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OBVIATING THE MORAL HAZARDS THAT CAUSED THE RECENT BANKING CRISIS AND FUTURE DISLOCATIONS WITH THE IMPOSITION OF REGULATIONS, RESERVE REQUIREMENTS, REVENUE/RISK ADJUSTED PAYOUTS

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ABSTRACT

This paper will examine the critical aspects of the Glass-Steagall Act of 1933 including a detailed analysis of the objective of the act on the banks and the economy. A further review will explore the atmosphere and psychology of the various banking practices that were implemented during the 1980's and 1990's. A chronology of pivotal events will prove that the current environment of deregulation and erosion of the distinct line between commercial and investment banks is actually attributed to monetary policies dating back to Alan Greenspan and the Federal Reserve Board actions of the 1990's. The start of the 21st entury saw the rapid growth of derivative instruments that were not regulated, prompting the moral hazard which caused the mortgage banking industry collapse. A further analysis of the reckless practices will show how these lending practices caused financial chaos. The companies that failed did so because of overleveraging and failure to control risk effectively while rewarding themselves without establishing adequate reserves. The paper will conclude with an analysis of the present arguments to strengthen the core requirements for both the investment and commercial banking.

JEL: G01, G24, G28

KEYWORDS: Moral Hazards, Revenue/Risk Adjusted Payouts

INTRODUCTION

Derivative trading moved from a total outstanding nominal value of $106 trillion in 2001 to a value of $531 trillion in 2008 (Kwak, 2012). At the same time, the Glass-Steagall Act was dismantled. Federal Reserve monetary policy favored financial leverage. Financial services company leverage blossomed; Merrill Lynch assets to equity moved from a low of 18:1 in 2002 to 32:1 in 2007 for Merrill Lynch (Kwak, 2012). Such circumstances created moral hazard, which the authors deem to be the root cause of the Great Recession. In 2007 United States unemployment was approximately 4.3%. By 2010 it reached almost 10% (U.S. Bureau of Labor Statistics). Delinquency rates on home mortgages were less than 2% in 2005. By 2010 the rates was above 11% (Board of Governors of the Federal Reserve System (US)). The statistics speak to the long lasting, devastating effects of the liberal policies created by the Federal Reserve. In 2016 the Federal Reserve continues to struggle with setting monetary policy to gently bring the U.S. fundamentals to their appropriate place. The literature on the subject of the root cause of the financial crisis is typically pointed at a singular cause, for example, deregulation, giving way to use and

abuse of collateralized debt obligations. Other experts credit commercial banks' liberal mortgage lending practices and ensuing real estate collapse as the main cause for the 2008 financial collapse.

This paper links the issues commonly addressed in the literature with Federal Reserve practices dating back to the 1990's. The authors present a compelling argument that the Federal Reserve actually created the moral hazard which caused the meltdown of the financial markets. In addition, the authors analyze the benefits of strengthening the core requirements for both the investment and commercial banking systems. The body of the paper presents important regulatory decisions since 1990 that have changed the financial services' climate. The root cause of bank failures such as Wachovia and Washington Mutual are examined. Connections between deregulation and financial services leverage are presented along with diminished reserve requirements. The authors provide needed examination of Value at Risk measurements. The conclusion makes a strong case for the importance of proper examination of leverage and avoidance of liberal Federal Reserve policy.

LITERATURE REVIEW

Glass –Steagall Act, also known as the Banking Act of 1933(48 Sat.162) was passed in 1933 and forbade commercial banks from engaging in the investment banking business (New York Times,2012). The enactment was an emergency response to the failure of nearly 5,000 banks during the Great Depression. It was originally a section of President Franklin D. Roosevelt's New Deal program and became a permanent measure in 1945. Some of the more important features included tighter regulations for national banks in the Federal Reserve System, prohibited banks from the sale of securities and created the Federal Deposit Insurance Corporation (FDIC), which insures bank deposits with a pool of money appropriated from banks. Beginning in the 1900's commercial banks established security affiliates that floated bond issues and underwrote corporate stock issues. The expansion of commercial banks into securities underwriting was substantial until the 1929 stock market crash and the subsequent Depression. In 1930, the Bank of the United States failed, reportedly because of activities of its security affiliates that created artificial conditions in the market. In 1933 all banks were required to close for a four day "Bank Holiday" and 4,000 closed permanently. Bank closings coupled with an already devastated economy pushed public confidence in the U.S. financial structure to new lows. In an attempt to reverse this spiral and restore the public's confidence that bank's would follow reasonable banking practices Congress created the Glass-Steagall Act.

The Act forced a separation of commercial and investment banks by preventing commercial banks from underwriting securities, with the exception of U.S Treasuries and federal agency securities and municipal and state general obligation securities. Conversely investment banks were not allowed to receive banking deposits. Investment banking consists mostly of underwriting securities and related activities, making secondary markets in those securities and setting up merger and acquisition activities, restructuring and over business advisement. The Glass- Steagall Act helped restore confidence in the banking industry during and after the Depression. Many historians however gesticulate that the practices of the commercial banks of the time had little actual effect on the already devastated economy and were not a major contributor to the crisis environment. Over the years legislators, economists and businessmen have argued that Glass-Steagall was outdated, created an atmosphere of uneven playing field between domestic institutions and those globally who were not constrained by such restrictions. There was also a strong feeling of government overreaction to a crisis in attempt to insure against repeat economic distress. The world economy became more dynamic with the emergence of the strong Japanese economy and the geopolitical impact of the Middle Eastern states buttressed with growing oil revenues.

In 1994 the Government proposed letting the banks enter new fields of business, including allowing big banks selling real estate, computer services and possibly even securities. The new rules would allow banks to set up subsidiaries that could undertake any activity "incidental to or within the business of banking" Until now, subsidiaries of federally chartered banks have been limited almost exclusively to banking

(Bradsher, 1994). Critics of big banks were quick to warn that new regulations could undermine Glass-Steagall which is murkily written and open to interpretation "said Diane Casey, executive director of the Independent Bankers of America, a Washington based trade group that represents small banks (Bradsher, 1994). While the Treasury was not actively involved in drafting regulations the proposals were consistent with the Clinton administration's general position that banks should be allowed to diversify into other industries. The first breach in the Glass-Steagall Act occurred in 1989 when some big banks were granted permission from the Federal Reserve to set up separate subsidiaries for trading securities and J.P. Morgan was the first obtaining the right to trade corporate debt and stocks in 1990.

These holding companies were legally separate from the banks and were limited to trading securities and could not engage in activities like real estate brokerage and data processing. The Financial Services Modernization Act of 1999 was passed by Congress after 12 attempts in 25 years. Congress finally repealed Glass-Steagall, rewarding financial companies after 20 years and $300,000,000 of lobbying efforts (Weill, 2014). The key element of the repeal of Glass- Steagall was the proposed merger of Citicorp and Travelers Insurance. The merger was granted temporary approval by Alan Greenspan's Federal Reserve. The official stance of the White House was that the Financial Modernization Act was tearing down the antiquated laws and granting banks significant new authority. The signing of the Gramm-Leach-Bliley Act in late 1999 repealed Glass-Steagall once and for all paving the way for both consolidation and expansion in the banking/investment banking industry.

It must be remembered that deregulation and consolidation in the banking and investment banking area had been in place and growing over the past three decades. In fact there were more bank mergers and acquisitions from 1988-1998 sixty-nine in total than from 1998 to 2012, fifty-nine (Weill, 2014). It also could be argued that an overly accommodating monetary policy by the Federal Reserve since before the dot.com bust and post 9/11 was the fuel that propelled asset backed price appreciation. Alan Greenspan, in an effort to move the stalled economy post 9/11 kept interest rate at historically low levels as the stock market and economy struggled. Investment money flowed unabatedly into real estate as a safe haven. This accommodative policy along with a relaxation of regulations led to an environment of ever increasing laxity when it came to policing risk and its potential consequences (Carmassi, Gros & Micossi, 2009). The Glass –Steagall repeal did not lead to a tremendous consolidation of banks and mergers or takeover of brokerage firms on a large scale. It is not often mentioned that there existed and still does exist tremendous differences in culture of the two types of institutions. The genetic makeup of those who work in investment banks is drawn from the universe of alpha males and females as opposed to the more staid personalities in the commercial bank sector. In fact of all the firms those failed or were in danger of failing only one was the real benefactor of the repeal. The institution was the very one that hastened and lobbied for the repeal of Glass-Steagall, Citigroup. Citigroup was the combination of Citicorp and Travelers Insurance and its subsidiary of Salomon Brothers-Smith Barney that was allowed by the adoption of Financial Modernization Act mentioned earlier. In studying the other firms that fell victim to the Great Recession in the banking and investment industry all others were either banks or brokerage firms.

The three large brokerage firms were Lehman Brothers, Bear Stearns, and Merrill Lynch. Lehman Brothers unfortunately was unable to find a buyer and fell into bankruptcy in September of 2008. Earlier in March, 2008 Bear Stearns was bought by J.P. Morgan through the intervention of the Federal Reserve and Treasury. Merrill Lynch was acquired by Bank of America in September 2008. Wachovia was purchased by Wells Fargo in October, 2008 without any government assistance. Wachovia was saddled with troubled mortgages through its merger with Golden West Financial in 2006. Finally, Washington Mutual became the largest American bank to fail in September, 2008. Washington Mutual's assets were seized by Federal regulations and sold to J.P Morgan Chase. A number of Savings and Loan Companies along with Mortgage granting institutions also failed, the most prominent being Countrywide Credit which was acquired by BankAmerica. Glass Steagall in and of itself did not directly cause bank and or investment bank failures, it was a component of a string of ongoing deregulation and lax regulation that added fodder to the fire. One

must look at some of the other factors that allowed, indeed provided impetus for the failures. Deregulation in its broad stroke should spur competition as long as the remaining regulations are upheld and enforced. The first line of defense in any organization is regulating itself as a means of survival and the ability to prosper and thrive. Given an atmosphere of relaxed regulatory involvement the risk appetite will rise to meet the appetite and intestinal fortitude levels of your rivals. This is exactly what transpired during the melt down and the Great Recession. It would be wise to look at some of the more pertinent and elusive descriptions of Glass Steagall and what are indeed factual.

A TIMELINE OF RECENT EVENTS

Glass Steagall in fact was never repealed. It is still applicable to insured banks and forbids them from underwriting or dealing in securities. What was repealed in 1999 were the sections that prohibited insured banks from being affiliated with firms commonly called investment banks, those that are engaged in underwriting and dealing in securities. Repeal allowed banks to use taxpayer insured funds for risky trading, this is also not factual. Portions of Glass Steagall that remained after 1999 prohibited insured banks from underwriting or dealing in securities. Before and after repeal the banks were allowed to trade [buy or sell] bonds and other fixed income securities for their own account. Banks have always been allowed to trade securities they can invest in. Banks did not get into trouble 'trading' risky mortgage back securities they ran afoul by holding these instruments in their portfolios. This is basically the same thing as granting loans that defaulted during the meltdown. The repeal of Glass Steagall did not allow the Investment bank subsidiary to have access to insured deposits so unless they fraudulently comingled or poached funds this would not be possible. The banks failed by making bad loans. The investment banks that failed Bear Stearns. Merrill Lynch and Lehman were not affiliated with insured banks. These institutions by and large became insolvent because of over leveraging, something this paper will address in ensuing pages (Wilson, 2012).

Two of the biggest banks that failed, Wachovia and Washington Mutual got into trouble mainly by making risky loans to homeowners. Two large banks with investment banking arms, JP Morgan and Wells Fargo, resisted taking government money and arguably could have weathered the storm without it. BankAmerica nearly met the same fate of Wachovia and Washington Mutual but not because they bought Merrill Lynch but for their large investment in Countrywide Mortgage a plain vanilla mortgage company (Pearstein, 2012). It would be better to focus our research on some of the reasons that these failures happened at all. Deregulation has had strong government backing since and before even the Reagan Administration. We will look at the most current governmental easing starting with the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. This bill eliminated previous restrictions on interstate banking and branching. This was the first link in the foundation of allowing big regional banks to merge and acquire other banks while moving to a national platform. Figure 1 presents the deregulation timeline/key event.

Figure 1: Timeline of Key Events

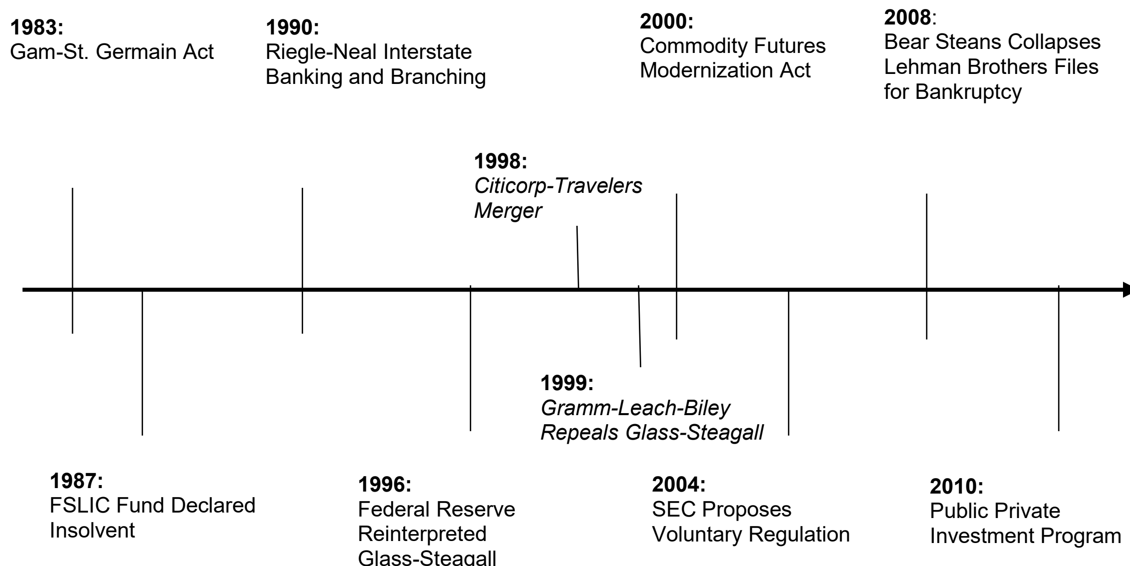

Figure 1 illustrates the chronological progression covering the repeal of the Glass-Steagall Act. Please note the confluence of the Citi-Travelers Merger and the Gramm-Leach- Biley Law as CitiCorp executives played a prominent role in lobbying for the repeal. Source: Sherman, Matthew. "Short History of Financial Deregulation in the U.S., Center for Economic Policy and Research," July 2009, [p.1.]

1996 - Fed Reinterprets Glass-Steagall. After several revisions bank holding companies were allowed to earn up to 25% of their revenues in Investment banking. 1998 – Citicorp-Travelers Merger, creates Citigroup, Inc. merges a commercial bank with an insurance company [Travelers owned Salomon, Smith Barney investment banks] to form the world's largest financial services company. 1999 – Gramm-Leach-Bliley Act—with support from Alan Greenspan, Federal Reserve Chairman, Treasury Secretary Rubin and his successor Lawrence Summer, repeals Glass-Steagall. 2000 – Commodities Futures Modernization Act-Passed with support from the Clinton Administration, including Treasury Secretary Lawrence Summers and bi partisan support in Congress. This bill prevented the Commodity Futures Trading Commission from regulating most over-the-counter- [non Listed instruments] derivative contracts, including credit default swaps [CDO's]. 2004 – Voluntary Regulation- the SEC proposes a system of voluntary regulation under the Consolidated Supervised Entities program, allowing investment banks to hold less capital in reserve and increase leverage. A pattern was emerging that eventually led to bank and investment bank failures. Investment banks were policing themselves more and more with less oversight by the SEC and Federal Reserve. This atmosphere allowed investment banks to increase leverage from 12-1 to 33-1 (Barker, 2012), this leveraging works wonders in a rising asset environment but downward spiraling of asset values leads to dire consequences very quickly.

What Went Wrong

Figure 2 shows the value at risk model that financial firms relied upon to create their CDO structures were predicted on the fact that housing prices experienced a general upward trend for over 50 years. In fact, their progression was upended as mortgage securitization became less "hand on" and more automated.

Figure 2: Financial Services Leverage

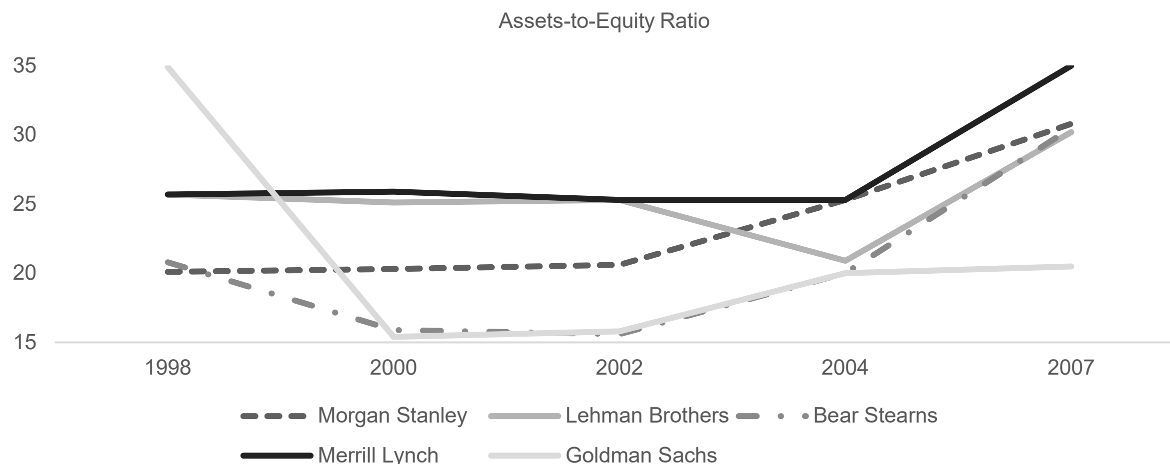

Figure 2 shows the value at risk model that financial firms relied upon to create their CDO structures were predicted on the fact that housing prices experienced a general upward trend for over 50 yearsSource: Kwak, James. "What Did the SEC Really Do in 2004?" www.baselinescenario.com /2012/01/30

Hands off Regulation

A rapid growth in the new types of derivatives instrument posed a major problem to regulatory agencies and removed any transparency that had here- to- fore existed. The financial industry developed a wide range of derivative instruments in the 1990's, most of which were not regulated, this growth continued unabated and accelerated in the first decade of the 21st century. The most important of these derivatives were credit default swaps [CDS] which were effectively a form of bond insurance, where the insurer would bear the risk in the event of a bond default (Financial Crisis Inquiry Commission, 2011). In a completely unregulated market, derivative trading ballooned from a total outstanding nominal value of $106 trillion in 2001, to a value of $531 trillion in 2008. Capital requirements were allowed to drift significantly low as result of S.E.C. actions in 2004 as reported in an article published by a former S.E.C official. SEC rule 15c3-1 allowed some financial firms to hold less capital and dramatically increase their leverage from 12-1 to 33-1. This move was in response to the existing regulatory ratio guidelines followed in Europe and was intended to help the 5 largest US investment banks remain competitive on a global basis. Before the rule change the broker-dealer was limited in the amount of debt it could incur, to about 12 times its net capital, though various reasons broker-dealers operated at significantly lower ratio. If, however, Bear Stearns and other large broker-dealers had been subject to the "typical haircuts on their securities positions" and aggregate indebtedness restriction, and other provisions for determining required net capital under the traditional standards, they would have not been able to incur their high debt leverage without substantially increasing their capital base (see Table 1).

An atmosphere of accommodative monetary policy, friendly bipartisan support for deregulation spanning two decades and an easing of regulatory oversight led to an appetite for increased leverage. This increased leveraging was in somewhat a response to the cries of shareholders for greater returns and a leveling of the playing field with European banks that routinely had leverage ratios even exceeding 40-1. The 2004 rule allowed the Investment banks to pile up debt at an unprecedented rate while at the same time weakening regulatory oversight (Labaton, 2008). It allowed, for the first time the S.E.C. to have a window on the bank's risky investments in mortgage related securities; unfortunately the agency never took true advantage of that part of the bargain. Christopher Cox who became the new Chairman of the S.E.C. a year later never considered this a high priority. The commission assigned seven people to examine parent companies—which in 2007 controlled financial empires with combined assets of more than $4 trillion [at the time of the

article in October 2008 not a single inspection had been made since the division was reshuffled] (Andrew, 2012). The 2004 decision reflected a faith that Wall Street's financial interests coincided with Washington's regulatory interests." In retrospect, the tragedy is that the 2004 rule making gave us the ability to get information that would have been critical to sensible monitoring, and yet the S.E.C. didn't oversee well enough" Mr. Goldschmid an S.E.C Commissioner and authority on securities law from Columbia University, said in an interview.

Table 1: Comparative Financial Leverage, 1997-2007 Debt-To GDP Ratio

	Economy-Wide		**Non-Financial Corporate Sector**		**Financial Sector**		**Households & Small Business**	
YEAR	EA	US	EA	US	EA	US	EA	US
1999	3.51	2.66	0.67	0.46	1.61	0.79	0.48	0.88
2007	4.54	3.47	0.92	0.49	2.32	1.17	0.61	1.28
2008	4.73	3.46	0.97	0.49	2.42	1.17	0.61	1.24
Change in 1999-2007	1.03	0.81	0.25	0.03	0.71	0.38	0.13	0.40

Table 1 shows the proliferation of related lending standards the entire economy employed greater balance sheet leverage. As housing comprised a major part of U.S. asset values, stock prices created a negative collateral effect thus exacerbating the credit crisis. Source: "The Global Financial Crisis: Causes and Cures," Journal of Common Market Studies, 2009. Vol. 47, No.5, [p.982]

Figure 3: Median and Average Sales Prices of New Homes Sold in the U.S 1963-2011 Annual Data

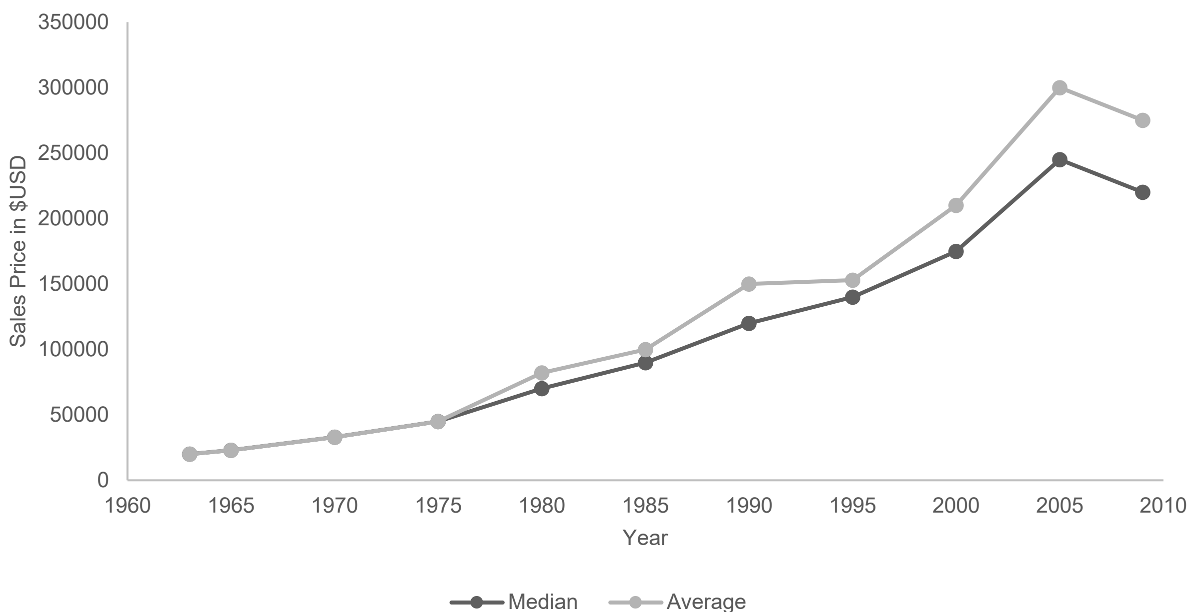

*Figure 3 illustrates how the relaxed leverage requirements led to a dramatic increase in borrowing by the major broker-dealer firms. In particular, the dramatic increase by Bear Stearns and Lehman Brothers helped to lead to their demise. Source: U.S. Census Bureau New Sales Residential Index *Sales price includes land, not inflated adjusted*

A Path Forward

Both commercial and investment banks are awarded government protection, without consideration for their risk taking via liberal lending practices and use of derivative instruments. The safety net provided to banks by the federal government actually protected commercial banks from suffering severe financial consequences when the mortgage market began to collapse. Making the country's exposure worse, was the activity which took place outside the traditional banking system, whereby private financial markets had willingly financed unprecedented amounts of leverage in more loosely supervised firms such as Bear Sterns,

Lehman and AIG (Geithner, 2014). In fact moral hazard became a global issue as the European Central Banks provided liquidity to the banks in Britain. "Never in the field of financial endeavor has so much money been owed by so few to so many. And one might add so far with little real reform." Mervyn King, Governor of the Bank of England, October 20, 2009. "If some banks are thought to be too big to fail, then in the words of a distinguished American economist, they are too big" (Blinder, 2013). Figure 3 illustrates how the relaxed leverage requirements led to a dramatic increase in borrowing by the major broker-dealer firms.

The Effect of Diminished Reserve Requirements and Declining Real Estate Prices on U.S. Banks

A drive for increased revenue combined with relaxed regulation and lower reserve requirements were major contributors to the banking crisis. The seeds of the Great Recession of 2008 were sewn with the advent of investment banks going from private to public partnerships in the late 1990's. The availability of public capital as opposed to the traditional partnership structure created the incentive for banks to take on ever-increasing risk. Striving to compete in a more aggressive global landscape they embraced the more relaxed reserve requirements. This, combined with the technology that allowed Quantitative Analysts, or Quants, the means to create new derivative structures, forged a path that ultimately led to a banking calamity. Global competitors, such as Deutsche Bank and Union Bank of Switzerland were using depositors' commodities-based wealth to strengthen their balance sheets. Concurrent with relatively relaxed regulations, made foreign banks more competitive thus giving them a business advantage and allowed them to attract valuable domestic talent. At the same time, the burgeoning hedge fund industry (who was also significant political donors) was demanding greater leverage from these U.S. Banks. The proprietary desks at these banks offered that leverage and mimicked those trades. New regulations allowed these banks to take on increased leverage, in some cases, approaching approximately thirty to one.

These banks relied on faulty statistical analysis to justify greater leverage. Housing prices had consistently increased in value without any dramatic retracement (see chart). This was mostly due to the fact that housing values have never experienced a significant downward trend in over fifty years. Value at Risk measurements that rely on standard distribution models, severely understated the probability of the significant decrease in housing stock assets. This risk was exacerbated by more accommodative lending standards in the mortgage industry. In the past, the traditional lending models more accurately assessed collateral. Banks, now funded with public money and relaxed reserve requirements, were more eager to offer mortgages to less credit worthy borrowers (Birger, 2008).

Quantitative modeling was employed to create a derivative structure that would enhance the offering of Collateralized Debt Obligations (CDO's). These CDO simulations used pools of mortgages that were assigned to different tranches according to their risk parameters. Using public money, the banks are able to generate significant commission revenue by packaging and selling these securities with buyers both domestically and offshore. Using enhanced leverage requirements, they purchased these securities for their own account trying to drive their revenue base higher, allowing them to be more globally competitive. These derivatives were mostly accounted for off balance sheet which further camouflaged the extent of the risk to the banking sector. Increase leverage allowed the banks proprietary desks to act like the hedge funds they serviced. The use of this leverage ultimately worked to their disadvantage. In comparison to the Long Term Capital debacle of the 1980's, the use of leverage proved ruinous. The rapid decline of housing prices tested a foreclosure system that was here to fore never stressed on a national or global scale. This created a system where the collateral backing these securities could not be judicially seized, creating more destruction. Ultimately, Investment Banks looking to increase their revenues in order to increase compensation levels, and to attract talent, employed ever increasing credit relying on mispriced VAR models and lenient reserve requirements and regulations. Credit rating agencies only magnified the problem by overstating their ratings on these CDO's. Finally, the system for monetizing these bad real estate-based

investments failed. This confluence of events, embodied by the need to create revenues to satisfy the public investor, set the stage for the debacle of 2008.

In the final analysis, it was the relaxation of reserve requirements that led to the Great Recession. Allowing banks to increase leverage, in some cases up to 33 to 1, a very small negative movement in the price of an underlying security would lead to the catastrophic losses experienced by the major bulge bracket firms. This leveraging, allowed by the 2004 relaxation, provided steroidal stimulus to investment banks dealing with investor expectation and overseas competition, where leverage of 40 to 1 had become the norm.Derivative trading exploded and oversight diminished and this allowed for an overabundance of leveraged induced profits. As long as the markets kept advancing the Investment banks were witnessing huge increases in profits but this turned into an incredible and insurmountable burden when markets began to unwind. None of the firms adequately established reserves that could reflect the possible adverse outcome that was about to unfold. This 'Black Swan' began to spread its wings and the leverage, which had provided the profits, came home to roost with a vengeance. If indeed, even with the 33 to 1 ratios, there would have been little ripple effect if the Investment banks had set up the proper reserves to reflect the VAR. If these safeguards were established then the compensation level would have been in line with historical norms and not hysterical levels. The revenues were paid out as bonuses as they were recorded on the books instead have held in abeyance until the contracts came due or the risk abated significantly.

Glass Steagall had less to do with these phenomena then was popularly assumed but was clearly the step child of the reason mentioned previously, Not just deregulation, which should be a boon to competition and aid the end user, but regulation that was not sufficiently enforced Leveraging that would lead to disastrous conclusions, this had been established as a fait accomplished of irresponsibility during the Long Term Capital debacle, so it was not an unexpected or new paradigm. Payouts were established based upon recording of business as opposed to completion and closure of the transactions. Reserves were not set up to counteract even the most damaging occurrences. Rates on commercial paper were shocked from the downgrades and made it impossible for some firms to survive, indeed some firms were not able to issue commercial paper at any rate. These losses were particularly acute at Lehman Brothers and Bear Stearns and led to their failures. Ultimately, the required reserves were not sufficient enough to protect these banks in the event of declining asset prices. At the same time, employees at these banks were still being compensated based on profitability and not risk aversion, this was a lethal combination.

CONCLUDING COMMENTS

As evidenced in this paper, numerous warning signals were evident prior to the 2008 financial crisis. The twenty year period of erosion of the Glass-Steagall Act contributed to the financial crisis by providing an opportunity for the explosion of the sub-prime mortgage market and creation of derivative instruments which fell outside the banking authority's realm of responsibility. Had Federal Reserve oversight been more stringent, perhaps excessive lending to largely financially unqualified American consumers could have been minimized, preventing the five largest investment banks from overleveraging to the point of disaster. The authors provide a clear case in support of strengthening the core requirements for both investment and commercial banks. A great deal of the financial dislocation, that world economies are experiencing today, has its roots in the relaxation and ultimate repeal of the basic tenets that were at the heart of the Glass Steagall (Glass Steagall) act of 1933. While important parts of Glass Steagall are still applicable, it was the ability for banks to harbor greater leverage on their balance sheets that drove our financial system to near ruin. One of the popular misconceptions is that financial intermediaries used taxpayer capital to fund risky speculation on titled backed assets. In fact, it was a combination of the need for U.S. banks to improve their competitive position, combined with an overly accommodative stance by the Federal Reserve that set the stage for the 2008 Crisis of Credit.

To recapitulate, U.S. banks were driven by their publicly funded nature to report better quarterly earnings.

Faced with this issue, and presented with a supposed solution created by lower rates, greater leverage and mispriced value at risk models; domestic. Financial institutions grossly over positioned highly priced asset backed securities. When one combines these bad facts with the false security created by flawed evaluations by American rating agencies you have a toxic mix that affects our economic system to this very day. In conclusion it is ironic that Glass Steagall was enacted as a reaction to the devastation caused by the Market Crash of 1929. The relaxed reserve requirements and regulations ushered in with the virtual repeal of Glass Steagall, in conjunction with the growth policies of the U.S. central bank almost brought us back to the precipice.

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