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# Financial Crises and Government Regulation

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Abstract

In the midst of turmoil, regulation is "a rule or directive made and maintained by an authority" to maintain order. More often than not, the authoritative figure that imposes and upholds regulatory standards, following its introduction to the specific industry or firm, is the government of the respective country or region. However, politicians, like the rest of us, are unable to predict when a crisis will occur and what appropriate regulation should be imposed to prevent that crisis. Thus, an inevitable concern with regulation is the fact that it is unable to thwart an unforeseeable future crisis but is instead a preventative measure in response to a previous event. As is the case with crises before and after the Financial Crisis of 2008, the imposition of new laws like Dodd-Frank and others were enacted following the destructive effects of each crisis. Unfortunately, financial crises are seemingly inevitable, as people are ultimately self-interested and continue to find loopholes in the laws of the financial system to create incredible profits by unlawful means. Currently the Foreign Exchange Market is facing this very issue in its own crisis as people within the industry are consistently taking advantage of a lack of regulatory infrastructure to make money. What regulations will be imposed remains to be seen. In this paper I will compare the factors that caused each respective crisis and determine what can be learned from the financial crisis and its resulting regulations that applies to the Foreign Exchange Market crisis.

The 2008 Financial Crisis

When economies are doing well there are powerful political pressures not to rock the boat. As an unintended consequence of these political pressures, regulatory bodies scale back on their activities. More often than not, the inactivity, or lack of existence, of proper regulatory bodies during periods of economic success has lead to the forces driving prosperity to go unchecked. As a result of this unchecked economic growth, people take advantage of the good times and grow their wealth by any means. Unfortunately, this mindset further influences some people to attempt to acquire wealth through improper, and more often than not illegal, activities. This was certainly the case with the 2008 financial crisis. This crisis is considered by many economists to have been the worst financial crisis since the Great Depression of the 1930s. It threatened the collapse of large financial institutions, which was prevented by government-funded bailouts, but was unable to prevent stock markets from dropping worldwide. As a result major financial regulations were imposed to prevent another financial crisis. Before I analyze the regulation that resulted from this crisis, it is essential to know how it all happened. In the midst of a booming housing market and strong economic conditions, the crisis brought two groups of people together; homeowners and investors. This union of homeowners – represented by their mortgages on houses – and investors – represented by the money from large institutions such as pension funds and insurance companies, became the underlying impetus of the crisis. Unfortunately, brokers and bankers on Wall Street orchestrated the combination of these normally separate, and seemingly disconnected markets to create immense wealth for themselves. In the process, they built their foundation for wealth creation on faulty premises that were bound to fail. On 15 September 2008 the bankruptcy of Lehman Brothers, the 158-year old investment bank, became the largest bankruptcy in US history. This event cued the beginning of the Global Financial Crisis.

In order to fully comprehend how the combination of homeowners and investors created the financial time bomb that paralyzed the global financial system, one must go back a few years before the crisis. In the wake of the “dot.com” bust of 2000 and September 11, 2001, Federal Reserve Chairman, Alan Greenspan, lowered interest rates to a mere 1% to keep the economy growing. Traditionally investors seeking secure investments went to the Federal Reserve to invest in very secure treasury bills, however by most investment standards, a 1% return is pitiful. As a result those investors who had invested in treasury bills started to look elsewhere for higher returns. In sharp contrast, banks on Wall Street were ecstatic that interest rates were lower as they could now borrow from the Fed at abnormally low rates. When these low interest rates were combined with "the general surpluses from Japan, China and the Middle East there [was] an abundance of cheap credit" (Done). Subsequently banks could borrow money at incredibly cheap rates and take full advantage of "leverage." Leverage is "the act of using borrowed money to buy an investment or a company." More simply put, leverage is borrowing money to amplify the overall profits from a deal. Given a safe market environment to borrow, leverage transforms good deals into great deals in exchange for the cost of borrowing. Since interest rates were so low, this key method of generating profits for banks was amplified, and as a result institutions on Wall Street (such as JP Morgan Chase, Citigroup, Goldman Sachs, Morgan Stanley, Merrill Lynch and Lehman Brothers) became highly leveraged. Wall Street institutions naturally then borrowed large amounts of money, made great deals, grew tremendously rich and subsequently paid the borrowed money back. Investors took note of this and wanted a piece of the action, rousing Wall Street to find a way to meet investor demands. Wall street obliged by connecting these investors to homeowners through mortgages.

As I mentioned earlier, the underlying cause of the crisis was this meeting of investors and homeowners, but one may ask why that is the case? It is important to note that becoming a homeowner during this period was fantastic, as housing prices had been consistently rising, seemingly forever, and increasing numbers of families were looking for homes. With ever-higher house prices, increasing numbers of families wanted to get onto the housing ladder and contacted a mortgage broker – who connected them to a lender eager to put his (borrowed) money to work.

The family bought their dream house; the broker made a good commission, and the lender obtained a revenue stream from the monthly mortgage payments. This cycle repeated itself every time an individual decided to purchase a home and everyone involved was happy. Investors assumed that housing prices would never drop, and saw what appeared to be an opportunity for arbitrage that made better returns than treasury bills. Suddenly investment bankers started to borrow millions of dollars in order to leverage thousands of mortgages from lenders. The now seemingly disconnected homeowners and investors were brought together, as investment bankers combined the purchased mortgages into asset-backed securities to be sold for their respective fees. Every month, through the securitization of these mortgages, the investment banker received monthly mortgage payments, very similar to Treasury bill coupon payments, making them very wealthy, which in itself is a good business. However, since there was no regulation at the time to prevent banks from taking further unlawful measures to expand their profits, they did. The bankers then repackaged the asset-backed securities and their respective revenue streams into further structured investment vehicles in the form of three separate types of mortgage debt, "safe," "okay "and "risky," more commonly known as a Collateralized Debt Obligations (CDO). CDO's essentially worked like three cascading trays. As money came in from homeowners paying off their mortgages, the top tray would fill to the brim and spill over until eventually the bottom tray filled up. Since CDO's offered differing levels of risk, they offered different returns, much like most forms of bonds. Thus, the riskier the CDO, the higher the yield it offered. Additionally, in an attempt to make the top tray even safer, banks insured them for a small fee, called a Credit Default Swap. Credit Default Swaps became crucial as "investors bought the safer tranches because they trusted the triple-A credit ratings assigned by agencies such as Moody's and Standard & Poor's" (The Economist). While the banks bought the safer CDO's and insured themselves with a credit default swap, the flaky mortgage-loan CDOs were bought by more risk-tolerant investors such as hedge funds. The investment banker made millions from selling these CDOs and immediately repaid any outstanding loans. However should homeowners' default on their mortgages, less money would come in, increasing the likelihood of the bottom tray not becoming full. Unfortunately, investors and homeowners disregarded the risk of default because they assumed that housing prices would never go down. The result of a default on a house mortgage was the foreclosure of the home, which the owner of the CDO claimed as their property. This home was easily resold, given the high levels of demand for homes in the housing market, and effectively starting the entire process of creating CDO's all over again.

Finally investors found a good investment for their money, much better than the 1% treasury bills. As housing prices continued to soar, investors were so pleased that they wanted more CDOs. The investment banker went back to the lender to buy more home mortgages, and the lender went to the mortgage broker to gather more mortgages to sell, "but everyone qualifying for a standard mortgage already had one – so, in combination, the lender and broker came up with an idea to squeeze things a bit further" (Done). This disastrous idea was to add more risk to new mortgages. Instead of selling to responsible homeowners (prime mortgages), brokers and lenders started providing mortgages to the somewhat less responsible. This idea was rationalized because in the end if homeowners defaulted the lender would get to keep the house, and if housing prices are perpetually increasing, the lender could sell the house for profit. Thus the infamous subprime mortgage was born, with no down payment or proof of income necessary.

Just as before the mortgage broker connected the family with the lender and a mortgage, made his commission, and the family with limited and unstable income bought a home. The lender would then sell the mortgage to the investment banker, who turned it into a CDO and sold the increasingly risky slices to investors and others. This worked quite nicely for everyone involved making the seller of the CDO extremely wealthy. No one was worried because as soon as they sold the mortgage to the next guy it was his problem. If the homeowner was projected to default, they didn't care so long as they were selling off their risk to the next guy and making millions. Essentially investors were playing hot potato with a financial time bomb. Not surprisingly, the less-stable homeowners defaulted on their mortgages, and banks started to foreclose on the owners. This meant, as I explained earlier, thousands of CDOs transformed into homes. No big deal, the bank would put it up for sale, but as more and more of the monthly payments turned into homes, the supply of homes spiked. Unfortunately for the new owners of thousands of homes, the rapid increase in supply was met with very low levels of demand, as anyone who was qualified or unqualified already had a home. What started with subprime individuals unable to pay back their mortgages worked its way up the chain to highly leveraged institutions across the board unable to pay their mountainous debts of millions of dollars. Since no one would buy any of the previously highly desirable CDOs, as investors already owned thousands of CDOs, home prices dropped causing institutions to go bankrupt.

The collapse of Lehman Brothers effectively caused the whole financial system to freeze as a result of major firms going bankrupt. Regrettably, "when house prices declined, the equity of those homeowners was quickly wiped out; in turn, "underwater" borrowers who owed more than their houses were worth were much more likely to default on their mortgage payments" (Bernanke). Thus as house prices started rapidly declining, "anyone still paying their mortgage of $250,000 was strongly incentivized to default too when all their neighbors' houses were now valued below $100,000" (Done). Suddenly the infallible assumption that housing prices could never decline was proved wrong as default rates swept through the US and house prices plummeted. The fear of financial oblivion was real and imminent and the Great Recession began.

Following the massive losses caused by the financial crisis, policy-makers sought to rectify the damage done to financial systems and economies by enacting a large set of financial reforms, both at the international and domestic level. The catastrophic levels of damage done to the system were simply too extensive for a simple solution as “the first series of actions, including broad-based guarantees of bank accounts, money market funds and liquidity by the Federal Reserve, were not enough” (Reyes). The Bush Administration was forced to go to extreme measures in order to address a rapidly deteriorating situation. On October 3, 2008, “congress passed and President Bush signed into law the Emergency Economic Stabilization Act of 2008 (Public Law 110-343), which established the $700 billion Troubled Asset Relief Program (TARP)” (St. Louis Federal Reserve Bank). Although TARP was eventually signed into law, the immediate reaction was poor. Subsequently the initial rejection of TARP on 30 September 2008 resulted in the largest one-day drop in the Dow Jones Industrial Average of 778 points, or $1.3 trillion in market value. Not ten days after TARP was signed into law the Treasury, Federal Reserve, FDIC and OCC announced the launches of the Capital Purchase Program (CPP) and the Temporary Liquidity Guarantee Program (TLGP). It was announced that CPP, under TARP, was designed to provide new capital to banks, which allowed them to loan more money to businesses and thus stimulate the economy. Under the program, the U.S. Treasury bailed out 707 qualifying U.S. banks and savings institutions when they purchased $205 billion of senior preferred shares. TLGP, on the other hand, was established to “temporarily guarantee – for a fee – the senior debt of all FDIC insured institutions and their holding companies, as well as deposits in non-interest bearing deposit transaction accounts” (The

Treasury). This was conceived to avert the two most immediate threats to the U.S. financial system, a drop in public confidence in the integrity of their depositary institutions and the disintegration of the interbank and short-term credit markets. Emergency measures such as TARP, CPP and TLGP were conceived in the immediate aftermath of the crisis in order to stabilize the economy. These short-term measures, although effective in their implementation, were not meant as permanent solutions to the Great Recession. In the wake of 8.8 million lost jobs and $19.2 trillion lost in household wealth, the Emergency Economic Stabilization Act of 2008 and the reactionary measures that followed, were merely the beginning parts of addressing the new global recession. The global impact of the crisis encouraged policy makers to reevaluate how to best oversee and organize money and finance, both in the domestic and international realms. The most profound measure that arose from the crisis was the Dodd-Frank Wall Street Reform and Consumer Protection Act, more commonly referred to as Dodd-Frank.

Dodd-Frank marks the greatest legislative change to US financial regulation since the inception of financial legislation in the 1930s, which resulted in the Federal Deposit Insurance Act, the Securities Act of 1933, the Glass-Steagall Act, the Securities Exchange Act of 1934 and the Investment Company Act of 1940, to name only the most important. The Obama Administration passed Dodd-Frank in 2010 to prevent the recurrence of events that caused the 2008 financial crisis with the aim “to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes” (United States Securities and Exchange Commission). The act is categorized into sixteen titles and drastically changes the existing regulatory structure of the financial services industry through a variety of measures, such as creating a myriad of new agencies (while merging and removing others) in an effort to streamline the regulatory process, increase oversight of specific institutions, promote transparency, and numerous additional changes. This legislation in many ways represents a change in the way America's financial markets will operate in the future. Although the act is a well-intentioned attempt to fix what went wrong in the years leading up to 2008, the problem with Dodd-Frank is that it consists of 1,000 pages of legislative guidelines, all of which need interpretation. The act is one of the lengthiest and most in depth pieces of legislation to be put into law. Due to the incredible complexity of the act I am going to focus on a few key points that can potentially be modified and applied to the recent foreign exchange scandal.

In retrospect, the financial crisis revealed a series of flaws within the financial system and Dodd-Frank is the attempt by which to correct and prevent those flaws from recurring. Some of these flaws were addressed by requiring that new financial bodies be formed to provide the rigorous standards and supervision needed to protect the economy, whereas others simply necessitated a series of requirements to meet regulatory demands.

A few of the new agencies that were created by Dodd-Frank include the Financial Stability Oversight Council (FSOC), the Orderly Liquidation Authority (OLA) and the Bureau of Consumer Financial Protection. These new agencies are either granted explicit power over a particular aspect of financial regulation, or that power is transferred from an existing agency. All of the new agencies are also obligated to report to Congress on an annual (or biannual) basis, to present the results of current plans and to explain future goals. One of the main goals of Dodd-Frank is to subject banks to a number of regulations along with the possibility of being broken up if any of them are determined to be "too big to fail." The FSOC council of 15 members is "charged with the goal of identifying risks to US financial stability that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or non-bank financial companies, or risks that could arise outside the financial services marketplace" (Guynn). If any of the banks gets too big in the council's determination, they could be regulated by the Federal Reserve, which can ask a bank to increase its reserve requirement – the money it has 'saved up' and is not using for lending or business costs. Accordingly the regulations imposed by the FSOC are intended to prevent bank insolvency. Before the financial crisis and Dodd-Frank, when a bank became insolvent, the Government would let natural economic forces take course and the bank would fail regardless of its importance. Under Dodd-Frank, banks are now required to have plans for a quick and orderly shutdown in the event that the bank becomes insolvent. These plans for shutdown are organized under provisions from OLA. This legislation "authorizes the Federal Deposit Insurance Corporation to pursue an agency-administered wind down for certain troubled financial firms" (Pellerin). This way, should a major financial institution find itself in trouble in the future the FDIC would step in and impose appropriate regulatory requirements in order to prevent the disastrous effects that the collapse of Lehman Brothers had in initiating the great recession. Both the FSOC and OLA are legislations that essentially protect banks from having their own toxic activities create another crisis, but unfortunately, neither is responsible for protecting consumers from unlawful business practices by banks. These are the duties of the Bureau of Consumer Financial Protection. The Bureau works with regulators in large banks to stop transactions that hurt customers, such as risky lending. In doing so consumers are given access to information about mortgages and credit scores in plain and simple English. These measures to increase transparency, in what are traditionally complicated documents, finally allows consumers the opportunity to understand the documents they sign. Effectively the Bureau will prevent predatory loans from being created and prevent consumers from taking out that have a high probability of default or foreclosure. In an effort to increase constructive communication, the bureau allows for consumers to report issues with financial services via their website or a 24-hour hotline. These reports can be reflective of any issue with financial services whether it is in practice or through legislation, such as questions regarding the Volcker Rule. This rule prohibits banks from owning, investing, or sponsoring hedge funds, private equity funds, or any proprietary trading operations for their own profit. Basically through this law, banks are to distinguish between which profits and funds are for customers and for the bank itself. Although the law generally prevents trading, the Volcker Rule does "allow some trading when it's necessary for the bank to run its business. For example, banks can engage in currency trading to offset their own holdings in a foreign currency" (Koba). The type of trading allowed under the Volcker Rule also includes the trading of derivative securities. Under Title VII of Dodd-Frank, the riskiest derivatives – like credit default swaps – are required to be regulated by the Securities and Exchange Commission or the Commodity Futures Trading Commission. In an effort to make them more transparent, Dodd-Frank attempted to establish a central exchange or clearinghouse so that derivative trades can be made in the public. Unfortunately, "the U.S. Treasury Department exempted foreign-exchange swaps and forwards from Dodd-Frank Act regulations intended to reduce risk and increase transparency in the derivatives market" (Brush). This exemption to the foreign exchange market highlighted a loophole within Dodd-Frank that traders could exploit. Before I describe why I believe the exemption is a key piece of legislation that should be implemented by the foreign exchange market to prevent a scandal, it is crucial to understand the nature of derivative securities.

Derivative securities are essentially contracts between buyers and sellers. There are many different types of derivatives and three of the more common types of derivatives are futures, forwards, and swaps. Futures are derivatives contracts used so commonly that they are standardized financial instruments, a feature that allows them to trade on exchanges, much like stocks. Forwards, on the other hand, are generally specialized contracts between two financial firms or between a financial firm and its customer. Multinational enterprises regularly enter into forward contracts to hedge against losing money on future changes in exchange rates. Swaps are similar to forward contracts but they require counterparties to make a series of future payments, whereas forward contracts require only one future payment. Swap contracts can, therefore, be viewed as a series of forward contracts. The most commonly used swaps are those that hedge against interest rate risk, but market participants use many different types of swap contracts. Historically, most swaps have been negotiated directly between large banks and other institutional investors—such as insurance companies, pension funds, and mutual funds—on the over-the-counter market rather than purchased on exchanges. The exemption of the foreign exchange market to the stipulations of Title VII in Dodd-Frank is another hole in the system. We do need controls to close the gaps that allowed the financial system to fall apart, which is the reason Dodd-Frank was implemented. The success of Dodd-Frank rests simply on whether or not it makes another crisis significantly less likely. Certainly this remains to be seen. Fortunately, unregulated portions of the financial system have the opportunity to thwart a potential crisis through the modification and application of certain aspects of Dodd-Frank to tie up some of their own loose ends. Through the implementation of proper financial reporting and the presence of a central exchange system the foreign exchange market may be able to avert future scandals similar to the current one.

The Foreign Exchange Scandal

Sadly, the processes that have led to previous crises and subsequent regulations, like that of the 2008 financial crisis and Dodd-Frank, were not isolated instances. Crises are growing increasingly inevitable, as people are ultimately self-interested and will continue to find loopholes in the laws of the financial system to create incredible profits by unlawful means. The Foreign Exchange Market (FOREX) is currently in the midst of its own scandal as people within the industry have consistently taken advantage of the lack of regulatory infrastructure. Unbeknownst to those outside of the finance industry, FOREX is the largest, most liquid market in the world with nearly 180 different types of currencies and about $5.3 trillion changing hands every day, which is 30 times greater than that of the stock market. But despite its huge size, this is a market that is far from extensively regulated and that has no single global body to police the massive 24/7 FOREX market and "for retail FX traders, the biggest risk of non-regulation is that of illegal activity or outright fraud" (Aitken). The market is decentralized and operates with no central exchange or clearing house. Consequently in order to regulate the market there are several governmental and independent supervisory bodies around the world, such as the National Futures Association, the Commodity Futures Trading Commission, the Australian Securities and Investments Commission and the Financial Conduct Authority. In fact since no one government agency is responsible for policing the currency market, but rather "leaving it up to committees, some run by the banks themselves, to set guidelines" the regulatory void has produced another round of criminal accusations and multi-billion dollar penalties (Corkery).

In the relatively short period of time following the financial crisis it is appalling that the firms that have been swept up in the investigations of the FOREX scandal are not relatively unknown firms. Firms like HSBC, Citigroup, UBS, Barclays and other big banks have been accused of collusion and manipulation of foreign exchange rates. Although most have already announced settlements with the Department of Justice, accruing penalties large enough to wipe out nearly all the revenue that major investment banks generated from their foreign exchange businesses last year, how they pulled off the scandal is what is most concerning. In order to fully comprehend how the FOREX scandal took place one must understand how foreign exchange traders make money. For the most part, currency pairs are quoted to four decimals, with the smallest fraction known as a “pip.” A Euro to U.S. Dollar pair might be quoted, for example, at 1.2567/1.2570 – a three-pip spread. The lower "bid" price is the offering price if anyone wished to "sell" the pair, and conversely the higher "ask" price is the price at which a trader can "buy" the pair, meaning the trader is speculating on a rise in the euro against the dollar. The larger the price spread, the more the pair has to move in the desired direction for the trader to make a profit. Since traders buy or sell currency pairs without broker commissions; the pip spread represents the broker's profit margin. Although a pip spread seems to be marginal at best, it is important to note that a standard currency position involves 100,000 units of currency. Thus with larger quantities of currency a difference of as few as 35 pips can mean significant profits. The pip spread leading to profit is best represented by an actual example from the scandal, as “the sterling/dollar exchange rate fix fell from £1.6044 to £1.6009, HSBC made a $162,000 profit” (Chrispin). How banks managed to manipulate the foreign exchange market, like bankers did with mortgages during the crisis, was done during a period of time called “the fix.”

As I mentioned earlier, the FOREX market is open 24/7 allowing for trade to occur around the world uninterrupted. However, at 4pm in London all trading stops for a 60-second window and this period of time is called the fix. The fix establishes benchmarks at supposedly fair prices and is the closest thing the FOREX market has to a closing bell. For many customers around the world having that daily value is key because the fix is a time of day when banks guarantee investors a certain rate for their currency trade. A trader's job is to try and get an extra slice of each trade he makes for a client. Normally, trades are done immediately, but with the fix, the trader knows they have to buy a certain sum in half an hour as investors place their orders with a bank in advance. They see that obligation to buy as their risk for the bank that they need to hedge. However, at the fix, investors are guaranteed the mid rate – between the bid and ask price – of whatever the currency trades at in the one-minute window around the time of the fix. Consequently traders want to buy at a lower rate than the mid price of the fix to make their profit. Accordingly they want to try and work out where the market is likely to trade at 4pm. If they think the price of the euro might be lower at 4pm, for example, they might try to sell some in advance. Many investors like to use the fix because it removes any need to try and time the market that day.

Ironically, the fix appeared to have been fixed by traders in London, who had been rigging it to their advantage. The banks and traders alike managed to collude and manipulate prices through private chat rooms with suitable names like "the cartel," "the mafia" and "the bandits club." As one trader at Barclays wrote in an online chat room where prosecutors say the price-fixing scheme was conceived "If you aint cheating, you aint trying" (Corkery). To get an edge, traders at the banks and institutions involved colluded to pad their returns from at earliest at least 2007 and 2013. To carry out the scheme, one trader would typically build a huge position in a currency, and then unload it at a crucial moment, hoping to move prices. "Banging the close," as the process of manipulating the currency at the very last second of the fix came to be called, was where traders made their money. Through these chat rooms the traders would communicate in order to push the value of currencies lower or higher in order to bang the close and make large amounts of profit. Traders at the other banks would play along, coordinate their actions in online chat rooms, set rates at artificial levels and earn their profits, which ultimately came directly out of investors' pockets. Afterwards, traders congratulated themselves, saying "'Loved that mate... worked lovely... pity we couldn't get it below the 00", "there you go.. go early, move it, hold it, push it", "nice works gents..I don my hat" and "Hooray nice teamwork" (Chrispin). Without the presence of a single regulatory body overseeing the activities of the colluders "the trading of foreign currencies promised substantial revenues and relatively low risk" (Corkery). The activity was to be low risk trading In the end, five of the world's largest banks involved in the scandal agreed to plead guilty to U.S. criminal charges over manipulation of foreign exchange rates agreeing to pay roughly $5.7 billion in penalties. While the balance sheets of the biggest FOREX players will be able to easily absorb these fines, the damage inflicted by these scandals on investors' confidence in fair and transparent markets may be longer lasting.

The rate manipulation scandal highlights the fact that despite its size and importance, the FOREX market remains the least regulated and most opaque of all financial markets. It also calls into question the wisdom of allowing rates that influence the value of trillions of dollars of assets and investments to be set by similar groups of a few individuals, for example, "one corner of foreign exchange – the $2tn spot market – is controlled by a group of fewer than 100 individual traders at a handful of large banks" (Schäfer). Although traders insist there are rules, many of the finer points are vague allowing the FOREX market to be run by a small group of global traders. Whether its mortgages, currencies or interest rates, whenever one small group can set the prices for everyone odds are they will try to turn it to their advantage and unintentionally start the chain reaction to the next financial crisis.

Suggestions

As a result of a lack for oversight over the financial sector pre-2008 and currently with the foreign exchange market, gross manipulation occurred in places where manipulation should not have been allowed to occur. Brokers and lenders allowed for highly risky subprime loans to be granted to people who weren't very risk averse, and FOREX traders rigged the fix to make unjustified profits. The results of both actions have been on one hand a major financial crisis, and on the other hand $5.7 billion in fines. Consequently new regulations have to be imposed to prevent crises from recurring. Fortunately regulations of different markets can be modified to prevent illegal acts from occurring. Dodd-Frank is meant to protect consumers from risky behavior, abuse, or financial loss of financial institutions by making the financial system more transparent and accountable. Ironically it was the exemption of portions of Dodd-Frank that allowed for the FOREX market to remain unregulated. Through Title VII of Dodd-Frank the FOREX market was to be regulated through a central exchange and as a result FOREX would have been forced to implement the same stringent regulations that the rest of the financial sector was set to follow. However, on November 2012, the U.S. Treasury Secretary issued a final determination that exempted both FOREX swaps and FOREX forwards from the majority of the Dodd-Frank requirements for swaps. According to former Treasury Secretary, Timothy Geithner, the foreign-exchange market needed no special regulation sighting "an elaborate framework in place already to limit settlement risk" (Kuttner). Essentially an assertion that the FOREX market was sufficiently regulated, a statement proved incorrect by the manipulation of the FOREX market. This assumption is unfortunately the same sort of belief mortgage lenders made before the 2008 financial crisis and the resulting imposition of Dodd-Frank.

Dodd-Frank, under Title VII, basically requires all derivatives to be traded on regulated exchanges or central clearing facilities, where they are subject to prohibitions against market manipulation and where regulators have enough data to detect patterns of abuse. Exchange trading and central clearing also ensures that traders have enough capital to cover the trade if a deal goes bad. By requiring the majority of derivatives to be traded on exchanges, Dodd-Frank also brings transparency to financial markets, which means more competition, less price gouging of customers, and thus, lower windfall profits for bankers. In other words, this loophole would invite traders to artificially bring foreign currencies into other derivatives transactions in order to avoid the scrutiny of Dodd-Frank. During the Dodd-Frank debates, Senator Maria Cantwell stated, "I can't believe the first decision the administration would make to carry out Dodd-Frank would be an anti-transparency decision. The idea that the foreign-exchange markets are not at risk is preposterous. […] Anytime you have a lack of transparency, there is potential for abuse" (Kuttner). By contrast, the industry prefers no regulatory snooping and to have customized derivatives traded privately over the counter, where secrecy allows banks and their traders to book larger profits at the expense of customers. Creating another loophole for Wall Street could lead to an even bigger bailout in the future and could cause serious damage to the economy.

It would be a calamity to allow FOREX traders around the world to continue to gamble with trillions of dollars in foreign exchange without strong regulations and oversight. For a market that exchanges $5.3 trillion every day it is unfathomable that FOREX was exempt from Title VII. Through the full implementation of Title VII on the FOREX market, traders would be required to fully report their activities and would be effectively prohibited from manipulating prices. Combined with more frequent reporting, the FOREX market may for once be kept in check. Should Title VII be enforced along with more frequent reporting I find it difficult for Wall Street to create a calamity out of the FOREX market. Although the implementation of Dodd-Frank to international companies allows U.S. regulators to review trading data on trades between foreign firms, even if the U.S. has no interest in the transaction, it would still be difficult to enforce the regulation on foreign firms due to the need for global cooperation. Because Dodd-Frank is only enforceable on U.S. institutions, simply reporting FOREX abuses to congress won't be enough, as foreign governments would need to be involved in establishing both an international central clearing house and a standard reporting process. However, should the FOREX market continue down its current path of price manipulation and outright fraud it could "spell the end of unregulated foreign exchange markets" (Schäfer). Without regulation crises are bound to happen again and again and another wave of increasingly hefty fines will be handed out. While the balance sheets of the biggest FOREX players will be able to easily absorb exponentially larger fines, the damage inflicted by these scandals on investors' confidence in fair and transparent markets may be longer lasting. Until further regulation is imposed on the FOREX market, only through fining and firing perpetrators will companies begin to learn that their actions are unlawful. It is an unfortunate reality, because when you do things right people won't believe you've done anything at all.

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