing mortgages are subsidized in many countries, but the U.S. subprime excesses may have no equal elsewhere. And because of the economic weight of the United States, a financial breakdown has greater global repercussions than breakdowns elsewhere. These are the realities that have to be addressed as the United States reconfigures its banking structure.

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¹ *Wall Street Journal*, "Regulation Didn't Save Canada's Banks," May 7, 2009.

² Pietro S. Nivola and John C. Courtney, "Know Thy Neighbor: What Canada Can Tell Us About Financial Regulation," Brookings Institution, April 27, 2009.