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A Section

What Went Wrong; How did the world's markets come to the brink of collapse? Some say regulators failed. Others claim deregulation left them handcuffed. Who's right? Both are. This is the story of how Washington didn't catch up to Wall Street.

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A decade ago, long before the financial calamity now sweeping the world, the federal government's economic brain trust heard a clarion warning and declared in unison: You're wrong.

The meeting of the President's Working Group on Financial Markets on an April day in 1998 brought together Federal Reserve Chairman Alan Greenspan, Treasury Secretary Robert E. Rubin and Securities and Exchange Commission Chairman Arthur Levitt Jr. -- all Wall Street legends, all opponents to varying degrees of tighter regulation of the financial system that had earned them wealth and power.

Their adversary, although also a member of the Working Group, did not belong to their club. Brooksley E. Born, the 57-year-old head of the Commodity Futures Trading Commission, had earned a reputation as a steely, formidable litigator at a high-powered Washington law firm. She had grown used to being the only woman in a room full of men. She didn't like to be pushed around.

Now, in the Treasury Department's stately, wood-paneled conference room, she was being pushed hard.

Greenspan, Rubin and Levitt had reacted with alarm at Born's persistent interest in a fast-growing corner of the financial markets known as derivatives, so called because they derive their value from something else, such as bonds or currency rates. Setting the jargon aside, derivatives are both a cushion and a gamble -- deals that investment companies and banks arrange to manage the risk of their holdings, while trying to turn a profit at the same time.

Unlike the commodity futures regulated by Born's agency, many newer derivatives weren't traded on an exchange, constituting what some traders call the "dark markets." There were now millions of such private contracts, involving many of Wall Street's top firms. But there was no clearinghouse holding collateral to settle a deal gone bad, no transparent records of who was trading what.

Born wanted to shine a light into the dark. She had offered no specific oversight plan, but after months of making noise about the dangers that this enormous market posed to the financial system, she now wanted to open a formal discussion about whether to regulate them -- and if so, how.

Greenspan, Rubin and Levitt were determined to derail her effort. Privately, Rubin had expressed concern about derivatives' unruly growth. But he agreed with Greenspan and Levitt that these newer contracts, often called "swaps," weren't exactly futures. Born's agency did not have legal authority to regulate swaps, the three men believed, and her call for a discussion had real-world consequences: It would cast doubt over the legality of trillions of dollars in existing contracts and create uncertainty over how to operate in the market.

At the April meeting, the trio's message was clear: Back off, Born.

"You're not going to do anything, right?" Rubin asked her after they had laid out their concerns, according to one participant.

Born made no commitment. Some in the room, including Rubin and Greenspan, came away with a sense that she had agreed to cool it, at least until lawyers could confer on the legal issues. But according to her staff, she was neither deterred nor chastened.

"Once she took a position, she would defend that position and go down fighting. That's what happened here," said Geoffrey Aronow, a senior CFTC staff member at the time. "When someone pushed her, she was inclined to stand there and push back."

Greenspan and Rubin maintained then, as now, that Born was on the wrong track. Greenspan, who left the Fed job in 2006 after an unprecedented three terms, also insists that regulating derivatives would not have averted the present crisis. Yesterday on Capitol Hill, a Senate committee opened hearings specifically on the role of financial derivatives in exacerbating the current crisis. Another hearing on the issue takes place in the House today.

The economic brain trust not only won the argument, it cut off the larger debate. After Born quit in 1999, no one wanted to go where she had already gone, and once the Bush administration arrived in 2001, the push was for less regulation, not more. Voluntary oversight became the favored approach, and even those were accepted grudgingly by Wall Street, if at all.

In private meetings and public speeches, Greenspan also argued a free-market view. Self-regulation, he asserted, would work better than the heavy hand of government: Investors had a natural desire to avoid self-destruction, and that served as the logical and best limit to excessive risk. Besides, derivatives had become a huge U.S. business, and burdensome rules would drive the market overseas.

"We knew it was a big deal [to attempt regulation] but the feeling was that something needed to be done," said Michael Greenberger, Born's director of trading and markets and a witness to the April 1998 standoff at Treasury. "The industry had been fighting regulation for years, and in the meantime, you saw them accumulate a huge amount of stuff and it was already causing dislocations in the economy. The government was being kept blind to it."

Rubin, in an interview, said of Born's effort, "I do think it was a deterrent to moving forward. I thought it was counterproductive. If you want to move forward . . . you engage with parties in a constructive way. My recollection was, though I truly do not remember the specifics of the meeting, this was done in a more strident way."

Rarely does one Washington regulator engage in such a public, pitched battle with other agencies. Born's failed effort is part of the larger story of what led to today's financial chaos, a bipartisan story of missed opportunities and philosophical shifts in which Washington stood impotent as the risk of Wall Street innovation swelled, according to more than 60 interviews as well as transcripts of meetings, congressional testimony and speeches. (Born declined to be interviewed.)

Derivatives did not trigger what has erupted into the biggest economic crisis since the Great Depression. But their proliferation, and the uncertainty about their real values, accelerated the recent collapses of the nation's venerable investment houses and magnified the panic that has since crippled the global financial system.

A New Chain of Risk

Futures contracts, one of the earliest forms of a derivative, have long been associated with big market failures. Harry Truman's father was financially wiped out by agriculture futures, and rampant manipulation by speculators contributed to the market collapses of 1929. Regulators have long known that new trading instruments have a way of giving reassurance of stability in good times and of exacerbating market downturns in bad.

Futures -- essentially, a promise to deliver cash or something of value at a later time -- are traded on regulated exchanges such as the Chicago Mercantile Exchange, regulated by the CFTC. But Born was not questioning bets on pork bellies or wheat prices, the bedrock of futures trading in simpler times. Her focus was the arcane class of derivatives linked to fluctuations in currency and interest rates. She told a group of business lawyers in 1998 that the "lack of basic information" allowed traders in derivatives "to take positions that may threaten our regulated markets or, indeed, our economy, without the knowledge of any federal regulatory authority."

The future that Born envisioned turned out to be even riskier than she imagined. The real estate boom and easy credit of the past decade gave birth to more complex securities and derivatives, this time linked to the inflated value of millions of homes bought by Americans ultimately unable to afford them. That created a new chain of risk, starting with the heavily indebted homebuyers and ending in a vast, unregulated web of contracts worldwide.

By appearing to provide a safety net, derivatives had the unintended effect of encouraging more risk-taking. Investors loaded up on the mortgage-based investments, then bought "credit-default swaps" to protect themselves against losses rather than putting aside large cash reserves. If the mortgages went belly up, the investors had a cushion; the sellers of the swaps, who collected substantial fees for sharing in the investors' risk, were betting that the mortgages would stay healthy.

The global derivatives market topped $530 trillion as of June 30 this year, including $55 trillion in the suddenly popular credit-default swaps; that $530 trillion represents all contracts outstanding. The total dollars at risk is much smaller, but still a hefty $2.7 trillion, according to an estimate by the International Swaps and Derivatives Association.

To make sense of those figures, compare them to the value of the New York Stock Exchange: $30 trillion at the end of 2007, before the recent crash. When the housing bubble burst and mortgages went south, the consequences seeped through the entire web. Some of those holding credit swaps wanted their money; some who owed didn't have enough money in reserve to pay.

Instead of dispersing risk, derivatives had amplified it.

The Regulatory Rift

Born, after 30 years in Washington, found herself on President Bill Clinton's short list for attorney general in 1992. The call never came. Approached about the CFTC job four years later, she took it, seeing a chance to make a public service mark, colleagues say.

For several years before Born's arrival at the futures commission, Washington had been hearing warnings about derivatives. In 1993, Rep. Jim Leach (R-Iowa) issued a 902-page report that urged "regulations to protect against systemic risk" as well as supervision by the SEC or Treasury. Sen. Donald W. Riegle (D-Mich.), while acknowledging that swaps helped manage risk, saw "danger signs, on the horizon" in their rapid growth. He and Rep. Henry Gonzalez, a Texas Democrat, introduced separate bills in 1994 that went nowhere. Mary Schapiro, Born's predecessor, made her own run at the issue through enforcement actions.

In an earlier decade, President Ronald Reagan had described the CFTC as his favorite agency because it was small and it had allowed the futures industry to grow and prosper. Born swept into the agency, the least known of the four major regulators with primary responsibility for overseeing the nation's financial markets, determined to enforce its rules and tackle hard issues.

"One theory at the time was she was so disappointed not to be running Justice -- that she got this tiny agency as a consolation prize and was hell-bent to make it important. I'm not sure that was in her mind, but it was a point of criticism," said John Damgard, president of the Futures Industry Association. Damgard disagreed with Born's approach but said he respected her for fighting for her principles.

Daniel Waldman, Born's law partner at Arnold and Porter and her general counsel at the futures commission, said Born let the industry know she meant business. "She got into a knock-down, drag-out fight with the Chicago Board of Trade over the delivery points for soybean contracts," he recalled. "She believed it was her obligation under the statute to review decisions by the exchanges. If they didn't meet agency requirements, she was going to say so, not look the other way."

Born didn't back off on derivatives, either. On May 7, 1998, two weeks after her April showdown at Treasury, the commission issued a "concept release" soliciting public comment on derivatives and their risk.

The response was swift and blistering. Within hours, Greenspan, Rubin and Levitt cited their "grave concerns" in an unusual joint statement. Deputy Treasury Secretary Lawrence Summers decried it before Congress as "casting a shadow of regulatory uncertainty over an otherwise thriving market."

Wall Street howled. "The government had a legitimate interest in preserving the enforceability of the billions of dollars worth of swap contracts that were threatened by the concept release," said Mark Brickell, a managing director at what was then J.P. Morgan Securities and former chairman of the International Swaps and Derivatives Association.

Although Born said new rules would be prospective, Wall Street was afraid existing contracts could be challenged in court. "That meant anybody on a losing side of a trade could walk away," Brickell said.

He spent months shuttling between New York and Washington, working on Congress to block CFTC action. "I remember getting on an overnight train and arriving at Rayburn by 5:30 a.m.," he said. "I watched the sun rise and then went to work on my testimony without a whole lot of sleep."

Born, who testified before Congress at least 17 times, tried to counter the legal question by saying that regulation would apply only to new contracts, not existing ones. But she relentlessly reiterated her conviction that ignoring the risk of derivatives was dangerous.

In June 1998, Leach, who had become chairman of the House Banking committee, thrust himself into the regulatory rift. He herded Born, Rubin and Greenspan into a small room near the committee's main venue at the Rayburn House Office Building, thinking he could mediate. "This is the most unusual meeting I've ever participated in," Leach recalled. "I have never in my life been in a setting where three senior members of the U.S. government reflected more tension. Secretary Rubin and Chairman Greenspan were in concert in expressing frustration with the CFTC leadership. . . . She felt, I'm confident, outnumbered with the two against one."

Leach thought the futures commission lacked the professional bench to handle oversight. He pressed Born not to proceed until the Treasury and the Fed could agree which agency was best suited to the role. "I tried to take the perspective of, 'I hope we can work this out,' " he said. "Both sides -- neither side, gave in."

Rubin said, in the recent interview, that he had his own qualms about derivatives, going back to his days as a managing partner at Goldman Sachs. He later wrote in a 2003 book that "derivatives, with leverage limits that vary from little to none at all, should be subject to comprehensive and higher margin requirements," forcing dealers to put up more capital to back the swaps. "But that will almost surely not happen, absent a crisis."

Asked why he didn't suggest stricter capital requirements as an alternative in 1998, Rubin said, "There was no political reality of getting it done. We were so caught up with other issues that were so pressing. . . . the Asian financial crisis, the Brazilian financial crisis. We had a lot going on."

Crisis and Ice Cream

When the warring parties faced off next, in the Senate Agriculture committee's hearing room July 30, 1998, it was not a neutral battleground to air their differences. Chairman Richard G. Lugar, an Indiana Republican, wanted to extract a public promise from Born to cease her campaign. Otherwise, Congress would move forward on a Treasury-backed bill to slap a moratorium on further CFTC action.

The committee had to switch to a larger room to accommodate the expected crowd of lobbyists representing banks, brokerage firms, futures exchanges, energy companies and agricultural interests, according to a Lugar aide. A dubious Lugar opened the hearing by telling Born: "It is unusual for three agencies of the executive branch to propose legislation that would restrict the activities of a fourth."

Born would not yield. She portrayed her agency as under attack, saying the Fed, Treasury and SEC had already decided "that the CFTC's authority should instead be transferred to and divided among themselves."

Greenspan shot back that CFTC regulation was superfluous; existing laws were enough. "Regulation of derivatives transactions that are privately negotiated by professionals is unnecessary," he said. "Regulation that serves no useful purpose hinders the efficiency of markets to enlarge standards of living."

The stalemate persisted. Then, in September a crisis arose that gave credence to Born's concerns.

Long Term Capital Management, a huge hedge fund heavily weighted in derivatives, told the Fed that it could not cover $4 billion in losses, threatening the fortunes of everyone from tycoons to pension funds. After Russia, swept up in the Asian economic crisis, had defaulted on its debt, Long Term Capital was besieged with calls to put up more cash as collateral for its investments. Based on the derivative side of its books, Long Term Capital had an astoundingly high debt-to-capital ratio. "The off-balance sheet leverage was 100 to 1 or 200 to 1 -- I don't know how to calculate it," Peter Fisher, a senior Fed official, told Greenspan and other Fed governors at a Sept. 29, 1998, meeting, according to the transcript.

Two days later, Born warned the House Banking committee: "This episode should serve as a wake-up call about the unknown risks that the over-the-counter derivatives market may pose to the U.S. economy and to financial stability around the world." She spoke of an "immediate and pressing need to address whether there are unacceptable regulatory gaps."

The near collapse of Long Term Capital Management didn't change anything. Although some lawmakers expressed new fervor for addressing the risks of derivatives, Congress went ahead with the law that placed a six-month moratorium on any CFTC action regarding the swaps market.

The battle left Born politically isolated. In April 1999, the President's Working Group issued a report on the lessons of Long Term Capital's meltdown, her last as part of the group. The report raised some alarm over excess leverage and the unknown risks of the derivative market, but called for only one legislative change -- a recommendation that brokerages' unregulated affiliates be required to assess and report their financial risk to the government.

Greenspan dissented on that recommendation.

By May, Born had had enough. Although it was customary at the agency for others to organize an outgoing chairman's going-away bash, she personally sprang for an ice cream cart in the commission's beige-carpeted auditorium. On a June afternoon, employees listened to subdued, carefully worded farewells while serving themselves sundaes.

In November, Greenspan, Rubin, Levitt and Born's replacement, William Rainer, submitted a Working Group report on derivatives. They recommended no CFTC regulation, saying that it "would otherwise perpetuate legal uncertainty or impose unnecessary regulatory burdens and constraints upon the development of these markets in the United States."

Toward Self-Regulation

Throughout much of 2000, lobbyists were flying in and out of congressional offices. With Born gone, they saw an opportunity to settle the regulatory issue and perhaps gain even more. They had a sympathetic ear in Texas Sen. Phil Gramm, the influential Republican chairman of the Senate Banking Committee, and a sympathetic bill: the 2000 Commodity Futures Modernization Act.

Gramm opened a June 21 hearing with a call for "regulatory relief." Peering through his wire-rimmed glasses, he drawled: "I think we would do well to remember the Lincoln adage that to ask a society to live under old and outmoded laws -- and I think you could say the same about regulation -- is like asking a man to wear the same clothes he wore when he was a boy."

Greenspan and Rubin's successor at the Treasury, Larry Summers, still held sway on keeping the CFTC out of the swaps market. But Treasury officials saw an opportunity to push forward on a self-regulation idea from the Working Group's November 1999 report: an industry clearinghouse to hold pools of cash collected from financial firms to cover derivatives losses. But the report had also called for federal oversight to ensure that risk-management procedures were followed.

The swaps industry generally supported the clearinghouse concept. One amended version of the bill made federal oversight optional. Treasury officials scrambled to act, and a provision introduced by Leach requiring oversight prevailed.

The House passed the bill Oct. 19, but then the legislation stalled. Gramm was holding out for stronger language that would bar both the CFTC and the SEC from meddling in the swaps market. Alarmed, SEC lawyers argued that the agency at least needed to retain its authority over fraud and insider trading. What if a trader, armed with inside knowledge, engaged in a swap on a stock? Treasury Undersecretary Gary Gensler brokered a compromise: The SEC would retain its antifraud authority but without any new rulemaking power.

On the night of Dec. 15, with the nation still focused on the Supreme Court decision three days earlier that settled the 2000 presidential election in George W. Bush's favor, the act passed as a rider to an omnibus spending bill. The clearinghouse provision remained. At the time, it seemed like a breakthrough.

A clearinghouse would have created layers of protections that don't exist today, said Craig Pirrong, a markets expert at the University of Houston. "An industry-backed pool of capital could have cushioned against losses while discouraging risky bets."

But afterward, the clearinghouse idea sat dormant, with no one in the industry moving to put one in place.

'An Absolute Siege'

In 2004, the SEC pursued another voluntary system. This one, too, didn't work out quite as hoped.

For years, Congress had allowed a huge gap in Wall Street oversight: the SEC had authority over the brokerage arms of investment banks such as Lehman Brothers and Bear Stearns, but were in the dark about deals made by the firms' holding companies and its unregulated affiliates. European regulators, demanding more transparency given the substantial overseas operations of U.S. firms, were threatening to put these holding companies under regulatory supervision if their American counterparts didn't do so first.

For the SEC, this was deja vu. In 1999, the SEC had sought such authority over the holding companies and failed to get it. Late in the year, Congress passed the Gramm-Leach-Bliley Act, dismantling the walls separating commercial banks, investment banks and insurance companies since the Great Depression. But the act did not provide for any SEC oversight of investment bank holding companies. The momentum was all toward deregulation.

"I remember saying at the time, people don't get it -- the level of missed opportunities to address some of these problems," said Annette Nazareth, then the SEC's head of market regulation. "It was an absolute siege on regulation."

Five years later, the European regulators were forcing the issue again. Restricted by Gramm-Leach-Bliley, the SEC proposed a voluntary system, which the big investment banks opted to join. The holding companies would be permitted to follow their own computer models to assess how much risk they were taking; the SEC would get access to make sure the complex capital and risk-management models were up to the job.

At an April 28 SEC meeting, commissioner Harvey Goldschmid expressed caution. "If anything goes wrong, it's going to be an awfully big mess," said Goldschmid, who voted for the program.

Last month, the SEC's inspector general concluded that the program had failed in the case of Bear Stearns, which collapsed in March. SEC overseers had seen Bear Stearns's heavy focus on mortgage-backed securities and over-leveraging, but "did not take serious action to limit these risk factors," the inspector general's report said.

SEC officials say the voluntary program limited what they could do. They checked to make sure Bear Stearns was adhering to its risk models but did not count on those models being fundamentally flawed.

On Sept. 26, with the economic meltdown in full swing, SEC Chairman Christopher Cox shut down the program. Cox, a longtime champion of deregulation, said in a statement posted on the SEC's Web site, "the last six months have made it abundantly clear that voluntary regulation does not work."

It was too late. All five brokerages in the program had either filed for bankruptcy, been absorbed or converted into commercial banks.

Second Thoughts

On Sept. 15, 2005, Federal Reserve Bank of New York president Timothy F. Geithner gathered senior executives and risk-management officers from 14 Wall Street firms in the Fed's 10th-floor conference room in lower Manhattan for another discussion about a voluntary mechanism. Also arrayed around the wood rectangular table, covered by green-felt tablecloths, were European market supervisors from Britain, Switzerland and Germany.

E. Gerald Corrigan, managing director of Goldman Sachs and one of Geithner's predecessors at the New York Fed, had reported in July that the face value of credit-default swaps had soared ninefold in just three years. Without an automated, electronic system for tracking the trades or collateral to back them, the potential for systemic risk was increasing. "The growth of derivatives was exceeding the maturity of the operational infrastructure, so we thought we would try to narrow the gap," Geithner said in an interview.

Talks have continued on a range of issues, including how to set up a clearinghouse with reserves in case of default -- the same concept in the 2000 legislation -- and what kind of government oversight would be allowed. But three years later, there is no system in place. Some major dealers have preferred to go it alone, and no one in the government told them they couldn't.

With last month's death spiral of American International Group, the world's largest private insurance company until it was seized by the government, regulators saw their fears play out. AIG had sold $440 billion in credit-default swaps tied to mortgage securities that began to falter. When its losses mounted, the credit-rating agencies downgraded AIG's standing, triggering a clause in its credit-default swap contracts to post billions in collateral that it didn't have. The government swooped in to prevent AIG's default, hoping to ward off another chain reaction in the already shaky financial system.

The economic crisis has added momentum to the Fed's attempts to organize a voluntary clearinghouse. Geithner held two meetings last week with several firms and major dealers interested in setting up such a mechanism. Last week, the Chicago Mercantile Exchange announced it would team with Citadel Investment Group, a large hedge fund, to launch an electronic trading platform and clearinghouse for credit-default swaps. Other private companies and exchanges are working on their own systems, seeing opportunities for profit in becoming a shock absorber for the system.

The crisis has prompted second thoughts. Goldschmid, the former SEC commissioner and the agency's general counsel under Levitt, looks back at the long history of missed opportunities and sighs: "In hindsight, there's no question that we would have been better off if we had been regulating derivatives -- and had a clearinghouse for it."

Levitt, too, thinks about might-have-beens. "In fairness, while Summers and Rubin and I certainly gave in to this, we were not in the same camp as the Fed," he said. "The Fed was really adamantly opposed to any form of regulation whatsoever. I guess if I had to do it over again, I certainly would have pushed for some way to give greater transparency to products which turned out to be injurious to our markets."

Researchers Brady Dennis and Robert Thomason contributed.

Risk and Regulation. How did the world's markets come to the brink of collapse? Some say regulators failed. Others claim deregulation left them handcuffed. Who's right? Both are. This is the story of how Washington never caught up to Wall Street. Key Players in Market Regulation | Chat With Reporters. Part II. Banking Regulator Played Advocate The Office of Thrift Supervision let lenders grow out of control, then fail, including IndyMac Bancorp, Washington Mutual and Downey Savings and Loan. Regulator Let IndyMac Bank Falsify Report. Part III. The Frenzy When the housing market began There were many factors that led to the collapse of the Soviet Union, including political policies, economics, defense spending, and the Chernobyl nuclear disaster. Find out more about how this political entity dissolved.Â By some measures, the Soviet economy was the worldâ€™s second largest in 1990, but shortages of consumer goods were routine and hoarding was commonplace. It was estimated that the Soviet black market economy was the equivalent of more than 10 percent of the countryâ€™s official GDP. Economic stagnation had hobbled the country for years, and the perestroika reforms only served to exacerbate the problem. Wage hikes were supported by printing money, fueling an inflationary spiral. They claimed that in about 2008 the US would enter a period of crisis that would peak in the 2020s â€“ a claim said to have made a powerful impression on US president Donald Trumpâ€™s former chief strategist, Steve Bannon.Â How and why turbulence sometimes turns into collapse is something that concerns Safa Motesharrei, a mathematician at the University of Maryland.Â This comes back to what we mean by collapse. Motesharreiâ€™s group defines historical societies according to strict geographical limits, so that if some people survived and migrated to find new natural resources they would constitute a new society. By this criterion, even very advanced societies have collapsed irreversibly and the West could too. But it wouldnâ€™t necessarily mean annihilation.