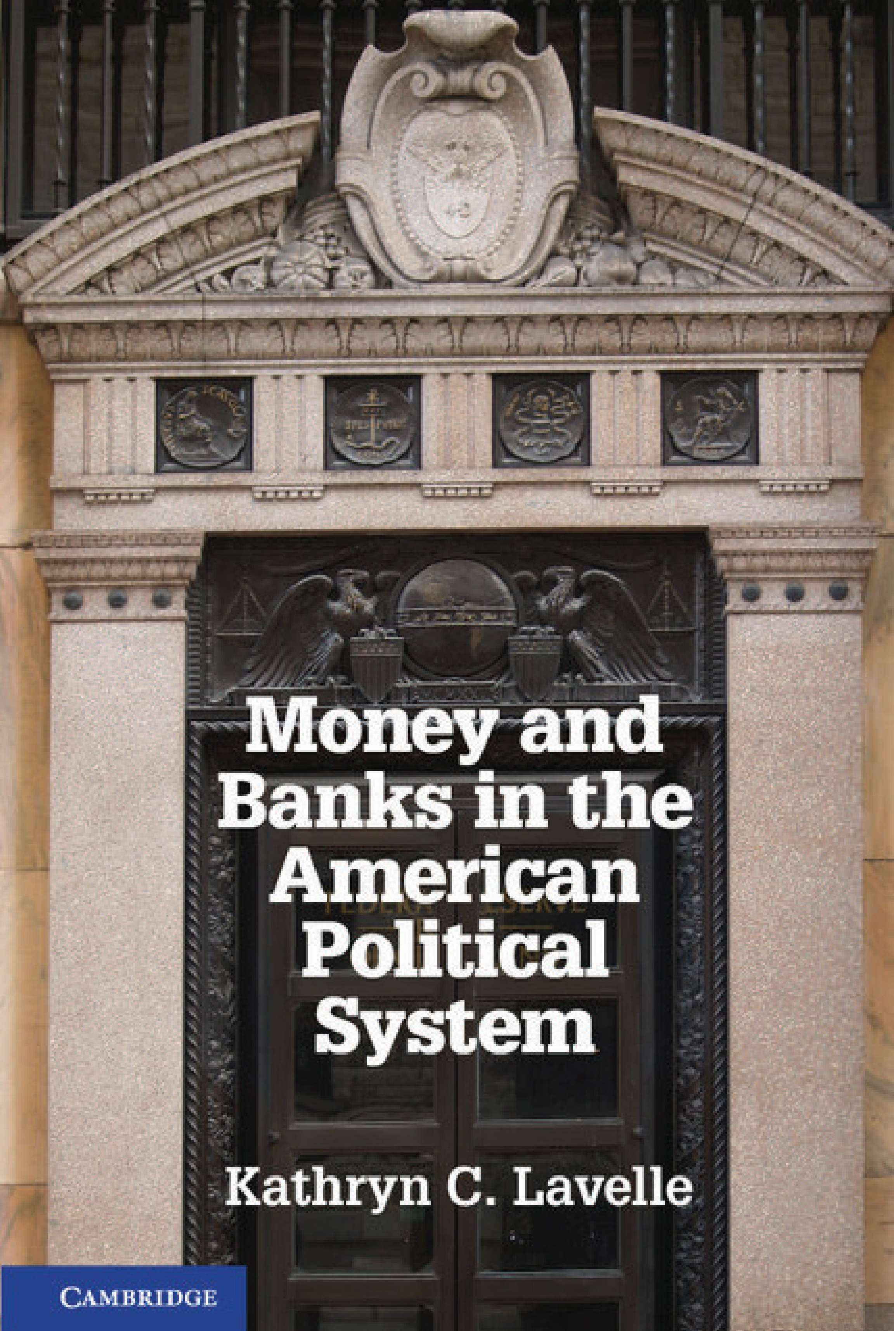

Money and Banks in the American Political System

Kathryn C. Lavelle

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Money and Banks in the American Political System

In *Money and Banks in the American Political System*, debates over financial politics are woven into the political fabric of the state and contemporary conceptions of the American dream. The author argues that the political sources of instability in finance derive from the nexus between market innovation and regulatory arbitrage. This book explores monetary, fiscal, and regulatory policies within a political culture characterized by the separation of business and state, as well as mistrust of the concentration of power in any one political or economic institution. The bureaucratic arrangements among the branches of government, the Federal Reserve, executive agencies, and government-sponsored enterprises incentivize agencies to compete for budgets, resources, governing authority, and personnel.

Kathryn C. Lavelle is Ellen and Dixon Long Professor of World Affairs in the Department of Political Science at Case Western Reserve University. She is the author of *Legislating International Organization: The US Congress, the IMF, and the World Bank* (2011) and *The Politics of Equity Finance in Emerging Markets* (2004). She served as the William A. Steiger Fellow in the American Political Science Association's congressional fellowship program, where she worked on the staff of the House Committee on Financial Services.

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To the memory of my grandmother, Pauline Noga Lucas, who taught me to never forget the human cost of the Great Depression

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Preface

The outrage that ordinary Americans feel over the 2008 financial crisis has not only persisted, it has intensified. Many people are angry because the U.S. government resolved the immediate threat to the financial system by issuing massive handouts to the very segment of the private sector that caused it in the first place. For some both inside and outside the financial services industry, the government should have let companies that made poor business decisions go bankrupt. For others, the government should have assisted individuals and companies caught up in the crisis with different types of intervention than it did. In July 2010, Congress passed a major piece of reform legislation attempting to make sure that such a crisis would never happen again. Yet before the ink on the bill was even dry, some vowed to work to repeal it. The media labels anti-bank sentiment as "populist," yet people's reactions are far from irrational or exaggerated. In the wake of the crisis, the benefits and burdens of the U.S. financial system do not appear to be evenly spread across the American taxpayer base or across industries. A coherent political reaction did not organize because political parties and interest groups have not been able to channel popular sentiment to promote reform in the same way they do in other policy issue areas.

Economic treatments of the American financial system emphasize the role played by markets and the accumulation of leverage in contributing to periodic crises. This book questions the role that U.S. *political* institutions play in making the system prone to episodes of instability. It does not just consider past crises, as important as they are, but the players, institutions, and politics that will surround crises to come. While many simplistic explanations for the political power of Wall Street rest with the size of corporate contributions to politicians' campaigns and the overall amounts paid to lobbyists in Washington, these explanations are too easy. Many industries, such as pharmaceuticals and oil and gas, also donate large sums and employ high-level government relations experts in Washington.

This book takes the view that a comprehensive understanding of how financial politics operate requires an understanding of finance and economics *combined with* an understanding of the political institutions that govern the system. American political culture has fostered an institutional separation between the business of banking and the operations of government throughout U.S. history; nonetheless, the work of the two are deeply connected to each other. Only a combination of changes in the operations of banks and securities firms, regulatory agencies of the government, and macroeconomic policy will yield solutions to the problem of economic governance in a capitalist, democratic environment. Therefore, this book borrows understandings of the policy process from other issue areas, such as health care and the environment, that have a rational component, an organic cultural component, and a bureaucratic component. But to understand the issue area of finance, the book highlights what makes money – and the politics surrounding it – different.

In a nutshell, history shows that the evolution of institutional arrangements among financial markets and the government have provided both a source of instability and innovation as each responds to developments in the other. Therefore, the problems in adequately regulating banking activities are not limited to the asymmetry of the financial sector relative to the rest of the economy, or its outsize lobbying budgets and campaign contributions. Political institutions and regulation channel competition in the banking industry that, in turn, plays a significant role in the structure of market transactions and interest groups representing market participants. Groups then approach federal and state legislatures that write the laws providing statutory justification for the regulation, in most cases seeking to preserve whatever advantages they hold in the marketplace. The Federal Reserve holds a special place among political institutions insofar as it plays a role in management of the macroeconomy through monetary policy and acts as a regulator. Thus, the Federal Reserve possesses its own internal cultural and bureaucratic interests with respect to multiple mandates that can compete with each other. When the Federal Reserve is added to the picture of political institutions, it is apparent that the three branches of government distribute power differently in the financial area but do not eliminate politics from it. The policy process, and thus the rewriting of regulation, is in constant motion and subject to revision. Moreover, since the policy process operates at both the state and national levels, opportunities to circumvent any one obstacle abound.

Misperceptions persist because few comprehensive studies exist. Academic departments in universities divide the topic among themselves. Economics texts fail to explore the inner workings of the political institutions that make it possible for markets to function. American politics texts devote only cursory attention to economic relationships because they are not usually high on the popular agenda and require some specialized knowledge. This book fills that gap by looking inside the Congress, presidency, Treasury, and Federal Reserve to see how and by whom they are influenced. In my view, many political disputes arise within institutions, but they also occur among agencies concerning the distribution of jurisdiction. Therefore, this book considers how institutions function internally, how they interact with each other during the normal course of the business cycle, and how they act during a crisis. Offering an accessible yet nuanced description of financial politics in American government, it provides a framework for understanding the distinct features of the American government's checks and balances as they apply to monetary, fiscal, and financial regulatory policy, as well as their connection to the banking system through the Federal Reserve.

In outlining this framework, I begin with Graham Allison's models of the political process in the American state.[1] I have augmented Allison's understanding with more recent works on American political development and bureaucratic politics to broaden its scope within the domestic financial context.[2] Allison's work is a good place to start because it is a scholarly approach that is used widely in graduate schools of government and public policy, business, and other professional training programs where the objective is to prepare for practice, not theory. As with Allison's original work, the audience for this book comprises both students and colleagues: colleagues who have a professional need to understand how the government intervenes, or does not, in the financial services sector, and students who are either political scientists seeking to deepen their knowledge of

[1] Graham Allison and Philip Zelikow, *Essence of Decision: Explaining the Cuban Missile Crisis*, 2nd ed. (New York: Longman, 1999).

[2] Some major works include Stephen Skowronek, *Building a New American State: The Expansion of National Administrative Capacities 1877–1920* (New York: Cambridge University Press, 1982); Richard Franklin Bensel, *The Political Economy of American Industrialization 1877–1900* (New York: Cambridge University Press, 2000); Susan Hoffman, *Politics and Banking: Ideas, Public Policy, and the Creation of Financial Institutions* (Baltimore: Johns Hopkins University Press, 2001); Marc Allen Eisner, Jeffrey Worsham, and Evan J. Ringquist, *Contemporary Regulatory Policy*, 2nd ed. (Boulder, CO: Lynne Rienner, 2006); Marc Allen Eisner, *Regulatory Politics in Transition* (Baltimore: Johns Hopkins University Press, 1993).

economic policy or economics or finance majors seeking to understand the functioning of the political structures that surround their field.[3]

As with Allison, the argument of this book is deliberately unfinished; it offers an invitation for the reader to join the discussion about where the most significant problems arise in terms of economic and governmental policy and how they should be resolved.[4] Moreover, an approach that offers different conceptual understandings of the political process allows the reader to observe what is going on from different vantage points, each with its own strengths and limitations.

My own interest in writing this book derives from the dual worlds of scholarship and practice. My first academic work was in international political economy, particularly the politics of stock markets. Hoping to broaden my base of inquiry, yet build upon what I had already investigated, I traveled to Washington, DC, as a congressional Fellow in the 110th Congress where I worked on the staff of the House Committee on Financial Services. At the beginning of my assignment in January 2007, the earliest signs of the 2008 financial crisis appeared. My interest grew more pronounced the next academic year, which I spent teaching at Case Western Reserve University in Cleveland, Ohio. By the beginning of 2008, the *Cleveland Plain Dealer* reported that nearly 24,000 people had lost their homes in Cleveland, and nearly 10,000 of the city's houses had been abandoned. Comparatively, in the New Orleans suburb of St. Bernard Parish, Hurricane Katrina destroyed about 13,700 homes and displaced 35,000 people. But Cleveland did not receive disaster relief, presidential visits, or public efforts to assist those devastated by the foreclosure storm.[5]

In 2008, I returned to Washington as a Fellow at the Woodrow Wilson International Center for Scholars. The next week, Lehman Brothers declared bankruptcy and Congress began to debate the Emergency Economic Stabilization Act creating the Troubled Asset Relief Program (TARP) that provided an unprecedented amount of money to the financial system. In November, Barack Obama was elected president and a new administration assumed control of the apparatus of the executive branch. Early in 2010, I was a Fulbright Visiting Chair at the Munk Centre of the University of Toronto. While residing in Canada, my understanding of financial politics was placed in sharp contrast to the different industrial structure, regulatory framework, and political culture of my host country.

[3] Allison and Zelikow, *Essence of Decision*, xi.

[4] See Graham T. Allison, *Essence of Decision: Explaining the Cuban Missile Crisis* (New York: Little, Brown, 1971).

[5] See John Kroll, "The Foreclosure Crisis," *Cleveland Plain Dealer*, January 20, 2008, http://blog.cleveland.com/metro/2008/01/the_foreclosure_crisis_how_it.html (accessed April 12, 2012).

Each of these experiences gave me a deeper understanding of financial politics and the "inside the beltway" operations of our nation's capital because each provided such a different vantage point. Most Washington "insiders" move among positions on Capitol Hill, to presidential administrations, to agencies like the Treasury and the Federal Reserve, to think tanks, and to governmental affairs departments of banks and financial services firms. As a researcher, I had the opportunity to interact with policymakers and academic fellows in the Washington think tank community. This world is separate and distinct from the financial markets in New York and housing markets in Cleveland, yet politics, financial markets, and ordinary Americans are profoundly dependent on each other. The effects of what happens in American financial markets are felt in other countries. My goal for this book is to "connect the dots" from the local, to the national, to the international banking system and show how the political pieces fit together.

The first chapter introduces the study of the political process surrounding finance at the intersection of institutions, regulations, and market innovation. It also introduces the concepts that will be developed later in the book with respect to the policy process, innovation in the financial sector, regulatory arbitrage, and the institutions of government in the United States, relative to other capitalist, industrial democracies. The second chapter presents a brief historical background to the political institutions surrounding the financial system, and the third explains the evolution of the banking industry. The fourth, fifth, and sixth chapters break down the monetary, fiscal, and regulatory policy domains as they are situated among the legislature, presidential administration, executive branch agencies, and Federal Reserve System. The seventh and eighth chapters consider how these institutions work in relation to each other, both in the normal course of the business cycle and in the 2008 crisis. The crisis of 2008 receives particular attention because its resolution has played a role in constructing the arrangement of political institutions going forward. The ninth chapter places the U.S. system into its international context. The tenth, concluding, chapter returns to the themes of the book and lays out the policy problems that will be confronted in coming years.

As a result of the crisis in 2008, we learned that a stable financial system is indispensable to the broader American economy. In the current era, most American workers' pension and retirement plans are defined contribution – not defined benefit – plans. The value of retirement funds is thus directly tied to the performance of the individual investments in them. The greatest single individual investment that most Americans will make remains their home. The reality of these new arrangements is such that the social welfare of ordinary American people is bound to the complexities of the governance of financial institutions in more significant ways than ever before. At the same time, individuals in the financial services industry have received higher levels of compensation partly because they have taken higher risks and devised innovative products that have expanded credit to wider segments of the public. Speculative activity is a necessary part of that system and also a danger to it.

The new reality of individual connection to an interconnected financial system operates within a long-standing political culture forged through civil and world wars, and across more than two centuries. Hence, this book does not provide a comprehensive understanding of the policy process that operates in order to "fix" it. It clearly defies a quick fix. Rather, in providing an understanding of the process, policymakers, students, and professionals can begin to see ways that degrees of stability have been achieved among actors over extended periods of time in American history. Only then can readers begin to formulate their own ideas for the best mix of market and regulatory features to come.

Acknowledgments

As the financial crisis unfolded from late 2008 to 2009, I was asked to answer questions in a variety of forums about the functioning and operations of the U.S. political economy. Just as any teacher knows that she does the best job when answering questions posed by intelligent students, I know how great my debt is to the cohort of Fellows and policy scholars with me at the Woodrow Wilson International Center for Scholars; participants at Munk Centre seminars sponsored by the Centre for International Studies when I was a resident there; and students and colleagues at Case Western Reserve University.

I could not begin to understand the political system in this area myself were it not for the willingness of the American Political Science Association and the House Committee on Financial Services to take me on as a congressional Fellow. Thus, I am deeply appreciative of my own "teachers" on the Hill – Jeff Biggs, Barney Frank, Daniel McGlinchey, Scott Morris, Jeanne Roslanowick, and Jim Segel – who instilled in me a great respect for our legislature and the people who make it work. Among them I am particularly grateful to Daniel McGlinchey for always demonstrating that the practice of politics has a heart as well as a soul and to Jim Segel for reminding us of the motto "don't let the perfect be the enemy of the good."

This book would never have taken shape without the input from numerous brown bag sessions organized by Lucy Jilka and episodes of *Dialogue* produced by John Tyler at the Wilson Center. In order to prepare for them, I thank David Biette, Joe Brinley, John Dysland, Kent Hughes, David Klaus, George Seay, Amy Wilkinson, and Don Wolfensberger. Once the outline for the project began to unfold, I appreciated the efforts of Dagne Gizaw, Michelle Kamalich, Jenny Ross, and Janet Spikes at the library of the

Wilson Center, and Krista Box at the library of the Federal Reserve Board of Governors, who ensured that I had access to the materials I needed. I also appreciated what I learned about the way that politics in Washington work from many informal conversations with Ray Ahern, Bob Burson, Randy Henning, Amy Kiesel, Bill Krist, Mike Rosenbaum, Marty Weiss, and Joe White.

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Finally, I am always indebted to my parents, brother, sisters, and nieces for their love and support. But in particular, I want to thank the two greatest men in my life – Aidan Lavelle and Luke Moorman – for constantly making me smile.

Abbreviations

ABA	American Bankers Association
ABCP	asset-backed commercial paper
AIG	American International Group
A-IRB	advanced internal ratings–based
ARM	adjustable rate mortgage
ASF	American Securitization Forum
BIS	Bank for International Settlements
CBO	Congressional Budget Office
CD	certificate of deposit
CDO	collateralized debt obligation
CDS	credit default swap
CEA	Council of Economic Advisers
CEBS	Committee of European Banking Supervisors
CEO	chief executive officer
CFPB	Consumer Financial Protection Bureau
CFMA	Commodity Futures Modernization Act
CFTC	Commodity Futures Trading Commission
CMO	collateralized mortgage obligation
CP	commercial paper
CPFF	Commercial Paper Funding Facility
CPP	Capital Purchase Program
CRA	Community Reinvestment Act
DIDMCA	Depository Institutions Deregulation and Monetary Control Act of 1980
ECB	European Central Bank
EFSF	European Financial Stability Facility

EMTA	Emerging Markets Traders Association
EMU	European Monetary Union
EOP	Executive Office of the President
EU	European Union
FAC	Federal Advisory Council
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FHLB	Federal Home Loan Bank
FHLMC/Freddie Mac	Federal Home Loan Mortgage Corporation
FIO	Federal Insurance Office
FNMA/Fannie Mae	Federal National Mortgage Association
FOMC	Federal Open Market Committee
FRBNY	Federal Reserve Bank of New York
FSAP	Financial Sector Assessment Program
FSOC	Financial Stability Oversight Council
G7	Group of 7
G8	Group of 8
G20	Group of 20
G30	Group of 30
GAAP	generally accepted accounting principles
GAO	Government Accountability Office
GDP	gross domestic product
GMAC	General Motors Acceptance Corporation
GNMA/Ginnie Mae	Government National Mortgage Association
GSE	government-sponsored enterprise
HAMP	Home Affordable Modification Program
HOEPA	Home Ownership and Equity Protection Act
HUD	Department of Housing and Urban Development
IASB	International Accounting Standards Board
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
IndyMac	Independent National Mortgage Corporation
IRA	individual retirement account
IRB	internal ratings–based
ISDA	International Swaps and Derivatives Association
JEC	Joint Economic Committee
LTCM	Long-Term Capital Management

MBS	mortgage-backed securities
MOU	memorandum of understanding
NABE	National Association for Business Economics
NBER	National Bureau of Economic Research
NCUA	National Credit Union Administration
NEC	National Economic Council
NOW	Negotiated Order of Withdrawal
NSC	National Security Council
OCC	Office of the Comptroller of the Currency
OECD	Organisation for Economic Co-operation and Development
OFHEO	Office of Federal Housing Enterprise Oversight
OFR	Office of Financial Research
OIRA	Office of Information and Regulatory Affairs
OMB	Office of Management and Budget
OTC	over-the-counter
OTS	Office of Thrift Supervision
PAC	political action committee
QE	quantitative easing
S&L	savings and loan
Sallie Mae	Student Loan Marketing Association
SAP	Statement of Administration Policy
SBA	Small Business Administration
SEC	Securities and Exchange Commission
SED	Strategic Economic Dialogue
SGP	Stability and Growth Pact
SIFMA	Securities Industry and Financial Markets Association
SIV	structured investment vehicle
SPV	special-purpose vehicle
TARP	Troubled Asset Relief Program
VaR	Value at Risk
WaMu	Washington Mutual
WHO	White House Office

1

The Institutional Foundations of Financial Politics in the United States

As the financial crisis of 2008 wound down, economist Willem Buiter quipped, "self-regulation is to regulation as self-importance is to importance."[1] We know intuitively that they are not the same thing. Buiter goes on to comment that if a large corporation such as Airbus or Boeing wants to double its operations, it would need four or five years to assemble the money, build the factories, and ramp up its business. However, a bank can double, triple, or even quadruple its operations with incredible speed under the right circumstances of optimism, trust, and confidence. Unlike a large manufacturing operation that needs a plant and inventory of parts, a bank borrows and re-lends money to increase its operations without the same need for physical infrastructure. The problem is that the speed works in reverse. In the absence of the large fixed costs associated with plants and heavy machinery maintenance, pessimism, mistrust, lack of confidence, and fear or panic can force banks to shrink their operations at an even faster rate than they grow. Given the centrality of the banking system to economic activity and this unique feature of its operations, the industry cannot be left to police its own activities.[2]

Policing the activities of banks poses a unique set of problems in the United States. By world standards, American political culture contains a very antigovernment streak. The early patriots resented taxation by the

[1] See Willem Buiter, "Regulating the New Financial Sector," based on comments delivered on February 20, 2009, at the Center on Capitalism and Society conference "Emerging from the Financial Crisis" held at Columbia University, February 20, 2009, http://www.voxeu.org/index.php?q=node/3232 (accessed April 12, 2012).

[2] Ibid.

British parliament. Unlike many constitutions that detail a role for government, the Bill of Rights in the American Constitution is a list of things the government *cannot* do. The political activities of banks and financial institutions are no exception to this rule. Like the rest of American business, they seek the freedom to conduct their affairs with a minimal amount of government intervention to maximize their profits. The problem is that the failure of a large bank has very different societal effects than the failure of other firms. The entire U.S. economy is dependent on the banking system for money, credit, and a way to make payments. Therefore, it has been compared to the trunk of a tree that feeds the branches and leaves of the broader capitalist system. The loss of a branch or leaves might do serious damage, but the loss of the trunk kills the tree.

When the system fails and banks must be bailed out, ordinary Americans are generally angry. Although they do not understand the details of money, power, banks, and finance, they have an intuitive sense that some groups are benefiting more than others, and that those who cause the problem do not pay the same price as those who must bail them out. At times, they direct their anger solely at bankers. Other times, they direct it both at the banks and the political system that seems unable to respond to the crisis by rewarding those who behaved responsibly while punishing those who behaved irresponsibly. Although the political anger may be justified, it frequently operates in an atmosphere that lacks an understanding of what is really going on.

What makes the politics of finance so difficult to follow? In short, American universities separate the study of economics from political science. Although some political scientists study "political economy," it is generally a field within international relations that concerns the practices of the International Monetary Fund, World Bank, or Basel Committee.[3] While authors are aware of the U.S. power that results from the use of the dollar as the primary currency in most international transactions, they do not examine the governing institutions of the United States.[4] Moreover, they are rarely concerned with the day-to-day practices of the banking and

[3] For a few examples from a very large body of literature, see Jeffrey A. Frieden, *Banking on the World: The Politics of American International Finance* (New York: Harper and Row, 1987); Benjamin J. Cohen, *In Whose Interest? International Banking and American Foreign Policy* (New Haven, CT: Yale University Press, 1986); Louis W. Pauly, *Who Elected the Bankers? Surveillance and Control in the World Economy* (Ithaca, NY: Cornell University Press, 1997); David Andrew Singer, *Regulating Capital: Setting Standards for the International Financial System* (Ithaca, NY: Cornell University Press, 2007); Tony Porter, *Globalization and Finance* (Malden, MA: Polity Press, 2005).

[4] For recent contributions, see Eric Helleiner and Jonathan Kirshner, eds., *The Future of the Dollar* (Ithaca, NY: Cornell University Press, 2009) and Mark Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century* (Cambridge:

financial services community. Sophisticated discussions of money, finance, and banking in the American academy are reserved for economics departments and business schools in which political discussions are secondary.

Therefore, for most people, the first of two chief obstacles is that this area requires an understanding of what money and finance are, along with what role they play in a capitalist economy. People need to know how money and credit are created and how they affect the prices of what we buy and sell. *Money* is defined as something accepted as a medium of exchange, a measure of value, or a means of payment, whereas *finance* is generally understood to be the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of funds.[5] These terms, however, are meaningless without operating within some kind of political institution or government. A person cannot spend U.S. dollars in France or yen in the United States. As a medium of exchange or store of value, paper dollars and metallic coins do not have any value once they are taken out of the jurisdiction of the country or countries that created them, unless someone is willing to exchange them for something that can be used locally. Therefore, money and the political institution that issues it are tightly connected; at the same time, political actors and the private sector sing the virtues of the independence of central banks and "keeping politics out" of the regulatory systems that finance needs to exist. These two realities cannot coexist.

The second chief obstacle to understanding why the government does what it does in the financial area comes from the organization of political science departments. Discussions of Congress, the presidency, international organizations, or federal agencies in Washington tend to be fragmented, and work that ties them together is usually conducted in policy-oriented, not

Cambridge University Press, 2002). This type of work on other countries exists within literature on comparative politics; however, oddly, little is written on the United States itself. For some important contributions within a body of literature more numerous than countries in the world, see Sylvia Maxfield, *Governing Capital: International Finance and Mexican Politics* (Ithaca, NY: Cornell University Press, 1990) and *Gatekeepers of Growth: The International Political Economy of Central Banking in Developing Countries* (Princeton, NJ: Princeton University Press, 1997); Jung-en Woo, *Race to the Swift: State and Finance in Korean Industrialization* (New York: Columbia University Press, 1991); Saori N. Katada, *Banking on Stability: Japan and the Cross-Pacific Dynamics of International Financial Crisis Management* (Ann Arbor: University of Michigan Press, 2001); Peter A. Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (New York: Oxford University Press, 2001); Victor Shih, *Factions and Finance in China: Elite Conflict and Inflation* (New York: Cambridge University Press, 2008).

5 Merriam- Webster, *Webster's New Collegiate Dictionary* (Springfield, MA: G & C Merriam, 1981), 426, 736.

theoretical, settings. Therefore, different agencies and processes surrounding economic policy in the U.S. government are investigated by different bodies of literature in political science, and the research is reported in different academic journals. It is easy to demonstrate that certain industries make large campaign contributions or use high-priced lobbyists. However, to understand why the government has bailed out some banks and not others, or the auto industry and not the housing industry, also requires an understanding of agency capture, the policy process, and bureaucratic politics in a crisis. Many of the seminal books that explore the topic of bureaucratic politics have little to say about money and finance as an issue area.[6] Political scientists who investigate these different topics do not necessarily converse with each other, let alone economists. Nonetheless, these disparate areas of study in political science offer a great deal of insight into the politics behind money and banking in general, and in a crisis in particular.

All political scientists, however, do not have the same understanding of how the political process works. Graham Allison, in his early study of bureaucratic politics in an international crisis, offers three models that could be used to assess the strategic limitations and possibilities of government action.[7] In the first of these, "the government" acts as one coherent unit and does what it does in pursuit of a clear, observable goal. In the second model, the government is a loose alliance among semi-independent organizations, each operating according to its own internal logic or standard procedure. In the third model, the government functions in the bargaining among units, where each sees different aspects of the problem and advantages in different ways of resolving it.

Each of these three models operates within a unique American political culture. Gabriel Almond and Sydney Verba define *political culture* as the "attitudes toward the political system and its various parts, and attitudes toward the rule of the self in the system. It is a set of orientations toward a special set of social objects and processes."[8] Although Americans can be

[6] James Q. Wilson, *Bureaucracy: What Government Agencies Do and Why They Do It* (New York: Basic Books, 1989); Herbert A. Simon, *Administrative Behavior: A Study of Decision-Making Processes in Administrative Organizations* (New York: Macmillan Company, 1957). For some exceptions to the rule that were unfortunately published prior to the 2008 crisis, see Eisner, Worsham, and Ringquist, *Contemporary Regulatory Policy*, and Jeffrey Worsham, *Other People's Money: Policy Change, Congress, and Bank Regulation* (Boulder, CO: Westview Press, 1997).

[7] Graham T. Allison, *Essence of Decision*; Graham T. Allison and Morton H. Halperin, "Bureaucratic Politics: A Paradigm and Some Policy Implications," *World Politics* 24 (Spring 1972), 40–79.

[8] Gabriel A. Almond and Sidney Verba, *The Civic Culture: Political Attitudes and Democracy in Five Nations* (Princeton, NJ: Princeton University Press, 1963), 4. Almond and

deeply divided on some issues, they also share some common views and expectations of government's role in the economy at all levels. Since the Great Depression, they have had high expectations for the federal government to play a role in managing the economy to promote full employment and lower inflation.[9] Yet the mix of public and private interests in the financial services industry reflects a unique political culture that distrusts any concentration of power in government and also distrusts the concentration of economic power in banks. For example, in one poll after the financial crisis in 2008 and prior to the passage of the Dodd-Frank reform bill, more than 40 percent of those polled responded that the government had gone too far in measures to fix the financial industry. At the same time, banks were viewed badly by 54 percent of poll respondents, and 60 percent had a negative opinion of insurance companies.[10]

When Allison's different models of policy analysis are embedded in understandings of American political culture, they reveal that the source of the financial community's political power is not to be found exclusively in its lobbying activities or even campaign contributions. Instead, it is deeply rooted in the historical and cultural way the banking system is woven into the patchwork of government agencies that regulate it, particularly the connection between home ownership and the American dream. Although lobbyists' campaign contributions certainly play a role in the immediate days when the system threatens to collapse or in the final days when a significant piece of legislation is being negotiated, the heads of agencies such as the Treasury Secretary and Federal Reserve Chair, as well as the chief officers of financial services firms such as Citibank and Goldman Sachs, negotiate directly with the president, members of Congress, and each other to protect the interests of their institutions, as well as to secure future profits.[11] At times the goals clash, and at times they are indistinguishable from each other.

Thus at different junctures in American history, distrust of both government and banks, as well as understandings of the appropriate degree of separation between the two, have played out in market and political

Verba referenced in Karen C. O'Connor and Larry J. Sabato, *American Government: Continuity and Change*, Election Update ed. (New York: Longman, 2000), 17.

[9] Almond and Verba, *American Government: Continuity and Change*, 30.

[10] Poll results available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a4nQoiYaj2ag&pos=1 (accessed April 7, 2012).

[11] See Tom Braithwaite, "Arkansas Sharpens Debate on Bank Risks," *Financial Times*, June 10, 2010, 3. See also Phil Mattingly, "Jamie Dimon Joins Final Round of Lobbying on Financial Bill," *Bloomberg Business Week*, May 27, 2010 (accessed May 28, 2010, site now discontinued).

arrangements surrounding finance. Susan Hoffman makes the point that one of the important contributions of the Populist movement to thinking within the Democratic Party at the end of the nineteenth century was the notion that monetary arrangements should be controlled by public policy, not just banks.[12] Advocates of one or another point of view or public philosophy created political institutions that embodied these philosophies, such as the Federal Reserve System, during those moments in history. Thus Americans constructed the regulatory framework within which the industry operated, infusing it with a particular purpose that can seem to contradict itself when placed alongside preexisting institutions, such as the Office of the Comptroller of the Currency (OCC) in the Treasury. Later ideologies such as monetarism helped to dismantle the regulatory system constructed after the Great Depression and designated a greater role for some existing political institutions that worked to advance monetarist goals, such as the Federal Reserve.

In this way, the interaction of markets, government bureaucracy, and politicians has created niches for all participants. Much of the politics among them has involved efforts to alter or preserve these distinctions.[13] The fragmented nature of the financial services area means that there are many places where policy discussions take place. As Allison's model of bureaucratic politics would predict, conflicting coalitions of regulators and interest groups compete to maintain their turf. Thus there are ample opportunities within the system to stop any radical change.[14]

What we learn from studies of politics complements what we learn from economics because the stakes are different. Economic actors seek profit as a goal. Politicians have electoral incentives to pursue their goals. Bureaucrats compete for governing authority, budgets, and personnel. The American distrust of both concentrated political authority and concentrated economic power has meant that in governing finance, American citizens have made various demands on their government at different historical epochs. In response, the government formed and maintained a dual set of political institutions at both the state and federal levels. The paradox is that the bureaucratic structure allows for industry to innovate in response to technological and other changes in the world economy; at the same time, its complexity opens up channels for industry to evade regulation, even by the agencies that were created to prevent this outcome. Thus the structure that results from history is its own source of instability going forward.

[12] Susan Hoffman, *Politics and Banking*, 111.
[13] Eisner, Worsham, and Ringquist, *Contemporary Regulatory Policy*, 95.
[14] Ibid., 115.

PUBLIC POLICY AND ECONOMICS IN AMERICAN GOVERNMENT

In their seminal study of eight centuries of financial crises, Carmen Reinhart and Kenneth Rogoff find that policymakers inevitably fall victim to the notion that "this-time-is-different," or the thinking that government policy and institutions have improved so much that a highly leveraged economy is not vulnerable to a crisis of confidence.[15] Why haven't government policies and institutions been able to prevent crises when they appear to have? Or, to put it another way, what is it about this government that contributes to financial instability? I find the answer to this question in the political system that interacts with the economic one, or in the arrangement of political institutions that permits the excessive borrowing to occur. Although this *time* may not be different, the American government *is* different insofar as its fragmented regulatory system presents many opportunities for regulatory arbitrage to occur. Fragmentation does not appear to pose an immediate threat to the stability of the system because the market innovation that accompanies it advances the opportunities for greater numbers of Americans to participate in economic activity, when properly applied.

Finance professionals use the term *regulatory arbitrage* to refer to the practice of taking advantage of differences in regulation that exist in two or more markets to earn greater profits. Arbitrage comes in many forms. In some instances, a firm evades regulation through financial engineering that exploits the difference between what is going on in the transaction and how it is treated under the regulations in place. Particularly in the world of banking, such regulatory arbitrage can be used to lower or avoid capital adequacy requirements by selecting safe assets to keep on the books of the financial institutions and riskier ones to transfer off of them. It can also be used to lower the risk that regulators attach to assets by transforming them through various forms of securitization. In other usages, the term can refer to situations in which the firm conducts business in a physical place where the regulations are lighter, albeit this latter use is sometimes distinguished as "regulator shopping."[16] When these practices are compounded, they can restructure the risk inherent in the entire banking system.

In examining the sources of financial instability that emanate from the political system, I demonstrate how the fragmentation of regulators in the United States offers endless opportunities for regulatory arbitrage of all types to occur. However, regulatory fragmentation and arbitrage are not

15 Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, NJ: Princeton University Press, 2009).

16 See, for example, http://moneyterms.co.uk/regulatory-arbitrage/ (accessed November 14, 2011).

the only sources of instability from the political system; they both derive from the broader policy process among institutions that determine what the government does in this area, particularly in a crisis. As the process works, new financial instruments enter the marketplace and generate new winners and losers who, in turn, constitute new potential political pressure groups. The old institutional arrangements that created the regulations in the first place must respond. Rather than romanticizing previous arrangements that might have achieved a degree of stability for a given number of years, yet might have also excluded large segments of the population from access to credit, I attempt to show how the interaction of financial markets, regulations, and the political institutions that created them are in a constant state of flux.

This book's comprehensive examination of both markets and the agencies that make policies allows readers a view of the political playing field that encompasses the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Treasury, congressional committees, and presidential administrations – all of which are commonly left unexamined in economic treatments in any systematic way. Most economists are far from oblivious to the political world in which the market economy functions. However, those that take it into account either abstract away the institutional structure and bureaucratic politics among agencies or include it in parts.

For example, Hyman Minsky argues that the source of instability lies within the banking and regulatory system; he terms *banking* to be an "endogenous destabilizer."[17] Regulation is meant to control the destabilizing forces of banking and finance; however, regulation cannot prevent destabilization because banks adjust the composition of their portfolios in response to it. Although Minsky acknowledges that there are political, organizational, and competence reasons for separating the Federal Reserve System and the FDIC (in particular), he does not elaborate on them.[18] Likewise, Simon Johnson and James Kwak pay particular attention to the role of campaign contributions and agency capture in creating an environment where profits and bonuses in the industry are transformed into political power. They posit a "new American oligarchy," which is their term for a group that gains political power from economic power and then uses it for its own benefit.[19] Beyond the existence of large campaign contributions and regulatory capture, however, they do not offer any systemic analysis for

[17] Hyman P. Minsky, *Stabilizing an Unstable Economy* (New Haven, CT: Yale University Press, 1986), 250–53.

[18] Ibid., 57.

[19] Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (New York: Pantheon Books, 2010), 6.

how these activities play into politics in Washington, nor do they answer critics of such approaches in political science literature.[20]

I posit that the evolution of institutional arrangements among financial markets and the government have provided both a source of instability and innovation as each responds to developments in the other. Regulations channel competition in the industry that gives rise to interest groups representing market participants in distinct compartments within an industry. The interest groups feed back into the federal and state legislatures that provided the statutory justification for the regulation in the first place. Therefore, the paradox of bank regulation is not limited to the size of the financial sector relative to the rest of the economy or its disproportionate lobbying budgets and campaign contributions. The policy process, and thus the rewriting of regulation and assignment of tasks among political institutions, is in constant motion and subject to revision.

The Study of Public Policy

Policy is usually defined as the output of government institutions, or what the government does in any given area. In the financial area, that includes what the government spends to support financial institutions and how it taxes them. Policy also includes how the government regulates the activities of the banking, securities, and insurance industries, thus influencing their costs of doing business. The government's management of the macroeconomy to promote full employment and low inflation also affects the activities of these industries, because government spending and the size of the money supply have important consequences for interest rates. With the exception of monetary policy, each of the other domains explored in this book – fiscal and regulatory – operates at both the national and state level in the United States. In fact, state and local budgets constitute about 40 percent of total government spending.[21]

Although the policymaking process in any one of these three domains does not have clear boundaries or beginning and endpoints, in most areas it begins when individuals identify a problem and seek government action to resolve it. Identification of a problem in the financial system is somewhat different from other areas, however, because the problems are not immediately apparent to nonexperts. Knowing where, or how, the government

[20] See, for example, David Vogel, "The Power of Business in America: A Reappraisal," in *Kindred Strangers: The Uneasy Relationship between Politics and Business in America* (Princeton, NJ: Princeton University Press, 1996), 268–97.

[21] C. Randall Henning and Martin Kessler, "Fiscal Federalism: US History for Architects of Europe's Fiscal Union, Working Paper 12–1," in *Working Paper Series* (Washington, DC: Peterson Institute for International Economics, 2012), 22.

might be able to intervene is even more difficult without knowledge of how monetary and fiscal policy is spread across institutions of rule in the United States. As with other areas such as health care or the environment, policy can seem to progress incrementally or as a variation on what the government has done in the past. It can also emerge from political compromise among policymakers, from the actions of elites that flow downward, from new opportunities, or from individual preferences that get translated into collective outcomes that are not preferred by any individual.[22]

Most observers of the American policy process note that benefits accrue to the same group of elites with little change over time despite the existence of many interest groups. These areas of limited interference and deference to the judgment of experts have been called "policy monopolies," "iron triangles," "policy whirlpools," and "subsystem politics" at different times, depending on the author.[23] Initially, iron triangles were defined as the administrative agencies, legislative committees, and interest groups at a single level of government that formulated policy in a consensual manner.[24] Later, the concept was broadened to include journalists, researchers, and policy analysts who play an active role in disseminating policy ideas, as well as actors at all levels of government who are active in policy formation and implementation.[25] Analysts have pointed out that various degrees of conflict are inherent within advocacy coalitions. Moreover, a political actor's organizational affiliation (e.g., interest group, government agency, research institution, media outlet, etc.) does not always dictate that actor's position on an issue. Rather, Sabatier and Jenkins-Smith propose that agency officials, researchers, and journalists are all potential members of an advocacy coalition who may engage in some degree of coordinated activity in pursuit of their common policy objectives.[26]

[22] Charles E. Lindblom, *The Policy-Making Process* (Englewood Cliffs, NJ: Prentice-Hall, 1968). See also David B. Truman, *The Governmental Process: Political Interests and Public Opinion* (New York: Alfred A. Knopf, 1968). For more recent studies, see Thomas R. Dye, *Top Down Policymaking* (New York: Chatham House Publishers 2001); James E. Anderson, *Public Policymaking* (New York: Houghton Mifflin, 2000); Kenneth N. Bickers and John T. Williams, *Public Policy Analysis: A Political Economy Approach* (New York: Houghton Mifflin Company, 2001).

[23] Frank R. Baumgartner and Bryan D. Jones, *Agendas and Instability in American Politics* (Chicago: University of Chicago Press, 1993), 7. For an early statement of subsystem politics, see J. Leiper Freeman, *The Political Process: Executive, Bureau-Legislative Committee Relations*, rev. ed. (New York: Random House, 1965).

[24] Jeffrey M. Berry, *The New Liberalism: The Changing Power of Citizen Groups* (Washington, DC: Brookings, 1999), 80.

[25] Paul A. Sabatier and Hank C. Jenkins-Smith, "The Advocacy Coalition Framework: An Assessment," in *Theories of the Policy Process*, ed. Paul A. Sabatier (Boulder, CO: Westview Press, 1999), 119.

[26] Ibid., 127.

The context matters. Without a crisis, the system may operate for years in the absence of serious opposition and with only incremental change. Although the apathy of elites may give these processes the appearance of stability within intervals, there is a lack of a true equilibrium. Policy subsystems and advocacy coalitions within them are constantly in a process of creation and destruction. The changed alignments become apparent when a crisis inevitably does occur, and public attention becomes focused on a specific problem.[27] Media attention can shake public indifference and result in dramatic changes in policy outputs. For this reason, policy entrepreneurs fight to either get their issue onto the public agenda or keep it away.[28]

Therefore, when formulating policy, politicians and regulators do not respond to the financial industry, institutions, or voters in the same way at each moment in the cycle. Within intervals, voters may not even be aware that incremental change has occurred. Only when a crisis erupts and media attention is directed at a problem do others become involved and voters' concerns become more of a consideration to politicians. When dramatic change is at stake, interest groups and institutions likewise align their interests relative to each other.

The Importance of Institutions

Within understandings of bureaucratic politics, the institutions or organizations of the American government play a significant role because they provide the context for the formulation and implementation of policy. Marc Eisner argues that they define the tasks and determine the way in which, and the extent to which, specialized knowledge will be brought to bear among agencies, private associations, and organized constituencies.[29] Those who study public policy debate the degree to which change results from the conflicts among these individuals in an iron triangle or policy subsystem. For some authors, bureaucracies respond to the direction set by elected officials in a relationship resembling that of a principal and agent in business, wherein the principal is the owner who does not engage in the day-to-day management of the firm but authorizes management to act on his or her behalf. For other authors, bureaucracies are motivated by the motivation and behavior of bureaucrats and the bureaucracy itself as organizational phenomena.[30] Nonetheless, there is a degree of agreement among authors that institutional arrangements shape and constrain human action. In

[27] John W. Kingdon, *Agendas, Alternatives, and Public Policies* (Boston: Little, Brown, 1984).

[28] Baumgartner and Jones, *Agendas and Instability in American Politics*, 20.

[29] Marc Allen Eisner, *Regulatory Politics in Transition*, 10.

[30] Eisner, Worsham, and Ringquist, *Contemporary Regulatory Policy*, 19.

other words, institutional arrangements explain why bureaucracies do what they do.

Political institutions such as the presidency, Federal Reserve, Treasury, and Congress are important because they specialize in different areas. Specialization breeds a tendency to work with specific sets of instruments such as monetary or regulatory policy. In an early study of administrative behavior, Simon noted that within this environment, administrators have limits on rationality, or limits on knowing the consequences of each and every choice that they might make.[31] Any human only possesses fragmentary knowledge of the conditions surrounding his or her action. Without being able to see all of the possible patterns of behavior that they even could choose among, humans *satisfice* because they don't have the ability to maximize their choice. In other words, administrators search for a course of action that is "good enough."

The result of studies of institutions is that public bureaucracies make only marginal changes in existing policy in any given round. Change is incremental because bureaucrats rarely consider a problem in its entirety. They usually just consider a slice of the whole. Then they do what satisfies all, or most, interests in their immediate political environment.[32]

THE MAIN ACTORS IN THE AMERICAN GOVERNMENT SURROUNDING FINANCE

To take a comprehensive view of the American government surrounding finance, and thus to detail what contributes to episodes of instability, this section offers a picture of both the division of power among branches of government in the United States, as well as a view of the bureaucracy that has evolved over the years to implement public policy with its assortment of agencies, independent regulatory commissions, single-headed regulatory agencies, and hybrid entities such as the Federal Home Loan Banking system and government-sponsored enterprises Fannie Mae and Freddie Mac. Chapters 2 through 6 will explore each of these areas in depth. The evolution over the course of U.S. history has occurred in such a way that unified, consistent policy is complicated by the division of tasks among state and national levels. This complexity would serve as a source of instability even if the financial services industry did not possess disproportionate resources to employ at all levels of government.

[31] Simon, *Administrative Behavior*, 81.

[32] Carl E. Van Horn, Donald C. Baumer, and William T. Gormley Jr., *Politics and Public Policy* (Washington, DC: CQ Press, 1989), 103.

The Operation of the Federal Reserve System within the Branches of Government

In their essays on the U.S. Constitution collected as the *Federalist Papers*, James Madison, Alexander Hamilton, and John Jay express concern over the concentration of power in any one political institution.[33] The U.S. Constitution drafted at the time outlines a political structure that gives each of the three branches of government a degree of oversight and control over the policymaking capabilities of the others. Article 1, Section 8 of the Constitution gives Congress – not the executive branch or the courts – the power to coin money; hence, the Federal Reserve System is a creation of one of the three branches – the legislature – and could be ended or amended with legislation and not necessarily a Constitutional amendment. Nonetheless, when Congress created the Federal Reserve in the early twentieth century, it attempted to shield the new institution from day-to-day politics. The president appoints members of the Federal Reserve Board. The actions of the Federal Reserve are subject to judicial oversight. Hence, economic policymaking challenges the division of powers in a unique way – when the government intervenes to stabilize the macroeconomy, different branches with the quasi-independent central bank handle different aspects of the intervention.

The consequence of this design is that the president, Congress, and Federal Reserve all play a role in creating the policies. No one branch or organization bears the total responsibility for doing so; therefore, each has an interest in supporting the popular ones and avoiding blame for the unpopular ones. The president participates in the federal budgeting process; however, Congress exercises the ultimate control over government spending and tax policy. Moreover, the Federal Reserve controls the money supply, which can also be employed as a powerful lever during the various phases of the business cycle. Although the Federal Reserve is usually covered in the press as being independent of politics, the Federal Reserve Chair is far from immune to political pressure from other sources, chiefly the presidential administration that reappoints him or her. The bottom line is that no mechanism exists in the overall separation of powers that compels the legislature, executive branch, and Federal Reserve to reconcile tax policy, the money supply, and the overall level of spending.[34] When a crisis occurs and reform is on the horizon, the agencies of the federal government enter

[33] Alexander Hamilton, James Madison, and John Jay, *The Federalist Papers* (New York: Bantam Books, 1988).

[34] William Greider, *Secrets of the Temple: How the Federal Reserve Runs the Country* (New York: Simon and Schuster, 1987).

the legislative process to protect and defend their own organization and its range of activities.

As Chapters 2 through 6 will show, this separation of powers among branches and agencies profoundly influenced the development of the national banking system that a strong macroeconomy requires. In the period between the end of the Second Bank of the United States in 1836 and the establishment of the Federal Reserve Act in 1913, the country lacked a true central bank. National banks could not establish foreign branches until passage of the Act. They did not grow until the regulations that controlled the amount of interest paid on domestic time deposits (Regulation Q of the Federal Reserve System) were changed. When multinational corporations grew in size and global reach, they were able to raise dollars from banks in countries overseas that kept dollar deposits outside the territorial United States. In using these funds, these corporations could borrow money that had a lower interest rate and was more convenient.

Therefore, since the Federal Reserve was established, it sits awkwardly within the branches of the federal government. As it has evolved, the Federal Reserve uses monetary policy to seek to stabilize prices, lower unemployment, and sustain economic growth. These goals can create friction with the fiscal goals of the Treasury that seeks to assure reasonable stability in the value of the dollar, balance federal expenditures and revenues with economic growth, and create employment opportunities. Both the Federal Reserve and Treasury act as regulators in the banking system. Although banks generally support the political independence of the Federal Reserve as an actor, it does encounter opposition to its policies from time to time. At these moments, it has some formidable political resources of its own that it exercises. Chief among these are the connections that the regional Reserve Banks maintain where they are located. Their board members are from the local communities, and they tend to support the Federal Reserve as an institution. When a crucial vote comes up in Congress, the Board of Governors in Washington can call on members of the regional Reserve Banks to write letters and show support for its position.[35]

In studies of American government, a federal government agency that is supposed to regulate an industry is considered to be "captured" if the connection between industry executives and agency heads becomes so tight that they are indistinguishable from each other. Agencies are captured because most of them require the kind of specialized knowledge and expertise that only the industry can provide. As with interest groups, exchanges between industry and agency are not inherently bad. Problems occur, however, when the interests of industry conflict with those of society at large and

[35] Ibid., 162.

the agency consistently places industry's needs above societal ones. More than other bureaucratic agencies, the Federal Reserve System can be captive to the industry that it regulates because banks literally own shares of its regional Reserve Banks, which banks can vote to elect some officers. The Federal Reserve's actions, however, are always ultimately hemmed in by the possibility that Congress can reform it, or terminate it, with legislation. Therefore, its position as a quasi-autonomous agency makes it simultaneously strong and peculiarly vulnerable.

The Structure of the Federal Government in the Financial System

What does the rest of the structure around finance look like in the United States? As Allison and others pointed out, governmental actions can be understood as the outcomes of procedures followed by separate organizations, and as a result of compromise and competition among them. In the American system, there is no single entity that "makes" financial policy. It comes from a mixture of executive branch agencies, independent regulatory commissions, self-regulating organizations, financial firms, and political actors who differ substantially on any particular issue and who compete to advance their own personal and organizational interests as they try to influence decisions in a crisis.[36] Therefore, to explain the decisions of the government in financial politics, an analyst needs to identify the games and players amid the coalitions, bargains, and compromises without forgetting to acknowledge the confusion in the process overall.[37] The decisions and actions of the U.S. government do not solve any one, given problem but result from compromise, conflict, and confusion among public officials with diverse interests and unequal influence over the outcome. The bureaucracy matters because it channels regular political conflict. As with a game of chess, the federal government's moves can be explained as the result of bargaining among players with separate and unequal power over particular pieces on the board.[38]

Figure 1.1 depicts a rough sketch of the institutional actors in three major finance-related national policy domains. With the president as both the head of state and government in the American system, the office holds the central position in terms of appointing key individuals to the Department

[36] J. Garry Clifford, "Bureaucratic Politics," in *Explaining the History of American Foreign Relations*, eds. Michael S. Hogan and Thomas G. Paterson (New York: Cambridge University Press, 2004), 93. See also Daniel Carpenter, "Institutional Strangulation: Bureaucratic Politics and Financial Reform in the Obama Administration," *Perspectives on Politics* 8, no. 3 (2010), 825-46.

[37] Allison, *Essence of Decision*, 146.

[38] Ibid., 162–63.

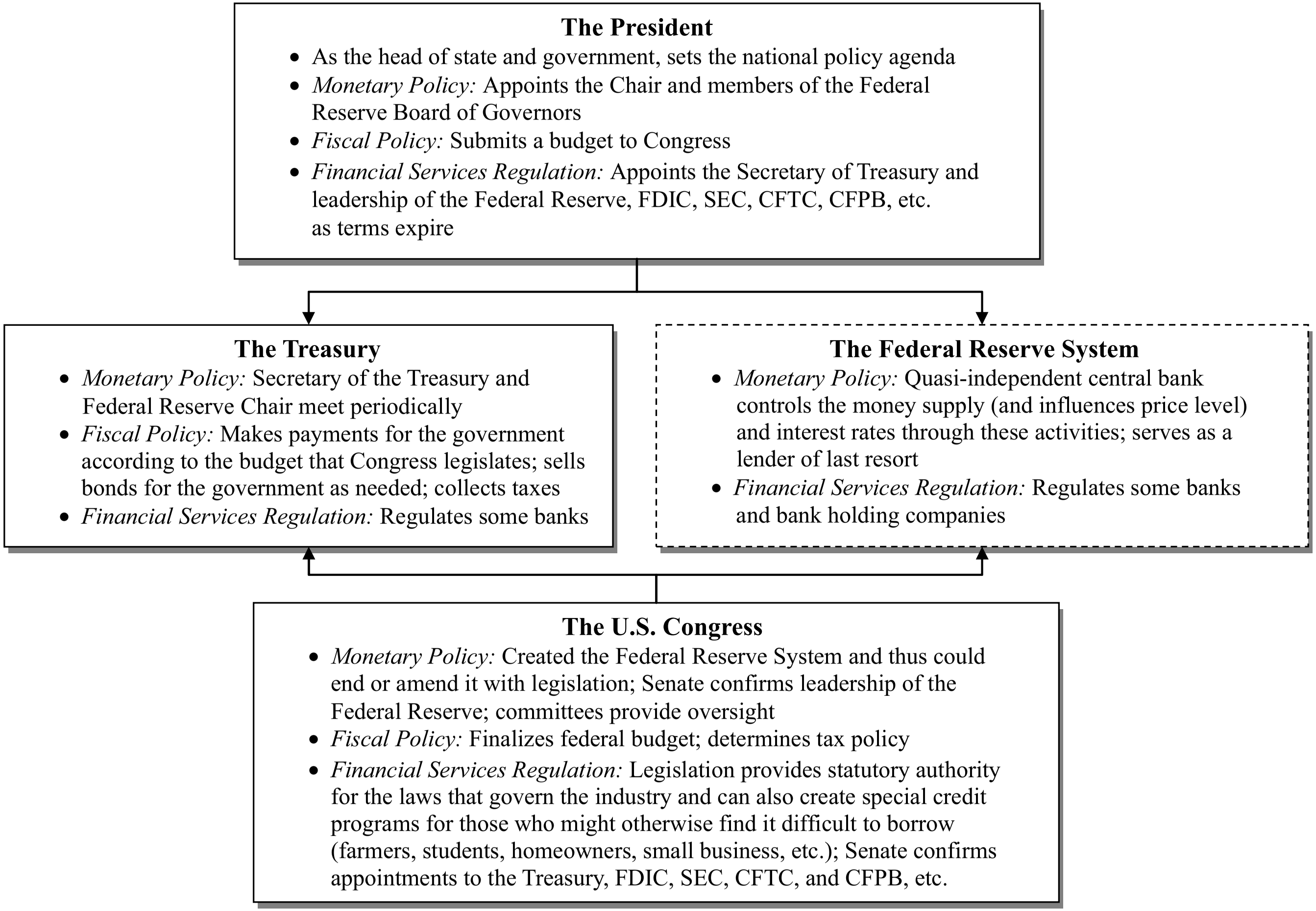

FIGURE 1.1. Primary Institutional Actors in Finance-Related National Policy Domains

of the Treasury and Federal Reserve Board of governors who actually carry out policy. The president also submits a budget to Congress, so he also plays a role in determining the overall level of government spending. Nonetheless, the president has few day-to-day powers in the financial area. The few that he has are curtailed by Congress, which controls the money the government spends and determines who and how citizens are taxed. In addition, the Senate must confirm the president's nominees to the agencies. The Federal Reserve System is shown in Figure 1.1 with a dotted line to indicate its somewhat independent status within the overall process. As discussed, the entire Federal Reserve System is a creation of the legislature because the Constitution gives Congress the power to coin money. The Federal Reserve acts as a central bank in the American system by controlling the money supply; it also regulates some banks. These regulatory duties overlap, however, with the Treasury. Therefore, economic policy comes from political actors in presidential administrations, Congress, and these agencies; however, it also comes from their interaction among each other.

Despite the diversity of the banking system, the U.S. banking system operates in a capitalist system that values the formal separation of business from the political system. Even during the height of the financial crisis of 2008 when the government purchased equity shares of large banks, there was a near universal consensus that politicians should not determine lending criteria within the entities where it owned their shares. Rather than formulating lending policy for either national or international purposes by formally allocating credit to an industrial sector, specific firm, or even specific individuals, banks and other financial services firms decide who gets a loan. The U.S. government regulates the banks themselves so that the market economy can function with maximum efficiency. This regulation occurs at the state and national levels among the Federal Reserve, FDIC, and Comptroller of the Currency (in the Treasury). Banks have a remarkable degree of control in selecting which institution will regulate and supervise them; in effect, they pick their own regulator. In addition, the government does not decide when, and if, a company can sell stock. The government does, however, regulate the operations of the market through the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) so that investors can make appropriate decisions about a firm within the context of a capitalist economy.

As Chapters 2 through 6 will show, changes in the law do not necessarily result in changes to the way that political institutions are configured. One of the more significant pieces of legislation seeking to reform the system – the 1999 Financial Services Modernization Act – ended the Glass-Steagall separation of commercial banking from investment banking. However, the legislation did not change the fragmentation of regulatory authority. The

Act gave the two main regulators – the OCC in the Treasury and the Federal Reserve – shared oversight. Subsidiaries are partitioned according to their functional regulator, meaning that securities subsidiaries are subject to the SEC, and insurance is subject to state regulators. National bank regulators are authorized to police the relationship between the bank and a subsidiary; however, prior to the passage of Dodd-Frank, the Federal Reserve was prohibited from examining functionally regulated non-banks unless it suspected that actions posed a material threat to an insured bank. Nor can the Federal Reserve institute capital requirements or other regulations on these banks. In short, the 1999 Financial Services Act dismantled the previous regulatory framework but preserved the mix of regulatory *authorities* created by the New Deal.[39] Likewise in 2010, the Dodd-Frank reform bill required many changes in the regulations but again left most of the bureaucracy with its competing organizations largely intact, adding a Consumer Financial Protection Bureau (CFPB) at the Federal Reserve and a Financial Stability Oversight Council as a collaborative body in the Treasury Department to monitor for systemic threats. Only the Office of Thrift Supervision was eliminated by merging it with the OCC.

The judicial branch of government also influences the outcomes of financial politics; however, that role usually occurs later in time and is subject to being overturned by a higher court. Nonetheless, the same forces that shape monetary, fiscal, and regulatory policies can also influence the judicial process from the outset. In other words, the financial firms that bring suits, and defend themselves when others bring them against them, have greater resources at their disposal than the government does. For example, if a firm is sued by an agency of the federal government, it can generally employ more lawyers for its defense than most agencies can deploy to prosecute an individual case. Moreover, some argue that lawyers working for government agencies may hope to work for private firms at a later date, potentially influencing their conduct.[40] However, the logic of this latter argument can be contested insofar as it is not clear why a private firm would find such employees desirable, if they are so easily influenced.

In one recent case, the SEC charged that Citigroup included specific securities in a $1 billion mortgage fund sold to its investors so that it could bet against its customers and profit when the value of the fund declined. According to the SEC, the action constituted fraud because Citigroup told investors that an independent party chose the portfolio. Citigroup made

39 Eisner, Worsham, and Ringquist, *Contemporary Regulatory Policy*, 113.

40 See transcript of report, "In the Aftermath of Financial Crisis, Who's Being Held Responsible?" PBS NewsHour, Air Date November 24, 2011, http://www.pbs.org/newshour/bb/business/july-dec11/financialcrisi_11-24.html (accessed July 26, 2012).

$160 million from the deal, whereas investors lost $700 million. In 2011, the SEC tried to settle the case for $285 million; however, the settlement required the approval of a federal judge. The judge rejected it on the grounds that the SEC had not *proven* that Citigroup committed fraud, and Citigroup had not admitted to it. As with similar cases, the judge argued that such settlements undermine the Constitutional separation of powers by asking the judiciary to rubber-stamp the executive branch's interpretation of the law.[41] It was not clear to him that the settlement was in the public interest. In March 2012, a three-judge appeals panel argued that the judge in the lower court had overstepped his authority. A different panel of appellate judges for the Second Circuit is scheduled to hear arguments on whether to overturn the rejection of the proposed settlement later in 2012.[42] The time frame for resolution of the issue was thus extended, and the amount of the settlement appeared insufficient to deter future activities of this kind.

HOW POLITICS OPERATE AROUND THE FINANCIAL SERVICES INDUSTRY

The president, Congress, agencies, and courts constitute the formal mechanisms of the U.S. government. However, informal actors also play a significant role in the operation of financial politics. The United States has a pluralist system of group representation, wherein diverse associations funnel multiple concerns, values, and interests for deliberation and resolution.[43] Groups work across institutions and have contacts in the many agencies of the federal government. The way that political scientists see it, interest groups go between what individuals want and democratic political institutions provide by screening and aggregating demands.[44] As part of

[41] Edward Wyatt, "Judge Blocks Citigroup Settlement With S.E.C.," *New York Times*, November 28, 2011, http://www.nytimes.com/2011/11/29/business/judge-rejects-sec-accord-with-citi.html?pagewanted=all (accessed April 12, 2012). See also transcript, "In the Aftermath of Financial Crisis."

[42] Edward Wyatt, "Ruling Gives Edge to US in Its Appeal of Citi Case," *New York Times*, March 15, 2012, http://dealbook.nytimes.com/2012/03/15/s-e-c-appears-poised-to-win-appeal-in-citi-settlement-deal/ (accessed March 19, 2012).

[43] William E. Connolly, "Pluralism," in *Blackwell Encyclopedia of Political Thought*, ed. David Miller (New York: Blackwell Reference, 1987).

[44] Robert R. Alford and Roger Friedland, *Powers of Theory: Capitalism, the State, and Democracy* (New York: Cambridge University Press, 1985), 92; Hamilton, Madison, and Jay, *Federalist Papers*: 42–9; Alexis de Tocqueville, *Democracy in America*, eds. J. P. Mayer and M. Lerner, trans. G. Lawrence (New York: Harper, 1966); Marvin Zetterbaum, "Alexis de Tocqueville," in *History of Political Philosophy*, eds. Leo Strauss and Joseph Cropsey (Chicago: University of Chicago Press, 1972), 715-36.

the process, interest groups and lobbyists provide information about specific issues to members of Congress and their staffs who in turn pursue certain policy goals.[45] Therefore, groups play an important role in shaping the specific policy preferences of both the executive branch and members of Congress. The vast financial resources available to groups also allow them to play a role by making sizeable campaign contributions.

Advocacy Groups and the Financial Services Industry

Political science literature on lobbying finds that lobbyists generally do not try to change a politician's mind. Rather, they tend to make and maintain contact with members who already agree with them.[46] In this way, a lobbyist serves as an important source of political intelligence and labor for friendly members that can be costly to generate. In exchange, the member can extend effort, constitutional access to the process, and political goodwill with colleagues.[47] Much of the daily work of business pressure groups involves persuading industry executives to write or talk to their member of Congress about an issue and in providing general public relations and education.

Interest groups are not good or bad in and of themselves. People tend to like groups that fight for their own concerns and not like those on the other side. In the best of all worlds, every view is represented and roughly balanced. A wide discussion of possible solutions to a problem can then emerge from deliberations when bills are up for a vote or when a candidate runs in an election. Problems emerge when groups do not form, or are so severely unbalanced that deliberation is impossible.

Those who study American politics have long noted that different sides of a political struggle are rarely matched and many views are not represented at all.[48] Early theorists argued that more powerful groups try to resolve their issues privately, whereas weaker groups try to get theirs out in the

45 Raymond A. Bauer, Ithiel De Sola Pool, and Lewis Anthony Dexter, *American Business and Public Policy: The Politics of Foreign Trade*, 2nd ed. (Chicago: Aldine, Atherton, 1972); Lester W. Milbrath, *The Washington Lobbyists* (Chicago: Rand McNally, 1963); Theodore J. Lowi, *The End of Liberalism: The Second Republic of the United States* (New York: W. W. Norton, 1969).

46 Milbrath, *The Washington Lobbyists*.

47 Richard L. Hall and Alan V. Deardorff, "Lobbying as Legislative Subsidy," *American Political Science Review* 100, no. 1 (2006), 69-84. See also Marie Hojnacki and David C. Kimball, "The Who and How of Organizations' Lobbying Strategies in Committee," *Journal of Politics* 61, no. 4 (1999), 999-1024.

48 E. E. Schattschneider, *The Semisovereign People: A Realist's View of Democracy in America* (New York: Harcourt Brace Jovanovich College Publishers, 1975).

public where they can hopefully draw in others to widen the scope. The power ratio among private interests does not always prevail and is usually dependent on how prominent the issue is on the public's radar screen. Other theorists have noted that groups tend to form and fight for a cause when the benefits of that cause can be reserved for those who fought for it. When benefits are distributed to everybody, an individual does not have the same incentive to join because he or she will benefit regardless.[49]

All of these insights with respect to interest groups and American politics apply to the financial services industry. Commercial banks, investment banks, hedge funds, and corporations prefer to operate out of view, which makes it seem from the outside as if they all agree. Their unpopularity during times of crisis leads them to work through intermediaries and strategize with other industries. Therefore, it is not easy to offer a clear picture of their activities. In the first three quarters of 2009, the financial services industry spent $344 million on lobbying. However, the firms' representatives did not necessarily go to Capitol Hill themselves. In many cases, the banks' corporate customers lobbied directly on financial services legislation as "end users" of the financial products the industry provides. For example, Boeing was part of the public campaign on financial services reform but is far from being a "Wall Street" interest. Nonetheless, airlines use derivative financial products to protect themselves against swings in the price of fuel. These products cost less if they are traded off of an exchange and without being subject to formal regulation. Therefore, Boeing shares an interest with the providers of derivatives in the industry and can play a more public role in defending it than the banks can.[50]

The direct political operations of the financial services industry are conducted through three main types of business associations inside the Beltway: leadership associations, trade associations, and specialized business groups.[51] They compete for membership and do not necessarily agree on all issues or policy solutions. The leadership, or general business, associations are the National Association of Manufacturers, the Chamber of Commerce, the National Federation of Independent Business, and the Business Roundtable. These associations have broadly based memberships on behalf of the business community overall. Staff members in their

49 Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge, MA: Harvard University Press, 1971).

50 See Michael Hirsh, "Why is Barney Frank So Effing Mad?" *Newsweek*, December 14, 2009, 50.

51 This typology is drawn from Lehne. See Richard Lehne, *Government and Business: American Political Economy in Comparative Perspective* (New York: Chatham House, 2001), 139.

headquarters monitor events in Congress and the executive branch and develop positions on issues affecting their members. They represent the views of their members to government officials and encourage firms to engage the political process as well.[52]

Trade associations are business associations that represent specific industries. Among these, the American Bankers Association (ABA) was founded in 1875 and is one of the country's largest. Reflecting the industry's diverse structure, the majority of the ABA's members are banks with assets of less than $165 million, and they have many different types of charters. Although government relations are an important part of what the ABA does, it also conducts professional training, research, and education programs for its members. Likewise, the Clearing House has provided payment and clearing services since the 1800s. It has emerged as a major voice on bank regulatory issues on behalf of top executives at the roughly twenty largest U.S. commercial banks. Finally, the Financial Services Forum offers a forum for chief executive officers at the twenty largest financial services companies, including some non-banks, to meet and formulate policy positions on issues directly and indirectly tied to the financial services industry.[53]

Other associations concentrate on specific segments within the industry, such as the Consumer Bankers Association, which includes members of both large and medium-sized retail banking operations, and the Mortgage Bankers Association. The Securities Industry and Financial Markets Association (SIFMA) represents the interests of participants in global financial markets. SIFMA members include international securities firms, U.S.-registered broker-dealers, and asset managers. Similar to the ABA, SIFMA represents the industry on regulatory and legislative issues and initiatives; it also serves as a forum for outreach, training, education, and community involvement. SIFMA has offices in New York, Washington, DC, London, and Hong Kong, where its sister organization, the Asia Securities and Financial Markets Association, is located. These associations may speak for just part of a big bank and not necessarily the entire institution.

Even more specialized business associations serve the needs of specific groups within an industry. The Emerging Markets Traders Association (EMTA) was formed to serve the needs of participants in the financial markets for developing country debt in 1990. The American Securitization Forum (ASF) is the securitization industry's unifying forum, converting

[52] For a discussion of the Business Roundtable in particular, see Vogel, *Kindred Strangers*, 281.

[53] See Joe Adler, "Who Speaks for the Big Banks? It's Not Always Clear," *American Banker* November 8, 2011, 1.

ideas into action to enhance and improve the securitization market. The New York State Bankers Association was formed with a mix of educational and legislative efforts to assist commercial banks and thrift organizations in New York State. The National Association for Business Economics (NABE) is a professional association for business economists and those who use economics in the workplace. The Association of Chinese Finance Professionals is for a specific group of people employed on Wall Street.

Therefore, when a bank or financial services firm seeks to influence a specific policy, it can use a business association, rely on its own public affairs office, or create an ad hoc coalition to address it.[54] Studies of business lobbies indicate that a firm hoping to change policy will generally turn to the established business association first, unless members disagree within the organization. A firm can then use its own public relations or government affairs department or retain a contract lobbyist for hire. For example, Citibank occasionally used the Washington law firms Wilmer, Cutler, Pickering Hale & Dorr and Hogan and Hartson as lobbyists from 2000 to 2009 when lobbying the Senate. These firms charge fees that can be high; however, they provide extensive knowledge of the Washington political terrain. Many employ former members of Congress who can offer access to their former colleagues on the Hill that others might find difficult to obtain. These firms can also charge high fees because many have former policymakers on their staffs who have exceptional firsthand knowledge of the policies and process, as well as access to the players.

When a policy proposal affects the banking industry in a particular way, affected groups may form ad hoc coalitions. Such coalitions may work with other industry groups and with citizens groups or issue-advocacy groups to effect change. Once a particular issue is in play, groups, public relations firms, and lobbyists attempt to shape how it is perceived through advertising campaigns and sponsored studies in policy research centers such as the Heritage Foundation or American Enterprise Institute. They create defensible positions for elected officials and work at the grassroots to connect members to their constituents with industry-specific information from the district.[55] For example, they can provide detailed information to a member of Congress about how many individuals in their own district have jobs that rely on the health of a particular industry, or even a particular company. Other specialized, private research institutions devoted to the study of international economic policy, such as the Peter G. Peterson Institute for International Economics, may weigh in with research and events focusing on the issue.

[54] Lehne, *Government and Business*, 158.

[55] Ibid., 160–61.

Despite widespread agreement on most issues, some in the banking industry argue that large banks have too many voices to be truly effective as an industry association, because each trade group emphasizes different things. At times, groups compete to lead the advocacy for a given issue. In general, the association that initially identifies the issue takes the lead. On issues more directly relevant only to large banks, such as deposit insurance premiums, the Clearing House has led efforts in submitting comment letters to agencies or in analyzing how regulatory policy will affect the industry by using data driven research on legislative and regulatory proposals.[56]

Campaign Contributions and the Financial Services Industry

The previous section pointed out that lobbyists and interest groups work best with members who are already in agreement with them in principle. Therefore, the banking and financial services industries also try to make sure that as many agreeable politicians as possible get elected in the first place. Groups work on both sides of the aisle in this regard. Although banks traditionally favor Republican candidates, most of the major banks gave more to Democrats than Republicans in the 2008 election cycle. Sixty-three percent of the securities and investment industry presidential contributions in the 2008 campaign went to then Senator Barack Obama.

Post-Watergate campaign laws allow corporations to contribute to political action committees (PACs) that are organized for the purpose of electing a candidate. The seventh largest PAC in the United States from 2009 to 2010 was the ABA. In general, the PACs that contribute the most to federal campaigns are sponsored by membership associations such as the ABA PAC and SIFMA-PAC. In the 2010 election cycle, the ABA's PAC gave the highest amount in the commercial banking industry, with $869,500 going to Democratic candidates and $1,810,500 to Republican candidates. The ABA and Independent Community Bankers of America were followed by individual banks such as Bank of America, Citibank, and JPMorgan Chase, which have their own PACs. Although many firms on Wall Street collapsed in the 2008 election cycle, banks still contributed more than $37 million to federal candidates and parties during that period. Securities and investments firms spent $95.2 million.[57]

Banks have also taken advantage of changes in campaign finance laws related to two Supreme Court decisions in 2010. In April 2012, a group of leaders in the banking industry formed the industry's first SuperPAC, or

[56] See Joe Adler, "Who Speaks for the Big Banks?".
[57] See Center for Responsive Politics, http://www.opensecrets.org/.

independent-expenditure only committee, which will attempt to influence the outcome of a handful of close elections. Traditional banking PACs target multiple House and Senate races and limit individual donations to no more than $5,000 a year. The new SuperPAC, "Friends of Traditional Banking," does not face these same restrictions on contributions but is not permitted to coordinate its activities with candidates. The relationships among traditional PACs and the newer form continue to evolve. When Friends of Traditional Banking formed, only 407 others existed, and only 18 had raised more than $1 million. At the time, the ABA remained outside the effort, focusing instead on its traditional PAC and floating proposals to create a similar entity of its own.[58]

AMERICAN INDUSTRY STRUCTURE AND INDUSTRIALIZATION IN COMPARATIVE PERSPECTIVE

What makes *this* country different? Or to put it another way, what makes the U.S. financial policy system different from other countries? Thus far, we have seen that the checks and balances among branches of the federal government, agencies of the federal government, and participation of interest groups in the policy and electoral processes distinguishes the United States from other advanced, industrial democracies. Most countries have a single bank supervisory authority. In Barth, Caprio, and Levine's study of 153 countries, only 26 assigned supervision to multiple authorities as the United States does.[59] The result of these institutional arrangements and manners of participation has been regulations that channel competition among banks and financial services firms; this competition affects the way the businesses themselves are organized. Moreover, although eight of the twenty-nine banks designated to be systemically important to the world economy under the Basel III Agreement are American, there is not one individual bank among them with branches in each of the fifty states.[60] Industry structure ultimately feeds back into the political system in the form of lobbying and the revolving doors between industries and agencies because participants of all sizes and at all levels of government have industry representation at the state and federal levels.

[58] Barbara A. Rehm, "Bankers Form SuperPac for 'Surgical' Strike at Industry's Enemies," *American Banker*, April 5, 2012, 3.

[59] James R. Barth, Gerard Caprio Jr., and Ross Levine, *Rethinking Bank Regulation: Till Angels Govern* (Cambridge: Cambridge University Press, 2008), 85.

[60] See http://www.forbes.com/sites/afontevecchia/2011/11/04/the-worlds-29-most-systemically-important-banks/ (accessed November 9, 2011). The U.S. banks named are Bank of America, Bank of New York Mellon, Citi, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street, and Wells Fargo.

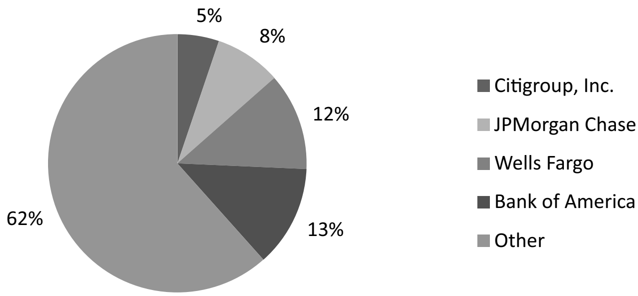

FIGURE 1.2. Major U.S. Commercial Banks by Market Share, 2010. *Source:* "Commercial Banking in the US." IBISWorld Industry Report, May 2010, http://www.ibisworld.com.

The Structure of the Banking Industry in the U.S. Economy

The U.S. banking industry is highly fragmented relative to the rest of the world. Prior to the 1980s, it was characterized by the large number of small banks distributed across its fifty states. The activities of branches were restricted, so large banks concentrated in a few geographic locations. The major changes from deposit deregulation in the early 1980s, the relaxation on restrictions on branch banking later in that decade, and multiple innovations in technology and applied finance caused a degree of consolidation in the industry. Eventually, these innovations led to the expansion of securitization and derivatives markets.[61] From 1979 to 1994, the number of banking organizations declined; the assets of the few dozen extremely large financial institutions grew. In the ten years that followed, the rate of consolidation appeared to stabilize prior to the shocks in 2007 and 2008. Figure 1.2 compares the size of major commercial banks in the United States following the financial crisis.

The structural consolidation in the U.S. banking industry in recent years makes regulation all the more important in determining where risk can accumulate in the system overall. On one hand, as the size of assets under control of the largest U.S. banks has grown, the largest are considered "too big to fail" or the system will fail with them. Big banks can gain a political advantage from this status because the government feels compelled to act in a crisis on behalf of the overall system. On the other hand, despite the consolidation in the industry, the United States still has a large number of banks controlling much smaller asset levels that are distributed across the fifty states, relative to other countries. Because congressional districts in

[61] Kenneth D. Jones and Tim Critchfield, "Consolidation in the U.S. Banking Industry: Is the 'Long, Strange Trip' About to End?" (Washington, DC: Federal Deposit Insurance Corporation, 2006).

the House of Representatives are geographic, that distribution of small and medium-sized banks means that many more congressional districts have these institutions as constituents than the large banks that are concentrated in New York, California, and North Carolina. As legislation moves through Congress and regulations are produced in agencies, all banks do not necessarily share the same interests, depending on where they are located and how many assets they control.

Industrialization in Europe and the United States

Just as the structure of the banking industry in the United States reflects American political culture with it distrust of the centralization of power, France, Germany, and Japan are also products of their own histories, where government and business collaborated more closely during bursts of industrialization both before and after World War II. In postwar France, the government set out steps for French economic growth and development that were to be produced in collaboration with major economic groups, including the banking industry. The goal was for the French to be able to shape market forces and position French firms to take advantage of opportunities. The government owned large industrial enterprises such as the railroads, airline, and utilities. Even when the state began to sell its share in these firms and open to world markets, it has been with a particularly French character. Ministries have become partners rather than leaders of industry.[62]

Another significant difference is that businesses are arranged differently within advanced, industrial economies. In Germany, banks own and vote their shares of stock in major corporations. Similarly in Japan, banks are part of interlocking business groups called *keiretsu*. The bank lends money to the companies in its group and owns equity in them. Japanese banks thus exercise a great deal of control over some firms. With fewer banks differently integrated into national industrial structures, Germany and Japan have consolidated regulators, business associations, and lobbyists. German and Japanese business associations are usually "peak" organizations, meaning that smaller associations are members of the national ones. The national associations collaborate more successfully with governments in economic decision making because they are expected to adopt positions that benefit societal and industry interests, not just those of individual companies.[63]

[62] Graham K. Wilson, *Business and Politics: A Comparative Introduction* (New York: Chatham House, 2003), 89. For a discussion of different shareholding patterns in firms, see Kathryn C. Lavelle, *The Politics of Equity Finance in Emerging Markets* (New York: Oxford University Press, 2004).

[63] Lehne, *Government and Business*, 151.

Similar market pressures at the end of the twentieth century and stress from the financial crisis of 2008 caused changes in the banking sectors of these other countries as well, although not necessarily with the same results. For example, the United States had roughly 15,000 banks with assets in 1982. The 10 largest American banks accounted for 18 percent of the U.S. commercial banking sector's domestic assets, and the 20 largest had 25 percent. At that time, the European and Asian banking sectors had public components. Germany had 3 major private banks and about 182 domestic banks, and Japan had 86.[64] The recession in Japan in the decade of the 1990s forced many of the largest Japanese banks out of business. Hence, the lines around the *keiretsu* are not drawn as distinctly as they were previously. The financial crisis of 2008 caused many *landesbanken* (German banks in the public sector) to fail. The result is that two major banks – Commerzbank and Deutsche Bank – now dominate the private system in Germany.

The presidential system of government in the United States also contrasts with most other industrial democracies that are parliamentary. As pointed out previously, the U.S. president sits at the center of the American system but does not control the legislature, because the president is elected independent of Congress. With a parliamentary system, the majority party or coalition in the legislature picks the head of government, effecting more consistent policies among them. Therefore, political scientists distinguish the American Congress as a *policymaking* legislature from the other parliaments that serve mainly to ratify policy made in the party or coalition. Although central banks have a degree of independence in all of these countries, they do not have to operate in an economic policymaking environment such as that in the United States, where the head of government may pursue one objective and the majority party in the legislature another.

Given the differences in the nineteenth-century industrial patterns of the United States and other industrial democracies, the other countries are less apprehensive about the concentration of power in a given industry and the centralization of regulation in one authority. After World War II, Germany, Great Britain, and Japan recognized their dependence on the international economy. Whereas the United States promoted competition among companies within its own national economy, Germany, Great Britain, and Japan tended to take competition among countries as a given. Thus, they promoted individual industries in the global economy that helped accomplish other government objectives, many of them related to banking.[65]

[64] J. Andrew Spindler, *The Politics of International Credit: Private Finance and Foreign Policy in Germany and Japan* (Washington, DC: Brookings Institution, 1984), 185.

[65] Lehne, *Government and Business*, 49.

CONCLUSION

In sum, the American capitalist system separates business and government to the greatest extent possible. Specific decisions about which person or company actually receives a loan, buys a share of stock, or purchases insurance is almost never made by a politician. Therefore, the picture of the American economy and its relation to the financial sector is strangely apolitical, where the financial and political realms are separate and distinct from each other. Yet politics infuse the American financial system at every level, and the results have substantial consequences for the distribution of wealth across American society. Although the most visible debates about monetary policy are battles among technicians who do not openly consider who benefits or is hurt by their actions in fighting inflation, promoting economic growth, or lowering the rate of unemployment, their activities have distributive results on various groups in the U.S. economy: those who might be unemployed, those who lose the purchasing power of their savings to inflation, or those whose investments yield to slow economic growth.

Why don't affected groups mobilize on the other side? Although it is nearly impossible to determine why something does not happen, one reason the unemployed rarely mobilize for specific financial policies is because they channel their concerns through different business and labor associations and across different income classes and political parties.[66] Those who lose their savings to inflation or investments to slow growth are likewise nearly impossible to organize as a coherent group across business organizations, class, and employment lines. Unlike the extensive network of groups and lobbyists in the banking industry that operate for the winners who understand the policies that benefit them, differences in mobilization and the operation of politics within different bureaucratic agencies disadvantage the losers to specific economic policies in the resolution of problems in a crisis as well.

The remainder of this book focuses on the bureaucratic political aspects of economic policymaking. To do so, it begins with an examination of American history and emphasizes the bureaucratic politics paradigm, thus explaining government policy outcomes to be determined by bargaining among players positioned hierarchically in the government along regularized circuits. Rather than taking the government to be a unitary actor, the bureaucratic politics model considers many actors to be players. Moreover, the bureaucracy does not focus on a single issue but on many simultaneously. However, the book does not ignore other conceptual approaches

[66] John T. Woolley, *Monetary Politics: The Federal Reserve and the Politics of Monetary Policy* (New York: Cambridge University Press, 1984), 181.

when they shed light on a particular problem. This understanding complements the work of economists but does not replace it. It provides insight into the crisis of 2008 and more importantly into the political origins of financial crises across American history.

Perhaps the greatest global distinction between the United States and the rest of the industrial world – and the one that will have the greatest impact on the future – lies in the position of the U.S. economy at the core of the world economy since the end of World War II. Other countries and the companies in them not only use dollars to pay many international transactions, they hold the dollar as a reserve currency in their central banks. Ultimately, these holdings serve as a source of revenue to the U.S. government through what economists call "seignorage," or the money a government generates just by printing it. Despite these considerable benefits, the ability of the Federal Reserve to control the money supply and address problems with some types of inflation has been curtailed as global financial markets have integrated and deepened. Moreover, American banks were more insulated in previous eras, whereas they have global competitors now. Looser banking regulations in other countries can make it tougher for American financial services firms to compete, adding additional pressure to lower standards. Whereas innovation and change in previous eras derived from opportunities to circumvent obstacles at the state or federal level in such a decentralized system, the future presents new sources of regulatory arbitrage and change from international circumstances.

SECTION I

A HISTORICAL BACKGROUND

The next two chapters consider the historical background within which the bureaucracy surrounding finance emerged that distinguishes the United States from other advanced, industrial democracies. The general unease that exists between the business community and the American state can be explained, at least in part, by the time frame of the development of the two in relation to each other and a political culture that distrusts the concentration of political and economic power. The way that this state capacity – or the national administrative capability – to govern finance was built across American history matters today because it influences the way the system operates with its inherent competition among agencies for authority, budgets, and personnel, as well as the way that different interests have captured different agencies.

David Vogel argues that early in U.S. history, the country's most talented individuals pursued economic gain and material growth; thus they did not work to develop national political and administrative capacity. As a result, a large number of firms dominated the American economy by 1909 whose successors operate today, such as Standard Oil (now ExxonMobil and others in the oil and gas industry), United Fruit (now Chiquita Brands International), and General Electric. It was not until the late 1930s that the annual revenues of the federal government rivaled those of the assets of the largest industrial corporations.[1] This sequence means that many corporations are far older than the government agencies of comparable importance. Moreover, unlike many other countries, the American business community did not have the historical experience of coexisting

[1] David Vogel, *Kindred Strangers*, 42–43.

or competing with other established institutions, like the military, clergy, universities, or aristocracy.[2]

The historical review depicts a system where political institutions are challenged by external shocks such as war or internal ones such as runs on the banking system. New government agencies are grafted onto the existing structure. As the system returns to normal, the financial industry gradually responds to the new regulatory boundaries with practices and products that test the limits of the environment for change. Chapter 2 explores the development of state capacity in this area, meaning the development of the federal government's ability to administer its territory with respect to money and banking. It shows that a variety of political institutions have been formed throughout American history in response to crises and war that have created a patchwork of agencies to address financial problems through regulation. Chapter 3 examines the market side of this political development, by investigating the response of private capital markets to institutional and regulatory growth, as well as growth from hybrid public-private entities such as Fannie Mae and Freddie Mac. Politics and economics came together as the United States industrialized and home ownership emerged as an integral aspect of the American dream. To promote home ownership, a niche of financial institutions, quasi-government agencies, and later sophisticated financial instruments met the needs of consumers, politicians, and those providing finance.

[2] Ibid., 49.

2

Developing State Capacity for the Conduct of American Finance

Broad tensions have existed throughout American history over the division of power between the federal government and states, most prominently in the areas of taxation and slavery. In the financial area, tensions have been shaped by an American political culture that distrusts government, banks, and bankers. This chapter reviews these distinctive aspects of American government and political culture by specifically questioning the demands that Americans have made on their government with respect to the provision of finance, as well as how governing institutions have responded to these demands. It shows that American financial practices have evolved within a framework of institutions that developed as a result of unique interests and political ideologies at specific historical junctures, layered over time. Thus the answers to these questions provide insight into the origins of the web of regulatory agencies that have emerged in this area, into the difficulties inherent in changing the system to prevent future crises, and the tendency to create new agencies when new problems and ideologies emerge. The answers also provide insight into the role played by political parties in shaping the institutions of finance. The first parties formed around the debates concerning the First Bank of the United States, took shape after the War of 1812 with the Second Bank of the United States, and aligned over divisions in the silver debates at the close of the nineteenth century.

As American political institutions and economic development occurred, the United States built what political scientists term *state capacity* in the financial area.[3] Strictly speaking, state capacity refers to the building of

[3] For some examples, see Marc Allen Eisner, *Regulatory Politics in Transition*; Theda Skocpol and Kenneth Finegold, *State and Party in America's New Deal* (Madison:

a *central* apparatus for the U.S. federal government between 1877 and 1920, when national administrative institutions were built and wrested control away from party domination, direct court supervision, and local orientations.[4] In Stephen Skowronek's analysis of the process, American state capacity grew out of institutional struggles rooted in the way the old regime was structured and was mediated by shifts in electoral politics.[5] Therefore, to understand government action as resulting from Allison's models of either semi-independent organizations operating according to their own logic, or as the outcome of bargaining among units, it is necessary to revisit the older struggles between state and national government, ideologies about the proper division between public and private authority, and the role of the individual citizen in American democracy to see where the component parts came from in the first place.

The development of state capacity in this area explains a good deal about why the United States regulates banks the way it does, and why this system leaves it open to periodic crises. Governments and banking systems need each other; yet given the distinct American political culture, the U.S. government and financial services industry seek the highest possible degree of separation and local control. Subsequent struggles over financial politics had to address industrialization, the Civil War, and how to finance two world wars. Current struggles over financial politics occur over the consequences of the end of the Cold War, the winners and losers in globalization, and how to resolve the tension between private welfare systems in advanced, industrial democracies and global competition from industrial, industrializing, and nonindustrial countries.

THE FIRST AND SECOND BANKS OF THE UNITED STATES

The Founding Fathers can seem to be a very homogenous group of men; however, they had profound differences concerning the role of government in the national economy that were not easily resolved when the United States was first created. They disagreed strongly over whether or not to create a central bank, which would be necessary to forge a strong national economy but would also be a very powerful institution. A review of this history shows that the divisions over the First and Second Banks of the United States contained all of the conflicts that still exist in American financial politics today, such as the balance of power between the federal

University of Wisconsin Press, 1995); and Stephen Skowronek, *Building a New American State*.

4 Skowronek, *Building a New American State*, 15.

5 Ibid., 13.

and state governments, the contradiction between individual liberty and equal opportunity for all, and the clash between the materialistic values of capitalism and spiritual values of many of the American people. When the charter for the Second Bank of the United States expired in 1837, the U.S. government did not renew it. Therefore, the country did not have a central bank until the creation of the Federal Reserve in 1912. Rather, the country operated with state-chartered banks and later national banks. It paid its bills and collected its payments through a division of the Treasury Department.

Hence, the origins of the banking and political systems go back to the problem that George Washington faced in 1789 when the United States was burdened with the remaining debt of the American Revolution. In a broader political compromise to resolve the debt problem and create the First Bank of the United States, the capital city was moved to the banks of the Potomac River where Washington, DC, would be located. Therefore, the United States has had two "capital" cities with two distinct cultures from its origins: a political capital in Washington and a financial capital in New York. Despite the growth in the number of corporations that are headquartered in Washington, 27.1 percent of the total labor force there works in the federal government. By contrast, 5 percent of total employment and 25 percent of total wages immediately prior to the crisis of 2008 in New York were in the financial sector.[6] The culture of Washington places a greater deal of emphasis on the pursuit of power, whereas the culture of New York revolves around the pursuit of wealth. As a result, the two cities have an uneasy relationship.

The First Bank of the United States

The American Revolution left the newly independent colonies with a large volume of debt. After the Constitution was ratified and George Washington took office as the first president, his Secretary of the Treasury, Alexander Hamilton, proposed that the federal government create a central bank that would be similar to the Bank of England.[7] As part of the broader national project, the government would assume the debt of the states so that they

[6] Office of the Comptroller, New York State, "The Securities Industry in New York City," Report 7–2009, November 2008, http://www.osc.state.ny.us/osdc/rpt7-2009.pdf; Government of the District of Columbia, "D.C. Economic Indicators: October 2008," vol. 9, no. 1, http://cfo.dc.gov/cfo/frames.asp?doc=/cfo/lib/cfo/eioctober2008.pdf.

[7] Some key differences between the two existed. In political terms, the hostility toward the Bank of the United States could be understood to result from its regulatory action first and its competitive advantages second, whereas the hostility in England toward the Bank of England was reversed, with dislike of its competitive advantages

would be willing to participate. The bank would have a federal charter and issue currency that could be used to pay taxes. While the government would be the largest stockholder and share in its profits, it would not manage the bank directly. Having a central bank would benefit the new government because it would be a source of loans and a place to deposit federal funds. With a central depository, the federal government could transfer money among cities and clear payments on the national debt. Hamilton saw the interests of wealthy citizens and the young country to be one and the same. Having a central bank would strengthen the federal government and broaden the role of the executive in the new American democracy by establishing institutions and precedents that would limit the role of Congress in financial affairs. At the same time, the bank would also serve private clients.

Not everyone agreed about how strong the federal government should be, let alone what role the bank should play. New England industrialists supported it. However, it was opposed by Southern agrarians, among them Thomas Jefferson. He argued that the Constitution had not granted the federal government the power to incorporate a bank. States had chartered banks that generated investment earnings and tax revenues that the states could use for public finance. By taking away the power of states to issue paper money, the U.S. Constitution had also removed a source of money for states to finance their activities.[8] Thus the initial debate over the bank was tied up in the broader debate over the implied powers of the federal government, yet it also embodied real material interests among geographic regions. The result was that the pro- and anti-bank factions constituted the early Federalist and Democratic-Republican parties, respectively, which were the first of their kind to form in the new republic. The tension on the issue did not dissipate. Although the First Bank of the United States was established in Philadelphia in the years when that city served as the temporary capital of the United States, its charter was not renewed after it expired in 1811.

The Second Bank of the United States

The War of 1812 brought on the same problem with how to pay off the national debt incurred in a war. The Madison administration and the

first and regulatory action second. See Bray Hammond, *Banks and Politics in America: From the Revolution to the Civil War* (Princeton, NJ: Princeton University Press, 1957), 447.

8 Richard Sylla, John B. Legler, and John J. Wallis, "Banks and State Public Finance in the New Republic: The United States, 1790–1860," *Journal of Economic History* 47, no. 2 (1987), 391–403.

Democratic-Republican Party that Madison and Jefferson had founded were left once again with debt and fiscal chaos. Ironically, the party that had been born in opposition to a central bank created the Second Bank of the United States in 1816 with another twenty-year charter.

However, the American economy has never been a monolith. Different regions have relied on different industries, and regional markets have varied in their ability to counteract economic upswings and downturns. As the country industrialized and constructed public works in the early years, different regions raised capital from various sources.[9] In the East, governments and individuals could raise large amounts of capital from domestic sources. For example, the capital for the New York canals was secured easily and almost entirely domestically. Others drew on European sources – English ones in particular.[10] New England banks were relatively small, their stock was closely held, and they granted discounts to local farmers, merchants, and artisans whom the managers knew well. In Virginia, like most other southern and western states, branch banks thrived.[11]

Because the United States had paid off its debt by 1832, it was a popular country for English investors to invest in.[12] No other country had done the same. Foreigners purchased securities and extended capital through commercial credit. U.S. firms obtained credit with Anglo-American houses in London or Liverpool that allowed agents to draw on them at four months to pay for goods purchased and shipped to the United States. British customers bought products from Americans for cash and sold their own on credit. This meant that American capital was liberated from having to finance trade – and it was thus available for carrying out improvements elsewhere.[13] However, little such capital was available in the West and Southwest.

With the rise of Jacksonian democracy in the 1820s, Democrats and old Jeffersonians who had never wanted a central bank got together with small bankers and businesses who thought they had been denied access to credit. These groups particularly opposed the "special privilege" of the Second Bank of the United States. Jackson did not only oppose the hybrid public and private structure of the bank; he also believed that

9 See Howard Bodenhorn, *A History of Banking in Antebellum America: Financial Markets and Economic Development in an Era of Nation-Building* (New York: Cambridge University Press, 2000).

10 Guy Stevens Callender, "The Early Transportation and Banking Enterprises of the States in Relation to the Growth of Corporations," *Quarterly Journal of Economics* 17, no. 1 (1902), 139.

11 Bodenhorn, *A History of Banking in Antebellum America*, 32, 41.

12 Callender, "Early Transportation and Banking," 143.

13 Ibid., 145.

incorporated banking violated the boundary between public and private spheres of government. Because the essence of banking was the issuance of paper notes that substituted for what some at the time regarded as "real" money, or specie, this activity meant that banking corporations possessed privileges denied to individuals.[14] In 1837, the bank's federal charter expired.

Following the end of the Second Bank of the United States, President Martin Van Buren moved to sever the central government from all banks completely. He asked Congress to establish the Independent Treasury (independent from banks, not the government) as a line agency in the Treasury Department to collect, hold, and disburse the government's money.[15] After a protracted legislative struggle, it was established in 1840.

Therefore, until the Federal Reserve System took over these functions in 1920, the Independent Treasury collected, held, and disbursed its own funds. It held government receipts in subtreasuries rather than banks so that banks did not collect interest by lending out money the government had on deposit. With Andrew Jackson having paid off the national debt, the banks did not hold federal government bonds as capital. Thus they did not earn a return from the American people (who would have been paying a return in the form of interest on the bonds to the banks that held them). Many different currencies circulated that were backed by specie; however, the government's transactions were only handled in specie.[16] Table 2.1 reviews the chronology of American central banks.

If Americans distrusted the concentration of economic or political power, how did the financial industry become so concentrated in New York? At first, some private banks operated without state or federal charters and were free of regulatory restrictions. Among these were J.P. Morgan and Company, Brown Brothers and Company, and Lazard Freres.[17] Banking grew even more concentrated in New York after the passage of the National Bank Act in 1863. After passage of the Act, money flowed from across the country to the national banks in New York because a country bank with a national charter kept a portion of its reserves in larger reserve cities specified in the law. The reserve city banks kept theirs in reserve city banks in Chicago, St. Louis, and New York. New York banks thus held a great deal of reserves and had to be ready to distribute them on demand. To generate earnings in the meantime, many invested the reserves in call loans to Wall

14 Hoffman, *Politics and Banking*, 62.
15 Ibid., 67.
16 Ibid., 68, 103.
17 Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (New York: Oxford University Press, 2011), 18.

TABLE 2.1. *Chronology of Central Banks in the United States*

1791	Congress creates the First Bank of the United States.
1811	Charter for the First Bank of the United States expires and is not renewed.
1816	Congress charters the Second Bank of the United States.
1836	Charter for the Second Bank of the United States expires and is not renewed.
1840	Independent Treasury is established as fiscal agent of the federal government.
1913	Federal Reserve Act creates the Federal Reserve System.
1920	Federal Reserve assumes the fiscal agency of the federal government.
1935	Banking Act reorganizes the Federal Reserve.
1951	Treasury–Federal Reserve Accord establishes the independence of the Federal Reserve in controlling the money supply.
1978	Congress passes the Full Employment and Balanced Growth Act, also called the Humphrey-Hawkins Act, which clarifies the objectives of national economic policy to be economic growth in line with the economy's potential to expand, a high level of employment, stable prices, and moderate long-term interest rates.

Street brokers, contributing to resentment across the country toward New York.[18]

In 1895, the J.P. Morgan partnership underwent a major reorganization. It subsequently embarked on a program of reorganizing failing firms under the control of the banks. In the case of the railroads, a majority of stock was transferred to "voting trusts," which amounted to John Pierpont Morgan and his associates running them. In so doing, Morgan traded money for power and eroded the distinction between finance and industry through the money trust.[19] The "morganization" of industry that followed meant financial dictatorship over labor, managements, and shareholders.[20] By 1912, J.P. Morgan and Company controlled or dominated three banks, three trust companies, and three life insurance companies. Through stock ownership, voting trusts, and directorships, it dominated ten railroad systems. By means of voting trusts, stock ownership, and directorships, it dominated five industrial corporations – United States Steel, General Electric, American Telephone and Telegraph, International Harvester, and Western Union. In all, Morgan partners held seventy-two

18 Hoffman, *Politics and Banking*, 112.

19 Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York: Atlantic Monthly Press, 1990), 68.

20 Lewis Corey, *The House of Morgan: A Social Biography of the Masters of Money* (New York: Grosset and Dunlap, 1930), 283.

interlocking directorships in forty-seven of the largest financial and other corporations.[21]

While the relative degree of industrial centralization during the same years was greater in Europe, particularly Germany, Populists and other advocates of small-scale industry in the United States railed against the money trust. In his famous writing on the topic, *Other People's Money*, Louis Brandeis pointed out that the high interest rates charged by trusts led to a toll on the rails, corporations, and consumers. Moreover, the trust suppressed competition in these areas.[22] The Pujo Commitee hearings famously investigated the system prior to the establishment of the Federal Reserve.

THE CIVIL WAR, "GREENBACKS," PANICS, AND CRISES

Anti-bank sentiment was particularly strong in the West. By the 1850s, five western states prohibited banks entirely. Two others had state monopolies on them.[23] Nonetheless, in the years after the demise of the Second Bank of the United States, regional conflicts were far more pronounced over slavery, ultimately erupting in the Civil War. In this section, we will see that just as the two previous experiments with central banks resulted from a lack of ability to address the debt associated with the American Revolution and the War of 1812, the inadequacy of the financial system in place to fund the Civil War forced the federal government to experiment with solutions that would expand both the availability of money and national financial regulation.

Abraham Lincoln was elected president in 1860, and the Civil War began in 1861. The demands of the war far outstripped the gold and silver available to cover the government's growing budgetary needs. When the availability of loans to the government in gold ran out in 1862, the government began to issue its own notes, called "greenbacks." Since the notes were legal tender, they became a national currency of sorts even though a government banking monopoly continued to be regarded as dangerous. Significant legislation followed the next year. The Currency Act created a single currency, and the National Bank Act permitted the federal government to charter banks. The latter also created the Office of the Comptroller of the Currency (OCC) – the part of the Treasury responsible for chartering, supervising, and examining these national banks. Thus the Act laid

21 Ibid., 354.

22 Louis D. Brandeis, *Other People's Money and How the Bankers Use It* (Fairfield, NJ: Augustus M. Kelley, 1986).

23 Woolley, *Monetary Politics*, 31. See also Hammond, *Banks and Politics in America*, 708.

the groundwork for a national banking system wherein banks could be chartered under a federal statute, but the statute also restricted the power of the banks chartered under it.[24]

At the time, policymakers thought that the heterogeneous state banks would gradually disappear by converting their charters, thus being absorbed into the national system. When all banks had a national charter, there would be a common regulatory framework. To encourage the process, Congress placed a 10 percent federal tax on the circulation of state bank notes in 1866, and subsequent Supreme Court decisions outlawed state bank note issues. Many state banks did, in fact, convert.[25] In 1860, there were 1,562 state banks. After the National Bank Act tax was imposed, the number dropped to 247.[26]

However, the new national system had stricter supervision and less profitable opportunities for those who chose to operate within it. Moreover, it did not meet the country's need for adequate supplies, geographical distribution, and functional allocation of money. In the 1870s and 1880s, national banks could not make as much profit on notes because the yield on bonds eligible for note backing fell. Therefore, the amount of national bank notes in circulation fell by the 1880s, and the national banks' advantage in this area was a less significant factor in banking overall.[27] State banks got around the prohibition on issuing notes by making loans in the form of deposit credits and specializing in demand deposit, or checking, accounts.[28] In time, state legislatures began to charter increasing numbers of banks again. The result was that rather than uniting the system, the national charters divided it, particularly in areas that lacked the necessary capital to initiate national banks, such as the South after the Civil War and the West.

The birth of national banks and the issuing of greenbacks increased the supply of money that was needed for the war.[29] Nonetheless, increasing the supply of money can also have an inflationary effect and can benefit certain

[24] Eisner, Worsham, and Ringquist, *Contemporary Regulatory Policy*, 92. See also Cynthia Crawford Lichtenstein, "Lessons for 21st Century Central Bankers: Differences between Investment and Depository Banking," in *International Monetary and Financial Law: The Global Crisis*, ed. Mario Giovanoli and Diego Devos (New York: Oxford University Press, 2010), 220.

[25] Hoffman, *Politics and Banking*, 96.

[26] George E. Barnett, *State Banks and Trust Companies since the Passage of the National Bank Act* (New York: Augustus M. Kelley, 1969), 11.

[27] Kenneth Spong, *Banking Regulation and Its Purposes, Implementation, and Effects*, 4th ed. (Kansas City, MO: Division of Bank Supervision and Structure, Federal Reserve Bank of Kansas City, 1994), 17.

[28] Hoffman, *Politics and Banking*, 97.

[29] See Bensel, *The Political Economy of American Industrialization*, 133.

groups in a political system. Inflation benefits borrowers, because when a loan must be repaid, higher prices mean that the money buys fewer goods. Conversely, inflation hurts lenders because when a loan is repaid, higher prices mean that the money does not go as far. Since most borrowers at the time were farmers, they would be paid the higher prices for their products with inflation; they would not necessarily feel the same pain as those who could buy less when their money was repaid. Therefore, the greenbacks tended to be popular with groups that needed credit, such as farmers, and unpopular with lenders.

When the war ended, Secretary of the Treasury Hugh McCulloch began to retire the greenbacks to return to the use of specie and thus address the problem of inflation that issuing the greenbacks had created. However, this move was resisted the next year when western farmers, hit with large debts, wanted inflation rather than the deflation that accompanies a contraction in the money supply, as McCulloch's policy did. Congress therefore stopped retiring greenbacks and eventually left some in circulation. The issue persisted through the rest of the 1860s and 1870s. By 1878, the failure of national banks to meet the economic needs of the South and West convinced Congress that the government should not retreat from playing a role in monetary affairs. The Bland-Allison Act of 1878 signified the nation's permanent acceptance of the outstanding Civil War greenbacks and its preference for governmentally issued currency. The Act ordered the Treasury to purchase at least two million dollars' worth of silver bullion a month to be coined into silver dollars that were given legal tender status. Incidentally, most of this silver was coined but not placed into circulation.[30]

In the second half of the 1800s, a series of financial crises occurred about once every ten years. They would begin when banks would stop exchanging paper money for specie. When a crisis would occur, groups would form that perceived the solution to have favored others that already had wealth and power. By the end of the 1800s, many protest movements arose as reactions against industrialism, urbanism, and the gold standard that was favored by the East Coast. Agrarian interests thought that the Republicans had not gone far enough in regulating banks and asserting government control over the money supply. Democrats were divided on these issues. President Grover Cleveland got the Sherman Silver Purchase Act of 1890 through Congress, but a major debate over silver followed. In 1893, the stock market collapsed and then other prominent firms failed while there were two runs on banks. By 1894, the Treasury's gold reserves sank, and the administration had to sell bonds to maintain the gold standard.

[30] Ibid., 380.

John Woolley identifies three political and ideological traditions that took shape by the early twentieth century: Jeffersonian, laissez-faire, and Hamiltonian.[31] The Jeffersonian tradition was a "main street," or small town, agrarian strain that feared concentration of financial power and wanted government control of the money supply (prices) because the government was viewed as the only possible rival to the large urban banks. This group included Democrats and some Republicans. The laissez-faire strain comprised Midwest bankers of the Jacksonian era and after. Consisting of economists, academicians, the financial press, Protestant clergy, and educated middle class, this group came from both parties and wanted the federal government to *minimize* its role, with banks issuing paper money. The Hamiltonian tradition was politically dormant after the demise of the Second Bank of the United States. However, East Coast Republicans continued to seek a strong national economy with a national currency. The tradition reappeared during the Civil War with the passage of the National Bank Act and its renewed federal role in money and banking. After that time, this group sought a nationally focused, centralized banking system and alliance between government and finance that tilted power toward private banking interests.[32]

When William Jennings Bryan entered the debate, he sought to return control of the situation to the citizenry through the free coinage of silver. His famous quotation – "You shall not press down upon the brow of labor this crown of thorns. You shall not crucify mankind upon a cross of gold"[33] – refers to the fact that with the free coinage of silver, the money supply would have expanded and helped debtors and farmers who needed credit. Without free silver, they would suffer. Financial interests in the Northeast opposed the inflationary proposal. The agrarian interests that were largely debtors, miners in the West, and those in the South who still opposed the federal government role in the money supply, supported it. The Democratic Party, however, was split, contributing to its lack of popularity at the polls. The party's losses in national elections of 1894 and 1896 meant that with the exception of the Wilson administration, the Republican Party dominated national politics in the United States until the 1930s.

In sum, the Civil War and related creation of federally chartered banks gave rise to the "dual" banking system, meaning that parallel state and federal systems allow a diverse set of banking institutions the freedom to choose their regulator in the United States. This distinction continues

[31] Woolley, *Monetary Politics*.

[32] Discussion drawn from ibid.

[33] William Jennings Bryan, *The Cross of Gold* (Lincoln: University of Nebraska Press, 1996), 28.

today. As the two systems grew in tandem, state and national banks were chartered and supervised at different levels, with two regulatory structures. Regulatory differences *among* states also persisted. At different times in U.S. history, different advantages have accrued to banks holding either state or federal charters. Advocates of the dual banking system argue that it has encouraged innovation and dynamism both in terms of new products, such as checking accounts, adjustable rate mortgages (ARMs), and automatic teller machines, and in regulation. No one federal agency can veto an applicant for a state bank charter or engage in excessive regulation. Critics point out that the system fosters opportunities to evade regulation by choosing charters and regulators that advantage certain behaviors.

CREATING A FEDERAL RESERVE SYSTEM

The emerging national financial system at the close of the nineteenth century was fragmented by state banking charters, regulations, and the absence of a central bank. It was constantly subject to debates over the role of the federal government in the economy. It was intermittently patched together as a result of the needs of financing war. A series of crises following the Civil War prompted discussion and debate over what type of system might make the currency less prone to panic.

One early proposal emerged from the American Bankers Association in 1894. The centerpiece of the plan was a new currency that would be backed by bank assets (i.e., bank loans rather than gold or specie) and guaranteed jointly by banks against emergencies through a central fund. Many larger banks opposed this plan, and most bankers were preoccupied with stopping the free silver movement.[34] Congress considered the issue in 1907 and 1908 when another panic occurred. None of the various plans suggested received much support; nonetheless, a compromise drafted by Edward Vreeland and Nelson Aldrich was passed as the Aldrich-Vreeland Act, which attempted to initiate reform. The provisions of the Act were only used once, but it established a National Monetary Commission whose report provided detailed recommendations for the Federal Reserve.[35]

In 1914, there was an incipient banking panic in the run up to World War I that pointed to the need for a more central solution. This panic resembled the panic of 1861 because both had their origins in the outbreak of war: the Civil War in 1861 and World War I in 1914. In 1861, Southerners had wanted to liquidate their Northern assets. An association of banks in New York, which had formed a clearinghouse in 1853 to exchange checks,

[34] Woolley, *Monetary Politics*, 33.

[35] Ibid., 34.

coupons, and other certificates of value among themselves, pooled their reserves to address the crisis. In 1914, emergency currency was issued as authorized by the amended Aldrich-Vreeland Act. Moreover, the New York Clearing House banks issued clearinghouse loan certificates. Therefore, both panics were prevented as banks were willing to subordinate their own interests to nationalism.[36]

After the National Monetary Commission completed its investigation of European central banks, the Aldrich Plan, named for Senator Nelson Aldrich (R-RI), called for the establishment of a national reserve association to hold a portion of member bank reserves, determine discount rates, buy and sell financial instruments on the open market, and issue currency. However, the plan was doomed by the debate over the issue of the role of the banks versus the government in the institution to be created. Many feared that the plan would simply legalize the "money trust" that had come to dominate large industry.

Momentum shifted when the Democrats swept the 1912 election. Woodrow Wilson had reconciled the Democratic Party and began work on the issue immediately after he was elected. With Aldrich retired and William Jennings Bryan installed as Secretary of State, the initiative shifted from the Senate to the House of Representatives and Representative Carter Glass (D-VA), who was a Southerner and suspicious of the concentration of power of the federal government and Wall Street. The more conservative Glass preferred a decentralized, private system with fifteen regional banks that would be controlled mostly by bankers, albeit the president would make some appointments to a national board. The Senate plan, created by progressive Senator Robert Owen (D-OK), would have erected a system of reserve banks under the direct control of the government. Wilson leaned toward greater government control, whereas Glass leaned toward the bankers. Nonetheless, Wilson insisted. They reached a compromise formula that placed the central authority in a board appointed by the president.

At the time it was created, the bankers argued that the Federal Reserve was socialistic, revolutionary, and unconstitutional. Populists did not think that the new agency had enough government control. As initially created, the Federal Reserve did not solve the problem of concentrated financial power in the money trust that was still in private hands. The Democrats had assumed that the presidential appointments to the Federal Reserve Board

[36] Elmus Wicker, *The Great Debate on Banking Reform: Nelson Aldrich and the Origins of the Fed* (Columbus: Ohio State University Press, 2005), 44. For an excellent discussion of the international dimensions to the problem, see J. Lawrence Broz, *The International Origins of the Federal Reserve System* (Ithaca, NY: Cornell University Press, 1997).

would mean that banking and monetary policy conformed to the public good, not banking interests. However, some of Wilson's first appointments to the board were from Wall Street. Democrats also declared that Federal Reserve notes were to be obligations of government, but they did not set criteria for establishing the money supply or determining credit policy.

The problems of the division of authority among the Federal Reserve, Treasury, and regional banks persisted in the interwar period, exacerbating the distinction between New York as the capital of finance and Washington as the nation's political capital. Of the twelve regional Reserve Banks created, the New York Federal Reserve was the largest and came to dominate the system by virtue of its size and expertise. In the mid-1920s, the Federal Reserve Bank of New York (FRBNY) was two and a half times as large as that of Chicago and ten times greater than that of Minneapolis.[37] During the same years, the United States accumulated the greatest percentage of international gold reserves, far in excess of what it needed relative to the size of its economy. The Federal Reserve System went from being the central bank of the United States to being the central bank of the entire industrial world.

In the late 1920s, the institution operated as it had been established: the twelve banker-dominated regional Reserve Banks made decisions about the level of interest rates and credit conditions, while the central board in Washington oversaw their activities. Only the Reserve Banks could initiate policies, but they had to be approved by the board. Hence, there was a high degree of ambiguity in the system. The twelve governors, six political appointees, Secretary of the Treasury, and Comptroller of the Currency all competed for power. The board did not even have its own offices but worked in the Treasury building. Since salaries were lower than in the private sector, and even in the regional banks, the board did not attract competent employees.[38] When the FRBNY coordinated with European central bankers, its officials did not necessarily notify the board in Washington. The board took the view that it could veto the Reserve Banks' decisions but not force them to change policy. The board eventually tried to compel the Reserve Banks to follow the majority, at which time a conflict ensued. The Federal Reserve appeared to be paralyzed by the standoff between its principal arms.[39]

[37] Liaquat Ahamed, *Lords of Finance: The Bankers Who Broke the World* (New York: Penguin, 2009), 58.

[38] Ibid., 172–73.

[39] Ibid., 298–99, 322.

DEPRESSION-ERA REFORMS

The unresolved institutional problems within the Federal Reserve System came to a head in the Great Depression of the 1930s. The stock market collapse on "Black Tuesday," October 29, 1929, marked the opening event. Although the stock market recovered to early 1929 levels in April 1930, these levels were still 30 percent below its peak in September 1929, prior to Black Tuesday. Moreover, the turmoil triggered a series of banking panics and collapses that resulted in a sustained period of low expenditures and high unemployment for the next decade. The Depression reinvigorated the debate over the role of the federal government in the management of the economy because without government intervention, the private sector was not investing enough to raise production and pull the economy out of the recession. British economist John Maynard Keynes argued that under these circumstances, the government should step in by increasing spending or lowering taxes.[40]

Franklin D. Roosevelt's election ushered in the era of the interventionist state, wherein the federal government plays a much more active and extensive role in the national economy. In May 1933, the Senate Committee on Banking and Currency held a series of hearings to investigate how the catastrophe occurred. Named for the former prosecutor who was special counsel to the committee, Ferdinand Pecora, the Pecora Commission changed the public's image of Wall Street because it exposed what many individuals had done prior to the collapse. In one of the more famous exchanges, J. P. Morgan's son, Jack Morgan, concluded his testimony with the statement that he considered the private banker a national asset, not a national danger. Pecora almost immediately asked Morgan what was his business or profession. When Morgan answered that he was a private banker, the audience burst into laughter.[41]

The public spectacle of the hearings made possible new laws and regulations that would prevent a similar banking catastrophe. Among them, the Glass-Steagall provisions in the Banking Act of 1933 separated commercial banking from investment banking and created the Federal Deposit Insurance Corporation (FDIC) to insure bank deposits. The Securities Act of 1933 required that investors be given full and accurate information about the stocks and securities they were being offered. The Securities Exchange Act of 1934 created the Securities and Exchange Commission

[40] John Maynard Keynes, *General Theory of Employment, Interest, and Money* (London: Palgrave Macmillan, 1936).

[41] Anecdote as recounted in Alan Brinkley, "When Washington Took on Wall Street," *Vanity Fair*, June 2010, 160.

(SEC) to regulate stock exchanges, enforce the Securities Act, and lower the number of stocks bought on margin.[42] The Banking Act of 1935 reorganized the Federal Reserve System by removing the Secretary of the Treasury and Comptroller of the Currency from the board in Washington and establishing the Federal Open Market Committee (FOMC) as the seat of monetary authority that buys and sells government securities. Thus the ambiguity in the system was resolved by making the Federal Reserve a true central bank insofar as authority for all major decisions was vested in a restructured board, and the regional Reserve Banks could no longer conduct open market operations on their own. The FRBNY in particular lost much of its clout, although its president has a permanent seat on the FOMC.[43]

The Depression had stretched the limits of the new Federal Reserve System. The creation of a central bank had not solved the problem of banking panics. Economists Milton Friedman and Anna Schwartz argued that its lack of response to the banking crisis was the greatest cause of the Depression because the Federal Reserve failed to act as a lender of last resort, which would have prevented the collapse of banks throughout the system.[44] Unlike the Keynesian emphasis on managing demand in the economy through government spending and taxes, Friedman and Schwartz argued for an emphasis on government action through management of the money supply.

THE TREASURY–FEDERAL RESERVE ACCORD

As we have seen, the Treasury was one of the first agencies established after the American Revolution. The Federal Reserve is a product of the early twentieth century. It came into existence after a protracted struggle over the issue of national currency and debate over the question of the appropriate role of government in the financial system. Its institutional role and governance structure were refined along the way. Given when each institution was created and the way they developed subsequently, the Treasury and Federal Reserve have some similar and overlapping responsibilities, particularly in the area of bank regulation. The FDIC and SEC came about as a result of Depression reforms. The relationships among all of the institutions have evolved as the functioning and operations of the Federal Reserve have changed. While the Federal Reserve was designed to be "independent"

[42] O'Connor and Sabato, *American Government*, 660.
[43] Ahamed, *Lords of Finance*, 475.
[44] Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton, NJ: Princeton University Press, 1971).

of politics, notions of how that independence would play out within the institutional context of the American government have changed as well.

After the Depression-era reforms, U.S. economic policy was directed at the paramount goal of financing and supplying the country in World War II. The Federal Reserve shared the aims of the Treasury in meeting the requirements of war finance. Moreover, the Secretary of the Treasury was a member of the "inner council" of the Roosevelt administration during the war. These two met daily, whereas the Chairman of the Federal Reserve met with Roosevelt once or twice a year. When disagreements occurred between the Treasury and the Federal Reserve, the Chairman generally deferred to the Secretary, in part because the Federal Reserve did not consider itself to be a "regular" department of the U.S. government, and in part because there was the sense that the institution would not win.[45] Were the Federal Reserve to conflict openly with the Treasury and the administration, there was always the ultimate possibility that Congress could alter or abolish the entire system.[46]

Wars are usually followed by bursts of inflation, and there were concerns that this would occur after World War II. Once it ended, a substantive conflict emerged between the two agencies over the conduct of monetary policy. The chief concern of the Treasury was to maintain confidence in government debt. The Treasury borrows money by issuing bonds, and the price of bonds rises and falls in an inverse relationship to their yields (i.e., interest paid). When yields rise, the price of bonds falls; in this case, investors would lose confidence in them, which would complicate refunding the government's debt. Conversely, the Federal Reserve was concerned with managing inflation after the war. Inflation could only be managed if the Federal Reserve loosened its commitment to maintaining a stable, low yield (i.e., high price) for Treasury securities.

When the Korean War commenced in mid-1950, the new war and the new presidential administration changed the equation. While President Harry Truman was sympathetic to the Treasury's concerns that the price of government bonds be maintained, the rising rate of government spending would have produced inflation unless the Federal Reserve dropped its commitment to a particular pattern of interest rates. Investors who had purchased government bonds out of patriotism would feel cheated if their value declined when interest rates rose; however, the Federal Reserve could not expand the money supply indefinitely to maintain those rates and curb inflation. Truman became actively involved in 1951 by meeting with the FOMC.

45 George Leland Bach, *Federal Reserve Policy-Making: A Study in Government Economic Policy Formation* (New York: Alfred A. Knopf, 1950), 144.

46 Ibid., 147.

The issue was resolved with the Treasury–Federal Reserve Accord of 1951 that eliminated the obligation of the Federal Reserve to monetize Treasury debt at a fixed rate. In terms of the analysis of bureaucratic politics, the Accord expanded the independence of the Federal Reserve in setting monetary policy since it gave the Federal Reserve tighter control over the money supply relative to Treasury. The trend toward the independence of the Federal Reserve was reinforced after 1953 when the Eisenhower administration was even more sympathetic to the Federal Reserve's concerns about inflation. After that time, the central bank's policy moved away from supporting the price of public debt and toward having to "lean against the wind" and counteract cyclical variations in money and credit with the goal of price stability. However, both Treasury and the Federal Reserve each retained an ability to regulate some banks.

GLOBALIZATION AND BROADER CITIZEN PARTICIPATION IN THE FINANCIAL SYSTEM

By the 1970s, many of the regulatory structures established in the Great Depression began to erode as a result of the opening of international capital markets and inflation, which emerged once again as a serious political issue. Inflation in the 1970s was not the worst ever experienced in U.S. history; however, in previous episodes, an inflationary cycle was followed by deflation. After World War II, the deflationary periods ended. Moreover, practices in the banking industry changed. As banks sought to grow their resources, they preferred to manage their liabilities by purchasing a deposit base with large certificates of deposit (CDs) and Eurodollar deposits of $100,000 and above, and then making loans. Banks' relationship with their customers changed as they expanded their customer base to include the larger deposits. Customers' relationship with banks changed as they sought higher rates of interest to protect their savings in the inflationary environment, as well as new mechanisms with which to finance their homes and make other large purchases.

Domestic politics also changed the equation, particularly those associated with the civil rights movement and the legacies of government housing policies that had distorted lending practices toward some neighborhoods and away from others. Chapter 3 will detail how the U.S. mortgage industry evolved as a product of post-Depression federal market intervention. Suffice it to say here that the history of discriminatory lending in American cities pre-dated the New Deal. Nonetheless, in the 1930s, the federal government became directly involved when the Home Owners' Loan Corporation developed a set of color-coded maps that used racial criteria to categorize lending and insurance risks. Eventually, banks, insurers, and the

Federal Housing Administration adopted the maps and practices to guide lending and insurance decisions and to assess locations for new housing construction that would be federally insured.[47] In later times, what came to be called "redlining" has referred to practices wherein banks would lend to lower-income white customers but not to African Americans, deny banking and insurance services to residents in certain areas that were often racially determined, or charge higher costs to these residents. In the 1970s, the legacy of redlining added to the concern that banks were not making loans in inner cities so that they could make the large, profitable, international ones.[48]

Inflationary market pressures, more sophisticated forms of regulatory arbitrage in international markets, and distortions from domestic government action in the past thus contributed to political pressure for the passage of two major pieces of legislation that altered citizen and bank participation in the financial system. First, the Community Reinvestment Act (CRA) placed demands on regulators and regulated institutions to see to it that loans are made where the institution is chartered. Next, the Depository Institutions Deregulation and Monetary Control Act of 1980 (also known as DIDMCA or the Monetary Control Act of 1980) reshaped the role of the Federal Reserve within the agencies of the federal government and commenced the process of deregulation of the industry overall.

Community Reinvestment Act

During the presidency of Jimmy Carter in 1977, Congress passed the CRA to encourage lending and the extension of financial services to some U.S. communities. The Act requires the appropriate federal financial supervisory agencies to encourage regulated financial institutions to meet credit needs of the local communities in which they are chartered, consistent with safe and sound operation. To enforce the CRA, the agencies examine banking institutions for compliance, as well as consider compliance when the bank applies for permission to open a new branch or to undertake a merger or acquisition.

Although the CRA only applies to deposit-taking, insured institutions, it has been highly controversial from the start. Its detractors regard it as

47 See "Redlining," *Encyclopedia of Chicago*, http://encyclopedia.chicagohistory.org/pages/1050.html (accessed February 2, 2012).

48 See the series of Pulitzer prize–winning articles written on housing finance in Atlanta titled "The Color of Money" by Bill Dedman in *The Atlanta Journal-Constitution*, first published May 1988. Of particular interest at the national level was Dedman's piece "Blacks Turned Down for Home Loans by S&Ls Twice as Often as Whites," January 22, 1989, A1. Series consulted at http://powerreporting.com/color/53.html (accessed June 13, 2011).

credit allocation and as the most burdensome federal regulation with which banks must comply. Its supporters view the CRA as a trade-off for banks in exchange for government support in other areas such as FDIC insurance, or the lender-of-last-resort function of the Federal Reserve. Many of the immediate controversies arose from its implementation. Regulators use points to grade large retail institutions according to three tests: lending, investment, and service. The examination ends with a rating and written report that becomes part of the supervisory record for that bank. Although the law emphasizes that an institution's CRA activities do not require it to make loans that would bring loss to the institution, its detractors argue that in passing it, the federal government intervenes into the lending criteria of individual banks. Because compliance with the CRA has been cited as a factor in the rise of the subprime market for housing, later chapters will show that it has likewise been argued to have contributed to the crisis of the early twenty-first century.

Inflation and the Recession of the 1980s

Many of the Depression-era reforms became obsolete in the new environment for finance of the 1970s and 1980s, leading to a reconfiguration of institutions and regulations. Section 11 of the Banking Act of 1933 had prohibited member banks from paying interest on demand deposits or checking accounts. Regulation Q – the rule that implemented the Banking Act in the 1930s – limited the rate of interest that banks could pay on savings and time deposits. By the 1970s, Regulation Q provided an incentive for banks to construct accounts that could evade it, such as money market accounts, that paid more interest. As banks worked around the national and international regulations, the Federal Reserve's control over the money supply was diminished.

When interest rates rose at the end of the 1970s, the effects did not fall evenly across the American population, depending on one's status under the U.S. tax code. Whereas everyone can deduct interest payments, corporations saved 46 percent of their interest costs through their tax bill in the form of allowed deductions. Wealthy individuals saved 50 percent or 70 percent, if all of their income was from stocks and bonds. Others had nothing to deduct, particularly if their business was not doing well and showed little or no income. Therefore, some paid the full amount; others, depending on their tax bracket, could deduct portions of their interest payments from taxes. Greider argues that this system was a kind of credit rationing, but credit rationing by price and not fiat.[49] Banks made commitments (for

[49] Greider, *Secrets of the Temple*, 138.

a fee) to their corporate customers, thus raising their loan commitments. This limited the supply of money available. Available credit flowed to the top.

When Paul Volcker took over as Chairman of the Federal Reserve Board in 1979, he commenced an attack on inflation by cutting the money supply. Interest rates rose further, and eventually unemployment rose with them, creating a politically difficult situation for President Jimmy Carter, who had appointed him. Inflation was lowered, but the Federal Reserve became a political target among those who felt that the costs had not been born equally across the American economy.

During these years, the Federal Reserve encountered a different type of problem in its relations with its member-banks. In 1978, the number of banks in the Federal Reserve System was in decline. To stay in the system, a bank had to maintain its balance at the Federal Reserve, where it was not paid interest. State banking regulations required fewer reserves, and banks could maintain their deposits at a correspondent bank where they would be paid through income-producing securities. As a result, banks continued to leave the Federal Reserve System. It is an open question as to whether it matters how many banks are members of the system, because the Federal Reserve still remains the only source of money creation. The largest banks would most likely not have left.

Nonetheless, in 1980, Congress passed the Monetary Control Act in part to address this issue. The Act mandated all depository institutions, including savings and loans (S&Ls) and credit unions, to maintain their reserves at the Federal Reserve. The effect of this law was to protect the Federal Reserve's national political base that benefited from lobbying by banks and businesses associated with the regional Reserve Banks.[50] The Act also extended the benefits of Federal Reserve membership to all banks, which were now forced to comply with the same reserve requirements. Thus it lowered the distinctions between state and federal banking regulations in the dual banking system because it gave the Federal Reserve more authority over nonmember banks than it had held previously. However, it did not end the parallel framework. Moreover, the Monetary Control Act began the overall deregulation of the industry by starting to phase out interest rate ceilings on personal checking accounts that had been set by Regulation Q and commencing competition among depository institutions for asset growth.

The Monetary Control Act was followed in 1982 by the Garn-St. Germain Act, which broadened the types of loans and investments that thrifts could make. Garn-St. Germain permitted banks and thrifts to issue

[50] Ibid., 157.

interest-only, balloon payment, and ARMs, even where state law prohibited these types of loans. With a balloon mortgage, the borrower has lower payments for a number of years but must then pay the rest in a lump sum at the end of the period. The lower initial payments are attractive to borrowers who anticipate that their financial position will improve and that they will be able to make the final payment. They are risky, however, because the sum is due when the balloon expires, and refinancing terms might be prohibitive. Floating mortgage rates effectively transferred the risk of interest rate fluctuations from lenders to borrowers because if prevailing market rates changed during the term of the loan, the borrower would pay more or less, and the bank would receive the market rate.[51]

The initial moves toward deregulation of the banking industry thus resulted in an expansion of the number and types of loans available to consumers. It also resulted in excessive asset growth in some institutions, with a mismatch between assets and liabilities. Later in the decade, when banks and thrifts made riskier loans, housing bubbles developed in Texas and California. When the bubbles burst, approximately 3,000 commercial banks and thrifts failed. By 1994, one-sixth of all federally insured depository institutions either closed or required financial assistance. In what came to be known as the "S&L crisis," over 1,000 bank and S&L executives were convicted of felonies associated with the events.[52]

Therefore, the long-term effects of the Monetary Control and Garn-St. Germain Acts are debated along with those of the CRA. Nonetheless, deregulation efforts progressed. The decisive dismantling of Depression-era banking regulations would come later with the Gramm-Leach-Bliley Act in 1999, which repealed part of the Glass-Steagall Act of 1933. However, important components of this later bill clarified the requirements of banks under the CRA and attempted to allow U.S. financial services firms to compete with their European counterparts by opening up the market among banking companies, securities companies, and insurance companies. The legislation of the 1970s and 1980s is significant because it changed the shape of the banking industry, as well as the federal government agencies that operate around it.

CONCLUSION

Unlike most other countries, the United States has always had "anti-bank" elements within its ranks, intrinsically connected to broader struggles over

[51] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, Authorized ed. (New York: Public Affairs Reports, 2011), 34.

[52] Ibid., 36.

the centralization of political and economic power. This anti-bank sentiment extends to the origins of the United States and its economic relationship with the larger British economic system. At first, the political power of foreign investors, chiefly British, was resented. When Jackson vetoed the renewal of the charter for the Bank of the United States, he cited his opposition to the profits that non-American investors had earned. Representatives of British interests paid bribes to American politicians, which prevented any significant political action against foreign investors.[53] Later, Populists resented the Anglo-American establishment House of Morgan because it controlled the nation's money supply and could determine the prospects of many businesses. Thus the disputes were not just over who would have power over money, but over who would have power at all.

Although we do not usually think of it in these terms, debates over money and banking have played such an important role in U.S. political history that they crystallized the alignment of the first modern mass political parties and shaped the institutions of finance themselves.[54] The first political parties appeared in the Washington administration over the debates concerning the First Bank of the United States. Mass political parties took shape after the War of 1812 with the Second Bank of the United States. When the charter lapsed and the United States lacked a central bank, the silver debate took place alongside the rise of the Republican Party and the gold standard. When the Democrats regained power with Woodrow Wilson, the Federal Reserve was established as a compromise within the Democratic Party.

This chapter has shown that the disjoined evolution of the national U.S. financial system characterized by intermittent experiments with central banking, regional variation in financing patterns, and diverse political interests thus reflects the broader American struggle between state and private enterprise as government institutions have responded to demands for change in a series of crises. Wars in particular have exposed the mutual needs of the state and private enterprise; however, vestiges of the past remain in the present in the form of entrenched bureaucratic interests that work to preserve the status quo. Most debates over the role of government in the industry are not new; they result from continued innovation in the industry, crisis, regulation, and renewal.

53 Walter Russell Mead, *Special Providence: American Foreign Policy and How It Changed the World* (New York: Alfred A. Knopf, 2001), 17.

54 Richard T. McCulley, *Banks and Politics During the Progressive Era: The Origins of the Federal Reserve System, 1897–1913* (New York: Garland, 1992).

3

Creating Increasingly Complex Financial Products

The U.S. government does not own banking and financial services companies directly; it regulates them extensively and channels funds to them through a variety of mixed public-private organizations created at different junctures in the country's history of industrialization and war. This chapter thus completes the historical review from Chapter 2 by asking how the *market* interacted with the evolution of state capacity in the area of money and credit. It shows how distinct market niches grew up within regulatory boundaries and within which financial services firms operated and earned profits.[1] Chief among the regulatory niches created were those for commercial banks, thrifts, credit unions, and securities dealers. Over time, market innovation and external forces such as war, trade imbalances, and growing competition from international banks put pressure on the old boundaries to change. Competition opened up among participants where they had previously been separated by law. Regulations and federal agencies with clear governing authority over these new vehicles were now mismatched with the financial reality on the ground. Thus the onward march among institutions, the regulations they create, and the market's innovative response to them have expanded access to credit and at the same time created the political circumstances that lead to crises.

This chapter therefore turns to the market side of the state-market equation. It asks this basic question: What is in the financial services industry for the federal government to regulate? It begins by exploring the role of deposit-taking commercial banks and other financial intermediaries.

[1] Marc Allen Eisner, *The American Political Economy: Institutional Evolution of Market and State* (New York: Routledge, 2011), 182.

It then explores how financial markets have responded to regulatory change through product innovation in financial instruments, which in turn create the need for new regulations and access to finance and frequently contribute to crises. Since the greatest need that most Americans will ever have for credit is to purchase a home, most of the innovations explored here originated in industry and surround the availability of mortgage finance. As Mark Eisner has argued, from the New Deal reforms to the 1970s, regulations segmented industries that were defined by the products and services that each offered.[2] As the banking industry deregulated, the specialized markets intermingled in the informal, or "shadow," industry that grew up around the traditional depository intermediaries.

The result was that many newer, higher-risk groups of people gained access to mortgage finance. It was provided from the shadow industry comprising investment banks and other entities that do not take deposits, where profit margins are much higher. However, there is an intrinsic connection between the shadow banking system and the formal system because both systems play a role in financial intermediation. The collapse of one threatens the collapse of the other. This systemic risk creates the problem of entities that are "too big to fail" and the accompanying political problem that society has needed to bail them out in several episodes. The connections among political institutions, regulation, financial innovation, and crises explored here will serve as a context for later discussion of the specifics of the financial crisis of 2008, as well as their resolution, within the broader context of American political economy.

DEPOSIT-TAKING FINANCIAL INTERMEDIARIES: BANKS, THRIFTS, AND CREDIT UNIONS

Although the financial services industry has changed in recent years, banks have served as the traditional deposit-taking financial intermediaries. An intermediary is a go-between for borrowers and lenders. Without banks, those of us who needed to buy a car, buy a home, or finance college would either need to save the money in advance or get it from our immediate circle of friends and relatives. Most of us would most likely not be able to do so because we only have a limited set of people who would be willing, and we would all have wildly different time frames. The person making the purchase needs the money at a certain time, and the one lending it needs it back at another. Therefore, because banks bring together so many borrowers and lenders, they can match people's borrowing and savings needs to expand the amount of credit and savings available to everyone. In

[2] Ibid.

other words, someone who needs to borrow money can get it at a particular date, for a particular period of time, and at the lowest possible cost. By lending through a bank, someone who wants to lend money minimizes risk, minimizes costs of finding a borrower, and is able to convert a loan back into cash if cash is needed on a different time frame.[3]

Because most people do not need their savings at any given time, banks only keep a percentage of it and lend out the rest. A bank earns a profit on the difference between what it pays out in interest and what it earns on the interest from its loans. Therefore, it has an incentive to lend out as much as it can to maximize the amount it takes in. As part of the process of lending a fraction of what depositors leave in deposits, money is created. Money multiplies because the percentage the bank lends out is eventually redeposited in another account, and a percentage of that is lent out again. Thus as each portion is lent and re-lent, it grows at a mathematical rate of the inverse of the reserve requirement (or the percentage the bank keeps on hand for depositors). Economists call this process the "money multiplier." No new paper money is actually created. When the loan is paid back, the money disappears from the system. An economic system needs banks to perform this function because they match the time frames among individuals participating.

Economic systems also need banks because they offer people a way to pay their bills, or provide a "payment system." Most people do so by writing checks against their checking accounts or by using debit cards. In the modern era, people also pay their bills with automated payments like direct debits and standing orders. They can also use credit cards.[4] Then at the end of the month or billing cycle, they only have to make one payment for many bills. Customers pay banks to perform these services for them either directly through fees on accounts, indirectly by maintaining large balances that allow the bank to earn interest, or on fees charged to merchants when they make credit card purchases. Banks need these fees because, like any business, they need to earn a profit for their shareholders.

The balance sheet of a bank is relatively straightforward. As with any balance sheet, assets are equal to liabilities plus equity. A bank's assets are its loans where it earns a return through interest; its reserves and cash on hand; and whatever buildings, property or other investments it owns. Its liabilities are its deposits from customers because it must return their

[3] See Barbara Casu, Claudia Girardone, and Philip Molyneux, *Introduction to Banking* (London: Pearson, 2006), 5. For more detailed examinations of financial institutions, see Meir Kohn, *Financial Institutions and Markets*, 2nd ed. (New York: Oxford University Press, 2004); John K. Thompson, *Securitisation: An International Perspective* (Paris: Organisation for Economic Co-Operation and Development, 1995); Roy C. Smith and Ingo Walter, *Global Banking* (New York: Oxford University Press, 1997).

[4] Casu, Girardone, and Molyneux, *Introduction to Banking*, 26.

money if asked for it. The difference between the bank's assets and liabilities is bank capital, or equity. As with any company, banks can increase the amount on the liability side of the balance sheet (raise capital) by issuing stock (ownership shares that do not need to be repaid) or selling bonds (which are essentially IOUs). Usually, however, a bank's money comes from deposits.[5] When a loan goes bad, the bank loses an asset. Because assets and liabilities are equal, if too many loans go bad at the same time, the bank runs the risk that it will not have enough money in cash on hand or reserves to cover its deposits or repay its bondholders (liabilities). As with other firms, a bank is insolvent if it cannot meet its debts as they come due. A bank has "balance sheet insolvency" if its liabilities exceed its assets (or equity is a negative figure).

Housing poses a particular problem for banks because the loans are large and paid back over a long period of time by individuals whose credit profile might change dramatically. However, they are very important in consumer financial markets because the purchase of a home is the largest investment most ordinary Americans will make and thus presents their greatest need for credit. Because the majority of Americans use money from loans to pay for their home (as opposed to paying cash), they pay interest on the loans that drive up the cost of the house even when the rate is low. Housing construction is therefore one of the most sensitive sectors of industry to interest rates because a small rise in interest rates could raise the monthly payment on a thirty-year fixed-rate mortgage so high that some buyers will not be able to purchase the home. The sensitivity means that if rates rise, the builder must lower the price of the home (and receive less profit on its construction), or buyers must pay more each month (and perhaps buy a smaller home to compensate for the higher interest rate).

Despite these problems with finance, home ownership has been an important component of most conceptualizations of the American Dream. When housing was not well served by banks, a unique type of financial institution – the savings and loan (S&L), or thrift – met the need. The first American thrift was organized in 1831 when a group of individuals outside Philadelphia created the Oxford Provident Building Association along the lines of the mutual building societies in England. Each member paid $5 a share and $3 a month thereafter. Later in that year, the association was able to provide the first mortgage to a local lamplighter; it eventually provided funds to all members who wanted funds and then dissolved.[6]

The industry grew. By the late 1890s, more than 5,000 savings associations existed, mostly consisting of individuals in the same neighborhoods

[5] Ibid., 21.
[6] Hoffman, *Politics and Banking*, 152.

or employed by the same firms. As Americans moved to cities, the demand for housing grew, and by the 1920s, there were about 12,000 savings institutions. The safety of the institutions and the modest returns they offered attracted depositors who did not necessarily want to buy a home. Although the industry suffered in the Great Depression, the advent of deposit insurance and the building boom after the war further encouraged their growth in the postwar years. By the 1950s and 1960s, thrifts originated about two-thirds of U.S. mortgages, and the institutions held more than 80 percent of their assets in home loans.[7]

Despite the rather high interest rates that individuals have historically paid, the introduction of long-term, thirty-year fixed-rate mortgages allowed potential homeowners to stretch out the interest and principal payments so that they could make these large purchases through the development of the thrift industry. Although these institutions were organized primarily to take deposits and provide mortgages, they earned a profit because there was a comfortable margin between what they took in as interest payments and paid out to depositors. Regulations led to the jocular "3-6-3 rule," wherein bankers paid 3 percent interest, charged 6 percent on loans, and were on the golf course by 3:00 in the afternoon.

Other financial products appeared that also met specific consumer needs. For example, some hotels had offered credit cards to their regular customers as early as 1900. But the need to purchase manufactured goods such as cars and washing machines brought other providers of finance into the marketplace. By 1914, gasoline companies and large retail department stores issued credit cards to some customers. At first, the cards were essentially a way to run a tab with a business because the balance had to be paid in full each month. Then, credit cards offered the option of paying in installments with interest accruing to unpaid balances. Later innovations allowed one card to be used at many businesses. Thus competition came to this industry as well. By the 1950s, commercial banks had entered the credit card business.[8]

Prior to the deregulation of the 1970s and 1980s, different types of business offering finance to consumers had unique missions and cultures that developed within them. Hoffman argues that the regulatory frameworks for financial intermediaries can be associated with when they appeared in American history and with the political philosophy that enabled their

7 See Department of the Treasury, Office of Thrift Supervision, http://www.ots.treas.gov/?p=History (accessed March 16, 2010).

8 Alan Greenspan, "Consumer Finance," remarks at the Federal Reserve System's Fourth Annual Community Affairs Research Conference, Washington, DC, April 2005, http://www.federalreserve.gov/BoardDocs/speeches/2005/20050408/default.htm (accessed December 14, 2011).

establishment.[9] Along these lines, Lichtenstein offers two types of financial business that may be distinguished from each other with very different origins: depository banking and investment banking.[10] Within the first category, depository banks take deposits from the public and lend them to productive enterprise. Their culture could best be described as boring and safe. Nonetheless, the mission of banks was to maximize profit for themselves and the businesses they financed. S&Ls, or thrifts, likewise take deposits. Their mission was to allocate money to support home ownership, viewed as an individual and societal good. Finally, credit unions are another type of depository institution that are owned and controlled by their members. The historical mission of credit unions was to provide individuals with control of their own money for their own purposes.[11] In the second category apart from depository banking, investment banks were primarily engaged in the business of selling, trading in, investing in, and underwriting securities. Their internal culture was characterized by risk taking. However, because they were organized as partnerships with the partners' own capital at risk at the time, they had an inherent interest in limiting their overall leverage.

FEDERAL GOVERNMENT EXPANSION INTO HOUSING FINANCE

From the 1800s until the Great Depression, the system of housing finance was particularly fragmented, inefficient, and illiquid. Mortgage rates varied by region, and some regions lacked funds completely. A bank or thrift would issue a mortgage, collect payments, and keep the mortgage on its books until the principal was completely paid. The lack of capital limited the number of new mortgages that could be written. The situation changed as home ownership became a societal goal embraced by politicians on both sides of the aisle. The entrance of the federal government to promote this policy goal would reshape financial markets by channeling funds to individuals for a specific purpose.

President Herbert Hoover was a pioneer in linking home ownership to the collective good and in redesigning the financial infrastructure to promote it. He believed that owning one's home made for happier married life, better children, confidence and security, courage to meet the battles of life, and better citizenship. He argued that the democratic foundations

[9] Hoffman, *Politics and Banking*, 225.

[10] Lichtenstein, "Lessons for 21st Century Central Bankers," 229.

[11] Credit unions met the needs of average people for small amounts of borrowing, such as loans to pay a doctor bill or groceries when a wage earner was incapacitated. At the time, small loans operated outside of the law and charged exorbitant interest rates. The circumstances were known collectively as the "small loan evil." See Hoffman, *Politics and Banking*, 190.

of the United States could not be threatened from homeowners, no matter how humble they might be.[12] As Secretary of Commerce, he established the Division of Building and Housing to foster a public interest in home ownership and later proposed a broad mortgage rediscount bank. He received little support from the major financial institutions or Congress for it and was forced to scale it back. As president, however, Hoover was successful in establishing the Federal Home Loan Bank (FHLB) system – a new institution with twelve regional banks throughout the country that would channel money to financial institutions on the collateral of their home mortgages and enable them to meet pressure from deposit withdrawals, refinance mortgages, and make new ones.[13] The FHLB would thus boost the market for new and existing homes.

The FHLB was not without controversy. Opponents to the Federal Home Loan Bank Act argued that it would encourage individuals to buy homes who should not be buying them. Moreover, it would encourage overbuilding in the housing industry. Opponents claimed that the standard, straight mortgages available at the time were enough.[14] Nonetheless, a collection of interest groups, including individual associations, state leagues, real estate boards, and the U.S. League, helped the administration to draft the initial legislation for the Act. They gathered requested data for the congressional committees and organized telegram campaigns in support of it. When passed in 1932, the Act established the FHLB Board to charter and supervise federal S&Ls. It also created FHLBs to lend to them. However, shortly after it was passed, the Senate held hearings to repeal it. The new banks were perceived as aiding financial institutions without helping individuals hit hard by the Great Depression.[15]

When Franklin Roosevelt assumed the presidency after Herbert Hoover, the New Deal reforms that created a regulatory structure for the banking sector likewise encouraged home ownership and sought to make capital available to Americans who needed it. Notably, the Roosevelt administration created the Federal National Mortgage Association (Fannie Mae) in 1938 to create a liquid secondary mortgage market that would make it possible for loan originators to issue more housing loans once they sold the initial loan to Fannie Mae.

The weakness of the Depression-era system was that Fannie Mae bought mortgages with borrowed money, which appeared on the books of the

[12] Ibid., 151.

[13] For an extensive study of the FHLB system, see Susan M. Hoffman and Mark K. Cassell, *Mission Expansion in the Federal Home Loan Bank System* (Albany: State University of New York Press, 2010).

[14] Hoffman, *Politics and Banking*, 166.

[15] Ibid., 168.

federal government. In 1968, the Johnson administration and Congress reorganized Fannie Mae as a publicly traded corporation to move the debt off of the government's balance sheet. They also created a new government entity, the Government National Mortgage Association (Ginnie Mae) to take over Fannie Mae's subsidized mortgage programs and loan portfolio. In addition, Ginnie Mae guaranteed pools of Federal Housing Administration (FHA) and Veterans Administration mortgages. The new Fannie Mae purchased federally insured mortgages as a "government-sponsored enterprise." In 1970, Congress chartered the Federal Home Loan Mortgage Corporation (Freddie Mac) to help thrifts sell their mortgages.[16]

A government-sponsored enterprise (GSE) operates as an instrumentality of the government and not as an agency, albeit they are referred to as agencies colloquially. Control of a GSE is very different from control of an agency because the latter is managed directly through the federal management hierarchy. An agency is subject to federal appointment of its senior officers, civil service and federal procurement laws, and federal budget and other direct federal management controls. An instrumentality is not subject to these same laws. Fannie Mae and Freddie Mac operated as private firms after 1968. In exchange for perks such as immunity from taxation, a GSE cannot change its own charter or conduct activities contrary to its intent.

Fannie Mae and Freddie Mac were thus significant innovations in the lending structure of the U.S. banking industry because they were neither public nor private, but GSEs with a mission to provide liquidity, stability, and affordability to U.S. housing and mortgage markets. Therefore, whereas they were technically private firms in the heyday of their lending in the 1990s, there was always an implied government backing to their activities because they were not completely distinct from it.[17] At that time, one of their chief executives boasted that Fannie Mae and Freddie Mac were the equivalent of a Federal Reserve system for housing.[18] This means that before the Treasury placed them into conservatorship in 2008, the GSEs were supervised but not directly managed by the federal government.[19]

[16] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, 38–39.

[17] See, for example, David Reiss, "The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab," *Georgia Law Review* 42 (2008), 1019-83.

[18] Andrew Ross Sorkin, *Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System and Themselves* (New York: Penguin Books, 2010), 186.

[19] Kevin R. Kosar, *Government-Sponsored Enterprises (GSEs): An Institutional Overview*, (Washington, DC: Congressional Research Service Report for Congress, 2008), 3. With conservatorship, the companies would still be traded publicly but with the government as a trustee exercising control.

These activities grew and changed over the years. Initially, Fannie Mae held a near monopoly on the secondary mortgage market. Later, the GSEs provided liquidity to local lending markets by buying mortgages from S&Ls and then selling them in mortgage-backed securities (MBS), or mortgage pass-throughs. With a pass-through, the mortgages are transferred to a trust, which in turn issues certificates representing a slice of the principal and interest it receives. Ginnie Mae was the first to securitize mortgages in 1970. Large investors found pass-throughs problematic because mortgages did not fall neatly into a high- or a low-risk category of investment. They were not quite safe enough to be rated AAA – the top-rating bond rating that agencies give – however, they did not yield the amounts that high-risk investors want for investments with lower ratings. The payment streams from mortgages were monthly, whereas bonds would pay interest only twice a year. Finally, home mortgages have uncertain maturities. When interest rates fall, homeowners refinance. If interest rates rise, they do not. Therefore, while the homeowner has options, an investor can lose returns if the maturities shift unexpectedly.[20] Nonetheless, Freddie Mac began selling MBS in 1971. Fannie Mae followed after a spike in interest rates in 1981 that caused large losses on its portfolio.[21]

In 1992, a Democratic-majority Congress passed, and Republican president George H. W. Bush signed, legislation that required the GSEs to purchase a certain number of mortgages that had been made to low-income individuals. At this point, Fannie Mae and Freddie Mac had changed definitively from being agencies that *bought* individual mortgages and held them, to agencies that bought and *securitized* mortgages, to agencies *purchasing securities* composed of subprime mortgages to comply with the new congressional mandate. While it remains an open question what Fannie Mae and Freddie Mac would have done in the absence of the 1992 legislation, the political connection to their operations in the years that followed was undeniable. They became notable places for ex-politicians from both parties to work. Each had boards that were well represented by Democrats and Republicans alike. Hence, they were not staffed by individuals whose primary expertise was financial.

In brief, Fannie Mae and Freddie Mac operated as private firms and made money for their shareholders in two ways before being placed into government conservatorship in 2008. The first was through the fees that they were paid to guarantee against the risk of mortgage default. They did not guarantee all loans but only those that conformed to certain size

[20] Charles R. Morris, *The Trillion Dollar Meltdown: Easy Money, High Rollers, and the Great Credit Crash* (New York: Public Affairs, 2008), 38.

[21] Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Report*, 39.

and credit limits, notably not jumbo loans (then defined as loans of more than $417,000). As discussed, they repackaged these loans as MBS and sold them to investors who did not want to have to assess each and every mortgage, but wanted to buy bundles of mortgages, viewed as stable long-term investments. The second way that Fannie Mae and Freddie Mac made money was by repurchasing their own securities, as well as similar ones created on Wall Street, and holding them in their own portfolio. Since Fannie Mae and Freddie Mac's status allowed them to borrow at low rates, they could earn a profit on the difference between the low cost of borrowing and the higher amount the mortgages yielded. This second source of revenue was approximately three-fourths of the total generated for Fannie Mae and Freddie Mac when they were held privately.[22] The latter source was far more controversial because it generated profits for shareholders, but did not necessarily put people into homes.

As their size and influence grew, the GSE's activities raised concerns. They are among the largest financial institutions in the United States and thus constitute a large percentage of systemic risk. They were formerly regulated by the Office of Federal Housing Enterprise Oversight (OFHEO) inside the Department of Housing and Urban Development (HUD), an agency with no experience in regulating financial services companies. Moreover, unlike the other regulators that will be discussed in Chapter 4, the OFHEO was subject to the congressional appropriations process, meaning that its funding was at the mercy of politicians. Not surprisingly, it was a weak regulator.[23]

In addition, the GSEs were controversial because they were plagued with a series of scandals. In 2003, Freddie Mac was fined for understating earnings by $5 billion. Fannie Mae and Freddie Mac spent $175 million on lobbying from 1998 to 2008. Their employees gave political action committees nearly $5 million in contributions since 1989. Before being taken over, Fannie Mae had thirteen lobbying firms on its payroll and Freddie Mac had thirty-three. In 2006, the Federal Election Commission fined Freddie Mac $3.8 million for illegal campaign contributions benefiting members of the House Committee on Financial Services, then chaired by Michael Oxley (R-OH).

Many Republicans argue that affordable housing mandates contributed to the lax lending standards in the early years of the twenty-first century

[22] Bethany McLean, "Fannie Mae's Last Stand," *Vanity Fair*, February 2009, 122.

[23] Ibid., 123. For a journalistic account of the scandals at Fannie Mae and Freddie Mac, see Gretchen Morgenson and Joshua Rosner, *Reckless Endangerment: How Outsized Ambition, Greed, and Corruption Led to Economic Armageddon* (New York: Times Books, 2011).

and perhaps even undercut their purpose of broadening access to housing. The controversy also contributed to growing concerns over the GSEs. When George W. Bush assumed the presidency in 2001, he included home ownership as a central aspect of his notion of the American Dream. In policy terms, his administration announced plans to help 5.5 million Black and Hispanic Americans purchase homes. When the event announcing this initiative ended, the heads of Fannie Mae and Freddie Mac flew back to Washington with President Bush on Air Force One.[24] The GSEs were to increase the percentage of mortgages purchased from individuals below the median income. However, in retrospect, the more homeowners enter the market, the greater the upward pressure on the price of homes. Without the entrance of the new borrowers who most likely would have been previously denied credit, prices would not have escalated as they did in the housing bubble prior to the financial crisis of 2008.

Fannie Mae and Freddie Mac's entrance into the subprime market is even more hotly debated than their connection to the affordable housing mandates. Because Fannie Mae and Freddie Mac never originated loans, they did not technically lend money to subprime borrowers. However, as middlemen, they made more money available to lenders for that market than would have otherwise been available. Through their participation, therefore, they helped the subprime market to grow. In 2008, the top executives at Fannie Mae and Freddie Mac argued that the companies took on the riskier loans to keep up with market competition. As more and more private-label securities became available, executives feared that lenders would sell products that the GSEs were not buying, and Congress would conclude that they were not fulfilling their mission.[25] The actual amount of their exposure to subprime mortgages has also been opened for debate. A Securities and Exchange Commission (SEC) lawsuit against former executives in late 2011 charged that Freddie Mac understated its exposure to subprime mortgages in filings to the SEC as only 1 to 2 percent of the total amount actually held. Fannie Mae similarly excluded 90 percent of its subprime exposure by labeling the mortgages differently.[26]

Regardless of their reason for expanding in the subprime area, the GSEs were popular with both political parties. While regulatory efforts were frequently blocked by Democrats perceived to be "friends" of the GSEs,

[24] McLean, "Fannie Mae's Last Stand," 143.

[25] Charles Duhigg, "Pressured to Take More Risk, Fannie Reached Tipping Point," *New York Times*, October 4, 2008, http://www.nytimes.com/2008/10/05/business/05fannie.html?pagewanted=all (accessed January 19, 2012).

[26] See Bonnie Kavoussi, Jillian Berman, and Loren Berlin, "SEC Sues Former Fannie Mae and Freddie Mac Executives for Fraud," *Huffington Post*, December 16, 2011, http://www.huffingtonpost.com/2011/12/16/fannie-freddie-sec_n_1153603.html (accessed January 19, 2011).

individual Republicans joined the Democrats in many key instances. Despite the accounting scandals, congressional hearings, and attempts to reform their practices, the GSEs escaped serious reforms until the financial crisis hit. When the Republicans sought to regulate the GSEs, they attempted to reduce the size of their portfolios. When the Democrats attempted to regulate them, they sought a tax on their operations. Both sets of reform measures died in Congress. Democrats argue that the reform efforts failed when the Republicans controlled Congress. In 2005, when the Republican Party controlled both chambers, a Republican-sponsored bill aimed at curbing the investments made by Fannie Mae and Freddie Mac passed out of the Senate committee. However, the lack of Democratic support meant that it would not pass on the floor of the Senate. The GSE bill that did eventually pass was in July 2008, when the Democrats controlled both chambers and a Republican president signed it.

Evaluations of the success or failure of the GSEs vary, along with evaluations of the broader role of the expansion of the federal government into housing finance. Table 3.1 reviews these initiatives. In terms of meeting their congressional objective to provide national liquidity to credit markets, the GSEs have been successful.[27] They have served rural agriculture's requirements, lowered the cost of home mortgages, and increased liquidity through the capital markets. Moreover, they assist low- and low-middle income individuals to become homeowners. However, any evaluation of the GSEs is complicated by the advantages they receive relative to their congressional objective as public or private entities, chiefly their exemption from state and local income taxes, presidential (political) appointees on their boards, and line of credit at the Treasury. Because the GSEs were technically private corporations after 1968, their assets were not backed by the federal government. However, their debt was thought to hold an implicit guarantee. Their size alone made them "too big to fail." Investors from other countries, such as China, may have believed that they *were*, in fact, guaranteed. When they were placed into government conservatorship, the government took on their debt, which Chapter 8 will point out has proven to be one of the largest components of the 2008 financial crisis bailout.

THE DEREGULATION OF THE BANKING INDUSTRY AND PRODUCT INNOVATION

The regulatory structure that emerged from the Great Depression had established a set of distinct institutions that issued regulations and created

[27] In addition to Fannie Mae and Freddie Mac, Congress also created the Government National Mortgage Association (Ginnie Mae), Federal Agricultural Mortgage Corporation (Farmer Mac), and Student Loan Marketing Association (Sallie Mae) as GSEs.

TABLE 3.1. *Chronology of Federal Government Expansion into Housing Finance*

1932	Congress passes the Federal Home Loan Bank Act during the Hoover administration to lower the cost of home ownership. It establishes the FHLB Board, which is permitted to charter and supervise federal S&Ls. FHLBs lend to S&Ls and thus augment the resources available to the S&Ls with a state charter.
1933	The Home Owners' Loan Act is enacted as part of the New Deal legislation of the Roosevelt administration. It establishes a corporation that refinances one of every five mortgages on urban private residences.
1934	Deposits in federal S&Ls are insured with the subsequent formation of the Federal Savings and Loan Insurance Corporation. Congress creates the FHA, which provides mortgage insurance on loans made by FHA-approved lenders.
1938	The government creates Fannie Mae to keep S&Ls with funds.
1965	The FHA becomes part of HUD's Office of Housing.
1968	Congress charters Fannie Mae as a private, shareholder-owned company.
1968	The government creates Ginnie Mae, which guarantees the payment of principal and interest on MBS backed by federally insured or guaranteed loans. These are mainly the loans insured by the FHA or guaranteed by the Department of Veterans Affairs (VA). Other guarantors or issuers of loans eligible as collateral for Ginnie Mae MBS include the Department of Agriculture's Rural Housing Service (RHS) and the Department of Housing and Urban Affairs Office of Public and Indian Housing (PIH).
1970	Congress charters Freddie Mac to liquify local lending markets by buying the mortgages from S&Ls and then selling them in MBS, or mortgage pass-throughs.
2008	Director James Lockhart of the Federal Housing Finance Agency (FHFA) is appointed as conservator of Fannie Mae and Freddie Mac. In the same month, the company enters an agreement with the Department of the Treasury wherein the Treasury provides capital as needed to correct any net worth deficiencies.

niches, or compartments, within the larger financial services industry, among them banks, thrifts, and credit unions. Through Regulation Q, the Federal Reserve set low interest rates for savings accounts and prohibited interest on checking accounts. Thus the regulatory structure eliminated price competition within a compartment. The Federal Deposit Insurance Corporation (FDIC) insured deposits to prevent runs on banks, which prevented bankruptcies. However, the inflation of the 1960s and 1970s put this entire system under stress because depositors lose the purchasing power of their money if they are not paid a rate of interest that compensates them for its use when prices are low. Therefore, depositors sought the highest possible rate of interest on their savings to keep pace with the loss of purchasing power at the same time the regulatory structure discouraged competition.

In response to these pressures from inflation, banks innovated at the state level by allowing Negotiated Order of Withdrawal (NOW) accounts that paid interest on checking. Other innovations forced regulators to respond. As discussed in Chapter 2, Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), which phased out some Regulation Q restrictions and raised the level of competition among the depository institutions that they no longer protected. Now that S&Ls, or thrifts, did not necessarily pay a government-sanctioned higher rate of interest, they were at a disadvantage, albeit the bill allowed them to invest up to 20 percent in nonmortgage assets and to issue credit cards. After 1980, all depository institutions could offer NOW accounts.[28] The upshot was that to the consumer, all depository institutions started to look the same.

Therefore, the results of these regulatory changes and those that followed in the marketplace for financial services were such that the previously compartmentalized institutions and industries blended into each other. The growing supply of MBS had the effect of "disintermediating" credit, meaning that credit flowed around the traditional bank intermediaries and instead through the market for securitized financial products – themselves questionably tied to national and state banking regulations. Investment banks, not just commercial banks, now competed in areas where they had previously been excluded by law. At the same time, the financial stability that had characterized the post–New Deal era also began to unravel.

Deregulation, Consolidation, and Collateralized Mortgage Obligations

As the lines among financial intermediaries became blurred, new financial products arose to meet the demands of increasingly sophisticated consumers of credit. The result was that a variety of financial institutions steadily expanded into roles traditionally served by banks and S&Ls in providing credit and acting as financial intermediaries. Restrictions on interstate banking were gradually removed in the early 1980s, when individual states agreed among themselves to allow reciprocal interstate banking. The practical result was that individual customers could now make a deposit in the branch of a bank in one state, and it could be credited to an account in

[28] Eisner, *The American Political Economy*, 183.

another state. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 allowed nationwide interstate banking through holding company banks and eventually allowed interstate branch banking. With the new possibilities for transactions across state lines, there was a high degree of merger activity since 1980 that further restructured the banking industry. From 1980 to 1998, there were approximately 8,000 mergers. Among these were some of the largest in U.S. history.[29] The three largest deals of the entire ten-year period from 1994 to 2003 by asset size were all in 1998, notably the Citicorp-Travelers Group merger in April of that year, which will be explored in Chapter 4.[30] As the number of banks decreased, the assets in the ones that remained were highly concentrated, and the number of banking offices grew. Moreover, the number of checks cleared continued to increase.

As the industry consolidated, one of the first major product innovations was the creation of some of the first collateralized mortgage obligations (CMOs) by Larry Fink and a First Boston team for Freddie Mac in 1983. The CMO solved many of the old problems with the time frame of mortgages and their credit ratings, which in turn, made them much more attractive to long-term investors. After placing the mortgages in a trust as they had with the previous pass-throughs, the CMO was then sliced (tranched) horizontally into three segments with three different bonds that absorbed losses based on the credit rating associated with their level of risk. The top tier bonds, approximately 70 percent of the value sold, had first claim on *all* cash flows. Since 30 percent of a normal mortgage portfolio is highly unlikely to default, rating agencies gave these bonds a AAA, or top, rating. The second tranche typically included the next 20 percent and sold at a higher yield, whereas the third tranche was the first to absorb all losses. It paid the highest yields. Therefore, the CMOs offered choices to meet the needs of a broader class of investors with different appetites for risk.[31] The mortgage market expanded significantly with the new availability of finance from the new source.

New Borrowers Propel Housing Market Growth

As reviewed in Chapter 2, the deregulation of the banking industry was accompanied by the expansion of credit to broader segments of the

29 Stephen A. Rhoades, *Bank Mergers and Banking Structure in the United States, 1980–98* (Washington, DC: Board of Governors of the Federal Reserve System, 2000), 1.

30 Steven J. Pilloff, *Bank Merger Activity in the United States, 1994–2003* (Washington, DC: Board of Governors of the Federal Reserve System, 2004), 5.

31 Morris, *The Trillion Dollar Meltdown*, 40.

American middle class through legislation such as the Community Reinvestment Act (CRA) of 1977. On the positive side, many groups of people benefited from the CRA who had been previously excluded from credit markets; as well, it made payments much easier for those in the system. In addition, Congress amended the Fair Housing Act in 1974, which equalized access of women to credit. Prior to that time, women frequently could not get credit cards or mortgages in their own names, and a woman's income was discounted on a joint loan application. In 1981, the number of single men and women seeking mortgages was approximately the same. By the end of the 1980s, more single women bought homes than single men.

Credit was also expanded through innovative lending terms. For example, young families at an early stage in their careers with moderate incomes might not have the necessary down payment for a mortgage, or older family members to help, particularly in some regions of California or the East Coast. However, based on their expected *lifetime* earnings, they might be able to afford a house. Mortgages with low payments for the first few years, or low down payments, help to deal with these problems.[32] The credit card industry expanded to new groups as well. For example, in the 1980s, college students could obtain their own credit cards. They met a need because students could use credit in limited amounts to purchase books and pay some fees at the start of a semester. Then, they could stretch out the payments over the course of many weeks and not need the entire amount up front.

As their effects accumulate, the negative results of some of these practices have become apparent. The CRA has been criticized because more lending does not necessarily mean *better* lending. Commentators from the right have argued that with the CRA, the government entered into lending decisions in such a way that banks lent money to people they otherwise would not have lent to. Some of these individuals have also been subjected to predatory practices, including, but not limited to, unfair pricing on interest rates, short-term loans with unusually high fees, and failure to disclose the terms of the loan accurately. Mortgages with low or no down payment means that homeowners have no "skin in the game," or none of their own money invested that they would not want to lose if they could not make payments. Hence, they are more willing to walk away from a loan if conditions deteriorate. In the credit card area, high levels of unsecured debt to students can impose a burden on new college graduates who may also be strapped with large tuition loans.

As interest rates remained low following the recession in 2001, some groups began to borrow large sums who were clearly not as justifiable as

[32] Martin Neil Baily, Robert E. Litan, and Matthew S. Johnson, *The Origins of the Financial Crisis* (Washington, DC: Brookings Institution, 2008), 19.

the other new groups, chiefly subprime borrowers. A subprime borrower is an individual with a poor credit history who pays a higher rate of interest to compensate for the riskier nature of the loan. Information from an individual's credit report is used to calculate a FICO score, which credit-granting institutions use to determine the category of risk. An individual with a score less than 620 is considered subprime.[33] As the housing bubble expanded, the share of subprime and Alt-A (the category less risky than subprime but riskier than prime) mortgage originations jumped from 2 percent in 2002 to 20 percent in 2006. Of these, 92 percent had adjustable rates.[34]

The new borrowers changed the landscape in ways that made retrospective mathematical models less accurate. Borrowers were screened by mortgage brokers rather than banks. Banks that hold a loan are compensated by the spread between loan repayments and what the bank pays out to depositors. Brokers are compensated by the volume of mortgages they make and by luring individuals into large, high interest rate loans.[35] Therefore, the stakes are different for a mortgage broker who makes a loan and intends to sell it on the capital market than for a bank that makes a loan and keeps it on its books to earn interest over the life of the loan. What came to be known in the banking system as the "originate to distribute" business model thus favors lending to riskier customers and passing that risk on in the capital markets.

Furthermore, as reviewed previously, the success of Fannie Mae and Freddie Mac meant that a great deal of market risk was concentrated in few entities involved in so much of the mortgage industry. While they did not make or securitize subprime mortgages, they did become involved in the subprime industry by guaranteeing Alt-A mortgages – that is, those loans made to people who had better credit scores than a subprime customer's but who might not have a job. In the run-up to the financial crisis, the GSEs owned $780 billion in the riskiest mortgages, despite the fact that the private securities they bought had been rated AAA.[36] Again, the answer to the question of why Fannie Mae and Freddie Mac put so much Alt-A into their portfolios is debated. Both companies claimed that they were forced to do so because they needed to meet HUD affordable housing goals. However, Alt-A loans did not necessarily help them with these goals, while the private securities did. Most likely, both companies purchased the Alt-A loans

[33] FICO is short for Fair, Isaac and Company, the firm that develops the mathematical formulas used to produce these scores.

[34] See Herman M. Schwartz, *Subprime Nation: American Power, Global Capital, and the Housing Bubble* (Ithaca, NY: Cornell University Press, 2009), 176.

[35] Ibid., 180.

[36] McLean, "Fannie Mae's Last Stand," 145.

because they helped the bottom line when they operated as private firms, and the GSEs did not want to become irrelevant at a time when so much of the mortgage activity was moving into the shadow industry.[37]

To review the developments in the housing market, in the old, heavily regulated days, a customer borrowed money from a thrift or bank to buy a home. The individual paid a fixed rate of interest over the long term and lived in the house. The regulated thrifts were required to make a certain amount of their loans as mortgages. In exchange, they could pay a higher rate of interest to attract deposits. The average consumer may have opened a checking account at a bank because thrifts were prohibited from offering these types of account. He or she might also have obtained a credit card from a different institution altogether.

As new financing opportunities became available with deregulation, loans from myriad financial services firms competed to meet the needs of consumers and provide checking, savings, home loan, credit card, car loan, and brokerage services. Consumers' jobs and lifestyles were such that they would likely move every five years or so to another city or to a larger dwelling. The rate of the mortgage could be fixed for an initial period and then allowed to adjust, or reset, to the market rate after that. If the family remained in the home when the period was up, the mortgage could be refinanced with terms that would better meet the family's circumstances at that time, perhaps a traditional thirty-year fixed mortgage, perhaps something else. If high net worth customers wanted to avail themselves of the tax advantages of interest rate deductibility, they might arrange for an interest-only mortgage on a much larger sum with no down payment. Furthermore, the rising prices in the housing sector encouraged many to enter the market for real estate where they did not necessarily live, but made purchases as investment properties, under the (erroneous) assumption that housing prices only go up. These mortgages were then bundled, passed on, and traded in a liquid market for the securities fostered by the U.S. government.

THE RISE OF DERIVATIVES AND THE SHADOW BANKING SYSTEM

In Chapter 8, we will discuss the placement of Fannie Mae and Freddie Mac into conservatorship by Congress during the financial crisis of 2008 – an action that commenced a serious discussion about their connection to the public sector going forward.[38] However, in the immediate term examined here, the housing boom and its related innovation in financial

[37] Ibid., 146.
[38] Kosar, *Government-Sponsored Entities (GSEs)*, 4.

markets changed the landscape of banking by creating a shadow system that operated both in concert and in competition with the regulated commercial banking world. To put it another way, it blended the niches in the banking industry together. The new, amorphous industry was rife with competition among participants, and its boundaries were not policed by its own specific regulator – nor insured against runs by the FDIC.

The changes in regulation created new problems for firms in managing risk to maximize profits. In particular, the new products created by sophisticated financial engineering allowed commercial banks to cross the line from the regulated to the unregulated world of financial intermediation, chiefly through innovations in derivative products. In its most simple form, a derivative is a contract whose value derives from some other asset, such as a stock, bond, foreign exchange, or quantity of gold. The contract essentially makes a bet on what the future value of that asset will be so that investors can either protect themselves from price changes in the future, or just make bets on the future value of that asset at some point in time. While derivatives have existed for several centuries, the modern era commenced in 1848 with the founding of the Chicago Board of Trade that created a market for futures and options on agricultural commodities. Futures and options are derivative contracts giving the obligation – or the right but not the obligation – to an individual to buy or sell a commodity at a certain date and price. The volatility and technological advances of the 1970s ushered innovations into the market that was increasingly used to buy diversified assets.

The newer derivative products also blended the work of what had previously been segmented between commercial and investment banks. In August 2007, Paul McCulley coined the term *shadow banking system*, referring to the newer institutions that funded themselves with uninsured short-term funding, which they may or may not back up with a credit line from a regulated bank. Without being directly subject to formal bank regulations, the highly leveraged intermediaries were similarly not backed up by the Federal Reserve's discount lending window or FDIC deposit insurance.[39] Why would a bank want to operate like a non-bank intermediary? Without having to hold reserves, the profit margins are higher. Why would investors put their money outside the traditional channels and forgo the security that came with it? In brief, they earn a higher rate of return. To give the

[39] See speech given by PIMCO's Paul McCulley, "The Shadow Banking System and Hyman Minsky's Economic Journey," reprinted in *Global Central Bank Focus*, May 2009, http://www.pimco.com/EN/Insights/Pages/Global%20Central%20Bank%20Focus%20May%202009%20Shadow%20Banking%20and%20Minsky%20McCulley.aspx (accessed April 13, 2012).

appearance that the deposits are secure, non-bank intermediaries rely heavily on high ratings from credit rating agencies such as Moody's or Standard and Poor's.

The Market for Derivative Financial Products

One of the first major innovations in derivative markets were swaps. A swap is an agreement between two parties to exchange securities, interest rates, or currencies. Salomon Brothers pioneered an early currency swap between IBM and the World Bank in 1981, wherein IBM had Swiss and German currency, and the World Bank could raise money in dollars but needed the foreign currency. Rather than raising it in those currencies, the World Bank borrowed dollars and swapped payments with IBM for the Swiss and German amounts.[40] In housing markets, banks could earn large fees by creating swaps, which allowed two parties with complementary needs to exchange payments. Thus two homeowners could agree to swap payments each quarter as opposed to each party seeking a new loan. The actual mortgage loans would not need to change hands but could stay on the books of the original banks as "synthetic" deals.

Tett's examination of the origins of derivatives products at J. P. Morgan argues that the type created in the 1990s were far riskier than those created in previous eras. Management told those working in the swaps department that they would have to generate half of their revenues each year from a product that had not existed in the year before. That meant that the department was supposed to create products and then hand them off so that it could make more. This requirement further propelled financial innovation on Wall Street as other firms likewise created new financial products that skirted government regulations but were tied to regulated banking institutions.

With a credit default swap (CDS), the seller guarantees that the financial instrument will make the payments that it is supposed to make by exchanging the risk of default on a security between parties (see Figure 3.1). A CDS allows market participants to transfer risk because it takes it from whomever owns the fixed income security (or bond in the structured financial product) and transfers it to the seller of the CDS. That means that the individual buying the CDS will be entitled to the full amount of the bond – if the holder defaults – in much the same way that individuals buy insurance on cars or houses.

[40] Gillian Tett, *Fool's Gold* (New York: Free Press, 2009), 11. See also Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (New York: Random House, 2000), 103–104.

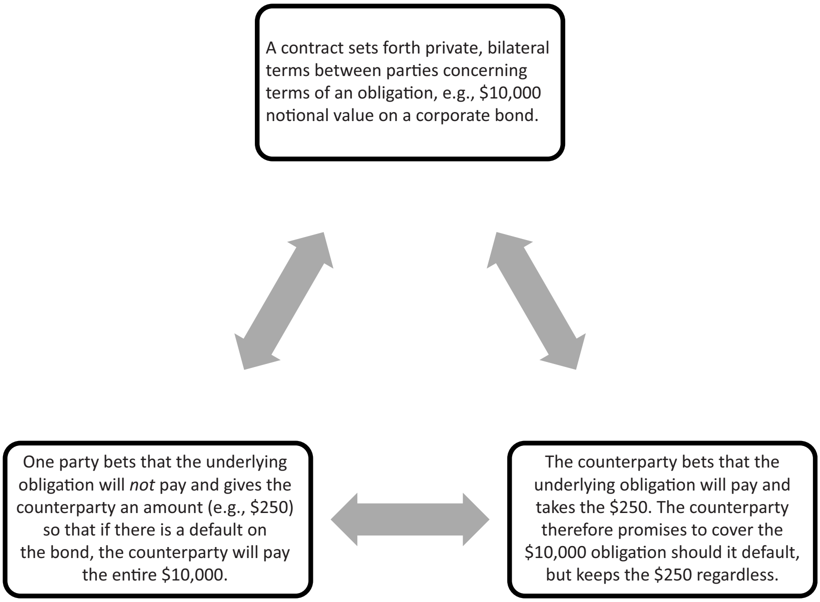

FIGURE 3.1. A Simple Credit Default Swap

The chief difference between traditional insurance and a CDS is that the traditional insurance market, like the traditional banking sector, is highly regulated. Insurance firms must hold a certain amount in reserve in case a calamity strikes, and they are forced to pay out huge sums. To take out an insurance contract, the party must have an "insurable interest" in it, meaning that the party derives benefit from its continuing existence, thus distinguishing insurance from gambling. The CDS market is a set of contracts and thus is not required to hold the same reserves. Nor is a counterparty to a CDS required to have insurable interest in it. Hence, the market is orders of magnitude greater than what is actually insured.

Special Purpose Vehicles and the Shadow Banking System

Financial engineers began to combine MBS with derivatives in new and creative packages that contributed to the growth of the shadow banking system outside the regulated industry. The growth in volume and types of mortgages that could be easily sold in liquid markets fueled the system. Originators' ability to turn the loans into CMOs allowed them to do so in much higher volumes by working together with commercial and investment banks to create special purpose vehicles (SPVs). An SPV is an entity that is bankruptcy remote from the other parts of the corporate entity, such as an asset-backed security, a structured investment vehicle (SIV), or a conduit.

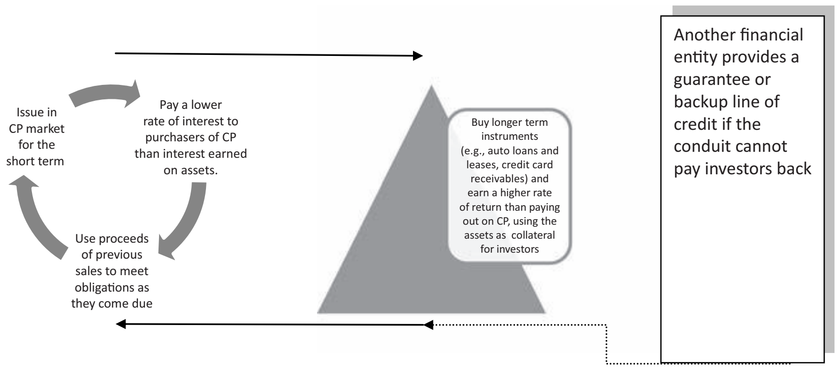

FIGURE 3.2. A Simple Conduit Funded with Commercial Paper

In the event of a bankruptcy, the claims on the rest of the firm should be protected by law.

Among these SPVs, a conduit is a financial vehicle set up and run by a bank that can enable investors to take advantage of the difference between short- and long-term interest rates. The conduit buys longer-term assets such as MBS or CMOs that pay a higher rate of interest but are not liquid and raises the money to pay for them with shorter-term commercial paper (CP). CP is usually issued by corporations that use it to meet short-term debt obligations, such as inventories and account receivables. It is usually an unsecured debt, meaning that only firms with very good credit ratings can sell CP and pay a rate of interest that is low enough to make it more attractive than borrowing money in some other way. When a conduit sells CP, it must pay interest on the amount lent to it (that it used to buy the longer-term assets), and it must pay off the notes when their term comes due. Nonetheless, the conduit generates a profit because it can meet these payments with the money coming in from longer-term investments – that are, in theory, paying a higher interest rate. As shown in Figure 3.2, if it cannot continue to sell CP, it can tap a line of credit from a bank (in some cases) or sell assets (if backed by assets) to meet its obligations.

There is no problem as long as the conduit continues to roll, or sell CP, and its investments continue to generate income. Potential problems arise if short-term interest rates escalate, the firm can no longer sell CP with a high enough rating to get favorable terms, the underlying longer-term investments go bad, or – as in the case of 2007 and 2008 – the CP market freezes. In the last case, the conduit will look to its line of credit with a commercial bank, or all conduits will look to their commercial banks simultaneously. Suddenly, the "shadow" banking system becomes very much a part of the formal, regulated system. If the conduits' underlying longer-term investments look shaky, the bank may be forced to loan money to an entity with a questionable ability to repay it. This lending can then threaten the bank itself. Therefore, while conduits are "off balance sheet" because they are technically separate from the regulated balance sheet, they are a part of the overall entity and the financial system as a whole.

The structured investment vehicle (SIV) is a similar type of SPV that was popular before the financial crisis of 2008. A SIV is another quasi-shell company often set up by banks. It borrows its seed cash from a third-party investor by issuing asset-backed commercial paper (ABCP) – CP that is less risky because it is backed by some collateral – and medium-term notes that need to be rolled constantly. Because the SIVs were bankruptcy remote, these shorter-term funds could be obtained at a cheaper rate than the banks could obtain them, and they therefore lengthened the spreads between the short-term liabilities and long-term assets. The SIVs bought MBS, collateralized debt obligations (CDOs), and other long-term institutional debt with the shorter-term assets. Immediately prior to the crisis, approximately 30 percent of SIV assets were MBS, with 8.3 percent in subprime MBS and 15.4 percent in CDOs.[41]

The earliest SIVs were created by bankers at Citibank who were attempting to evade new international risk-based rules for capital requirements in the late 1980s. These rules – agreed to in the Basel Committee on banking regulation to be discussed in Chapter 9 – stipulated that banks did not need to hold capital against any line of credit that was less than a year in duration. Since an SIV raised a degree of its funds independently and was not on the balance sheet of the bank it was connected to, it could hold many assets that the banks could not. The SIVs' credit lines and conduits were for 364 days or less. Bankers sold notes that paid off in only a few months in the short-term CP market, such as certificates of deposit. They re-lent the money by buying safe, long-term debt such as mortgage bonds. Their profit came from arbitrage, or from their taking advantage of interest rate differentials in the long- and short-term markets in what was called the "carry trade." The profit margins were small, however.

SIVs were so highly leveraged – meaning they had borrowed so much money – that they were actually quite risky. Because they always needed to be replenished with short-term funding, SIVs were always vulnerable to a cutoff of cash or a dramatic decline in the value of their underlying

[41] Figures reported in Baily, Litan, and Johnson, *The Origins of the Financial Crisis*, 29, n. 25. The report cites the International Monetary Fund as the source. See International Monetary Fund, *Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness*. Washington, DC, April 2008.

assets. As with conduits, if the participants who *bought* CP (such as pension fund managers) ever stopped buying it, the SIV or conduit's funding would be gone. If the market value dropped and the asset prices were "marked to market" at once, the buyers would most likely decide *not* to buy it. However, the market functioned under the assumption that this likelihood was nearly impossible with AAA assets.[42] In addition, to minimize the threat that the SPV will not be able to meet its obligations, the financial engineers that constructed it purchased insurance against default in the form of a CDS. Few regulators seemed focused on the nuances of the SIV assets. Few investors seemed aware of exactly what the SIVs held or what regulations actually governed their actions. Hence, they were able to borrow in a manner that their parent firm was clearly not able to do.

The initial layers of the shadow banking system thus far are reasonably straightforward. People need large sums of money to buy houses, cars, and finance consumer debt on credit cards. These payments are not consistent across time, and individuals default on their obligations. However, when mortgages, car loans, and credit card receivables are bundled and sold as bonds, the payments can be standardized, and the risk managed, because some people will default, but most likely, *everyone* will not default simultaneously. When packaged as bonds and insured, they are very appealing to investors who want to loan their money over a longer period with moderate risk and consistent returns.

The complexity and difficulty with the shadow banking system arises as layer of financial product is piled on layer. As discussed previously, synthetic products were originally created to mimic the movement of other products to manage risk better. However, they can also destabilize institutions because traders use them to bet on future price movements, or the likelihood that an institution will default. In the unregulated market for CDS, any two parties may enter into a contract – in effect, buying insurance against default. But unlike the regulated market for insurance where it is not unusual to buy insurance on your own home mortgage, in the unregulated CDS market *everybody* on your street can buy mortgage insurance on your loan. When they do, their action can send a weird message to the market, particularly when you next need a loan.

REGULATION AND THE SHADOW BANKING SYSTEM

As the derivatives industry grew, so did the debate over its regulation. In 1991, Federal Reserve Bank of New York president E. Gerald Corrigan called Peter Hancock of J.P. Morgan to discern the facts about derivatives

[42] Tett, *Fool's Gold*, 97–98.

before he decided whether or not to pursue their regulation. J.P. Morgan appeared to be the most likely place to start because the firm had hired a former executive vice president of the New York Federal Reserve, Stephen Thieke, to act as its chief risk officer.[43] According to Tett's retelling of the episode, Corrigan appeared to want to pursue regulation a few weeks later. International regulators, led by Corrigan, were preparing to define how the Basel rules should be applied to market activities. The Group of 30 (G30) – a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia – determined that it would conduct a study. J.P. Morgan was wary of collaborating with the study because the firm did not want to share proprietary secrets or contribute to any regulations that would result. Nonetheless, Chief Executive Officer Dennis Weatherstone insisted that the bank cooperate.[44]

The resulting G30 report contained three volumes and mixed conclusions. It laid out norms for how to run a derivatives business and suggested that all banks adopt internal risk assessment tools. It suggested that managers should learn how these products work. However, it did *not* recommend regulation. Nor did it hint that swaps would benefit from a centralized clearing system. Without a clearinghouse, there is no record of the volume of trades that could provide a comprehensive measure of market activity. Nor is there anything to protect investors from the eventuality that the other side of the trade (i.e., the counterparty) might not be able to make good on the contract. In sum, without a clearinghouse, derivatives traders left themselves open to so-called counterparty risk.[45] Those who wrote the G30 report argued against a clearinghouse because the investors had strong incentives to monitor counterparty risk themselves. If it were private, it could be subject to such voluntary oversight.[46] At that time, the president of the Federal Reserve Bank of New York called for more public disclosure in the derivatives market, specifically addressing the complexity that derivatives add to the ability to read a balance sheet.[47] Four proposed derivatives bills made it to Congress, one of them sponsored by Henry Gonzalez, the Chair of the House Banking Committee. Each was opposed by the International Swaps and Derivatives Association (ISDA), and each was successfully stopped by 1994.[48]

43 Ibid., 24.
44 Ibid., 28.
45 Ibid., 35.
46 Ibid., 158.
47 See Alan Friedman, "New York Fed Seeks New Rules for Derivatives," *New York Times*, March 18, 1994, http://www.nytimes.com/1994/03/18/business/worldbusiness/18iht-fed_0.html (accessed April 13, 2012).
48 Tett, *Fool's Gold*, 38, 40.

The internal solutions used by banks may have furthered the problem of risk assessment. As firms increasingly bought, sold, and relied on derivatives to insure against risk, they also increasingly relied on sophisticated mathematical models to attempt to manage risk within the firm. The most widely used tool was the VaR, or Value at Risk – a group of related models based on well-known statistical and probability theories. The benefit of the VaR was that it could express risk as a single number across asset classes in dollars over a short period in a typical market. If a portfolio had $25 million of weekly VaR, there was a 99 percent chance that it would not lose more than $25 million in a week. A combination of VaRs from several portfolios could produce a net number that would represent the amount at risk for the entire firm. It clarified the chaos from the mix of products and instruments. A risk manager could use the figure to quantify the firm's risk to its board. Later in the 1990s, when the SEC mandated that firms disclose market risks in their financial statements in a quantitative manner, the firms generally chose VaR to do so. At the same time, when the international banking regulations were applied, they allowed banks to use their own internal VaR calculations to set their capital requirements. A lower VaR meant that the bank had to keep fewer reserves on hold. The only problem with the models was that they were never intended to measure what would happen in the event of a complete financial meltdown, as occurred in 2008.[49]

CONCLUSION

This brief history of the changing world of bank and non-bank intermediaries reviewed how the regulatory system established by the New Deal created compartments within the financial services industry that were relatively insulated from competition but also prevented firms within them from earning large profits. As the regulatory system gradually ended, the industries were subject to greater competition among themselves and could earn greater profits; they gradually intermingled. The old deposit-taking intermediaries remained, but as the shadow banking system rose, banks both competed with it, and were linked to it, through a set of dizzying financial products that relied heavily on the CP market. Chapter 8 will detail how a sudden cessation of the ability of conduits, SIVs, and other SPVs to borrow in this market triggered the need to activate long-standing, yet unused, lines of credit with the formal banking sector. Eventually, the market was restored when the Federal Reserve Bank of New York created

49 For a review of the history of Value at Risk models, see Joe Nocera, "Risk Management," *New York Times Magazine*, January 2, 2009.

the Commercial Paper Funding Facility (CPFF) in October 2008, restoring a degree of liquidity to the CP market. In its first two weeks, the CPFF purchased the majority of newly issued three-month CP.

However, the restoration of a mortgage market independent of government life support is a knottier problem to solve because of the public-private nature of Fannie Mae and Freddie Mac – the pre-existing enterprises now in conservatorship. The old thrift industry declined with the deregulation of the 1980s. The heart of the problem with the banking system in the early twenty-first century rested with the "off balance sheet" nature of many of the transactions and the volume of the mortgage market in the U.S. financial system. Some, but not all, of these activities will be regulated with the enactment of the Dodd-Frank bill. Given the complexity of financial engineering, it can be impossible for responsible entities to read the balance sheets of banks to assess their financial positions, particularly when markets are chaotic. Hence they cannot make decisions about lending, regardless of whether or not the firm is regulated. Without a central clearinghouse for unregulated insurance, there is no real way for financial market participants to know how many other contracts that entity has also taken on, and how much it might have to pay out if they all default simultaneously.

Returning to the political system, we find that the system still rests on the actions of the regulator to enforce regulations and the law to enforce the contracts. However, the structure of the industry has changed since the regulatory agencies were created. Although new laws have been written to attempt to address the new reality, if a disproportionately large company cannot meet its payments as they come due and is forced to declare bankruptcy, the societal costs of the ripple effect can be unsustainable and require government intervention in the form of unpopular bailouts.

SECTION 2

BUREAUCRATIC POLITICS AND FINANCE

Chapters 2 and 3 considered the historical background within which major government agencies and financial markets appeared. Although the basic unit of analysis in the policy process is the action of a *government* as a whole, the U.S. government is not a monolith. It is a conglomerate of loosely allied organizations, each with a life of its own. Actions in the bureaucratic politics paradigm are constrained or biased by the characteristics of the behavior of other large organizations.[1] To explain governmental action in the monetary, fiscal, and regulatory domains of financial politics, the analyst must identify regularized sets of procedures for producing particular classes of actions, or what Allison and Halperin refer to as "action channels."[2] Therefore, the three chapters in this section break down the main components of the U.S. government that structure, regulate, and supervise the operations of the financial economy – Congress, the presidency and executive branch agencies, and the Federal Reserve System – to see how bureaucratic politics operate within and among them, chiefly in terms of their governing authority, budgets, and personnel.

To examine these sets of procedures or action channels, we will emphasize the day-to-day activities that shape the interests of Congress, the executive branch, and the Federal Reserve. Within any one organization, the menu of policy options available is limited in number and character because they are all encumbered by routines, particularly in normal times. While routines mean that many low-level employees at agencies such as

[1] See Allison and Halperin, "Bureaucratic Politics," 54. For Allison's use of Model II in *Essence of Decision*, see Allison and Zelikow, *Essence of Decision*, 143.

[2] Allison and Halperin, "Bureaucratic Politics," 45.

the Office of the Comptroller of the Currency (OCC) or Securities and Exchange Commission (SEC) can address multiple situations without too much thought on a daily basis, standardization also means that in critical instances such as an acute financial crisis, where a "standard" behavior would be inappropriate, these same organizations are ill equipped to design innovative solutions. Bureaucratic politics are also fueled by shared attitudes and images that answer common questions such as these: What is the appropriate degree of separation between business and government in the American economy? What is the appropriate way for the government to try to turn around an economic slowdown? Even when some employees in an individual bureaucracy such as the Federal Reserve or Commodity Futures Trading Commission do not share the values of the whole, they are inclined to act as if they do to avoid arousing the suspicions of others.[3] Therefore, we will investigate the ideologies and attitudes that have informed these agencies' actions over time.

In sum, we will examine the specifics of the U.S. government in the financial policy area along the lines of the organizational behavior model, wherein each organization attends to a special set of problems and acts with a relative degree of independence on them. But the discussion will show that few important issues relevant to monetary, fiscal, or regulatory policy domains are the exclusive province of one or the other. In fact, management of the macroeconomy is shared among them with almost no mechanism for coordination or formal action channel. Each branch or agency has a limited range of actions that it *can* take. Hence, government behavior relevant to any important problem in the area of finance reflects the output of the actions of Congress, the president and executive branch agencies, and the Federal Reserve System. However, government leaders cannot precisely control their specific behavior.[4]

[3] Ibid., 56.

[4] Allison and Zelikow, *Essence of Decision*, 143.

4

Making Financial Policy in Congress

In a statement to the Senate Banking Committee, former Federal Deposit Insurance Corporation (FDIC) Chair William Seidman commented on the problem with banking regulation in the United States: "You have three totally independent agencies in the business. There is no power on earth that can make them agree – not the President, not the Pope, not anybody. The only power that can make them agree is the Congress of the United States by changing the structure so that the present setup does not continue."[5] Therefore, this chapter begins with Congress. Among the branches of the U.S. government, the legislature sits in the center of the U.S. financial system because Article I of the Constitution gives it the power to tax, borrow money, regulate commerce, and coin money. Moreover, Congress is at the center because it writes the laws. Laws are necessary to grant authority to agencies to regulate the financial services industry and perform other tasks, such as granting bank charters.

Congress plays a central role in all three policy domains associated with financial politics. It actively engages in managing the economy through taxing and spending policy, oversight of monetary policy through the Federal Reserve System, and passing major pieces of regulatory legislation. Moreover, when agencies seek to preserve governing authority, budgets, and personnel, they do so through the legislature. The sheer breadth of these topics demonstrates the great power that Congress has in the financial area. Yet with so many tasks to accomplish, the division of labor within Congress

[5] U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs. *Regulatory Consolidation Proposals for Insured Depository Institutions*, 103rd Cong., 1st sess., September 14, 1993, 15.

makes it difficult to change the structure of banking regulation as Seidman suggested or to coordinate monetary and fiscal policy in the management of the macroeconomy. Individual members have goals that are more circumscribed. They may want to consolidate their power in a particular policy area or just want to maximize their chance of being reelected.[6] Members do their work in committees that have jurisdiction over different areas. The Chair of each committee in both the House and Senate controls the committee's business. The committees' staff assist members in their work. Leaders of committees tend to be reluctant to see change come about because it could mean a loss of their own authority or ability to shape policy and to control the resources of the federal government.

To accomplish their goals of policy formation and reelection, members work in political parties. One way that political scientists understand parties is through the concept of *shared risk*, because controlling either the House or Senate allows a political party to advance its members' ideological goals, as well as political goals of winning office and wielding power.[7] Members of the majority party have an interest in maintaining control and the committee roles that come with it, whereas members of the minority party have an interest in taking control from the majority. Even when members do not have clear-cut policy preferences – as many do not on the arcane issues attached to financial politics – they have a tendency to try to discredit the opposition on the grounds of its incompetence and lack of integrity. Otherwise, they can have a tendency to rally around the initiatives of their own party's president and oppose the initiatives of the other party's president.

In addition to the organization of Congress in committees and the operation of political parties, the geographic makeup of both the House of Representatives and the Senate, as well as their electoral cycles, influence how both chambers work. For members of the House, elections take place every two years; for senators, elections are on a six-year cycle. Identical legislation must pass both chambers for a bill to become a law. Therefore, the legislature as a whole operates on a two-year cycle. While members of Congress are also influenced by their colleagues, party, and policy preferences, they are their constituents' first access point to the legislative process within the system. Many policy analysts in the nation's capital might consider the policy's effect on the whole country, but members of Congress

6 David R. Mayhew, *Parties and Policies: How the American Government Works* (New Haven, CT: Yale University Press, 2008).

7 Frances E. Lee, *Beyond Ideology: Politics, Principles, and Partisanship in the U.S. Senate* (Chicago: University of Chicago Press, 2009), 3. Lee references David B. Truman, *The Congressional Party: A Case Study* (New York: John Wiley and Sons, 1959).

consider its most basic units, rendering "all politics local." Members of the House of Representatives are particularly attuned to the needs of their home constituencies if they would like to be reelected.[8]

In mapping out the work of members in congressional committees shaping economic policy, the first section of this chapter considers the management of the macroeconomy on the fiscal side of the monetary and fiscal equation. Congress makes fiscal policy through the complex annual budgeting system, wherein the legislature, together with the president, makes decisions about the amount of money the government will collect in taxes and spend to promote goals of full employment and limited inflation. The legislature is constrained as well. When crafting the budget, many members' activities have policy results that they may or may not intend because they may skew the economy by mandating spending in certain areas, or the legislation may be constrained by what budget the president is willing to sign.

The next section of the chapter picks up the monetary side of the economic policy equation by exploring the work of the legislature in providing oversight of monetary policy and the Federal Reserve. On the monetary side, Congress set the dual mandate for the Federal Reserve to maximize employment and stabilize prices. Hence, the Federal Reserve itself controls the policy options concerning the money supply and seeks to remain as independent of the legislature as it can. We will review literature that questions why Congress appears to give the Federal Reserve free reign with respect to monetary policy, even though it has the ability to legislate in this area.

The final section considers Congress as the branch of government that makes the laws. It reviews the history of the two major pieces of regulatory legislation that configured the boundaries within which financial markets and institutions operate: the Glass-Steagall Act that separated depository and investment banking activities and the Gramm-Leach-Bliley Act that repealed it.

FISCAL POLICY: THE TAXING AND SPENDING COMMITTEES

Since the advent of the interventionist state in the 1930s, the U.S. federal government has attempted to stabilize the economy through the conduct of monetary and fiscal economic policies. Fiscal policy, or the government's taxing and spending activities, injects money into the economy when the government makes purchases, such as construction materials and

[8] David R. Mayhew, *Congress: The Electoral Connection* (New Haven, CT: Yale University Press, 1974) and his *Parties and Policies*.

equipment, or when it employs people who then make purchases. Companies that supply the materials earn a profit that their owners and employees can spend to go shopping, eat in restaurants, or invest in other businesses. The government also takes money out of the economy when it taxes people. With less to spend, individuals and businesses might not buy as much, or they might wait longer to make new investments. Taxing can therefore slow an economy down when the government seeks to constrain growth.

However, Congress does not only tax and spend to conduct fiscal policy. It must raise money and spend it to operate the social welfare programs and conduct the other activities of the federal government such as wars and law enforcement. Most observers note that the popular sentiment in American politics has been an ideology of "no new taxes." It began with the passage of California's Proposition 13 in 1978 and was followed by the election of Ronald Reagan in 1980 and his subsequent lowering of taxes on corporate dividends and capital gains. This ideology has only grown stronger with the Tea Party movement, despite the consistent demand for popular government programs such as Medicare, Social Security, and student aid. As a result of the conflict between this antitax ideology and the demands for social services, Congress must constantly resolve the contradictions among what is politically expedient (not raising taxes in any way) and paying the country's bills (that generally requires some form of taxation) while aiming to stabilize the macroeconomy by running budget surpluses and deficits. The burden for resolving these contradictions falls on the budget and taxation committees.

Congress and the Management of the Economy

How did Congress get involved in managing the economy? When World War II ended, policymakers were concerned that the transition to a peacetime economy might trigger a depression of the sort that had occurred at the end of World War I. To prevent this, President Harry Truman and Senator James Murray (D-MT) promoted a bill that would guarantee the right of employment to anyone willing to work. Republicans and Southern Democrats opposed the bill, as well as business groups who were apprehensive about government control of the economy. In its completed form, the Employment Act of 1946 created the Council of Economic Advisers (CEA) to advise the president on economic matters. The president was directed to present an annual economic report to Congress, in which he or she would detail current conditions and identify a program of action to address them. The Employment Act also set up the Joint Economic Committee (JEC) from both chambers of the legislature, which would consider the report and advise each chamber on its content and recommendations.

The JEC, comprised of ten senators and ten representatives, would also hold hearings and commission studies on economic policy.[9] Over the years, it took on the issue of American global competitiveness.[10] Therefore, as a result of the Employment Act, the national government formally entered the management of the economy to sustain a prosperous economy.

Part of this management is conducted through the federal budget process by the president and Congress. The instruments of fiscal policy are budget surpluses and deficits that are manipulated through the total amount of money spent by Congress against how much it takes in through taxes. Keynesian theory holds that when the level of spending in the macroeconomy falls to levels where full employment is not possible, the government can expand its spending to make up for the decline and keep people working. If prices rise because many customers are seeking too few goods and services, the government can reduce its own spending and thus reduce the overall demand for goods and services that may have been bidding up the prices.

The political problem is that many different agencies of the federal government actually spend the money, which means that many committees have jurisdiction over it, as well as an interest in maintaining the level of funding to help their constituents and not just manage the macroeconomy. With power spread out in Congress this way, any one committee is constrained by what the others do, or do not do.

The Budget Process

Each year, the formal budget process begins when the president prepares an annual budget for the government and submits it to Congress. The Office of Management and Budget (OMB) assists the president in this task for the fiscal year, from October 1 through September 30 of the next year. Prior to the president's submission, the OMB works with departments and agencies to help them prepare their budget requests. Conflicts between the president and Congress frequently occur, particularly when the president is from one party and one or both chambers are controlled by the other.[11] When he makes his request, the president includes an amount for all federal executive departments and independent agencies.

Next, the budget committees in the House and Senate must pass a budget resolution. The resolution establishes a plan for the fiscal year and

9 Discussion drawn from O'Connor and Sabato, *American Government*, 663–64.

10 See Kent H. Hughes, *Building the Next American Century: The Past and Future of American Economic Competitiveness* (Washington, DC: Woodrow Wilson Center Press, 2005).

11 O'Connor and Sabato, *American Government*, 676.

four years ahead. It also establishes the totals for the fiscal year and divides it into categories that are then allocated among the taxing and spending committees. Therefore, because the president does not sign the resolution, it is a legislative device for the Congress to regulate itself as it works on the spending and revenue bills, but it does not have the force of law. The resolution matters for fiscal policy, however. In the process of formulating it, the committees hold hearings and receive testimony from a variety of sources, including agencies, the general public, and national organizations, concerning the overall economic policy of the federal government. Three regular hearings include separate testimony from the director of the OMB, the director of the Congressional Budget Office (CBO), and the Chair of the Federal Reserve Board. The OMB director provides an explanation of the president's budget submission; the CBO director presents an analysis of the president's budget proposals and independent baseline budget projections; and the Federal Reserve Chair provides an assessment of the state of the national economy.[12]

Next, committees must pass appropriations bills that fit within the categories of spending outlined in the budget resolution. These categories cut across agency lines and range from national defense to energy to agriculture to international affairs. The committees of legislative jurisdiction for each agency must pass authorizing legislation for a program. An authorization bill authorizes a program, specifies its aim, and establishes a ceiling of money that Congress can use to finance it within a set period of time. However, when the program is included in the appropriations bill, the amount authorized serves as a ceiling. The appropriations bill that grants the actual budgetary authority, or authorization for the outlay itself, could be lower than the amount in the authorizing bill or could be fully eliminated.[13] There are thirteen annual appropriations bills, which together fund the entire federal government. Figure 4.1 depicts the process.

The dynamics of appropriations committees are somewhat different from the others because each side of any dispute knows that the bills must pass, or a continuing resolution must pass, or the government will shut down. Appropriations hearings are held annually in conjunction with the

[12] Bill Heniff Jr., *Formulation and Content of the Budget Resolution* (Washington, DC: Congressional Research Service, 2007).

[13] Appropriations bills can be general, continuing, or supplemental. A continuing appropriation is passed when the fiscal year begins without a regular appropriations bill having been passed. It holds spending at rates based on previous years. A supplemental appropriation is passed after the regular appropriation for "unanticipated" expenses; however, the use of supplemental appropriations in funding the war in Iraq has called into question the practice. For a discussion of federal budgeting see Allen Schick, *Congress and Money: Budgeting, Spending and Taxing* (Washington, DC: Urban Institute, 1980).

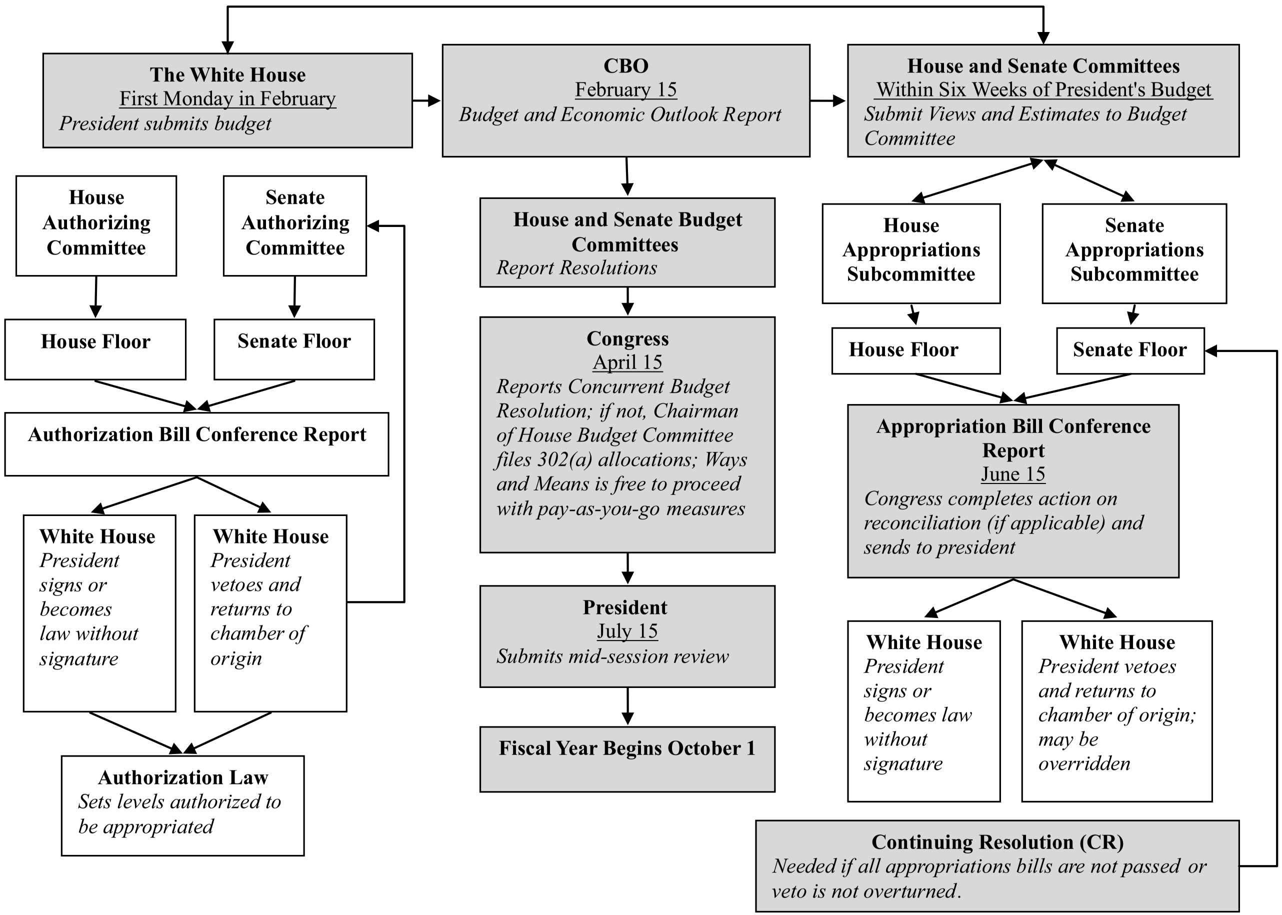

FIGURE 4.1. The Regular Federal Budget Process

president's budget request. Thus individuals who testify are almost always U.S. government officials. Moreover, lobbyists approach appropriations committee members and staffs differently from authorizing committees.[14] The appropriations committees operate within the budgeting system in Congress, and that process has undergone substantive change. Despite rules that prohibit changes to the authorization, appropriations bills attract riders – that is, attempts to change policy that go beyond simple funding of agencies.[15]

While federal government spending generally follows the budget process outlined in the Congressional Budget and Impoundment Control Act of 1974, some important recent developments have operated outside the confines of the annual federal appropriations bills. If the process is not complete by the start of the new fiscal year in October, Congress commonly passes a continuing resolution, which keeps the level of spending the same until the process is complete. Other spending occurs outside of the formal process with supplemental budgetary allocations. These are supposed to be for requests that were unknown to the president when he submitted his annual request. In recent years, they have been used to cover large amounts of spending for the wars in Iraq and Afghanistan. After the wars commenced, it is difficult to argue that their expenses are unforeseen. However, they have contributed far more to the overall U.S. budget than what the regular process would have stipulated at the outset.

The budget process is not complete without a plan for revenue. The U.S. Constitution stipulates that revenue bills must originate in the House, and the House Committee on Ways and Means is the oldest and chief tax-writing committee in Congress. Likewise, the Senate Committee on Finance is one of the original committees established in the Senate; this committee is responsible for tax policy. These committees also have jurisdiction over the Medicare and Medicaid (in the Senate) programs; they are both highly influential and have a great impact on the overall level of government spending.

The impact of the budget and taxation committees, together with other committees involved in directing spending in the American economy, plays a significant role in overall economic growth and the level of inflation outside the formal confines of monetary policy. Inflation, or rising prices, can be the result of "too many dollars chasing too few goods." Thus the problem can originate when there are too many dollars (i.e., the Federal

14 Joseph White, "Making Connections to the Appropriations Process," in *The Interest Group Connection: Electioneering, Lobbying, and Policymaking in Washington*, ed. Paul S. Herrnson, Ronald G. Shaiko, and Clyde Wilcox (Washington, DC: CQ Press, 2005), 175.

15 Ibid., 165. See also Diana Evans, "Appropriations in the Republican Era," *Extensions: A Journal of the Carl Albert Congressional Research and Studies Center*, Spring (2007).

Reserve's monetary policy) or too few goods (i.e., the U.S. government itself can create excess demand by buying items or directing consumers toward some purchases and not others). Employment levels can rise when the government hires workers through its programs, or it can fall if it cuts back on its orders and demand drops. Hence, the fiscal policy that emerges from the congressional budget and other processes that seeks to stabilize the economy by running budget surpluses and deficits must be considered within the context of the work that other agencies and branches are doing, chiefly the Federal Reserve.

MONETARY POLICY: OVERSIGHT IN THE BANKING COMMITTEES

When we divide economic management into its monetary and fiscal components, the House Committee on Financial Services and the Senate Banking Committee have primary legislative jurisdiction over the Federal Reserve System. These are the committees that could exert the greatest influence over monetary policy in the American economy if they choose to exercise it. The committees also oversee all components of the nation's housing and financial services sectors, including banking, insurance, real estate, public and assisted housing, and securities. As a part of these activities, they review the laws and programs related to the U.S. Department of Housing and Urban Development, Federal Reserve, FDIC, Comptroller of the Currency, former Home Loan Bank Board, Federal Savings and Loan Insurance Corporation, Export-Import Bank, SEC, Small Business Administration, Fannie Mae, and Freddie Mac. Subcommittees handle specific areas of work.

As unemployment rose in the 1970s, the vague wording of the Employment Act of 1946 that had first committed the government to stabilize the economy began to trouble some members of Congress. As a result, the legislature looked to the role of the Federal Reserve in making economic policy, and in particular the development of sound monetary policy as one aspect of it. In 1978, Congress passed the Full Employment and Balanced Growth Act, or Humphrey-Hawkins bill, to clarify that the economic goals to be sought are full employment, growth in production, price stability, and a balance of trade and budget. One of the provisions of the bill is that the Board of Governors of the Federal Reserve must transmit a Monetary Policy Report to Congress twice a year, detailing its monetary policy. The Federal Reserve Chair therefore appears before the House and Senate Banking committees twice each year to answer questions with respect to this report.[16] In addition, the Federal Reserve Chair is mandated under the

[16] Incidentally, the Secretary of the Treasury is also obligated by U.S. law to submit a report to Congress each year on U.S. participation in the International Monetary Fund (IMF). After submitting the report, he or she must appear before the House Committee on

Act to connect monetary policy to the economic policy of the presidential administration.

The Operations of the Banking Committees

Like all committees in Congress, the functioning of banking committees is influenced by the style of leadership of the Chair, the organization of subcommittees, the committee staff, the members who serve on it, how well it works with other committees, and the external agencies with whom it deals.[17] Moreover, the work of the committees varies according to what is going on in the economic area that they cover. For example, during World War II, the Senate Banking Committee was a highly desirable assignment. It had responsibility for price and rent controls, government reconversion policy, and the Employment Act of 1946. After the war ended, the postwar housing bills were also attractive assignments. However, by the 1960s, the work of other committees became more desirable, and the size of the Senate Banking Committee was cut from fifteen to fourteen members to reflect its diminished status as an assignment.[18] One of the reasons the banking committees are less attractive is because they control a much smaller amount of selective pork barrel benefits, albeit members of these committees no doubt attract a high volume of campaign contributions from banking political action committees (PACs) and other lobbies.[19] Overall, though, these advantages do not make up for the benefits offered by other committees.

When confrontations over monetary policy or the actions of the Federal Reserve emerge, they do so within the House and Senate Banking committees. Because the Federal Reserve was created by the legislature and not mandated in the Constitution, committee members can threaten to legislate or change the operations of the Federal Reserve. Thus, in theory, Congress has the ability to confront the system directly through the appointments process or directives to the Federal Reserve on monetary policy. The legislature could remove the Federal Reserve's insulation from the budgetary

Financial Services and the Senate Committee on Foreign Relations to present testimony on progress made in reforming the IMF, status of efforts to reform the international financial system, compliance of countries with any conditions attached to assistance from the Fund, and the status of international anti–money laundering and counterterrorist financing standards by the IMF. In recent years, this testimony has ranged beyond the activities of the IMF. *Foreign Relations and Intercourse, US Code*, vol. 22.

17 John Bibby and Roger Davidson, *On Capitol Hill: Studies in the Legislative Process* (New York: Holt, Rinehart, and Winston, 1967), 184. See also Christopher J. Deering and Steven S. Smith, *Committees in Congress*, 3rd ed. (Washington, DC: CQ Press, 1997).

18 Bibby and Davidson, *On Capitol Hill*, 185.

19 Woolley, *Monetary Politics*, 134.

process, subordinate it to the president, open its operations to the public, remove the private status of regional Federal Reserve Banks, or change the length of appointments. This happened in the 1980s when high interest rates and high unemployment provoked anger and concern in Congress. Members of the committees introduced bills and resolutions to instruct the Federal Reserve about conduct of policy. Some were sponsored by influential members of Congress – including leadership in both parties. Some would have had the effect of removing a degree of autonomy from the Federal Reserve.

In one episode between Congress and the Federal Reserve, the Chair of the House Committee on Financial Services, Henry B. Gonzalez (D-TX), held a series of hearings on the issue of Federal Reserve transparency. He wanted the Federal Reserve and Federal Open Market Committee (FOMC) to conduct more of its affairs in public. Since 1976, the Federal Reserve had audiotaped meetings of the FOMC so that they could be turned into transcripts. While the Federal Reserve had informed Congress that transcripts of FOMC meetings were routinely disposed of prior to Gonzalez's inquiry, and unavailable to the public, the Chair could not believe that the central bank did not keep records of its meetings. In the hearings that followed, officials testified that there had been an FOMC conference call prior to the hearing to plan a strategy of not mentioning the cache of secret transcripts. Federal Reserve Chair Alan Greenspan's recollection was that he had assumed the tapes were erased once the minutes were done. He claimed that he learned that this was not the case when he was preparing for his Banking Committee testimony. In fact, the unedited transcripts were kept in a file cabinet down the hall from his office.[20] President Clinton kept his distance from the dispute. Since 1994, the Federal Reserve has released verbatim transcripts with a five-year lag. The Federal Reserve also issues a press release on the day of the meeting. However, after Gonzalez uncovered the transcripts, the Federal Reserve destroyed draft transcripts of the meetings, and the FOMC members voted to pull the plug on their recording systems. Many draft transcripts have been discarded.[21]

During the financial crisis of 2008, members again called for greater transparency in the operations of the FOMC and sought to restructure some

[20] Alan Greenspan, *The Age of Turbulence: Adventures in a New World* (New York: Penguin Press, 2007), 151. For a review of the entire episode, see U.S. Congress, House Committee on Banking, Finance and Urban Affairs, *The Federal Reserve's 17-Year Secret*, 103rd Cong., 2nd sess., January 27, 1994.

[21] See "The Painful History of Fed Transparency," *Market Watch*, May 8, 2006. http://www.marketwatch.com/story/story/print?guid=65A48CC1-3F14-42 (accessed November 16, 2009). See also Robert D. Auerbach, *Deception and Abuse at the Fed: Henry B. Gonzalez Battles Alan Greenspan's Bank* (Austin: University of Texas Press, 2008), 92.

arrangements among the regional banks and the Board of Governors. Some senators threatened not to reappoint Ben Bernanke as chairman, given the criticism of his response to the crisis. The Obama administration lobbied heavily on his behalf. Bernanke visited with senators who wavered. When the Senate voted to close debate, seventy members voted for confirmation, representing the smallest margin for reappointment of a Federal Reserve Chair ever. Republicans facing reelection were roughly 30 percent less likely to vote to confirm. Others objected out of populist anger at government bailouts. Senators relying on campaign support from the financial sector voted disproportionately in favor of confirmation.[22]

Relations with the Federal Reserve

Despite these moments, confrontations between the Federal Reserve and the congressional banking committees are surprisingly infrequent, particularly with respect to the Federal Reserve's conduct of monetary policy. Even when members of Congress have advocated altering the structure of the Federal Reserve, they have never really focused their action on shaping its behavior.[23] Why would members of Congress tolerate a federal agency that makes choices inconsistent with the immediate goals of members and, according to some accounts, actually follows the direction of the president?

Answers to the puzzle vary. Some political scientists speculate that the Federal Reserve may be a useful scapegoat for members of Congress when the macroeconomy fails, whereas members may feel that they do not receive credit when exerting their influence has been a success. Most observers agree that members gain a distinct advantage from central bank autonomy, or the appearance of it.[24] Therefore, they stay out. Other political scientists speculate that members may actually control the outcomes produced by the Federal Reserve, whereas its action could be the observed consequence of effective latent control. According to the Weingast-Grief principal–agent relationship model, the principal (Congress) holds all the cards over the agent (the Federal Reserve), as well as the one most prized by the agent – the congressional grant of independence. Knowing that it will lose what it most prizes if it goes against Congress, the Federal Reserve divines the policy desired by its principal and follows it. Providing support for this theory,

[22] See Sarah A. Binder, "Ben Bernanke's Second Term as Chairman of the Federal Reserve," The Monkey Cage, January 30, 2010, http://www.brookings.edu/opinions/2010/0130_bernanke_binder.aspx (accessed December 14, 2011).

[23] Woolley, *Monetary Politics*, 132.

[24] J. Kevin Corder, *Central Bank Autonomy: The Federal Reserve System in American Politics* (New York: Garland Publishing, 1998), 14.

various bills limiting the independence of the Federal Reserve surfaced in the 1970s, and as they made their way through Congress, the Federal Reserve eased policy.[25] However, Beck argues that the principal–agent theory of Congress and the Federal Reserve is not supported by the quantitative evidence.[26]

Other theorists try to explain the paradox by arguing that if a policy outcome offers a *universal* outcome, it will be the focus of presidential time; if it offers a *concentrated* benefit, it will be the focus of congressional time. Monetary policy scholarship thus assumes that monetary policy outcomes are macroeconomic and will be presidential, with congressional interest low.[27] The political goals of the president and Congress may be so different simply because the president has no other choice of instruments to affect macroeconomic or credit market outcomes. The central bank's work naturally benefits or hurts the president, so the executive pays attention and Congress does not. In addition, central bankers prefer executive control.[28] For political scientists Cordier and Beck, Congress exerts a particularistic fiscal policy but not a particularistic monetary policy. According to theories of universal versus concentrated benefits, members of Congress benefit from providing the individual benefits, which they can do by helping out a specific sector of the economy with credit or favorable tax policy.[29]

However, political scientists also note that legislators may lack effective mechanisms to influence central bank activity. The Federal Reserve is a notoriously opaque institution. It may be the case that Congress refrains from confronting the Federal Reserve because other levers over the system are more effective. As reviewed in Chapter 3, it can play a role in housing markets through entities such as Fannie Mae and Freddie Mac and the Federal Home Loan Bank System, or it can write laws affecting the functioning of the financial system. The selective government intervention that has occurred has been in the form of both loan guarantees and direct loans. The most significant intervention has been in the residential mortgage market through the federally supported secondary market.[30] Another significant intervention has been through the Small Business Administration (SBA). The SBA loan guarantee program is the largest source of federal subsidy to small business.

[25] Nathaniel Beck, "Congress and the Fed: Why the Dog Does Not Bark in the Night," in *The Political Economy of American Monetary Policy*, ed. Thomas Mayer (New York: Cambridge University Press, 1990), 136.

[26] Ibid., 140.

[27] Corder, *Central Bank Autonomy*, 155.

[28] Ibid., 11.

[29] Beck, "Congress and the Fed," 143.

[30] Corder, *Central Bank Autonomy*, 158.

These credit programs are not limited to the jurisdiction of the banking committees. For example, the Senate Committee on Health, Education, Labor, and Pensions and the House Committee on Labor and Education oversee student loan programs that grant easier terms to individuals who might not otherwise be a good bet for the market. The House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry subsidize credit to the agricultural sector through the "Farm Bill." Agricultural policy is designed to allow farmers to borrow at below-market rates or to allow farmers to value their security (i.e., crops) above market valuation.[31]

There is also an element of path dependence to the congressional relationship with the Federal Reserve. In the early years of the history of the Federal Reserve, Representative and then Senator Carter Glass played a leading congressional role in all matters pertaining to the system. His attitude was consistently adverse to congressional intervention in board and open market committee policymaking.[32] The Board of Governors has the usual minor contacts when congressional staff request information, members visit, and so on. However, few members are interested in the affairs of the Federal Reserve and do not make substantive inquiries of the Board. If Congress created the Federal Reserve de novo, it might be more involved, but the institution has been around since 1913, and the relationships were established otherwise.[33]

PASSING THE LAWS THAT REGULATE THE FINANCIAL SERVICES INDUSTRY

In addition to monetary and fiscal policy, Congress also writes the laws that either regulate the financial services industry or delegate authority to federal agencies to write the rules. Therefore, numerous other committees play a role where they have legislative and oversight jurisdiction. The House Committee on Financial Services and the Senate Banking Committee have oversight of the Federal Reserve System and the SEC. The Commodity Futures Trading Commission falls under the jurisdiction of the Agriculture committees. To see how these committees, agencies, and interest groups operate together, we will review the two major pieces of legislation that defined the regulatory contours of the financial services industry in the twentieth century: the Banking Act of 1933 and the Financial Services Modernization Act of 1999. This brief review of the legislative process

[31] Beck, "Congress and the Fed," 142.
[32] George Leland Bach, *Federal Reserve Policy-Making*, 162.
[33] Beck, "Congress and the Fed," 144.

points to the issues of bureaucratic rivalry and involvement in crafting a final bill. Whereas the financial services industry played a role through lobbying and campaign contributions, the agencies themselves also played a role. Therefore, the history provides support for Wilson's notion of bureaucratic behavior that Congress is almost never an unchallenged principal that directs an agency. Rather, the legislation always competes within its own political environment.[34]

The Erosion of the Banking Act of 1933

As we saw in Chapters 2 and 3, regulatory policy changes are usually propelled by a crisis. The Great Depression of the 1930s made it possible to move many new pieces of regulation in the banking industry. One of the more prominent among them was the Banking Act of 1933, colloquially known as the Glass-Steagall Act for four provisions within it that sought to stabilize the banking system by prohibiting banks from speculating in securities. Under its terms, commercial banks could not own securities firms or pay interest on commercial checking accounts. Moreover, the Act provided for the establishment of the FDIC, which would insure bank deposits, and capped the interest rate on savings accounts. Nine thousand banks failed between October 1929 and March 1933. One year after the FDIC was established, only 9 banks failed out of the remaining 13,000.[35]

It is commonly thought that Glass-Steagall was justified by the risky and abusive securities practices of banks prior to the Great Depression that caused many of them to fail. Some economic historians dispute this notion, arguing that banks with security affiliates did not have a higher risk of failure and claim that there is not convincing evidence that banks' losses through securities affiliates caused massive failures.[36] Nonetheless, supporters of the Glass-Steagall bill were concerned with speculation and its harmful effects on the productive economy as a whole. More importantly, a bank engaged in promoting stocks faces an inherent conflict of interest between stock promotion and the interest of individual investors. Separating investment and commercial banking had implications for constraining concentrations of economic power. Thus legislators drew on proposals from earlier eras. However what was new was that the bill would curb

34 Wilson, *Bureaucracy*, 237.

35 Darryl E. Getter and Oscar R. Gonzales, *The Federal Deposit Insurance Corporation: Efforts to Support Financial and Housing Markets* (Washington, DC: Congressional Research Service Report for Congress, 2009), 1.

36 George J. Benston, *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered* (New York: Oxford University Press, 1990).

bankers' conflicts of interest through regulation, even if economic power grew more concentrated.

After passage of the bill, all integrated banking firms had to separate their investment banking from commercial banking operations. For example, J.P. Morgan and Company – still the world's most powerful bank – chose to continue as a commercial bank because it was more profitable at the time. Henry S. Morgan and Harold Stanley, two J.P Morgan partners, formed the investment bank Morgan Stanley shortly thereafter in 1935.

In the years that followed, distinct cultures formed within the compartments that Glass-Steagall created in the industry. Commercial banks took deposits, paid interest, and made loans. When they did make investments, they chose among the most conservative available with the understanding that they were protecting their deposit base, which received the benefit of taxpayer protection in the form of FDIC insurance. While investment banks operated in a culture with a greater tolerance for risk-taking operations, the New York Stock Exchange prohibited member firms from public incorporation until 1970. Therefore, investment banks were organized as partnerships. Partners were consequently risk averse to the downside of any investments the firm made because such investments risked their own capital. After the Stock Exchange changed the rules concerning incorporation in the 1970s, investment banks went public in waves, with Goldman Sachs as the last of the bulge bracket banks to do so in 1999.[37] Thus the risk-taking culture within the investment banking world evolved as management no longer faced the same leverage constraints.

Although we have seen that major regulatory changes occur in a crisis, incremental regulatory changes occur around the edges of a policy subsystem in the absence of serious opposition. Although policy subsystems are in a state of constant creation and destruction, the changed alignments only become apparent when a crisis inevitably occurs. Therefore, a series of economic transformations in the 1970s and 1980s were only apparent when media attention became fixed on the banking system during various crises. The result was a reconfigured industry operating under the regulatory institutional structure left over from the Great Depression. The new interests aligned to erode this structure, and they faced little or no organized public opposition.

In the 1970s, inflation made it impossible for the Federal Reserve to maintain controls on interest rates. At the same time, more Americans began to *need* financial services when their employers changed the manner

[37] See, for example, Alan D. Morrison and William J. Wilhelm Jr., "The Demise of Investment-Banking Partnerships: Theory and Evidence," *Journal of Finance* 63, no. 1 (2008), 311–50.

in which they constructed retirement plans. With the older, defined benefit plan, the employer promised to make a certain amount of payments when the employee retires, based on the number of years of service, salary, and other factors. Legislation made it possible for individuals to make contributions to 401(k) plans. Many employers found these newer, defined contribution plans attractive. With these plans, the individual must make his or her own choices with respect to how and where to invest for retirement. The contribution itself is defined, so the more the individual puts in, the more that will (theoretically) be available in retirement, depending on how well the investments perform. Individuals play a role in selecting those investments with the help of an investment manager and generally invest in funds managed by industry professionals.

As the controls on interest rates were phased out and individuals began to purchase more financial products, the debate about the separation of banking and nonfinancial activities heated up because the old divisions that had prevented competition within and among the industry's compartments came down, chiefly the division between commercial banks and investment banks. Large companies turned to commercial paper markets for short-term credit or for seasonal lending because the interest payments were lower than those on loans from a commercial bank, meaning commercial banks lost their niche in wholesale lending. When large banks moved into the securities business, they did so through subsidiaries whose stock was held by the bank holding companies owning all of the stock of the depository institutions. Thus they could offer limited investment banking services. Nonetheless, commercial banks continued to lose business to investment banks when the latter began to securitize car loans and mortgages. By 1986, J.P. Morgan even considered forgoing checking accounts and deposit insurance altogether and converting its charter so that it could enter the full range of securities market activities.[38]

In 1984, J.P. Morgan produced a document *Rethinking Glass-Steagall*, which attempted to make an intellectual case for change. An early supporter of the movement was Alan Greenspan, then a Morgan director.[39] At the time, Paul Volcker was Federal Reserve Chair and would not move on the issue out of his deeply held skepticism about banks that engaged in risky securities work. Nonetheless, in 1986, the Federal Reserve Board reinterpreted Section 20 of the Glass-Steagall Act and allowed banks to earn up to 5 percent of their gross revenues from the investment banking business. Headed by Greenspan after August 1987, the Federal Reserve slowly added the ability to underwrite commercial paper and municipal

[38] Ron Chernow, *The House of Morgan*, 717.

[39] Ibid., 716.

revenue bonds to commercial banks, as well as limited power to float corporate bonds in January 1989.

Several events of the 1980s also revealed problems with the old Glass-Steagall distinction between investment banking and commercial banking in the public mind. Given the boundaries around the investment banking industry, the securities houses appeared to be an insiders' cartel protected by the law. When a series of Latin American creditors defaulted on their loans during the decade, it became apparent that the commercial banks were engaged in far riskier activities than had been previously understood. Since European banks could underwrite securities in the United States, the law appeared to disadvantage American banks against their foreign competitors. Support for reform of the old distinction grew within the political system.[40]

Several megamergers and the changes in rules at the Federal Reserve allowed giant financial groups to circumvent Glass-Steagall even when it was still on the books. However, disagreements among banks, investment firms, and insurance companies over the specific provisions that affected each industry's turf initially slowed any progress on legislation to repeal it outright. The conflict between banking and insurance goes back to the passage of the National Bank Act of 1864 and later laws that prevented banks from entering the insurance business. In 1991, the George H. W. Bush administration attempted banking reform but no bill was passed.[41] After that time, the campaign contributions of these financial entities to the political process grew at a rapid rate. Between 1993 and 1998, banks, investment firms, and insurance companies took in nearly $250 million in soft money, PACs, and individual campaign contributions. About 40 percent of the contributions went to members on the relevant congressional committees: House Banking and Senate Banking.[42]

The Financial Services Modernization Act of 1999

When Bill Clinton took office in 1993, the financial services industry continued to press for the repeal of Glass-Steagall. After the Republican Party gained control of Congress in the 1994 midterm election, House Banking Chair Jim Leach (R-IA) and Senate Banking Chair Phil Gramm (R-TX) shared the belief that the line between banking and commerce should be erased.

[40] Ibid., 718.

[41] Thomas Stratmann, "Can Special Interests Buy Congressional Votes? Evidence from Financial Services Legislation," *Journal of Law and Economics* 45, no. 2 (2002), 345–373.

[42] Figures reported in Dye, *Top Down Policymaking*, 100.

The Clinton administration's first attempt at banking reform would have created an administrator that would coordinate the supervision of state-chartered banks, leave the OCC as supervisor of nationally chartered banks, and reduce the examination and rule-making roles of the Federal Reserve. The House Banking Committee passed a reform bill in 1995 but it never reached the floor. Alan Greenspan, who mobilized the state banking commissioners, defeated the effort.

The consolidation in the financial services industry continued nonetheless. On April 6, 1998, Sanford Weill, the chairman of Travelers, and John Reed, the chairman of Citigroup, announced a $70 billion stock swap that would constitute the largest corporate merger in history. According to Reed's retelling of the events, the transaction was an important effort to transform the opportunity space within which his bank operated because investment banks were doing the business that he would have preferred to have done for his customers.[43] Because the transaction contradicted the Glass-Steagall Act, the merged corporation had to be formed in such a way that it could divest any businesses that did not comply within two, or possibly three, years. However, from the outset, Weill and Reed sought to change the law. They met with Federal Reserve officials before the merger to garner their support and in March and April made calls in Washington on Federal Reserve Chair Alan Greenspan, Secretary of the Treasury Robert Rubin, House Banking Chair Jim Leach (R-IA), and Senate Banking Chair Al D'Amato (R-NY), seeking tacit support for repeal. The day before the announcement of the merger, Weill and Reed made a call on President Clinton to brief him on it. When questioned about the company's application to become a bank holding company, Weill replied, "I don't think we have to spin anything off to make this happen."[44]

The direction in Congress was not so clear. One week before the announcement, Congress had stalled in the ongoing efforts to repeal Glass-Steagall. The emerging legislation on this issue was not only blocked by splits within the financial services industry, it was also blocked by the turf war between the Treasury and the Federal Reserve over the supervision of banks. The Senate version gave most of the responsibility for supervision to the Federal Reserve as overseer of bank holding companies and state-chartered institutions that chose to be regulated by it. The House version

[43] See John Reed, "John Reed on Big Banks' Power and Influence," transcript from *Moyers & Company*, January 27, 2012, http://billmoyers.com/wp-content/themes/billmoyers/transcript-print.php?post=2905 (accessed February 4, 2012).

[44] Mitchell Martin, "Citicorp and Travelers Plan to Merge in Record $70 Billion Deal: A New No. 1: Financial Giants Unite," *New York Times*, April 7, 1998, http://www.nytimes.com/1998/04/07/news/07iht-citi.t.html?pagewanted=print (accessed February 7, 2012).

favored the Treasury and the OCC as supervisors of nationally chartered banks. The two versions could not be reconciled in committee.

The newly formed Citigroup conglomerate nonetheless pressed for the necessary legislative change, propelled by investor concern that regulatory change might not happen in the limited time frame necessary to comply, which caused the share prices of both companies to fall. After the finance, insurance, and real estate industries spent more than $200 million on lobbying and more than $150 million in political donations during the 1997–98 election cycle, the 106th Congress opened in January 1999 and again took up the issue of the repeal of Glass-Steagall.[45] As with any large package of legislation, top industry representatives, in this case Citigroup officials, reviewed and approved drafts of it even before it was introduced.

In July, Robert Rubin left his position at the Treasury and was replaced by Lawrence Summers, a Harvard economist. Accounts of the bill's passage point out that since Greenspan and Summers were both trained as economists, they shared an economist's sense that a large bank with operating subsidiaries would be a more efficient entity than a holding company with separable affiliates.[46] They negotiated directly on the issue and passed their agreement to Congress, which became the law.[47] Many reluctant Democrats came aboard in October after Republicans agreed to strengthen provisions of the Community Reinvestment Act, as well as address some privacy considerations. In an exaggerated example of the revolving door between government and industry, Rubin took a top position at Citigroup shortly after the Clinton administration announced its support for what came to be called the Financial Services Modernization Act.

The Gramm-Leach-Bliley Act, or Financial Services Modernization Act of 1999, is thus one of the most notable pieces of banking legislation in the twentieth century because it repealed major provisions in the Glass-Steagall Act of 1933 and opened up the compartments among banking, securities, and insurance firms into a shadow banking industry loosely tied to the regulated sector. However, it left the labyrinth regulatory framework in place, creating even more opportunities for regulatory arbitrage. For example, the bill curtailed the authority of the OCC on larger issues such as the power to authorize insurance activities within a bank or exemption from SEC regulation. The argument in favor of the bill was that agencies

[45] See "The Long Demise of Glass-Steagall," chronology available from Frontline at http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html (accessed February 7, 2012).

[46] For a detailed account, see Martin Mayer, *The Fed: The Inside Story of How the World's Most Powerful Financial Institution Drives the Market* (New York: Simon and Schuster, 2001), 48.

[47] Greenspan, *The Age of Turbulence*, 198.

other than banking supervisors will control what banks and their affiliates can do outside of banking itself. Nonetheless, early concerns registered within the Treasury over the bill's design. One official at the OCC called it "fragmented."[48]

CONCLUSION

This overview of the legislature in the financial area has shown that Congress appears to be able to do anything, and nothing. When acting to intervene in economic policy, members must tread carefully because they are open to constant criticism either for intervening in some areas that are better left alone or not meddling when their constituents suffer. Navigating the poles between the appearance of government intervention and free market control allows members of both political parties to satisfy constituents and focus on areas that reap the greatest electoral rewards.

Unlike other branches of the American government and much of what occurs in financial politics, Congress invites interest groups in by design. The legislative operations of both chambers are conducted out in the open. House and Senate floor proceedings, as well as many hearings, are aired on C-SPAN. Transcripts and drafts of legislation are available online. Therefore, organized interest groups and firms play a significant role in what transpires there. However, the arrangement of committees and the relationships between committees and executive agencies also matters in understanding how the government intervenes, or does not intervene, in financial activities. Although it may be unpopular to help constituents through one agency or mechanism, it might be quite popular to help them through another.

Three insights emerge from this exploration into the bureaucratic organization of Congress in the financial area. First of all, it becomes clear at the outset why congressional policy frequently appears contradictory. There are numerous jurisdictions among committees, and the chambers are not always controlled by the same political party. It is particularly difficult for members of the minority party to move legislation in the House. When legislation moves through each chamber, there are numerous "gatekeepers" or "veto-players" who can stop an initiative, even if they cannot advance their own.[49] Moreover, the president may or may not be from the same party as the Congress. Hence, when Congress intervenes, there are too many sites of activity and leaders for the institution to promote a

48 Mayer, *The Fed*, 50.

49 George Tsebelis, "Decision Making in Political Systems: Veto Players in Presidentialism, Parliamentarism, Multicameralism and Multipartyism," *British Journal of Political Science* 25, no. 3 (1995), 289–325.

unified policy. Finally, policy may appear contradictory because unrelated policies may have effects on fiscal policy that were never intended with that goal in mind.[50] For example, the House and Senate Education and Agriculture committees have created programs that make credit available to constituencies that the market might otherwise ignore. Other committees, such as those that handle energy policy in the House and Senate, have an enormous impact on the way that firms and individuals spend money within the economy when they direct money toward environmental projects or vary tax policy in pursuit of environmental goals.

The second insight to emerge from this investigation is the low degree of priority that many members make of financial politics during most years, despite its importance to many in their districts and states. With the 2010 Dodd-Frank bill as an exception, the banking committees are not usually central to partisan conflict. This general lack of attention can be explained by the fact that many interest groups helped or harmed by monetary policy are not mobilized, or partisan in orientation. Even if they were, the time lag between monetary and fiscal policy and their effects on the economy makes it difficult for a member to advance one position before another issue comes along. Thus many liberal members of Congress regularly vote for pro-banking positions.[51]

The lack of attention may also be explained by the high degree of technical expertise required to shape monetary policy and questions about what an individual member *could* do if he or she were motivated. To conduct proper oversight, members would have to spell out exactly what they want the Federal Reserve officials to do in appropriate technical language, and they would have to do so persistently in a clear, consistent way. The president, monetary economists, and bankers can do this far more readily. Members of Congress and those on the banking committees are poorly suited to do it. Few electoral benefits accrue to members for acquiring the expertise. Without it, they fear looking ignorant at hearings. Furthermore, they are reluctant to disrupt mutually beneficial relationships with agencies by rocking the boat. Some view personal contacts to be more effective than congressional oversight hearings. Aggressive oversight may provoke reprisals from the agency's constituency. Finally, members may want to avoid embarrassing presidential appointees if they are from the same party. The bottom line for Woolley is that many members do not understand monetary policy, do not really care, and are therefore willing to listen to the Federal Reserve on monetary policy.[52] When they do intervene on

[50] The author thanks David Klaus for making this point.
[51] Woolley, *Monetary Politics*.
[52] Ibid., 136.

economic policy, they do so through specialized lending programs that target specific political constituencies.

The third insight is that the geographic representation in Congress makes the institution attentive to the particularistic interests of constituencies. This feature explains the central role played by housing in congressional politics, echoing the importance attached to the mortgage market in the banking industry. Homeowners are the one constituency that transcends both Democratic and Republican constituencies. In short: every member of Congress has homeowners in their district. In remarking on the politicization of mortgage lending in the United States, former Senator Phil Gramm once related that during a 1990 campaign, he learned from a poll that the best predictor of whether or not someone would vote for him was not the person's level of income or education, but whether or not he or she owned a home. Eighty-two percent of Texans who owned a home voted for him. He quipped, "You didn't have to convince me that homeownership was a good thing!"[53]

[53] Gramm quoted from event, "Is Deregulation a Cause of the Financial Crisis?" American Enterprise Institute, Friday, January 23, 2009, Washington, DC. Audio available at point 16:00, http://www.aei.org/events/2009/01/23/is-deregulation-a-cause-of-the-financial-crisis-event/ (accessed July 26, 2012).

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Making Financial Policy in the Executive Branch and the Federal Bureaucracy

Students of American government learn that the president controls the executive branch. After all, the president is the titular head of the executive branch of government and the only individual elected by *all* of the American people. However, those working in government know that the reality is much more complex. The president has three main levers of control over the bureaucracy, but as Chapter 4's discussion on the legislature demonstrated, none is absolute. He can make appointments to the top layer of management at each, but these appointments must be confirmed by the Senate. He can try to reorganize the bureaucracy, but these maneuvers are resisted by congressional committees who would then be subject to shifting jurisdictions. He can issue executive orders – that is, presidential directives to agencies – and leave himself open to criticism that the action is autocratic. In the most extreme cases, Congress can overturn an executive order with legislation or refuse to provide the necessary funding for it.

This chapter explores the connection between presidential administrations and agencies in the monetary, fiscal, and regulatory policy realms. The connection poses a unique problem in the financial area because any administration's ability to control the myriad agencies that regulate and manage the financial system varies dramatically according to how their governance structures were arranged when they were established and the organizational characteristics they have developed since then. Moreover, the agencies themselves operate within the same complex system of conflicting jurisdictions and mandates as the congressional committees. It gives each of them their own interests in preserving their areas of competence and authority, as well as an inherent tension among them. The result is that once Congress passes legislation, the contest over policy moves to the administrative agencies through the rulemaking process; if it is not satisfactory, it moves back to Congress or to the courts. Disputes over policy therefore occur in a variety of locations, with interest groups trying to gain an advantage each step of the way.[1]

The relationships among the agencies fill in the picture offered by the bureaucratic politics paradigm by showing how government leaders cannot control the specific behavior of the conglomerate of organizations because each has a life of its own. Most agencies were designed to minimize political influence – the Federal Reserve and monetary policy being the preeminent example. The president appoints governors of the Federal Reserve for a term of fourteen years. The Chair serves a four-year term. However, none of the terms overlap with the presidential election cycle by design. The requisite monetary conditions for maximum sustainable long-term growth and employment do not necessarily coincide with the needs of politicians who are subject to constituents' demands. To make matters more complicated for the regulatory policy associated with the Federal Reserve, the Office of the Comptroller of the Currency (OCC) has the authority to charter national banks. Smaller state banks can decide whether or not they wish to be a member of the Federal Reserve, and many do not. They are regulated by the Federal Deposit Insurance Corporation (FDIC) – a New Deal agency that must pay out its own funds in the event of a bank collapse.

This chapter demonstrates that financial issues emerge piecemeal over time: one problem emerges in one context and the next in another. Presidential administrations must fix one problem in that instance and then rush on to the next. Therefore, any decision of the government is not *one* resolution to the problem of an issue such as "the financial crisis" but is a mishmash of actions across a compressed time frame. Allison argued that nowhere is the gap between academic literature and the experiences of participants in government wider than on this point. There is no such thing as "the government" that acts, as some academic literature and pundits depict it to. Rather, the government constitutes multiple actions and decision points.[2] Moreover, government leaders, including the president, do not have the same interests. Their priorities and perceptions are shaped by their positions. These positions give them different, independent bases of power; thus, their ability to make a difference on outcomes is shared among them and not necessarily responsive to the president.[3]

Nonetheless, the executive branch, and the White House in particular, have centralized authority over policy development in American

[1] Lehne, *Government and Business*, 169.
[2] Allison and Halperin, "Bureaucratic Politics," 44.
[3] Allison, *Essence of Decision*, 146.

government since the 1960s. This trend has been reinforced by the tendency of the president to have to promote policies when his party is different from the party that controls Congress, and to manage an increasingly large bureaucracy. More recent presidents from Ronald Reagan to Barack Obama have continued this trend by centralizing authority in the Executive Office of the President (EOP).[4] While the president has limited power in conducting fiscal policy, relative to the legislature, the Office of Management and Budget (OMB) within the EOP is responsible for developing and executing the federal budget, through which the president can implement decisions, policies, and priorities across all economic areas.

We begin with the president because he or she is the head of the executive branch of government. We then review the bureaucracy and the relations among executive leaders in the departments, independent commissions, and agencies such as the Treasury, Federal Reserve, FDIC, Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC). The chapter pays particular attention to the competing interests and mandates among these agencies during the regulatory process with input from the banking industry and others when they make – or do not make – rules. The upshot is that interests do not just form within industry and specific groups. They also exist among *agencies* that are influenced to different degrees by industry and their relations among each other to carry out governing tasks and protect their budgets.

THE PRESIDENCY

The president is the only national political leader elected by all of the people of the United States. However, the men who wrote the Constitution distrusted the concentration of power in one body and sought to divide it among the three branches. Therefore, the U.S. president leads the largest and most diverse economy in the world. Nonetheless, he shares his power to make economic policy not only with the other branches but also with the myriad agencies that regulate banks and create monetary policy. As far back as the administration of George Washington, the president has always received advice from his cabinet – an informal grouping of the heads of the major departments that generally includes the vice president and any additional agency heads the president would like. Over time, the cabinet became less important as an advisory body because members of the cabinet are subject to Senate approval and interest group pressure. These competing demands divide their loyalty.

4 George E. Shambaugh and Paul J. Weinstein, *The Art of Policy Making: Tools, Techniques, and Processes in the Modern Executive Branch* (New York: Longman, 2003).

In response to the changing role of the presidency and steady development of state capacity to govern finance, several layers of advice and mechanisms for executive control have evolved to allow the individual who holds office to handle the broader range of activities. One of the first layers – the EOP – was established by President Franklin Delano Roosevelt in 1939. The EOP originally provided oversight on the New Deal programs; but as it grew, the EOP expanded to give the president a staff to help direct the offices of the executive branch. Next, when the Employment Act of 1946 established the Council of Economic Advisers (CEA), it was situated within the EOP. Later presidents established different advisory bodies, such as President Ronald Reagan's working group on financial markets, established after the stock market collapse on October 19, 1987 (the Secretary of the Treasury, Federal Reserve Chair, and heads of the SEC and CFTC). President Clinton's National Economic Council (NEC) was established as part of his campaign pledge to place economic policymaking at the center of his agenda (comprising a broader group with the vice president, secretaries of State, Commerce, Energy, Transportation, Health and Human Services, and other attendees). These groupings are significant because unlike the cabinet members with their competing loyalties between president and agency, the advisors who are the closest to the president work with him in the White House. These individuals do not have to be confirmed by the Senate, and their ability to influence the president derives from their personal relationship with him.

The way that the president uses the cabinet and additional layers of advisory institutions are as unique as each person who holds the office. Some presidents have a more hierarchical managerial style, wherein they set the guidelines and allow their staff to follow through on their own. Others are more involved and reach down into the agencies for input and execution. A great deal of the power of the president to intervene into the economy comes from his ability to make appointments at the top levels of the departments and independent agencies of the federal government. However, it also comes from his ability to organize and use these advisory bodies in the best way he sees fit. Thus there is not *one* CEA, NEC, or working group on financial markets. In a crisis, the president and his top advisors determine who will be included in the decision-making process and what action channels will be used.

THE PRESIDENTIAL ADMINISTRATION AND THE FEDERAL BUREAUCRACY

Each president organizes his cabinet and relationship with the White House in a particular style that can vary according to the specifics of the jobs assigned, as well as the personal relationships among people, and the presidential term. Surprisingly, the president has few direct powers over the economy. The Federal Reserve is a creation of Congress and has a quasi-independent status. The president cannot spend money without it being in the congressional budget. Therefore, the president derives his influence from his position at the center of the policymaking process and the bargaining advantages that flow from it. As Neustadt argued, he has the "power to persuade," but to do so he must induce others to believe that what he wants of them is in their own interest and not his.[5]

Thus the president must rely on others to shape policy outcomes. At the end of the George W. Bush and the beginning of the Barack Obama administrations, presidential management became centralized in the EOP, whose two largest and most influential offices are the OMB and the White House Office (WHO). To assist the president in creating fiscal policy, five resource management offices in the OMB work to prepare the federal budget and supervise the administration of executive branch agencies. The Office of Information and Regulatory Affairs (OIRA) within the OMB also plays a role in regulatory policy by reviewing agencies' proposed drafts and final regulatory actions. In addition, executive agencies send all prospective bills to the OMB prior to their transmission to Congress for clearance so that other affected agencies and appropriate EOP staff may review it. Agencies may propose substantive or technical amendments, or even a substitute. Although rare, the administration may refuse to transmit a bill to Congress from an agency if it conflicts with an important objective or is not in accord with the president's program. The OMB conducts other legislative activities such as preparing Statements of Administration Policy (SAPs) for major bills scheduled for floor action in the House or Senate in the coming week, collecting the views of agencies on legislation sent to the president for his signature after it has passed both the House and Senate, and drafting any signing statements to accompany the president's signature.

In addition to the OMB, the EOP houses two prominent policy councils: the NEC and the National Security Council (NSC). Merging monetary, fiscal, and regulatory policy roles, the NEC plays the role of broker among actors in the process, think tank for policy development, and protector of the president's agenda. Unlike the other agencies and departments, the NEC has no programmatic constituency other than the president. Hence, the non-cabinet members of the NEC are presidentially appointed but not confirmed by the Senate. They run no programs, set no regulations, and do not have

[5] Richard E. Neustadt, *Presidential Power: The Politics of Leadership* (New York: John Wiley and Sons, 1960), 46.

to testify to Congress on policy issues, albeit they have been subpoenaed by congressional committees under certain circumstances. Thus the council has the perception of legitimacy in the process within Washington and coordinates responsibility for action.[6] Nonetheless, the daily operations of government programs still rest with the cabinet, noncabinet, and independent agencies of the executive branch.

The Department of the Treasury

The Department of the Treasury is the country's finance ministry. Congress established the Treasury in the first Congress convened in 1789. Thus the department is among the oldest. It advises the president on economic and financial issues and regulates some aspects of financial institutions. It produces coin and paper money, makes payments to the public on behalf of the federal government, collects taxes, and borrows money that the government needs to function. It also works with other agencies and governments to promote growth and prevent financial crises. In international affairs, it protects national security by implementing economic sanctions against foreign threats to the United States and identifies and targets the financial support networks of terrorists. Like most countries, the United States divides responsibility for financial matters between its finance ministry (Treasury) and central bank (Federal Reserve). As will be discussed in Chapter 6, the Federal Reserve controls the short-term interest rate and U.S. money supply, whereas the Treasury has responsibility for exchange rate policy, which includes decisions about U.S. intervention in the foreign exchange markets, and decisions about whether to engage with other countries about what they are doing in theirs.

In John Taylor's recollections of his time working at the Treasury as Under Secretary for International Affairs, there is no clear-cut way to determine which issues should, or should not, be passed along the chain of command to the president and/or coordinated with other agencies such as the Federal Reserve. This makes it difficult for outsiders to determine who is in charge of exchange rate policy. Taylor recalled cooperating with Alan Greenspan on all major exchange rate issues in a series of meetings with the Federal Reserve Chair at the Treasury and the White House. If there were an intervention, the Federal Reserve and the Treasury would intervene together, with the Federal Reserve using some of its foreign exchange and the Treasury using the Exchange Stabilization Fund.[7]

[6] Shambaugh and Weinstein, *The Art of Policy Making*, 20.

[7] John B. Taylor, *Global Financial Warriors: The Untold Story of International Finance in the Post-9/11 World* (New York: W. W. Norton, 2007), 284.

The area of bank regulation is similarly shared among agencies of the federal government. Two main banking regulatory bodies were established within the Treasury: the OCC and the Office of Thrift Supervision (OTS). The latter has been eliminated by the Dodd-Frank reform legislation; nonetheless, both are part of the story of the fragmented nature of the agencies that charter, regulate, and supervise banks that reflects the halting experiments with national banking in American history reviewed in Chapter 2. They were established in very different eras and monitor and examine different categories of banks. As with the rest of the federal bureaucracy, the president's ability to control these agencies rests with his ability to appoint the heads of the agencies.

Also discussed in Chapter 2, the first of the two federal agencies that regulate and supervise banks – the OCC – was established during the Civil War when Treasury Secretary Salmon P. Chase recommended establishing a system of federally chartered national banks to issue standardized national bank notes based on U.S. bonds held by the bank, or "greenbacks." The OCC became the agency authorized to hire a staff of national bank examiners to supervise and periodically examine national banks, and to regulate lending and the investment activities of the banks as well. While national banks no longer issue currency, they play a role in the economic well-being of the United States. As of January 2010, the OCC regulates and supervises more than 1,500 national banks and 50 federal branches of foreign banks in the United States, accounting for nearly two-thirds of the total assets of all U.S. commercial banks. As part of their supervision, the OCC can examine the banks; approve or deny applications for new charters, branches, capital, or other changes in corporate or banking structure; and take supervisory actions against banks, such as removing officers and negotiating agreements to change banking practices. As with the other regulatory agencies, the OCC can also issue rules and regulations that govern bank investments, lending, and other practices. The OCC determines when national banks become insolvent and appoints the FDIC to be the receiver for such banks.

The OTS is the other main, although short-lived, banking regulatory body established within the Treasury. It was created in response to the savings and loan (S&L) crisis in 1989, but its origins are much deeper, in the old Federal Home Loan Bank board created by President Hoover in 1932. With primary responsibility for monitoring the soundness of federal S&Ls and their holding companies, and funded by assessments on covered institutions, the OTS also supervised federally insured state savings associations. However, the OTS's function was added at a time when the lines separating the financial services industries were rapidly disappearing. The Dodd-Frank bill targeted the OTS for closure, albeit the agency's 1,000 employees cannot be fired for up to four years. Most of them will be moved to the OCC, where they will oversee the same companies. In the future, the transfer of authority may undercut the incentives to operate under a federal thrift charter and prompt a round of "regulator shopping." Early evidence is mixed. Thirty-five savings and loans have applied to switch from national to state charters from July 2011 to April 2012, whereas others have opted for a credit union charter, contending that the OCC does not understand local regulation of smaller banks.[8] Nonetheless, the bill preserves a federal thrift charter as a separate category of financial institution.

Why would firms choose a federal thrift charter and thus regulation by the OTS? First, the charter shields the institution from some state regulations because federal banking law can preempt state law. Second, it permits the institution to open branches nationwide under one regulator, while state-chartered thrifts must comply with the state regulator in each state where it operates. Third, a federal thrift charter and its holding company are regulated by the same regulator, but a federal bank charter may split regulation of the institution and its holding company between the OCC and the Federal Reserve.[9] In the run-up to the 2008 crisis, some of the largest institutional failures were regulated by the OTS, most likely because it offered a more lax regulatory environment. For example, the mortgage lender Countrywide had been regulated by the OCC under the rules for national commercial banks until 2007. In March of that year, the OTS approved its application to convert its charter.[10] The regulator depends on fees paid by the banks it regulates, thus the large financial firm was a welcome addition to the OTS.

Coordinating Leadership between the Treasury and the Federal Reserve

Because some of the functions and operations of the Treasury and the Federal Reserve overlap, particularly in bank regulation, the relations among the agencies are of paramount importance in managing national economic policy. However, if the Treasury is one step removed from the inner office of the White House and the NEC, the autonomous Federal Reserve is even one *further* step removed. Individuals who head the Treasury and Federal Reserve are not necessarily from the same political party, nor were they

8 Jessica Silver-Greenberg, "Small Banks Shift Charters to Avoid US as Regulator," *New York Times*, April 2, 2012.

9 Mark Jickling and Edward V. Murphy, *Who Regulates Whom? An Overview of U.S. Financial Supervision* (Washington, DC: Congressional Research Service, 2009), 14.

10 See "OTS Approves Countrywide Application," http://www.ots.treas.gov/_files/777014.html (accessed June 7, 2011).

necessarily appointed by the same president. Therefore, what follows is a brief review of how the personal relationships can vary and have a significant impact on overall policy, drawn from the memoirs of men who have held the position of Treasury Secretary and Federal Reserve Chair.

For example, in President Ronald Reagan's first term, Donald Regan was Treasury Secretary and Paul Volcker was held over from his appointment by Jimmy Carter as Federal Reserve Chair. Regan came from Merrill Lynch and had very little prior experience in Washington or public service, whereas Volcker had a career in the government and was popular with the banking community. Neither man knew Reagan well. In what he calls "the guesswork Presidency," Regan stated that in the four years he served as Secretary of the Treasury, he never saw Reagan alone and never discussed economic philosophy or fiscal or monetary policy with him one-on-one. He figured out what the president sought to accomplish by studying his speeches and reading the newspapers.[11]

When Volcker was at the Federal Reserve and Regan was at the Treasury, the coordination between the Treasury and the Federal Reserve was complicated by the congressional budgeting process, which resulted in high levels of government spending when the Federal Reserve was cutting the money supply. This situation was akin to Congress with its foot on the accelerator and the Federal Reserve with its foot on the brakes. It left little room for action on the part of the administration to end the crippling recession. Congress would not lower the rate of spending, and Volcker would not change his policy with its resulting high interest rates.[12] Volcker would only accommodate the administration by easing monetary policy (and thus lowering interest rates) if there was movement on the high rate of deficit spending. Otherwise, the Federal Reserve Chair feared that the lower interest rates would spur inflation. The sooner the Reagan administration moved, the sooner rates would come down.[13]

In the second Reagan administration, a new Secretary of the Treasury took over, and Volcker initially stayed on at the Federal Reserve. Donald Regan swapped jobs with James Baker, who had been the Chief of Staff in the White House. Therefore, Baker arrived at the Treasury with a good deal of Washington experience and a desire to continue Reagan's work on reforming the tax code. On assuming the job of Treasury Secretary, Baker noted that he lost his daily proximity to the president. Unlike White House staff who have constant contact, cabinet officials need an appointment to

[11] Donald T. Regan, *For the Record: From Wall Street to Washington* (New York: Harcourt Brace Jovanovich, 1988), 142.

[12] Ibid., 171.

[13] Ibid., 178.

see the president. Baker accepted this reality because he had such a close relationship with Reagan, having worked on his 1980 and 1984 elections, as well as having served as chief of staff. Nonetheless, he still found the dynamics at the Treasury to be different because, as a White House advisor, he had remained in the room after the cabinet official left. This reality gave him the last word to the president on whatever issue was at hand. Baker lost this influence when he became a cabinet official himself and had to return to the Treasury Department at the end of a meeting.[14]

With the switch at the Treasury in the Reagan administration, Volcker was not reappointed. He saw political difficulties as early as 1986, when he was outvoted on the board of governors by Reagan appointees. They rejected an increase in the interest rates on loans that the Federal Reserve made to banks. He reportedly prepared his resignation, and the appointees backed down. But when Volcker offered his resignation at the end of his second term, he was not asked to remain. Baker was reportedly glad to see him go.[15]

Alan Greenspan was installed as the next Federal Reserve Chair by Reagan; therefore, he was already installed at the Federal Reserve and hoped for a collegial relationship when George H. W. Bush assumed the presidency. George H. W. Bush's Treasury Secretary Nicholas Brady, Budget Director Richard Darman, CEA chairman Michael Boskin, and others were his longtime acquaintances and friends. However, Alan Greenspan's main economic concern was with the level of deficit spending, and the Bush administration did not manage it. Despite the fact that they were all Republican appointees, by Greenspan's own admission, "We ended up with a terrible relationship."[16] Bush delegated economic policy to Brady, Darman, and Boskin, and these individuals did not have a kind view of the Federal Reserve. Brady asked Greenspan for an agreement that if the budget deficit were cut, he would lower interest rates. When the two could not reach an agreement and the recession at the time worsened, the friction grew. When Bush did not win reelection, he commented that Greenspan had disappointed him despite the fact that he had reappointed him.[17]

The Clinton administration was Democratic, but Greenspan remained in his position to finish his term. While ideological differences existed between parties outwardly, internal relations improved dramatically between the Federal Reserve and Treasury. Bill Clinton's managerial style was notably

[14] James A. Baker III, "*Work Hard, Study . . . and Keep Out of Politics!" Adventures and Lessons from an Unexpected Public Life* (New York: G. P. Putnam's Sons, 2006), 221.

[15] Auerbach, *Deception and Abuse at the Fed*, 31.

[16] Greenspan, *The Age of Turbulence*, 113.

[17] Ibid., 120.

different from that of Reagan and George H. W. Bush. Clinton's first Treasury Secretary, Lloyd Bentsen, had been a senator and worked well with Greenspan. When Robert Rubin took over as Secretary of the Treasury, he, his deputy Lawrence Summers, and Alan Greenspan formed an immediate bond when the three had to work together on a Mexican rescue package in 1995. Because Greenspan and Rubin worked so well together, the Federal Reserve chief rarely attended economic policy meetings in the White House.[18] Relations between the Treasury and the Federal Reserve were so good, in fact, that Clinton reappointed the Republican when his term ended.

Greenspan's relations with the Republican George W. Bush administration started out well. Unlike Treasury secretaries who came from Wall Street, President George W. Bush's first Treasury Secretary, Paul O'Neill, had a background in corporate America and in the Ford administration with Dick Cheney, the vice president. More importantly, he maintained a close friendship with Alan Greenspan, who had endorsed him for the board of directors of Alcoa in the 1980s. Greenspan had later promoted him as a candidate for chief executive officer of Alcoa and called O'Neill to encourage him to take the Treasury position when George W. Bush offered it.[19] Some questioned whether O'Neill was more in sync with the Federal Reserve than with the president.[20] Although O'Neill did not maintain good relations with the White House and eventually left the administration over a serious difference of opinion on preemptive war and deep tax cuts, he continued to support the policies of his friend Greenspan.

President George W. Bush's last Treasury Secretary, Henry Paulson, had been the head of Goldman Sachs prior to his turn to government service. However, he forged a solid working relationship both with the Republican-appointed Ben Bernanke at the Federal Reserve and the Democratic Chair of the House Committee on Financial Services, Barney Frank. During the financial crisis in 2008, Ben Bernanke (who replaced Greenspan in the George W. Bush administration) and Paulson worked together, at times without the president. For example, they did not take any White House staff to the Hill to present key features of the legislation that helped to secure congressional authority for placing Fannie Mae and Freddie Mac into conservatorship, as well as for passage of the Troubled Asset Relief Program (TARP).[21]

[18] Ibid., 161. See also Robert Rubin, *In an Uncertain World* (New York: Random House, 2003).

[19] Greenspan, *The Age of Turbulence*, 209.

[20] Ron Suskind, *The Price of Loyalty: George W. Bush, the White House, and the Education of Paul O'Neill* (New York: Simon and Schuster, 2004), 67.

[21] Henry M. Paulson Jr., *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System* (New York: Business Plus, 2010).

This review demonstrates that political party affiliation or the presidential administration that appoints the Federal Reserve Chair do not predict how well the leaders of the Treasury and Federal Reserve Board will work together. Each must be placed into the context of the political economy of the day and the style of the presidential administration, as well as the specific issues and problems faced by these policymakers.

The Federal Deposit Insurance Corporation

Outside of the Treasury but also regulating some banks, the FDIC is an independent agency of the federal government from the Depression-era reforms. It was created in response to the bank failures of the 1920s and 1930s. It is managed by a five-person Board of Directors who are appointed by the president and confirmed by the Senate. No more than three directors can be from the same political party. As with other industry-specific commissions, board members have staggered terms. The goal is to evade partisan politics to the greatest extent possible, which makes industry-specific commissions more difficult for the president to control. The president does not always have the occasion to make the appointments that would drive change at the most opportune time.

The primary role of the FDIC is to provide deposit insurance for more than $7 trillion worth of deposits in the United States. It also plays a role as a regulator and seeks to limit the effect on the economy and the financial system when a bank or thrift institution fails. The FDIC is known primarily for identifying, monitoring, and addressing risks to its deposit insurance fund. The existence of deposit insurance ironically raises the level of risk in the system overall. Congress created deposit insurance to make some parts of the banking industry "safe" places for individuals to put their money. However, once in place, the safety feature means that depositors no longer pay attention to the soundness of the financial institution; they will receive their money (up to a limit) even if it fails. Therefore, consumers put their money in the bank offering the highest rate of interest, irrespective of the solvency of the institution.[22] Deposit insurance thus allows commercial banks to borrow (i.e., take in deposits from people) at a subsidized rate because once the insurance scheme was put in place, depositors have not paid attention to the soundness of the financial institution. They might not make deposits in some banks if they did pay attention. To do its job, the FDIC does not receive congressional appropriations but is funded by bank and thrift premiums, as well as earnings on investments in U.S. Treasury securities.

The FDIC also examines and supervises more than 4,900 banks and savings banks for operational safety and soundness to address the issue of

[22] Lichtenstein, "Lessons for 21st Century Central Bankers," 223.

the solvency of the institution. This number represents more than half of the institutions in the system. Under the dual banking system, banks can be chartered by the states or by the federal government. Those chartered by states have the choice of whether to join the Federal Reserve System, whereas the FDIC is the primary regulator of banks that are chartered by the state banks that do not join. That makes the FDIC the backup supervisor for the remaining insured banks and thrift institutions.

When a bank or thrift institution fails, the FDIC responds immediately. The institution is closed by its chartering authority, the state regulator, the OCC, or the OTS. The FDIC can then attempt to resolve the failure, generally by selling the failed institution's deposits and loans to another institution. After the bank is closed, customers automatically become customers of the new institution. They do not lose access to their funds.

Bureaucratic problems among the FDIC and other bank regulators derive from the fact that the FDIC must cover the losses of institutions that other agencies may or may not regulate or examine. Hence, the FDIC tends to be a conservative regulator among the group, because it must pay out of its insurance fund even if a bank regulated by one of the others fails, whereas the others do not. To get around these problems, the regulators often make agreements among themselves. In 2002, the FDIC agreed to conduct special examinations of banks when they received their periodic review by their primary regulator. At the time, the FDIC could not examine banks that their primary regulator considered to be financially healthy. During the financial crisis of 2008, the FDIC argued that it lacked the information needed to evaluate banks' risk and therefore to put together strategies for resolving them after they failed. FDIC Chair Sheila Bair stated, "The FDIC needs to have a more active on-site presence and greater direct access to information and bank personnel to fully evaluate the risks to the deposit insurance fund on an ongoing basis and to be prepared for all contingencies."[23] With the updated agreement among regulators, the FDIC gained unlimited authority to investigate banks.

Similar to the FDIC, the National Credit Union Administration (NCUA), formed in 1970, is another independent federal agency that charters and supervises federal credit unions. It operates the National Credit Union Share Insurance Fund, which insures the savings of eighty million account holders in all federal credit unions and many state-chartered credit unions. The NCUA was part of the broader reforms in the 1970s that changed the products and services offered by financial institutions and credit unions.

[23] See "F.D.I.C. Gets More Power to Evaluate Banks' Risk," *New York Times*, July 12, 2010.

The Securities and Exchange Commission

Like the FDIC, the SEC was created during the Great Depression. The SEC oversees the major participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisors, and mutual funds. In each of these areas, the SEC maintains enforcement authority wherein it brings hundreds of civil enforcement actions against individuals and companies for violation of securities laws. The most common infractions are insider trading, accounting fraud, and providing false or misleading information about securities and the companies that issue them. Also similar to the FDIC, the SEC is governed by five commissioners and appointed by the president, with staggered five-year terms. One is the designated Chair of the Commission. By law, no more than three may belong to the same political party so that decision making is nonpartisan.

The SEC also protects securities customers, counterparties, and creditors by requiring that broker-dealers have sufficient liquid resources on hand at all times to satisfy claims promptly under its uniform net capital rule. In addition to the minimum base capital requirements, the Commission, together with self-regulating organizations in the industry such as the National Association of Securities Dealers and the national exchanges, have established "early warning" levels of capital that are higher than the broker-dealers' minimum capital requirement. This advance warning alerts regulators that a broker-dealer is experiencing financial difficulty and allows them to initiate corrective action.[24]

Unlike the banking reforms of the Depression that built on existing law and seek to prevent transgressions prior to catastrophic institutional failure, the securities laws seek to protect the purchasers of publicly sold securities through disclosure of all facts that could be materially relevant. The Securities Act of 1933 and Securities Exchange Act of 1934 were consumer-oriented pieces of legislation that established a new agency, funded by annual appropriations to implement its provisions. Hence, the mission of the SEC is investor protection – that "sunlight is the best disinfectant" and that large institutions or private individuals should have access to certain basic facts about an investment prior to buying it and for as long as they hold it. Nothing in the legislation or securities regulation prepared the SEC to think about the safety of the institutions themselves or the risk that they posed to the soundness of the *system*.[25] Therefore, the SEC differs from the banking regulators insofar as its primary purpose is to require public

[24] See SEC, "Key SEC Financial Responsibility Rules," http://www.sec.gov/about/offices/oia/oia_market/key_rules.pdf (accessed April 12, 2012).

[25] Lichtenstein, "Lessons for 21st Century Central Bankers," 224.

companies to disclose meaningful financial and other information to the public.

This mission has somewhat constrained what the SEC can do within the regulatory structure. Congress gave the Commission the statutory authority to impose civil penalties against a corporation only recently and the authority to impose large penalties even more recently. That is, prior to the enactment of the Securities Enforcement Remedies and Penny Stock Reform Act (otherwise known as the Remedies Act) in 1990, the SEC's penalty authority was limited to its ability to seek penalties in district court for insider trading violations. Although the Remedies Act gave the Commission the authority to seek civil money penalties in enforcement and enhanced its authority to fine individuals, it limited what could be sought and to whom it could be paid. It was not until passage of the Sarbanes-Oxley Act in 2002 that penalties did not automatically go to the Treasury but instead could go to the benefit of victims.[26]

Because good information on the activities of corporations rests on sound accounting practices, the Division of Corporate Finance within the SEC supervises the activities of the accounting profession, particularly the Financial Accounting Standards Board (FASB). This means that the division considers the generally accepted accounting principles (GAAP) and increasingly the International Accounting Standards Board (IASB). The SEC treats accounting standards adopted by the FASB as authoritative. If it disagrees with these accounting standards, it can refuse to give them deference. During times of distress, firms tend to pressure the FASB to change accounting standards to inflate the value of assets. Under certain circumstances, there may be a legitimate need to recognize that stresses on large financial institutions may threaten the system. These stresses, however, can be handled through banking regulators that can reduce regulatory capital requirements or by changing the accounting standards. Many individuals in the SEC have opposed the latter changes because they could allow financial services firms to hide their true financial positions from investors.[27]

The Commodity Futures Trading Commission

The CFTC is an additional independent agency that plays a role in the regulatory policy domain. In 1974, during the Gerald Ford administration,

[26] See SEC, "Statement of the Securities and Exchange Commission Concerning Financial Penalties," 2006-4, http://www.sec.gov/news/press/2006-4.htm (accessed April 12, 2012).

[27] See Roderick M. Hills, Harvey L. Pitt, and David S. Ruder, "Don't Let Banks Hide Bad Assets," *Wall Street Journal*, November 18, 2009, http://online.wsj.com/article/SB10001424052748704782304574542134264068424.html (accessed April 13, 2012).

Congress passed the Commodity Futures Trading Commission Act that created the CFTC with exclusive jurisdiction over futures trading in futures and options on a wide array of commodities from cotton, corn, and wheat to meats and precious metals. These were previously responsibilities housed in the Department of Agriculture. The trading of futures contracts extends back to early history. Aristotle makes references to the future delivery of products at a certain price. In the United States, the Chicago Board of Trade was formed in 1848 to provide an open, transparent market where contracts could be traded and legally honored.[28] The result was that the contracts were eventually standardized. The CFTC would therefore prove to be an important part of the risk structure of the financial services industry as products evolved, because it was a site where agricultural derivatives were regulated.

The trajectory of the CFTC is closely tied to innovations in the derivatives industry and attempts to evade regulation altogether. After an extended rulemaking struggle over the regulation of over-the-counter (OTC) derivatives, which we will discuss later in the chapter, President Clinton signed the Commodity Futures Modernization Act (CFMA) of 2000, which reauthorized the Commission for five years but overhauled the Commodity Exchange Act of 1936. Although some accounts claim that the Obama administration initially sought to fold the CFTC into the SEC, President Obama later signed the Dodd-Frank Act that amends the Commodity Exchange Act to establish a new regulatory framework for swaps and security-based swaps.[29] The bill provides for the registration and comprehensive regulation of swap dealers and major swap participants, imposes clearing and trade execution requirements on standardized derivatives, creates recordkeeping and reporting regimes, and enhances the CFTC's rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to its oversight.

MAKING RULES IN THE EXECUTIVE AGENCIES

Congress makes laws, but the executive agencies headed by presidential appointees must implement them. They do this by issuing rules, or regulations that govern the operations of government programs and have the force of law. Therefore, much of the actual rulemaking within the federal government is done within the executive agencies. The rulemaking process is where the interactions – personal and political – among the presidential

[28] Ron Suskind, *Confidence Men: Wall Street, Washington, and the Education of a President* (New York: Harper, 2011), 170.

[29] Ibid., 172.

administration, agencies, and interest groups can be seen most clearly. In 1946, the Administrative Procedure Act established a transparent procedure for making rules so that everyone can participate. Nonetheless, lobbyists from the affected industry have the greatest stake in the outcome of the process, as well as the resources to follow the details. Thus the technical nature of rulemaking offers firms and their lobbyists a greater advantage because they may receive a fuller hearing in the agency than in other political venues.[30]

The first step in the rulemaking process is to publish notice of the time, place, and nature of rulemaking proceedings in the Federal Register. In the second step, interested parties are given the opportunity to submit written arguments and facts that are relevant to the rule. In the third step, the agency states the statutory purpose and basis of the rule, and thirty days or more later it goes into effect. For example, Congress passed the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Sarbanes-Oxley Act in 2002. These statutes were drafted broadly and set out the basic principles and objectives of the law. However, to make sure that there are common understandings of the intent of Congress in specific circumstances, and to respond to new technological innovations in securities markets, expansion in their size, and new products and offerings, the SEC makes rules to implement the Acts.

In the specific example of the SEC, rulemaking begins with a rule proposal, but sometimes an issue is unique and complicated. Therefore, the Commission seeks public input on which, if any, regulatory approach is appropriate. A concept release is issued describing the situation and the Commission's concerns with it. It usually identifies different approaches to addressing it, along with a series of questions to ask for the public to provide views on the issue. This feedback is important in considering which approach, if any, to follow. The next step is to propose the rule for public comment, wherein the public has between 30 and 60 days to review and comment on it. Just as with the concept release, public comment is considered vital to the formulation of the new rule. Finally, the commissioners take into consideration what they have been given by the public and attempt to craft the final rule. If it is adopted by a vote of the full Commission, it becomes a part of the official rules that govern the securities industry.[31]

In the absence of legislation, the president can initiate rule changes. This process usually starts when an administration makes a policy decision

[30] Lehne, *Government and Business*, 167.

[31] See SEC, "The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation," http:///www.sec.org (accessed March 14, 2010).

and seeks to implement it through the agencies. The White House issues a decision memorandum that can contain both policy recommendations and policy implementation recommendations. For example, President Clinton received a memorandum from his advisors in 1993 recommending that he reform the Community Reinvestment Act (CRA). The Act had been criticized for being overly bureaucratic. Therefore, Clinton attempted to streamline the CRA and issue regulations that would be performance-based instead of subjective criteria. Clinton's advisors suggested that he send a presidential directive to the four banking regulators asking them to revise their CRA regulations. The advisors did not just offer a policy change, but a way to implement it. They could have advised him to seek legislation as well. In fact, later changes to the CRA have come from the law. Clinton's advisors also could have advised him just to use the presidential bully pulpit to initiate rules changes. The choice of which technique to use depends on the policy itself and the political climate, particularly if the president lacks support in Congress for whatever he seeks to achieve.[32]

FINANCIAL INNOVATION, RULEMAKING, AND CRISIS IN THE EXECUTIVE BRANCH

The nature of bureaucratic politics makes it difficult for regulatory practice to keep up with financial innovation, and at times promotes innovation around regulation, as was reviewed in Chapter 3. In short, the patchwork of banking and securities regulators provides a great deal of complexity to the effective protection of some aspects of the industry. The political arrangements, terms of office, conditions of governance, and rivalries among the political leadership at the top of these entities further complicates it. The result is that in the abstract, the fragmented nature of financial regulation and the bureaucratic rulemaking process cover all areas of financial markets. In practice, the system is even messier, particularly when it involves powerful political interests connected to the highest levels of a presidential administration and congressional leadership. In these cases, financial innovations and practices can fall through the cracks, and cracks can be created for them.

The case of OTC derivatives is an example that shows the political process operating among the president, executive agencies, and financial sector through regular action channels. There is overlapping jurisdiction on these instruments because the Commodity Exchange Act vests the CFTC with jurisdiction over futures and commodity option transactions, but explicitly excluded certain types of OTC derivatives from the Act in the 1990s,

[32] Shambaugh and Weinstein, *The Art of Policy Making*, 59.

including transactions in foreign currencies, government securities, and certain other financial instruments. Options on securities and options on securities indexes were also excluded from the Act and are subject to the jurisdiction of the SEC. Despite efforts to correct for the risk inherent in OTC derivative transactions, rulemaking was thwarted by the numerous veto points that stopped it at different junctures in different instances.

In the prominent case of rulemaking in the derivatives area, the Clinton administration appointed Brooksley Born as Chair of the CFTC. As head of this agency in 1996, she was also a member of Clinton's working group on financial markets with Federal Reserve Chair Alan Greenspan, Secretary of the Treasury Robert Rubin, SEC Chair Arthur Levitt, and Treasury official Lawrence Summers. A lawyer practicing in the derivatives area prior to her work in the administration, Born and the CFTC board learned of the existence and potential harm inherent in the market for OTC derivatives through a lawsuit filed by Proctor and Gamble against Bankers Trust, claiming that Bankers Trust had sold products that Proctor and Gamble did not really understand.[33] As a result of the lawsuit and its subsequent proceedings, information about these products became available to the government in the form of audiotape recordings of telephone calls among Bankers Trust brokers that the CFTC would not otherwise have had access to.[34] It therefore became apparent that there was no way for the government to know about the market, its size, or operations.

As the name implies, "OTC" products were contracts held privately by hedge funds, law firms, and other parties but were unregulated due to an exemption in these transactions from a requirement of exchange trading. Hence, they were traded OTC. In the 1990s, the market for OTC derivatives had grown to approximately $25 or $30 trillion.[35] If an institution could not pay the obligation the derivative incurred, the terms of the private contract could bring it down, and possibly any broader financial markets

33 This case study relies heavily on the episode as related in the PBS Frontline documentary "The Warning," October 20, 2009, http://www.pbs.org/wgbh/pages/frontline/warning/. See also transcript of "The Warning," http://www.pbs.org/wgbh/pages/frontline/warning/etc/script.html (accessed March 15, 2010), 5. For another version of the same episode, see Michael Hirsh, *Capital Offense: How Washington's Wise Men Turned America's Future Over to Wall Street* (New York: John Wiley and Sons, 2010), 6–7.

34 Individuals from Bankers Trust during the era assert that the conversations on the tapes were taken out of context. See Nina Mehta, "The Legacy of BT," *Derivatives Strategy*, http://www.derivativesstrategy.com/magazine/archive/2000/1100fea2f753.asp?print (accessed March 23, 2010). See also John Thackray with Carol Bere, "The Two Faces of Kevin Hudson," *Derivatives Strategy*, http://www.derivativesstrategy.com/magazine/archive/2000/1100fea3f753.asp?print (accessed March 23, 2010).

35 See interview with Brooksley Born, http://www.pbs.org/wgbh/pages/frontline/warning/interviews/born.html (accessed March 15, 2010).

attached to it. Orange County, California, went into bankruptcy because it had speculated with public money in the OTC derivatives market on interest rate swaps. There were also fraud cases associated with the market.

Armed with this information, Born considered regulating the OTC derivatives market in 1998 by initiating a concept release in the rulemaking process that described the issue and the CFTC's concerns. The Division of Trading and Markets at CFTC prepared a list of questions about the nature of the market and the grounds for concern, such as fraud, collapses in the market, rapid growth, and lack of enforcement tools, to allow the CFTC to police the markets for fraud and manipulation. The concept release also asked questions about whether changes needed to be made, whether there needed to be recordkeeping, if there should be reporting to a regulator, and if a clearinghouse would help to protect against the risk of a counterparty default on one side or the other.[36]

The pushback from the financial services industry was immediate. Bankers, derivatives dealers, and their lobbyists approached Summers, Rubin, and Greenspan, as well as the relevant members of Congress.[37] The American Bankers Association objected that the concept release disturbed the status quo of legal and regulatory certainty that has enabled the OTC derivatives market to thrive for the benefit of the U.S. economy.[38] In response to this initial stage, the president's working group held an emergency meeting to try to convince Born to stop the process.

Born had not worked on the early Mexican rescue package that had cemented ties among the agency heads, nor did she have a close familiarity with President Clinton. Her personal connection to all of these men was through her relationship with Hillary Clinton when Hillary was a prominent lawyer in Little Rock, Arkansas. Arthur Levitt, one of the groups' members, commented that he was told she was "irascible, difficult, stubborn, unreasonable."[39] She nonetheless published the release two weeks later. At this stage, only Congress could stop Born because the executive branch agencies could not coordinate among themselves over the issue and its resulting turf war. By issuing a statement preventing the CFTC from oversight, Greenspan, Rubin, and Levitt attempted to pursue legislation of OTC derivatives to clarify the role of the CFTC in the rulemaking process.[40]

[36] See transcript of "The Warning," 3.

[37] Ibid., 7.

[38] U.S. Congress, House Committee on Agriculture, *Regulation of the Over-the-Counter Derivatives Market*, 105th Cong., 2nd sess., June 10, 1998, 19.

[39] In fairness to Levitt, he later regretted that he had accepted the assessment. See transcript of "The Warning."

[40] See Department of the Treasury Press Release, "Joint Statement by Treasury Secretary Robert E. Rubin, Federal Reserve Board Chairman Alan Greenspan and

The House and Senate committees held a series of hearings with the relevant regulators, wherein Levitt and Greenspan testified. In response to the alarm over the concept release, the three agencies (the Treasury, Federal Reserve, and SEC) proposed legislation to restrict the activities of the CFTC. Deputy Secretary of the Treasury Lawrence Summers testified in a word-for-word repetition of the American Bankers Association testimony that the release cast a shadow of regulatory uncertainty over a thriving market.[41] Federal Reserve Chair Alan Greenspan argued that the OTC dealers' fear of loss of their good reputation was a more powerful incentive for them to moderate their behavior than regulation was.[42] Arthur Levitt from the SEC raised the issue of the CFTC's jurisdiction. He argued that his own agency's proposal would address the issue without expanding or shrinking any agency's jurisdiction.[43]

Shortly thereafter, the Long-Term Capital Management (LTCM) hedge fund melted down as a result of its OTC obligations, just as Born had predicted was a possibility. Moreover, LTCM was the type of hedge fund whose participation in the OTC derivatives market threatened not only itself but also the large banks attached to it. A hedge fund is a limited partnership with no other particular status in securities law. Unlike mutual funds, hedge funds are private and largely unregulated investment pools. They do not register with the SEC, although some make filings to the CFTC. Because they operate outside of most regulation, they must limit their ownership to fewer than 100 investors, each worth at least $1 million, or up to 500 investors, assuming each has a portfolio of at least $5 million. The idea is that if it is only open to a few investors who have enough money that they can lose their investment, the SEC does not need to regulate it.[44] The hedge fund industry grew along with the shadow banking industry in the 1990s and particularly as the access to credit exploded. LTCM's strategy was to leverage its capital twenty to thirty times because it would allow the fund to make a profit on the gap between the bonds that it intended to buy and sell.

Despite these features that allowed LTCM to operate outside the regulated sector, its collapse nonetheless threatened that sector. When it moved into purchasing stock, LTCM was limited by the Federal Reserve's

Securities and Exchange Commission Chairman Arthur Levitt," RR-2426, May 7, 1998, http://www.treasury.gov/press-center/press-releases/Pages/rr2426.aspx (accessed April 13, 2010).

41 U.S. Congress. Senate Committee on Agriculture, Nutrition, and Forestry. *Over-the-Counter Derivatives*, 105th Cong., 2nd sess., July 30, 1998, 8.

42 Ibid., 13.

43 Ibid., 17.

44 Lowenstein, *When Genius Failed*, 24.

"Regulation T," which set a limit on the amount of loans that brokers could make to purchase stocks. However, LTCM was able to evade the restrictions on borrowing by buying OTC derivative contracts that mimicked the behavior of stocks, but were not the actual equities themselves. It would purchase a swap contract with a bank that would agree to pay LTCM whatever profit it would have earned if had actually purchased the stock. In exchange, LTCM would make an annual payment calculated as interest on a certain amount of money. Therefore, LTCM could make a large investment in stock without having to put money down or make the usual disclosures.[45] Without having to account for its total exposure, each regulated bank doing business with LTCM only knew the extent of its own exposure to the individual client, not whether the hedge fund might be exposed to a dozen other banks.[46]

The interconnections among the nonregulated, lightly regulated, and regulated sector ultimately called for government action to prevent a catastrophic collapse. At the time of the meltdown, LTCM had $1.25 trillion in notional value of OTC derivatives and only $4 billion in capital to support the investment. Were it to default, the counterparties in the derivatives contracts – that is, the derivatives dealers – would suffer the consequences. Although Alan Greenspan was uncomfortable with government involvement in the situation, the president of the Federal Reserve Bank of New York, William McDonough, had concerns that if a firm of LTCM's size collapsed, the fire sale of its assets on the market would cause prices to collapse and trigger a chain reaction that would bankrupt other firms. Despite the fact that the Federal Reserve does not have authority over hedge funds, McDonough gathered officials from sixteen of the largest banks and investment houses and explained the situation. After a few days of tense negotiations, the bankers infused $3.5 billion into LTCM so that it could be dissolved in an orderly way. The funds were not provided by the Federal Reserve, but it had been involved in coordinating the resolution.[47] Thus it provoked public criticism of a "bailout."

Undeterred by the LTCM debacle, the President's Working Group issued an OTC derivatives report to Congress that suggested there was no need for regulation. The CFMA was passed in 2000, which took the jurisdiction for OTC derivatives away from the CFTC, as well as the SEC. It also prohibited state regulators from interfering with these markets. In this round of bureaucratic politics over rulemaking abilities, the combination of the SEC, Federal Reserve, and Treasury won. There would be no

[45] Ibid., 103.
[46] Ibid., 106.
[47] Greenspan, *The Age of Turbulence*, 194.

transparency in derivatives contracts and no outright prohibitions on fraud. The CFTC itself was changed insofar as it lacked the authority to regulate OTC derivatives after the CFMA was signed into law. As reviewed previously, the issue resurfaced during the negotiations associated with Dodd-Frank, and most OTC derivatives should be cleared on an exchange as a result of Dodd-Frank. However, this legislation will itself pass through the rulemaking process, where many significant definitional terms remain to be determined.

INTEREST GROUPS, REGULATION, AND "AGENCY CAPTURE"

Organizational behavior models of bureaucratic behavior stress the importance of shared values within an organization. Even when some do not hold these values, they hesitate to diverge from the majority to avoid being marginalized. The values of the financial services industry infuse the values of major agencies in the bureaucracy of the federal government insofar as the agencies share understandings of the proper role of the government in the economy, and in the appropriate actions of banks and financial intermediaries in particular. When the connections are so tight, it is difficult to ascertain if the government agency works in the public's interest or in that of the industry. They are difficult to untangle because the best people with the expertise necessary to regulate an industry have probably worked in it.

Why are industries and agencies so closely aligned? Top industry officials usually serve in government for limited periods and then move to the private sector in what can be called "the revolving door" between the two. As far back as the 1950s, analysts recognized the mutually reinforcing relationship between employees of the agencies and the groups that comprise its "clientele." Examples at the highest levels abound. When John Heimann testified before the Senate Banking Committee in 1993, the Chair noted,

> [He is] an old friend of this committee. He is currently the chairman of the national markets at Merrill Lynch. He has also had a distinguished career in both the private and public sectors. He served as the Comptroller of the Currency from 1977 to 1981. He has sat on the boards of the FDIC, the Federal Mortgage Association, and the Neighborhood Reinvestment Corporation. He chaired the Federal Financial Institution's Exam Council from 1979 to 1981.[48]

Alan Greenspan had worked in private industry, including service as a corporate director at J.P. Morgan and Company and Morgan Guaranty Trust Company of New York, before assuming the Chair of the Federal Reserve's

[48] U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Regulatory Consolidation Proposals for Insured Depository Institutions*, 103rd Cong., 1st sess., September 14, 1993.

Board of Governors. Robert Rubin had been the head of Goldman Sachs prior to his service in the Clinton White House and Treasury Department.

The connections among politicians, interest groups, and the agencies that regulate, or do not regulate, industries have given rise to notions of what political scientists call "agency capture." Both agencies and clientele are highly concerned about agencies' rules, goals, and access to resources. Both understand the nuances of policy in the issue area and can speak convincingly on it before the relevant congressional committee, should the need arise.[49] Because the connections are so tight between the financial services industry and the Treasury, the issue of agency capture has been taken one step further and depicted within notions of C. W. Mills's power elite in a "Wall Street-Treasury complex," or Gramscian hegemony in a "Washington-Wall Street alliance."[50] Wade and Veneroso place the concept into an international context, in concert with and at times including the International Monetary Fund, although the mechanisms for coordination are not specified.[51] Johnson and Kwak argue that the six megabanks that feed into this policy network – Morgan Stanley, Goldman Sachs, Wells Fargo, Citigroup, JPMorgan Chase, and Bank of America – constitute an oligarchy that is larger, more profitable, and more resistant to regulation than ever.[52]

Attempts have been made to mitigate the worst excesses of these types of relationships. Restrictions on agency decision makers limit contacts with lobbyists. Lobbyists must disclose their contacts with executive branch officials. Government officials may not work for the companies that appeared before them for a period of time after they leave office. In addition, agencies hold hearings so that all groups may register their views.

Nonetheless, lobbyists maintain the ability to influence decisions within agencies through a variety of channels. They can present their views to members of Congress or the White House who then present their views to the agencies. They can promote certain candidates for appointment to a given position or block others who might not share their views. They can organize campaigns to rally public support for initiatives. They can

49 J. Leiper Freeman, *The Political Process*, 88–89.

50 For C. W. Mills's power elite, see C. Wright Mills, *The Power Elite* (London: Oxford University Press, 1956). Jagdish Bhagwati coined the phrase "Wall Street–Treasury Complex." Richard Peet depicts a "Washington–Wall Street alliance." See Jagdish Bhagwati, *In Defense of Globalization* (New York: Oxford University Press, 2004), 205, and Richard Peet, *Unholy Trinity: The IMF, World Bank and WTO* (London: Zed Books, 2003).

51 Robert Wade and Frank Veneroso, "The Asian Crisis: The High Debt Model Versus the Wall Street-Treasury-IMF Complex," *New Left Review*, March-April (1998), 3–23.

52 Johnson and Kwak, *13 Bankers*. Johnson and Kwak's six megabanks are the four commercial banks in Figure 1.2 together with the two investment banks that converted during the financial crisis, Morgan Stanley and Goldman Sachs.

attempt to organize the bureaucracy to their advantage. They can serve on departmental advisory committees. Most importantly, they can participate in the rulemaking process and maintain contact with staff at the agencies.[53]

The highly technical nature of the financial services industry, combined with the growing concentration of wealth in that sector, makes it particularly vulnerable to agency capture both in the executive branch and the Federal Reserve System. Johnson argues that the situation grew more extreme when the invention of securitization, interest rate swaps, and credit default swaps increased the volume of transactions on which bankers could make money. The invention of the individual retirement account (IRA) and 401(k) plan meant that the broader population invested more. Wall Street benefited from these developments. From 1973 to 1985, the financial sector never earned more than 16 percent of domestic corporate profits. After the year 2000, it reached as high as 41 percent. Compensation rose with profits. As a result, bankers gained political weight and wealth.[54]

The belief system that held the political and financial worlds together was the notion that what was good for Wall Street was good for the country. The industry therefore did not have to operate within the system as other industries do because policymakers bought into the notion that large financial institutions and free-flowing capital markets enhanced the position of the United States in the world. Like other industries, individuals such as Robert Rubin and Henry Paulson moved between government and Goldman Sachs, George W. Bush's Treasury Secretary John Snow left to become chairman of Cerberus Capital Management, and Alan Greenspan became a consultant to Pimco. Unlike many other industries, Johnson argues that the influence of the ideology spread to finance and economics professors and the culture at large. The crisis of 2008 has only augmented the political strength of the big banks.[55]

The demise of the OTS is one of the rare examples where Congress directed that a regulator be closed and dismembered in eighteen months, with its work and employees distributed among other regulators. This provision in the Dodd-Frank legislation met with little opposition. Why was this regulator the exception to other examples of agency capture and the revolving door?

The story of the thrift industry mirrors the story of the regulator. When the industry died, so did the regulator. The postwar housing boom was the golden age for S&Ls. Deregulation allowed S&Ls to expand into new

53 Lehne, *Government and Business*, 169.

54 See Simon Johnson, "The Quiet Coup," *The Atlantic*, May 2009, http://www.theatlantic.com/magazine/print/2009/05/the-quiet-coup/7364/ (accessed March 9, 2010).

55 Ibid.

businesses. Many thrifts and their regulators lacked experience in these areas, which led to the failure of more than 2,000 banks between 1985 and 1992, with a peak of 534 in 1989.[56] Nonetheless, the industry still had enough political clout that when the Federal Home Loan Bank Board was closed and replaced by the OTS in 1989, ostensibly to tighten supervision of the industry, almost nothing changed but the name. Industry consolidation followed, with a group of "supersize" S&Ls such as Washington Mutual, IndyMac, and Countrywide Financial dominating the thrift industry. In 2000, the boards of America's Community Bankers (the thrift trade association) voted to merge with the American Bankers Association. At the beginning of 2006, the OTS oversaw 863 S&Ls with assets of almost $1.5 trillion. Among them, Washington Mutual was the largest to fail in U.S. history. As a result, the total number of thrifts was lowered to 757 by March 2010, with assets of only $950 billion because the losses were disproportionate to the largest institutions' failure.[57] Even though the head of the OTS objected to the closure of the agency, there was not even an independent trade association to lobby on its behalf in other branches of the government.[58] Therefore, while agency capture might be a problem with regulatory policy, when there is no industry to regulate, there are not groups to capture the relevant agency.

CONCLUSION

Former FDIC head William Seidman commented, "All regulators fear losing turf, but most of all they fear losing it to Congress."[59] This commentary is echoed in the memoirs of all "inside the beltway" participants. Academic descriptions of the policy process begin with an initial step where a problem is identified that calls for government action. Some economic problems can be identified where one agency can potentially offer a remedy, or where Congress can pressure regulators to issue rules. However, most economic – particularly financial – problems require solutions involving multiple agencies and more than one branch of government. In the most extreme cases where the problem could result in the collapse of the entire system, the heads of agencies and large financial services firms must bargain among themselves to prevent that outcome. Then, as the threat recedes, the more typical operations of the interest groups and the machinery surrounding

56 Johnson and Kwak, *13 Bankers*, 74.
57 See Binyamin Appelbaum, "Onetime Cop, Out of Business," *New York Times*, July 14, 2010, B1.
58 Ibid., B4.
59 Lewis William Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas* (Washington, DC: Beard Books, 2000), 136.

political institutions in Washington returns to the fore. In these interactions, the president draws influence from his bargaining advantages. Having the power to persuade, the president can induce members of Congress and others to believe that what he wants of them is what they think their own responsibilities require them to do or is in their interest. Nonetheless, the president's direct powers over financial politics in the United States are deeply divided between federal and state levels, spread across branches of the government, and splintered among the independent regulatory agencies.

6

Making Financial Policy in the Federal Reserve System

As the political institution that serves as a central bank in the American system, the Federal Reserve is, in its essence, a bank. The Treasury pays the government's bills. A bureau of the Treasury, the Internal Revenue Service, collects taxes. The president and Congress control who the Treasury pays and taxes – and how much – when they negotiate the annual budget. But the Treasury's general account is at the Federal Reserve. At this time in American history, the notes of that bank are the legal tender for the country and, incidentally, most global financial transactions. Although it is not a branch of the government laid out in the Constitution, the Federal Reserve System plays a major role in financial politics because it determines monetary and some regulatory policy. It has been constructed over time through the political process, so it does not have the same structure as a commercial bank. Moreover, it handles many additional tasks that can seem to contradict each other outright. These contradictions result from the political compromises necessary to bring it into existence only a century ago.

In brief, the Federal Reserve System is structured with a central Board of Governors in Washington, DC, and Reserve Banks in each of twelve districts whose stock is owned by commercial banks that have chosen to join the system (i.e., member banks). Policy results from a mix of the activities between the board and the Reserve Banks. Monetary policy is made in the Federal Open Market Committee (FOMC), a committee comprising the seven board members in Washington appointed by the president, the head of the most significant regional Reserve Bank, the Federal Reserve Bank of New York (FRBNY), and four additional members that rotate among the heads of the remaining eleven Reserve Banks. Regulatory policy is issued through the board. The regulations issued can apply to the entire banking system or just to member banks, depending on their nature. The Reserve Banks operate a nationwide payment system and supervise and regulate member banks and bank holding companies. As a part of these activities, they distribute coin and currency throughout the country.

This chapter examines the competing mandates of the Federal Reserve to situate the organization within the broader context of the bureaucratic politics within which it operates. In his study of bureaucracy, James Q. Wilson argues that the analyst needs to show how an organization copes with its critical task. To be successful, there needs to be agreement on the way that task is defined or what its sense of mission is.[1] However, one of the most striking features of the Federal Reserve as an organization is that it is a system with competing roles and functions. It is both a central bank and a regulator; both a federal government body and twelve privately held regional banks; and a quasi-government agency that seeks to be independent of the political system that created it. As Chapters 4 and 5 have detailed, the Federal Reserve constrains and is constrained by the output of the legislature and other agencies of the federal government.

The first section of this chapter considers the contradictions between the Federal Reserve's task as a central bank and its task as a regulator. The Federal Reserve has argued that it can do a better job managing the money supply if it has the presence in, and knowledge of, the banking system. It gains access to this information when it acts as a regulator. Others have disagreed, arguing that the Federal Reserve should not be a regulator or, at a minimum, should only regulate large banks and holding companies.[2] Another contradiction explored in the second section of this chapter lies with the national versus regional nature of the Federal Reserve. Those who designed the institution believed that its organizational structure could solve the problem of the political power that would accrue to a central bank. Thus its framers created a decentralized system to prevent the threat of both Wall Street and government domination. As part of their progressive faith in expertise, effectiveness of the machinery of government, and distrust of politicians, they believed that gold would provide objective criteria for regulating the money supply in this system.[3]

The third main contradiction in the role considered in the third section of this chapter is the Federal Reserve as part of the government, and at the same time independent from politics. Since an Act of Congress created the

[1] Wilson, *Bureaucracy*, 25.

[2] Stephen H. Axilrod, *Inside the Fed: Monetary Policy and Its Management, Martin through Greenspan to Bernanke*, rev. ed. (Cambridge, MA: MIT Press, 2011), 173.

[3] Woolley, *Monetary Politics*, 40.

Federal Reserve, the legislature can end it, or modify it, with legislation and not a Constitutional amendment. Major modifications were made in the 1930s, 1950s, 1980s, and in 2010. Therefore, the nature of the independent status of the Federal Reserve is in a constant state of transition, usually under pressure from both U.S. politics and global financial transformation. Nonetheless, the Federal Reserve retains some formidable political allies when its independence is threatened within the domestic political system.

A CENTRAL BANK AND A REGULATOR

As previous chapters have shown, the menu of policy options available to the Federal Reserve is constrained by its legislative mandate and by the control that Congress exerts over fiscal policy. This section explains the policy options the Federal Reserve has in managing the macroeconomy, and the financial system in particular. The most significant of these is its role in managing the money supply, or its role in formulating and executing monetary policy. In addition, as a bank with special powers, it has the statutory authority to act in a crisis. Thus it is frequently the first line of defense in a banking crisis. However, the Federal Reserve is also a regulator. These missions can contradict each other when the central bank must choose whether or not to make massive loans to a bank it knows from its regulatory activities to be failing. It could be that the Federal Reserve works to gain political leverage among the banking regulators by striking deals among them or conducting favorable operations with respect to troubled banks. It might also be that the Federal Reserve works to pursue systemic financial stability when it makes large loans to failing institutions. If it receives favorable reviews in the press for its actions, these reviews can add an additional layer of political leverage. The Federal Reserve can threaten that less independence or a diminishment of its regulating authority would weaken its ability to avert panics.[4] Nonetheless, the role the central bank plays in regulating banks has been contested throughout U.S. history.

Operations of the Federal Reserve in Managing the Money Supply

As a central bank, the top job of the Federal Reserve is to manage the amount of money in the U.S. financial system. Legislation mandates two objectives in doing so: managing prices and promoting full employment. At the same time, the institution would prefer to pursue these goals, or

[4] James L. Pierce, "The Federal Reserve as a Political Player," in *The Political Economy of American Monetary Policy*, ed. Thomas Mayer (New York: Cambridge University Press, 1990), 159.

its "dual mandate," in such a way as to protect its ability to make an autonomous contribution to macroeconomic policymaking. It can appear that these objectives are difficult to address simultaneously.[5] However, officials at the Federal Reserve have attempted to do so by shifting the time frame through which to evaluate success from the short run to the intermediate or long run. If price stability is maintained over the longer horizon, then the Federal Reserve will have done what it can to create the conditions for the economy to grow at its potential. At the same time, it would have attained the maximum rate of employment that it can hold over time.[6]

However, in either the short or long run, managing monetary policy with the goal of price stability is knotty. Too many dollars make prices go up, and too few make them go down. Therefore, making sure that that there is enough money, but not too much, is analogous to keeping the level of water in a bowl constant when it could evaporate or spill. Add too much water, and it is difficult to get the precise amount out either by pouring or heating it. Add too little water, and the level is not constant. In our analogy with too much water, prices would rise. Monetary economics teaches that the Federal Reserve has many options when it wants to add and subtract money from the system because money is not just created when dollars are printed. It is also created through the "money multiplier."

To review from Chapter 3, money multiplies when banks re-lend a percentage of what they have on deposit so that the bank can earn interest payments. The bank's profits are the difference between what it pays a depositor in interest and what it earns in interest on loans from borrowers. Therefore, the more it lends, the more money is created through the multiplier. Banks don't lend out all of their deposits, however, because depositors might need them. The amount that they do lend out is eventually redeposited elsewhere, and another fraction of that is re-lent. As each portion is lent and re-lent, it grows at a mathematical rate of the inverse of the reserve requirement (or the percentage the bank keeps on hand for depositors). Once the loan is repaid, the money disappears from the system.

The FOMC is the policymaking committee within the Federal Reserve that determines the actions necessary. It has twelve members: the seven members of the Board of Governors, the president of the FRBNY, and four of the presidents of the remaining eleven Reserve Banks who serve a one-year term on a rotating basis. Nonvoting Reserve Bank presidents attend FOMC meetings, participate in the discussions, and contribute to

[5] Woolley, *Monetary Politics*, 2.
[6] Axilrod, *Inside the Fed*, 15.

the overall assessment of the economy and which policy to pursue. To minimize political influence on the Committee and Federal Reserve overall, the governors are appointed for fourteen-year terms, which are staggered so that they do not all expire simultaneously.

Traditionally, the Federal Reserve has two main levers when there is either too much or too little money created. The first is its ability to conduct open market operations at the FRBNY. When the FOMC authorizes open market operations, the sheer volume of its transactions affects the amount of money in the system and the rate of interest that commercial banks charge each other for overnight loans (i.e., the federal funds rate). When the Federal Reserve sells a large volume of Treasury bills to banks, the banks effectively lend money to the government and the overall supply falls. With less money in the system, interest rates rise and other loans are more difficult to obtain. Conversely, when the Federal Reserve buys a large volume of short-term debt securities from banks, the supply of money available to the banks grows. With more money to lend, interest rates fall and the economy is stimulated.

The second lever is its ability to make direct loans to banks. The Federal Reserve does this with an administered rate through the discount window at each of the twelve regional banks, wherein commercial banks borrow to maintain their required reserves when they are short. As long as the discount rate is a penalty rate (i.e., above market rates), it will be used only when other forms are unavailable. However, after the Federal Deposit Insurance Corporation (FDIC) was established during the Great Depression, it provided insurance on deposits. Thus the Federal Reserve did not have to offset the effects of bank reserves due to massive withdrawals as had occurred before – other than during a few incidents when a particular bank or thrift failed – because deposit insurance prevented runs on the system as a whole. Even when runs occurred, those who withdrew their money deposited it into another bank. Therefore, the private markets could take care of the problem that the discount rate was intended to solve, and it would seem to be an unimportant tool in a system that has deposit insurance.

However, since 1970, the Federal Reserve has fundamentally changed the role of the discount window in ways that have added to the institution's power and prestige. The discount rate is usually *not* a penalty rate. It is usually *below* the federal funds rate, which makes it act as a subsidy. To keep its use under control, the Federal Reserve rations credit through the discount window and tries to limit access to it in emergencies through rules. However, the power to dispense access to the discount window is no longer only for banks that borrow too much. In the 1960s, the Federal Reserve induced small banks into the "circle" by making funds available through the discount window to meet their seasonal and other needs. That was a boon to small agricultural banks. Thus they became a part of the base of the Federal Reserve's operations.[7]

Other extensions of the use of the discount window followed. In 1970, Penn Central Transportation filed for bankruptcy after it failed to receive a bailout from the federal government. This left its commercial paper (CP) open and put the general market for CP into a panic. Only those with the strongest credit could issue their own CP, and widespread insolvency was a threat. The Federal Reserve intervened in this crisis and provided assurance that the liquidity essential to their operation would be preserved. Although it did not lend directly to Penn Central, it did allow the regional Reserve Banks to channel funds from the discount window through commercial banks to offset the drain on liquidity in the private sector, which followed the shrinkage of the CP market. After the failure of Penn Central Railroad in 1970, many feared that substantial and highly solvent firms would not be able to roll their own CP. Following the "panic," creditors in the CP market insisted that borrowers have formal credit lines at banks that could be drawn on in another panic. Then banks began issuing irrevocable standby letters of credit obligating the issuing bank to pay off the CP should the borrower default. In effect, banks assumed the credit risk of borrowers in the CP market, and the federal safety net was extended indirectly to the market because the banks were within the net.[8]

Prior to the crisis of 2008, the FOMC would announce a benchmark rate for federal funds (the rate of interest that banks charge when they lend to each other overnight) and conduct its open market operations in an attempt to reach that goal. It also could use the discount window as a tool in a crisis. However, the large numbers of defaults on home mortgages in 2008, combined with lack of investment in the economy, prompted a massive deleveraging across the U.S. macroeconomy. Thus the events put the money multiplier in rapid reverse, wreaking havoc on the supply available by shrinking it so quickly. To cope with this situation, the Federal Reserve set a target federal funds rate between zero and .25 percent so that there would be enough liquidity in the system, and hopefully enough to stimulate the economy. In so doing, however, it lost one of its two key policymaking tools for the foreseeable future because it cannot lower the rate below zero to encourage lending.

How else could the Federal Reserve raise the money supply that had contracted swiftly? It needed to find other tools. In one such effort described as quantitative easing (QE), the Federal Reserve sought to lower the interest rate on mortgages by buying $500 billion in mortgage-backed securities

[7] Pierce, "The Federal Reserve as a Political Player," 156.
[8] Ibid., 157.

issued by Fannie Mae and Freddie Mac. Initially announced in November 2008, the program sought to buy up $100 billion of their debt and $500 billion of mortgage-backed securities issued by the companies. By January, the Federal Reserve had bought only $30 billion, but that action pushed the average rate on a thirty-year fixed-rate mortgage down to 5.1 percent by January from 6.1 percent in November. In another effort, the Federal Reserve announced plans to use $200 billion to support lending through credit cards or for car loans, student loans, and small business loans. Finally, the central bank bought long-term Treasury bonds to try to push down interest rates on longer-term borrowing. Whereas the Federal Reserve usually intervenes in short-term markets, buying longer-term bonds was thought to lower borrowing costs for companies and individuals who needed it for longer periods.[9]

The massive and dramatic efforts to raise the money supply through QE resulted in approximately $1 trillion being created by the central bank between September 2008 and January 2009. Another program dubbed "QE2" for the second round of QE followed late in 2010. How the Federal Reserve plans to unwind these programs, and what their ultimate effects on inflation will be, remain outstanding questions. As the federal funds rate remained so low, observers began to worry that the cheap money would fuel speculative bubbles in commodities, stocks, and real estate markets in the United States and other parts of the world.

The Federal Reserve and Regulation in the Dual Banking System

At the same time it manages the money supply, the Federal Reserve is also a regulator. It has primary responsibility for regulating state-chartered member banks. As discussed in Chapter 2, responsibility for regulating and supervising banks grew in a piecemeal fashion out of the experiences with national currency and the Civil War along with those related to central banking and the compromises over the Federal Reserve Act. We have seen that national banks are regulated by the Office of the Comptroller of the Currency (OCC) and state-chartered nonmembers by the FDIC and state regulators. But the Federal Reserve's preeminent regulatory power is that it alone is responsible for regulating bank holding companies. All large banks, and many small ones, are affiliated with a bank holding company.

The resulting regulatory framework can be considered as two parallel systems, or the "dual banking system." The hallmark of the system remains

[9] See Neil Irwin, "Fed Enters Uncharted Policymaking Territory," *Washington Post*, January 27, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/01/26/AR2009012602343.html (accessed April 13, 2012).

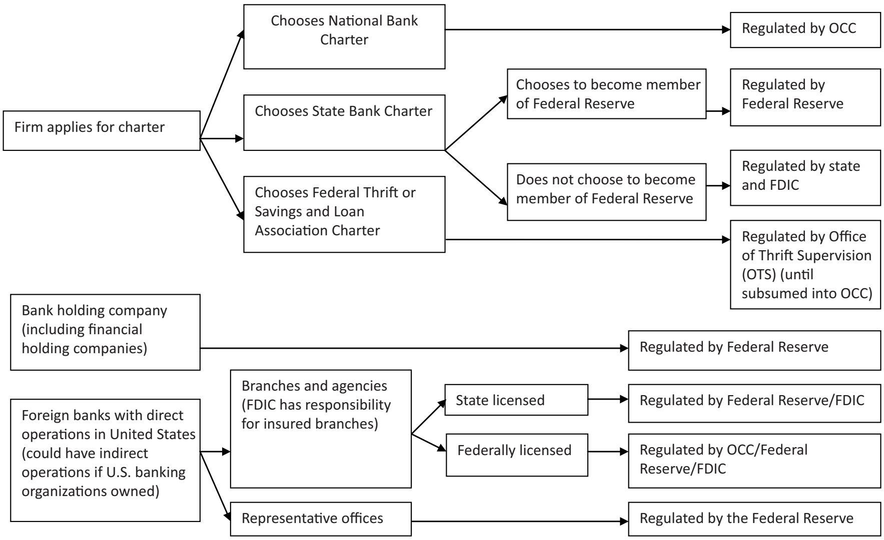

FIGURE 6.1. The Dual Banking System

the ability for a bank to choose which federal agency will serve as its primary regulator, and whether to operate under a federal or state charter. If it so chooses, a bank can convert its charter to operate under a different regulatory scheme. The bank's freedom to choose its regulators is viewed as protection from unreasonable regulatory behavior. The doctrine of choice is also believed to promote a healthy dynamic among regulators. It can be criticized by banks, however, for creating unnecessary duplication of regulation. The conflict between state and federal regulators can become heated when national banks operating in multiple state jurisdictions must comply with state banking laws.

The Organization of the Dual Banking System. Under the federal system, the bank obtains a federal charter, its powers are defined under federal law, it operates under federal standards, and has oversight from a federal supervisor. Under the state system, the bank obtains a state charter, has powers defined under state law, operates under state standards, and has oversight from a state supervisor and/or the Federal Reserve, depending on whether or not it is a member of the Federal Reserve and whether or not it is under a holding company. On the ground, the situation can be confusing because the bank holding company can be regulated by the Federal Reserve and its subsidiary banks by another agency. However, the agencies agree among themselves that each bank will have only one examiner: the OCC examines national banks, the Federal Reserve examines state member banks, and the FDIC examines the rest. Figure 6.1 sketches the system of regulation in the dual banking system.

The focus of federal and state banking laws has been prudential, meaning the supervisor is to ensure the safety and soundness of banks under its tutelage through examination.[10] Other types of regulatory systems operate with different goals and philosophical orientations than a prudential system. For example, with a regulatory system like the Securities and Exchange Commission (SEC), the system sets out acceptable and unacceptable behaviors and the agency administers the regulations and sanctions violations. Hence, violators are punished *after* an infraction occurs, but there is no prior oversight to prevent transgressions. Most business corporations are administered through regulation of this type because the government lacks the resources to examine all firms to make sure their managers obey the law.

Supervision of banks under the FDIC, OCC, and Federal Reserve differs from the other forms because the goal of prudential regulation is to ensure compliance. Supervisors conduct scheduled examinations of banks by government employees who are trained in the legal requirements to which the entity is subject. Examiners follow a manual and must determine whether or not innovations are allowable. Rather than waiting for an infraction to occur, the examiner may suggest that the bank stop some practices before an outside lawsuit is raised.

When a bank is examined by the Federal Reserve, a team of examiners goes to the firm for two weeks. During this time, operations of the firm are investigated by using information such as the loans on the books and securities in its portfolio. The team conducts interviews with loan officers and talks with members to identify issues of concern. Next, a report is written and the bank is rated using the CAMELS rating system. In this system, C refers to capital, A to asset quality of loans and securities, M to management, E to earnings, L to liquidity, and S to sensitivity to market risk. If the findings from the examination indicate actions to be taken, the examiner lets management know what to do to correct the problem. They then decide on a follow-up plan, which may include some kind of tracking mechanisms. If the problem is serious, the examiner may return to the bank more frequently or take supervisory actions with the bank's board. Enforcement actions can be informal, such as requesting board resolutions or a Memorandum of Understanding (MOU) of what is needed with the board's signature. They can also be formal, such as written agreements detailing what is expected that are enforceable in court. In an extreme case, the Federal Reserve can issue a cease-and-desist order to stop dangerous behavior, or behavior the bank is not licensed to do.

[10] Lichtenstein, "Lessons for 21st Century Central Bankers," 224.

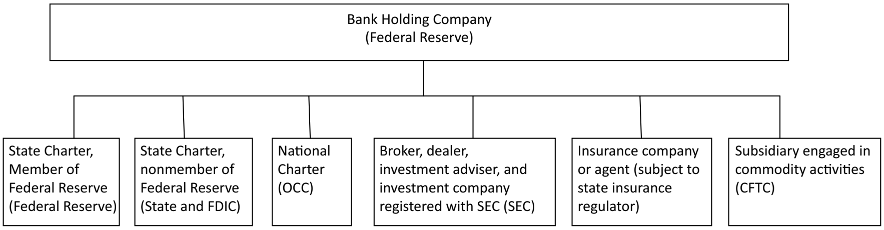

FIGURE 6.2. Possible Corporate Components of Banking Organizations Showing Regulator of Functionally Regulated Subsidiary

Historically, a bank examiner's purpose was to make sure that the values of the assets the bank's management claimed that it held were, in fact, reasonable. However, this is a subjective process because minor adjustments in value may allow management to claim that the real value of the assets is larger than the nominal value of liabilities, thus making it difficult to close even badly run banks. The law forbids publication of information derived from a bank examination, despite the fact that depositors and lenders might have thought their money was safe there.[11]

The complexity of the dual banking system means that differences can arise depending on how the components of the conglomerate are structured, chartered, and thus supervised and examined. The OCC examiners have been trained to freeze the institution. Federal Reserve examiners have tended to look at the ongoing enterprise. When a nationally chartered bank is owned by a holding company, the Federal Reserve does not examine the bank. The OCC examiners (bank examiners) have no authority to examine anything *but* the bank, unless invited to do so by the Federal Reserve (holding company examiners). Among the three, the Federal Reserve and OCC have kept the FDIC away from troubled institutions. The FDIC may have no knowledge of a bad situation until the bank collapses, although the FDIC's role has been clarified since the financial crisis of 2008 to allow for greater access to information going forward.[12]

Moreover, the regulation of any large financial entity is complex because different units could be regulated by different agencies. Figure 6.2 shows some of the possible complexity that could arise if different corporate components have forms of organization that call for different regulators.

The differences in supervisory practices among the parts of a financial services conglomerate matter, particularly with the regulation of securities, because the depository and investment banking regulators have such different supervisory outlooks that can be maneuvered to the advantage

[11] Mayer, *The Fed*, 265.
[12] Ibid., 271.

of the firm. Recall that the SEC's regulatory style emphasizes disclosure and operates under the notion that sunlight is the best disinfectant for the SEC.

Prior to the passage of the 1999 Financial Services Modernization Act that repealed Glass-Steagall, the Federal Reserve supervised and examined the securities subsidiaries of large banks. After the 1999 Act was passed, the SEC became the primary regulator of the subsidiaries. At the time, it made sense to put all of the investment banks under the same regulator, and they lobbied heavily for this provision. But the SEC had no culture of supervision or notion of the "systemic risk" that these entities might pose to American financial markets, let alone the global financial system. Moreover, Congress did not appropriate adequate funds to examine broker-dealers in the years before the 2008 crisis.[13] Incidentally, these appropriations remain a political issue. In July 2011, the House appropriations committee cut the SEC's fiscal 2012 budget request by $222.5 million – to $1.19 billion – despite the new responsibilities the agency had received under the Dodd-Frank Act. The committee report stressed, "With the federal debt exceeding $14 trillion, the committee is committed to reducing the cost and size of government."[14]

The managers of a financial conglomerate may choose not to operate all parts under the same national or state charter for myriad reasons, including how the firm came together, the fee structure, or what an individual state will allow the bank to do. First of all, a bank could choose among different regulatory arrangements because the parent company took over another set of banks that were already operating in that way. For example, if Northeast-based PNC acquires a set of retail banks from RBC in the American South, it may not convert all of their charters immediately. Second, those that have a state charter and are members of the Federal Reserve may choose this arrangement because they prefer the fee structure for examination. As of April 2010, neither the FDIC nor the Federal Reserve charged for bank examinations, whereas the OCC assesses and charges fees for bank examinations, which are used to support the agency's work in supervising national banks. Finally, an entity might choose a state charter because the state system is perceived to be more accepting of new ideas, beginning with their specialization in checking accounts after the Civil War, through their creation of the first adjustable rate mortgages, and use of

[13] Lichtenstein, "Lessons for 21st Century Central Bankers," 227.

[14] Committee report and figures cited in James B. Stewart, "As a Watchdog Starves, Wall Street Is Tossed a Bone," July 15, 2011, *New York Times*, http://www.nytimes.com/2011/07/16/business/budget-cuts-to-sec-reduce-its-effectiveness.html?pagewanted=all (accessed December 14, 2011).

automatic teller machines. In the 1980s, state banks took the lead in bank deregulation.

The doctrine of choice has been derided as creating a "competition in laxity" wherein federal and state regulators do not want to lose banks to the least restrictive regulator, so they compete to be lax regulators themselves. The Government Accounting Office (or GAO, now the Government Accountability Office) conducted a study in the 1970s among thirty of the forty-two banks that closed between 1971 and 1976 that addresses the complexity of this issue. In each case, it was found that the supervisor delayed regulatory action that made the situation worse in the intervening months. In asking why they had not been more aggressive earlier, the investigators found that the delay resulted from fears that the public would learn of the action, which would would harm the bank; that formal actions are cumbersome; that the agency might have been too zealous in seeking to minimize governmental interference with management decisions; and that in some cases the agency did not understand its own legal powers. While these are serious issues that speak to the American reluctance to have governmental interference in business decisions, the investigators did not find evidence that the agencies feared that banks would switch regulators.[15]

However, in more recent years, fears that banks will switch regulators have become more open. In debating the 2010 financial services reform legislation, a group of state bank supervisors lobbied Congress that if the Federal Reserve and FDIC began to charge fees (as the proposed bill mandated), state member banks might flip their charters to the national system and thus fall under the OCC and the Federal Reserve, undercutting a source of revenue for New York, Alabama, and Ohio. With fewer banks to regulate, many states would have to raise their examination fees, reinforcing the move away from the state system as smaller institutions would consider converting.[16]

Evidence of the direction of – and reason for – banks changing their charters is not clear. Despite the large volume of assets held in the national system, approximately 70 percent of commercial banks operate under a state charter. Moreover, changing regulators has its own costs, chiefly legal. Many banks have complex structures because one entity acquired an existing bank in another state. Therefore, the structure does not necessarily reflect an attempt at regulatory arbitrage as it may reflect firms that were

[15] U.S. General Accounting Office, *The Debate on the Structure of Federal Regulation of Banks* (Washington, DC: General Accounting Office, 1977), 18.

[16] See Donna Borak, "States See Threat to Dual Banking System in Dodd Bill," *American Banker*, April 1, 2010, www.americanbanker.com/.

TABLE 6.1. *Relative Number and Sizes of FDIC-Insured Institutions*

	Number	Total Assets ($ in millions)	Total Deposits ($ in millions)
Commercial Banks	**6,213**	**12,786,340**	**9,387,089**
FDIC Supervised	4,096	2,042,067	1,586,402
OCC Supervised	1,281	8,906,005	6,377,424
Federal Reserve Supervised	836	1,838,269	1,423,264
Savings Institutions	**1,027**	**1,139,210**	**873,469**
OCC Supervised	576	803,577	620,721
FDIC Supervised	451	335,633	252,748
Total Commercial Banks and Savings Institutions	**7,240**	**13,925,550**	**10,260,558**
U.S. Branches of Foreign Banks	10	71,727	33,764
Total FDIC-Insured Institutions	**7,250**	**13,997,277**	**10,294,322**

Source: Financial data, adjusted for mergers, as of March 31, 2012. FDIC insured institutions as of July 19, 2012. Available at http://www2.fdic.gov/IDASP/ (accessed July 27, 2012).

taken over at some point. To switch charters, they must have a rationale and be financially sound. Moreover, if they wish to become members of the Federal Reserve System, they must file an application. They are not automatically accepted. Table 6.1 compares the number, assets, and deposits of institutions by regulator.

The trend seems to be that more banks are actually selecting state charters. Since 2000, consolidation shrank the overall number of charters. Nonetheless, the number of banks the OCC supervised declined 43 percent – to 1,349 – from 2000 to 2011, when the number of state banks only fell 18.5 percent – to 5,064. Banks facing enforcement action are barred from changing regulators. In the same period from 2000 to 2011, 300 banks flipped national charters to state charters, whereas 92 state charters converted to a national charter. The migration of the smaller banks to state charters appears to be driven by the OCC's relatively more standardized approach to regulation of large and small banks, expecting the smaller ones to have the same controls in place as the larger ones. State examiners may be perceived to be more aware of local conditions. Among the state banks, 250 have left the FDIC to join the Federal Reserve since 2000. Only 88 state banks moved in the reverse direction from Federal Reserve to FDIC during the same time period. Since the financial crisis of 2008, the Federal

Reserve has lost the fewest number of banks, albeit it has the fewest to supervise.[17]

The Problems of Consolidating Regulatory Agencies. Controversies over the complexity of the banking regulatory system are certainly not new. The policy question of consolidation of the dual banking system arose with the creation of the Federal Reserve. The Bank of England, on which the Federal Reserve was partially modeled, had no tradition of examination of banks. Between 1919 and 1921 alone, there were four bills introduced into Congress to end the distinction between the OCC and the Federal Reserve's examination and supervision functions. When the FDIC was created in the Great Depression, these debates heated up as analysts considered how the FDIC could be folded into a more centralized system. Since that time, reform proposals have been either to consolidate regulation in the Federal Reserve System as the agency that sets monetary policy, the FDIC to protect its insurance fund, the Treasury as the logical center of financial policymaking, a new comprehensive agency, or some combination of proposals. State banks could be under a new agency with the OCC as supervisor of national banks or some other type of coordinating council.[18] However, instead of consolidation, a new agency – the Office of Thrift Supervision (OTS) – was created under the auspices of the Treasury after the savings and loan (S&L) crisis and its functions were transferred to the OTS in 2011 under a provision in the Dodd-Frank bill.

Those in favor of consolidation argue that greater centralization will diminish the problem that if a regulator takes action, banks will change supervisors. In addition, it would eliminate the confusion over situations where the holding company has one regulator and the subsidiary another. Consolidation of regulation would make the new agency more accountable to Congress because it would end the fragmentation of jurisdiction in the legislature where no one individual agency is responsible for anything. Finally, greater consolidation would address the problem that the Federal Reserve serves as a lender of last resort for banks that it does not supervise.

The arguments against consolidation rest on the American aversion to the concentration of power in one agency. Supporters of the dual banking system point out that depositors have not lost money since the advent of FDIC insurance. Consolidation of supervision would result in the excessive

[17] From 2008 to 2011, the Federal Reserve lost 6.1 percent, the OCC 17.3 percent, and the FDIC 11.2 percent. For figures, see Barbara A. Rehm, "Two-Decade Trend Squeezes Choice from Dual Banking System," *American Banker*, October 27, 2011, 2.

[18] U.S. General Accounting Office, "The Debate on the Structure of Federal Regulation of Banks."

centralization of power in one agency and would end the competition among agencies that is conducive to innovation. Rather than "competition in laxity," they see a healthy flexibility, wherein consolidation would result in an agency that could be more easily captured by industry.[19]

As studies of bureaucracies would predict, it is undeniable that the dual banking system is not only supported with the power of ideas, but with the bureaucratic agencies themselves, each with its own goals and stake in the outcome. Traditionally, the OCC has been concerned with the financial soundness of a bank, whereas the FDIC has sought to protect its insurance fund. The Federal Reserve must take any loans outstanding into consideration when dealing with "problem" banks, as well as what effect a closure would have on the nation's economy. However, the bottom line is that when the Federal Reserve lends money to a failing bank, it is against the best collateral that the bank has to offer. If the bank then collapses, the FDIC receives an entity with far less value, which occurred in 1973 with the collapse of U.S. National of San Diego and in 1974 with Franklin National of New York.[20]

In the latter case of Franklin National Bank, investigators noted that the resolution to the bank's failure had been delayed as each agency's interest was coordinated: the OCC (Franklin National's primary regulator) concerned with the financial soundness of the bank, the FDIC concerned with losses to its fund, and the Federal Reserve concerned with the $1.7 billion it had already lent Franklin National and the effect of its collapse on the nation's economy.[21] When former Federal Reserve Vice Chair J. L. Robertson testified to the Senate Banking Committee concerning the collapse, he commented that there was an institutionalized reluctance on the part of regulators to pull the rug out from under their own banks. He compared the situation to the psychological difficulty of parenting wherein "parents are determinedly unwilling to punish that child in public, lest it reflect poorly on the child's upbringing and discipline."[22]

Rulemaking in the Federal Reserve

When acting as a regulator, the Federal Reserve plays the same role in rulemaking as other agencies of the federal government, which means that Congress makes the laws and the Federal Reserve implements them. As

[19] Ibid., 40.
[20] Mayer, *The Fed*, 38.
[21] U.S. General Accounting Office, "The Debate on the Structure of Federal Regulation of Banks," 15.
[22] U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs. *Federal Bank Commission Act*, 94th Cong., 1st sess., 1975.

with the other agencies, the 1946 Administrative Procedure Act guides the Federal Reserve's process in how to do so in order that the greatest number of individuals can participate. However, we have seen that the rulemaking procedure is a political, as well as legal, process. Congress can give an agency the authority to make rules, but there may be a delay in starting the process, or avoidance of doing so entirely. If the agency does not make the rules that it has been given the authority to make, Congress can hold hearings that might prompt action, write additional legislation sanctioning the agency if it does not act, sue the agency if it could be shown to affect individuals or communities, or transfer the rulemaking authority to another agency altogether. Congress could also use more indirect political tactics, such as cutting specific budgets – e.g. the travel budget for the Secretary's office – or withholding appointments in the Senate confirmation process in either that agency or others to pressure the administration to force the agency to act. However, the separation of the Federal Reserve's budget from the regular appropriations process, combined with its lack of transparency, makes these usual avenues more difficult to traverse.

In one of the more notorious cases of inaction at the Federal Reserve with respect to consumer regulations, Congress passed the Home Ownership and Equity Protection Act (HOEPA) in 1994. Prompted by concerns about abusive and predatory lending practices that affected low-income borrowers in particular, the Act included a host of specific consumer mortgage protections and authorized the Federal Reserve to issue comprehensive rules ending such lending practices. Among the Federal Reserve's competing missions, Alan Greenspan did not make regulation a priority when he was Chair of the Board of Governors. It was not until two years after HOEPA was passed that the Federal Reserve held the first set of hearings that it mandated. Rules were not written to bring the desired policy in HOEPA to fruition. In 2007 and 2009, the House of Representatives passed additional bills designed to protect consumers from predatory lenders. Only when the House took up the issue of antipredatory lending legislation in 2007 did the Federal Reserve, under the chairmanship of Ben Bernanke, issue rules to regulate subprime lending pursuant to the 1994 HOEPA.[23] During deliberations over regulatory reform after the 2008 financial crisis, the Federal Reserve's failure to issue rules pursuant to HOEPA for such a long period of time was used as a rationale for the creation of a separate

[23] See "Home Ownership and Equity Protection Act (HOEPA) Public Hearing," June 14, 2007, http://www.federalreserve.gov/events/publichearings/hoepa/2007/20070614/default.htm. For a discussion of HOEPA and the failure of the Federal Reserve to write rules, see Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (New York: Public Affairs Reports, 2011), 76–77.

Consumer Financial Protection Bureau associated with, but independent of, the Federal Reserve.

A CENTRAL BOARD OF GOVERNORS AND REGIONAL BANKS

A second major contradiction in defining and coping with its critical task is the nature of the Federal Reserve as a system of regional banks, as well as a federal agency. This hybrid nature reflects the American political culture's distrust of central control and ambivalence about the institution of a central bank at all. The original act sought to diffuse control.[24] In the early days of the Federal Reserve, regional Reserve Banks could conduct their own open market operations, and the New York Federal Reserve was arguably a more significant economic institution than the Board of Governors in Washington. For example, Benjamin Strong, President of the New York Federal Reserve in the 1920s, arranged a $200 million loan to the Bank of England after an informal conversation with the governors of some other regional Reserve Banks.[25] Even after it has been more centralized, this arrangement is confusing to foreigners and opens up many opportunities for political conflict within the system itself.

The institutional contradiction between the Federal Reserve as both a central board and a set of regional Reserve Banks is not surprising. The Federal Reserve System was structured as a series of political compromises among some who sought government control of the banking system for the benefit of certain political interests, as well as others who sought to evade government control for the benefit of their own. They created a system that sought to balance the political interests between the seven-member Board of Governors in Washington appointed by the president and the twelve regional Reserve Banks whose stock is owned by private member banks, albeit this stock does not carry the same control rights as ownership of common stock in a corporation.[26] Some historians argue that members of Congress who supported the original Federal Reserve Act were not even aware that they were creating a central bank. Rather, they thought they were creating a group of autonomous regional Reserve Banks that would promote elasticity in the currency to prevent crises. Some thought that it would function like a public utility, keeping interest rates both low and stable and serving as a clearinghouse.[27]

[24] Mayer, *The Fed*, 68.
[25] Ibid., 81.
[26] Board of Governors of the Federal Reserve System, *The Federal Reserve System: Purposes and Functions*, 9th ed. (Washington, DC: Federal Reserve, 2005), 12.
[27] Woolley, *Monetary Politics*, 39.

The Board of Governors and the Reserve Banks

Congress was ambiguous about the power that it allocated to the Federal Reserve Board versus what it allocated to the regional banks. Not surprisingly, the role of regional Reserve Banks has evolved. The original legislative compromise left power divided among Washington, New York, and the other regional banks. Washington's authority later grew, but some 17,000 of the Federal Reserve's 20,000 employees work at the regional banks where they oversee 800 small state-chartered banks and more than 5,000 bank holding companies.[28]

Prior to the passage of Dodd-Frank, the presidents of the regional Reserve Banks were selected by the regional boards, six of the nine of whose members were elected by member banks of the Federal Reserve. One of the key reforms of the Dodd-Frank bill was to end the practice of Class A directors – those elected by member banks in the district to represent member banks – participating in the selection of presidents of the regional Reserve Banks. Class B and C directors – those elected by member banks in the district to represent the public and those appointed by the Board of Governors to represent the public – will continue to vote for the presidents of the Reserve Banks. Thus the private member banks will retain a degree of influence.

The FOMC likewise contains these elements of compromise between national and regional, public and private interests. To review, the FOMC designates seven votes to the governors and five others who rotate among the twelve district presidents. Only the president of the New York regional bank does not rotate annually but is a permanent member of the FOMC. This balance between public and private, federal and regional distinguishes the Federal Reserve from other countries' central banks because most other arrangements do not include regional banks, and most others are more directly accountable to elected politicians in cabinets, with the notable exception of the European Central Bank.

The regional Reserve Banks conduct other operations in the system that blend the regional with the national, such as providing financial services to commercial banks and conducting operations for the Treasury. The Federal Reserve charges fees for these services and uses the money raised to pay its own operating expenses. Any additional amounts earned are turned over to the Treasury. For example, when banks need cash to meet their customers' needs, they get it from the Federal Reserve. Likewise, when they have more than they need, they send the excess to one of the regional Reserve Banks, and it appears as a credit on their accounts. The Federal

[28] See Jon Hilsenrath, "Battle Inside Fed Rages Over Bank Regulation," *Wall Street Journal*, March 8, 2010, A1.

Reserve also processes approximately one-third of the checks written in the United States and electronic payments services for banks and the public, such as social security payments that are received as electronic credits in an individual bank account. The regional Reserve Banks also have research staffs of economists who provide support to the president for monetary policy. Finally, the supervision of banks is a delegated function of the Board of Governors. Therefore, it is conducted in the regional Reserve Banks with oversight from Washington.

The Federal Reserve Bank of New York

Despite the best efforts of the Federal Reserve System's planners to avoid a concentration of power, and the Depression-era reforms of the FOMC, the New York Federal Reserve is preeminent among the regional Reserve Banks because Wall Street is located within its district. For this reason, it can be perceived as taking a shorter, more market-oriented view than the rest of the system. As a quasi-private entity, it is not subject to the same salary strictures of the federal government that the Board of Governors is. For example, when Paul Volcker was promoted from president of the New York Federal Reserve to Federal Reserve chairman, his annual salary was reduced to $57,500 in Washington from $110,000 in New York. In 2003, the New York Federal Reserve president was paid $310,000 while Board Chair Alan Greenspan was paid $171,900.[29]

Like the other regional Reserve Banks, the New York Federal Reserve has a board of directors including bankers, businesspeople, and community leaders who select the bank president with the approval of the Board of Governors in Washington. However, the composition of the New York board, combined with the financial power of Wall Street, make it a political target because such prominent corporate leaders select the individual who heads it. For example, William Dudley, who became president of the New York Federal Reserve in 2009, was selected by directors including Jamie Dimon, the head of J.P.Morgan Chase; Jeffrey Immelt, the head of General Electric; and Richard Fuld, the head of Lehman Brothers before it went bankrupt. Prior to joining the Federal Reserve, Dudley was a partner and managing director at Goldman Sachs, where he worked for twenty years, including ten as chief economist.

In this respect, the FRBNY can be caught between a rock and a hard place. An individual like Dudley comes from one of the major firms that he now regulates, and his experience helps him to understand how the markets work and possibly fail. From the FRBNY's perspective, being close

29 Auerbach, *Deception and Abuse at the Fed*.

to the firms gives its regulators crucial intelligence that allows them to prevent a catastrophe.[30] Nonetheless, the controversy over selection of the head of the New York Federal Reserve persists even after the Dodd-Frank reforms because this particular regional bank is so important to the national system, and its head is not selected through the political system in Washington. The heads of some of the largest insurance and pharmaceutical corporations in the world were among the FRBNY's Class B directors in 2010. One Class B director headed a firm that was the largest recipient of the federal guarantee of CP. These are not "ordinary" members of the public. Some proposals would call for the president of the United States to select the head of the New York Federal Reserve, given its role in the overall system.[31]

Problems with conflicts of interest between the regional boards and private enterprise that may benefit from the Federal Reserve's emergency programs and other activities are not easily solved in any district, and not just in New York. The other regional Reserve Banks are charged with the same inherent conflict of interest that exists in New York insofar as they select their own leadership. The boards of the Reserve Banks each have three directors representing local commercial banks, three nonbankers chosen by banks, and three directors picked by the Federal Reserve in Washington. The boards then select the Reserve Bank presidents in consultation with Federal Reserve headquarters. The local boards' response to the charge is that the boards of the Reserve Banks do not have a say in supervision and provide input into understanding economic circumstances.[32]

As the financial services industry evolves, more companies have become involved in financial services work, or have become interconnected with those that are involved. Even when there is not a real conflict of interest, there may appear to be one. A 2011 GAO study recommended that all Reserve Banks clearly document the directors' role in supervision and regulation activities in their bylaws to increase transparency. As well, the Reserve Banks should develop and document a process for requesting conflict waivers for directors.[33] Other proposals call for democratizing the FOMC by requesting the president of the United States to nominate

30 See Neil Irwin, "At N.Y. Fed, Blending In Is Part of the Job," *New York Times*, July 20, 2009, A1.

31 See Elliot Spitzer, "The ABCs of Reform: How Washington Blew Its Chance to Bring Real Change to Wall Street," *Slate*, July 1, 2010, http://www.slate.com/id/2258802 (accessed June 28, 2011).

32 See Jon Hilsenrath, "Battle Inside Fed."

33 Government Accountability Office, *Federal Reserve Bank Governance: Opportunities Exist to Broaden Director Recruitment Efforts and Increase Transparency* (Washington, DC: Government Accountability Office, 2011).

members to represent the Federal Reserve Regional Banks who would then be subject to Senate confirmation, but not otherwise employed by the Federal Reserve System.[34] In a more detailed proposal, former Financial Services Chair Barney Frank advocates removing regional presidents from playing any role in monetary policy, given their tendency to favor the inflation-fighting side over the unemployment-fighting side of the Federal Reserve's dual mandate.[35]

A GOVERNMENT ENTITY INDEPENDENT OF POLITICS

The final contradiction in critical mission of the Federal Reserve is its independence from politics at the same time it needs to engage the political system. It demonstrates many independent features. While the legislature sets forth the two goals of the Federal Reserve in making monetary policy – maximum employment and stable prices – the central bank is free to interpret and pursue them as it sees fit. Decisions of the Board of Governors do not require congressional approval and are extremely difficult for another branch to reverse. In addition, the Federal Reserve pays its employees from its own earnings, primarily derived from earnings on U.S. government securities that it has acquired in open market operations. Therefore, the agency does not go through the same annual congressional budget allocation process as many other agencies of the executive branch.

Nonetheless, while the Federal Reserve is designed to be independent of the political process, it is a creature of the political institutions that created and foster it, albeit in a unique way. It is subject to congressional oversight, even if the legislature rarely exercises it. The Senate must confirm the president's choice of Federal Reserve Chair and nominees to the Board of Governors. In both accommodating inflation and fighting it, the Federal Reserve's policies can hurt people. For example, declines in real income can be caused either by inflation, or by a recession caused by fighting it. Thus policymakers might tolerate inflation if they feel the shock is temporary. Moreover, an inability to direct credit to particular sectors through credit policy may place even more pressure on monetary authorities to accommodate inflation. Those hurt can remove politicians from office. Therefore, no matter how much the Federal Reserve attempts to remain independent of politics, the effects of its policies and operations have political consequences.

34 See House Committee on Financial Services, "Frank Calls for Increased Democratization of the Federal Open Market Committee," Press Release, September 12, 2011.

35 Congressman Barney Frank, "The Selection of Voting Members to Serve on the Federal Open Market Committee," Unpublished statement, September 12, 2011.

The Federal Reserve's Influence with the Bureaucratic Arena

The Federal Reserve strives to have the greatest possible independence from the political *process*. As a quasi-independent agency with a national structure and unique policy area, the Federal Reserve engages in bureaucratic politics in a somewhat different manner on a day-to-day basis than other agencies of the federal government, and with respect to other interest groups that it regulates and affects through its conduct of monetary policy. When the Federal Reserve tries to influence issues within the bureaucracy, its lack of budgetary control by Congress gives it a unique power. While other agencies of the federal government are prohibited from using regulated industries as lobbyists – for example, as the Federal Power Commission could not enlist executives of the oil and gas companies that it regulates to lobby Congress under 18 U.S. Code 1913 – the Federal Reserve is technically exempt from that statute because its funds are not appropriated by Congress. However, it does not have to exercise this technicality because it has other resources at its disposal through the regional Reserve Banks and the interest of other actors in the dual banking system that have proven to be highly effective.

First of all, the boards of the regional Reserve Banks can be seen as an important source of the organization's political power. The boards of directors of the twelve Federal Reserve banks and twenty-five branch offices have directors who are not only bankers but also prominent businesspersons and other community leaders. Members of the boards tend to identify with and support the Federal Reserve. Therefore, the system has important contacts beyond banking alone. Board members are natural vehicles to influence elected politicians. The Federal Reserve is aware of this role – and has vehemently and successfully opposed attempts to eliminate the regional Reserve Banks because of it.[36]

In one of the more notable episodes of the Federal Reserve attempting to lobby Congress, two bills came up in 1974 and 1975 that were opposed by commercial banks. One would have authorized an audit of the Federal Reserve by the GAO. The other would have opened the Federal Reserve to the "Government in the Sunshine" Act. The Federal Reserve Board in Washington organized the boards of directors with ties to the banks and corporations all over the United States. In addition, they involved associated trade associations, such as the Business Roundtable and the American Bankers Association (ABA). Board presidents asked board members to contact their members of Congress to promote the Federal Reserve's position on the audit and an exemption from the Sunshine Act. Their efforts

[36] Beck, "Congress and the Fed," 155.

were successful in keeping the audit bills from reaching the full House for a vote. The same bill was reconsidered in the Government Reform Committee, and the Federal Reserve lobbied for restrictions on the audits, placing the monetary and international exchange activities off limits.[37]

Second, as mentioned earlier in the chapter, the Federal Reserve's political defenders within the bureaucratic arena include other governmental actors as well, such as state banking regulators in the dual banking system. The Dodd version of the financial services reform bill would have undercut the role of the Federal Reserve in bank regulation and examination. The New York State Superintendent of Banks and Conference of State Bank Supervisors entered the debate on behalf of the dual banking system itself and the fee structure of bank examination. Whether or not they coordinated with the Federal Reserve is moot because the interests of the state examiners ran against any move to consolidate regulation at the national level, as had been the original intent of the legislation.[38]

Finally, in addition to the regional boards and governmental actors, the Board of Governors can offer policy advice to other parts of the government that for some calls into question the political independence of the institution. For example, in January 2012, a *Wall Street Journal* editorial harshly criticized the Board of Governors for sending an "uninvited" twenty-six page paper to the leadership of the House and Senate Banking committees that the *Journal* charged was an attempt to "provide intellectual cover for politicians to spend more taxpayer money to support housing prices."[39]

Interest Groups and the Federal Reserve

While banks *do* have a substantial lobbying organization in Washington involving many former government employees, they devote most of their efforts toward the banking committees and the tax-writing process in Congress – not the Federal Reserve. Among them, the ABA is the largest and most inclusive. Most ABA officials have worked on Capitol Hill or at the Treasury or the Federal Reserve. Their lobbying structure is backed by a grassroots organization with "contact bankers" in each congressional district.[40] However, these same groups do little direct lobbying of the Federal Reserve Board about monetary policy. For example, the ABA does

37 Corder, *Central Bank Autonomy*, 159. For a discussion in congressional testimony, see also Committee on Banking, Finance, and Urban Affairs, *A Bill to Promote the Accountability of the Federal Reserve System*, 95th Cong., 1st sess., July 18 and 26, 1977, 5.

38 See Donna Borak, "States See Threat to Dual Banking System in Dodd Bill," *American Banker*, April 1, 2010, www.americanbanker.com/.

39 See editorial, "The Fed's Housing Politics," *Wall Street Journal*, January 10, 2012, A12.

40 Woolley, *Monetary Politics*, 75.

not allocate research staff primarily to following monetary policy. Some would argue that no lobbying is necessary – the Federal Reserve already knows their general preferences. Bankers usually prefer less inflation and a lower rate of growth of the money supply. Direct contacts would do little to influence decisions. In addition, there is some evidence that bankers use their resources to support the Federal Reserve's *independence* because they want it to play a role in fighting inflation.

Moreover, should interest groups try to influence the Federal Reserve on monetary policy, the technocratic nature of the issue provides a degree of insulation from them. Bureaucratic politics models emphasize channels of influence: interest groups try to gain access to forums where decisions are made that regularly and directly affect them, in this case the FOMC. There is almost no persuasive evidence that large or small business, agriculture, construction, labor, or state and local governments have a sustained interest in monetary policy – or that they direct resources at the Federal Reserve. In one exception during the recession of the 1980s, groups from industries affected by high interest rates, primarily construction groups, launched grassroots mail campaigns aimed at the Federal Reserve.[41] As low interest rates continued into 2011, the president of the Independent Community Bankers of America wrote an op-ed in the *Washington Post* charging that the Federal Reserve's monetary policy was nothing but a backdoor bailout for the Wall Street megabanks and investment houses while harming Main Street's banks, small businesses, and Americans.[42] But such targeted attacks are rare.

Why don't groups act more directly in seeking to influence monetary policy? Woolley surmises that groups may not derive important benefits from regularly allocating resources to following monetary policy whose effects they only feel intermittently. When they do take an interest, it is not easy to redeploy contacts and expertise from one institutional setting to another, even when they realize that the problem comes from the other setting. Hence, they prefer to act through Congress.[43] The lack of mobilization may also be a timing issue. Groups mobilize in reaction to what happens to them rather than in response to a policy. With monetary policy, they find themselves responding to policies taken weeks or even months earlier. Thus there is a mismatch in the timing between the costs of restrictive monetary policy (unemployment) that precede the benefits (lower inflation). Supporters and opponents of the policy are mobilized asynchronously.[44]

41 Ibid., 25.

42 See Jeffrey Bell, "Republicans Learn Moneyball," *Weekly Standard*, October 24, 2011, 15.

43 Woolley, *Monetary Politics*, 26.

44 Ibid.

Aside from monetary policy, there is much more open contact between interest groups and the Federal Reserve on regulatory policy through the rulemaking process, particularly during the comment period. Moreover, while bankers are not invited to lobby Federal Reserve Board members about specific pending regulatory decisions, a formal channel exists through their representation on the Federal Advisory Council (FAC) – albeit by 1970, the FAC did not play much of a role in making policy. In addition, connections between banks and the Federal Reserve exist in the Federal Reserve districts. Moreover, there is a high degree of *informal* contact between bankers and Federal Reserve Board members. Board members attend banking and financial conferences far more frequently than consumer or labor ones. In a crisis, the Federal Reserve Chair meets directly with the heads of the major banks, such as when the FRBNY coordinated the rescue of the Long-Term Capital Management hedge fund or orchestrated the takeovers of failing financial institutions in 2008.

CONCLUSION

As discussed in Chapter 5, political scientists use the concept of "agency capture" to depict a situation where government agencies that were established to regulate industries wind up being controlled by them instead. Although the Federal Reserve was designed to be closely linked to the banks, it was supposed to be independent of them and not their captive. It is not so easy to separate the two.[45] The mechanisms that connect the Federal Reserve to the banking community, however, vary according to the task at hand. Any influence over monetary policy is indirect and channeled through the minority of regional Reserve Bank presidents who are selected by boards chosen by local classes of shareholders. Influence over regulators is through the rulemaking system. Both could be a part of the "revolving door" between agency and industry.

Monetary politics in the United States are characterized by limited interference and deference to the judgment of experts. One of the main reasons for this insulation from traditional interest group politics is the nature of the work of the Federal Reserve in setting monetary policy that seeks very specific, technical goals. The decisions of the Federal Reserve cannot be reversed by other agencies of the government; otherwise, these decisions would only be good until someone more powerful sought to change them. However, as a creation of Congress, the Federal Reserve is ultimately subject to it, as well as political calls for reform when its actions and goals are unpopular. These politics are not conducted through the same bureaucratic channels as many other issue areas due to the insulation of the Federal

[45] Ibid., 70.

Reserve. They nonetheless cut to the core of American democracy and the proper separation of the state from private property.

This chapter has shown that the dual banking system is supported with the power of ideas as bureaucratic politics models would predict and with the arrangement of bureaucratic agencies themselves. Each agency has its own goals and stake in the outcome. Whereas the OCC has been concerned with the financial soundness of a bank, the FDIC has sought to protect its insurance fund. As both a regulator and a central bank, the Federal Reserve must consider what effect the closure of a troubled bank would have on the nation's economy.

The personalities of the Federal Reserve Chairs play a role in successfully navigating the political process and the operations of the FOMC and relations with the regional banks.[46] For many years, the Federal Reserve's legislative strategy relied on the relationships Alan Greenspan built over a period of decades, both socially and professionally, with senior members of Congress in both parties. Ben Bernanke is quite unlike Greenspan in this respect. As an economics professor at Princeton prior to his appointment, he is more of a Washington outsider and forced to rely on his personal credibility and praise for helping to curtail the damages to the financial system in 2008. In an unusual move for a Federal Reserve Chair, he made appearances on television shows such as *60 Minutes* to defend the Federal Reserve to the public in his hometown.[47]

The "Fed-bashing" of the past was concentrated among liberal Democrats who argued that the Federal Reserve made inflation fighting a priority over fighting unemployment. In the post-2008 financial crisis era, Fed-bashing is more likely to come from the right wing of American presidential politics. Candidate Ron Paul (R-TX) has been a long-standing critic; however, he has been joined by Governor Rick Perry of Texas, who expressed concerns that Bernanke would loosen the money supply and boost growth before the election. By October 2011, three candidates – Herman Cain, Ron Paul, and Newt Gingrich – had hinted their support for some kind of return to the gold standard. Almost all of the Republican presidential candidates expressed support for replacing Bernanke.[48] In another initiative, Representative Kevin Brady (R-TX) introduced a bill that would end the dual mandate of the institution by removing its mandate to pursue policies that would sustain maximum employment. At the same time, Brady's

46 Axilrod, *Inside the Fed*.

47 See Sudeep Reddy, "Congress Grows Fed Up Despite Central Bank's Push," *Wall Street Journal*, November 21, 2009, A2.

48 See Jonathan Chait, "Bernanke, Pinata," *New York Magazine*, October 3, 2011, 18. See also Bell, "Republicans Learn Moneyball."

legislation would restructure the FOMC to give permanent seats to the twelve regional Federal Reserve bank presidents. These initiatives are the opposite of Representative Barney Frank's (D-MA) effort to entirely eliminate the seats the regional Reserve Bank presidents hold and give more power to the seven members of the FOMC who are subject to presidential nomination and Senate confirmation.

SECTION 3

THE OPERATION OF THE FINANCIAL POLITICAL ECONOMY

This section picks up the historical review covered in Section One and integrates it with the bureaucratic politics among the president, agencies, and the legislature covered in Section Two to see how the system operates in motion. The stakes of the actors involved are brought into particularly sharp contrast during the business cycle and in a crisis. The process in motion matters because responses to developments in the financial sector and political institutions compel citizens and bankers to make demands on their government for change, as well as for the government to respond. Politics are not static. The process of regulation, institutional competition, and financial innovation thus results in new configurations of state capacity to regulate the financial sector – with one of the most dramatic episodes having occurred in 2008.

The section divides the analysis into the operations of the government in response to the ups and downs of the business cycle, from how it operates in response to a crisis, and from its international context. In these chapters, a *crisis* is a sporadic, disruptive event that alters the boundaries defining the legitimate use of coercion. Actions taken to meet these challenges often lead to the establishment of new institutional forms, powers and precedents.[1] Chapter 7 explores the politics associated with the business cycle, when the president, Congress, and the Federal Reserve respond to the competing demands of those citizens disadvantaged in a downturn. Each organization responds according to the range of opportunity allowable under its mandate, and change among them is incremental. Even prior to the crisis of 2008, the tendency was for the Federal Reserve to play a

[1] Skowronek, *Building a New American State*, 10.

greater role in macroeconomic management, and for Congress to cut taxes without raising revenue from other sources. In Chapter 8, we see how the pace of change escalated during the financial crisis of 2008. The chapter divides the government's response to the crisis into the short term, where it stretched the boundaries of legitimate use of its resources to save the system, and the intermediate term, where the legislature reorganized the regulatory framework and established a new agency for consumer protection.

Chapter 9 considers the operations of the U.S. financial system in the international economy since the end of World War II. In studies of political development, war presents the most extreme external shock to the government.[2] The international bureaucracy here is no less complex than the domestic one, but the chapter emphasizes that any decisions taken in international forums must be reconciled with domestic U.S. laws and practices. Therefore, the opportunity for any dramatic change in the absence of a crisis is further constrained by the competing venues where issues are discussed, or addressed, in any material way. In addition, the variable international context for finance offers yet another arena in which innovation, regulatory arbitrage, and instability can occur.

[2] Ibid.

7

The Process in Motion

Political Institutions, Money, and the Business Cycle

Although previous chapters have considered them separately, Congress, the president and executive branch organizations, and the Federal Reserve all operate in an environment that responds to what is going on in the macroeconomy. Their response has political and economic stakes. For politicians, the ultimate censure for poor performance in an economic downturn is to lose office. For organizations such as the Office of Thrift Supervision (OTS) or Federal Deposit Insurance Corporation (FDIC), it is to lose governing authority, budget, or personnel, and ultimately to be disbanded. For the Federal Reserve, it is to lose its independence from the political institutions that created it. As the United States has opened up to the broader world economy and financial markets have grown, each of these actors has had to respond to the new challenges posed by a new environment where voters expect them to do more, and where they actually have less under their control.

This chapter considers the politics attached to fluctuations in the business cycle to uncover the day-to-day expectations that political constituencies have for individual politicians and organizations as the economy expands and contracts. It begins with a discussion of what the business cycle is, how economists have measured it, and how different schools of economic thought have attempted to provide solutions to mitigate its effects. The next section considers public policy in a recession and a recovery, as politicians attempt to translate these economic solutions into a practical government program of action. The effects of previous economic interventions often inform thinking and institutional direction going forward. The historical review offered in Chapter 2 ended with the initial moves toward deregulation in the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn–St. Germain Depository Institutions Act in 1982. It continued in Chapter 4 with the discussion of the passage of the Financial Services Modernization Act in 1999. The third section in this chapter picks up the deregulation story and considers what the recession of 2001 and its aftermath reveal about how monetary, fiscal, and regulatory policies were reshaped among the legislature, presidential administrations, Federal Reserve, and agencies of the federal government in the wake of such major legislation.

The upshot is that after 1980, political ideologies of deregulation converged with preferences for monetarist macroeconomic management centered on monetary (and not more Keynesian, fiscal) policy. In institutional terms, economic problems and their solutions were defined away from Congress, where taxing and spending policies are made, and toward the presidential administration and Federal Reserve, where monetary policy is made. The result of the shift to the Federal Reserve in conducting monetary policy, combined with a philosophy of deregulation, set the stage for the government's response to the catastrophic events in 2008 when major financial institutions failed and the existing bureaucratic structure lacked the tools or institutional capacity to handle their collapse.

THE ECONOMICS OF THE BUSINESS CYCLE

Economists define the business cycle as the irregular rise and fall of economic activity that is measured by how much the economy is producing, or movements in gross domestic product (GDP). It is not a consistent or predictable movement; identifiable moments are evident in any cycle. The economy contracts to the point where it reaches a trough, or low point in what is being produced. Then at some point it turns, and the economy produces more until it hits a peak and turns again. Economists call a severe contraction a recession and call a deep recession a depression. However, they do not agree on how many quarters of GDP decline or what other variables determine a recession or a depression. Moreover, such fluctuations are not consistent across time because the American economy is diverse and subject to change. A downturn in one sector may be accompanied by an upturn in another. Even within a region, municipal areas fare differently. One region might experience long-term, structural decline, such as the "rust belt," and another growth, such as metropolitan areas in the South.

Given all of these complexities in the American economy, economists also fail to agree on when a recession begins and ends. In a commonly used set of measures, the National Bureau of Economic Research (NBER) characterizes a recession as a significant decline in economic activity spread across the economy, visible in lower real GDP, real income, employment, industrial production, and wholesale–retail sales. It can then be defined as a period between a peak and a trough of economic activity, not just as two successive quarters of falling GDP. Using this somewhat more subjective measure than others, the NBER finds that there have been four recessions since the 1970s: a sixteen-month downturn from July 1981 to November 1982, an eight-month downturn from July 1990 to March 1991, an eight-month downturn from March 2001 to November 2001, and the downturn commencing in December 2007 through June 2009 associated with the financial crisis.[3] Table 7.1 reviews the NBER's specifications.

Just as modern economists debate the parameters of a recession, they also debate its causes. For neoclassical thinkers, economic activity reacts to exogenous disturbances, such as the oil price shocks in the 1970s, and the economy will eventually right itself. For Keynesians, the economy has its own internal logic that impedes adjustment and can lead to less than satisfactory outcomes. In short, the economy can become stuck with levels of high unemployment unless the government acts to change it. With such dramatically different understandings of the root cause of a recession, the discipline debates the role of government instruments in responding to fluctuations in the business cycle. Government intervention is either necessary or makes matters worse. As they are taught in the United States, both neoclassical and Keynesian schools accept the necessity of some role for monetary policy in managing the macroeconomy.

However, the competing schools of thought embody more than just academic debates for politics and politicians. They inform different policy responses that affect political constituencies differently. Moreover, they inform bureaucratic politics because different agencies play different roles in each, resulting in greater governing authority, budgets, and personnel for one actor or another. The policy preferences can be roughly grouped according to those associated with the neoclassical approach that emphasizes intervention through the money supply and the operations of the central bank, and those associated with the demand management approach that emphasizes intervention through a variety of government spending programs and operations of the agencies of the federal government.

The Monetarist Response

One of the preeminent monetarist thinkers, Milton Friedman, argued that inflation could be attributed to an excessive quantity of money supplied

3 For National Bureau of Economic Research information, see "Business Cycle Dating Committee," http://www.nber.org/cycles/sept2010.html (accessed December 20, 2011).

TABLE 7.1. *U.S. Business Cycle Expansions and Contractions*

Date of Peak (with quarter)	Date of Trough (with quarter)	Duration in Months (from peak to peak)
	December 1854 (IV)	–
June 1857 (II)	December 1858 (IV)	–
October 1860 (III)	June 1861 (III)	40
April 1865 (I)	December 1867 (I)	54
June 1869 (II)	December 1870 (IV)	50
October 1873 (III)	March 1879 (I)	52
March 1882 (I)	May 1885 (II)	101
March 1887 (II)	April 1888 (I)	60
July 1890 (III)	May 1891 (II)	40
January 1893 (I)	June 1894 (II)	30
December 1895 (IV)	June 1897 (II)	35
June 1899 (III)	December 1900 (IV)	42
September 1902 (IV)	August 1904 (III)	39
May 1907 (II)	June 1908 (II)	56
January 1910 (I)	January 1912 (IV)	32
January 1913 (I)	December 1914 (IV)	36
August 1918 (III)	March 1919 (I)	67
January 1920 (I)	July 1921 (III)	17
May 1923 (II)	July 1924 (III)	40
October 1926 (III)	November 1927 (IV)	41
August 1929 (III)	March 1933 (I)	34
May 1937 (II)	June 1938 (II)	93
February 1945 (I)	October 1945 (IV)	93
November 1948 (IV)	October 1949 (IV)	45
July 1953 (II)	May 1954 (II)	56
August 1957 (III)	April 1958 (II)	49
April 1960 (II)	February 1961 (I)	32
December 1969 (IV)	November 1970 (IV)	116
November 1973 (IV)	March 1975 (I)	47
January 1980 (I)	July 1980 (III)	74
July 1981 (III)	November 1982 (IV)	18
July 1990 (III)	March 1991 (I)	108
March 2001 (I)	November 2001 (IV)	128
December 2007 (IV)	June 2009 (II)	81
Average 1854–2009 (33 cycles)		55
Average 1854–1919 (16 cycles)		49
Average 1919–1945 (6 cycles)		53
Average 1945–2009 (11 cycles)		66

Source: National Bureau of Economic Research.

by the central bank.[4] In what is also known as the "Chicago School" of economic thought because it is associated with the economics department at the University of Chicago, Friedman and his followers argued that the problem is not the economy but rather governmental policies in providing *too much* money. Hence, the best way to promote growth is through strict control of the money supply. In terms of the federal bureaucracy, monetary policy is not controlled by Congress or the president but by the Federal Reserve. As we have seen in Chapter 6, its main tools in expanding the supply are to lower the reserve requirement (raising the amount of money that banks have available to lend), buy government securities from banks (which also gives banks more money to lend), put more money into circulation, or lower its discount rate (again, encouraging banks to lend because the rate is lower). However, all of these expansionary policies can have the effect of raising inflation if they are used improperly.[5]

As discussed in Chapter 6, the Federal Open Market Committee (FOMC) makes decisions concerning how much or how little money should be in the economy. However, the Federal Reserve does not work alone. It conducts these operations in an environment where it must take into consideration the fiscal policies of Congress, which can also pour money into the economy through spending or take it out through taxation. Although the Federal Reserve is a technocratic institution and attempts to be isolated from politics, controlling the money supply is far from a precise science, given the uncertain national and international political environment. Hence, the FOMC must pursue its own objectives, as well as those assigned to it by the Congress, with a good deal of guesswork. To do so, FOMC members consult a variety of econometric models without knowing which one is the closest to the actual functioning of the economy. Members must also steer a course between inaction (risking the creation of an uncontrollable situation) and over-action (risking unnecessary damage to the economy).

Even when it is apparent that the economy is expanding or contracting, it is not clear to officials how long a lag time exists between their previous actions and the present, to gauge between the two extremes of inaction and over-action. Rather than stopping too soon, the Federal Reserve is particularly prone to keeping with a policy too long because the decision to raise or lower interest rates is made by committee. As a way of making decisions, a committee must come up with one final decision, but many members participate. In arriving at the final decision, their views may be nearly the same, or

[4] Friedman and Schwartz, *A Monetary History of the United States*.

[5] Larry Berman and Bruce Allen Murphy, *Approaching Democracy*, 2nd ed. (Upper Saddle River, NJ: Prentice Hall, 1999), 572

there may be substantial disagreements with a close division among them. Nonetheless, the committee must aggregate those individual preferences. Even if the Chair is more than a "first among equals," he or she must bring the other committee members along so that he or she is not on the losing side of a vote. Consensus-building takes time, and it adds to the tendency for the FOMC to keep with a policy too long.

To explain the time lag between the Federal Reserve's action and its effect, former FOMC member Alan Blinder uses the "parable of the thermostat." A traveler in an unfamiliar hotel finds a room to be too cold, so he or she turns up the thermostat. After taking a shower, the person might still find the room to be too cold and add a degree or two before going to sleep. At times, such a traveler might wake up in an overheated room when the heating device actually kicks in. Similarly, the Federal Reserve might take the temperature of the economy and at each decision-making juncture decide to tighten the money supply a notch. Given lags in policy implementation, the central bank can keep tightening for too long.[6]

When implementing policy, the Federal Reserve's main instrument is the federal funds rate – the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight. The federal funds rate, however, is a nominal rate and not a real one, which means if the nominal rate is too high, the real rate can be too high, aggregate demand can fall, and inflation then falls. In the absence of an adjustment, the real rate can continue to rise, and falling inflation (or prices rising at a slower rate) can become deflation (or falling prices). In theory, there is a neutral federal funds rate. At this rate, the growth rate of real GDP is stable in relation to aggregate supply in the long run at the expected inflation rate. The problem is in knowing exactly what the neutral interest rate is that would provide for a steady state of economic activity. In fact, Blinder argues that it is impossible to know what that neutral rate is precisely.[7] Hence, the FOMC must constantly reevaluate the situation to determine the appropriate type and degree of operation.

The central bank plays a particularly important role in a crisis for monetarists. If we take a crisis to mean the actual or threatened breakdown of the free and efficient functioning of financial markets, the threat of a crisis always exists because banks are so interdependent and need liquidity to function properly. Liquidity in an individual firm refers to the amount of cash that it has on hand in proportion to the payments it needs to make, such as withdrawals by depositors, payments to outside vendors, or wages

[6] Alan S. Blinder, *Central Banking in Theory and Practice* (Cambridge, MA: MIT Press, 1999), 16.

[7] Ibid., 33.

to employees. To prevent a liquidity crisis from occurring if many depositors seek to withdraw funds simultaneously, the system needs some kind of "lender of last resort" that banks can turn to that will make sure enough cash is available in the system when a crisis appears imminent.

One of the classic expositions of the notion of the central bank as the lender of last resort was outlined by Walter Bagehot after having lived through a series of panics in nineteenth-century England. For Bagehot, the tendency of everyone in a panic is to hoard cash. The central bank, therefore, should lend freely to cut the panic short by making it unnecessary to keep cash out of the banking system in fear that it will not be available. Banks then borrow instead of calling in loans that would reduce deposits and force an economic contraction and bankruptcies in the economy as a whole. To lend, the central bank should make advances on all good banking securities to prevent further alarm, and only at a high enough rate of interest to prevent anyone from applying for emergency loans who does not absolutely need it.[8] For banks operating under the gold standard as they did in Bagehot's day, the government would be advised to suspend the central bank's requirement to pay out gold or silver on demand. Then the central bank could issue more currency to meet any demand than reserves might be available to back them. The additions to currency would return to the banks as deposits. Banks could repay their loans at the central bank. Eventually, the government could restore the requirement to pay out gold.[9]

Although the banking system has changed since Bagehot's era, similar rules continue to apply in a crisis: the central bank needs to provide liquidity by ensuring that there is always at least one buyer for all good-quality securities offered by those under pressure to meet their obligations. It needs to keep those in the system from becoming addicted to using these credit facilities. In other words, the central bank has to remain a lender of last, not first, resort. This can be accomplished with interest rates that guarantee that other banks will use the central bank for help last and pay it first. In the modern era, however, most central banks do not use the discount rate as a penalty but reserve the right to deny assistance in the future.[10]

Although Friedman and his followers did not disagree in principle with the idea that a market economy needs stabilization, they argued for a more

[8] This discussion is drawn from William C. Melton, *Inside the Fed: Making Monetary Policy* (Homewood, IL: Dow Jones-Irwin, 1985), 155. Melton references Walter Bagehot, *Lombard Street: A Description of the Money Market*, John Murray, 1922 ed. (London: Kegan, Paul, 1873).

[9] Allan H. Meltzer, *A History of the Federal Reserve: Volume I, 1913–1951* (Chicago: University of Chicago Press, 2004), 2.

[10] Melton, *Inside the Fed*, 156.

circumscribed form. A central bank that keeps the money supply growing on a steady path is all that is required to prevent depressions. Friedman and his collaborator, Anna Schwartz, argued that if the Federal Reserve had done its job by providing liquidity to the system as a lender of last resort, the Great Depression would not have happened. At Friedman's ninetieth birthday celebration, Ben Bernanke, who was then on the governing board of the Federal Reserve, apologized for the actions of the Federal Reserve during the Great Depression and said that thanks to Friedman, it wouldn't happen again.[11]

The Demand Management Response

Economists do not agree on the role that the supply of money plays in the expansion and contraction of the business cycle. Classical economics had put its faith in the market's ability to correct an economic imbalance. Keynes argued that the government must play a role in moving the economy out of a downturn to solve the accompanying problems of unemployment. Keynesian economics paid particular attention to the problem of aggregate demand, or how much consumers, businesses, and government spend. According to this school of thought, there is not enough demand for goods in an economic downturn. Production drops and unemployment rises. When demand grows, factories produce more and employment rises. The government can play a role in creating aggregate demand through fiscal policy, or its ability to tax and spend. By raising spending and cutting taxes, the government creates increased demands for goods and services and thus helps to raise employment to meet them. Conversely, when prices go up because there is too *much* spending in the economy, the government can raise taxes and reduce spending. These actions give people less to spend and reduce demand.[12] Unlike monetarist policy that is controlled by the Federal Reserve, taxing and spending are controlled by the president and Congress.

The problem of too much government borrowing is thought to be that the government "crowds out" business investment, or borrows so much of the money available that there isn't much left for private business. Banks thus charge more to lend what money they do have available. Most economists agree that massive government spending to finance the deficit plays a role

[11] As recounted in Paul Krugman, "How Did Economists Get It So Wrong?" *New York Times Magazine*, September 6, 2009.

[12] Berman and Murphy, *Approaching Democracy*, 570. See also John Maynard Keynes, *General Theory of Employment, Interest, and Money* (London: Palgrave Macmillan, 1936).

in crowding out the ability of business to borrow. In other words, if the government borrows to stimulate the economy and interest rates rise, business would not be able to borrow at the lower rates that would stimulate the economy. However, they point out that the shorter impact of the crowding out effect can be reduced by financing the deficit through growth in the money supply so that there is plenty of money to lend. When the economic pie is enlarged, hopefully permitting investment to have greater access to credit, the result is termed "crowding in," or growing the economy through both government and private investment and not one to the detriment of the other.[13] As the economy approaches full employment, however, most economists understand the crowding out to be absolute. No resources available by increased government expenditure are available to the private sector. Therefore, with Keynesian theory, both government spending and monetary policy play a role in fine-tuning the macroeconomy.[14] Effecting Keynesian policies brings in a much wider set of political institutions, ranging from the Federal Reserve to Congress to the taxing and spending agencies of the government.

THE POLITICAL BUSINESS CYCLE: PUBLIC POLICY IN A RECESSION AND RECOVERY

The Federal Reserve's dual legislative mandate to promote price stability and maximum employment were clarified by an amendment to the Federal Reserve Act in the 1970s. The sequence in which these goals are pursued, however, has political repercussions, making some groups push to pursue one first and the other second, or one to the detriment of the other. As discussed in Section Two, there is no ongoing mechanism to coordinate the actions of the president and the Federal Reserve on matters of economic policy. Even if there were, Congress would have to pass a budget that is in line with what the president and Federal Reserve seek. The terms of office of the Federal Reserve's Board of Governors do not coincide with the presidential election cycle by design. An appointee from one party may work with a presidential administration, while one or both chambers of Congress have a majority of the other. For example, when the Reagan economic policy was adopted that included large tax cuts and a defense buildup that stimulated the economy, Volcker's Federal Reserve was working in the opposite direction with interest rates at 20 percent and the risk of a recession. When President Clinton was attempting to push a stimulus package through Congress, the Federal Reserve under Alan Greenspan

[13] Melton, *Inside the Fed*, 139.
[14] Stephen Rousseas, *Post Keynesian Monetary Economics* (New York: Macmillan, 1998).

began to raise interest rates to tighten the money supply and slow down the economy.[15]

Nonetheless, the lack of coordination and difficulty of control do not stop the suspicion that the government intervenes to manipulate voters. Some have suggested that there is a "political business cycle" or an "opportunistic political business cycle," wherein those in government attempt to time economic upturns (and not just interest rates) so that they coincide with elections. If the economy is stimulated in the short run, the politicians will be reelected. According to this line of thinking, because voters tend to evaluate government performance according to how the economy is performing, at election time they reward politicians who lower unemployment and raise production and incomes.

The incentives to intervene in the macroeconomy are clear in both the long run and the short run. In the long term, representation in the federal government is driven by broad economic patterns. Populations shift along with industry, which leads to adjustments in how representatives are apportioned in the House of Representatives. For example, after the 2000 census, Texas, Florida, Georgia, and Arizona each gained two seats. New York and Pennsylvania each lost two. Thus more industry and more population translates into more seats in the House and greater attention in presidential races, which translates into a greater ability to influence politics at the national level and vice versa. In addition, manufacturing states with large, albeit declining, numbers of electoral votes such as Michigan, Ohio, Pennsylvania, and Indiana have became important swing states in presidential elections. Policies that promote exports can have particular salience in these races.

Most theories of a political business cycle, however, focus on short-term incentives to intervene. In the short term, when interest rates rise and fall, different groups of people gain advantages and disadvantages depending on their role in the economy. A person's role as either a borrower (who wants low rates) or saver (who wants high rates) makes interest rates a highly political issue, not just a technocratic problem for monetary policymakers at the Federal Reserve. When most Americans lived on farms, one of the greatest needs for credit was to finance agricultural production. Farmers preferred cheap credit to buy seeds and other goods until crops could be harvested and the money could be paid back. Banks wanted to earn the highest rate possible on their loans. Farmers therefore preferred low interest rates and a larger money supply; banks preferred higher rates and a tighter money supply. In the industrial society we live in, the largest

[15] Berman and Murphy, *Approaching Democracy*, 572.

purchase that most Americans make is their home, followed by their car. When interest rates are low, it is easier to obtain a mortgage and more individuals can own, instead of rent, their homes. When they rise, mortgages are more difficult to obtain, the real cost of the home rises, and construction and other related industries suffer. Industries related to construction and manufacturing prefer for the Federal Reserve to lower rates, and their representatives try to pressure Congress to help their situation either when hearings on the Federal Reserve are held or through special programs that subsidize interest rates for houses or cars.

An early theory linking the business cycle to politics came from Polish economist Michal Kalecki. He argued that full employment changed the power relationship between employers and workers because it eliminated the reserve army of the unemployed. Kalecki thought that governments would resort to recessions to restrain the power of organized labor but that these downturns would be of short duration.[16] Other early proponents of the concept of a political business cycle were Edward R. Tufte and William Nordhaus. Tufte argued that unemployment was generally lower and productivity higher in the months directly prior to presidential elections.[17] Nordhaus pointed to the lag time between the lower unemployment and the inflation that followed. A president can stimulate the economy and gain the benefit of lower unemployment prior to an election, then inflation will follow after.[18] Empirical evidence since Tufte's study, however, has been inconclusive and conflicting at best. Challenges to Tufte's theory have pointed out that voters consider other factors than the economy in their decisions. Nordhaus's theory has been critiqued on its logic. If manipulating the economy is not really in the country's best interest – but is in the politicians' interest – voters would realize that they were being manipulated for political purposes. They would not reward these individuals at election time but would punish them.[19]

In later versions of the political business cycle, the initiative for manipulation does not come from policymakers. Rather, it comes from rational voters in the moderate middle who do not want either extreme of the two political parties. Authors in this version begin with the premise that politics

[16] Michal Kalecki, "Political Aspects of Full Employment," *Political Quarterly* 14 (1943).

[17] See Edward Tufte, *Political Control of the Economy* (Princeton, NJ: Princeton University Press, 1978). See also Berman and Murphy, *Approaching Democracy*, 571.

[18] William D. Nordhaus, "The Political Business Cycle," *Review of Economic Studies*, no. 42 (1975), 169–90.

[19] For a review of the literature, see Harold D. Clarke et al., *Controversies in Political Economy: Canada, Great Britain, the United States* (Boulder, CO: Westview Press, 1992), 174.

is polarized in such a way that Democrats are more concerned with reducing unemployment and Republicans with inflation.[20] These preferences generate recessions and expansions. Therefore, macroeconomic policy is not predictable because no one knows the outcome of elections in advance, wherein policies will favor either the Democratic or Republican preferences for attacking either inflation or unemployment. Moreover, outcomes do not only depend on which party holds the presidency, but on how strong each party is in Congress. Policy emerges from the interaction between the two. According to Alesina and Rosenthal's "rational partisan business cycle," voters are aware of these differences and take advantage of the checks and balances to promote moderate politics. Because policy results from compromise, voters restrain a president from one party by electing a Congress from the other party. If they think that Congress will remain under the control of the same party, they may tilt the other way in a presidential election. Even a minority opposition in Congress can provide some balance to a president of the opposing party.

More overtly partisan models likewise point to the differences between Democrats and Republicans in their preference for policy instruments to address macroeconomic problems, with Democrats preferring more expansionary policies than Republicans. However, once in office, both parties respond to rising inflation. Constantine Spiliotes resolves this contradiction by arguing for "conditional partisanship."[21] In other words, the president has an incentive to act either on behalf of his party or to get reelected. Once in office, he becomes responsible to the institution of the presidency to pursue sound macroeconomic management. Therefore, his desire for votes or to fulfill a party mandate is constrained by the trade-offs he must make on behalf of the office.

Other contemporary work on the political business cycle across Organisation for Economic Co-operation and Development (OECD) countries has introduced the concept of policy uncertainty and investor behavior into the equation. For Brandice Canes-Wrone and Jee-Kwang Park, private investors wait to make expensive investments if they think that policies might change after an election.[22] Therefore, when "costly to undo" sectors' investments such as machinery, equipment, or construction are considered apart and policy uncertainty is high, they observe what they call a "reverse

[20] Alberto Alesina and Howard Rosenthal, *Partisan Politics, Divided Government, and the Economy*, Political Economy of Institutions and Decisions (New York: Cambridge University Press, 1995).

[21] Constantine J. Spiliotes, *Vicious Cycle: Presidential Decision Making in the American Political Economy* (College Station: Texas A & M Press, 2002).

[22] See Brandice Canes-Wrone and Jee-Kwang Park, "Electoral Business Cycles in OECD Countries," *American Political Science Review* 106, no. 1 (2012), 103–22.

electoral business cycle" wherein the economy experiences a real decline in the preelection period. At the same time, these private fixed investments tend to obscure what evidence *does* exist for the more traditional opportunistic cycles in the other sectors. What matters to Canes-Wrone and Park is the degree of competition in the race and whether or not the parties hold similar positions on major policies.

THE POLITICAL ECONOMY OF THE 2001 RECESSION AND ITS AFTERMATH

Theorizing about presidential action in response to the business cycle is complicated by the diverse personalities and administrative styles of the men who have held the office, as well as the environment in which they have worked. Because economists do not agree about the appropriate instruments of government intervention into the economy to adjust for the effects of the business cycle, it is difficult to tell if the president was trying to manipulate the macroeconomy as best he could, or if he just pursued inappropriate policy according to the wrong rationale. This section considers the political economy of the 2001 recession to demonstrate the complicated exchange among schools of thought in economic policy, the individuals holding office, and the effects of fighting a recession that can present possible solutions to problems or causes for the next downturn. It will detail how the 2001 recession shaped the arrangements among the Federal Reserve, agencies, and regulators.

The Recession of 2001

In 2001, the U.S. economy experienced a contraction that has been attributed to a variety of causes, most commonly the collapse of the "dot com" bubble. As shown in Table 7.1, swings in the business cycle appeared to have been moderated after the end of World War II, but this recession seemed different. The 2001 recession was so short in duration and the economy had not experienced a recession for so many months prior that some observers began to argue that the United States had entered into a period of "the great moderation," wherein fluctuations in economic activity were less severe and the business cycle had been smoothed.

Economists provided three possible explanations for this development: the structure of the economy, credit policies and access were better, or the United States got lucky.[23] According to the first explanation, the structure

[23] This review draws on Marc Labonte, *Why Has the Economy Become Less Volatile?* (Washington, DC: Congressional Research Service Report for Congress, 2007).

changed in such a way that a greater percentage of economic activity comes from services and not manufacturing. Even if that were not the case, better inventory management on the manufacturing side might have helped moderate the cycle. Other structural theories argued that access to credit played a role. Consumers can smooth their own purchases by financing expenditures with debt and repaying it when they have more money. Otherwise, policy approaches at the Federal Reserve focused on fighting inflation after the 1970s contributed to macroeconomic stability. According to the third explanation, the economy in the period of the great moderation was not subjected to the kind of external shocks that it had been previously and thus benefited from fortuitous circumstances. Therefore, the national and international context may have contributed to what appeared to have been a smoother cycle.

Each of these views has been contested, and the truth probably lies in some combination of them. However, any combination of explanations obscures the policy implications. If the moderation occurred because individuals had access to credit, or businesses managed their inventories well, then individuals and firms were the solution. If it was the Federal Reserve's management of monetary policy, then the Federal Reserve should be the primary agency to manage the economy. If the great moderation was mostly luck, then there is little or no role for the government at all.[24]

When the economy contracted in 2001, George W. Bush was inaugurated president, and the 107th Congress opened with a Republican House and a Democratic Senate. However, the party majorities were slim, and members changed affiliations in the months ahead. The Senate switched to a Republican majority and then back to a Democratic one. Thus the policy direction was subject to change. In May 2001, Congress enacted a major piece of tax legislation with a series of cuts to be phased in over the coming years. However, the initial tax cuts were part of the new president's campaign promises and not aimed at stimulating the economy. As concerns over the economy grew, President George W. Bush and Congress proposed a rebate program. The rationale for the rebate policy was that individuals need to spend stimulus money when the economy is still in a recession. Moreover, the lower the income a person has, the more likely the person is to spend the money and not save it.[25] With a rebate, checks could be mailed to individuals based on what they had paid on their previous returns, thus producing faster stimulus effects than waiting to issue larger returns in the next spring. Rebate checks could be mailed to individuals from July to October.

[24] Ibid., 4–6.

[25] *Jane G. Gravelle, Tax Cuts for Short-Run Economic Stimulus: Recent Experiences* (Washington, DC: Congressional Research Service Report for Congress, 2008).

Economic concern grew even more after the September 11 attacks that occurred in the economy's financial center. The concerns were translated into a combination of tax cuts and low interest rates. This round of tax cuts was initially directed at business. Congress passed a two-year bonus depreciation that allowed a business to deduct 30 percent of its costs to acquire business equipment when the costs were incurred rather than depreciating them over several years. Later, Congress also passed a temporary reduction in taxes on dividends and a reduction in the capital gains tax. With Congress providing tax cuts on the fiscal side, the Federal Reserve repeatedly cut interest rates on the monetary side. Between January 2001 and June 2003, the Federal Reserve cut the target federal funds rate from 6.5 percent to 1 percent – its lowest in decades. It then kept that target until June 2004, then began to raise the rate for the next two years.

Although popular at the time, the Federal Reserve's low interest policy has become controversial in the years that followed because it had a profound effect on housing. With such low rates, large purchases financed with credit cost much less. Because monthly interest payments are lower, people can buy bigger homes than they might otherwise be able. As seen previously, both political parties promoted housing. The consequence was that across the political spectrum, getting people to buy a home, not rent one, was seen as highly desirable.

The wisdom of large housing purchases also appeared to receive support from economic data. Between 1975 and 2006, the Office of Federal Housing Enterprise Oversight (OFHEO) index of housing prices hardly dropped. The one significant period of decline was between 1981 and 1982, and it was attributed to the severity of the recession at the time. Because housing prices rose faster than other asset classes and people believed that residential real estate was a safe investment, demand remained strong in the run-up to the crisis. However, the continuing rise in the index did not mean that housing prices *could not* drop or that the market as a whole was not vulnerable to speculative activity that could throw off the pricing mechanism completely. Nonetheless, new borrowers continued to enter the market, particularly the subprime sector where borrowers with poor credit would not have been eligible for a loan in the past. Those who owned homes could take out additional loans as their equity increased, further concentrating lending in this market. In many cases, the loans were used to finance consumer purchases such as televisions or cars that were unrelated to the value of the home.

The Aftermath of the Recession

The lax lending practices and availability of cheap credit that emerged after the recovery from the 2001 recession were connected in ways that became immediately apparent when credit began to freeze in late 2006. The result was the massive growth of the shadow banking system where profits were greater, underpinned by the innovations in financial products detailed in Chapter 3. Under the easy monetary policy at the Federal Reserve and poor regulatory oversight, banks and other financial institutions that now competed fiercely with each other borrowed more and more and purchased mortgage-related securities. They also created structured investment vehicles to purchase assets that were not subject to regulatory capital requirements. Analysts point to the shocking lack of risk assessment on the underlying mortgage-related assets they held and traded in each link of the chain. Not the mortgage originator, the loan servicer, the mortgage-backed security issuer, the collateralized debt obligation (CDO) issuer, or the credit default swap (CDS) seller questioned the computer risk models or blatant deterioration of the loan terms of the actual mortgages themselves.[26]

More subprime borrowers had entered the markets, and eventually lenders lent not only to those with poor credit histories but also to those who did not have jobs or adequate resources to repay the loans. Lenders offered teaser rates on adjustable rate mortgages (or ARMs) that exacerbated the problems with the poor quality of the loans because many of these individuals would have never qualified for the higher rates, were they to adjust. Extensive securitization of mortgages allowed some financial institutions to "hide" the questionable mortgages because the attraction to a mortgage-backed security was that the investor relied on the institution and rating agency to evaluate the individual loans. The participation of the government-sponsored enterprises (GSEs) amplified the volume of these practices because their access to even cheaper credit provided a seemingly endless supply of capital into the system. The complex financial instruments didn't seem "toxic" at the time because they were insured with a variety of sophisticated, yet unregulated, insurance products in the form of CDSs.

The buildup of debt within the system was magnified with new and expanding lending practices. When financial institutions needed additional liquidity, some relied on overnight repurchase agreements that added an additional layer of systemic risk. With a so-called repo agreement, a bank pledges its assets as collateral in an overnight arrangement with another bank and agrees to buy the assets back the next day at a higher price. This process seemed to present a low credit risk during good times, but it tied the financial institutions together in such a way that when one had problems, they could be transferred to all of the entities with whom that institution was doing business. The high percentage of repo agreements contributed to the overall systemic risk. From 2001 to 2007, overnight repos as a share

[26] Baily, Litan, and Johnson, *The Origins of the Financial Crisis*.

of investment bank assets grew from 12 percent to more than 25 percent. This growth meant that investment banks were rolling over liabilities equal to one-quarter of their balance sheets overnight, thus making the banks heavily dependent on their access to short-term credit for their survival.[27]

The continued growth and lack of regulation in the shadow banking industry eventually threatened the interconnected global financial system. Many factors contributed to the maelstrom, beginning with changes in the operations of the credit rating agencies, through the growth of the subprime mortgage market, together with new business models that emphasized the origination of loans to be distributed and held on books heavily reliant on a credit rating.

The rating agencies matter at this juncture because a key aspect of financial intermediation is trying to figure out how likely it is that a borrower will repay a loan. In U.S. history, a distinct institution – the rating agency – came to perform this function. When bank deregulation occurred, ratings helped lower-rated companies that wanted to issue bonds to raise capital by allowing them to sell bonds with higher interest rates, and by allowing higher-rated issuers to price their bonds with lower rates to reflect their lower risk of default. Otherwise, some issuers would have been excluded from the market altogether. Early Moody's business models recognized that asking for payment from a bond issuer obviously posed a conflict of interest, insofar as the higher ratings would appear to be for sale.

However, a conflict of interest developed in the early 1970s when the rating agencies began to charge issuers for their opinions. In 1975, the SEC allowed banks to base their capital requirements on the ratings of securities they held. Whereas rating agencies' revenue had primarily come from investors who bought the research and analysis, they now began to realize more revenue from issuers and thus work more closely with them. The firms therefore gradually moved from being arbiters between issuers and investors to becoming the ally of issuers. In 1998, a new executive at Moody's refocused the firm on the individual contribution of each analyst to produce a set amount of revenue each year and thus profit. In 2000, Moody's became a public firm and the same management sought quarterly profit growth, further shifting its work from the low-margin ratings of simple bonds to the lucrative ratings of much more complex instruments. The AAA rating became even more attractive as banking regulations, particularly in Europe, used the ratings to calculate the amount of capital they had to hold on reserve.[28]

[27] Ibid., 30.

[28] See Gretchen Morgenson, "Debt Watchdogs: Tamed or Caught Napping?" *New York Times*, December 7, 2008, 1. For an extensive examination of the role of rating agencies in world politics, see Timothy J. Sinclair, *The New Masters of Capitalism: American Bond*

As their role evolved, the conflict of interest inherent in the work of the credit rating agencies became a problem because they received higher fees from rating the more complex instruments than other activities. The firms' profit incentive was to rate more and more of them – not to provide an unbiased assessment of their actual risk to those who used the rating. Hence, the business model also had an external conflict between the agency as a profit-making firm to assign higher ratings (indicating low risk) for one set of customers who issued securities, and to assign lower ratings (indicating high risk) for another set of customers who needed an impartial assessment of risk to assess their investments accurately. The boom in housing and mortgage markets propelled this growth. Investors did not necessarily understand the instruments that bundled the mortgages; however, they relied on the ratings given by the ratings agencies, with the conflict of interest in accurately disclosing the risk.[29] Because the CDO market operated outside of the regulated market, the rating agencies became proxies for regulators. Even the OCC used the rating agencies to assess CDO quality.

The rating agencies' conflict of interest was exacerbated by the risk models they used, which were drawn from 1992 until the early 2000s, a time when mortgage default rates were low and housing prices rose. Thus there was never a factor for what would occur in a general housing bust, or when many mortgages go into default simultaneously. Moreover, the conflict of interest between the credit rating agencies as arbiters and advisors grew more profound after 2000. They sought to advise a CDO issuer on how to structure the CDO with the lowest funding possible. They also worked to optimize the size of the tranches to maximize the size of highly rated, lower-yielding ones. If an issuer did not receive the rating it sought, it could go to another agency.[30]

What started as innovations in financial engineering had gone to extremes, particularly in those mortgages originated in 2005, 2006, and 2007, where the default rates were significantly higher and occurred much more quickly than in other years.[31] For example, at the height of the subprime mortgage frenzy, originators issued "NINJA" or no income, no job, and no assets loans. In previous eras, a responsible financial institution would have questioned how an individual without an income, job, or assets could possibly make payments on a mortgage. The individual would most likely have been denied the loan outright. Thus the housing bubble was reinforced by the cheap access to credit and expansion in the number of

Rating Agencies and the Politics of Creditworthiness (Ithaca, NY: Cornell University Press, 2005).

[29] See Gretchen Morgenson, "Debt Watchdogs."

[30] Baily, Litan, and Johnson, *The Origins of the Financial Crisis*, 35.

[31] Phillip Swagel, "The Financial Crisis: An Inside View," in *Brookings Papers on Economic Activity* (Washington, DC: Brookings Institution, 2009), 6.

borrowers that kept entering the market and ensuring that prices kept rising. At the same time, there were outright fraudulent lending practices in some places by some firms. For example, lenders could manipulate applications for mortgages or lead borrowers to higher-priced subprime loans when they would have qualified for lower rates. In other examples, proper paperwork was not always filed. In the aftermath of the crisis, Bank of America, GMAC Mortgage, and other major loan servicers testified to Congress that they signed, and in some cases backdated, thousands of documents claiming personal knowledge of facts about mortgages that they did not actually know to be true.[32]

SHIFTING IDEOLOGY AND INSTITUTIONAL PREFERENCES FOR ECONOMIC MANAGEMENT AMONG THE PRESIDENT, CONGRESS, AND FEDERAL RESERVE

The ideological underpinnings of economic policy are significant because they inform different policy responses that affect constituencies differently. Moreover, they have an impact on the conduct of bureaucratic politics because the responses are carried out through different agencies. Therefore, different parts of the federal government gain influence, governing authority, budgets, and personnel, depending on which school of thought carries the day. As the monetarist approach ascended in the academy and policy worlds, intervention by the Federal Reserve through manipulations in the money supply became the preferred policy response along with it. Thus monetarism involved a process of institutional reconfiguration that altered the relations among American monetary authorities and financial markets.[33]

The Rise of Monetarist Thought

Although Alan Greenspan's tenure as Federal Reserve Chair has been criticized after the crisis in 2008, in November 2000 his biographer Bob Woodward referred to him as "Maestro" both for his musical talent and his ability to conduct the political and economic orchestra.[34] Members of Congress

[32] See Congressional Oversight Panel, *November Oversight Report, Examining the Consequences of Mortgage Irregularities for Financial Stability and Foreclosure Mitigation* (Washington, DC: U.S. Congress, 2010).

[33] For an alternate view of how this occurred, see Martijn Konings, "The Institutional Foundations of US Structural Power in International Finance: From the Re-emergence of Global Finance to the Monetarist Turn," *Review of International Political Economy* 15, no. 1 (2008): 37. See also chapter 11 in his *The Development of American Finance* (New York: Cambridge University Press, 2011), 131–152.

[34] Bob Woodward, *Maestro: Greenspan's Fed and the American Boom* (New York: Simon and Schuster, 2000).

hung on his words at Federal Reserve oversight hearings, and he was highly regarded for his role in the boom economy during much of his time on the job. Aside from judgments about Greenspan, his actions reignited centuries-old ideological debates about the role of the American government in the financial system. On one side, analysts view government action in the form of the Federal Reserve's policy and the GSE's promotion of housing as the cause of the housing bubble and subsequent 2008 crisis. On the other side, analysts view the lack of government regulation and enforcement of existing regulations as its cause. Remarkably, both sides viewed monetary policy as preferable to fiscal policy in managing the economy prior to the crisis, although according to different rationales.

The sentiment against government intervention in the economy extends to the debates between Thomas Jefferson and Alexander Hamilton over the First Bank of the United States. By the end of the twentieth century, however, the debate gained particular ground in U.S. governing institutions, arguably as a result of the end of the Cold War. Hirsh purports that Reagan's election paralleled the rise in popularity of Milton Friedman's views in the academy and popular culture.[35] At a time when about ten firms controlled about 75 percent of trading on Wall Street and bankers did not make much money relative to other professions, Senator Phil Gramm, Representative Jack Kemp, and others began to push for banking deregulation.[36] Wall Street did not have a significant lobby in Washington, DC. Government affairs professionals worked in New York and commuted to Washington for a pressing matter, then returned when it was concluded.

Nonetheless, when Alan Greenspan became Chair of the Federal Reserve Board in 1986, the change that was already under way gained an important ally at the Federal Reserve. An economist who had worked in the government and served on a number of corporate boards, including J.P. Morgan, Greenspan's orientation toward markets and regulation had been heavily influenced by the writer Ayn Rand, whose novels illustrated a libertarian philosophy emphasizing reason, individualism, and enlightened self-interest. Greenspan was conscious of the inherent contradictions between many libertarian principles and government service. Both when he was sworn in as a member of President Gerald Ford's Council of Economic Advisers and as Chairman of the Federal Reserve, he noted that he was aware he would have to pledge to uphold not only the Constitution but also the laws of the land, many of which he thought were wrong.[37] His policy advice was inevitably not to intervene, even with the smallest pieces

[35] Hirsh, *Capital Offense*, 59.
[36] Ibid., 61.
[37] See Greenspan, *The Age of Turbulence*, 52, 372–73.

of regulation. His defense of his position was not that regulation was bad but that in the end it would do more harm than good. In this thinking, he was supported by James Buchanan and Vernon Smith of George Mason University, who received Nobel prizes for their arguments that regulation generated more costs than benefits, and markets were better at allocating resources and generating efficiency than governments.[38]

The Bureaucratic Shift to the Federal Reserve

Policymakers in the Clinton administration did not necessarily share Greenspan's ideological views, but they did place priority on the Federal Reserve as an actor that could respond to the ups and downs of the business cycle. When Robert Rubin assumed the head of the National Economic Council early in the Clinton administration, he advised the president-elect that to avoid a recession, Clinton would have to cut the federal budget deficit substantially, or government spending would crowd out private investment. The only way to do so without triggering a recession from the demand side (when the budget was cut) would be if the Federal Reserve and bond traders drove down interest rates. Cutting the budget deficit would thus change the market psychology.[39] Rubin knew Greenspan's views, so the Clinton administration was able to gauge his likely reaction to their fiscal choices.[40]

Rubin's influence grew within the Clinton administration, and his beliefs about the economy reinforced an accommodating stance toward the Federal Reserve. He maintained that global financial markets were a part of contemporary economic reality. He deferred to the power of the markets, as well as to the Federal Reserve.[41] The administration did not comment publicly on its interest rate policy, and Rubin and Greenspan met regularly when Rubin was Secretary of the Treasury. Others in the Clinton administration, such as Lawrence Summers, never completely abandoned their Keynesian roots but advocated market stabilization, privatization, and liberalization as a package that loosely became known as the "Washington Consensus."[42]

A liberal ideology that sought to keep government out of the economy thus propelled both political parties to accept the notion that the Federal Reserve plays a privileged role in managing macroeconomic policy.

[38] Hirsh, *Capital Offense*, 79.
[39] Ibid., 91.
[40] Robert Rubin, *In an Uncertain World*, 120.
[41] Hirsh, *Capital Offense*, 97. See also Rubin, *In an Uncertain World*.
[42] Hirsh, *Capital Offense*, 119. The Washington Consensus has other definitions as well.

Policymakers in a democratic presidential administration focused on stimulating the economy when the budget deficit was already high found the central bank to be a useful tool in keeping interest rates low. The role of Congress in making macroeconomic policy was relegated by both political parties to promoting particularistic lending programs and tax cuts in much of the run-up to the 2008 crisis.

CONCLUSION

This chapter has shown that when faced with an economic downturn, policymakers have options informed by two major yet competing economic theories: monetarism and Keynesian demand management. Each is more closely associated with a different part of the government. The Federal Reserve directly conducts monetary policy, whereas Congress directly conducts fiscal policy and indirectly influences monetary policy through the effects of budget deficits on interest rates. Since the 1980s, economic management has tended to rely more heavily on monetary than fiscal policy for a range of reasons reflecting the rise of free market ideologies, and the political reality that Keynesian demand management policies require the government (Congress) to cut spending once the economy is stimulated. Whereas providing *more* money to increase demand among constituents is popular with politicians, cutting popular programs is far more difficult. The central bank – not the legislature – is therefore left with the tough job of pulling away the punch bowl once the party gets started.

The result of the move to the Federal Reserve within macroeconomic management, combined with the free market ideology, has had important implications for the functioning of the bureaucratic apparatus surrounding finance. Congress has increasingly directed its attention to cutting taxes and has been reluctant to engage in stimulus spending programs. Members might relieve pressure on monetary policy to provide the necessary stimulus in advance if they raised spending in a downturn and then lowered it when the economy recovered. In the absence of congressional action, and when interest rates are close to zero, the Federal Reserve is left to resort to more extreme quantitative easing measures because it has no other policy tools at its disposal. For its part, the Federal Reserve has focused on its role as a central bank to the detriment of its role as a regulator in the banking system. These factors, along with the long-standing lack of institutional coordinating mechanism among the executive, legislature, and central bank, remain unresolved.

8

The Process Approaches Collapse

Politics in the Financial Crisis of 2008

Unlike the response to a downturn in the business cycle that unfolds over months or years, the government's response to a financial crisis must be immediate to prevent a collapse of the entire system. No doubt, many people are hurt in an economic downturn. However, should a catastrophic failure in the banking system occur, individuals would lose access to their savings and retirement accounts, businesses would not be able to make payments or be paid by their customers, and the government would not be able to conduct its affairs. The aftereffects of policies implemented in a crisis are also more profound than those taken during the ordinary course of the business cycle. A crisis changes the margins around the legitimate use of government action. As a result, the government's response leads to the creation of new institutions, new powers for existing agencies, and new precedents for the future.[1] Hence, this chapter considers the crisis of 2008 to situate it within patterns of conduct of American government in response to crises since the end of the Civil War. Although economic assessments have demonstrated that the excessive accumulation of debt is a common theme in the buildup to a range of financial crises, a particular institutional arrangement and political culture allow them to occur in the United States.[2]

Therefore, rather than providing the type of exhaustive review of the financial crisis of 2008 and government bailouts that are available from other excellent sources, we will explore the politics of the financial system

[1] Skowronek, *Building a New American State*, 10.

[2] Reinhart and Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, NJ: Princeton University Press, 2009).

by placing the events against the backdrop of the congressional calendar and bureaucratic politics more broadly.[3] This chapter divides the events and the government's response to them into their immediate and medium-term phases. Each resulted in the passage of a major piece of legislation: one that forced a degree of democratic accountability on the government for the rescue, and another that altered the governing authority among agencies of the federal government and created a new one.

The review of the immediate phase adapts Allison and Halperin's analyses of politics in an international crisis. Their bureaucratic politics model focuses on the individuals within a government and the interaction among them. What a government does can be understood as the result of bargaining among players positioned hierarchically. They point out that government leaders have competitive, not homogenous, interests. Their priorities and perceptions are shaped by their positions. To see how players' stands are aggregated to yield governmental decisions and actions, a researcher must first see who plays and what determines each player's stand. The result of the immediate phase was the unprecedented intervention in the shadow banking system through the creation of the Troubled Asset Relief Program (TARP) and the related bailout of the auto industry.

The review of the medium-term phase of the crisis also utilizes political science studies of the policymaking process that emphasize the operations of politics within policy subsystems and the accompanying importance of media attention. Unlike crises in other policy areas such as pharmaceuticals or tobacco, the financial crisis in 2008 rushed through policy areas as diverse as housing, banking, and autos in a cascade. For scholars of the policymaking process, the system may have operated without opposition and only piecemeal changes for years in any one of these individual policy areas. However, media attention can concentrate public attention on a problem and thus open a window of opportunity for change.[4] Therefore, those involved either fight to get their issue onto the agenda (if they seek change) or keep it off (if they benefit from the status quo).[5] The media attention attached to successive bailouts exposed the overall vulnerability of the shadow banking system through the complexity of the financial products created, as well as their connection to the formal banking system. To restore a degree of confidence in the system and encourage market

[3] For some other sources on the events of the crisis, see David Wessel, *In Fed We Trust: Ben Bernanke's War on the Great Panic* (New York: Crown Business, 2009); Sorkin, *Too Big to Fail*; Hirsh, *Capital Offense*; Paulson, *On the Brink*.

[4] John W. Kingdon, *Agendas, Alternatives, and Public Policies* (Boston: Little, Brown, 1984).

[5] Baumgartner and Jones, *Agendas and Instability in American Politics*, 20.

participants to return, policymakers sought to bring the unregulated part of the industry into some regulated framework through the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in the summer of 2010.

More importantly, the media attention directed at the human cost of housing foreclosures exposed the vulnerability of individual consumers to aggressive lending practices in the industry, as it had evolved since the 1980s. In other words, when banking deregulation caused the financial services industrial compartments to merge and compete with each other, no one regulator existed to protect the *individual* in the face of the new competition in the bazaar. Although attempts to provide government relief to individual homeowners were largely unsuccessful, an agency was created in the medium-term reform effort to address individual consumer protection. This action follows in a long line of regulatory frameworks that Hoffman argues are institutional manifestations of public philosophies, in this case the emphasis on the individual consumer in the financial services marketplace.[6]

The result of the crisis and the government's response is therefore similar to those in the past wherein a new agency is layered onto the existing patchwork without consolidating the existing ones. The new consumer protection bureau will have to compete for its governing mandate, personnel, and possibly budget among existing ones as it struggles to become fully functioning. The Securities and Exchange Commission (SEC) will have to do the same to fulfill the new mandates set forth in the Dodd-Frank reform bill.

THE CRISIS IN THE SHORT TERM: PREVENTING COLLAPSE

Observers of the financial crisis place a great deal of emphasis on the passage of the Emergency Economic Stabilization Act of 2008 that established the TARP. It stands out among the government's political responses because it was the one instance where elected officials were forced to put their views concerning these bailouts on the record and voted publicly on it. Later oversight of the program allowed for the disclosure of the government's activities and justification for action. The sheer size of the bill is significant because in passing it, Congress and the George W. Bush administration redefined the boundaries of acceptable action in rescuing the financial sector from collapse. It allowed the Obama administration to devise (unsuccessfully) a program to help individual homeowners. However, it was only one element in a succession of bailouts organized by different government

[6] Hoffman, *Politics and Banking*.

agencies in response to the crisis. Disclosures in 2011 revealed that the seemingly large size of the TARP – of up to $700 billion – was, in fact, dwarfed by the amount lent by the Federal Reserve through its discount window that had not been made public at the time.[7] In one day, the Federal Reserve had outstanding loans of $1.2 trillion.[8]

To understand how the U.S. government decides what to do in the immediate stage of a financial crisis, an analyst must first see who is involved in making decisions, as well as what determines their stand on them. Whose interests and behavior have an important effect on the government's decisions and actions in the financial area? Unlike decision making in a foreign policy crisis where bureaucratic actors align against an enemy government, in the acute phase of a domestic American banking crisis the bureaucratic actors must work *with* private banks, not against them. In Henry Paulson Jr.'s retelling, the innermost circle comprised himself, Ben Bernanke, and Timothy Geithner.[9] There are other circles of players a level or two out, particularly as the immediate crisis abated and the Obama administration took office, including the "car czar" Steven Rattner, National Economic Council head Lawrence Summers, and prominent members of the financial press, representatives of the major banks and financial institutions, and individuals in the community of Washington think tanks.[10]

Lobbyists certainly play a role. But the direct contact between the heads of the major banks and heads of government agencies at several junctures in the financial crisis far outweigh the best efforts of any lobbyist to effect outcomes. When measured over the first seven months of Secretary of the Treasury Timothy Geithner's tenure, the number of contacts between Geithner and Citigroup was higher than with House Financial Services Chair Barney Frank (D-MA), and contacts with Goldman Sachs higher than with Senate Banking Chair Christopher Dodd (D-CT). During that period, Geithner had at least eighty contacts with Goldman Sachs head Lloyd Blankfein, JPMorgan Chase Manhattan head Jamie Dimon, and Citigroup chairman Richard Parsons and chief executive Vikram Pandit.[11]

7 See Bob Ivry, Bradley Keoun, and Phil Kuntz, "Secret Fed Loans Gave Banks $13 Billion Undisclosed to Congress," *Bloomberg Markets Magazine*, November 27, 2011, http://www.bloomberg.com/news/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html (accessed December 21, 2011).

8 See "Fed Faces New Scrutiny for Trillions in Assistance to Banks After Crisis," PBS NewsHour analysis airing November 29, 2011. Transcript available at http://www.pbs.org/newshour/bb/business/july-dec11/fedloans_11-29.html (accessed December 1, 2011).

9 Paulson, *On the Brink*.

10 Allison and Halperin, "Bureaucratic Politics," 47.

11 See Daniel Wagner and Matt Apuzzo, "Wall Street Has Geithner's Ear," *Washington Post*, October 9, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/10/08/AR2009100804132.html (accessed May 1, 2012).

According to the bureaucratic politics paradigm, a player's position in the system shapes his perceptions and preferences for what is to be done. Although all may agree on certain macroeconomic goals, reasonable individuals can disagree about how to achieve them. Most members of an organization believe that the health of their organization – be it the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Treasury, or SEC – plays a vital role in the health of the economy. Thus they seek to maintain its influence and fulfill its mission by maintaining its autonomy and organizational morale, protecting its essence, maintaining or expanding its roles and missions, and maintaining or expanding its budget. Organizations rarely take stands that require elaborate coordination with other organizations. They compete for roles and missions in a crisis.[12]

The stakes for both members of Congress and government officials were clear: members of Congress were forced to take unpopular action with an election quickly approaching. Agencies, chiefly the FDIC, Federal Reserve, and Treasury, sought to preserve their governing authority, budgets, and personnel – in short, their "turf."

Buildup to the Crisis

One of the thornier aspects of the U.S. financial crisis in 2008 was that it rolled out in stages from the housing markets to the commercial paper market and shadow banking industry, to the investment bank collapses, to the international payments system, to the recession and eventually to the sovereign debt crises in Europe that threaten the collapse of the eurozone. The problem at each stage concerned different but connected industries, agencies that regulate them, and congressional jurisdiction over them, or what Chapter 1 referred to as an "iron triangle" or "policy subsystem." According to most observers of the American policy process, such tight networks among industry, agency, congressional committee, journalists, researchers, and policy analysts formulate policy with little change over time despite the existence of many interest groups because they operate with limited interference from the outside and deference to the judgment of experts.[13] However, the context matters. Inevitably, a crisis occurs and media attention becomes focused on a specific problem.[14] The attention can shake public indifference and result in dramatic changes in policy outputs. Therefore, the 2008 financial crisis in the United States was dramatic

12 Allison and Halperin, "Bureaucratic Politics," 49.

13 Baumgartner and Jones, *Agendas and Instability in American Politics*, 7; Berry, *The New Liberalism*, 80; Sabatier and Jenkins-Smith, "The Advocacy Coalition Framework," 119.

14 Kingdon, *Agendas, Alternatives, and Public Policies*.

because it did not just occur in one iron triangle or policy subsystem, as with most other policy areas, but rather tore through a series of them in rapid succession.

The first policy subsystem to be affected was housing. When the housing market began its decline in 2006, the latest borrowers showed the first signs of problems, indicating that it was not just economic circumstance but the underwriting of the loans that contributed to the meltdown. Some borrowers could not afford the new (higher) rates when their adjustable rates reset, whereas others didn't see any point in continuing to pay a mortgage when the value of the property declined and they owed more than the home was worth.

Next, the problems flooded the financial policy subsystem when the commercial paper market froze in response to the growing mortgage crisis. Investors became reluctant to buy commercial paper when two Bear Stearns hedge funds filed for bankruptcy after sustaining heavy losses in the mortgage market in August 2007. Recall that liquidity refers to the ability to trade large amounts of securities quickly and without affecting their price appreciably. Liquidity in the commercial paper market matters because the ability to roll, or sell, commercial paper provides the source of external funds that the banks needed to stay afloat. However, investors were concerned about the default rates in the underlying assets held in the structured investment vehicles of large banks and financial firms. Without being able to roll commercial paper, the banks did not have access to the money they needed to conduct their day-to-day business. In theory, most of these vehicles had some kind of backup line of credit through a regulated bank or other entity if the defaults grew so great that they needed it. Investors, however, saw the glaring systemic risks when it appeared that *all* of these lines might be accessed simultaneously. To show that it was prepared to act, the Federal Reserve cut the discount rate (the rate it charges banks) and thus provided money to the commercial paper market that the investors did not. Nonetheless, on-again, off-again runs on the commercial paper market persisted through the next year, and institutions began to collapse in the financial instability.

One of the earliest institutions to be threatened with bankruptcy was Bear Stearns, Wall Street's fifth largest bank. The Treasury and the Federal Reserve responded with the Treasury putting together a deal. The Federal Reserve backed $30 billion in loans so that JPMorgan Chase could buy Bear Stearns for $10 a share on May 30, 2008. The authority to use its funds this way was derived from a provision in the Federal Reserve Act that allowed it to lend under "unusual and exigent circumstances" when the loans are secured to its satisfaction. JPMorgan secured the loans until the deal closed.

A broader banking crisis became apparent when regulators seized IndyMac on July 11, 2008. IndyMac was the largest financial institution to close in history. The ultimate failure of the housing finance system was prevented by the September 7, 2008, takeover of Fannie Mae and Freddie Mac. The Treasury put them into a conservatorship under the authority of the Housing and Economic Recovery Act of 2008 that had been passed two months earlier and replaced their management in an attempt to forestall further turmoil in housing markets. The Treasury's action meant that they would still be traded publicly, but the government would serve as a trustee exercising control. Thus their new regulator became their new manager – the Federal Housing Finance Agency (FHFA). In guaranteeing their debt, the U.S. government became indirectly responsible for providing approximately three-fourths of funding for new home loans in the United States. It guaranteed most of the rest through the Federal Housing Administration.

The Acute Phase in September 2008

Accounts of the month of September 2008 agree that the main actors in the drama surrounding the immediate crisis in the U.S. financial system were Secretary of the Treasury Henry Paulson Jr., then New York Federal Reserve Bank President Timothy Geithner, the presidents of the afflicted institutions, and those who had the potential to purchase them, such as Richard Fuld at Lehman Brothers, Kenneth Lewis at Bank of America, and Bob Diamond of Barclays. There is also an agreement that the White House was not involved in the rescue efforts but that the Treasury had a great deal of latitude to address the situation as it saw fit.[15] However, the Treasury was disorganized internally, and relations with the White House were strained.[16]

The week of September 14 triggered the immediate need for some kind of legislative involvement, because in the same week Lehman and American International Group (AIG) failed, the Reserve Fund money market mutual fund "broke the buck" by having its value per share fall below the $1 par level, and a flight from money market mutual funds ensued. Commercial paper markets froze again, this time not only in the banking and financial services industry but also among the major industrial companies that fund their daily operations with commercial paper. The fear of higher numbers of unwilling market participants to meet claims is

[15] See James P. Stewart, "Eight Days," *New Yorker*, September 21, 2009, 72. See also Wessel, *In Fed We Trust*

[16] Swagel, "The Financial Crisis," 2.

at the heart of a crisis, because if one firm collapses, others can fall like dominoes.[17] The major industrial firms told the Treasury that they faced imminent liquidity problems, which could result in wide-scale bankruptcies if not resolved promptly.

As models of bureaucratic politics would predict, the events occurred in such a manner that, as one participant from the Treasury in the Bush administration, Phillip Swagel, noted, "Decisions had to be made rapidly in the context of a cascade of market events."[18] Therefore, the Emergency Economic Stabilization Act of 2008 that created the TARP program was proposed in the context of the events of that week. Time constraints meant that actions were taken that might not have been the preferred policy approach under different circumstances, but were needed to deal with the immediate problems in the face of broad runs on the entire system. The week of September 14, 2008, is significant because two major failed institutions failed closely on the heels of the government takeover of Fannie Mae and Freddie Mac that further involved government agencies and, ultimately, Congress in rescuing the financial system.

Of the two institutions that failed in the week of September 14, Lehman Brothers was an investment bank that, relative to its other work in structured finance, securitized a high percentage of subprime mortgages. When it created the structured financial products associated with the mortgages, Lehman tended to keep the lower tranches, thus making it highly vulnerable to any downturn in the housing market. Lehman borrowed large sums to fund its investments. As its level of debt had grown, it relied heavily on an accounting gimmick associated with repurchase agreements to transfer packages of dubious assets of up to $50 billion off of its books at the end of an accounting quarter with an agreement to buy them back in a few weeks. In some of its more notorious transactions, Lehman's repurchase agreements were called "Repo 105" because the firm actually sold bonds for 100 percent of the 105 percent they were worth. The transaction was recorded as an actual sale, despite the fact that the firm had agreed to repurchase them shortly thereafter at the higher price. Lehman used the cash from the sale to pay some bills and file a quarterly report (with less debt on its books and appearing to be healthier than it was); it then borrowed more money to repurchase them when the time came. However, this new debt was entered on the books after the quarterly report was complete. The transaction amounted to paying 5 percent of the assets exchanged but allowed the firm's balance sheet to appear more sound than it was

[17] Melton, *Inside the Fed*, 155.
[18] Swagel, "The Financial Crisis," 2.

for a longer period of time.[19] Obviously, the practice also made the firm extremely vulnerable to finding enough other market participants willing to participate. As its stock price slid, few were willing to provide short-term funding of any kind.

The other institution to fail in the week of September 14 was AIG – a holding company engaged in a broad range of activities in the United States and abroad, including general insurance, life insurance and retirement services, financial services, and asset management. One of these subsidiaries – its financial products division – was a major source of its difficulties because it engaged in a wide variety of financial transactions, including standard and customized financial products. As far back as 1998, AIG had begun to insure the least risky part of corporate loans on assets bundled into securities. To lower its risk, it structured these deals so that it would not have to make early payments. As the housing bubble expanded, AIG began to insure subprime mortgage deals. Therefore, although AIG was one of the largest insurance companies in the world, it had grown unstable due to its activities in insuring parts of subprime mortgage deals that were not regulated.

When Lehman's collapse became imminent, Paulson and Geithner sought to achieve a rescue along the lines the New York Federal Reserve had used with Long-Term Capital Management, where no governmental money would be used. They called a meeting to discuss the Lehman collapse and at the same time learned that AIG had fallen into a crisis of its own. Concerns about the decline in the value of collateralized debt obligations (CDOs) insured by AIG's credit default swap portfolio translated into serious concerns about the firm because it would have to pay out large sums if it had to make good on the insurance contracts associated with the CDOs. It was unable to raise additional capital or secure a bridge loan in September; on September 15, the rating agencies downgraded its debt three notches. As AIG's share price fell, counterparties withheld payments and refused to conduct transactions with AIG. The political stakes posed by AIG were different from Lehman because its collapse would threaten the millions of households whose 401(k) savings were on deposit, as well as millions more in life insurance policies and pensions. Thus unlike Lehman, it was more "consumer facing."[20]

[19] For a discussion of Repo 105, see Michael J. De la Merced and Julia Werdigier, "The Origins of Lehman's 'Repo 105,'" *New York Times*, March 12, 2011, http://dealbook.nytimes.com/2010/03/12/the-british-origins-of-lehmans-accounting-gimmick/ (accessed December 21, 2011).

[20] Swagel, "The Financial Crisis," 32.

Unable to find a buyer, Lehman Brothers filed for bankruptcy on September 15. The next day in its first round of intervention, the Federal Reserve Bank of New York loaned AIG $85 billion and took an 80 percent stake in the insurance giant. The loan was for the general corporate purposes of AIG and its subsidiaries and to pay obligations as they come due.[21] However, in addition, the loan sought to prevent the systemic risk that could result from a failure or further rating downgrade. Later assistance and subsequent restructurings were to prevent systemic risk from the failure of AIG by allowing it to sell assets and restructure operations in an orderly manner. Because AIG never declared bankruptcy, as Lehman had, its counterparties were paid in full. By November 2009, Goldman Sachs had already received $62 billion on its contracts with AIG that was made possible by the assistance.

Numerous controversies surround these actions by the Federal Reserve and Treasury. It could be argued that given his prior tenure at Goldman Sachs, Paulson had a long-standing business interest in the collapse of Lehman, whereas he had an interest in the rescue of AIG. Because the bailouts came from different sources and were in different forms (loans, guarantees, stock purchases, etc.) and benefited the direct recipients as well as their counterparties, it is difficult to provide an unbiased and accurate report of who actually received the most bailout money, and who paid it back. Paulson, Bernanke, and Geithner argued that they were reluctant to use public money to rescue a firm that had become a very risky investment. There was simply no buyer for Lehman without government assistance.[22]

The Troubled Asset Relief Program

The size of the AIG bailout even took members of Congress by surprise. Although the Federal Reserve had the legal authority to act in an emergency, its actions drew attention to its power and independence from the legislature, which could possibly put the latter in jeopardy. Few politicians understood that the Federal Reserve could create money from nothing and without presidential or congressional approval. After the first AIG rescue, Barney Frank, the Chair of the House Committee on Financial Services asked the Chair of the Federal Reserve if he had $80 billion to lend. Bernanke reportedly replied, "Well, we have $800 billion" in

[21] See Orice M. Williams, "Federal Financial Assistance: Preliminary Observations on Assistance Provided to AIG, GAO-09–490T" (Washington, DC: GAO, 2009), http://www.gao.gov/new.items/d09490t.pdf (accessed April 12, 2012), 3.

[22] Stewart, "Eight Days," 80. See also Paulson, *On the Brink*.

reference to the value of the Federal Reserve's assets.[23] When Paulson pointed out to the Bush administration that the Federal Reserve could continue to finance the rescue without Congress, Bernanke cited the limits of the Federal Reserve's legal authority even in unusual circumstances. When the sums reached such an enormous magnitude, the entire political system, including Congress, would need to be on board or the legitimacy of the enterprise would be threatened. Bernanke began to search for a way to share political accountability with Congress.

Therefore, the Federal Reserve's role had become an increasing political concern to those involved. As a creation of Congress, it is ultimately subject to it. After the bailout of AIG, Paulson and Bernanke met with Christopher Cox of the SEC, Vice President Dick Cheney, and President George W. Bush to seek the legal authorization to purchase billions of dollars of troubled assets to remove them from the books of the floundering banks. In seeking the money from Congress, the Treasury would dispense it, not the Federal Reserve.[24] This change in actor might make the program more politically acceptable. Although the options for some kind of program to buy the toxic assets had been formally written at the Treasury as early as March, the tense relations between a Democratic Congress and Republican administration had posed an initial political problem. When the Treasury finally went to Congress with the idea for the TARP, Paulson insisted that the rescue had to be conducted through fiscal policy, not the Federal Reserve.[25] Tension was high with the White House as well. When Paulson and Bernanke went to Capitol Hill later, no one from the White House accompanied them. The Treasury Secretary and Federal Reserve Chair agreed to act as a unified front against the opposition they knew would come.[26]

The first version of the TARP bill introduced in Congress was only three pages long. When the time came for the first vote in the House of Representatives, the Democratic and Republican leaderships both attempted to get a certain minimum number of votes on each side. The bipartisan congressional leadership knew that the measure would be unpopular, but they were convinced of the grave threat to the stability of the economy. The first vote failed. Whereas the perception might have been that the Democrats consciously shifted votes away to defeat the bill when the Republicans had not provided enough support, the opposite had happened. Fewer Republicans voted "yes" than their leadership had been told would do so, but

[23] As reported in Wessel, *In Fed We Trust*, 198. See also Stewart, "Eight Days," 73.
[24] See Stewart, "Eight Days," 76; see also Wessell, *In Fed We Trust*.
[25] Swagel, "The Financial Crisis," 32.
[26] Wessel, *In Fed We Trust*, 203.

more Democrats voted "yes" than anticipated. Once it became clear during the voting session that the bill would be defeated, Steny Hoyer (D-MD) (the House majority leader) and Roy Blunt (R-MO) (the minority leader) gathered in the well of the House and began to plan for what they could do to turn votes around. In other words, the party leadership on both sides did not blame each other but tried to change the situation. They decided to try to change the vote out of the public view, however, because to do it in the open would only inflame public opinion.[27]

The effect on financial markets was immediate. Market participants watching the coverage of the vote began to sell stock without delay. Hence, stock prices dropped, with the Dow Jones Industrial Average going down 777.68 points – its biggest drop in a single day. During negotiations held over the TARP bill in the Senate, institutions continued to fail. On September 25, 2008, the Office of Thrift Supervision (OTS) seized Washington Mutual (WaMu)– at that time, the largest bank in U.S. history to fail. Together with the mortgage originator Countrywide, WaMu had fueled the housing boom in California and was transformed into the sixth largest depository institution in the United States. It was sold to JPMorgan Chase for $1.9 billion.

After the initial failure of the TARP bill in the House, those in favor stepped up their pressure on members of Congress to pass it. Democratic leadership in the House worked with the administration, the Senate, and Republican leaders in the House to reverse it. Debates raged privately within the administration and publicly in Congress. Provisions were added, notably one for a recapture by the Treasury of the funds, and another for the ability to keep TARP spending lower than originally projected by releasing it in tranches. Many tax breaks that would have expired were extended. FDIC insurance was extended from $100,000 to $250,000. What started as a 3-page bill grew to more than 450 pages. When the negotiations were complete, the House voted 263–171 on October 3 to approve the revised bailout package that the Senate had passed October 1. The stock market turned around.

Although Congress passed the legislation with the intent that the Treasury would purchase toxic assets to remove them from the balance sheets of the troubled institutions, the Treasury changed course and put the money into the banks themselves. On October 13, it injected $250 billion into the nine largest U.S. financial institutions by taking preferred stock with no voting rights attached.[28] On October 28, the Treasury purchased

[27] Private correspondence, House of Representatives Committee on Financial Services, January 6, 2011.

[28] The initial banks were the four largest U.S. commercial banks (JPMorgan, Bank of America, Citigroup, and Wells Fargo), the three largest investment banks (Goldman Sachs,

$125 billion of preferred stock in these nine institutions, and by the end of 2008, it had invested approximately $177.6 billion in banks through its Capital Purchase Program (CPP).[29] Citigroup and Bank of America received an additional infusion through the purchase of $20 billion in preferred shares through the targeted investment program, which was utilized only for these two banks. Also in November, the Treasury, Federal Reserve, and FDIC put together a $301 billion guarantee of Citigroup assets and a similar $118 billion of Bank of America assets, albeit the latter was never finalized.[30] Eventually, Barclays bought Lehman's North American operations as a result of the bankruptcy proceedings. Goldman Sachs and Morgan Stanley, the last remaining investment banks, were converted into bank holding companies, an action which brought them into the regulated banking framework. The Federal Reserve introduced a program to back up the commercial paper market, the Commercial Paper Funding Facility (CPFF).

When the election was held six weeks after the TARP vote, Barack Obama was elected president, and the Democrats retained control of the House and Senate. Some prominent individual Democrats and Republicans lost their seats, in part because of their vote on the TARP, such as Christopher Dodd (D-CT) and Robert Bennett (R-UT). Numerous bailout programs operated simultaneously from 2008 to 2009.

Why do critics single out the TARP? One reason is that the political stakes were the greatest in this program because it offered the most democratic accountability. In other words, although appointed government officials organized the early Bear Stearns and AIG bailouts behind closed doors, Henry Paulson and Ben Bernanke proposed the TARP in the very public setting of Congress where hearings and open debate occurred. Members of Congress recorded public votes on the bill, and they must answer to home constituencies when they face reelection. Therefore, the George W. Bush administration that created the TARP, the Obama administration that continued to carry it out, the elected officials that voted for it, and the financial services firms that received funds from it all have concentrated political interests in its perceived success or failure.

With so much at stake, whether or not the government made a profit on the TARP is hotly debated. Any evaluation reflects how the program is accounted for and what initiatives are included when measured against

Morgan Stanley, and Merrill Lynch), and the two largest custodian banks (State Street and BNY Mellon). At the time, these banks held $10.3 trillion in assets, representing more than 75 percent of the assets in the American banking system. Congressional Oversight Panel, "The Final Report of the Congressional Oversight Panel," (Washington, DC: U.S. Congress, 2011), 13, 145.

29 Ibid., 13.

30 Ibid., 14.

the program's stated goals. When the TARP's congressional oversight panel completed its work in March 2011, the Congressional Budget Office (CBO) estimated that it would cost taxpayers $25 billion. The CBO revised these figures nine months later in December to $34 billion, due to a drop in the market value of the government's investments in AIG and GM.[31] Even though this amount is much less than the $356 billion the CBO originally estimated, other programs administered by the FDIC and Federal Reserve shifted some costs of the rescue off of the TARP's balance sheet and onto their own. Nonetheless, the efforts of the Treasury in selling stock options recovered $1.03 on the dollar, contributing $8.6 billion in returns to taxpayers.[32] The overall rate of return for the CPP and targeted investment program associated with the TARP as of March 2011 was 10 percent.

Despite these recorded returns, the figures obscure the amount of risk guaranteed or insured by the federal government that could have added $4.4 trillion in the face value of financial assets to the taxpayers' bill, if the financial system had experienced another shock.[33] The type of cost-benefit analysis that market participants ordinarily use would price the risk the taxpayers incurred, which was not spread evenly across the institutions that received cash infusions. Specifically, the declining stock prices of Citigroup and Bank of America would put them at the bottom of the group. Rather than factoring these differences in risk into the equation, the Treasury used a "one size fits all" investment policy, resulting in Treasury payments that were higher than the market value of the assets that it purchased in the program.[34] According to some calculations, although the Treasury was not acting as a normal private investor, the terms of the CPP provided the weakest banks with a subsidy somewhere between $21 and $44 billion, and $121 billion to bondholders.[35] By treating all banks the same, the stronger institutions received lower, or even negative, increases in enterprise value from the announcement of the TARP infusions.

Later releases of information from the Federal Reserve in 2011 provide support for the argument that the TARP and Federal Reserve lending programs operated in sync with each other. The TARP helped to insulate the central bank from losses, whereas the Federal Reserve's willingness to provide massive amounts of finance guaranteed that these banks would not collapse, thus protecting the Treasury's TARP investments. The sheer size of

[31] For estimates, see http://www.cbo.gov/publication/42637 (accessed July 27, 2012).
[32] Congressional Oversight Panel, "Final Report," 4, 160.
[33] Ibid., 2, 153.
[34] Ibid., 29–30, 44.
[35] Ibid., 45.

this lending made the largest financial firms even larger despite the severity of the crisis. The six biggest U.S. banks increased their assets 39 percent from $6.8 trillion on September 30, 2006, to $9.5 trillion on September 30, 2011.[36]

Additional Financial Institutions Pulled into the TARP

Strains on the shadow banking system did not end with the TARP vote or Barack Obama's election. Other institutions were pulled into the crisis because they had diversified into mortgage lending during its heyday, and thus other policy subsystems were pulled in as well. Among the most significant were those financial firms connected to the auto industry. The auto industry is an important political actor not only due to its size in the U.S. economy but also due to its network of dealerships that operate in so many congressional districts. Dealerships thus employ many individuals in congressional districts and act as community supporters. After a home, the purchase of an automobile is the largest one that most Americans will need to finance. Therefore, the industry needs credit to finance both the distribution and sale of automobiles. To provide it, the industry lends wholesale to dealers for inventories and retail to consumers to purchase a vehicle.

When the rest of the shadow banking industry expanded around mortgages, the financing arms of the major auto companies saw opportunities for profit in these same areas and securitized these additional loans – tying the auto industry to the housing industry through finance. Therefore, although General Motors Acceptance Corporation (GMAC) began as a financing arm of GM, it grew into a diversified financial services firm that conducts mortgage, insurance, and commercial finance operations. On November 30, 2006, GM sold 51 percent of the equity in GMAC to an investment consortium led by Cerberus Capital Management, L.P. (Cerberus) for about $14 billion. Through ResCap – its core mortgage subsidiary – GMAC became the sixth largest residential mortgage originator and the fifth largest servicer in the United States, originating approximately $55 billion in residential mortgage loans in 2008 and servicing approximately $365 billion in residential mortgage loans as of December 31, 2008.[37]

As with other residential mortgage companies, ResCap had been quite profitable initially. Also like the others, its mortgage operations ran into difficulties in 2007 under the widespread strain in the U.S. housing markets.

[36] Ivry, Keoun, and Kuntz, "Secret Fed Loans."

[37] Congressional Oversight Panel, "The Unique Treatment of GMAC under the TARP," (Washington, DC: U.S. Congress, 2010), 30.

It converted into a bank holding company so that it could borrow with low rates from the Federal Reserve on December 30, 2008. The Treasury bought $5 billion in preferred equity shares in GMAC that was owned by GM and Cerberus. After intervention, the U.S. government owned 56.3 percent of GMAC.

As these related industries were drawn into the crisis, Obama's transition team began to plan for what would occur when he took office. He selected Timothy Geithner to head his Treasury Department. This action ensured that few of the key players would change, since Geithner had arranged many of the initial bailouts in his position as president of the New York Federal Reserve. Bernanke's term would not expire at the Board of Governors immediately. Moreover, the congressional leadership was intact because the Democratic Party retained its control in the election.

In February 2009 with the new administration in place, Geithner announced that the Treasury would engage in extensive stress testing of nineteen of the country's largest financial institutions, wherein it would evaluate their strength under various changing circumstances, such as rising interest rates or unemployment. The stress tests took ten weeks and were part of an effort to determine how the financial institutions would measure up against the goal for each to have a given level of reserves under the different scenarios. When the results were released, the usefulness of the exercise was questioned on Wall Street and on Capitol Hill. However, they did influence which firms received funds in the public bailouts that continued in the new year.

GMAC was one such firm. In a report to the congressional oversight panel for the TARP, the Treasury argued that GMAC was significant to the auto industry, and to GM and Chrysler in particular, and that the firm had participated in the stress tests.[38] The Treasury never argued that GMAC *itself* was systematically important, although some staff believed that were GMAC to fail, it would have contributed to further disarray in the financial system during the crisis. Rather, the Treasury defended its assistance to GMAC as supporting its investments in GM and Chrysler (the auto companies), which were made for several reasons, not least of all the level of system risk that *they* posed if the domestic auto industry were to fail.[39]

Another bailout in another industry that was pulled into the crisis fared differently. The Treasury initially supported the CIT Group, Inc., a hundred-year-old company that provided a variety of commercial financing and leasing products and services, including factoring, and that was

[38] Ibid., 70.
[39] Ibid., 66.

an important source of lending for small businesses. Like GMAC, CIT was hit hard by the financial crisis because the company had heavy exposure to underperforming assets, including subprime mortgages and student loans.[40] As with GMAC, the Federal Reserve had concerns in late 2008 that CIT's failure would harm the delicate economy because it specialized in providing distinctive financial services such as small business lending and factoring services. In December 2008, the Federal Reserve, citing "unusual and exigent circumstances affecting the financial markets" and "emergency conditions," approved the conversion of CIT Group to a bank holding company.[41] The action allowed CIT to become eligible for TARP funds. The next day, the Treasury gave its preliminary approval to what became a $2.33 billion investment in the firm.

In the case of CIT, however, the Treasury, Federal Reserve, and FDIC did not coordinate a rescue to preserve the Treasury's previous actions. After months had passed, the Treasury would not continue to provide funds to CIT alone. Because the firm could not raise private capital, it had to restructure or enter bankruptcy. It filed for bankruptcy on November 1, 2009, and emerged December 10 of that year. As part of its reorganization plan, the TARP investment was subordinated to the interests of CIT's senior creditors. Hence, taxpayers lost the entirety of their investment of more than $2 billion.

One of the key differences between GMAC and CIT is that GMAC was a stress-tested bank and CIT Group was not. The Treasury had committed to making GMAC TARP-eligible. It did not make a similar commitment to CIT, which specialized in lending to small business. Thus it was not the primary provider of credit to any recipient of TARP funds as GMAC was to the auto industry. The Treasury did not have the same interest in preserving its TARP investment by means of CIT.[42] The Federal Reserve also lacked the same interest in providing loans to CIT to protect the Treasury's TARP investment as it had in other firms.

These examples show that as more information becomes available about the size and recipients of the government's action in the short-term phase of the crisis, accounting for the size of the bailouts grows increasingly difficult because different actors have different *political* stakes in accounting for the outcomes in terms of their success or failure. It is to everyone's advantage to show an accounting success in the public programs and to conceal failures in the areas where the information is not readily available to the public. In some cases, the absolute amount shown for

40 Ibid., 67.
41 Ibid., 68.
42 Ibid., 70.

the program is not weighed against its intended goal. In others, parts of a broader program are singled out so that it appears to have resulted in a profit for the agency involved, and the true costs are accounted for elsewhere.

For example, the media company Bloomberg sued the Federal Reserve under the Freedom of Information Act to require the release of the names and details of banks that borrowed money from the discount window during the crisis. After a series of legal maneuvers that lasted more than a year, the Federal Reserve released the data in the form of a compact disc on a request basis. The data calls into question how much Congress knew about issues such as the size of the Federal Reserve's balance sheet. In the altercation between Bernanke and Congress over how many billion the Federal Reserve had to lend, Bernanke used the $800 billion figure. However, its balance sheet had actually grown from what *had* been $855 billion in August 2007 to 2.28 trillion in October 2008 when the exchange occurred.[43] The release also offers insight into how foreign banks were treated by the Federal Reserve. At the peak of the crisis in the week of October 2008, foreign banks received at least 70 percent of the $110.7 billion borrowed from the discount window. In addition, six European banks were among the top eleven companies that sold the most debt to the CPFF – $274.1 billion in total.[44]

Although secret at the time, the Federal Reserve's loans were nonetheless politically contentious after they became public knowledge, not only for their size and recipients but because they offered the opportunity for banks to earn so much income on the difference between the below-market rates the Federal Reserve charged and any higher earnings generated by the banks that received them. When guarantees and lending limits are added to the totals the Federal Reserve lent, it had committed as much as $7.77 trillion to rescuing the financial system as of March 2009. The TARP was orders of magnitude smaller and had strings attached. The Treasury and TARP received the media attention, but the Federal Reserve also supplied enormous amounts to TARP recipients, assuring that they would not collapse. With these loans at below-market rates, recipients did not have to sell assets to pay investors and depositors who made withdrawals during that time. Therefore, a certain amount of assets could remain on the books

[43] See Central Banking Newsdesk, "Fed Reveals Details on Emergency Funding Recipients," *Central Banking*, April 1, 2011, http://www.centralbanking.com/ (accessed December 21, 2011).

[44] Bradley Keoun and Craig Torres, "Foreign Banks Tapped Fed's Secret Lifeline Most at Crisis Peak," *Bloomberg*, April 1, 2011, http://www.bloomberg.com/news/2011-04-01/foreign-banks-tapped-fed-s-lifeline-most-as-bernanke-kept-borrowers-secret.html (accessed July 28, 2012).

of the banks, earning some amount in interest. Depending on how these earnings are calculated, they could represent as much as $13 billion on all of the bailout funds. Even without the Federal Reserve loans, banks received some amount of subsidy in access to the line of credit that the discount window represented because banks in a free market system do not extend lines of credit to corporations for free.[45]

THE CRISIS IN THE MEDIUM TERM: RESTORING CONFIDENCE IN THE SYSTEM

Restoring confidence in the financial system in the medium term poses a different kind of political problem than merely preventing its collapse in the short term. The short term required massive infusions of money and the cooperation of the banking system, the democratic institutions of rule, and to a certain extent other countries. The medium term requires the cooperation of a wide variety of market participants, such as investors who need to be enticed back in, banks that need to resume lending for houses and cars, and consumers who need to go back to borrowing money without fearing that they are being taken advantage of. The medium term is where the public philosophies associated with a given era can become manifested in institutions formed for this purpose. In proposing the Consumer Financial Protection Bureau (CFPB), the Obama administration pointed out that the continuing existence of four regulatory agencies make any coordination of supervisory policies difficult, delay responses to emerging consumer protection threats, and create opportunities for regulatory arbitrage where firms can choose the least restrictive regulator.[46]

How does the government change people's gut feelings about the financial system? The reform legislation associated with restoring confidence in the financial system has been plagued with the problem that psychological aspects of the crisis might be the most difficult to resolve, once the excesses of the financial sector have been exposed and so many of the same individuals remain in charge. Moreover, the crisis cut across so many policy areas – from housing to banks to shadow banks to insurance to auto – that the psychological aspects could not be addressed through existing political vehicles such as industry groups or the Democratic or Republican Parties. Thus the entire political, as well as economic, system had taken a blow.

45 Ivry, Keoun, and Kuntz, "Secret Fed Loans."

46 See Department of the Treasury, *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation* (Washington, DC: Department of the Treasury, 2009), 55.

This section reviews two major attempts to restore confidence in the medium term: one to modify mortgages held by individuals through the Home Affordable Modification Program (HAMP), and the other to restructure the regulatory environment for finance through Dodd-Frank. As with all politics, politics in this policy area operate with a classic conundrum that some groups are organized and others are not. Organization fails to occur because individuals are not aware of their interests, their interests are kept off of the public agenda, or they confront a "free rider" problem because few individuals have an incentive to organize voluntarily to promote goals such as low inflation, lower government expenditures across the board, or the regulation of derivatives. Organization takes up people's time and costs them money. Hence, one side organizes and "captures" the agencies of the federal government. It knows the channels to pressure and has the information to provide policymakers who need it. The other side does not organize or is so highly fragmented in different policy areas that it is ineffective. It is no surprise that outcomes benefit the organized and not the unorganized.

To restore confidence, however, all affected groups need to be brought back into the system. The legislature is the branch of government that interest groups consult the most comfortably by design. However, the legislation connected to the financial crisis was initially hemmed in by the congressional calendar. Figure 8.1 outlines the financial crisis as it unfolded over the course of the 110th and 111th Congresses. The calendar matters not only because it takes time for legislation to progress through each chamber but also because intervening elections change the political dynamics of the process. The 110th Congress was a Democratic Congress, and it had to address the immediate crisis and send TARP legislation to a Republican president six weeks before the election. In the 111th Congress, the Democratic Congress had a longer stretch of time and was able to work with a Democratic president. Nonetheless, the 111th Congress had to work with the deadline of the end of the two-year cycle because the midterm elections loomed once again. The Dodd-Frank reform bill passed in July 2010, but the Democrats lost control of the House in the November election.

Modification of Mortgages for Individuals

The political dimension to the crisis cut in two directions: the institutional and the individual. On one hand, the failure of large bank and nonbank financial intermediaries threatened the lifestyles of large numbers of individual Americans and social institutions that were completely unconnected to the housing market. For example, the collapse of hedge funds and private

2007 (110th)

- January 3, 2007 Democrats regain majority of House and Senate in 110th Congress
- March 2007 Subprime housing market industry collapses due to higher than expected foreclosure rates
- August 2007 Commercial paper market freezes; Federal Reserve cuts discount rate charged to banks
- September 17, 2007 Alan Greenspan warns that housing market turmoil is “identical” in many ways to that which occurred in 1987 and 1998
- October 16, 2007 Treasury Secretary Paulson warns that the housing collapse is the most significant risk to the economy

2008 (110th)

- March 2008 Federal Reserve expands window of collateral for overnight loans
- March 17, 2008 JPMorgan Chase agrees to buy Bear Stearns for $2 a share
- May 30, 2008 JPMorgan Chase completes Bear Stearns purchase in deal engineered by Treasury and backed by loans from the Federal Reserve
- July 11, 2008 Regulators seize IndyMac, the second largest financial institution to fail in U.S. history
- September 7, 2008 Government announces that it will take over Fannie Mae and Freddie Mac
- September 15, 2008 Lehman files for bankruptcy
- September 16, 2008 Federal Reserve steps in to rescue AIG with 80% of the company
- September 25, 2008 OTS seizes Washington Mutual, the largest bank to fail in U.S. history
- October 3, 2008 House passes revised TARP legislation after Senate amendments

2009 (111th)

- January 20, 2009 Barack Obama sworn in as forty-fourth president of the United States
- January/February 2009 Stimulus package passes Congress
- June/July 2009 IMF finance bill passes after G20 London Summit
- June 17, 2009 Obama team introduces legislative package for financial reform
- Late September 2009 House introduces package
- November/December 2009 Senator Christopher Dodd adds his amendments
- December 11, 2009 Reform bill passes House

2010 (111th)

- January 6, 2010 Christopher Dodd announces planned retirement
- February 2, 2010 Senate responds to Obama proposals on separation of speculative activity
- April 2010 SEC announces lawsuit against Goldman Sachs on synthetic CDO activities
- July 21, 2010 President Obama signs Dodd-Frank reform bill

FIGURE 8.1. Timeline of the Financial Crisis over the 110th and 111th Congresses

equity funds that had relied on credit default swaps, off–balance sheet vehicles, and other shadow banking products to invest their money hurt large institutional investors such as pension funds, the endowments of cultural organizations such as symphony orchestras and art museums, and large and small universities and private colleges. Aiding the financial intermediaries to prevent further damage to these institutional investors also appeared to assist those actors who had caused the crisis in the first place.

In addition to the harm to large institutional investors, the crisis harmed many individuals who just happened to live in neighborhoods where the most egregious lending had occurred, or who had invested in 401(k) plans to save for their retirement. For example, when mortgages re-set at higher rates, large numbers of defaults in concentrated areas or on a street occurred. Entire neighborhoods collapsed. In some places, families simply abandoned properties, creating problems for local law enforcement and city maintenance. Staying behind and continuing to pay a mortgage when others left meant that an individual in a housing development might live across the street from someone who had purchased a foreclosed property for a fraction of what the original owners paid. Therefore, those who had been responsible in paying their mortgage were carried along with those who had been irresponsible when property prices fell. The dramatic fall in prices put many homeowners "underwater" on their mortgages, insofar as they owed more on their houses than the current appraisal indicated it was worth. If individuals needed to sell their house for any reason, such as a job transfer or need for a larger dwelling, they were all trapped when markets froze even if they had good credit and a down payment available to purchase another one.

The disconnect between responsible and irresponsible borrowers, as well as individuals and institutions, posed a serious political problem that was not easily resolved with a common policy because everyone defaulting on a mortgage, or owning property on a street where values declined, was not alike. Some underwater mortgage problems occurred with those borrowers who owed more on their homes than they were worth when the value of housing in the neighborhood declined, but others had borrowed for home improvements that were not wise investments. A separate set of problems occurred with those homeowners who were experiencing payment and income problems. In addition, all state law on these matters is not the same. In some states, individuals can walk out on a mortgage and lose whatever they paid in, but the bank cannot seize any further assets beyond the house as collateral. If they had not paid a large amount on the mortgage and did not have ties to the community or a local school, they had little incentive to remain in these homes and continue to pay, even if they could. In other states, the bank can seize other assets.

Therefore, the differences in borrowers and their circumstances complicated any common policy solution because consumers make wildly different choices for different reasons. In short, the Bush administration did not want to spend public money to subsidize people "living in McMansions they could not afford with flat screen televisions paid out of their home equity line of credit."[47] However, it was difficult to sort these people from others who might have been the victims of fraud or abusive lending practices, or those caught in a neighborhood that collapsed.

After taking office, President Obama created the HAMP program by signing the Helping Families Save Their Homes Act of 2009. One of the provisions in the bill when introduced was to allow bankruptcy judges the discretion to modify mortgages on an individual's primary residence, called a "cram down." This provision did not survive into the final Senate bill. Nonetheless, the Obama administration still sought to help qualifying homeowners avoid foreclosure with the program by refinancing into a stable thirty-year fixed mortgage with lower payments for five years. Once established, a lender could write down the amount owed, or lower the interest rate on the loan, for approved individuals through the program. The lender would have an incentive to do so from fees paid to renegotiate the terms.

However, the new administration confronted the same political quandary with HAMP as the former administration had, insofar as all of the participants did not appear to be equally sympathetic. In the popular media, CNBC Business News editor Rick Santelli called the defaulted homeowners "losers" and accused the government of "promoting bad behavior."[48] To avoid a political backlash, the Obama administration pulled back from its original goal of helping three to four million homeowners. Even after expectations were scaled back, HAMP's detractors charge that many more families were moved out of their homes through foreclosure in the program than were saved through modification. Many problems in its execution contributed to the mess. For example, the Treasury hired Fannie Mae to run HAMP. Rather than moving homeowners to the five-year relief plans, Fannie Mae allegedly kept thousands of them in the trial plan, which was the part of the program that made the most profit.

HAMP's defenders charge that the Treasury Department was limited in its ability to compel the servicers to reduce mortgage amounts. Were the government to force the issue, the servicers could exit the program.

47 Swagel, "The Financial Crisis," 15.

48 Episode reported in Kate Berry, "Barofsky Blasts Treasury, Obama for Housing Mess," *American Banker*, December 22, 2011, http://www.americanbanker.com/issues/176_241/tarp-hamp-neil-barofsky-housing-mortgage-1044860-1.html (accessed July 28, 2012).

Moreover, the Treasury needed eligible applicants along with cooperative servicers. Officials could not control the number of applicants who were delinquent, had hardships, had debt-to-income ratios above 31 percent, who decided to pay and remain current, and who decided to remain in their homes, all of which made them ineligible.[49] With a lack of coherent organization, Table 8.1 shows that individual homeowners have received little government relief relative to the much larger amounts provided to the major financial institutions.

The Dodd-Frank Legislation

In the medium term, legislation was also needed to address the lack of confidence in the financial markets that had failed. Those arguing that the absence of regulation in the shadow banking industry had caused the crisis hoped that by bringing the "shadow" banking industry out of the shadows and into the regulated framework, confidence would be restored. The Obama administration released its initial legislative proposals in June 2009 in the form of a White Paper emphasizing regulatory reform by closing gaps, creating new bodies, and increasing the environment for regulation overall. Although some on the left argued that the only effective measure would be to break up the large banks, the administration veered toward fixing the system that was broken rather than attempting to build a new one in its place.

The specific proposals that became part of the massive bill came from different quarters, many from within the bureaucratic apparatus of the American government and from former officials. Some existed in previous legislative incarnations. For example, earlier provisions to influence executive compensation had passed the 110th Congress in H.R. 1257, the Shareholder Vote on Executive Compensation Act, but had not passed the Senate and thus died without having been sent to President George W. Bush.

Other provisions were added from ideas generated in the academy and Wall Street commentary. For example, an idea for a consumer bureau came from Harvard Law School professor Elizabeth Warren, whose article "Unsafe at Any Rate" commented that "it is impossible to buy a toaster that has a one-in-five chance of bursting into flames ... but it is possible to refinance an existing home with a mortgage that has a one-in-five chance of putting the family out on the street."[50] When the TARP began to dispense

[49] See Sewell Chan, "Inspector Reports That Program to Help Prevent Foreclosures Falls Short," *New York Times*, July 22, 2010, http://query.nytimes.com/gst/fullpage.html?res=9E0DE7DE1E31F931A15754C0A9669D8B63 (accessed April 12, 2012).

[50] See Elizabeth Warren, "Unsafe at Any Rate," *Democracy: A Journal of Ideas*, http://www.democracyjournal.org/article.php?ID-6528 (accessed April 12, 2012).

TABLE 8.1. *The Size of Some of the Major Bailouts by Mid-2009*

Participant	Amount (in billions)	Government Program
Bear Stearns	30	JPMorgan purchased Bear Stearns; the Federal Reserve provided a $30 billion credit line to ensure the sale would go ahead.
Fannie Mae/Freddie Mac	400	The Housing and Economic Recovery Act of 2008 authorized the Treasury's action in placing the government-sponsored enterprises into conservatorship of the Federal Housing Finance Agency (FHFA).
AIG	180	The government aided AIG to keep it from collapsing in four separate programs. An initial $85 billion credit line came from the Federal Reserve and eventually totaled $110 billion; $70 billion came from the Treasury.
Six hundred forty-nine banks	218	The Capital Purchase Program (CPP) provided funding to 649 banks; 8 institutions total $134 billion; received $70.1 billion in capital repayments.
GM, Chrysler, GMAC, Chrysler Financial	79	Automotive Industry Financing Program (AIFP).
Small businesses	15	Unlocking Credit for Small Businesses (UCSB) purchased securities backed by Small Business Administration (SBA) loans.
Citigroup, Bank of America investments	40	Targeted Investment Program (TIP).
Citigroup	5	The Asset Guarantee Program (AGP) provided ring-fence asset guarantee.
Mortgage loan holders	50	Making Home Affordable (MHA) program to modify mortgage loans. Of the $50 billion initially announced, which includes funding for state housing finance agencies and the Federal Housing Administration, the Congressional Budget Office (CBO) estimates that $16 billion will eventually be disbursed as of March 2012.

Source: Bear Stearns and Fannie Mae/Freddie Mac figures from Jesse Nankin, Eric Umansky, Krista Kjellman, and Scott Klein, "History of U.S. Gov't Bailouts," updated April 15, 2009, http://www.propublica.org/special/government-bailouts (accessed June 21, 2011). CPP, AIFP, UCSB, TIP, AGP, and MHA figures from the Office of the Special Inspector General for TARP, "Statement of Neil Barofsky," July 21, 2009, http://www.sigtarp.gov/reports/testimony/2010/Testimony%20Before%20the%20Senate%20Committee%20on%20Finance_7_21_2010%20Final.pdf (accessed May 1, 2012). AIG figures are available from both sources. MHA program information is augmented with CBO, "Report on the Troubled Asset Relief Program–March 2012," March 28, 2012, 4 n. d., http://www.cbo.gov/sites/default/files/cbofiles/attachments/03-28-2012TARP.pdf (accessed May 1, 2012).

funds, Elizabeth Warren chaired its congressional oversight panel and took on the issue of the lack of consumer protections across banking regulatory agencies. The CFPB was eventually proposed as part of the emerging financial services reform bill. Consumer groups supported it and sought the maximum degree of independence for the new agency. Large banks, concerned that its activities would cut into their profits outside of lending (such as credit card and overdraft fees), opposed it.

As soon as it was apparent that some type of bureau would be created, banks sought to place it inside the Federal Reserve, where the record on regulation is so weak. They succeeded in preventing the formation of an entirely new agency, but one with a quasi-independent status. In the final version of the bill, the new agency will be housed physically at the Federal Reserve and will tap the Federal Reserve's revenues for consumer affairs to fund its operations. However, as planned, it will not be controlled by officials at the Federal Reserve. The objective is to use the Federal Reserve as a place where the agency's mail can be delivered, but not opened.[51]

Also proposed from the public arena, Paul Volcker used his considerable popular support in political and financial services to promote what came to be known as the "Volcker Rule." In its initial form, the rule would have banned commercial banks from engaging in proprietary trading, or risking their own funds to speculate on products like mortgage-backed securities or credit default swaps. It sought to return to the spirit of the Glass-Steagall regulatory era when commercial banks received a greater degree of federal support and had to limit their trading activities. As the bill progressed, Volcker made calls to members of Congress and visited Washington to try to enhance the legislation. He offered what he called "constructive advice," emphasizing that he was not acting as a lobbyist.[52]

Other inputs came from the international community as leaders met in periodic summits to debate the direction to be taken by efforts at coordination. The Europeans did not want to impose the same higher amounts of regulatory capital on banks as the United States did. They also did not take the same view of some banks as being too big to fail. There was a sense in the international community that passing reform legislation in the United

[51] Positions of interest groups taken from House Financial Services Chair Barney Frank on "Charlie Rose," PBS, aired Thursday, July 15, 2010, and http://www.charlierose.com/view/interview/11126 (accessed December 21, 2011). For a review of the history of Warren's involvement, see Daniel Carpenter, "Institutional Strangulation."

[52] Volcker interviewed in Louis Uchitelle, "Volcker, Loud and Clear," *New York Times*, July 11, 2010, http://query.nytimes.com/gst/fullpage.html?res=9400E5DC1138F932A25754C0A9669D8B63&pagewanted=all (accessed April 12, 2012).

States would get a package on the table, as well as allow the United States to assume a leading role in these summits, such as the Group of Twenty meeting held in Toronto in June 2010.

Once politics settled back into a more predictable routine, various agencies acted to protect their turf, as they would be expected to in ordinary models of bureaucratic politics. The Federal Reserve successfully defended its own institutional role while the reform legislation progressed through each chamber and prevented an audit of the Federal Open Market Committee's activities. The Federal Reserve gained two new allies on the audit issue: House Committee on Financial Services Chair Barney Frank and Treasury Secretary Timothy Geithner, who had previously been head of the New York Federal Reserve. As has been his custom, Federal Reserve Chair Ben Bernanke met privately with many lawmakers to make his case against audit proposals and to argue for the Federal Reserve's role as a bank supervisor while the bill was being negotiated. The regional banks also worked on the board's behalf. Presidents of the Federal Reserve's regional banks from Dallas, Kansas City, and Richmond, among other cities, also pressed their cases to members of Congress from their districts.[53] In a compromise maneuver, the Government Accountability Office will have limited authority to examine the Federal Reserve's crisis decisions, and after a two-year lag it will disclose the details of loans that it makes to banks through the discount window.

Some immediate changes were made to the system to preempt legislation that could be more draconian. For example, after Goldman Sachs converted from an investment bank to a Federal Reserve–regulated bank holding company, the Federal Reserve Bank of New York allowed Stephen Friedman, then a Goldman director and owner of a considerable number of Goldman shares, to remain as chairman of its board. Friedman later received a waiver of the prohibition on Class C directors owning shares of bank holding companies; however, he purchased additional shares of Goldman stock before the waiver was granted. The search committee for Timothy Geithner's successor at the New York Federal Reserve, led by Friedman, selected the head of the Federal Reserve's markets desk who had previously worked at Goldman Sachs. The situation caused a degree of embarrassment when it received media attention.[54] Congressional pressure on the regional Reserve Banks threatened the prospect of legislation. Senator Dodd had

[53] See Jon Hilsenrath, "Fed Emerging Intact from Challenge to Its Power," *Wall Street Journal*, June 18, 2010, http://online.wsj.com/article/SB10001424052748703650604575313112463327710.html (accessed April 12, 2012).

[54] See Kate Kelly and Jon Hilsenrath, "New York Fed Chairman's Ties to Goldman Raise Questions," *Wall Street Journal*, May 4, 2009, http://online.wsj.com/article/SB124139546243981801.html (accessed March 3, 2012).

proposed that directors of Reserve Banks chosen by banks would be selected by the Board of Governors in Washington, and the presidents of the regional Reserve Banks would be appointed by the president and confirmed by the Senate. In response, the Board of Governors tightened its rules on who can sit on regional boards. The new rules created by the board stipulated that the board members who represent the public must end any association with a firm that becomes the owner or part owner of a bank, thrift, or credit union.[55] Legislation on the matter was thus averted.

An unusual aspect of the trajectory of the Dodd-Frank legislation, relative to other bills as they move between congressional chambers, was that the legislation became stronger as it moved from the House to the Senate. One explanation for this outcome is that during the initial House deliberations on the Wall Street Reform and Consumer Protection Act, the media was largely focused on the Obama health care legislation and social unrest attached to it. During that stage, powerful banking interests were able to extract stronger concessions on issues such as derivatives and the Volcker Rule. However, when the bill moved to the Senate, it also moved further into the spotlight. At this stage, additional provisions were added and not subtracted.

One of the issues strengthened was related to derivatives and the regulation of swaps. A swap essentially exchanges one stream of cash flow for another. Five of the largest banks control approximately 90 percent of this type of derivative. Thus banks are the largest swaps dealers. The explosion of risky swaps is often cited as a cause of the crisis, but it is highly lucrative for dealers. The Agriculture Committee has jurisdiction over the Commodity Futures Trading Commission (CFTC) and thus this issue. Senator Blanche Lincoln (D-AK) had assumed the chair of the Senate Agriculture Committee when Senator Tom Harkin (D-IA) left it to become Chair of the Health, Education, Labor, and Pensions Committee. Although the previous version of the reform bill had been favorable to industry, when she became Chair, Lincoln gained a new staffer on the issue who had worked with the head of the CFTC and understood the issue well. Not wanting to appear "soft" on Wall Street in a tough primary election, Lincoln announced that she supported an initiative to remove all derivatives operations from banks. Although the provision was modified again in the final version, her bill passed the committee 13 to 8, with a vote from Charles Grassley (R-IA).[56]

[55] See Sudeep Reddy, "Fed Tightens Rules on Regional Directors" *Wall Street Journal*, November 27, 2009, A6. See also Michael McKee and Scott Lanman, "Fed Tightens Rules on Board Eligibility for Regional Banks," *Plain Dealer* (Cleveland), November 26, 2009, C2.

[56] Ron Suskind, *Confidence Men*, 398–400.

Prominent regulators opposed the move to force the banks to strip swaps desks from depository institutions. The Federal Reserve's Ben Bernanke wrote a letter to several senators opposing it. The FDIC's Sheila Bair wrote directly to Senators Lincoln and Dodd with her objection. Former Federal Reserve Chair Paul Volcker opposed the move, and Treasury Secretary Timothy Geithner did not endorse it. On the other side, prominent academics such as Joseph Stiglitz and Federal Reserve Bank of Kansas City President Thomas Hoenig supported it in letters.[57] They argued that banks enjoy the taxpayer financed protection of federal deposit insurance and cheap funds from the Federal Reserve. They should not use that taxpayer support to subsidize bets on derivatives. In the final legislation, the SEC and CFTC must conduct a study to determine which contracts will be considered swaps within fifteen months of enactment.

The unfolding elections also changed the dynamic on swaps. The primary runoff between Lincoln and Bill Halter received national attention because Lincoln had been the author of the aggressive derivatives section of the Senate version. Were she not reelected, it appeared the provision might be dropped altogether. The national coverage of the race included descriptions of the measure and how it would affect financial reform. Therefore, it shifted from being an obscure issue to being a litmus test for Lincoln as someone "tough on Wall Street." Although she lost the general election later in November, she won the Democratic primary. As a result, a much stronger version of derivatives regulation made it into the final bill passed in July than had been intended prior. With an open conference committee procedure, the trend toward strengthening the bill continued.

The precise definition of swaps contracts is only one of numerous examples of the importance of the rulemaking process that commenced immediately on the bill's passage on July 21, 2010. Even before the bill was passed, the political activity moved from the Congress to the federal agencies that will set the exact boundaries where the legislation is vague. By one estimate, Congress only detailed 25 percent of the expansion of industry oversight. Significantly, regulators will have to decide how much money banks have to set aside against unexpected losses, so lobbyists immediately moved to convince them that requiring too much would hurt the economy. At the same time, consumer groups and others perceived a disadvantage when the struggle would move to the regulators. The agencies seek data that can be used to justify decisions and not political considerations. Trade groups and firms usually generate favorable research that can be used as data to support their positions. Thus consumer groups such as AARP worked

[57] See Edward Wyatt, "In Tough Stance, Democrat Finds Few Allies," *New York Times*, May 15, 2010.

to correct their disadvantage by initiating their own research to be presented to regulators on the parts of the bill that they favor. Likewise, the Consumer Bankers Association's board voted to increase the rulemaking group's budget and staff.[58]

The lineup of groups, however, will not remain consistent because industry groups are divided, depending on their role in a transaction. For example, consumer groups are generally pitted against industry groups. However, when customers swipe debit cards, they pay a fee. Dodd-Frank seeks to cap the fees but does not specify the amount. In this instance, retailers want a lower cap, whereas banks want a higher one. The two industry groups are on opposite sides of the rulemaking process. Only by continuing to follow through on the decisions made through the rulemaking process in the agencies will the final effects of the Dodd-Frank bill be able to be judged as any real victories or realignments.

Moreover, some groups were successful in gaining exemptions in the legislation. In one significant example, auto dealerships sought an exemption from coverage under the new CFPB. They were successful despite the opposition of the House committee Chair for three main reasons. First, there is an auto dealership in nearly every congressional district, whereas few other industry groups have such wide geographical coverage. Second, there was a degree of residual sympathy for the dealerships on the Hill because it appeared that they had been mistreated in the auto-sector bailout. Finally, auto dealers are natural politicians because they are salesmen. They possess an innate ability to take their views to individual members and present them in a compelling, personal narrative.[59]

Therefore, the passage of Dodd-Frank strengthened the hand of regulators in ways that were previously unimaginable. Nonetheless, the controversies associated with many of the issues it sought to address persist as the components of the bill are worked out through the rulemaking process. They will continue to be contested in elections and legislation to come.

CONCLUSION

In November 2008, voters elected Barack Obama as president, which meant that a new Democratic administration took over the reins of power and controlled the bureaucracy in concert with a Democratic Congress. However,

[58] See Binyamin Appelbaum, "On Finance Bill, Lobbying Shifts to Regulations," *New York Times*, June 27, 2010, 1.

[59] Explanation for auto dealers' success given by House Financial Services Chair Barney Frank on "Charlie Rose," PBS, aired Thursday July 15, 2010, and http://www.charlierose.com/view/interview/11126 (accessed April 12, 2012).

when Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, the emerging consensus is that it is wide ranging, but it does not change institutional behavior. As one observer summed it up, it is "business as usual, with some moderation."[60] As an editorial in the *New York Times* concluded, it "leaves intact a handful of behemoth, multitasking banks whose size and scope would make them difficult to dismantle in a crisis."[61] In the system moving forward, large banks are larger. The mortgage market that had relied on government-sponsored enterprises now relies on the government directly. In short, the bureaucracy surrounding finance remained intact and added an agency. It seemed as if little changed.

Why? Most of the leadership of the federal agencies remained intact after the transition. Timothy Geithner moved from the New York Federal Reserve to the Treasury Department. Obama reappointed Bernanke for another term at the Federal Reserve. Sheila Bair likewise stayed at the FDIC. Due to problems with Timothy Geithner's Senate confirmation hearings, many lower-level appointments at the Treasury were stalled for a year or more.[62] Many members of the Bush administration, particularly those handling the TARP, agreed to stay for the lengthy transition.

Moreover at the institutional level, political and market institutions shared an interest in preserving the capitalist system and in promoting the free market. Some changes were preempted by industry's restructuring during the crisis – notably Goldman and Morgan Stanley's conversion to bank holding companies – some by intensive lobbying by the financial services firms and their allies, and some by the lack of organization of any countervailing pressure to stop the industry's activities. However, a significant amount of change was prevented by the entrenched interests of the bureaucracies themselves in Washington, aligning with congressional jurisdictions, and banks and financial services firms. Notably, the Federal Reserve has its traditional interest in preserving its independence vis-à-vis the legislature; the FDIC has its traditional interest in protecting its insurance fund. By the time TARP funds were available for the Treasury's use, it had an interest in their repayment. Just as the large banks survived the crisis, so too did most of the agencies of the federal government, except for the OTS.

60 See Eric Dash and Andrew Martin, "New Rules May Affect Every Corner of JPMorgan," *New York Times*, June 25, 2010, http://dealbook.nytimes.com/2010/06/28/new-rules-may-affect-every-corner-of-jpmorgan/ (accessed April 12, 2012).

61 Editorial, "Financial Regulation," *New York Times*, June 27, 2010, 9.

62 See Jonathan Weisman, "Geithner's Tax History Muddles Confirmation," *Wall Street Journal*, January 14, 2009, http://online.wsj.com/article/SB123187503629378119.html (accessed December 21, 2011).

Did the reforms restore confidence? Although confidence is a difficult thing to measure, the evidence is mixed. Individuals on Wall Street have begun to earn outsized bonuses again, and earnings are high. But a 2011 analysis in *New York Magazine* described the mood as "anxious." The feeling inside many banks is downbeat or even paranoid. Some individuals profiled in the media felt that the twenty-year bull run that led to the crash may turn out to be a golden age that will never return.[63] A 2012 headline read, "The End of Wall Street As They Knew It."[64]

63 See John Gapper, "Anxious…," *New York Magazine*, April 18, 2011, 24.

64 See Gabriel Sherman, "The End of Wall Street as They Knew It," *New York Magazine*, February 13, 2012.

9

The Process in Its International Context

Politics in International Institutions

The financial political economy operates in the context of national and international institutional arrangements. Hence, monetary, fiscal, and regulatory financial policies respond to shocks from within the country, as well as to what happens outside of it, during the course of the business cycle and during a crisis. As with the national economy, developments in the international political economy compel citizens and bankers to demand change, and for the U.S. government to respond.

This chapter explores the connections between international monetary and financial arrangements to the organizations of the federal government that we have seen thus far. Thus the chapter introduces a wide range of international institutions into our consideration of the domestic monetary, fiscal, and regulatory policy domains. For political scientists who study international relations, institutions are not just formal bodies such as Congress or the Department of the Treasury. They are all of the administrative agencies, laws, norms, and operating procedures that mediate policy outcomes.[1] Therefore, they can be formal, with a building, rules, and procedures, or informal, insofar as they constitute a set of principles that specify appropriate conduct for a class of state actions.[2] The upshot is that all political institutions of the international financial system do not have the same status in international law, or the same effect on the functioning of the

[1] Judith Goldstein and Robert O. Keohane, "Ideas and Foreign Policy: An Analytical Framework," in *Ideas and Foreign Policy: Beliefs, Institutions, and Political Change*, eds. Judith Goldstein and Robert O. Keohane (Ithaca, NY: Cornell University Press, 1993), 20.

[2] John Gerard Ruggie, ed. *Multilateralism Matters: The Theory and Praxis of an Institutional Form* (New York: Columbia University Press, 1993); Robert O. Keohane, "Multilateralism: An Agenda for Research," *International Journal* 45 (1990). For a study specific

domestic economies of states. At present, there is no formal international monetary system outside of regional arrangements like the eurozone, albeit there have been formal arrangements in the past.

By reviewing the evolution of international institutions alongside the American ones, we see how international forces have interacted with domestic American financial politics in four major formal and informal institutions: the Bretton Woods financial institutions, the European Monetary Union (EMU), the Basel Committee, and summit meetings among heads of state. The United States came to play a major role in world financial affairs by virtue of the ascendance of New York as a financial center and American military, economic, and political hegemony after World War II.[3] The first section shows how with the rise of regulatory compartments in the banking industry after the Great Depression and World War II, the formal Bretton Woods Agreements accommodated extensive government involvement in the international monetary and financial system through the creation of the International Monetary Fund (IMF) and World Bank. As deregulation occurred in the 1970s, the international financial system grew more integrated with the domestic one. The second section of the chapter considers the formation of the EMU and its implications for the American economy. Thus it examines the sovereign debt crises in members of the eurozone that have repositioned the IMF among international agencies and the United States. The third section explores how national banking regulators began to meet regularly with their foreign counterparts to discuss issues of common concern, culminating in the Basel I, II, and III Agreements. The fourth section of the chapter shows that alongside these major institutional and bureaucratic developments, presidential administrations and the Treasury Department maintain contact with their own counterparts through the Group of 8 (G8) and Group of 20 (G20) summit processes as well as the Strategic Economic Dialogue (SED) with China.

THE INTERNATIONAL MONETARY FUND: A FORMAL INTERNATIONAL ORGANIZATION

The international monetary (money) and financial (banks and other intermediaries) systems are closely intertwined because international flows of capital and investment must be translated into another country's money. People in Japan cannot use dollars to pay the rent, go grocery shopping, or

to the concerns in this chapter, see Chris Brummer, *Soft Law and the Global Financial System: Rule Making in the 21st Century* (New York: Cambridge University Press, 2012).

[3] See Randall D. Germain, *The International Organization of Credit: States and Global Finance in the World Economy* (New York: Cambridge University Press, 1997).

otherwise conduct business. If they have earned money in dollars, they must translate those dollars into yen to spend what they have earned. Likewise, a Chinese tourist in New York cannot pay a hotel bill in yuan. Dollars must be purchased with Chinese currency. Banks and other financial intermediaries handle these transactions. If the price of the dollar is high, relative to yuan, the tourist must use more yuan to buy what is needed, and there will be less left over to spend in restaurants or stores. If the dollar is low relative to yuan, more dollars can be purchased and, in theory, spent in the United States on other goods and services. At this time, most major currencies float against each other at whatever rate each party is willing to pay.[4] Therefore, if large sums of money are needed for investments overseas, fluctuations in the exchange rate between two currencies can have a dramatic affect on the value of whatever is denominated in each.

The practice of finance has always been international. In fact, there was an international economy before there were national economies.[5] International banking regulation began with the customs of merchants. Eventually, other participants who were not merchants joined their activities.[6] Payment across borders was initially made in precious metals, free from the influence of political powers because if a ruler lowered the content of silver or gold in its coins, it was simply worth less when exchanged. Ordinary people used local currencies or barter.[7] Because governments were not initially involved, merchants and financiers worked directly with each other in a private system. In the United States, foreign banks established branches in New York, and some American firms were partially owned by foreign interests, such as J.P. Morgan and Company. An international system based on gold emerged by the beginning of the twentieth century wherein governments would convert their monies into gold at a fixed price on demand.

After World War II ended, governments tried to create formal arrangements among themselves to govern finance, embodying the ideas about government intervention in the economy and full employment associated with

[4] Some important exceptions exist. For example, the Chinese yuan does not float freely. Moreover, in September 2011, the Swiss National Bank began to enforce a minimum exchange rate of CHF 1.20 per euro. The government set the rate set to guard against the threat to the Swiss economy and the risk of deflationary development from massive overvaluation of the Swiss franc related to financial turmoil in Europe. See Swiss National Bank, "Monetary Policy Assessment of 15 September 2011," http://www.snb.ch/en/mmr/reference/pre_20110915_1/source (accessed February 2, 2012).

[5] Herman M. Schwartz, *States Versus Markets: History, Geography, and the Development of the International Political Economy* (New York: St. Martin's Press, 1994), 13.

[6] John Braithwaite and Peter Drahos, *Global Business Regulation* (New York: Cambridge University Press, 2000), 140.

[7] Robert Gilpin, *The Political Economy of International Relations* (Princeton, NJ: Princeton University Press, 1987), 12.

the New Deal in the international realm. Government intervention was necessary at the international level to address the reality that the gold standard was politically vulnerable in democratic societies. The costs of economic adjustment in shifting prices fell on citizens who now had expanded opportunities to participate in the political system. In other words, many more people could vote. Countries created two formal financial organizations at a meeting in Bretton Woods, New Hampshire, that would have headquarters, universal membership, and an agreed goal of promoting international stability. The International Bank for Reconstruction and Development (IBRD) – the first organization within what became the World Bank Group – would reconstruct countries after the war. The IMF would provide liquidity to countries experiencing balance of payments problems. Members of the IMF fixed their currencies to an amount in U.S. dollars and gold.

Unlike the old gold standard that was a loose arrangement among bankers, the IMF was established by treaty with states as members. Official business would be conducted through finance ministries. In the United States, it would be handled by the Treasury Department.[8] Members incurred obligations under the treaty and were potentially subject to sanctions when they did not comply. Also, unlike the gold standard, the amount of money in the system was not fixed by the discovery of natural resources but through the actions of governments. If a country experienced an imbalance over time, it could adjust its rate of exchange within the organization. With this fixed parity arrangement, countries established the principle of a postwar monetary system that the value of one's currency was a matter of international concern and international law.[9] Gradually, the international economy was restored and international financial transactions resumed.

Mechanisms of Adjustment and the International Monetary Fund

Economists point out that for any international monetary system to function effectively, it needs three mechanisms: adjustment, liquidity creation, and confidence-building measures.[10] First of all, countries need a way to adjust against each other when one country habitually buys more from a country than it sells to it. As with an individual who consistently buys more than he or she earns and must withdraw from savings to pay the bills, a

[8] For the role of the U.S. Congress in the World Bank, see Kathryn C. Lavelle, "Multilateral Cooperation and Congress: The Legislative Process of Securing Funding for the World Bank," *International Studies Quarterly* 55, no. 1 (2011).

[9] Andreas F. Lowenfeld, *International Economic Law* (New York: Oxford University Press, 2002), 503.

[10] See, for example, Benjamin J. Cohen, *The Geography of Money* (Ithaca, NY: Cornell University Press, 1998).

country can sustain an imbalance for a while by drawing down its reserves, or borrowing the extra amount until it can sell more in the future to pay the loan back. Eventually, the imbalance must be corrected by buying less, selling more, imposing controls over international transactions, or realigning exchange rates so that the goods in the surplus country cost more to citizens in the deficit country, forcing them to buy less. Any of these ways of adjusting, however, are politically unpopular with the groups that benefit from the status quo, particularly those who must lower consumption of foreign goods in the deficit country, and those who will lose customers in the surplus country.

In addition to a way to adjust, an international monetary system needs both liquidity and confidence among participants. Liquidity in this context refers to the international supply of money – enough money to finance purchases and sales but not so much that inflation results. Confidence refers to the belief among countries that a leader will not pursue inflationary policies, which would make their own reserves held in that country's currency worth less. Once participants lose confidence, they will move their reserves into other assets. More of that currency will be for sale on world markets, making it seem less valuable. Interest rates must rise in the country whose currency is used as a reserve to keep everybody from selling theirs at the same time. The reserve currency country must undertake other confidence-building measures; otherwise, the destabilization will spread throughout the system when all countries sell the currency simultaneously and global prices are out of alignment.

The creation of the IMF resolved the need for an adjustment mechanism insofar as countries could realign their exchange rates. It was, however, much more complicated for the United States to do so at the center of the system because all other countries would have to realign against the dollar. This problem of U.S. adjustment did not seem serious at the end of World War II when the system was established. The United States had a large supply of gold, military preeminence, and an intact industrial economy. The IMF also addressed the need for global liquidity because dollars were exchangeable for gold; thus dollars produced by the Federal Reserve could serve as a source of global liquidity. Once again, this did not seem to pose a problem at the end of World War II because the United States held the largest share of the world's gold reserves. As for the confidence requirement, few could have envisioned a loss of confidence in the dollar as World War II was winding down and the U.S. military force was hegemonic.

Nonetheless, these three goals are inherently contradictory. Historically, a dominant economic and military power such as the United Kingdom or the United States provided strong leadership to the monetary system by establishing rules that generally reflect its interests. The leader takes the initiative in solving technical problems and providing the key currency used for maintaining reserves, carrying out economic transactions, and providing liquidity. The leader also acts as the "lender of last resort" and in that role provides financial assistance to countries in financial distress.[11]

When the United States was playing this role, economist Robert Triffin predicted that once the country started to buy more goods from overseas than it was selling abroad, confidence in the dollar would be undermined.[12] If the Federal Reserve continued to increase the money supply, there would be enough liquidity, but too much of it would ultimately prove to be inflationary. Benjamin Cohen argued that the position of the United States at the top of the world's political and military hierarchy meant that problems related to money required a political, as well as economic, solution. The problem of expanding liquidity and loss of confidence in the dollar became more of a reality during the Cold War. American allies agreed to hold overvalued dollars out of the fear that the United States would retreat into foreign policy isolation, thus leaving them exposed.[13] Eventually, the rise in spending associated with the U.S. war in Vietnam and the Great Society Programs of the Johnson administration resulted in a higher global rate of inflation. On August 15, 1971, the Nixon administration suspended the conversion of gold into dollars and forced the devaluation of the dollar. Later efforts to devise a new system of fixed exchange rates failed, thus ending the postwar Bretton Woods monetary arrangement.

A New Role for the International Monetary Fund in Bailing Out Governments

Once the fixed parity system ended, the IMF lost its primary *raison d'être* as an international organization. Nonetheless, the international bureaucracy that had been constructed to manage it continued to exist. Louis Pauly argues that it expanded its role in economic surveillance.[14] Moreover, the international financial system continued to expand and deepen with the United States playing a unique role in its center even after the formal monetary system collapsed.

Many of the international developments concerned the production and consumption of oil. When oil exporters received a windfall from rising petroleum prices after 1973, most oil-importing industrial countries

[11] Robert Gilpin, *The Challenge of Global Capitalism in the World Economy in the 21st Century* (Princeton, NJ: Princeton University Press, 2000), 116.

[12] Robert Triffin, *Gold and the Dollar Crisis: The Future of Convertibility* (New Haven, CT: Yale University Press, 1960).

[13] Benjamin J. Cohen, *Organizing the World's Money: The Political Economy of International Monetary Relations* (New York: Basic Books, 1977).

[14] Pauly, *Who Elected the Bankers?*

experienced high levels of inflation. Investors sought to put their money into savings accounts that would pay the highest rate of return – in this case, dollar-denominated accounts outside of the United States where they were not subject to restrictions on interest rate payments as they were then within the United States. At the time, British and American banks began to operate under looser regulations and would lend to riskier clients that paid a higher rate of interest. Therefore, the largest international banks recycled a substantial amount of deposits received from oil producers through their unregulated subsidiaries to less developed countries in Latin America and later communist countries in Eastern Europe. When observers commented that this accumulation of debt could destabilize the system, Walter Wriston, the president of Citibank, famously stated that "countries don't go out of business."[15] The investment boom ended at the end of the decade of the 1970s, and a series of countries could not pay their debts. Thus a string of sovereign debt crises in developing countries ensued.[16]

Now the IMF had a new role: backstop to the international financial system in a sovereign debt crisis. This role was far from what its planners intended, and the organization operated differently for rich and poor countries. It was popular with neither. Members of Congress objected to using taxpayer money to bail out banks that made the risky loans. Citizens in the countries that defaulted rallied against the conditions that the IMF attached to the funds, because the terms included closing or consolidating insolvent banks and enterprises and laying off large numbers of workers in state-owned enterprises. In the 1990s, Asian countries experienced a liquidity crisis whose size required another enormous rescue package. Paul Volcker quoted a finance minister as summarizing the international political situation by joking, "When the Fund consults with a poor and weak country, the country gets in line. When it consults with a big and strong country, the Fund gets in line. When the big countries are in conflict, the Fund gets out of the line of fire."[17]

But by the close of the twentieth century, the IMF was under assault from the left and the right in the United States.[18] On the right, commentators such as George Schultz and Milton Friedman argued that the IMF and World

[15] Wriston quoted in IMF "Money Matters: An IMF Exhibit – The Importance of Global Cooperation," http://www.imf.org/external/np/exr/center/mm/eng/mm_dt_01.htm (accessed February 2, 2010).

[16] Gilpin, *The Challenge of Global Capitalism*, 140.

[17] As quoted in Lowenfeld, *International Economic Law*, 506, n. 28. Lowenfeld's source for the quote is Paul Volcker and Toyoo Gyohten, *Changing Fortunes, the World's Money and the Threat to American Leadership* (New York: Times Books, 1992), 143.

[18] Gilpin, *The Challenge of Global Capitalism,* 158–59. See also his *Global Political Economy: Understanding the International Economic Order* (Princeton, NJ: Princeton University Press, 2001), 272.

Bank's rescue efforts contributed to a problem of global "moral hazard" wherein banks knew that their structural significance to the system would force governments to bail them out in the event of a massive default.[19] Therefore, they could take advantage of profits on the upside without worrying about the downside. On the left, the cause of international financial crises has been attributed to the faulty policies of the IMF and U.S. Treasury that were designed to open foreign markets to American investment. These critics charged that crises accumulate. Resolutions to one crisis caused the next. For others on the left, undemocratic international organizations should not direct globalization. Rather, it should be directed by what Peet terms "a democratic alliance of social movements in opposition to the alliance of the rich, the famous, and the gratuitously philanthropic."[20]

During the financial crisis of 2008, the IMF once again reshaped its image as a crisis-fighter. This time, the banks initially in trouble were those in Europe who had lent to others in Eastern Europe. The next section will review how a series of sovereign debt crises emerged within the EMU. The IMF appeared to be a neutral outsider that could provide a political solution to the habitual political problem of using taxpayer money to bail out banks. In return for increased contributions and pledges from its members, the Fund agreed to set aside its more onerous lending conditionality and develop arrangements that were more suitable to all parties affected. However, the outcome of this process is unclear in mid-2012.

THE EUROPEAN MONETARY UNION AND THE INTERNATIONAL MONETARY FUND: CHANGING RELATIONSHIPS AMONG INSTITUTIONS

As the role of the United States in the international monetary and financial system has evolved, the system has also evolved in response to U.S. power and actions. One of the most significant new arrangements to emerge after the collapse of fixed parity in the IMF has been the formation of the EMU and the subsequent threat of its collapse. The EMU matters to all three policy domains because were it to collapse, demand from most major U.S. trading partners would drop dramatically. Some major banks in Europe that hold risky sovereign debt would inevitably collapse, wreaking havoc on the international payments system and global money supplies and most likely triggering a global recession. Regulations would have to address

19 See *Congressional Record*, October 24, 1997, E2075. See also George P. Shultz, William E. Simon, and Walter B. Wriston, "Who Needs the IMF?" *Wall Street Journal*, February 3, 1998.

20 Richard Peet, *Unholy Trinity*, 260.

the new arrangements. This section will detail how crises in the eurozone have already reconfigured the arrangements among sovereign debtors, the European Union (EU), the United States, and the IMF.

The Creation of the Eurozone

After the breakdown of fixed parity in the IMF in the 1970s, inflation and high interest rates in the United States meant that foreigners bought dollars to get the benefit of high interest rates offered by American banks. The volume of these currency transactions meant that the individual European currencies were devalued against the dollar, regardless of the conditions in each country and trade patterns. This situation was particularly severe between trading partners, such as Germany and France. Thus the problem of intra-European trade and prices against the dollar became one factor among many in the decision to find an arrangement that would stabilize European currencies among themselves.[21] Later political developments associated with the collapse of communism and unification of Germany contributed to the decision on the part of the member states of the EU to continue their efforts to create a common currency.[22]

After several attempts at monetary coordination, the Europeans adopted a common currency – the euro – on January 1, 1999. Monetary policy is conducted by a central bank – the European Central Bank (ECB) – which operates under a narrow inflation mandate that is similar to the German central bank's approach. The ECB is banned from financing governments directly, either through direct loans or purchases of government bonds at auction. Fiscal policy and banking supervision remain the province of the member states. To prevent countries from running excessive deficits, the Stability and Growth Pact (SGP) limits individual countries' debts and deficits, and opened the possibility for fiscal sanctions when countries did not meet these limits. However, the Pact's criteria were watered down in 2003 when France and Germany missed the criteria themselves.

The institutional framework that governs the system therefore lacks a mechanism to sanction a country's irresponsible fiscal spending or to resolve such a problem once it becomes unsustainable. Specifically, the framework lacks a way to transfer money to the country that needs to decrease its debt. In addition, the treaty that regulates the monetary union contains a "no bailout " clause, wherein no member country can be forced to pay the debts of others. The arrangements in 2011–12 thus constitute a collective

[21] Mayer, *The Fed*, 231.

[22] Ingo C. Walter and Jonathan Story, *Political Economy of Financial Integration in Europe* (Manchester, UK: Manchester University Press, 1997).

breach of the laws that established the eurozone. A country can only exit by leaving the EU under the terms of the Lisbon Treaty that created the zone. There is no provision for action by other countries that may wish to expel a noncompliant member state from the eurozone.[23]

European debates over the fiscal governance of the euro area frequently reference the United States.[24] The ECB presides over a European System of Central Banks as the U.S. Federal Reserve System does, but is wholly independent of national governments. The thinking at the time the zone was created was that were European economies to function with only one currency and interest rate, the unified entity would pose as formidable an economic power as the United States does. Likewise, as the use of the euro grew, securities could be sold across more countries more easily. A euro-denominated bond, for example, could be sold without exchange risk or the need to convert proceeds into local currency in more countries than a franc-denominated one could. When the Europeans adopted a single currency, however, they did not immediately solve the problems that a single currency zone for a continental economy poses, and that a unified political system can help to fix, as the U.S. federal government does. As with Europe, significant regional differences in economic performance exist in the continental U.S. economy. However, unlike Europe, the United States manages differences through a national political framework and common taxation system.

A comparative example illustrates the differences. If the economy in Ohio is depressed and that in Georgia is not, people in Georgia pay more federal income taxes. The contributions from taxpayers in Georgia finance more of the total of national defense spending than those from Ohio, but Ohio will not lose protection from the U.S. army. In addition, people regularly move within the United States to get new jobs or higher paying ones. In a given year, roughly one in six Americans moves, and 3 percent of them change states.[25] When these realignments occur in the United States, real estate and other asset prices fall in the affected regions. In this example, people will eventually move to Georgia for jobs. Housing prices fall in Ohio and rise in Georgia. Those who move may not want to, but they will still vote in

[23] See Joachim Fels, "Statement for the Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Security and International Trade and Finance," hearing on the European Debt and Financial Crisis: Origins, Options and Implications for the US and Global Economy, September 22, 2011, http://banking.senate.gov/public/index.cfm?FuseAction=Files.View FileStore_id=4cc1ee8e-4d2f-4b84-af40-ff6c75fce4ff (accessed April 12, 2012), 2–3.

[24] See C. Randall Henning and Martin Kessler, "Fiscal Federalism: U.S. History for Architects of Europe's Fiscal Union," (Brussels, Belgium: Brugel, 2012).

[25] Lawrence B. Lindsey, *Economic Puppetmasters: Lessons from the Halls of Power* (Washington, DC: A.E.I. Press, 1999), 123.

national elections and travel freely to visit friends in Ohio without a loss of national identity. Eventually, the lower housing and other costs in Ohio may attract economic activity back.

This is not the case in Europe. When one national European economy is depressed in comparison to the others, the depressed government lacks a source of revenue and the others do not automatically pick up the slack. Prior to the launch of the euro, when the business cycle pushed one or another European state out of alignment, exchange rates could act as an adjustment mechanism to stabilize them against each other. A recession would depress a country's real interest rate, making its currency less attractive and its exports more so. In a boom, higher real interest rates would raise the currency's value and cool off the domestic economy by reducing exports and encouraging imports. With a single currency, however, this mechanism is lost. Moreover, cultural and language barriers prevent the kind of labor migration among the states of Europe as occurs within the United States. Nor does a national tax system exist. Hence, local European commercial banking systems and local real estate and investment markets can suffer without any help being available from monetary authorities, as exists when the central bank is a national one.

Sovereign Debt Crises in Europe and the International Monetary Fund's Response

These design issues related to the eurozone were academic when the European markets boomed. In theory, the ability of a sovereign government to repay its debts is limited only by its political will to tax citizens or find other means of payment over time. However, once problems emerged in Europe and doubts about payment arose, the need for an institutional reconfiguration became acutely apparent. Were a member of the eurozone to default, the financial institutions that held its bonds as reserve capital would lose the value of those assets, destabilizing the entire system once again. The country in default would not be able to raise new capital, thus jeopardizing its ability to pay government workers, pensioners, and other bills as they came due. A social, political, and economic catastrophe would loom.

In October 2009, the newly elected government of Greece announced that the country's budget deficit was headed for a figure more than three times the previous government's official forecast. The announcement triggered a crisis as investors questioned the ability of the government to finance its debt. The country turned to other eurozone member states and the IMF for financial assistance, but there was no consensus on how to provide it. The eurozone had no mechanism to prevent default by one of its own members. For French president Nicolas Sarkozy, Eurogroup president

Jean-Claude Juncker, and ECB chief Jean-Claude Trichet, using the Washington-based institution would make Europe appear weak.[26] Germany's Angela Merkel argued that the IMF's involvement would allow her to convince voters in her country that aid to Greece was part of an IMF program of economic adjustment. Moreover, IMF conditionality might deter other indebted eurozone countries from seeking aid.

The stakes for France and Germany differed, and the resolution was unique. Sarkozy realized that the crisis could threaten the entire zone and used the issue to prove his leadership and raise his popularity at home. He sought greater freedom for national governments to provide support to each other as they wished. Merkel worried more about how domestic voters and her own supreme court would react, were she to contribute taxpayer money to Greece with its history of massive deficits. She preferred any aid to come from individual countries and not the EU so that they could control the process and insist on certain reforms. The initial $143 billion Greek package assembled in May 2010 was a standard IMF program, combined with resources from the European Commission and the ECB. Nonetheless, it was unusual considering the IMF had not previously lent money to a eurozone member, because the zone did not exist when it last lent to a European state in the 1970s. It is also a relatively large program. The hope was that assistance combined with austerity measures would prevent the government from default or abandoning the euro and returning to a national currency.[27]

The next month, the Europeans also created an internal rescue fund by committing about $575 billion in guarantees for the European Financial Stability Facility (EFSF). Member states of the EU pay into the fund in proportion to their contribution to the paid-up capital of the ECB, plus 20 percent to ensure that the fund can repay its obligations, even if one country defaults. The EFSF itself issues bonds and then takes the proceeds to lend to other countries. Thus the amount for the facility was not lending capacity of $575; it was *guarantee* capacity that dropped immediately when Greece's guarantee was removed from the package. Nonetheless, it sought and received a AAA rating, which allowed it to obtain funding at a lower rate than the individual members of the EU could obtain, because only six had AAA ratings in June 2010. Ireland was the first country to apply for help from the EFSF.[28]

[26] Marcus Walker, Charles Forelle, and Brian Blackstone, "On the Secret Committee to Save the Euro, a Dangerous Divide," *Wall Street Journal*, September 25, 2010, 1.

[27] Rebecca A. Nelson et al., *Frequently Asked Questions about IMF Involvement in the Eurozone Debt Crisis* (Washington, DC: Congressional Research Service, 2010), 2.

[28] See Kathryn C. Lavelle, *Legislating International Organization: The US Congress, the IMF, and the World Bank* (New York: Oxford University Press, 2011), 169–70.

Despite these moves, ongoing disagreements among the governments of the stronger European economies, as well as the degree to which private lenders will need to be involved in future rescues, have contributed to continuing sovereign bond market uncertainty across the eurozone. In early 2012, the EFSF, among some other European countries, was downgraded from AAA to AA+. Resolutions to the turmoil all pose their own national and international political dilemmas. Although the debt to gross domestic product ratios in some cases were high enough to make default a possibility, writing down the value of the sovereign debt – and thus forcing the costs of adjustment on those who bought the bonds – is not easy because many of the buyers were European banks, the ECB, and banks and other financial institutions in the United States, who would be further destabilized by the write-down. To shore the system up, commercial banks could raise their capital ratios, and the EU could enlarge the size of the EFSF from 400 billion euros to more than a trillion euros. However, banks have tended to raise their capital ratios by decreasing their lending rather than raising capital. Moves to raise the capital ratios of banks might thus result in even less lending in economies that need it. Germany opposes moves to raise the size of the EFSF by borrowing. In addition, a trillion euros might not be large enough if Italian and Spanish debt were to appear to be insolvent.[29]

Other potential resolutions exist that involve new roles for different organizations within the EU. The ECB could buy national bonds directly (and not on the secondary market) to prevent interest rates from rising. However, this approach is prohibited by the "no bailout" conditions of the Maastricht Treaty that established the eurozone. Moreover, Germany opposes it because it has the potential to spur inflation and raises the risk of losses on the bonds the ECB would purchase. Rather, Germany prefers to deepen the fiscal union among the EU members, wherein countries with surpluses would transfer money to those with deficits. In exchange, the European Commission would gain the authority to review the national budgets and impose policies that would alter the imbalances.[30]

The initial moves at the beginning of 2012 seem to favor the German approach. Although the euro thus far has caused political problems that may actually deepen with moves toward a fiscal union, the European heads of state agreed to draft a treaty to develop one, and twenty-five countries in the EU signed it. It will be enacted when twelve countries have ratified it. The proposed fiscal compact would amend, but not replace, the rules of the Maastricht Treaty by strengthening the compliance mechanism

[29] Martin Feldstein, "The Failure of the Euro: The Little Currency that Couldn't," *Foreign Affairs* 91, no. 1 (2012), 110.

[30] Ibid.

associated with the Stability and Growth Pact so that countries could not circumvent it so easily. Britain, the third largest economy in the Union, yet not a eurozone member, announced that it would remain outside the negotiations. In February 2011, the EU built on the Committee of European Banking Supervisors (CEBS) – an existing body comprised of national banking authorities – to establish the European Banking Authority to ensure common regulatory and supervisory standards across the EU.[31]

The Greek crisis wears on through 2012. By the end of 2011, Greece was unable to borrow in global capital markets and had to rely on the ECB and IMF to pay its bills. In exchange for continuing membership in the zone, the prime minister of Greece was required to pressure his parliament to accept the package created by the German and French leaders. He did so and then resigned. A former vice president of the ECB became the temporary prime minister to implement the budget. The Greek government reached an arrangement with its private bondholders in March 2012, wherein these creditors will take a 75 percent loss on their Greek bond holdings. The ECB provided approximately a trillion euros in cheap loans to banks (and not directly to countries) between December and March, which brought a reprieve to their balance sheets. However, the resulting structure of debt now rests even more squarely on the official sector, including the ECB, the IMF, and individual European nations that have lent money to Greece or contributed to the bailout fund.

Unhappiness abounds, which puts the future arrangements within these organizations in jeopardy. Greek people resent the forced changes, and German taxpayers do not want to have to pay to bail Greece out.[32] Other members of the EU have seen their own banking systems destabilized due to the systemic nature of many problems in the eurozone. By extension, members of the U.S. Congress proposed that no American contributions be used through the IMF for European bailouts.

THE BASEL COMMITTEE: INFORMAL ARRANGEMENTS AMONG REGULATORS

The EU and IMF are international organizations established with states as members. Other international arrangements also exist among banks that skirt the frontier between public and private institutions.[33] One that became

[31] See Donato Masciandaro, Maria j. Nieto, and Marc Quintyn, "The European Banking Authority: Are Its Governance Arrangements Consistent with Its Objectives?" *VoxEU*, February 7, 2011, http://www.voxeu.org/article/european-banking-authority-are-its-governance-arrangements-consistent-its-objectives (accessed July 28, 2011).

[32] Feldstein, "The Failure of the Euro," 111.

[33] Lowenfeld, *International Economic Law*, 804.

more prominent as a result of the rise of the international transactions of banks is the Basel Committee on Banking Regulation and Supervisory Practices (Basel Committee) at the Bank for International Settlements (BIS). States are not members of the BIS. Central banks are. The BIS does not have a code of conduct and does not seek universal membership, although it has expanded its membership in recent years.[34]

The American role in the BIS has been ambiguous for much of its history.[35] The Federal Reserve was one of the founding institutions of the bank, and U.S. citizens have served as its Chair. But the Federal Reserve did not take a seat on its board of directors or exercise its voting rights until September 1994. The original subscription of shares was not taken up by the Federal Reserve in the interwar period, but by a consortium of three major American commercial banks. Nonetheless, officials of the Federal Reserve have regularly attended monthly meetings, participated in the work of the committees of experts, and worked with the BIS in response to crises in the international monetary system since its inception.

Despite its ambiguous nature, the BIS could be considered to be an intergovernmental institution because it holds discussions among national regulators in a small and more technically oriented format than the IMF. Central bankers from the industrial countries and some emerging market economies meet eight times a year as its directors. They do not discuss much of what happens outside of that meeting. Nor does its annual report discuss what occurred during the meeting; it presents the views of the managing director on the year's happenings. When it drafts commonly accepted principles, these principles must ultimately operate within the confines of the laws that are established in the U.S. banking system. It is unlikely that regulators would agree to principles that contradict U.S. law, because they are well aware of it. However, differences of interpretation can lead to lawsuits over the implementation should regulators seek to do so in the United States.

The Early Basel Agreements

In response to a series of crises in the early 1970s, the Basel Committee at the BIS drafted a set of principles for supervision of banks' foreign establishment, known as the Basel Concordat, in September 1975.[36] The

[34] Ibid., 622.

[35] For a review, see Charles J. Siegman, "The Bank for International Settlements and the Federal Reserve," *Federal Reserve Bulletin*, October 1, 1994. ISSN: 0014–9209.

[36] Braithwaite and Drahos, *Global Business Regulation*, 113.

principle that emerged from the initial talks was that the home country regulator should take responsibility for the branches or subsidiaries of banks in the United States because it was able to see the consolidated results for the enterprise.[37] The Basel Concordat and Agreements that followed represent arrangements among the regulators who negotiated them (in this case, the Federal Reserve); however, they are not treaties. Under the U.S. Constitution, only the executive branch has the power to negotiate a treaty. It must then be ratified by a two-thirds vote of the Senate. Because the Federal Reserve is a legislative creation (and not of the executive branch), it cannot negotiate one. Nonetheless, Basel agreements influence the actions of banks that wish to operate in more than one country because they serve as direct inputs into the domestic policy processes of many countries.

When international banking scandals continued to occur, there was a sense that there should be some kind of international standards for capital adequacy, or how much money banks keep on reserve, in addition to bank supervision. Policymakers again turned to the BIS and the Basel Committee. They reached the first Basel agreement on capital adequacy (Basel I) in 1988, based on the idea that a bank's capital requirements should reflect the likelihood that the loans it has on its books will be repaid, or "risk-based" capital approach. Prior to that time, U.S. regulators used a common capital standard for all loans and assets, known as "leverage-based capital." With the risk-based approach, a bank has to hold more capital against its high-risk loans but can hold less against its low-risk loans. Congress approved aspects of the Basel agreement as part of the law that rescued the savings and loan (S&L) industry during that crisis.[38]

The bureaucratic politics that operate among agencies of the federal government over domestic jurisdiction similarly operate on issues originating in international forums such as the Basel Committee. As with any law, the implementation is through the rulemaking process in the agencies. A turf war broke out at home among regulators concerning how the initial Basel standards would apply. The problem centered on the risk-based capital approach. Under the Basel standard, mortgages were considered to be riskier than sovereign bonds. Therefore, with the new (international) standards, banks would have held far less capital against sovereign bonds than against mortgage loans. Although sovereign bonds are more likely to be repaid than mortgages, they do have a degree of risk.

To have changed the domestic standard to the international one would have threatened the insurance fund of the Federal Deposit Insurance

[37] Mayer, *The Fed*, 233.

[38] See Public Law 97–110 and H.R. 4879, The International Banking Facility Deposit Insurance Act.

Corporation (FDIC) at the time. The action would have allowed nine out of ten small banks to lower their capital cushion (based on the loans on their books) when banks were failing and the whole system was subject to a higher degree of risk. Because the FDIC has its own power to implement standards, it sought a standard that would retain a leverage standard of 6 percent capital to loans. The Office of the Comptroller of the Currency (OCC) wanted to use the Basel standard for sovereign bonds because it wanted the banks that it regulates to be able to compete with foreign banks that would use the lower standards. The Federal Reserve was not satisfied with the line of the OCC and compromised with the FDIC. Eventually, the OCC agreed with the FDIC–Federal Reserve compromise, but not until a lengthy delay caused a good deal of confusion in the industry about how the agreement would be implemented.[39]

The Basel II Agreement

Therefore, Basel I established the principle of risk weighting in capital adequacy requirements, but the risk weights assigned had been trouble from the start. Organisation for Economic Co-operation and Development (OECD) countries' bonds received favorable risk weightings, whereas American mortgages were always difficult to categorize. As discussed in Chapter 2, one of the more significant innovations in financial products appeared around 1994. To finance mortgages, move deals off the books of commercial banks, and evade Basel rules for capital requirements associated with mortgages, bankers created structured investment vehicles to purchase the loans, assemble them into larger instruments, and sell the bonds sliced and diced from them.[40] The underlying assets received AAA ratings from the credit rating agencies, which gave them favorable treatment under the international rules.[41] Among other reasons, member states proposed to establish a new accord to replace the 1988 Accord and remove the distortions with respect to the treatment of mortgages.[42]

When completed, the final Basel II accord was structured around three pillars that address different aspects of banking regulation. Pillar 1 outlines capital requirements, with banks having a choice among three methodologies for assigning capital: calculation with a standardized approach based on the external credit ratings assigned to a security (a more complex

[39] Seidman, *Full Faith and Credit*, 133.

[40] Gillian Tett, *Fool's Gold*, 97.

[41] Ibid.

[42] George Kaufman, "Basel II vs. Prompt Corrective Action: Which Is Best for Public Policy?" *Financial Markets, Institutions, and Instruments* 14, no. 5 (2005): 351.

version of Basel I), calculation by using internal ratings-based approach (IRB approach), or calculation with an advanced internal ratings-based methodology based on their ability to employ its own estimates of the probability of default (A-IRB approach). Pillar 2 addresses the supervisory reviewing of a bank's capital adequacy and internal assessment process. Pillar 3 proposes a wide range of disclosure initiatives that would enhance the effective use of market discipline to encourage sound banking practices.[43] In sum, the Basel II agreement sought to reward banks that used more sophisticated risk management system with lower capital requirements.

The Bureaucratic Politics of Implementing the Basel II Accord

When the time came to commence implementation, the Federal Reserve announced that the United States would use a bifurcated approach. The implementation of Basel II thus posed a challenge because all methodologies would not be available to all U.S. banks. At the time, this meant that of the approximately 9,000 banks in the United States, only 20 banks would be expected to use the Basel II framework.[44] In the first category that would use the framework, the core banks already had risk management systems in place that were close to what was required to implement the advanced approaches that Basel II required. Thus the costs for large banks to adapt were perceived to be much lower than for small banks. Most likely, their capital charges would be lower in the new system.[45] Hence, large internationally active banks would be required to qualify for, and implement, the advanced approaches; however, the standardized approach would not be available. The 11 or so "core banks" would be joined by another 10 banks expected to opt in. In the second category, the thousands of other U.S. banks would not implement Basel II because the benefits were small relative to the costs. Thus all other U.S. banks would continue to apply existing rules unless they chose to meet qualifications for adopting advanced approaches.[46]

Initially, it appeared that the bifurcated approach would be acceptable to all parties. Non-core banks would be exempt from additional capital

[43] Michael R. King and Timothy J. Sinclair, "Private Actors and Public Policy: A Requiem for the New Basel Capital Accord," *International Political Science Review* 24, no. 3 (2003): 351.

[44] See Mondaq Business Briefing, "United States: Financial Services Alert Quarterly," November 15, 2006, http://www.lexisnexis.com/ (accessed September 13, 2010).

[45] Richard J. Herring, "The Rocky Road to Implementation of Basel II in the United States," *Atlantic Economic Journal* 35 (2007): 418.

[46] Ibid., 416. For an excellent review of the Basel agreements and the United States, see Rosemary Foot and Andrew Walter, "Financial Regulation," in *China, the United States, and the Global Order* (Cambridge: Cambridge University Press, 2011).

requirements and compliance costs. The overall level of regulatory capital in the banking system should have remained roughly the same. The capital reductions to take place would be tempered by maintaining a leverage ratio. And non-core banks could obtain approval to apply Basel II if they were willing to invest in the necessary risk management infrastructure.[47] The regulators allowed some areas of securities lending to obtain the capital benefits of Basel II prior to the conclusion of the rulemaking stage through special exception. Thus they used value-at-risk models to reduce their risk capital requirements.[48]

However, implementation called these suppositions into question when it became obvious that the stakes differed for the different categories of banks. Some large U.S. banks objected that the leverage ratio persisted at home, because they felt it contradicted the spirit of the intended capital reductions in the international agreement. Non-core banks perceived that competitive advantages would accrue to core banks when the latter adopted the new standards. However, the most contentious issue was over the effect of the bifurcated approach on the market for residential loans. Non-adopting banks were perceived to lose a considerable market share on mortgages because the risk weight to be used under Basel II was a fraction of that under Basel I. Thus banks that adopted the Basel II standard would not have to hold as much regulatory capital against mortgages as those continuing to use Basel I would, giving them a major advantage.

A series of quantitative impact studies sought to clarify the situation but only muddied it further. One comparison of risk weights estimated by several banks for the same residential mortgage portfolio produced weights ranging from less than 1 percent to 74 percent. Even core banks began to question whether or not competitive inequities would emerge among themselves.[49] Banks turned to their regulators to level the field. Eventually, four of them (Citigroup, JPMorgan Chase, Wachovia, and Washington Mutual) lobbied the Federal Reserve to allow for the option to implement the standardized approach. The FDIC Chair and OTS director supported a U.S. version of the standardized approach, while the Federal Reserve remained opposed on the ground that it would not allow for adequate risk sensitivity and would unduly delay the further implementation process.[50]

47 Herring, "The Rocky Road to Implementation," 419; Edward J. Kane, "Basel II: A Contracting Perspective," *Journal of Financial Services Research* 32, no. 1 (2007).

48 See Mondaq Business Briefing, "United States."

49 Herring, "The Rocky Road to Implementation," 422.

50 See Steven Sloan, "Baies, Bair Diverge on Readiness of Basel II Proposal," *American Banker*, February 27, 2007, 4. See also "Remarks by Sheila Bair Chairman, U.S. Federal Deposit Insurance Corporation," 2007 Risk Management and Allocation Conference, Paris, France, June 25, 2007, http://www.fdic.gov/news/news/speeches/archives/2007/chairman/spjun2507.html (accessed August 30, 2010).

On July 20, 2007, the agencies announced their agreement on a new rule to implement Basel II. The advanced internal ratings–based approach was to be mandatory for core banks. However, the agencies would develop a proposed rule to provide all non-core banks the option of adopting a standardized approach under Basel II.[51] The agencies agreed to publish a study at the end of the second transitional year to evaluate deficiencies in the framework. Banks will not be allowed to complete their transition until such deficiencies are addressed in regulation.[52] In the meantime in 2006, the EU had gone ahead with its incorporation of Basel II. The OCC was the first to approve its rule on November 1, 2007, as the financial system in the United States began to unravel. It went into effect on April 1, 2008.

The Financial Crisis and Basel II

As the agencies worked to resolve their differences on Basel II implementation, the financial crisis reshaped the financial services industry in the United States. The largest investment banks either failed (Lehman Brothers), were taken over by commercial banks (Bear Stearns), or converted to bank holding company charters (Goldman Sachs, Morgan Stanley). The largest S&L associations failed or were sold during the crisis (Countrywide Financial, IndyMac, and Washington Mutual). The mortgage finance system was likewise reshaped in the summer of 2008 when the government-sponsored enterprises Fannie Mae and Freddie Mac were placed into government conservatorship. Thus the implementation of Basel II would need to occur in the new landscape, while national leaders immediately called for a "Basel III."

Changes in regulation progressed more rapidly at the domestic level in the United States than at the international level. As reviewed in Chapter 8, the U.S. Congress passed the Dodd-Frank Act in July 2010. The legislation covered a wide range of topics related to the credit rating agencies, chiefly accountability, internal controls to avoid conflicts of interest, and public disclosure of the information on which the ratings are based to allow investors, and others, to evaluate accuracy and compare performance of different agencies. In an attempt to make the rating agencies operate better, Section 939A of the Act requires that reliance on credit ratings must be removed from all U.S. regulations within one year of enactment. In place of references or requirements related to credit ratings, each agency must substitute a standard of creditworthiness that the agency

[51] See Comptroller of the Currency News Release, "OCC Approves Basel II Capital Rule," NR 2007-123, November 1, 2007, http://www.occ.gov/news-issuances/news-releases/2007/nr-occ-2007-123.html (accessed August 31, 2010).

[52] Herring, "The Rocky Road to Implementation," 426.

determines is appropriate. Although retail, wholesale, and equity exposure capital calculation approaches do not require direct reliance on external ratings, the Basel II framework for securitization does rely on them. U.S. banks immediately argued that these changes would put them at a competitive disadvantage relative to their non-U.S. peers once it would go into effect.

At the same time Congress passed the Dodd-Frank bill, banks regulators and central bankers met again in Basel to try to reach an agreement on capital requirements, now known as Basel III. Europeans immediately questioned whether the United States would implement the Accord, if and when it would be reached.[53] The week after Dodd-Frank was passed, the House and Senate banking committees announced that they would hold hearings on the Basel negotiations.[54] Before an agreement had been reached, banks objected that the economies of the United States and Europe would be 3 percent smaller after five years if Basel III is implemented than if it is not. Even more contentious has been the proposal to impose a capital surcharge of 2.5 percent on the largest financial institutions that are considered "systemically important."[55]

Therefore, the Basel Committee has not led to the globalization of banking regulation, albeit it does serve as an input into the rulemaking procedures of U.S. regulators, chiefly the Federal Reserve. When the Federal Reserve proposed new capital rules for banks in December 2011, it noted that the formal rules were unlikely to be more stringent than the international limits still in development.[56] At some point, Congress may be called on to make Basel II and Basel III part of U.S. banking law. However, that is unlikely until the implementation process can be aligned with the regulatory changes mandated by the Dodd-Frank legislation. Unlike U.S. statutes, member states of the Committee do not always fully implement the rules into national law and regulation, as was seen with the U.S. and Basel II implementation. Some countries find unusual ways to interpret what they do implement. Nonetheless, the IMF's Financial Sector Assessment Program (FSAP) assesses every financial system against the principles in the

[53] See Damian Paletta and David Enrich, "Basel Accord Negotiators Likely to Dilute Proposals," *Wall Street Journal*, July 14, 2010.

[54] See Yalman Onaran and Alison Vekshin, "Dodd, Frank Plan Congressional Hearings on Basel Bank-Capital Regulations," *Bloomberg Businessweek News*, http://www.bloomberg.com/news/2010-07-29/dodd-frank-plan-congressional-hearings-on-basel-bank-capital-regulations.html (accessed September 10, 2010).

[55] Barbara A. Rehm, "Drawing Contrast with Dimon, Pandit Offers Basel Alternative," *American Banker*, October 13, 2011, 1.

[56] See Edward Wyatt, "Fed Proposes New Capital Rules for Banks," *New York Times*, December 20, 2011, http://www.nytimes.com/2011/12/21/business/fed-proposes-new-capital-rules-for-banks.html (accessed January 24, 2012).

Basel Accord.[57] This usage by the IMF extends its significance to states that were not active in negotiating it. For this reason and the others, the agreements have led to a certain degree of standardized capital requirements around the world.

SUMMIT MEETINGS: INFORMAL ARRANGEMENTS AMONG LEADERS OF THE G8, G20, AND G2

Summit meetings among world leaders have become a prominent vehicle across many issue areas of international relations, particularly those that appear to have come to an impasse. Whereas the Treasury plays the preeminent role at the IMF and the Federal Reserve at the BIS, presidential administrations play the major role in the conduct of international financial politics through summit meetings. The president is the only politician elected by all of the American people, thus his role as their ultimate representative and national leader allows him to work through seemingly intractable problems face-to-face with his counterparts in other countries. Although summits rarely resolve matters of substance, they do have psychological value insofar as they open lines of communication for establishing goodwill. In anticipation of the event, they allow for more protracted professional contact by officials at high levels, thus broadening the number of face-to-face contacts on all sides. As with the Basel agreements, what democratic leaders agree to in a summit must be incorporated in the national political systems. Thus they provide an additional channel through which international inputs can enter the U.S. policy process in the form of concrete proposals with universal goals.

The G8 and G20

A variety of summits are held that address economic issues. A presidential administration's preference for one outlet or another tends to shift over time, and tends to favor outlets where there is the perception that the president has an advantage, such as in voting rights assigned to him, or the amount of information that he must make public about the meeting. In the mid-1970s, the leaders of the seven principal industrial states began to hold annual summit meetings to address the issues surrounding the breakup of the Bretton Woods monetary system in what became known as the Group of 7 (G7). Increased to the Group of 8 (G8) when Russia was invited to attend, the group has attempted to coordinate exchange rates and

57 Howard Davies, "A Review of the Review," *Financial Markets, Institutions, and Instruments* 14, no. 5 (2005): 248.

TABLE 9.1. *Membership of the G20*

Argentina
Australia
Brazil
Canada*
China
EU*
France*
Germany*
India
Indonesia
Italy*
Japan*
Mexico
Russia*
Saudi Arabia
South Africa
South Korea
Turkey
United Kingdom*
United States*

* Indicates membership in the G8 as well as G20.

intervention in foreign exchange markets, and in more recent years address the problem of developing countries' debt and development. As with other summit meetings, the preparatory meetings of the G8 allow top officials to identify common problems, consider coordinated solutions, and exchange views. The leaders' sherpas (or chief delegates) draft a communique on these issues and leave difficult points for the leaders themselves to address at the meeting.

In 1999, then Treasury Secretary Lawrence Summers sponsored the creation of a "finance G20" with finance ministers and central bank governors from a broader section of the world economy than the G8 had. Comprising 85 percent of global output and two-thirds of the world's population, the larger group overshadowed the smaller one during the financial crisis when President George W. Bush convened an emergency summit of G20 heads of state in Washington, DC. Because the G20 is the only forum where major developed and developing countries meet at the highest level, it is unlike the United Nations Security Council, the Bretton Woods institutions, or the G8. President Obama declared the G20 to be the premier forum for international cooperation in September 2009. Table 9.1 compares the membership of the G8 and G20.

The G20 is credited with multilateral coordination during the 2008 financial crisis, but its effectiveness in the longer term is questionable. As the number of attendees goes up, the likelihood that it will reach specific policy solutions goes down. If the number of attendees are kept to a minimum, the impression that it is a truly legitimate forum is also minimized. In addition, the government structures of the G20 states vary dramatically from those of the industrial democracies that comprised the original G7 advanced industrial states. Russia operates with an authoritarian regime. Despite China's market liberalization initiatives, it is far from a capitalist economy. As a result of these different governing structures, the ability of G20 leaders to follow through on what they promise varies dramatically. For example, President Obama can pledge money for a program but only Congress can actually provide it. The history of G7 and G8 meetings is full of promises made by leaders, only to be dashed by national legislatures, such as the G8's 2005 Gleneagles agreement to increase foreign aid by $50 billion that fell short by $18 billion.

Although the G8 and G20 summits might appear to accomplish little, they do serve as a forum for bringing relevant parties together who communicate on an ongoing basis. These meetings are not confined to government heads. For example, when the G7 met in Washington, the Treasury held an "outreach dinner" in its Cash Room for chief executive officers from major financial firms such as Morgan Stanley, Merrill Lynch, Citigroup, JPMorgan, and Deutsche Bank.[58] Moreover, they may be more effective in a crisis when the need for cooperation is acute.

The Strategic Economic Dialogue with China

A final major input into U.S. financial policy from the international context has been the growing significance of the U.S.–Chinese bilateral relationship, or what some have called a "G2," albeit the term is not preferred by the Chinese leadership. As the Cold War receded and China moved toward a more market-driven economic system, its trading relationship with the United States grew. In addition to improved political relations, ongoing Chinese export growth has been fueled by an exchange rate policy that undervalues its currency, making everything it sells in the United States cheaper than it would otherwise be. If exchange rates floated freely, such imbalances would eventually be corrected by a rising renminbi. A higher price for the currency needed to purchase Chinese goods would translate into higher prices for these imported goods, making them less attractive to American consumers. However, with state intervention into exchange

[58] Paulson, *On the Brink*, 129.

markets, this adjustment does not occur and the trade imbalance persists. As Americans imported greater and greater quantities of Chinese goods, they paid for these goods with credit.

The political aspect of the problem is that unemployed American workers perceive their jobs to be lost to the Chinese manufacturing sector on an uneven playing field. Fairly or unfairly, the notion is particularly strong in the states hurt the most by the downturn in the U.S. manufacturing sector such as Michigan, Ohio, or Indiana. Members of Congress from states and districts most strongly affected follow the Chinese exchange rate issue attentively. The imbalance may continue as long as the Chinese economy grows and until a considerable number of Chinese peasants are absorbed into the system.

For a time, the two countries had compatible interests, which promoted this exchange. American consumers want to buy goods, and the Chinese regime wants to save and export on its way to prosperity. The government of China accumulated international reserves to smooth a large volume of international transactions.[59] As of July 2011, mainland China was the top foreign holder of Treasury securities with $1,173.5 billion. Japan followed with $914.8 billion, and the next holder was the United Kingdom with only $352.5 billion.[60] The accumulation of debt resulted from the trade imbalance. After the 2001 recession, the Federal Reserve kept interest rates low. The rates fueled the housing boom, which made Americans feel wealthier. Many refinanced mortgages and diverted their interest savings to consumption. During this period, the United States could run large deficits because other countries were willing to run large surpluses. The United States could save less because other countries saved more. Some described these global imbalances as a global savings glut. But Eichengreen points out that in the world system, there was also a U.S. savings drought.[61] The savers, particularly in China, were willing to purchase dollar denominated financial instruments such as Treasury bills and agency debt from Fannie Mae and Freddie Mac.

Henry Paulson was acutely aware of the significance of the U.S.–China relationship when he became Treasury Secretary in 2006. In his new role, he hoped to build on the knowledge of China that he had gained from his work in the private sector at Goldman Sachs when he had traveled to China on numerous occasions. As a result, he enjoyed a wide circle of contacts there.

59 Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton, NJ: Princeton University Press, 1996), 214.

60 See Department of the Treasury, "Major Foreign Holders of Treasury Securities," http://www.treasury.gov/resource-center/data-chart-center/tic/documents/mfh.txt (accessed October 11, 2011).

61 Eichengreen, *Globalizing Capital*, 214.

As Treasury Secretary, Paulson initiated the SED in September 2006 to bring together the most senior leaders of both countries to focus on long-term economic matters such as economic imbalances, trade, investment, finance, energy, and the environment. Paulson led the American team, and Vice Premier Wu Yi led the Chinese. In this area as well, administrative turf mattered. Paulson's recollection of his experience with the State Department was that it was important not to impinge on other cabinet secretaries' turf, particularly Condoleeza Rice, then Secretary of State. Her concern was that the State Department's mission not devolve into a catchall for any noneconomic issues. In other words, she did not want the United States to have one "economic" secretary of state and another secretary of state for everything else.[62]

As part of his efforts in the SED, Paulson pushed the Chinese to raise the cap on equity that foreigners could hold in Chinese financial institutions. The United States also pressured China to relax its foreign exchange policy so that its currency would appreciate against the dollar and lower its reliance on cheap exports. Whereas some commentators put the blame for the imbalances squarely on the Chinese policy of keeping its exchange rate artificially low, Paulson argued along the lines of Eichengreen that the lack of domestic American savings also played a role. With low savings, Americans imported large quantities and relied on foreign capital flows for credit. The U.S.–China rate had important international effects because with a peg to the dollar, the imbalances were transferred to relationships with other trading partners, particularly Canada and Europe. The yuan appreciated against the dollar after the G20 meeting in Cape Town, South Africa, and revived protectionist sentiment in the Congress.[63] Demonstrating the ongoing significance of the relationship, Secretary of the Treasury Timothy Geithner and Secretary of State Hillary Clinton have continued the tradition of meeting annually with the Chinese leadership through the SED.

CONCLUSION

International political institutions compete for mandates and jurisdictions just as U.S. domestic ones do. Hence, the international context affects all three domains of financial politics. In brief, exchange rates influence the money supply and the role of the dollar in international transactions. International markets influence demand management because more buyers exist overseas than in the domestic economy; thus the economic fortune of these people plays a role in fiscal policy as consumers of products in the

[62] Paulson, *On the Brink*, 53.
[63] Ibid., 83.

world economy and ultimately its related price levels. In the area of financial regulation, the international system offers the ultimate opportunity for regulatory arbitrage as the location of financial activities spreads across the globe, because relatively low transaction costs allow business to shift among locations in a short time. The effects of international regulatory policy feed back into the other areas because money can enter or exit the United States for regulatory purposes, tax evasion, or interest rate differentials.

In the years of the deregulation of the domestic banking industry in the United States when financial compartments relaxed and industries merged, the size of bond markets multiplied with the availability of global opportunities, particularly when banks sold off their developing country exposures with conversion into bonds. The IMF and World Bank encouraged the growth of stock markets whose shares could be traded across borders through privatization and other economic programs.[64] The result was that the proportion of transnational capital intermediated by commercial banks declined relative to the overall global market growth. However, the growth of global investment banking enterprises and capital markets was not accompanied by the growth of regulation to police their activities. Regulators lacked both capacity and information.[65] The international marketplace offered another layer of opportunity for regulatory arbitrage on top of the existing complexity of the American system.

What happens to one nation's currency matters in another, and what happens to one bank's loan portfolio matters to other banks as well, because a collapse of one can trigger a "domino effect," leading to a systemic crisis. It is difficult to track the degree of risk because large banks' portfolios have been international for many decades. They take deposits from overseas and make loans to overseas borrowers. Unlike other multinational firms, multinational banks generally operate through a branch system. In other words, they are not incorporated in each country in which they do business. Thus they do not always have to meet the capital requirements of each country where they are established. Rather, the capital of the whole enterprise may satisfy requirements for the operation of a branch in a particular jurisdiction.[66] Without knowing all potential assets and liabilities on a balance sheet, it is difficult for a regulator to obtain the appropriate data with which to do their job.

64 See Lavelle, *The Politics of Equity Finance in Emerging Markets*.
65 Braithwaite and Drahos, *Global Business Regulation*, 103.
66 Lowenfeld, *International Economic Law*, 671.

SECTION 4

CONCLUSIONS

10

Governing the U.S. Financial System

The book posed this question: What features of the American political system make the financial system so prone to crises? It has argued that the answer is far more complex than the common themes of large campaign contributions and agency capture by the financial services industry. Although these features of the system play their roles, we have found that a more profound understanding of the three domains of financial politics comes from an examination of the particular historical path the United States took in developing state capacity to regulate finance. Both the political and financial systems reflect an American political culture that distrusts the centralization of power in any one governing institution at either the federal or state level, and that distrusts the concentration of economic power that large banks by their nature hold. Thus the system is prone to crises because an overarching integrated monetary, fiscal, and regulatory solution at the state, national, and international levels would contract core American values concerning the separation of powers, federalism, and free market capitalism. The flip side is that as the system developed, it generated innovations that gave a diverse population and industries growing access to credit.

Policymaking in the financial area is thus destined to be a victim of its own success. If the regulatory system is working properly, market participants and the interest groups that represent them in the political system question why regulation is even necessary. Regulation appears to stunt growth and stifle innovation for no apparent reason. Interest groups are particularly incapable of organizing to protect themselves from dangers that might have arisen since the last set of regulations were written because they have no direct experience with which to understand such threats. Even if they organized to protect themselves, they would have to cover an immensely intricate and diffuse system that preserves competition among agencies. Thus interest groups do not organize to protect the benefits of a stable system. They organize to take advantage of what they see as opportunities to make a profit. The system of pluralist interest group representation, distorted by the size and resources of the industry, guarantees that change is a constant feature of the system.

The historical review of the development of state capacity has shown that systemic change can originate in the external environment from causes such as war or shifts in the balance of trade. It can also originate from technological advances that lower the cost of conducting highly sophisticated transactions. However, internal causes, chiefly the election cycle, can trigger legislative change as well. The interests, pressures, perceptions, and prejudices of members of Congress can be altered along with elections and other conditions.[1] Whereas coalitions form in favor of major legislation, others form to oppose it. If promoters or detractors fail in one session, they can always try again when circumstances improve.

The difficulty of addressing the root causes of instability in the financial system does not mean that policymakers cannot attempt to adjust it to improve the situation. In the study of international relations, it is well known that the problem of war among states will never be completely eradicated. However, states have created international institutions that have fostered peace for long stretches of human history. Likewise, states have carved out zones of relative financial stability within which commerce operates effectively, and individuals have had access to credit and secure savings arrangements. Speculation can occur, and higher rewards can accrue to those who willingly choose to engage in it. Broad institutional initiatives in world politics have generally followed war. In financial politics, efforts at fixing the financial architecture have generally followed financial crises.

Nonetheless, many observers have asked how the financial crisis of 2008 could have been so severe with such incremental institutional change. Events in Europe related to sovereign debt suggest that the answer could be that the crisis is unfolding in stages and has not reached its ultimate conclusion. Conversely, grassroots movements in the United States and elsewhere may pose a serious challenge to politicians content with working within the status quo.

Thus the U.S. political system's medium-term response to the events of 2008 through 2011 can be understood through the nature of interest group activity in American democracy – a system where competing interest groups try to make coherent policy proposals to the government so that they can

[1] Walter J. Oleszek, *Congressional Procedures and the Policy Process*, 8th ed. (Washington, DC: CQ Press, 2011), 366.

influence outcomes to their advantage. In this system, all interests are not translated into group activity equally. Of those that are, all are not equally matched in terms of access to financial resources or policymakers. Moreover, the political story does not end with campaign contributions and the work of interest groups. When translating politics into policy, the American governmental process infuses politics with a bureaucratic component wherein the competing jurisdictions and loyalties prompt federal agencies to compete for resources and mandates, particularly in a crisis. Nowhere are these features more pronounced than in the issue area of banking and finance.

The government's policy response to the crisis came in stages. In the most immediate, the Secretary of the Treasury, Federal Reserve Chair, and heads of the largest banks scrambled to prevent the collapse of the system in a series of takeovers, buyouts, and industry rescue. In the medium term, the government response has been through the Dodd-Frank Wall Street Reform and Consumer Protection Act, a piece of financial reform legislation that seeks to restore confidence in American financial markets by instituting new requirements for some participants and establishing new regulatory oversight mechanisms for others. In the long term, the crisis continues to unfold in a series of European sovereign debt crises and the scrambling of domestic and international agencies to respond with agreements on international capital adequacy standards and politically unpopular bailouts in a monetary union that lacks a corresponding fiscal union.

Therefore, the conclusion offered here is that the solutions to the problems of regulating finance must be constantly renegotiated according to conditions in the world we live in by the politicians we elect. Individual and institutional investors must support initiatives that segment certain industries for stabilization while accepting that they will offer a lower rate of return in exchange for that stability. Unfortunately, there are no shortcuts.

BUREAUCRATIC POLITICS AND THE 2010 REFORMS

In American politics, the implementation of the Dodd-Frank reform bill offers a glimpse into the path ahead. During the closing days of the debate on financial services reforms, one analyst commented to House Financial Services Chair Barney Frank that many bankers privately felt they had dodged a bullet. He replied, "I was not trying to shoot the banks, I was trying to regulate them."[2] To many observers, it is ironic that the largest

[2] Barney Frank quoted on a CNBC Power Lunch show that aired Friday, June 25, 2010, http://www.cnbc.com/id/15840232?video=1530246658&play=1 (accessed April 12, 2012).

financial institutions have emerged stronger than ever in the four years that have passed since the collapse of Lehman Brothers. The two worst fates that they could have met – a government breakup or strict limits on their leverage – were avoided. Without Lehman Brothers and Bear Stearns, two competitors have been lost, making the remaining investment banks, Goldman Sachs and Morgan Stanley, more profitable than ever after converting to bank holding companies and thus the regulated sector.[3]

No doubt, the Dodd-Frank bill is a landmark piece of legislation that will reshape the industry as it is worked out through the rulemaking process. Many of the worst excesses of the industry have been eliminated, if for no other reason than many of the investors who bought the exotic financial instruments previously are not buying them now. Looking forward, many important questions remain that are particularly problematic because their potential solution stretches across the fragmented landscape of independent agencies, government-sponsored enterprises, and direct government control, especially the housing market that exists almost entirely on government support. The government response to business cycles of the future and shocks from the national and international economy will shape their answers over time.

In studies of the policy process, an event like the 2008 financial crisis receives a great deal of attention and compels legislators to respond. Whereas groups may have appeared to have been in agreement prior to that time, once a bill is in play with the potential to become law, new groups enter or exit the process and much more significant change becomes possible.[4] Once groups take sides, more differences of opinion or strategy among groups may become apparent. The key features of this process were apparent in the response to the 2008 crisis. In the years prior, some individuals had recognized the problems connected to unregulated over-the-counter derivatives. Others realized that there were problems in housing and mortgage markets.[5] However, the complexity of the issue, as well as the lack of serious media attention paid to it, left it largely unexamined in the popular mind. In such a vacuum, large banks have a good deal of influence over the process because they have the necessary technical expertise and government relations contacts to follow issues closely, particularly the rulemaking process in relevant regulatory agencies.

3 Christine Harper, "Out of Lehman's Ashes Wall Street Gets Most of What It Wants," *Washington Post*, December 28, 2010, http://www.washingtonpost.com/wp-dyn/content/article/2010/12/28/AR2010122800322.html (accessed April 12, 2012).

4 Kingdon, *Agendas, Alternatives*. See also Baumgartner and Jones, *Agendas and Instability in American Politics*, 20.

5 See, for example, Helleiner and Kirshner, *The Future of the Dollar*.

The crisis opened a policy window where political actors in the executive and legislative branches proposed reforms beginning in June 2009. Interest groups mobilized to influence the outcome of the bill that was enacted the next summer. As we have seen, agencies of the federal government have their own interests in the policy process. They seek to preserve and defend their role and mandate going forward. In this case, heads of agencies such as the Federal Reserve and Treasury Department participated in the legislative process by working within the jurisdiction of the relevant congressional committees. These committees had an interest in preserving the institutional structure because it preserves their ability to act on future oversight and legislation. The key features of the Dodd-Frank bill that resulted were as follows:

- Create a consumer watchdog authority, the Consumer Financial Protection Bureau (CFPB) to protect individuals
- Establish an interagency Financial Stability Oversight Council (FSOC), chaired by the Treasury and including the Federal Reserve, Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA), National Credit Union Administration (NCUA), CFPB, and nonvoting members including the Office of Financial Research (OFR), Federal Insurance Office (FIO), and state banking, insurance, and securities regulators to identify and respond to emerging risks throughout the financial system
- Establish a Resolution Authority to try to make it easier to close down financial institutions should they fail
- Require central clearing and exchange trading of the derivatives market and allow the SEC and CFTC to regulate them
- Require hedge funds to register with the SEC
- Prohibit proprietary trading and investing a bank's own money in hedge funds
- Close the Office of Thrift Supervision and transfer its authorities to the OCC, albeit the bill preserves the thrift charter

Whereas it is certainly a momentous piece of legislation that will bring the mortgage market under the regulatory authority of the banking industry more than it has been throughout American history, the details of the legislation do not dramatically restructure American capital markets or the bureaucratic agencies that surround them. Rather than moving away from securitization as a form of financial intermediation with all of the inherent complexity and questionable risk transfer practices it entails, the legislation only sought to reduce its risks by requiring companies that sell these products to retain at least 5 percent of the credit risk and require better disclosure about the underlying assets. Ironically, the Federal Reserve has emerged with new rulemaking authority from the legislation, despite its lack of enforcement in the past in other areas that it has been assigned. One of the major innovations of the bill, the CFPB, will be housed at the Federal Reserve. The international environment will continue to be a source of uncertainty. For example, it is unclear how the resolution authority would potentially handle the foreign subsidiaries of a large failing institution that poses systemic risk.

THE QUESTIONS THAT REMAIN

Despite the broad coverage of the Dodd-Frank reform bill, many questions concerning the future of the politics of the financial services industry remain. Some are connected to the residual policies of the bailouts in 2008 and 2009, particularly the new and awkward status of the federal government in owning shares of large firms. Others concern the regulations that the bill will either impose or have failed to impose. A final set of concerns emerges from the international environment and the accumulation of sovereign debt in the eurozone. All are ultimately tied to the provision of adequate funding for the regulatory agencies that police the activities of the financial sector, particularly the two most important ones charged with carrying out the Dodd-Frank reforms – the SEC and CFTC.

Hence, many of the age-old questions concerning the boundaries around the legitimate activities of the compartments in the financial services industries and accumulation of risk are still being addressed as the memory of the 2008 crisis recedes. This section singles out the future of American housing markets in the institutions of Fannie Mae and Freddie Mac, the accumulation of risk in derivatives markets, limits on the proprietary activities of banks, the concentration of power in a few large financial services firms, and the protection of the rights of individual consumers as the most significant issues being worked out in the years since the Dodd-Frank bill's passage.

Fannie Mae and Freddie Mac Reform

The future of government-sponsored enterprises (GSEs) is a paradox. When Fannie Mae and Freddie Mac were put into conservatorship, they were the political institutions to change first – and change the most – because the government now manages their affairs directly. However, because they were not covered explicitly in the Dodd-Frank bill and remain in that indeterminate status, they have had the least legislative attention. As time passes, they have been pushed later onto the reform agenda. Hence, their future is the greatest outstanding question of the 2008 financial crisis as of 2012, both because they received such a large percentage of the bailout money, and as a result of their size relative to U.S. financial markets and their connection to the American dream of home ownership. By the end of 2009, outstanding agency debt, either direct or as guarantees, was roughly equal to the debt of the entire U.S. government. As the bailout wound down, Fannie Mae and Freddie Mac had received $126 billion from the government, compared with $70 billion to AIG and $77 billion to GM and Chrysler together. They guarantee nearly half of the country's mortgages. They continue to prop up the fragile housing market by backing up three-fourths of new loans made in 2010, with the Federal Housing Administration guaranteeing most of the rest.

As discussed throughout this book, Fannie Mae and Freddie Mac expanded home ownership by putting money into the market and encouraging banks to lend more in this area. As the agencies promoting home ownership, they have advanced a part of the American dream insofar as homeowners join the middle class when their asset appreciates, thus creating wealth that might otherwise have been out of their reach. In addition, homeowners make for stable neighborhoods and have an incentive to keep their property up because they have equity in it. Thus they are an important political constituency and socioeconomic group. Because Congress chartered Fannie Mae and Freddie Mac, only Congress can abolish or modify those charters with a vision for what a new secondary market structure would look like.

Despite their role in the business of mortgage securitization and lack of an immediate alternative, the connection of the GSEs to home ownership has been called into question by the crisis and need for rescue. Considerations are complicated by the fact that different sides of the debate over the appropriate instruments of government intervention in the mortgage market understand the problem of Fannie Mae and Freddie Mac's connection to the subprime market differently. According to their detractors, affordable housing goals imposed by the government forced a decrease in lending standards. Many people bought homes who shouldn't have had access to the loans in the first place. In addition, Fannie Mae and Freddie Mac fueled the housing bubble because they had bought and held so many toxic mortgage products. For Fannie Mae and Freddie Mac's supporters, the GSEs were forced to lower their standards in the face of competition from private subprime lenders that could securitize even the worst loans. AIG's bailout had nothing to do with the push for egalitarian housing policy. Moreover, when banks turned to subprime mortgages, Fannie Mae and Freddie Mac were not making those kinds of loans.[6] Thus, Fannie Mae and Freddie Mac are alternately considered to be a cause or an effect of the phenomenon, depending on which end of the political spectrum the analysis comes from.

However, a reconsideration of the extent of the commitment to home ownership in American politics is under way across the political spectrum. Observers note that most of the communities that fared better in the housing bubble had a high percentage of renters.[7] In a speech to the Housing Association of Nonprofit Developers, FDIC head Sheila Bair argued that federal policy in support of housing has been supported by the home mortgage interest and property tax deductions for twenty-five years. To get at the heart of the subprime crisis, according to her view, the government needs to reconsider the political and psychological capital poured into the idea of owning a home as opposed to renting. In other words, the subprime market developed to make home ownership possible to those who did not have the income or credit scores to get a traditional mortgage. Supporting home ownership might be a good idea, but not *all* home ownership.[8] Likewise, in February 2010, Paul Volcker testified to Congress that the nation's entire home mortgage market needed to be reconstructed.

Proposed solutions to the problem also fall along a continuum connected to how one understands the problem. At one end, the GSEs could be replaced with a government agency that could buy mortgages and resell them to investors. In the absence of a profit motive, the agency would not be tempted to take the kind of risks that led to their collapse. It could also continue to subsidize the mortgage market so that it would be easier for more Americans to buy homes than might be possible with a purely private market. In the middle, Fannie Mae and Freddie Mac could be reconstituted as GSEs with new rules limiting their risk. At the other end, the government could reduce its role in selling insurance to cover mortgage default, which would reduce the risk to taxpayers but would make it tougher to get mortgages.[9]

As the crisis abates, the last option may be the most challenging in political terms. Home ownership has been a bipartisan goal, and the GSEs have cultivated many powerful political allies over the years. Even if they

6 Joseph E. Stiglitz, *Free Fall: America, Free Markets, and the Sinking of the World Economy* (New York: Norton, 2010), 10.

7 See Joe Nocera, "Wake-up Time for a Dream," *New York Times*, June 12, 2010, B1. Nocera refers to Richard Florida's *The Great Reset: How New Ways of Living and Working Drive Post-Crash Prosperity* (New York: Harper, 2010).

8 Nocera, "Wake-up Time."

9 Government Accountability Office, *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-Term Structures* (Washington, DC: U.S. Government Accountability Office, 2009).

were to be wound down, this process would have to occur over a very long period of time to prevent further market dislocation. As the issue of Fannie Mae and Freddie Mac moves forward, Congress must determine what arrangement will replace them before they can be abolished or a new line between public and private can be drawn. Many groups began to meet with the relevant House and Senate committees *prior* to the passage of the Dodd-Frank bill to begin to shape the outcome, including low-income housing advocates, realtors associations, home builders associations, and bankers.

The Market for Derivatives

As discussed in Chapter 3, a derivative financial instrument is any asset whose value is derived from another. Market participants use them at times to facilitate transactions that regulations would otherwise prohibit, or to "game the system." Among the most controversial derivatives are credit default swaps (CDSs), which can be used as a hedge against a possible default and thus help firms and investors to manage risk. However, in the run-up to the crisis, many mortgage investments did not contain any actual mortgage bonds. Rather, they were constructed from CDSs that referenced other bonds, which means that investors weren't really investing but were gambling on whether or not the other bonds would fail. Some bet that they would be paid off; others bet that they would not. Although these types of investments do not add value to the mortgage industry, they do raise the level of systemic risk. If the damage in the housing crisis had been confined to subprime loans, it would have only represented a fraction of the mortgage market. But synthetic investments multiplied the level of systemic risk created by the subprime market. One bond could be referenced in dozens of synthetic securities. Their buyers and sellers do not have a stake in the underlying instrument other than to gamble on it.

Therefore, the controversy over the CDS market is initially controversy over the moral hazard that they create in managing risk in the first place. Banks may be less likely to scrutinize mortgages and other loans if they can pass the risk off onto another entity with a CDS. But mortgages have nonetheless raised the level of overall risk in the system when the loans are made. The CDS controversy is amplified by orders of magnitude when second- and third-order securities layer wagers on top of wagers. Hence, the question that remains is the degree to which parties with no stake in the underlying instrument should be allowed to buy or sell CDSs.

At a minimum, regulators could set high capital requirements on the CDS so that counterparties do not overleverage themselves. Otherwise, tax policy could discourage swaps contracts that are held for the short term.[10] At a maximum, the CDS could be classified as insurance and the concept of "insurable interest" would apply. With this concept, a person cannot buy insurance on a home or car unless he or she has a demonstrable interest in it. As argued by CFTC head Gary Gensler, individuals bought insurance against ships sinking in eighteenth-century England. When the number of ships sinking rose, insurers became alarmed. The British parliament later passed a law that to buy ship insurance, the buyer had to have an interest in either the ship or its cargo. A similar conflict of interest exists today. The excessive use of the CDS market can force companies to fail. The market is thin enough that large purchases could make lenders nervous and provoke the affected firms' credit to freeze up. Hence, using the concept of insurable interest to guard against unnecessary bankruptcies and fraud, the purchase of CDS would be limited to those with an interest in the firm, and possibly limited to the level of their interest in it (i.e., one could not purchase more insurance than the level of their "insurable interest").[11]

Among other new regulations on swaps and derivatives, the Dodd-Frank bill requires CDSs to be traded on exchanges and to be processed, or cleared, through a third party to guarantee payment in case of a default. However, the bill contains a loophole: regulators have no clear authority to stop or undo a deal that has *not* been properly cleared and exchange traded, which opens this question: What happens if an entity does not list on an exchange? Whereas the legislation requires traders to disclose pricing data to encourage competition, regulators will decide which derivatives and how long traders can wait to disclose it.

The Obama administration opposed tougher measures. For example, hedge fund manager George Soros and Berkshire Hathaway Vice Chair Charles Munger suggested that regulators ban purchases of the so-called naked CDS – that is, contracts that allow speculators to profit if a debt issuer defaults. Senator Byron Dorgan (D-ND) offered an amendment that would have banned naked swaps, but other supporters in Congress backed down when they did not receive pressure from constituents to follow through on it. Dorgan was quoted as saying, "The debate that's necessary on these subjects is a debate that is so unbelievably complicated that the larger financial institutions have always controlled the narrative."[12] In his view, the industry has convinced people in Congress that it brings value to the

[10] See Roger Lowenstein, "Gambling with the Economy," *New York Times*, April 20, 2010, http://www.nytimes.com/2010/04/20/opinion/20lowenstein.html (accessed April 12, 2012).

[11] See Floyd Norris, "The Naked Truth on Default Swaps," *New York Times*, May 21, 2010, B1.

[12] Harper, "Out of Lehman's Ashes."

economy with new instruments, and anyone on the other side is a radical populist. Arguing against the ban, Secretary of the Treasury Timothy Geithner argued that it was not necessary because it is too hard to distinguish between a legitimate hedge and a speculative bet.

The Dodd-Frank bill gave regulators at the CFTC and SEC important new responsibilities for writing rules governing the $583 trillion market in over-the-counter derivatives. On December 16, 2010, however, the CFTC withdrew a proposed rule that would have required dealers of private swaps to quote prices to all market users before trades could be executed on an electronic system after one commissioner objected. With the new version of the rule that appeared on December 16, 2010, dealers will save billions of dollars because they will be able to limit price information to select participants.[13] The release of other rules associated with Dodd-Frank has been delayed.

The Volcker Rule

As the compartments in the financial services industry opened into each other in the wake of the passage of the Gramm-Leach-Bliley legislation, large banks combined activities that had been previously separated into commercial and investment banking houses. Many observers considered that the end of Glass-Steagall, which the bill represented, had contributed to the industry restructuring that allowed for the excessive accumulation of risk prior to the financial crisis in 2008. Although most of the participants in the financial services debate agreed that an outright return to the old Glass-Steagall provisions would not be feasible in the contemporary setting, many sought some separation of the functions of the commercial banking industry from its riskier components, thus returning to the spirit of the Glass-Steagall reforms.

Formulations of what came to be known as the "Volcker Rule" – after its most prominent advocate, former Federal Reserve Chair Paul Volcker – sought limits on the proprietary activities of banks, as well as ownership or sponsorship of hedge funds and private equity funds, under the rationale that further layers of risk added to the inherent risks of the essential functions of the commercial bank in the first place.[14] Proprietary trading of financial instruments – which is essentially speculative in nature and engaged in for the benefit of limited groups of highly paid employees

[13] Ibid.

[14] Volcker defines ownership or sponsorship of hedge funds and private equity funds and proprietary trading as placing bank capital at risk in the search of speculative profit, rather than in response to customer needs. See Paul Volcker, "How to Reform Our Financial System," *New York Times*, January 31, 2010, http://www.nytimes.com/2010/01/31/opinion/31volcker.html?pagewanted=all (accessed April 12, 2012).

and stockholders – does not justify the taxpayer subsidy implicit in routine access to Federal Reserve credit, deposit insurance, or emergency support.[15] According to Volcker, those risks are far better suited for other areas of financial markets. Only four or five mega-commercial American banks engage in these activities, and only twenty-five to thirty of them internationally do so. They could be better managed through smaller, private entities that would disperse the risk, and that could fail without threatening the financial system as a whole.

The final bill included a watered down version of the Volcker Rule. Rather than prohibiting banks to make investments in hedge funds and private equity funds, the bill allows them to invest up to 3 percent of their capital in these funds as long as the activities are conducted in a separate subsidiary. Banks will not be allowed to use credit to finance their investments by lending to a hedge fund. In addition, if regulators discover that a bank is overexposed, they are required to intervene to preserve the bank's well-being. The provision puts parts of the shadow banking industry under regulation where it was not subject previously.

However, the ultimate effectiveness of the Volcker Rule will not be known until the interpretation of terms such as "proprietary trading" are clarified under the rules and enforced by the regulators. Banks began to challenge some definitions and focus on building up their derivatives brokerage operations as soon as the legislation passed. In addition, banks may be able to work around the rule by working on behalf of their clients when making bets. In October 2011, the Federal Reserve Board, FDIC, and other financial regulators released a proposal related to the Volcker Rule, wherein banks with conflicts of interest could be prohibited from some activities, but only under specific circumstances. Moreover, they could evade the ban if they disclosed their conflict of interest, or erected informational barriers within the organization in an effort to protect customer's interests.

In this case, a coalition of more than 250 national, state, and local consumer groups, labor, investor, civil rights, community, small business, and senior citizen groups also formed to work for tough implementation of the provisions in Dodd-Frank – the Volcker Rule among them. In November 2011 at a meeting of a forum hosted by the coalition, Americans for Financial Reform, Senator Carl Levin (D-MI) took issue with the Volcker Rule proposal released in October. Levin commented that banks should not be permitted to obscure the disclosure in opaque language buried in a long

[15] See Paul A. Volcker, "Commentary on the Restrictions on Proprietary Trading by Insured Depositary Institutions," comment letter available at http://online.wsj.com/public/resources/documents/Volcker_Rule_Essay_2-13-12.pdf (accessed March 5, 2012).

document, and he commented that any information barrier within a bank would most likely not be effective. He stated that he would submit lengthy comments in response to the regulators' proposal.[16]

As the comment period came near an end in early 2012, Wall Street firms, lawyers, and trade groups wrote multiple letters to regulators. Whereas a regulatory comment letter is usually 10 to 20 pages, one by the Securities Industry and Financial Markets Association alone was 173 pages. The largest banks submitted their own comment letters, which is considered to be an unusually aggressive move because they generally have trade groups and lobbyists submit letters on their behalf. Whereas some suggested that the regulators reconsider the rule, or scrap it altogether, supporters argued that the volume of letter writing was a ploy to delay the decision on the rule until after the 2012 election when Democrats may no longer control the Senate and/or White House.[17]

Too Big to Fail

A financial firm that is "too big to fail" is one whose failure would threaten the survival of the rest of the system. Therefore, society has an interest in either regulating the activities of these firms so that they do not pose such a risk, or in preventing any firm from becoming so large that it can engage in risky behavior and earn high profits when times are good and be bailed out by taxpayers who absorb losses when times are bad.

One of the rationales used for bailing out some of the largest financial firms, and for putting Fannie Mae and Freddie Mac into conservatorship, was that they were too big to fail. Policymakers argued that during the crisis, they lacked the legal means to place firms into bankruptcy without catastrophic results.[18] The Dodd-Frank bill establishes a "resolution procedure" to dismantle a large firm if its failure threatens the system. The law also bars the Federal Reserve from lending to individual troubled firms. The goal is to ensure that stockholders and unsecured creditors take the loss – not taxpayers. However, it is unclear how the resolution authority will work in practice. Furthermore, it is unclear what will happen to the foreign subsidiaries of such a firm, if the government must exercise this provision.

[16] See Kevin Wack, "Levin Blasts Volcker Rule Proposal as Too Weak," *American Banker*, November 9, 2011, http://www.americanbanker.com/.

[17] See Ben Protess and Peter Eavis, "At Volcker Rule Deadline, a Strong Pushback from Wall St.," *New York Times*, February 13, 2012, http://dealbook.nytimes.com/2012/02/13/at-volcker-rule-deadline-a-strong-pushback-from-wall-st/ (accessed February 14, 2012).

[18] Sorkin, *Too Big to Fail*, 398.

Some on both the left and right have argued that if a bank is too big to fail, then it is "too big."[19] For these analysts, the only real resolution to the problem is to break up the largest banks. During the hearings for the bill, suggestions that the largest banks be broken up did not win support. Chief executive officers (CEOs) such as JPMorgan Chase head Jamie Dimon argued that most of the financial firms that collapsed during the crisis were narrowly focused investment banks, insurers, mortgage brokers, or thrifts, and not big integrated conglomerates.[20] Furthermore, regulations on size already exist. Since 1994, federal law prohibits any single bank from growing through acquisition after it controls 10 percent of the country's deposits; Dodd-Frank added a 10 percent asset cap. The Obama administration and Federal Reserve Chair Ben Bernanke have favored giving regulators the ability to seize and unwind firms on the brink of failure through the resolution authority and taking away the incentives to become too big to fail through oversight, higher capital requirements, greater liquidity requirements, and restrictions on interconnectedness.[21]

Nonetheless, the debate persists. Even after passage of the Dodd-Frank bill, Sheila Bair, the former head of the FDIC, Richard Fisher, the president of the Federal Reserve Bank of Dallas, and others argue that the best way to eliminate the too big to fail problem is to break up the largest firms. For Fisher, regulators are not the solution; smaller, less complex banks are. Banks that are too big to fail inhibit the mechanisms through which monetary policy influences the economy.[22] Their complexity prevents creditors and shareholders from exerting market discipline, as well as prevents bank supervisors from exerting discipline when the institutions lack appropriate internal management discipline.

The Consumer Financial Protection Bureau

Following in the tradition of creating agencies in response to financial crises that embody the political philosophy of the time, the CFPB that

[19] From the right, see Alan Meltzer, "End Too-Big-to-Fail," *International Economy*, Winter 2009, 49, http://www.international-economy.com/TIE_W09_Meltzer.pdf (accessed April 12, 2012). From the left, see Johnson and Kwak, *13 Bankers*.

[20] Harper, "Out of Lehman's Ashes."

[21] Donna Borak, "Bernanke Rejects Call to Break Up Big Banks," *American Banker*, April 26, 2012, http://www.americanbanker.com/ (accessed April 30, 2012). See also Barbara A. Rehm, "Breaking Up Big Banks Won't Work, Any Way You Slice It," *American Banker*, April 26, 2012, http://www.americanbanker.com/ (accessed April 30, 2012).

[22] Richard W. Fisher and Harvey Rosenblum, "The Blob That Ate Monetary Policy," *Wall Street Journal*, September 27, 2009, http://online.wsj.com/article/SB10001424052748704471504574438650557408142.html (accessed May 1, 2012). Richard W. Fisher and Harvey Rosenblum, "How Huge Banks Threaten the Economy," *Wall Street Journal*, April 4, 2012, http://online.wsj.com/article/SB10001424052702303816504577312110821340648.html (accessed May 1, 2012).

the Dodd-Frank bill established connects the individual to the system in a new way, seeking to mitigate the abusive lending practices on individuals. A part of the Federal Reserve, but distinct from it, the agency holds the potential to dramatically reshape the way individuals interact with banks and financial services firms. The other areas of the law, such as the financial stability panel, more transparent derivatives markets, limits on bank risk taking, and the ability to liquidate them, are mostly understandable only to industry insiders. The verdict on their design will only come when there is another crisis. The consumer bureau is different, however, because it takes on a role that the government was doing poorly across agencies and seeks to consolidate it so that it can do it better.

The first question posed by the agency was who would run it. The significance of the first head of the bureau was not lost on the relevant interest groups. Organizations tend to follow what political scientists term "path dependence," or the idea that once an agency goes down one path with respect to handle a problem, later developments tend to follow the initial course chosen. Consumer groups lobbied heavily for the individual who had the idea for the bureau in the first place – Harvard law professor Elizabeth Warren. Warren has a track record in fighting large banks as far back as the 1994 Congressional National Bankruptcy Review Commission, for whom she was the principal staff member and where she was considered to be a tenacious fighter on behalf of consumers' rights in the area of credit. Hence, her appointment to head the CFPB was opposed by banks that sought an agency head more receptive to their interests. In September 2010, President Obama appointed her as the Assistant to the President and Special Adviser to the Secretary of the Treasury on the CFPB, rather than agency head, to avoid an unpleasant Senate confirmation process.

When Republicans took control of the House in 2011, the new Chair of the House Committee on Financial Services, Spencer Bachus (R-AL), introduced a bill to establish a five-member board of directors for the agency in place of a single director, along the lines of the Federal Reserve, Federal Trade Commission, and FDIC. The change in structure of the bureau was a part of a broader attack on the agency as it began operations, by subjecting it to the annual appropriations process and altering the authority of other regulators over which regulations the bureau will issue. In a May 2, 2011 letter to President Obama, forty-four Republican senators stated that they would not support the consideration of any nominee to head the bureau until it was restructured.[23] Eventually, Obama selected former Ohio Attorney General Richard Cordray, who had been one of the nation's leading

[23] See Edward Wyatt and Ben Protess, "Foes Revise Plan to Curb New Agency," *New York Times*, May 5, 2011, http://www.nytimes.com/2011/05/06/business/06consumer.html (accessed November 14, 2011).

prosecutors of the financial industry, as the CFPB's first head. However, on September 6, when Cordray appeared before the Senate Banking Committee for his confirmation hearing, the Republican senators affirmed their pledge to block any nomination until their demands were met.[24]

The resolution to this quandary involves the political and most of the regulatory system. President Obama bypassed the congressional blocking action and installed Cordray as the director through a recess appointment. Politically, the action allowed Obama to appear willing to confront Congress on an issue of principle and appeal to the base of the Democratic Party that had been pushing him to do so on this issue. Poll results suggested that the public agreed with the Democrats. However, the action carries longer-term legal risks for the new bureau that may take years to resolve through the court system. The legality of the appointment is at issue, and thus the authority of the bureau to regulate nonbank authorities under the terms of the Dodd-Frank bill. Any such lenders that are sued by the bureau might countersue that the CFPB lacks the authority to regulate them. Thus, although Obama's action got the bureau off of the ground, it may be mired in lawsuits at a later date that will curtail its activities. Moreover, the Cordray appointment could delay the nominations of Martin Gruenberg to chair the FDIC and Thomas Curry to become Comptroller of the Currency, which were also held up by Senate Republicans in December, 2011.[25] Because the new head of the CFPB takes over the seat that the head of the Office of Thrift Supervision formerly held on the board of the FDIC, the appointment's legality could also affect enforcement actions from the FDIC. Any bank facing enforcement action could claim that the FDIC board's decision should not have been made with Cordray's participation.[26]

In sum, many of the Dodd-Frank provisions for re-regulating the financial services industry have been delayed in the years after its passage, as the statute is implemented through the rulemaking process. Of the forty-one actions that should have been taken by June 6, 2011, twenty-eight deadlines were missed and twenty-four requirements completed.[27] Observers

[24] See Suazanna Andrews, "The Woman Who Knew Too Much," *Vanity Fair*, November 2011, 231.

[25] See Kevin Wack, "How Politics Shaped Obama's CFPB Decision," *American Banker*, January 5, 2012; Kate Davidson, "Will Cordray Recess Appointment Cloud CFPB's Future?" *American Banker*, January 5, 2012; Rob Blackwell, "Why Obama Shouldn't Recess Appoint Cordray," *American Banker*, January 5, 2012. All articles are available at http://www.americanbanker.com/.

[26] See Joe Adler, "CFPB Chief Cordray Will Have a Big Voice at FDIC," *American Banker*, January 13, 2012, http://www.americanbanker.com/.

[27] See Louise Story, "Resistance Bogs Down Financial Overhaul," *New York Times*, June 6, 2011, B1. Article computes deadlines and requirements that do not add up to the total of forty-one.

argued that the resistance has been a stall tactic on the part of industry to prevent action until the next election. By swamping regulators with public comments, the agencies need more funds and personnel to meet demands. The result may be smarter outcomes as more groups participate; however, it may also be a serious setback for efforts to close loopholes.[28]

GRASSROOTS MOBILIZATION FOR CHANGE

The previous sections considered the implementation of the Dodd-Frank bill to reveal the direction of the path ahead in financial politics. Much of that discussion demonstrated how interest group activity has been concentrated on behalf of the financial services industry. However, this book has argued that the course of the path is not always constant. Change is a prominent feature of the system. The resentment over the bank and auto bailouts combined with anger over President Obama's economic stimulus package prompted groups in the conservative wing of the Republican Party to begin to rally around the "Tea Party" symbolism in early 2009.[29] In September 2011, left-leaning grassroots movements in New York and other cities began to use new forms of social media to protest the lopsided arrangements that favor certain segments of the corporate and banking sectors while disregarding the effects of some practices on the majority of the U.S. population, labeled the "99 percent." Although both groups would like to "Take Back America," one analyst commented that the two groups would disagree about *which* America needs to be taken back, and *from whom* (emphasis added).[30] In April 2011, a group of European consumer groups, retail investor associations, housing associations, trade unions, foundations, think tanks, and nongovernmental and other organizations established "Finance Watch" as a self-described citizens' counterweight to the private interest lobbying of the financial industry.

Lacking the specific policy proposals that characterize most interest group activity, what came to be termed the "Occupy" movement nonetheless forced many issues back onto the agenda that had not received a great deal of attention since the collapse in 2008. The initial Occupy Wall Street protest occurred on September 17, 2011, when a group of individuals with no single leader or policy platform began to camp in New York's Liberty, or Zuccotti, Park to fight the overwhelming power of banks and multinational corporations over the political process. Although the initial

[28] Story, "Resistance Bogs Down Financial Overhaul."

[29] Theda Skocpol and Vanessa Williamson, *The Tea Party and the Remaking of Republican Conservatism* (New York: Oxford University Press, 2012), 6.

[30] See Frank Rich, "The Class War Has Begun," *New York Magazine*, October 31, 2011, 24.

organizers had hoped that 90,000 people would turn out when the protest began, only a few hundred actually showed up. They were largely ignored by the mainstream media for the first three weeks. However, a series of confrontations with the police captured with primitive video and posted to the website YouTube pushed the events onto the national stage. The movement received a boost in October when some labor unions joined the cause and the initial protestors continued to camp in the open air.[31] Additional media attention followed.

When the first series of polls on the issue were conducted, the results revealed that the American public held a certain amount of support for the protestors. For example, one poll conducted in collaboration with NBC news found that 37 percent of Americans supported the protestors, 25 percent had no opinion, and only 18 percent opposed them. Other polls suggested an even greater degree of support. *Time* and Reuters found support as high as 54 percent.[32] Politicians such as Barack Obama and Federal Reserve Chairman Ben Bernanke later stated that they also shared some frustrations expressed by the protestors, albeit Bernanke pointed to some of the protestors' misconceptions about the Federal Reserve.[33]

Although the movement is a relatively recent phenomenon, many of the ideas offered in the occupation sites have a long tradition in American political thought. For example, Occupy Wall Street literature distributed in Cleveland, Ohio, questions the notion of corporations as persons, because a corporation cannot be imprisoned, drafted, and cannot die.[34] One statement argues, "Rights are for people: A Constitutional Amendment ending corporate personhood is our one demand."[35] Other groups call for an end to the Federal Reserve.[36] Whereas these demands may be difficult to achieve, the earliest Jacksonian debates over the Bank of the United States questioned the granting of a corporate charter to banks.[37]

Although the connection of the Occupy Wall Street movement to the political system is uncertain in 2012, it has played an important role in

[31] Ibid., 22.

[32] Polling statistics cited in ibid.

[33] See, for example, "Bernanke to Occupy Wall Street: 'I Get It,'" *Los Angeles Times*, November 2, 2011, http://latimesblogs.latimes.com/money_co/2011/11/occupy-wall-street-fed-bernanke-economy-inequality-1-99.html?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+LaLand+(L.A.+Land) (accessed on November 7, 2011).

[34] "Simple Truths from the 99%," unpublished literature distributed at Occupy Wall Street, Cleveland, OH, October 2011.

[35] Ibid.

[36] "End the Fed," unpublished literature distributed at Liberty Park, New York, NY, October 28, 2011.

[37] See Chapter 2, and Hoffman, *Politics and Banking*, 62.

the policy process insofar as the sustained media attention it generates has placed a discussion of the winners and losers in financial politics squarely back into national political discussions. Since the initial protests, the movement has expanded into new activities, such as the efforts of the New York General Assembly's "Occupy the SEC" to submit comments to the rulemaking process on the Volcker Rule.[38] This book has argued that the time frame of financial politics makes the issue area particularly difficult to resolve. Group mobilization generally corresponds to legislation and outcomes that are immediate, whereas the effects of fiscal and monetary policy, as well as lax regulation, occur in the medium to long term. On one hand, an occupation of the public space with sustained media attention to the issues it spotlights addressed the issue of time frame and gave voice to a large number of citizens' frustration with current arrangements. On the other hand, the occupations proved to be an ill-advised national tactic, given the weather in the industrial Northeast and local police action in many parts of the country that ended them. Either way, the efforts of the Occupy Wall Street protestors and their allies across American cities have demonstrated that the political story is far from over.

CONCLUSION

This book has shown that three features of the U.S. financial system and the country's related political culture have directed the flow of financial politics through various stages of the business cycle, and ultimately during a crisis: the fragmented structure of the banking system across state and federal lines, the preference for regulation and not ownership of banks, and the quasi-independent status of the Federal Reserve System. Because interest groups work differently at different points in this structure, no one part of the federal government is able to control any of the three domains of financial policy exclusively. Given their different constituencies and time frames involved, the branches of government frequently lack the necessary incentives to cooperate even when the same political party controls the presidency and legislature.

Therefore, organized groups, lobbyists, and their campaign contributions all matter in the political process surrounding finance. However, under different circumstances, different groups hold a clear advantage. Media attention to an issue can change this dynamic by shining light on priorities that help or hurt consumers, borrowers, businesses, and banks. The attention can serve as a catalyst for reform because it allows more

[38] Occupy the SEC comment letter available at http://www.occupythesec.org/ (accessed March 8, 2012).

groups to understand their interests and see a reason to get involved in a particular contest. In the absence of media attention, groups wanting to keep the status quo have the upper hand because they understand their interests and they devote resources within the political system to maintaining them. CEOs in an industry such as financial services have access to government officials at the highest levels and gain advantage in a crisis where they control the resources in the private sector necessary to resolve it. In addition, groups with widely dispersed geographical constituencies have an advantage in Congress because they can approach the greatest number of members. Groups with access to the financial resources necessary to generate data and follow the rulemaking process hold an advantage in the agencies because the rulemaking process has a higher threshold of expertise to enter. It is relatively easy to make an appointment with the staff of a member of Congress and present one's views. It is more difficult to comment and provide data to an agency during the formal rulemaking process without knowledge of the procedure, albeit the Internet has broadened access in recent years.

Looking to the future, the complexity of U.S. financial markets is matched only by the complexity of the bureaucratic agencies that surround them. Whereas industry and consumer groups have their own interests, so too do the organizational structures that compete within the federal government for budgets and mandates. At no time is this more apparent than in a crisis when the possibility of restructuring the bureaucracy exists, or when new jobs are created for agencies and older jobs become obsolete. At these times, the heads of agencies work together with relevant interest groups to create compromise solutions. Once interests have been identified and organized groups take them on, one side's victory is rarely complete. The international system adds layers of additional opportunities for regulatory arbitrage to occur outside the U.S. system, wherein policymakers face an ongoing struggle to provide an environment for the safe and transparent operation of financial intermediaries. They will be forced to constantly reform the system within the constraints set by previous arrangements.

Glossary

agency capture. The inordinate influence and control over federal agencies by the industries they are meant to regulate. It results from the "revolving door" between industry and government wherein elected officials and employees move between positions in industry and agencies in order to improve skills and prospects for greater pay.

agency debt. Bonds issued by government agencies such as Fannie Mae or Freddie Mac.

Alt-A borrowers. Individuals whose credit profile situates them between "prime" and "subprime" borrowers. Alt-A loans tend to be the loan of choice for non–owner-occupied investment properties. Because individuals are more likely to walk away from payments on a property they do not live in, these loans also tend to have higher default rates.

asset-backed commercial paper (ABCP). Security issued by a special purpose vehicle (SPV) and secured by a pool of high-quality assets such as credit card receivables, auto loans, and trade receivables. The repayment relies on the cash collections from the underlying asset portfolio and the SPV's ability to continue to sell CP when it matures.

bank examiner. A government official who inspects a depository institution to ensure compliance with regulations and generally focuses on one aspect of banking operations. *See also* bank supervisor.

Bank for International Settlements (BIS). An arrangement among central bankers organized in the interwar period to facilitate repayment of German reparations. It has evolved into a forum to coordinate banking regulations across states.

bank supervisor. A government official who follows the portfolio of a given bank on an ongoing basis to ensure compliance with regulations and is generally a level above the bank examiner.

Basel Committee on Banking Supervision (Basel Committee). Located at the Bank for International Settlements, the Basel Committee was organized to provide a forum for regular cooperation on banking supervisory practices in different countries.

Bretton Woods Institutions. Three international organizations envisioned by postwar economic planners when meeting in Bretton Woods, New Hampshire: a stabilization fund, an international bank, and a trade organization that would restore order to the world economy. The bank and the fund became the contemporary International Monetary Fund (IMF) and World Bank. The "Bretton Woods system" is said to have collapsed in 1971, when the United States suspended the convertibility of gold and thus ended the fixed exchange rate system that was associated with the early IMF.

bureaucratic politics. Term used by political scientists to refer to the political considerations within and among agencies of the federal government. Studies of bureaucratic politics stress the motivation of agency leaders to promote their own agency's interests in making decisions, chiefly budget and personnel maximization as well as to protect its governing authority.

business cycle. The rise and fall in how much the economy is producing, measured by changes in the gross domestic product (GDP).

capital adequacy. Percentage of a financial institution's capital held against its assets (i.e., its loans and investments). The more capital an institution holds, the greater its perceived strength and stability. However, capital held does not generate profits.

central bank independence. The ability of the central bank to set monetary policy free from political interference and to which its actions can, or cannot, be reversed by other parts of the government.

certificate of deposit (CD). A financial product offered by depository institutions and guaranteed by the FDIC or NCUA for a specified period of time. These products generally offer a higher rate of interest than an ordinary demand deposit account and require a higher amount to establish.

Chicago School of economic thought. Neoclassical approach to economic theory popularized by the economics department at the University of Chicago. Its adherents generally advocate for policies with a minimum of government intervention in markets except for strict governmental control of the money supply.

collateralized debt obligation (CDO). A type of security often composed of the riskier portions of mortgage-backed securities.

collateralized mortgage obligations (CMOs). Financial instruments created to make mortgages more attractive to long-term investors by placing them in a trust and slicing them into segments with different bonds for each. The top tier has first claim on all cash flows and the highest credit rating, the mezzanine tier sells at a higher yield, and the third is the first to absorb losses, pays the highest yields, and has the riskiest credit rating.

commercial paper (CP). A promissory note issued by a bank or corporation for a specific dollar amount and short maturity date, usually 30 days, used to pay for seasonal and working capital needs, and short-term debt obligations. Corporate CP is typically unsecured, whereas asset-backed CP is secured by underlying assets.

Commodity Futures Trading Commission (CFTC). Independent agency created by Congress in 1974 to regulate commodity futures and option markets. Dodd-Frank mandated the CFTC to write rules to regulate the swaps marketplace.

Community Reinvestment Act (CRA). Law passed in 1977 that encouraged lending and extension of financial services in some communities that were underserved.

Comptroller of the Currency. *See* Office of the Comptroller of the Currency.

conduit. A financial vehicle set up and run by a bank for a fee. It allows investors to take advantage of the difference between short-term and long-term interest rates by buying longer-term assets that pay a higher rate of interest with money borrowed in the shorter-term commercial paper market at a lower rate.

Congressional Budget Office (CBO). Nonpartisan agency that provides economic data to Congress in order to aid in economic and budgetary decisions on programs covered by the federal budget and in the information and estimates required by the congressional budget process.

Council of Economic Advisers (CEA). Created by the Employment Act of 1946 and placed within the Executive Office of the President to advise the president on economic matters.

credit default swap (CDS). An agreement arranged for a fee by broker-dealer banks wherein a counterparty promises to make good on losses in the event of a default, much like insurance.

credit union. Nonprofit, cooperative financial institution that is owned and run by its members who pool their funds and make loans to each other at reasonable rates. Members also select the volunteer board that runs each credit union.

defined benefit pension plan. Increasingly rare type of retirement plan where the employer commits to providing an employee specific benefits beginning with retirement and for the rest of his or her life. The amount of the benefit is specified in advance and generally depends on factors such as age, earnings, and the number of years the employee worked for the firm.

defined contribution pension plan. Increasingly common type of retirement plan where the amount of the employer's annual contribution to an individual account is specified. Benefits are then determined based on the amount credited to the account, any investment earnings, and any additional employee contributions. Because earnings fluctuate, benefits cannot be determined in advance.

deflation. Falling prices. Policymakers fight deflation because if consumers anticipate that something will cost less tomorrow, they tend to pull out of market activity and contribute to a downward spiral of prices and decrease in demand.

depression. A deep and long-term economic contraction. For some economists, a depression is a recession lasting two or more years.

derivative. A financial instrument whose price depends on (or is derived from) other underlying asset values, such as stocks, bonds, currency prices, or indexes of prices.

Dodd-Frank Wall Street Reform and Consumer Protection Act. Legislation passed in response to the financial crisis of 2008. The Dodd-Frank Act changed the financial regulatory structure and created new agencies in an effort to streamline the process, among them the Financial Stability Oversight Council, the Office of Financial Research, and the Consumer Financial Protection Bureau.

dual banking system. The parallel set of state and federal banking systems that allows a diverse set of financial institutions the freedom to choose their regulator.

Emergency Economic Stabilization Act of 2008. Created the Troubled Asset Relief Program. Members' votes on this piece of legislation have become controversial because they can be viewed as support for government bailouts.

equity security. Financial instrument signifying a share of ownership of a corporation, or stock. Owners have a claim on the firm's assets and profits. Most equity securities also assign some voting rights in governance matters.

eurodollar. Deposits and loans that are denominated in dollars but managed by banks outside the territorial United States. The term eurodollar or eurocurrency accounts can also be used to refer to any account or loan denominated in the currency of one country but held in another.

European Central Bank (ECB). The central bank for Europe's single currency – the euro. The ECB maintains the euro's purchasing power and price stability in the seventeen European Union countries that have introduced it since 1999.

eurozone. An economic and monetary union among the seventeen European Union members that have introduced the euro as their currency and sole legal tender.

Executive Office of the President (EOP). Office created in 1939 to oversee the New Deal programs. It gives the president a staff that can help to direct the offices of the executive branch.

Fannie Mae. *See* Federal National Mortgage Association.

Federal Deposit Insurance Corporation (FDIC). An independent regulatory agency that was established during the New Deal to regulate banks and provide deposit insurance.

Federal Home Loan Banks. Twelve regional cooperative banks that serve as a source for lending institutions to finance housing and economic development in local communities.

Federal Home Loan Mortgage Corporation (Freddie Mac). Government-sponsored enterprise created in 1970 to assure that funds flow to mortgage lenders in support of home ownership and rental housing.

Federal National Mortgage Association (Fannie Mae). Government-sponsored enterprise created in 1938 as part of New Deal legislation to ensure a reliable supply of home mortgages throughout the country.

Federal Open Market Committee (FOMC). The monetary policymaking body of the Federal Reserve system, composed of twelve members. Seven are the members of the Board of Governors, and five are from the twelve Reserve Bank presidents. Only the president of the Federal Reserve Bank of New York is a permanent member and Vice Chair of the Committee. Whereas all Reserve Bank presidents attend FOMC meetings, the five voting committee members rotate among them.

Federal Reserve System. The central bank of the United States. The Federal Reserve provides the country with a stable money supply and acts as a regulator and supervisor of some financial institutions. It also provides financial services to depository institutions, the U.S. government, and foreign government institutions, including playing a major role in operating the American payments system.

FICO score. Individual credit score that most lenders use to determine risk. The FICO score is calculated from data in a credit report, such as payment history, amounts owed, length of credit history, new credit, and types of credit used.

financial intermediaries. Go-between for borrowers and lenders such as banks or thrifts.

financial policy. What the government does in the issue area of money, credit, and banking, including government spending to support financial institutions, as well as its taxing of them. Financial policy can be considered to operate in three fields, or domains, including macroeconomic management through monetary and fiscal policy to promote price stability and full employment, as well as regulatory policy in the banking, securities, and insurance industries.

Financial Services Modernization Act. *See* Gramm-Leach-Bliley Act.

fiscal policy. Activities of the government in taxing and spending in order to manage demand. With an expansive fiscal policy, the government enters the market as a purchaser and thus raises demand. With a restrictive fiscal policy, the government spends less and lowers demand overall, thus lowering national economic output.

fixed income security. A financial instrument that pays a specific interest rate, such as a bond or money market instrument. The principal is the amount the lender lends, which must be repaid. The coupon is the amount of interest that must be paid. The maturity date specifies when the principal must be returned.

Freddie Mac. *See* Federal Home Loan Mortgage Corporation.

Full Employment and Balanced Growth Act of 1978. Legislation also referred to as Humphrey-Hawkins passed in 1978 that mandates the Board of Governors of the Federal Reserve to establish a monetary policy that maintains long-run growth, minimizes inflation, and promotes price stability. In addition, the Federal Reserve must report on these activities to Congress twice a year.

Glass-Steagall Act. Passed as a set of provisions in the Banking Act of 1933 that separated commercial banking from investment banking and created a Federal Deposit Insurance Corporation (FDIC) to insure bank deposits.

gold standard. International monetary arrangement where the standard unit is a fixed amount of gold.

Government National Mortgage Association (Ginnie Mae). Government-owned corporation created in 1968 that works with issuers and investors in mortgage-backed securities (MBS) to guarantee the payment of principal and interest on MBS backed by federally insured or guaranteed loans.

government-sponsored enterprise (GSE). Instrumentalities of the government created with immunity from taxation but cannot change their own charters or conduct activities contrary to their intent. Two of the most prominent are Fannie Mae and Freddie Mac.

Gramm-Leach-Bliley Act. Legislation also called the Financial Services Modernization Act passed in 1999 that repealed Glass-Steagall, thus allowing for a greater integration of commercial banking and investment banking operations within the same financial institution. The legislation also clarified requirements of banks under the Community Reinvestment Act.

greenbacks. Paper currency issued by the United States during the Civil War to meet military and other expenses.

Group of 7 (G7) or Group of 8 (G8). Informal group of heads of governments from the seven (and later eight with the addition of Russia) industrial countries that began to meet in response to the economic conditions of the 1970s.

Group of 20 (G20). Informal group of finance ministers and central bank governors created to bring together the systemically important industrialized and developing economies to discuss key issues in the global economy. Its first meeting took place in Berlin, December 15–16, 1999.

Humphrey-Hawkins. *See* Full Employment and Balanced Growth Act.

inflation. Rising prices. Policymakers fight inflation because it lowers the future value of money.

International Bank for Reconstruction and Development (IBRD). International organization created at the Bretton Woods conference that extends long-term loans to developing countries to finance the creation of the infrastructure necessary for poverty reduction and development. As other agencies were added on, the IBRD became part of the World Bank Group.

International Monetary Fund (IMF). Stabilization fund created at the Bretton Woods conference that was to eliminate balance of payments deficits to maintain stable exchange rates. In 1973, the world officially adopted a system of floating exchange rates, and the IMF has worked on issues related to the management of debt and balance of payments crises.

iron triangle. Term used by political scientists to describe the policymaking relationship among the executive agency, congressional committees, and interest groups related to a specific issue. In recent years, it has been broadened to include influential media, researchers, and other actors to encompass a policy subsystem or issue network.

Joint Economic Committee (JEC). Committee created by the 1946 Employment Act to consider the report presented by the President's Council of Economic Advisers, hold hearings on it, and commission studies on economic policy.

Keynesianism. An approach to macroeconomic management first articulated by John Maynard Keynes that prioritizes demand management by a government to obtain full employment.

liquidity. The ability to convert an asset quickly into cash.

macroeconomic policy. The government's use of monetary and fiscal policies to influence economic activity, including the rate of growth, rate of inflation, and level of unemployment.

mark to market accounting. This accounting method was introduced in 1993 after the savings and loan crisis. Assets are marked on the balance sheet to the value that they would have if they were to be sold on the marketplace. The practice poses some unique problems in a crisis because assets not traded regularly do not have an easily available market price, making them nearly impossible to value in the moment.

monetarism. An approach to macroeconomic management that prioritizes manipulation of the money supply by the central bank to keep prices stable as the economy grows.

monetary policy. Activities of the central bank in controlling the money supply, undertaken in an attempt to control inflation. With an expansionary monetary policy, the money supply grows, and most likely the rate of inflation along with it. With a restrictive monetary policy, the money supply contracts. In theory, inflation falls and unemployment rises.

money multiplier. Process wherein a percentage of money on deposit is re-lent. As the portion is lent and re-lent, it grows. Thus the money supply expands despite the fact that no new paper money is actually printed.

moral hazard. The notion that economic actors engage in activities they would not otherwise do, except for the belief that the government will bail them out. With respect to banks, moral hazard refers to the problem of increasingly risky lending that pays a high return when loans are repaid but are covered by society if they are not. Thus government bailouts can give banks the incentive to make risky loans, raising the likelihood that a crisis will occur.

mortgage-backed securities (MBS). Debt instruments secured by a pool of mortgages, either residential or commercial. They are commonly referred to as "pass-through" certificates because the principal and interest of the underlying loans is passed through to investors in the secondary market.

National Credit Union Administration (NCUA). An independent federal agency that charters and supervises national credit unions and insures savings in federal and most state-chartered credit unions.

off–balance sheet vehicles. Form of funding used in risk management that avoids putting the owners' equity, liabilities, or assets on the balance sheet of a firm. Rather, they perform a very specific purpose and are usually put on another entity's balance sheet by forming a special purpose vehicle.

Office of Management and Budget (OMB). White House office responsible for devising and submitting the president's budget to Congress each year.

Office of the Comptroller of the Currency (OCC). An independent bureau of the Treasury Department established to charter, regulate, and supervise national banks. The OCC also supervises federal savings associations and the federal branches and agencies of foreign banks. It receives funds to conduct these operations from fees it charges the entities it regulates and from earnings on its investment income, primarily Treasury securities.

Office of Thrift Supervision (OTS). Supervisor of thrifts and their holding companies. Its functions were transferred to the OCC by provisions in the Dodd-Frank reform bill.

originate to distribute model. Process used by banks to originate loans with the intent of passing them on to other investors through securitization markets. In older patterns, banks "originate to hold," or originate a loan and hold it on the bank's books until it matures. The originate to distribute model is perceived to add to systemic risk because it allows the financial institution to pass the risk on to an external investor rather than holding it.

Pecora Commission. A 1932 congressional inquiry formed to investigate the causes of the Great Depression.

policy. The output of government institutions.

policy subsystem. A network within a bureaucracy that controls policy with respect to a given area, characterized by limited interference and deference to the judgment of experts. The benefits of a subsystem seem to accrue to the same group of elites with little change over time despite the involvement of many groups.

political business cycle. The suspicion that politicians manipulate the business cycle to coincide with electoral benefits. According to this thinking, politicians are reelected when the economy is booming and forced out in a recession.

prudential regulation. The regulation of depository institutions through supervision of their conduct to limit risk taking. Unlike the regulation of other corporate entities where prosecution occurs after a violation has been alleged, banks and other deposit-taking institutions receive government insurance and are required to keep the financial system stable. Therefore, they are subject to periodic inspections and other activities to minimize the likelihood that they will deviate from accepted practices.

quantitative easing. Monetary policy used to increase the money supply. The Federal Reserve buys government or other securities, effectively releasing money into the system through them, in an effort to promote lending and liquidity. It is generally used when the interest rate is already near zero percent; thus, lowering the interest rate is not a policy option.

recession. For some economists, a recession is an economic contraction, or period between a peak and a trough of economic activity. For others, a recession is two successive quarters of falling GDP.

redlining. The practice of denying or putting a higher price on the cost of banking to residents in certain neighborhoods, often determined by race. The "red line" referred to former practices of marking of certain areas on a map.

regulatory policy. Activities of the government in issuing rules or orders that have the force of law to govern conduct.

reserve currency. Currency held by governments as part of their foreign exchange reserves.

rider. As a matter of legislative procedure, a measure attached to an otherwise unrelated bill. A rider may be used to pass controversial provisions that might not pass on their own, or that may be added to prevent the bill from being passed altogether.

savings and loan (S&L). Savings and loans appeared at a time when banking was still relatively limited in U.S. history. They are financial institutions that specialized in mortgage lending and were given more lenient treatment by federal regulations for much of the twentieth century insofar as they could pay a higher rate of interest on deposits than regular commercial banks could. They could not, however, offer checking accounts until deregulation occurred.

securitization. The practice of pooling debt or receivables such as mortgages, credit card or telecommunications receivables, and then selling the pools as bonds, pass-through securities, or collateralized debt obligations to various investors.

seignorage. An economic term referring to the difference that accrues between the cost of printing bank notes and coins, and their face value. The U.S. government benefits from international seignorage as its notes circulate internationally.

shadow banking system. The activities of financial intermediaries in creating credit outside the regulated system through entities such as finance companies, asset-backed commercial paper conduits, limited-purpose finance companies, structured investment vehicles, credit hedge funds, money market mutual funds, securities lenders, and government-sponsored enterprises. Prior to the financial crisis of 2008, they operated without access to central bank liquidity or public sector credit guarantees.

sovereign debt. Debt issued by a national government.

special purpose vehicle (SPV). A bankruptcy remote entity such as an asset-backed security, structured investment vehicle, or conduit created for a specific, or special, purpose.

specie. Coin or metallic money. Money backed by specie is paper money whose value is based on the mineral tied to it. Although the paper holds no value, it represents the mineral (generally gold or silver) in reserve. In theory, the holder could exchange the bill for the metal that it represents.

state capacity. Political science term used to describe the ability of the government to control territory through the construction of specialized institutions for economic and societal purposes.

Strategic Economic Dialogue (SED). Framework initiated in 2006 between President George W. Bush and Chinese president Hu Jintao to discuss the common economic interests of the United States and China.

structured investment vehicle (SIV). A special purpose vehicle that borrows cash from a third-party investor by issuing asset-backed commercial paper and medium-term notes and then buys mortgage-backed securities, collateralized debt obligations, and other long-term institutional debt. Because they are off–balance sheet, they have been used to boost returns without being required to set aside additional cash in case of losses. They do not depend entirely on banks to provide backup credit in times of stress as conduits do. Instead, they "mark to market" or place a value on their investments on a regular basis, meet performance tests, and sell portfolio assets to pay back investors when trouble hits.

subprime borrower. Subprime borrowers are those individuals with poor credit histories, generally defined as those with a FICO score below 620, who pay a higher rate of interest to compensate for their higher risk of default.

swaps. Derivative financial instruments that enable counterparties to exchange specific benefits of one party's financial instrument for the other's, such as streams of cash flow or interest payments.

synthetic CDO. A security that represents the bets an investor makes on the performance of a real mortgage security. Synthetic CDOs are said to have amplified the losses in the financial sector during the 2008 financial crisis because they raised the risk of one security across the system.

thrift. *See* savings and loan.

Treasury–Federal Reserve Accord. Agreement reached in 1951 that eliminated the obligation of the Federal Reserve to monetize Treasury debt at a fixed rate. The Accord had the effect of giving the Federal Reserve greater control in setting monetary policy.

Troubled Asset Relief Program (TARP). Program created by the Emergency Economic Stabilization Act of 2008 as one component of the government's effort to address the subprime mortgage crisis. Initially, TARP would buy toxic assets from financial institutions and thus remove them from their balance sheets. Problems with pricing these assets resulted in the Treasury Department using the funds to recapitalize banks and other firms instead.

Value at Risk (VaR) tools. Sophisticated mathematical models used by firms to manage risk. The benefit is that VaR can express risk as a single number, across asset classes, and in dollars over a short period in a typical market.

Volcker Rule. A piece of the Dodd-Frank reform legislation named after former Federal Reserve Chair Paul Volcker that seeks to limit the proprietary trading activities of banks in the spirit of the former Glass-Steagall separation of the activities of commercial and investment banks. Commercial banks are prohibited from engaging in proprietary trading that is not on behalf of their clients and from owning or investing in a hedge fund or private equity fund. The Volcker Rule also limits the liabilities that the largest banks can hold.

World Bank. *See* International Bank for Reconstruction and Development.

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