repealed Glass-Steagall, allowing investment banks and commercial banks to once again merge, pool assets, and co-mingle the monies of ordinary depositors with speculative trading operations, as in the pre-Great Depression days. Banks could (and did) return to the good old days of treating assets they held in trust for common depositors as resources available to underwrite higher yielding, riskier securities transactions, with no obligation to share the upside. The problem was that, once again, all the risk on the downside would be everyone’s problem. Freed from the regulatory shackles of Glass-Steagall, banks took risks of increasing magnitude and complexity. And just in case more cheap (virtually free) cash was needed, the Federal Reserve, under the Chairmanship of Alan Greenspan, made absolutely no effort to pushback against the growing speculative tide. Instead, the Fed fueled speculation by lending to banks at very low rates.

**Deregulation, Derivatives, and Brooksley Born**

Perhaps needing to shield a more sophisticated public from the degree of risk associated with its behaviors (after all, perhaps folks still remembered some of the lessons from 1929), the banks’ betting strategies increasingly relied on “financial innovations” which mainly served to conceal what they were up to.

As has been discussed in previous chapters, the concept of a mortgage changed from a relatively simple two-party contract into a multi-party apparatus involving layers upon layers of transactions, pass-through entities, and servicers. Bundles of mortgages were pooled together, forming the collateral for new “mortgage backed securities” (MBS). These, and various other instruments that “derived” their value from other financial arrangements, became known as “derivatives.” The risk associated with these and other new-fangled financial products could often be sold in the form of credit derivatives, which further shifted risk away from the original mortgage lender to unknown, distant parties.

Needless to say, the more complex the transactions grew, the more lucrative this was for the investment banks, such as Bear Stearns and Goldman Sachs, which had created them. Like the cost of any highly technical thing, banks charged higher commissions for each level of added complexity. While there is a story that bankers liked to tell about how these products grew the economy by lowering the risk of individual bad loans through their “pooling” with hundreds of other good and (even more) bad ones, a comprehensive survey of empirical economic data has revealed little evidence of such a benefit.⁶

Paul Volcker, the former head of the Federal Reserve Bank, may have expressed it best when he quipped that the most important innovation in finance over the last twenty years was actually the ATM. Volker lamented: “I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth—one shred of evidence.”⁷ And the nation’s leading private investor, Warren Buffet, memorably labeled the new derivative instruments “weapons of mass destruction.”

Much, but not all, of the risk of derivatives came from the fact that banks had virtually no obligation to disclose how many of them they held. As a result, they were able to massively shield their financial health from their many creditors. Derivatives are typically traded off the market, in an agreement between two