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Neil Barofsky: Another Financial Crisis All But Inevitable

By Ron Hera
September 18, 2012

Hera Research is pleased to present a sobering interview with Neil Barofsky, Senior Research Scholar, Senior Fellow and Adjunct Professor of Law at the New York University School of Law. From December 2008 until March 2011 Mr. Barofsky served as the Special Inspector General for the $700 billion U.S. Troubled Asset Relief Program (TARP) that bailed out the U.S. banking system in 2008.

In his role as Inspector General, Mr. Barofsky's mandate was to root out and prosecute waste, fraud and abuse. He gained nationwide recognition for his courage and willingness to stand up to the most powerful people and institutions in Washington D.C. and on Wall Street and for his relentless criticism of U.S. Treasury Department officials, including U.S. Treasury Secretary Tim Geithner.

Prior to his role as Inspector General, Mr. Barofsky served as a federal prosecutor in the United States Attorney's Office for the Southern District of New York for more than eight years. In that office, he headed the Mortgage Fraud Group as Senior Trial Counsel, to investigate and prosecute all aspects of mortgage fraud, from retail mortgage fraud cases to investigations involving potential securities fraud with respect to collateralized debt obligations (CDOs).

During his tenure as a member of the Securities and Commodities Fraud Unit, Mr. Barofsky gained extensive experience as a line prosecutor leading white collar prosecutions including the case that led to the conviction of Refco Inc. executives. For his work on the Refco matter, Mr. Barofsky received the U.S. Attorney General's John Marshall Award.

Mr. Barofsky also led the investigation that resulted in the indictment of the top 50 leaders of the Revolutionary Armed Forces of Colombia (FARC) on narcotics charges, which is the largest narcotics indictment filed in U.S. history.

Mr. Barofsky's critically acclaimed book, "Bailout: An Inside Account of How Washington Abandoned Main Street While Rescuing Wall Street," is a play-by-play, behind-the-scenes account of insider-dealing and mishandling of financial bailouts by the U.S. Treasury Department.

Mr. Barofsky is a magna cum laude graduate of the New York University School of Law.

Hera Research (HR): Thank you for joining us today. Why do you remain a critic of the TARP when the $700 billion has been paid back?

Neil Barofsky: To talk about the TARP only in terms of saving banks is revisionist history. When the financial crisis hit in 2008, then Treasury Secretary Henry Paulson went down on bended knee before the Speaker of the House, Nancy Pelosi, and essentially begged Congress to enact a bailout program in the measure of $700 billion. It was pitched as a bailout program to buy troubled assets including mortgages and mortgage related assets.

HR: Did the TARP go beyond saving banks?

Neil Barofsky: Yes. As the conversation between the Bush administration and Congress continued and the legislation was submitted, voted down, rewritten and eventually passed, a lot of things changed. First, the authority that Secretary Paulson got went well beyond buying mortgage related assets. Second, demands that Congress put on Treasury to authorize the $700 billion included helping homeowners and the economy. When the bill was passed it had sections that dealt with mortgage modifications and stimulating the economy.

HR: So the goals of the TARP changed?

Neil Barofsky: Yes. You have to go back and look at what the initial goals were; at what Treasury said it intended to accomplish and at the promises that Congress required Treasury to make.

HR: Were the original goals ever accomplished?

Neil Barofsky: No. If you look at the original goals, you can only conclude that the TARP was a failure.

HR: How could that happen?

Neil Barofsky: I think many members of Congress didn't realize how much the definitions in the legislation were expanded so that a troubled asset could be almost anything and a financial institution could be any regulated company, basically any public company and most private companies.

HR: Are you saying that it was bait and switch?

Neil Barofsky: By no means. The leadership in Congress was well aware that the legislation was giving Treasury a lot more latitude. The whole concept of using the money to fill in capital holes by buying shares of stock in the banks instead of buying mortgage related assets was specifically contemplated and in some quarters even encouraged by members of Congress. However, some members of Congress, those who were not in leadership positions, felt like it was bait and switch where instead of buying troubled assets, the program became a giveaway for banks.

HR: Did the TARP help to stem the financial crisis?

Neil Barofsky: Absolutely. It helped deal with a very acute, short term problem. There was a presumption in the market after Bear Stearns was bailed out in a sweetheart deal with JPMorgan Chase—I mean Bear Sterns' creditors were bailed out—and after Fannie Mae and Freddie Mac were taken into conservatorship, that the U.S. government would stand behind "too big to fail" financial institutions. When Lehman Brothers Holdings was allowed to collapse, the presumption of bailout was removed and it caused an incredible panic. The government had painted itself into a corner by encouraging the growth of financial institutions and the presumption of bailout. So when Lehman Brothers collapsed it caused runs on large financial institutions that certainly would have caused some of them to fail. There was a perceived need for the U.S. government to make a bold statement that they would never let any of these institutions fail. The TARP along with other extraordinary programs undertaken by the FDIC and the Federal Reserve all worked together to prevent the financial crisis from becoming much larger.

HR: How was the Bear Stearns acquisition a sweetheart deal for JPMorgan Chase?

Neil Barofsky: The U.S. government took off about $30 billion of the most toxic assets in Bear Stearns and then, having shifted the toxic assets to American taxpayers, facilitated the purchase of the company by JPMorgan Chase for a song without any risks. They paid $10 per share when it was trading a week before at $69.75 and no longer had those toxic assets.

HR: Did the TARP help to restore confidence in U.S. institutions and financial markets?

Neil Barofsky: Yes, but it was intended and required by Congress to do much more than that and Treasury said that it was going to deploy the money into banks to increase lending, which it never did.

HR: Were the initial goals of the TARP realistic?

Neil Barofsky: First, if the goals were unachievable, Treasury officials should never have promised to undertake them as part of the bargain. Second, even if the goals were not entirely achievable, it would have been worth trying. Treasury officials didn't even try to meet the goals.

HR: Can you give a specific example?

Neil Barofsky: The justification for putting money into banks was that it was going to increase lending. Having used that justification, there was an obligation, in my view, to take policy steps to achieve that goal, but Treasury officials didn't even try to do it. The way it was implemented, there were no conditions or incentives to increase lending.

HR: What policy steps could the U.S. Department of the Treasury have taken to help the economy?

Neil Barofsky: There are all sorts of things that Treasury could have done. For example, they could have reduced the dividend rate—the amount of money that the banks had to pay in exchange for being bailed out—for lending over a baseline, which would have decreased the bank's obligations. Or, they could have insisted on greater transparency so that banks had to disclose what they were doing with the funds. Treasury chose not to do any of these things.

HR: Weren't there other housing programs like the Home Affordable Modification Program (HAMP)?

Neil Barofsky: Yes, but there were choices made to help the balance sheets of struggling banks rather than homeowners. The HAMP program was a massive failure but it wasn't preordained. It was the result of choices made by Treasury officials.

HR: What could have been done differently in the HAMP?

Neil Barofsky: HAMP was deeply flawed with conflicts of interest baked into the program. The management of the program was outsourced to the mortgage servicers, which were thoroughly unprepared and ill equipped. The program encouraged servicers to extend out trial modifications. It was supposed to be a three month period but it often turned into more than a year. The servicers, because they could accumulate late fees for each month during the trial period, were incentivized to string the trial periods out then pull the rug out from under the homeowner, putting them into foreclosure, without granting a permanent mortgage modification. The servicers could make more money doing that then by doing mortgage modifications. If they had done permanent mortgage modifications, the banks couldn't have kept the late fees.

HR: Are you saying that the program encouraged banks to extract as much cash as possible from homeowners before foreclosing on them anyway?

Neil Barofsky: Yes. The mortgage servicers exploited the conflicts of interest that were in the program, and blatantly broke the rules, and Treasury did nothing.

HR: When you were serving as Inspector General for TARP, you issued a report indicating that government commitments totaled $23.7 trillion. What was that about?

Neil Barofsky: $23.7 trillion was simply the sum of the maximum commitments for all the financial programs related to the financial crisis. The number was misconstrued as a liability but the government never stood to lose that much. For example, the government guarantee of money market funds was a multi-trillion dollar commitment. Of course, not all of that money could have been lost because it would have required every fund to go to zero. The government guaranteed commercial paper but, again, for that commitment to have been wiped out, every company would have had to have defaulted. But the numbers were very important in terms of transparency. All of the data were provided by the agencies responsible for the various programs, so the $23.7 trillion number was simple arithmetic. It was important to understand the scope of the extraordinary actions that were being taken.

HR: What are the potential future losses that the U.S. government—that taxpayers—might have to absorb?

Neil Barofsky: The real issue is the potential for another financial crisis because we haven't fixed the core problems of our financial system. We still have banks that are "too big to fail." Standard & Poor's estimated last year that the up-front cost of another crisis, including bailing out the biggest banks yet again, would be roughly 1/3 of the U.S. gross domestic product (GDP) or about $5 trillion. The resulting problems will be even bigger.

HR: What were the problems resulting from the 2008 financial crisis?

Neil Barofsky: When you look at the fiscal impact of the 2008 crisis, you have to look at it not only in terms of lost tax revenues and increased government debt, but also in terms of the loss of household wealth. People who became unemployed suffered tremendous losses and the government's social benefit costs expanded accordingly. One of the reasons we had the debt ceiling debate last year, when the U.S. credit rating was downgraded, and why we are facing a fiscal cliff ahead is the legacy of the 2008 crisis. We have a lot less dry powder to deal with a new crisis and we almost certainly will have one.

HR: Why do you expect another financial crisis?

Neil Barofsky: It just comes down to incentives. A normally functioning free market disciplines businesses. The presumption of bailout for "too big to fail" institutions changes the incentives of a normally functioning free market. In a free market, if an institution loads up on risky assets with too little capital standing behind them, it will be punished by the market. Institutions will refuse to lend them money without extracting a significant penalty. Counterparties will be wary of doing business with companies that have too much risk and too little capital. Allowing "too big to fail" institutions to exist removes that discipline. The presumption is that the government will stand in and make the obligations whole even if the bank blows up. That basic perversion of the free market incentivizes additional risk.

HR: Are "too big to fail" banks taking more risks today than they did before?

Neil Barofsky: Bailouts give bank executives an incentive to max out short term profits and get huge bonuses, because if the bank blows up, taxpayers will pick up the tab. The presumption of bailout increases systemic risk by taking away the incentives of creditors and counterparties to do their jobs by imposing market discipline and by incentivizing banks to act in ways that make a bailout more likely to occur.

HR: Is it just a matter of the size of banking institutions?

Neil Barofsky: The big banks are 20-25% bigger now than they were before the crisis. The "too big to fail" banks are also too big to manage effectively. They've become Frankenstein monsters. Even the most gifted executives can't manage all of the risks, which increases the likelihood of a future bailout.

HR: Since bank executives are accountable to their shareholders, won't they regulate themselves?

Neil Barofsky: The big banks are not just "too big to fail," they're 'too big to jail.' We've seen zero criminal cases arising out of the financial crisis. The reality is that these large institutions can't be threatened with indictment because if they were taken down by criminal charges, they would bring the entire financial system down with them. There is a similar danger with respect to their top executives, so they won't be indited in a federal criminal case almost no matter what they do. The presumption of bailout thus removes for the executives the disincentive in pushing the ethical envelope. If people know they won't be held accountable, that too will encourage more risk taking in the drive towards profits.

HR: So, it's just a matter of time before there's another crisis?

Neil Barofsky: Yes. The same incentives that led to the 2008 crisis are still in place today and in many ways the situation is worse. We have a financial system that concentrates risk in just a handful of large institutions, incentivizes them to take risks, guarantees that they will never be allowed to fail and ensures that the executives will never be held accountable for their actions. We shouldn't be surprised when there's another massive financial crisis and another massive bailout. It would be naïve to expect a different result.

HR: Didn't the Dodd-Frank bill fix the financial system?

Neil Barofsky: Nothing has been done to remove the presumption of bailout, which is as damaging as the actual bailout. Perception becomes reality. It's perception that ensures that counterparties and creditors will not perform proper due diligence and it's perception that encourages them to continue doing business with firms that have too much risk and inadequate capital. It's perception of bailout that drives executives to take more and more risk. Nothing has been done to address this. The initial policy response by Treasury Secretaries Paulson and Geithner, and by Federal Reserve Chairman Bernanke, was to consolidate the industry further, which has only made the problems worse.

HR: The Dodd-Frank bill contains 2,300 pages of new regulations. Isn't that enough?

Neil Barofsky: There are tools within Dodd-Frank that could help regulators, but we need to go beyond it. The parade of recent scandals and the fact that big banks are pushing the ethical and judicial envelopes further than ever before makes it clear that Dodd-Frank has done nothing, from a regulatory standpoint, to prevent highly unethical and likely criminal behavior.

HR: Is the Dodd-Frank bill a failure?

Neil Barofsky: The whole point of Dodd-Frank was to end the era of "too big to fail" banks. It's fairly obvious that it hasn't done that. In that sense, it has been a failure. Dodd-Frank probably has been helpful in the short term because it increased capital ratios, although not nearly enough. If we ever get over the counter (OTC) derivatives under control, that would be a good thing and Dodd-Frank takes some initial steps in that direction. I think that the Consumer Financial Protection Bureau is a good thing. Nonetheless, the financial system is largely in the hands of the same executives, who have become more powerful, while the banks themselves are bigger and more dangerous to the economy than before.

HR: How are OTC derivatives related to the risk of a new financial crisis?

Neil Barofsky: Credit default swaps (CDS) were specifically what brought down AIG, and synthetic CDOs, which are entirely dependent on derivatives contracts, contributed significantly to the financial crisis. When you look at the mind numbing notional values of OTC derivatives, which are in the hundreds of trillions, the taxpayer is basically standing behind the institutions participating in these very opaque and, potentially, very dangerous markets. OTC derivatives could be where the risks come from in the next financial crisis.

HR: Can anything be done to prevent another financial crisis?

Neil Barofsky: We have to get beyond having institutions, any one of which can bring down the financial system. For example, Wells Fargo alone does 1/3rd of all mortgage originations. Nothing can ever happen to Wells Fargo because it could bring down the entire economy. We need to break up the "too big to fail" banks. We have to make them small enough to fail so that the free market can take over again.

HR: Does the political will exist to break up the largest banks?

Neil Barofsky: The center of neither party is committed to breaking up "too big to fail" banks. Of course, pretending that Dodd-Frank solved all our problems, as some Democrats do, or simply saying that big banks won't be bailed out again, as some Republicans have suggested, is unrealistic. Congress needs to proactively break up the "too big to fail" banks through legislation. Whether that's through a modified form of Glass-Steagall, size or liability caps, leverage caps or remarkably higher capital ratios, all of which are good ideas, we need to take on the largest banks.

HR: Do you think the U.S. presidential election will change anything?

Neil Barofsky: No. There's very little daylight between Romney and Obama on the crucial issue of "too big to fail" banks. Romney recently said, basically, that he thinks big banks are great and the Obama Administration fought against efforts to break up "too big to fail" banks in the Dodd-Frank bill. Geithner, serving the Obama White House, lobbied against the Brown-Kaufman Act, which would have broken up the "too big to fail" banks.

HR: What will it take for U.S. lawmakers to finally take on the largest banks?

Neil Barofsky: Some candidates have made reforms like reinstating Glass-Steagall part of their campaigns but the size and power of the largest banks in terms of lobbying campaign contributions is incredible. It may well take another financial crisis before we deal with this.

HR: Thank you for your time today.

Neil Barofsky: It was my pleasure.

After Words

According to Neil Barofsky, another financial crisis is all but inevitable and the cost will be even higher than the 2008 financial crisis. Based on the way that the TARP and HAMP programs were implemented, and on the watering down of the Dodd-Frank bill, it appears that big banks are calling the shots in Washington D.C. The Dodd-Frank bill left risk concentrated in a few large institutions while doing nothing to remove perverse incentives that encourage risk taking while shielding bank executives from accountability. Neither of the two main U.S. political parties or presidential candidates are willing to break up "too big to fail" banks, despite the gravity of the problem. The assumption that another financial crisis can be prevented when the causes of the 2008 crisis remain in place, or have become worse, is unrealistic. In the mean time, what Mr. Barofsky describes as a "parade of scandals" involving highly unethical and likely criminal behavior is set to continue unabated. Although the timing and specific areas of risk are not yet known, there is no doubt that U.S. taxpayers will be stuck with another multi-trillion dollar bill when the next crisis hits.

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