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Conflicts of Interest and the Financial Crisis

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Even the Queen of England could see that the economics profession messed up big time in the lead up to the financial meltdown. On a visit to the London School of Economics in 2009 she asked why economists’ failed to foresee the crisis. After a “serious” study, a group of eminent economists’ said economists had a “failure of imagination”, suggesting, perhaps, the need for more envisioning courses in Economics PhD programs. Paul Krugman pinned it mostly on economic theorists’ obsession with mathematical beauty and elegance at the expense of true understanding, what he called “mistaking beauty for truth”.

A more sensible answer begins with the observation that most of the economics profession was utilizing the wrong theories — theories based on efficient markets and rational expectations — rather than the much more informative ideas based on Keynes, Minsky, and those of my colleague James Crotty, among others (see the discussion at the Institute for New Economic Thinking) who see financial markets as inherently unstable and bankers in need of serious constraints.

But, until now, there has been way too little focus on the answer actually given by the Professor to whom the Queen originally directed her question. He reports: “…she asked me: ‘How come nobody could foresee it?’ I think the main answer is that people were doing what they were paid to do, and behaved according to their incentives, but in many cases they were being paid to do the wrong things from society’s perspective.” (Guardian, 26 July, 2009)

And as we like to remind our students, economists are people too.

Charles Ferguson’s new movie, Inside Job brings to the fore this crucial point: Financial economists who missed the build-up to the crisis and who are now urging mild reform are not simply blinded by their love of beauty, but also, it seems, by their love of money. Ferguson reminds us of Larry Summers’ long-standing advocacy of financial de-regulation, while pulling down more than $20 million from the financial-services sector between 2001 and 2008. Glenn Hubbard, Chairman of George Bush’s Council of Economic Advisers and an advocate of financial de-regulation, was paid $100,000 by the defense to testify in the case of the two Bear Stearns executives charged with fraud by the U.S. government. And, according to Inside Job, economists routinely get paid to provide testimony and write papers favorable to the financial industry.
While one cannot be sure these payments affect views on financial theory and regulation, they certainly create a conflict of interest. Yet, these economists almost never reveal their financial associations when they make public pronouncements on issues such as financial regulation. Jessica Carrick-Hagenbarth and I did a study of 19 prominent academic financial economists who were members of two influential groups that have played a key role in the financial reform and regulation debate in the U.S. Of the 19 academic economists in these groups, 70% advised, owned significant stock in or were on the board of private financial institutions. But you wouldn’t know by looking at their self-identification in media appearances, policy work or academic papers.

Examining their media appearances and academic papers between 2005 and 2009 in which they discussed financial reform, we found these economists rarely, if ever, revealed their ties to private financial firms, preferring instead to identify only their prestigious academic affiliations. The only economist who routinely identified his private financial affiliations is one who was trying to sell a financial product. These economists thus leave the impression that, in discussing issues of financial reform, they are speaking only from the perspective of “objective”, “scientific” economics while they might have more material matters at stake.

The American Economics Association, has no rules to discourage, much less prevent, this behavior (see the excellent work of George DeMartino). Universities have codes of conduct, but these discourage conflicts of interest that harm the University, not the general public. The American Sociological Association is an important exception: its code urges sociologists to disclose financial connections “that may have the appearance or potential for a conflict of interest….in public speeches and writing”). Economists should adopt this approach.

Even more importantly, more of us economists who are not faced with such conflicts should step up and get involved in the financial reform fight which is heating up over the implementation of the Dodd-Frank Act. Send in comments on key rule making, such as the Volcker Rule; join SAFER or other groups fighting for reform. We must act as a counter-weight to these self-serving economists who will continue to oppose serious financial reform as they drape themselves in the cloak of economic science.
that dominate the U.S. market will no longer be available to support their outsized positions. The capital of derivatives affiliates – even if within the same holding company – will necessarily be much smaller and will limit their aggregate positions. This will create opportunities for non-bank firms to enter the market with capital positions equivalent to those of the affiliates of major institutions.

By shifting the activity to affiliates, section 716 eliminates the burgeoning counterparty risk the largest banks incur through marketing and trading OTC derivatives. Encouraging an expansion in the number of dealers will help reduce the risk to the system as a whole. The intent in both the House and Senate bills to require clearing and trading on exchanges using a central counterparty structure is another critical element for alleviating interconnectedness but only if the pressure to create loopholes is resisted.

**Are there other provisions that mitigate these risks if banks are allowed to continue selling and trading derivatives?**

There are other provisions in the House and Senate bills that address some aspects of bank exposure to risks involving derivatives but none of them remove the government guarantee backing their marketing and trading by banks. For example, the Volcker Rule in section 619 of the Senate bill deals with the equally important problem of proprietary trading by proposing to bar trading in any financial instrument, including derivatives, for a bank’s own account. The Merkley-Levin amendment strengthens this provision by making the reform a statutory ban rather than leaving it to the discretion of regulators. In addition, it would crack down on trades that conflict with customers’ interests.

But Merkley-Levin is not a substitute for section 716. It would still allow banks to deal and trade on behalf of their clients. Their derivatives business would still be backed and subsidized by Federal Reserve lending and FDIC guarantees and, in the event of another crisis, might require taxpayer bailouts to protect the banking functions of these huge enterprises.

Other sections of the Senate bill – sections 608–611 – address the systemic risk posed by interconnectedness. Section 610 limits a bank’s credit exposure (including derivatives) to another bank or financial institution as a percentage of its capital. This provision will tend to shrink the OTC derivatives market since, as noted, over 90 percent of aggregate transactions involves trades between dealers or with other financial institutions. Another section (608) complements section 716 by limiting a bank’s credit exposure (including derivatives) to affiliates. But, again, banks would still be able to conduct their derivatives business within the bank and the government backing for the bank that constitutes a guarantee and subsidy for selling and trading derivatives would remain.

Both the House and Senate bills authorize regulators to impose aggregate position limits on traded contracts and swaps. These provisions complement both sections 610 and 716 in the Senate bill by allowing regulators to address excesses and imbalances in the derivatives positions of individual institutions and the aggregate market as well. They are a very important tool for strengthening the regulation of derivatives markets but – once more – they do not remove the anticompetitive government support uniquely enjoyed by the derivatives operations of the five largest U.S. financial institutions.

In summary, there are no substitutes for section 716 – no provisions that will accomplish what it does in terms of removing the subsidy enjoyed by (literally) a handful of institutions and ending the ongoing threat to the taxpayer that the guarantee of their derivatives business poses. Ignoring that threat would undermine all the other contributions to reform that the House and Senate bills provide.