Rollingstone.com

The Watchdog: Elizabeth Warren

She may be the only person in Washington who stands between us and Wall Street's next meltdown

TIM DICKINSON

Posted Apr 14, 2010

With the stock market on a roll and employment beginning to pick up, it's easy to think that the economy has finally turned the corner. Leading bankers and politicians assure us that the financial crisis is behind us – and the reckless gambles that cratered the global economy will never be repeated. But Elizabeth Warren, Washington's top financial watchdog, has news for you. The economy may be growing at long last – but unless Congress gets serious about reforming our financial system, we're doomed to repeat a catastrophic cycle of boom, bust and bailouts. "We have one slim chance, right now," says Warren, "to put the too-big-to-fail genie back in the bottle."

If Congress can deliver on President Obama's promise of financial reform, Warren says, it can create the conditions needed for 50 years of economic growth and shared prosperity – just as the Depression-era reformers did in the 1930s. But if lawmakers simply paper over the crisis, she warns, Wall Street's rash bets will continue to be rewarded – and the next crisis will be far worse. "It will be TARP 2.0," Warren says, "and our economy will never be the same."

A professor of law at Harvard, Warren has become the folk hero of the bailout era. Appointed to oversee the $700 billion TARP bailout, she's the one official in Washington who can be counted on to champion the interests of the middle class. As chair of the Congressional Oversight Panel – the aptly named COP – Warren exposed Hank Paulson's big lie: The initial round of TARP money was a $78 billion giveaway to Wall Street's most reckless banks, not, as Bush's treasury secretary claimed, a fair exchange of cash for equity. In a true display of bipartisanship, Warren has also kept the heat on the Obama

administration, grilling senior officials over their sweetheart treatment of AIG. (For a six-minute primer in Warren's prosecutorial prowess, search YouTube for "Timmy Geithner squirm.")

In the process, Warren has transformed her obscure post into a bully pulpit. As the intellectual architect of the proposed Consumer Financial Protection Agency, she has waged a relentless media campaign to ensure that the government safeguards borrowers from toxic financial products the same way the FDA protects patients from toxic drugs. Warren's critics have tried to paint her as a self-righteous, bank-hating, ivory-tower elitist. Sen. Richard Shelby, a Republican from Alabama, calls the consumer agency "the nanny state at its worst," and the U.S. Chamber of Commerce has launched an all-out campaign to "Stop the CFPA," claiming that it "would make a bad economy even worse."

If Warren has all the right enemies, she has also cultivated powerful friends. At the White House, she speaks directly to presidential wingman David Axelrod, and Obama himself has made the case for her agency on *The Tonight Show.* Warren strategized with Rep. Barney Frank, chairman of the House Financial Services Committee, to steer the CFPA to passage in the House. "She has a great sense of how to operate politically," Frank says. And in the Senate, where debate on reform is just heating up, Majority Whip Dick Durbin calls Warren his "go-to person."

But Warren isn't taking any chances. "She's carried this fight way beyond Washington to the American people," says Nobel Prize-winning economist Joe Stiglitz, who lauds Warren as a one-woman bulwark against the bank lobby. "So many of our politicians have failed us – and she has filled the gap."

Warren's look may be librarian chic – rimless glasses, bobbed hair parted down the middle and tucked primly behind her ears – but her style is more aw-shucks Midwestern than populist fireball. She adheres strictly to the Charles Schulz book of cursing – "Good grief!" and "Holy guacamole!" – delivered without a hint of irony. When we meet at a cafe near the White House, she mentions in passing that she bakes a

mean peach cobbler – a recipe she inherited, no joke, from her Aunt Bee.

Warren's unwavering defense of the middle class stems from her own experience – first as a child in Oklahoma, then as a professor researching bankruptcy law. Her parents grew up during the Dust Bowl, and by the time Warren was born in 1949, "they were beaten down financially." Fleeced by a business partner, her father was forced into a series of tough, dead-end jobs. Traveling salesman. Maintenance man. He suffered a heart attack. They lost the family car. At age 16, Warren managed to earn a full-ride scholarship to George Washington University. Working as a summer associate on Wall Street, she saved enough money to get her teeth straightened. But while her own hard work paid off, her family continued to struggle. "My dad, my brothers, my mother – they're good people who said, 'I'll do my best. I'll get out there, and I'll make this work.' But they're also living proof that it's *hard*."

Given her own bootstrap ethic, Warren began her academic career deeply skeptical of those she saw as taking the easy way out. As a young law professor in Texas in the early 1980s, she embarked on a research project on bankruptcy expecting to "expose deadbeats – people who take advantage of a too-generous legal system." But the data and the case files told a much different story. Warren discovered that most Americans who file for bankruptcy are hardworking folks who play by the rules – and wind up losing, through no fault of their own. They get sick. Their marriages hit the rocks. Their parents need nursing care. "These are my people," she says. "That, for me, was transformative."

The lesson was reinforced a decade later when Citibank invited Warren to propose ways to minimize its losses from cardholders in financial trouble. Warren had simple advice: When borrowers show signs of distress – missed payments and plunging credit scores – cut them off from new lines of credit. But after she finished her presentation, a banker at the back of the room bluntly rejected her suggestion. "We have no interest in cutting back on our lending to these people," he told Warren. "They are the ones who provide most of our profits."

That moment, Warren says, "began to change my whole vision of consumer finance." She came to see Wall Street banks as predators, offering too-easy credit and too-complex contracts designed to "trick and trap" borrowers into recurring fees and exploding interest rates. "If people ended up in bankruptcy," she realized, "it didn't matter for the profit model."

Today, says Warren, the fortunes of Wall Street and the fortunes of Main Street have become disastrously oppositional. Despite profiting from taxpayer bailouts, Wall Street has only made life more miserable for those scraping by in what she calls the "real economy." Banks are refusing to modify mortgages for the hard-strapped homeowners they deceived, and now they're even bilking credit-worthy borrowers with arbitrary interest-rate hikes. Worse, Warren says, bankers like Jamie Dimon of JP Morgan Chase have testified before Congress that we should expect cycles of boom and bust to recur every five to seven years. "What pisses me off – I didn't say that – what makes me so *angry* is that the financial collapse was not a natural phenomenon like a hurricane or a drought," she says. "It was the consequence of a series of deliberate regulatory choices. That Jamie Dimon has figured out how to make a profit off of that may make him willing to tolerate booms and busts – but for the rest of us, the consequences are catastrophic."

Even with Warren's plainspokenness, the battle over financial reform involves a host of complex and confusing options. Should Congress break up big banks? Regulate toxic deals like credit-default swaps? Expand the power of the Federal Reserve? Warren is well aware that politicians from both parties, whatever their differences, are eager to vote for a bill that they can tout as having reined in Wall Street. "They're going to call this *reform*, no matter what," she says. The question is: Will it do any good?

To make sense of what needs to happen, Warren distilled for *Rolling Stone* the three-part litmus test she uses to determine whether a proposed reform will actually protect consumers and ensure that we're rebuilding the economy on a solid foundation rather than erecting another house of cards. Think of them as Warren's Rules for Reform:

RULE ONE

Give the Little Guy a Fighting Chance

For Warren, a strong, independent consumer-protection agency is at the heart of any meaningful financial reform. If a cholesterol medicine carried a one-in-five risk of causing a heart attack, it would never get approval from the FDA. But a subprime mortgage that carries the same risk of ending in foreclosure, she points out, can be sold without any warning label. Such predatory products – running the gamut from payday loans to reverse mortgages – juice corporate profits by exploiting consumers who play by the rules, only to discover that the bank can change their interest rate without warning.

Warren's relentless focus on consumer protection has earned her honest criticism on Capitol Hill, even from her admirers. Sen. Ted Kaufman, a Democrat from Delaware, worries that the contentious debate over the CFPA will distract Congress from the larger question of how to rein in big banks. "If we don't do something about too-big-to-fail and we go through a crisis like this again," he says, "the cost to consumers is going to be extraordinary – even if we have a consumer-protection agency."

But Warren believes such criticism misses the point: Creating a safe and transparent marketplace for borrowers will ultimately protect Wall Street and the entire economy. The agency would have the power to police the kind of predatory lending – subprime mortgages being the key example – that not only drove individual borrowers into ruin, but became "toxic assets" as they were sliced, diced and securitized by banks looking for lucrative new instruments. "This whole economy failed one bad mortgage at a time," Warren says. "The raw material that fed into the crisis was *bad consumer financial products*. If nobody can sell mortgage-backed securities based on trillions of dollars of unpayable instruments, there's a lot less risk in the overall system."

As Warren envisions it, the CFPA would streamline government by consolidating regulatory authority now spread among seven bureaucracies – including the Office of the Comptroller of the Currency, which is run by a former bank lobbyist. The new agency would police everything from car loans to home mortgages, ensuring

that borrowers understand the costs and risks of a financial product before signing on the bottom line. In 1980, Warren points out, the average credit-card agreement fit on a single page. Today, it is more than 30 pages of incomprehensible legalese. "The maze of fine print and undisclosed practices," she says, makes signing up for a Visa card "like putting your head in a lion's mouth and hoping he isn't hungry." The CFPA would make choosing a credit card or mortgage a straightforward decision, based on the best available terms. Informed speculators would still be able to flip a house, but the agency would stop predatory lenders from refinancing a grandmother out of her home with a defective loan.

Much of the debate surrounding the agency has centered on where it should be housed. Warren is agnostic about location, as long as the agency hews to a four-point checklist: Is the agency headed by a presidential appointee? Does it have independent budget authority so it can't be zeroed out by a hostile Congress? Can it make and enforce its own rules? And does its scope cover the full range of financial products?

In the end, Warren is confident that she can hold the line on these criteria to ensure that the new agency doesn't degenerate into a regulatory mush. "We'll have something strong here," she vows, "or we'll have nothing at all."

RULE TWO
Make Bankers Pay For Their Mistakes

As a bankruptcy lawyer, Warren believes that regulatory reform must put the possibility of failure back on the table for America's biggest banks.

Americans tend to think of Too Big to Fail in terms of the billions of dollars it cost us in TARP funds and Federal Reserve guarantees. But Warren insists that the problem is best understood as a permanent form of federal insurance – one extended only to the world's richest and riskiest financial institutions, and one that produces ongoing hidden costs. In March, for example, the rating agency Moody's disclosed that it has upgraded Citi's debt solely because it believes the

government will step in to prevent default. How much does the government charge for that guarantee? "Zero. Zip. Nada," says Warren. "They paid not a penny for an insurance policy that's worth billions." That gives big banks an advantage over smaller competitors, fueling consolidation and encouraging risk.

As Warren sees it, there are three basic strategies available for ending the era of Too Big to Fail. Break up the banks. Prohibit them from engaging in too-risky behaviors, such as running their own hedge funds with federally insured deposits. Or create a credible form of bankruptcy that enables regulators to pull the plug on failing banks before they take down the entire economy. Although she believes all three will probably need to be used in concert, Warren views the third element as the linchpin. "I hope it is never necessary to kill off one of these companies, because that's a scary moment," she says. "But that's the point of law. Bankruptcy is there to have a set of rules in place for the potentially catastrophic moment."

Warren believes there are two reforms necessary to make bankruptcy work for massive, interconnected financial firms. First, make the process as painful as possible for those responsible. "The bankers have to know that they'll go down with the ship," she says. "Under TARP, the executives got to keep their jobs and earn bigger and fatter bonuses than ever before." Wall Street needs to know, she says, that if their institutions falter, top management will get sacked, shareholders will be wiped out, and creditors will get back pennies on the dollar. "It has to be tough enough so that the Goldman Sachs of the future will want to manage themselves – no matter what – to avoid bankruptcy."

The second key, Warren says, is to close the loophole that Wall Street lobbyists carved out in 2005, when Congress overhauled the nation's bankruptcy laws. Before the latest crisis, Chapter 11 bankruptcy was a tool powerful enough to wind down even massive, interconnected institutions like Enron. But the loophole introduced in 2005 allowed the holders of derivative contracts to ignore the freeze on a bankrupt company's assets. The collapse of Lehman Brothers brought the entire economy to its knees, says Warren, because derivatives holders were allowed by law to make a run on the bank, hollowing out Lehman's

carcass while the firm's other creditors were frozen out. The resulting panic sparked a market-wide contagion, which led to TARP. If financial reform doesn't shut down this derivatives loophole, Warren warns, "it's not real."

The tricky part of big-bank bankruptcy, Warren knows, is that taxpayer money may have to be made available to "fund runways for the bad landings." That requires Congress to perform a balancing act: It needs to hold banks accountable for their mistakes while injecting enough money into the system to stop a cascade of failures. "If they don't find a way to calm the creditors, then the next Uncle Hank won't use the bankruptcy authority," says Warren. "Instead, he will do a wholesale bailout – which is TARP 2.0."

RULE THREE
Stop Cooking The Books

The good news is that Warren's first two rules have a significant chance of becoming law. The House has already passed a version of the CFPA. And the bill under consideration in the Senate grapples seriously with bankruptcy authority – though Warren cautions that "the pieces are not all quite there yet."

The bad news is that there's another key to reform that's not contemplated in either bill: accounting reform. The fixes passed by Congress after the collapse of Enron in 2001, it turns out, were nothing but cosmetic changes that papered over the crisis. They did nothing to stop Lehman Brothers from inventing off-book accounting scams with code names like "Repo 105," or to force AIG to report the massive risks it was amassing, or to prevent Goldman Sachs from masking Greece's debt with phantom trades. "Was Enron a giant how-to manual?" asks Warren. "Have we learned nothing from Enron but how to do it? It's in everybody's analysis now of what went wrong in the current crisis – and yet there's virtually no serious call to deal with it."

If anything, funny-money accounting has received a federal seal of approval. Remember all those "toxic assets" that TARP funds were supposed to buy up and dispose of? They're still on the books of big

banks. The only thing that's changed are the accounting rules. With a wink from federal regulators, banks can now pretend that such assets are worth more than any buyer would pay for them. The same behavior has defined the response to the looming crisis in commercial mortgages. By the end of 2010, Warren calculates, half of all commercial real estate loans will be underwater. But so far, the government's response has been, once again, to simply tweak the rules for how to account for loans in default.

The goal of financial reform is to lay out the rules of the road for the next 50 years. But the best guardrails, Warren says, aren't going to make much difference if our economic engine blows up because we failed to make the necessary repairs. With toxic assets and commercial real estate, the economy's "check engine" light has gone on twice. But instead of fixing what's wrong, we effectively told the mechanic, *Just turn off the damn light*. This "extend-and-pretend approach," says Warren, destroys transparency and makes financial statements meaningless. "If this part doesn't get fixed," she warns, "then every effort to rebuild the economy will ultimately fail."

Warren knows that passing real reform will be tough, given the influence of Wall Street. Over the past decade, the financial sector has spent nearly $4 billion – more than any other industry – to sway policy in Washington. Capitol Hill now swarms with more than 1,400 bank lobbyists – three for every member of Congress. Chris Dodd, the chairman of the Senate Banking Committee, is not seeking re-election, in part, because of a scandal in which the nation's largest subprime lender gave him a sweetheart deal on his mortgage. And President Obama's top economic advisers played a central role in lifting key regulation, as Larry Summers did in the Clinton White House, and failing to police the reckless bets that caused the crisis, as Timothy Geithner did as head of the New York Fed. "There are times I despair," Warren says. "A year and a half ago, I thought that the will would be there to rewrite the rules of the road. But the Wall Street lobbyists have so dominated the conversation in Washington that even the most obvious reforms have become a heavy lift."

But Warren hasn't given up. In recent weeks, she says, the prospects for meaningful reform have gotten considerably brighter, thanks to the

president's victory on health care. "There was a point that Washington would have accepted *anything*," she says. "A couple of statutes that there could be a nice signing ceremony around – and everyone dusts their hands off and says, 'That's great. We're done.' But we're past that point. I don't think they can get away with that anymore."

http://www.rollingstone.com/politics/story/33082414/the_watchdog_elizabeth_warren