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Looters in Loafers

By PAUL KRUGMAN

Last October, I saw a cartoon by Mike Peters in which a teacher asks a student to create a sentence that uses the verb “sacks,” as in looting and pillaging. The student replies, “Goldman Sachs.”

Sure enough, last week the Securities and Exchange Commission accused the Gucci-loafer guys at Goldman of engaging in what amounts to white-collar looting.

I’m using the term looting in the sense defined by the economists George Akerlof and Paul Romer in a 1993 paper titled “Looting: The Economic Underworld of Bankruptcy for Profit.” That paper, written in the aftermath of the savings-and-loan crisis of the Reagan years, argued that many of the losses in that crisis were the result of deliberate fraud.

Was the same true of the current financial crisis?

Most discussion of the role of fraud in the crisis has focused on two forms of deception: predatory lending and misrepresentation of risks. Clearly, some borrowers were lured into taking out complex, expensive loans they didn’t understand — a process facilitated by Bush-era federal regulators, who both failed to curb abusive lending and prevented states from taking action on their own. And for the most part, subprime lenders didn’t hold on to the loans they made. Instead, they sold off the loans to investors, in some cases surely knowing that the potential for future losses was greater than the people buying those loans (or securities backed by the loans) realized.

What we’re now seeing are accusations of a third form of fraud.

We’ve known for some time that Goldman Sachs and other firms marketed mortgage-backed securities even as they sought to make profits by betting that such securities would plunge in value. This practice, however, while arguably reprehensible, wasn’t illegal. But now the S.E.C. is charging that Goldman created and marketed securities that were deliberately designed to fail, so that an important client could make money off that failure. That’s what I would call looting.

And Goldman isn’t the only financial firm accused of doing this. According to the Pulitzer-winning investigative journalism Web site ProPublica, several banks helped market designed-to-fail investments on behalf of the hedge fund Magnetar, which was betting on that failure.

So what role did fraud play in the financial crisis? Neither predatory lending nor the selling of mortgages on false pretenses caused the crisis. But they surely made it worse, both by helping to inflate the housing bubble and by creating a pool of assets guaranteed to turn into toxic waste once the bubble burst.

As for the alleged creation of investments designed to fail, these may have magnified losses at the banks that were on the losing side of these deals, deepening the banking crisis that turned the burst housing bubble into an economy-wide catastrophe.

The obvious question is whether financial reform of the kind now being contemplated would have prevented some or all of the fraud that now seems to have flourished over the past decade. And the answer is yes.

For one thing, an independent consumer protection bureau could have helped limit predatory lending. Another provision in the proposed Senate bill, requiring that lenders retain 5 percent of the value of loans they make, would have limited the practice of making bad loans and quickly selling them off to unwary investors.

It’s less clear whether proposals for derivatives reform — which mainly involve requiring that financial instruments like credit default swaps be traded openly and transparently, like ordinary stocks and bonds — would have prevented the alleged abuses by Goldman (although they probably would have prevented the insurer A.I.G. from running wild and requiring a federal bailout). What we can say is that the final draft of financial reform had better include language that would prevent this kind of looting — in particular, it should block the creation of “synthetic C.D.O.’s,” cocktails of credit default swaps that let investors take big bets on assets without actually owning them.

The main moral you should draw from the charges against Goldman, though, doesn’t involve the fine print of reform; it involves the urgent need to change Wall Street. Listening to financial-industry lobbyists and the Republican politicians who have been huddling with them, you’d think that everything will be fine as long as the federal government promises not to do any more bailouts. But that’s totally wrong — and not just because no such promise would be credible.

For the fact is that much of the financial industry has become a racket — a game in which a handful of people are lavishly paid to mislead and exploit consumers and investors. And if we don’t lower the boom on these practices, the racket will just go on.