
THE POLITICS OF FINANCIAL REGULATION AND
THE REGULATION OF FINANCIAL POLITICS:
A REVIEW ESSAY

Reviewed by Adam J. Levitin

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THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT. By Anat Admati & Martin Hellwig. Princeton, N.J.: Princeton University Press. 2013. Pp. xv, 398. \$29.95.

BULL BY THE HORNS: FIGHTING TO SAVE MAIN STREET FROM WALL STREET AND WALL STREET FROM ITSELF. By Sheila Bair. New York: Simon & Schuster. 2012. Pp. viii, 415. \$16.00.

BAILOUT: HOW WASHINGTON ABANDONED MAIN STREET WHILE RESCUING WALL STREET. By Neil Barofsky. New York: Free Press. 2012. Pp. xxvi, 272. \$16.00.

THE FEDERAL RESERVE AND THE FINANCIAL CRISIS. By Ben S. Bernanke. Princeton, N.J.: Princeton University Press. 2013. Pp. vii, 134. \$19.95.

AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD. By Alan S. Blinder. New York: Penguin Press. 2013. Pp. xix, 476. \$29.95.

THE PAYOFF: WHY WALL STREET ALWAYS WINS. By Jeff Connaughton. Westport, Conn.: Prospecta Press. 2012. Pp. viii, 277. \$24.95.

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INTRODUCTION

The financial crisis of 2008 was the first truly systemic and acute crisis to occur against the backdrop of the modern regulatory state. The panic of 2008 tested the modern financial regulatory system as it had never been tested before. How did the financial regulatory system fare? Did the regulatory system work before and during the crisis? Is

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the system basically sound, needing only minor reforms? Or does the crisis bespeak a more profound problem in financial regulation?

The answers to these questions have far-reaching implications. In the modern, financially intermediated economy, the regulation of financial markets impacts the economy as a whole. Financial regulation affects the aggregate amount and distribution of wealth in society. Do we trust the institutional structures and processes for ordering the financial marketplace to produce normatively acceptable distributional outcomes? Does the process have sufficient legitimacy to support its distributional effects?

The question of faith in the regulatory system as a means of economic ordering has animated American politics following the financial crisis. Both the Tea Party and Occupy Wall Street movements are sharp repudiations of the financial regulatory system as failing to produce normatively acceptable distributions of wealth in society.

The question of faith in the system also underlies and permeates virtually the entire literature about the financial crisis, as shown by titles such as *In Fed We Trust*¹ and *Regulatory Breakdown: The Crisis of Confidence in U.S. Regulation*.² In the five years since the crisis, a small literature has emerged on its causes, the government response, and potential reforms. Much of this literature has been in the form of journalistic accounts of either the run-up to the crisis or the government response to the crisis, sometimes with concluding policy proposals.³ More recently, we have begun to see academic examinations and insider accounts.⁴ These accounts tend to either lionize bank regulators as the expert heroes who staved off financial Armageddon or criticize them for the political priorities reflected in their decisions before and during the crisis. The former narrative extols regulatory independence, while the latter urges political accountability. These narratives also reflect a difference in priorities regarding banks and the real economy or, in shorthand, Wall Street versus Main Street. For those who see the current banking system as indispensable and inherently fragile, the rescue of the system was a triumph in the face of

¹ DAVID WESSEL, *IN FED WE TRUST* (2009).

² *REGULATORY BREAKDOWN: THE CRISIS OF CONFIDENCE IN U.S. REGULATION* (Cary Coglianese ed., 2012).

³ See, e.g., WILLIAM D. COHAN, *HOUSE OF CARDS* (2009); MICHAEL LEWIS, *THE BIG SHORT* (2010); ROGER LOWENSTEIN, *THE END OF WALL STREET* (2010); LAWRENCE G. MCDONALD WITH PATRICK ROBINSON, *A COLOSSAL FAILURE OF COMMON SENSE* (2009); BETHANY MCLEAN & JOE NOCERA, *ALL THE DEVILS ARE HERE* (2010); GRETCHEN MORGENSEN & JOSHUA ROSNER, *RECKLESS ENDANGERMENT* (2011); ANDREW ROSS SORKIN, *TOO BIG TO FAIL* (2009); WESSEL, *supra* note 1.

⁴ An early insider account is former Treasury Secretary Hank Paulson's memoir of the crisis, HENRY M. PAULSON, JR., *ON THE BRINK* (2010). Paulson's involvement in the crisis as Treasury Secretary ended in January 2009, enabling an early memoir.

potential catastrophe. For those who see the banking system merely as an imperfect means to the end of facilitating the real economy, the rescue of the banking system but not of the real economy (and of the housing market in particular) reflected misplaced distributional priorities enabled by a failure of governance. These narratives of crisis and response are judgments on the modern financial regulatory state. These judgments have important implications for the design of the financial regulatory system going forward in terms of how much discretion and independence financial regulators should have and the institutional framework in which they should operate.

Part I of this Review Essay examines six recent books on the financial crisis. Some of these books are by current or former insiders, while others are by academics. Some are scholarly or wonky, while others are gossipy. None of them tell the full story of the crisis and its aftermath. Yet taken together, they help explain both the regulatory failures that enabled the financial crisis and the shape of the regulatory response to the crisis. As a group, these books provide a *Rashomon*-type story of the financial crisis retold from a variety of perspectives: the Central Banker, the Establishment Economist, the Bank Regulator, the Prosecutor, the Lobbyist, and the Professors. These books also underscore the dueling themes of technocratic independence and democratic accountability, of faith in or rejection of the modern financial regulatory system, and of Wall Street versus Main Street.

Part II of this Review Essay steps back and considers how these dueling principles have played out in the political and regulatory response to the crisis and the lessons that might be learned. In particular, Part II discerns two basic narratives of the crisis in the books reviewed in Part I, each with different implications for regulatory reform. One narrative is that the financial regulatory system had become outmoded and was thus vulnerable to a “perfect storm.” This narrative points to regulatory updating and narrow technocratic fixes to regulation.

The other — and more convincing, if uncomfortable — narrative is a story of regulators failing to prevent the crisis, and even enabling it through deregulation, because they were captured. This capture narrative sees financial regulation as suffering from a core governance problem that has skewed the process of choosing between Wall Street and Main Street. The critique is one of both process and results, with the implicit assumption that better process would produce different results.

Three basic, if potentially conflicting, approaches to addressing capture problems can be discerned from post-crisis regulation: moving toward more democratically responsive and less technocratically independent regulation; restructuring the regulatory agencies to increase technocratic independence and better insulate regulators from politics; and capitalizing on the rent-seeking impulses of interest groups to produce offsetting political pressures on regulators, thereby enabling

space for genuinely neutral, technocratic policymaking. To the extent that we believe that there is a capture problem in financial regulation, reform efforts need to focus on taming politics, not technical regulatory questions. Future research should focus on identifying the most effective approaches to combat capture.

I. FINANCIAL *RASHOMON*

A. *The Central Banker*

Former Federal Reserve Chairman Ben S. Bernanke's *The Federal Reserve and the Financial Crisis* is a short volume based on a set of four lectures Bernanke gave at the George Washington University in March 2012.⁵ Bernanke's lectures cover some background on central banking and the history of the Federal Reserve before turning to an overview of the crisis and then a discussion of the actions the Fed and the Department of the Treasury took in response.

There is much that is odd about Bernanke's book. It was unusual for Bernanke, as a sitting Fed Chairman, to have published this book, which presumably underwent institutional vetting by the Fed. Like all central banks, the Fed is exceptionally careful about its messaging, knowing that its communications affect markets.⁶ Bernanke was undoubtedly constrained in what he could say by virtue of being in office. Not surprisingly, we learn no new facts about the Fed's response to the crisis from Bernanke's lectures. Instead, the book's message is that the Fed learned the lessons of the 1930s and the Great Depression.⁷ The book is actually a defense of the Federal Reserve's actions in the financial crisis. Bernanke is arguing that his Fed got it right where the Depression-era Fed got it wrong. The implication is that but for Bernanke's Fed getting it right, we would have witnessed a repeat of the 1930s . . . or worse.

The shadow of the Great Depression has long hung over the Federal Reserve. A foundational text of modern American monetary economics, Milton Friedman and Anna Schwartz's *A Monetary History of the United States, 1867–1960*, is an extended indictment of the Federal Reserve's monetary policy during the Great Depression. Friedman and Schwartz argued that monetary policy very much mattered for the Depression and that the Fed's failure to pursue an accommodationist monetary policy significantly exacerbated the economic downturn.⁸ This is a serious charge to throw at a central bank.

⁵ BEN S. BERNANKE, *THE FEDERAL RESERVE AND THE FINANCIAL CRISIS* (2013).

⁶ See, e.g., DOUGLAS R. HOLMES, *ECONOMY OF WORDS* (2014).

⁷ See BERNANKE, *supra* note 5, at 21–23, 74 (detailing the Fed's errors during the Depression).

⁸ See MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, *A MONETARY HISTORY OF THE UNITED STATES, 1867–1960*, at 10–11, 391–491, 511–33, 698–99 (1963).

Ben Bernanke got the message. Few monetary economists' careers were as directly shaped by Friedman and Schwartz as Ben Bernanke's. When Bernanke was a graduate student, Friedman and Schwartz's book was what "hooked" him on monetary economics and economic history and inspired his own illustrious academic career,⁹ which has included the careful study of the economic history of the Great Depression.¹⁰ Indeed, one of Bernanke's best-known articles is "complementary to that of Friedman and Schwartz."¹¹ In 2002, when Bernanke was a Fed Governor (but not yet Chairman), he famously owned up to the Fed's role in the Great Depression in a speech at a conference celebrating Friedman's ninetieth birthday:

Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again.¹²

In *The Federal Reserve and the Financial Crisis*, Bernanke is proclaiming the Fed redeemed. The ghosts of central bankers past have been laid to rest. The book is Bernanke's brief for having been a careful student of Friedman and Schwartz, as well as of the father of central banking, Englishman Walter Bagehot.

Bernanke argues that the Federal Reserve responded to the financial crisis in 2008 by following the implied Friedman and Schwartz playbook of accommodative monetary policy.¹³ The Fed engaged in an extremely accommodative monetary policy to hold down the interest rates on government securities and thereby encourage investment in higher-yielding private securities. Bernanke's Fed effected this policy not just through the traditional method of extensive purchases of short-term Treasury securities, which brings down short-term interest rates, but also through purchases of more than \$2 trillion of long-term Treasury and Agency bonds so as to lower long-term interest rates in a process known as Quantitative Easing or Large-Scale Asset Support.¹⁴

While Bernanke underscores that the Fed learned the lessons of the 1930s, he notes that the Fed had to exercise both its lender-of-last-

⁹ See Ben S. Bernanke, Governor, Fed. Reserve Bd., Remarks at the Conference to Honor Milton Friedman, University of Chicago, Chicago, Illinois: On Milton Friedman's Ninetieth Birthday (Nov. 8, 2002), archived at <http://perma.cc/A4JM-CRYJ>.

¹⁰ See, for example, the nine essays collected in BEN S. BERNANKE, *ESSAYS ON THE GREAT DEPRESSION* (2000).

¹¹ Ben S. Bernanke, *Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression* (Nat'l Bureau of Econ. Research, Working Paper No. 1054, 1983), archived at <http://perma.cc/KGR8-DLHK> (noting this compatibility in the abstract). This working paper was published as Ben S. Bernanke, *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 73 AM. ECON. REV. 257 (1983).

¹² Bernanke, *supra* note 9.

¹³ See BERNANKE, *supra* note 5, at 74, 77-78, 102-04.

¹⁴ *Id.* at 102-04.

resort and monetary policy tools in novel ways during the recent financial crisis. History repeats itself, but in a different key, and Bernanke, a saxophonist, demonstrates that he can transpose. Whereas central banks' lender-of-last-resort function was historically limited to lending to *banks* — that is, serving as a bank for banks — the bank runs that the Fed had to defend against in 2007 and 2008 were not runs on depositories, but runs on other short-term funded markets, such as repo, securities lending, commercial paper, and money markets. They also included runs on financial institutions outside of the United States that had dollar-denominated obligations and whose fate implicated the American financial system. Thus, as Bernanke notes:

[T]he crisis was like an old-fashioned bank crisis, but it happened to all different kinds of firms and in different institutional contexts. So the Fed had to go beyond the discount window. We had to create a whole bunch of other programs, special liquidity and credit facilities that allowed us to make loans to other kinds of financial institutions, on the Bagehot principle that providing liquidity to firms that are suffering from loss of funding is the best way to calm a panic.¹⁵

Not quite. Bernanke lucidly explains the crisis as a series of bank runs not by depositors or bank noteholders, but by other creditors in short-term financing markets. However, he tellingly glosses over a key part of the “Bagehot principle,” despite acknowledging it in the introductory lecture.¹⁶ The Bagehot principle is not simply that a central bank should make unlimited liquidity available. Instead, it is that when faced with a bank run, a central bank should lend freely, *at a high rate, on good collateral*.¹⁷ The idea is to discourage non-needy borrowers from gorging at the central bank trough. The central bank is supposed to supply liquidity in the Bagehot model, not subsidies. The lender of last resort is supposed to lend when the market is frozen, but it is not supposed to bail out or recapitalize insolvent institutions. Bernanke's Fed did not adhere to Bagehot's advice. The Bernanke Fed lent freely, on collateral of varying quality, and not at a high rate.¹⁸ Moreover, Bernanke's Fed (and Treasury) forced capital injec-

¹⁵ *Id.* at 77; *see also id.* at 97 (“What was different about this crisis was that the institutional structure was different. It was not banks and depositors; it was broker-dealers and repo markets, money market funds and commercial paper.”).

¹⁶ *Id.* at 7.

¹⁷ *See* WALTER BAGEHOT, *LOMBARD STREET* 196–98 (John Wiley & Sons, Inc. 1999) (1873); ALAN S. BLINDER, *AFTER THE MUSIC STOPPED* 94 (2013).

¹⁸ *See* CONG. OVERSIGHT PANEL, *FEBRUARY OVERSIGHT REPORT: VALUING TREASURY'S ACQUISITIONS* 4, 34 (2009), *archived at* <http://perma.cc/V5LC-CTZQ>.

tions on healthy as well as sick banks so as to avoid stigmatizing the sick ones.¹⁹

Bagehot is hardly the last word in central banking, and there is no particular virtue in slavish adherence to his dictum, but the part of the dictum that Bernanke glosses over is precisely the part that created trouble for the Fed and for the Bush and Obama Administrations. It is one thing to provide emergency temporary liquidity to financial institutions. It is another thing to provide it on subsidized below-market terms and yet another thing altogether to provide equity capital to insolvent institutions. Liquidity priced below market effectuates a wealth transfer from the government to bank shareholders and uninsured creditors, while capital investments provide a wealth transfer from the government to uninsured bank creditors. Even worse, some bailout recipients turned around and paid out large bonuses to employees.²⁰

While many parts of the bailout were undertaken by the Treasury rather than by the Fed, the Treasury and the Fed worked hand in glove during the crisis; the Treasury would not have undertaken actions absent support of the Federal Reserve Board. Thus, Bernanke and the Fed bear some level of responsibility for the bailouts undertaken by the Treasury, and Bernanke's Fed oversaw the bailout of banks' bondholders and derivatives counterparties. This sort of redistribution of wealth is a political act of the first order, not a mere technical exercise of the science of central banking. Bernanke surely knows this on an intellectual level (perhaps this is what he means when he calls the bailout experience "distasteful"²¹) but is loath to admit it publicly, and indeed for political reasons cannot. There is no avoiding the fact that monetary policy and bailouts have distributional consequences. Given that Bernanke's scholarly work has emphasized bank failures' spillover effects on the real economy during the Depression, it seems unlikely that Bernanke saw a rescue of the banking system as an end in and of itself. Arguably the bitter pill here was that Wall Street had to be bailed out in order to protect Main Street. Yet, it does not follow from this that the bailouts had to occur in the form they did or with precisely the distributional consequences that occurred.

Bernanke might have learned Friedman and Schwartz's lessons about the 1930s, but were those the right lessons to learn? And has Bernanke learned the lessons of 2008? Bernanke's defense of the Fed in terms of learning the lessons of the 1930s indicates that the econom-

¹⁹ See *id.* at 8–10; CONG. OVERSIGHT PANEL, JULY OVERSIGHT REPORT: TARP REPAYMENTS, INCLUDING THE REPURCHASE OF STOCK WARRANTS 43 (2009), archived at <http://perma.cc/83SQ-TLZB>.

²⁰ See Edmund L. Andrews & Peter Baker, *At A.I.G., Huge Bonuses After \$170 Billion Bailout*, N.Y. TIMES, Mar. 15, 2009, at A1.

²¹ BERNANKE, *supra* note 5, at 86.

ic generals were fighting the last war, which was about monetary policy and the lender-of-last-resort function. As a result, they had blind spots about contemporary bank regulation and politics and made serious mistakes in both areas.

Bernanke does not want to talk about the Fed's role as a bank regulator. Instead, his touchstone throughout the lectures is what he characterizes as a central bank's two essential roles: "macroeconomic stability" and "financial stability."²² The former refers to ensuring price and employment stability in the economy, while the latter refers to "keep[ing] the financial system working normally" and "mitigat[ing] financial panics."²³ To this end, Bernanke observes that central banks have three main tools: monetary policy to stimulate or cool down the economy by changing (primarily short-term) interest rates; liquidity provision during panics as a "lender of last resort"; and bank regulation and supervision to "keep the financial system healthy" and reduce the chance of a crisis.²⁴

Bernanke focuses almost exclusively on the Fed's monetary policy and lender-of-last-resort functions. Bernanke gives short shrift in the book to bank regulation. Bank regulation — one of the Fed's major tasks — gets less than eight pages of discussion in his 129-page book,²⁵ as Bernanke notes that the regulatory role is shared with other agencies and is not unique to central banks.²⁶ Thus, Bernanke only passingly mentions the regulatory failures leading up to the financial crisis or post-crisis regulatory reforms. Bernanke's reticence about bank regulation, combined with his emphasis on the Fed's lender-of-last-resort function, gives the impression that financial stability is really about "mitigat[ing] financial panics" rather than about "keep[ing] the financial system working normally."²⁷ Yet real financial stability entails crisis *avoidance*, not just crisis *management*.

It is understandable that Bernanke, writing as a sitting Fed Chairman, might be reluctant to discuss the post-2008 financial reforms, some of which his agency was tasked with implementing. Nor can one fairly expect Bernanke to open his heart about what he really thinks of the details of the Dodd-Frank Act²⁸ or the various rulemakings that have been enacted. Yet one wonders whether Bernanke simply

²² *Id.* at 3.

²³ *Id.*

²⁴ *Id.* at 3–4.

²⁵ *Id.* at 4, 50–51 (pre-crisis regulation), 117–21 (post-crisis reforms).

²⁶ *Id.* at 4.

²⁷ *Id.* at 3.

²⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

doesn't find the topic of bank regulation very interesting; monetary policy, not bank regulation, seems to be his passion.

Bernanke's eschewal of any substantive discussion of pre-crisis regulation is more curious. Again, it's understandable that Bernanke would not want to opine on other regulators' pre-crisis shortcomings. But it may also be a touchy topic because Bernanke was on the Board of Governors of the Federal Reserve from 2002 to 2005 before his appointment as Fed Chairman in 2006. This means Bernanke himself bears some share of the blame for regulatory failures. It's not clear how much he could have done alone, yet it is also not clear that he himself tried to do much until it was too late.

Bernanke does briefly own up to some of the Fed's regulatory failures, both in terms of consumer protection and risk management within bank holding companies, but he does so in general terms that do not approach the full list of regulatory failures captained by the Fed.²⁹ To this list one might add the Fed's role in preventing the regulation of credit derivatives³⁰ and the Fed's approval of the synthetic collateralized debt obligation (CDO) transaction structure, which was undertaken for regulatory capital arbitrage purposes and became the source of much of AIG's liability.³¹ Bernanke quarterbacked a multi-agency team that did stave off financial Armageddon.³² But how much should he be praised for putting out a fire that started on his watch?

Bernanke also downplays the political nature of the Fed, preferring to portray it as an essentially scientific enterprise, with monetary policy set according to the Taylor Rule and other principles of macroeconomics. The Fed, however, is engaged in deeply political enterprises in three of its four functions — monetary policy, bailouts, and bank regulation. (Its fourth function, as a financial services provider to banks, has its own subtler politics.) To acknowledge and admit to the political nature of the Fed would undercut the Fed's claim to authority and legitimacy, which derives from its supposedly independent, expert status and insulation from electoral pressures, rather than from its political accountability and responsiveness.

Thus, Bernanke does not discuss the winners and losers that the Fed's monetary policy produced. Low — near zero — interest rates were great for creditors, but devastating for debtors and savers. Nor is

²⁹ See *id.* at 50–51.

³⁰ See Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1698–700 (2011).

³¹ See William W. Bratton & Adam J. Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs*, 86 S. CAL. L. REV. 783, 819 (2013). A synthetic CDO is a securitization of credit default swap positions. It creates a security that mirrors the performance of the securities referenced by the credit default swaps.

³² See BERNANKE, *supra* note 5, at 86–87.

it so clear that low interest rates were the right move for the economy overall.³³ Tantalizingly, Bernanke acknowledges that the Fed's toolkit was insufficient to restore the housing market.³⁴ Historically, low interest rates stimulate the housing market, which is often the engine of economic recovery. Yet, as Bernanke notes, despite low mortgage rates, the housing market has not recovered. At best it has stabilized. Since 2007, there have been over seven million foreclosure or distressed home sales, which have flooded the housing market with low-priced inventory.³⁵ This supply glut has offset the demand-stoking effect of the Fed's monetary easing.

One solution to underwater mortgages would have been to inflate the debt away (presumably through even *lower* interest rates). Inflation is a standard tool for addressing debt overhang problems like underwater mortgages because inflation reduces the real value of fixed-rate debt. The Roosevelt Administration pursued inflation with some success during the Depression as a means of relieving the U.S. economy from its overleverage.³⁶ Inflationary policies, however, are a politically fraught approach. Inflation has serious distributional consequences. It benefits debtors at the expense of creditors, making it deeply unpopular with most financial institutions. While inflation would have benefited underwater homeowners, it would have harmed the financial system, which is what the Fed was focused on. Beyond this, the Fed also has a deep institutional aversion to inflation; one of the Fed's proudest accomplishments has been to tame inflation for the past three decades. Not surprisingly, inflation was never seriously considered as a strategy for dealing with the debt overhang problem created by the collapse of the housing bubble.

A similar story emerges with bank regulatory failures and bailouts. Bernanke seems insufficiently attentive to the politics of the 2008 bailouts that were necessitated by numerous regulatory failures. He understands that they were not popular, but insists that they were necessary:

I would like to emphasize that what we had to do with Bear Stearns and AIG is obviously not a recipe for future crisis management. . . . [I]t was a very difficult and, in many ways, distasteful intervention that we had to do to prevent the system from collapsing.³⁷

³³ See Binyamin Appelbaum, *In Fed and Out, Many Now Think Inflation Helps*, N.Y. TIMES, Oct. 27, 2013, at A1.

³⁴ BERNANKE, *supra* note 5, at 106–07.

³⁵ Adam J. Levitin, *The Paper Chase: Securitization, Foreclosure, and the Uncertainty of Mortgage Title*, 63 DUKE L.J. 637, 639 (2013).

³⁶ See Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1129–30 (2009).

³⁷ BERNANKE, *supra* note 5, at 86.

He is right, but the political valence of 2008 made it impossible to do other things like adopt a broader economic stimulus package in 2010, and it also ushered in the Tea Party. Because financial regulation is not a one-stage game, those distributional consequences can affect the political space for monetary policy and bailouts in the future.³⁸ Politics matter in terms of being able to administer the necessary financial and fiscal medicine.

The political price tag of bailouts became significantly higher after 2008. For regulators to be able to undertake the rescue operations that are necessary, they need to have popular trust. And that requires accountability. Bernanke, like all central bankers, is very cognizant of the importance of central bank communications as a tool for enacting monetary policy.³⁹ Markets hang on the words of the Fed Chairman as much as on the Fed's actual actions. Accordingly, the Fed is very careful in how it communicates about monetary policy. The same could not be said for the Fed's communication of its lender-of-last-resort activities during the crisis. The lack of clear communication was particularly problematic because the Fed was engaged in largely unprecedented behavior involving trillions of dollars of support for various parts of the economy via numerous obscurely named programs (for example, "Term Asset-Backed Securities Loan Facility") that stretched the Fed's statutory authority.⁴⁰

In his lectures, Bernanke seems oblivious to these shortcomings. Instead, in response to a question about Main Street–Wall Street tensions, Bernanke stated:

Clearly, the Fed is very accountable. We testify frequently, not just myself but other members of the Board or Reserve Bank presidents. We give speeches. We appear at various events and so on.⁴¹

This is accountability? Occasional legislative testimony and speeches and exposing oneself to the occasional question or heckle is a far cry from real accountability. Bernanke and the other Federal Reserve Board Governors serve fourteen-year terms⁴² and are removable only for cause.⁴³ They are not subject to discipline through the ballot box or

³⁸ Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 438, 492 (2011); see also Paul Krugman, *The Stimulus Anniversary*, THE CONSCIENCE OF A LIBERAL (Feb. 18, 2014, 2:57 PM), <http://krugman.blogs.nytimes.com/2014/02/18/the-stimulus-anniversary>, archived at <http://perma.cc/3EJ6-EZLN> (discussing political economy consequences from economic stimulus legislation being of insufficient scope to succeed).

³⁹ See BERNANKE, *supra* note 5, at 108; HOLMES, *supra* note 6, at ix.

⁴⁰ See Levitin, *supra* note 38, at 496–98.

⁴¹ BERNANKE, *supra* note 5, at 123.

⁴² 12 U.S.C. § 241 (2012).

⁴³ *Id.* § 242; see also *Humphrey's Executor v. United States*, 295 U.S. 602 (1935). *But see* Adrian Vermeule, *Conventions of Agency Independence*, 113 COLUM. L. REV. 1163, 1176–79,

the appropriations process or to regulatory review by the President's Office of Information and Regulatory Affairs (OIRA).⁴⁴ The Federal Reserve Board's meetings are closed to the public, with only limited summaries released — sometimes months later. Indeed, the Fed was deliberately designed to be one of the *least* politically accountable agencies, because that was the entire conceit behind its creation — a compromise to take financial regulation (and later monetary policy) out of the political sphere by putting it in the hands of a public-private entity.⁴⁵

Transparency has never been the Federal Reserve Board's strong suit. The Federal Reserve's monetary policy body — the Federal Open Market Committee (FOMC), which combines the Board of Governors and representatives of the regional Reserve Banks — releases minutes of its meetings three weeks after each meeting.⁴⁶ Transcripts of FOMC meetings are not generally released until several years after the meetings.⁴⁷ The Board of Governors itself releases transcripts only for its rare “open” meetings, but most of the Board's major regulatory decisions are not made in open meetings. The lack of transparency was a particular problem during the financial crisis. For example:

[I]t would not be until late 2011 that [the Fed] would fully disclose the true extent of the lending programs that it had launched during the crisis, and that was only after it was forced to do so by the courts in response to a lawsuit filed by Bloomberg News.⁴⁸

Indeed, it was not until 2014 that the Fed finally released the transcripts of its 2008 FOMC meetings, and when it did so, commentators noted how clueless these transcripts showed the Fed to have been about the unfolding crisis.⁴⁹ The Fed's claim to legitimacy rests on politically insulated technocratic expertise, not on democratic accountability and transparency, and Bernanke's defense of the Fed is based on showing that the Fed was technocratically masterful. This may be true in terms of the *response* to the crisis, but the Fed's failure to foresee and *prevent* the crisis raises serious questions about its technocratic

1196 (2013) (discussing whether Federal Reserve Chairs and Vice Chairs are removable at will by the President).

⁴⁴ The Federal Reserve Board does have an Inspector General. 5 U.S.C. app. § 8G(c) (2012).

⁴⁵ See 1 ALLAN H. MELTZER, *A HISTORY OF THE FEDERAL RESERVE* 65–66 (2003).

⁴⁶ See *Meeting Calendars, Statements, and Minutes (2009–2014)*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., <http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm> (last visited Mar. 30, 2014), archived at <http://perma.cc/NL49-QH7X>.

⁴⁷ See *Transcripts and Other Historical Materials*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/monetarypolicy/fomc_historical.htm (last visited Mar. 30, 2014), archived at <http://perma.cc/XC2J-PJDE>.

⁴⁸ SHEILA BAIR, *BULL BY THE HORNS* 187 (2012).

⁴⁹ See, e.g., Gretchen Morgenstern, *A New Light on Regulators in the Dark*, N.Y. TIMES, Feb. 23, 2014, at BU1 (noting that the transcripts “paint a disturbing picture of a central bank that was in the dark about each looming disaster throughout 2008”).

competence and political neutrality. For this charge, Bernanke's book has no answer.

B. The Establishment Economist

The Federal Reserve played a leading role in the response to the financial crisis, but the story of the financial crisis is far more than the story of the Fed. To date, there still is no definitive history of the crisis, and this is a major gap in the literature. Professor Alan Blinder, a noted academic economist⁵⁰ and pillar of the economics establishment who has also served in various policy and regulatory positions,⁵¹ has tried to fill that gap with a comprehensive account of the crisis, response, and needed reforms.

Unfortunately, what Blinder has produced in *After the Music Stopped* is a frustrating combination of introductory economics (related in excessively casual language in an attempt to make the subject accessible), retellings of well-known episodes, and cursory excursions into topics with thin connections to the financial crisis of 2008, such as the Eurozone/Greek debt crisis. Blinder simply tries to do too much in this book, which is too wonky for most casual readers yet insufficiently rigorous to satisfy academic readers — there are only ten pages of footnotes in a roughly 500-page book and numerous charts that fail to sufficiently indicate the source data.

Blinder's goal in *After the Music Stopped* is to write a "comprehensive history" of the crisis, although he warns us that his focus is more on the "why than on the what."⁵² Blinder disappoints both on his choice of focus and his execution. A blow-by-blow history of the crisis would be incredibly valuable and does not exist. Perhaps the closest thing to a play-by-play is the final report of the Financial Crisis Inquiry Commission, but the report is a partisan document that provides many disjointed details and is short on analysis.⁵³

Jumping into interpretative work without a clear and solid historical record is problematic, and results in some strange omissions and inclusions in Blinder's book. For example, Blinder regales readers with summaries of unadopted foreclosure prevention proposals by brand-name economists.⁵⁴ He also goes into the gory details of some of the Obama Administration's more obscure foreclosure prevention

⁵⁰ Blinder is a Princeton economics professor and co-author of a leading introductory college economics textbook. See WILLIAM J. BAUMOL & ALAN S. BLINDER, *ECONOMICS* (12th ed. 2012).

⁵¹ Blinder served on the Council of Economic Advisers (1993–1994) and as a Vice Chairman of the Federal Reserve (1994–1996).

⁵² BLINDER, *supra* note 17, at xvi (emphases omitted).

⁵³ FIN. CRISIS INQUIRY COMM'N, *THE FINANCIAL CRISIS INQUIRY REPORT* (2011), archived at <http://perma.cc/4PTM-HT9Z>.

⁵⁴ BLINDER, *supra* note 17, at 326–27.

programs, despite the fact that they had little impact.⁵⁵ (“Bored yet?” he asks!⁵⁶) The purpose of all this detail? To underscore that the Obama Administration did not ignore the foreclosure problem and that there was in fact progress made at halting foreclosures.

Blinder does ask why the Treasury allocated so little of the bailout funds to foreclosure prevention. His answer is that:

[Treasury Secretary Timothy Geithner, National Economic Council (NEC) Director Lawrence Summers,] and others in the administration were not convinced that there was a foreclosure-mitigation plan that could work on a large scale, was legal, and would have a large economic impact at reasonable cost. They thought there were other, more cost-effective uses of TARP [Troubled Asset Relief Program] money. Geithner may also have been worried that the TARP well would run dry.⁵⁷

In short, Blinder believes that the Obama Administration’s failure to pursue effective foreclosure prevention programs was the result of a reasonable and considered good faith judgment, nothing more.

Blinder recognizes that there were serious implementation problems with the Obama foreclosure prevention programs, but given the level of detail of his discussion, it is curious that he fails to even mention the major legislative initiative dealing with foreclosures — the attempt to amend bankruptcy law to allow mortgages to be modified in bankruptcy without lender consent (a process called “cramdown”). Cramdown legislation passed the House, but could never get cloture in the Senate,⁵⁸ despite its endorsement by candidate Obama and its inclusion in President Obama’s February 2009 foreclosure prevention proposal, made a month after he took office.⁵⁹

Opposition from the Geithner Treasury Department and the Summers NEC, as well as from bank regulators other than the Federal Deposit Insurance Corporation (FDIC), contributed to the failure of cramdown legislation. The Treasury and the NEC did not publicly oppose cramdown, but offered only the most tepid and generic of endorsements when pressed.⁶⁰ Treasury and NEC opposition to cramdown was widely known on Capitol Hill because of statements in private meetings by Geithner, Summers, and their aides.⁶¹

⁵⁵ *Id.* at 327–38.

⁵⁶ *Id.* at 336.

⁵⁷ *Id.* at 333. The TARP was a \$700 billion bailout fund authorized by Congress under the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (codified as amended in scattered sections of 12 and 26 U.S.C.).

⁵⁸ See Stephen Labaton, *Senate Refuses to Let Judges Fix Mortgages in Bankruptcy*, N.Y. TIMES, May 1, 2009, at B3.

⁵⁹ See Remarks at Dodson High School in Mesa, Arizona, 1 PUB. PAPERS 114 (Feb. 18, 2009).

⁶⁰ Victoria McGrane, *Geithner Lukewarm on Cramdown*, POLITICO (Apr. 21, 2009, 12:44 PM), <http://www.politico.com/news/stories/0409/21498.html>, archived at <http://perma.cc/C2T4-NT7H>.

⁶¹ Paul Kiel & Olga Pierce, *Dems: Obama Broke Pledge to Force Banks to Help Homeowners*, PROPUBLICA (Feb. 4, 2011, 7:48 AM), <http://www.propublica.org/article/dems-obama-broke>

The Treasury and the NEC feared that cramdown legislation would result in a surge of bankruptcy filings that would force banks to recognize losses not just on troubled mortgages, but also potentially on unsecured debt such as credit cards and particularly on the over \$400 billion in second-lien loans held by the largest four banks.⁶² The Treasury and the NEC were concerned that cramdown would display the true economic condition of the U.S. banking system, which ran contrary to their plan of stabilizing the system with massive liquidity injections and regulatory forbearance and then letting banks recognize losses over time against earnings.⁶³ Additionally, some Treasury officials worried about rewarding irresponsible borrowers or generating “moral hazard” through principal relief for underwater mortgages.⁶⁴

Cramdown, however, *was* just such “a foreclosure-mitigation plan that could work on a large scale, was legal, and would have a large economic impact at a reasonable cost.”⁶⁵ It did not have any legal problems, scale limitations, or costs to the Treasury. None of the reasons outlined by Blinder for the Obama Administration’s reticence on foreclosure prevention held true with cramdown, which was fiercely opposed by the financial services industry. The problem with cramdown, from the Treasury and the NEC’s perspective, was that it would have shown that the emperor had no clothes and that the banks

-pledge-to-force-banks-to-help-homeowners, *archived at* <http://perma.cc/BK8T-DMZN>; Mike Lillis, *White House Silence Paved Way for ‘Cramdown’ Crash*, WASH. INDEP. (May 7, 2009, 5:12 PM), <http://washingtonindependent.com/42220/white-house-silence-paved-way-for-cramdown-crash>, *archived at* <http://perma.cc/BZ99-APZD>.

⁶² See Vicki Been et al., *Essay: Sticky Seconds — The Problems Second Liens Pose to the Resolution of Distressed Mortgages* 10 n.58 (Aug. 2012) (working paper), *archived at* <http://perma.cc/4LGT-3P7Y> (noting \$436 billion in second lien loans on the books of the four largest banks in 2009).

⁶³ See NEIL BAROFSKY, *BAILOUT 157* (2012) (quoting Assistant Secretary of the Treasury for Financial Stability Herbert Allison talking about “helping [the banks] earn their way out of this”); Zachary A. Goldfarb, *Why Has the U.S. Recovery Sputtered?*, WASH. POST, Nov. 23, 2012, at A1 (noting that Summers opposed principal forgiveness for “underwater homeowners” because he believed those plans could have “effects worse than the cure’ . . . , such as cratering the financial system by forcing banks to absorb huge losses”); *infra* pp. 2021–22.

⁶⁴ BAROFSKY, *supra* note 63, at 197 (noting that Assistant Secretary Herbert Allison opposed principal reductions because of “moral hazard” and unfairness to “responsible borrowers” who remained current on their mortgages (internal quotation marks omitted)); *see also* Clea Benson, *Obama Housing Fix Faltered on Carrots-Not-Sticks Policy*, BLOOMBERG (June 11, 2012, 12:00 AM), <http://www.bloomberg.com/news/2012-06-11/obama-housing-fix-faltered-on-carrots-not-sticks-policy.html>, *archived at* <http://perma.cc/BPG7-4TXR> (noting that Geithner opposed principal reduction for mortgages because he was concerned “it could reward people who tapped home equity to support lavish lifestyles”). The irony of moral hazard arguments at a time when large banks were getting bailed out apparently did not register.

⁶⁵ BLINDER, *supra* note 17, at 333. *See generally* Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565 (discussing the benefits of cramdown).

that the Treasury had proclaimed to be safe and solvent were in fact of questionable solvency.

Given the opposition to cramdown from the Treasury and the NEC, it is hardly surprising that after the initial February 2009 foreclosure-prevention proposal, President Obama made no mention of the cramdown proposal. President Obama chose not to spend any political capital pushing the legislation, in contrast to his vocal support for the Credit Card Accountability, Responsibility, and Disclosure Act of 2009,⁶⁶ another (but far less important) consumer finance law that had languished in Congress prior to his vocal support.⁶⁷ As the *New York Times* editorial board noted, “when the time came to stand up to the banking lobbies and cajole yes votes from reluctant senators [on cramdown] — the White House didn’t. When the measure failed, there wasn’t even a statement of regret.”⁶⁸

The politics of the cramdown debate are critical to understanding the overall political dynamics of the crisis. The cramdown debate tells a story of President Obama’s economic policy being reoriented after the 2008 campaign by a Treasury Department and NEC headed by individuals — Geithner and Summers — with close ties to Wall Street. Cramdown presented the Obama Administration with a stark choice of supporting Wall Street or Main Street interests. The Administration, following the lead of the Treasury and the NEC, opted to pursue a policy that shielded Wall Street, rather than Main Street. This is a very different story than Blinder’s tale of good faith judgment calls.

Blinder also disappoints on the interpretative side because little, if any, of his interpretation is new, and the interpretation he presents never answers the key questions about the crisis. The book does not present a deeply considered argument about the causes of the crisis. For causes, Blinder gives us a bullet point list of the seven horsemen of the financial apocalypse: inflated asset prices of houses and bonds; excessive leverage; lax financial regulation; “disgraceful banking practices”; unregulated securities and derivatives built on bad mortgages; failure of the rating agencies; and perverse compensation in financial institutions.⁶⁹ Rather than harness these seven horsemen to one unified narrative, Blinder instead gives us a Financial Crisis 101 chapter on each. As a result, it is hard to see how all of these factors connect in Blinder’s book.

To be sure, none of the factors he identifies are wrong; all played a role in the crisis. Yet Blinder fails to distill them into a comprehensive picture. Blinder’s list could probably have been refined to just two

⁶⁶ Pub. L. No. 111-24, 123 Stat. 1734 (codified as amended in scattered sections of 15 U.S.C.).

⁶⁷ Lillis, *supra* note 61.

⁶⁸ Editorial, *As Foreclosures Surge . . .*, N.Y. TIMES, May 4, 2009, at A22.

⁶⁹ BLINDER, *supra* note 17, at 28.

items: mortgages and leverage. Mortgages (including their financing through securitization) were what inflated the housing price bubble, and once the housing bubble collapsed, leverage in numerous forms (often driven by compensation arrangements, among other factors) ensured a crisis.

Blinder's litany of seven causes creates the wrong impression of a "perfect storm" crisis, but this is not Blinder's argument. He recognizes that we would still have had a financial crisis of some sort even if any one of these factors had been different.⁷⁰ The difference would have been of degree, not kind. Thus, Blinder engages in a bit of counterhistory, asking whether the "mega-mess" was inevitable.⁷¹ "Absolutely not," is his answer.⁷² Blinder suggests that while the housing price bubble and the subsequent collapse would have happened, the collapse would not have been so bad if bank regulators had cracked down on bad mortgage lending, if Commodities Futures Trading Commission (CFTC) Chair Brooksley Born had stared down Messrs. Greenspan, Levitt, Rubin, and Summers and had succeeded in regulating over-the-counter derivatives, or if financial institutions had opted for less leverage and better risk management.⁷³ The implication of this counterhistory is that all of the causes of the crisis given by Blinder are not of equal importance. And so the reader is left wondering what Blinder is really arguing.

Perhaps more critically, Blinder's book never clearly answers the two essential questions for understanding the financial crisis: (1) why did the housing price bubble develop, and (2) why was the financial system so vulnerable to the collapse of *this* bubble, after weathering the collapse of the Internet bubble less than a decade prior? Blinder understands that the collapse of the housing price bubble is the centerpiece of the story: "The jig was up when house prices ended their long ascent; after that, the rest of the crumbling followed logically."⁷⁴ But Blinder does not have a clear answer for either question.

Blinder's story about the development of the housing bubble is muddled and not supported by the evidence. Blinder adopts as his main explanation the theory suggested by Yale housing economist Robert Shiller, namely that housing prices rose because of a demand-driven bubble caused first and foremost by homeowners' irrational exuberance for a can't-lose investment.⁷⁵ Blinder also throws in a bunch of other factors, such as homeowners looking for a safe invest-

⁷⁰ See *id.* at 85.

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.* at 87.

⁷⁵ *Id.* at 36–38. See generally ROBERT J. SHILLER, *THE SUBPRIME SOLUTION* (2008).

ment, strong fundamentals for housing, and easy credit from both banks and low short-term interest rates, but gives each of these factors no more than a paragraph.⁷⁶ Blinder never addresses the strong evidence that the bubble was driven primarily by supply-side causes: during the bubble, the supply of mortgage credit expanded even as its price fell, something that could only happen with a rightward shift of the supply curve.⁷⁷ This should raise the question of why there was an oversupply of underpriced mortgage credit. Blinder never probes the causes of the housing bubble very deeply.

Blinder comes a little closer on the second question, as he notes the development of what he terms a “second bubble” built on top of the housing price bubble, this one a bubble in bonds.⁷⁸ But Blinder fails to connect this bond bubble to the financial system’s vulnerability. The bond bubble differed in a critical way from the Internet bubble. The Internet bubble was a bubble in equity securities, many of which were issued by companies with little or no track record of earnings generation. While many investors had paper gains on these equity securities, they never entered into the financial system as a type of monetary equivalent because their value was always understood to be too speculative and volatile.

Not so with bonds, which are fixed-income securities, the value of which will seldom go much above par. The bond bubble Blinder identifies was primarily in structured securities,⁷⁹ most of which were based on mortgages and were rated AAA at issuance. These bonds were used as one of the predominant forms of collateral throughout the financial system, particularly for short-term lending in repo markets, where they were accepted as collateral at par value. As economist Gary Gorton has shown, AAA-rated bonds were used as a medium of exchange among financial institutions.⁸⁰ For this to work, however, the medium of exchange had to maintain a steady value. Once the value of the bonds became questionable, the whole system started to collapse, much as if the value of a currency became in doubt. Thus, what linked the housing bubble and the collapse of the financial system was the financing of housing through debt securities that were accepted as collateral without “haircuts.”⁸¹ Why the system

⁷⁶ See BLINDER, *supra* note 17, at 38.

⁷⁷ See, e.g., Adam J. Levitin & Susan M. Wachter, *Why Housing?*, 23 HOUSING POL’Y DEBATE 5, 7 (2013); Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1185 (2012).

⁷⁸ BLINDER, *supra* note 17, at 40–47.

⁷⁹ See Lloyd Blankfein, *Do Not Destroy the Essential Catalyst of Risk*, FIN. TIMES, Feb. 9, 2009, at 7.

⁸⁰ GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND 6–7 (2010).

⁸¹ A “haircut” is a discount applied to the value of collateral in a repo transaction in order to reflect the risk that the repo borrower will default on its repurchase obligation and the repo lender

developed this way is one of the crucial unanswered questions of the crisis.

There are moments, however, where Blinder's book shines. He excels at giving understandable, accessible, big-picture summaries. He provides a pellucid explanation of the Federal Reserve's monetary policy and lender-of-last-resort actions. Despite his failure to discuss the cramdown option, his summary of why successful foreclosure mitigation did not happen generally underscores his sensitivity not only to practical details, but also to politics: successfully mitigating foreclosures would have required overcoming numerous complexities and legal restrictions, would have placed billions of taxpayer dollars at risk, and would have entailed serious political risk. As Blinder puts it, "No wonder it didn't happen."⁸² Indeed, Blinder has an entire chapter devoted to the "backlash" against the bailouts.⁸³

Ultimately, Blinder's book fails to deliver either as a careful history of the crisis and response or as an interpretation of the crisis. It is also unsatisfying in terms of its forward-looking and prescriptive observations. The final part of the book, entitled "Looking Ahead," contains Blinder's thoughts on how the Fed will ramp down its support for the market without producing inflation, on the U.S. budget deficit, and on the Eurozone crisis. This is all getting rather far afield from 2008. What do federal budget deficits or Greek sovereign debt problems really have to do with the 2008 financial crisis? Blinder never tells us.

Blinder concludes with generic reform prescriptions in a gimmicky "The Ten Financial Commandments," such as "Thou Shalt Use Less Leverage" and "Thou Shalt Fix Perverse Compensation Systems," and a "Seven-Step Rehab Program for Policy Makers." The key pieces of the rehab program, however, show how sensitive Blinder is to the political accountability problem with the financial crisis. Six of the seven steps are about managing public perceptions: "Explain Yourself to the People," "Say It in Language That Ordinary People Can Understand," "Repeat [the Previous Two Steps]," "Set Expectations Low," "Pay Close Attention to People's Attitudes, Prejudices, and Misconceptions," and "Pay Rapt Attention to Fairness."

Notably, Blinder is not calling for more political control of the financial regulatory system. He is not calling for governance reforms. Instead, he is simply saying that regulators need to be more communicative with the public and account for the public's views. Put differently, there was a communication problem, not an accountability prob-

will have to sell the collateral. Stable value assets like Treasury bonds are typically used as collateral for repo agreements without haircuts. Collateral with more volatile market values receive deeper haircuts and thus enable less borrowing relative to the face value of the collateral.

⁸² BLINDER, *supra* note 17, at 341.

⁸³ *Id.* at 343-64.

lem. Regulators need to be better spin doctors, if only to maintain their independence.

C. *The Bank Regulator*

Bernanke's and Blinder's tales of the crisis present a remarkable contrast to former FDIC Chairperson Sheila Bair's *Bull by the Horns*. Bernanke's crisis takes place in an abstract, sanitized vacuum in which the existence of other regulatory agencies is barely mentioned, much less their leadership and foibles. Blinder's story too is one of institutions and markets, not individuals. In contrast, Bair, the Chairperson of the FDIC from 2006 to 2011, presents an incredibly valuable, gritty insider portrait of the rough and tumble world of bank regulation. As Bair describes this world, it is a shark tank of petty personalities, shifting alliances and cliques, jealous turf fights, bone-headed stubbornness, expletive-filled meetings, press leaks, gang ambushes, and routine backstabbing. Who knew bank regulation was a contact sport?

It's hardly news that Bair did not get along well with some of the other financial regulators, particularly Federal Reserve Bank of New York President and later Treasury Secretary Timothy Geithner, who plays the heavy in her story as the "bailouter in chief."⁸⁴ As Bair explains, there was "a profound philosophical disagreement between me and Tim Geithner. He did not want creditors, particularly bondholders, in those large, failing financial institutions to take losses. I did."⁸⁵ Bair sarcastically refers to Geithner's "precious bondholders"⁸⁶ and takes pleasure in noting that when Geithner was at the New York Fed, Ben Bernanke and Treasury Secretary Hank Paulson treated him "almost like staff,"⁸⁷ perhaps the worst degradation of a "principal" in D.C. parlance. Geithner is depicted as arrogant and disdainful of other regulators, treating them to "an expletive-laced tongue-lashing" for talking to members of Congress regarding regulatory reform.⁸⁸

This conflict takes on a heavily gender-laden overtone of Sheila versus the Boys' Club (with Bernanke and Paulson excepted as saintly, grown-up intervenors).⁸⁹ Bair is careful not to allege gender bias from the other regulators herself — instead merely noting that others have suggested it — but it's hard for a reader to miss the point. Bair rou-

⁸⁴ BAIR, *supra* note 48, at 142.

⁸⁵ *Id.* at 99.

⁸⁶ *Id.* at 105.

⁸⁷ *Id.* at 158.

⁸⁸ *Id.* at 191.

⁸⁹ *See id.* at 98, 128–29, 142. This gender dynamic echoes the 1999 conflict between CFTC Chair Brooksley Born and other (male) federal regulators regarding regulation of over-the-counter derivatives. *See id.* at 304.

tinely learned of developments during the crisis not from other regulators, but from the newspaper or even from post-crisis books. She asks:

Was it gross incompetence or unbelievable disrespect? Or was it just the all-boys network wanting to make the decisions among themselves, as many commentators have speculated? Maybe the boys didn't want Sheila Bair playing in their sandbox. Or, equally likely, they may have wanted to force [the FDIC] to bail out [banks] without imposing losses on market participants⁹⁰

What's clear is that Bair did not play ball with the other regulators, who blamed problems on her being "difficult"⁹¹ and complained that they could not "believe the continuing audacity of this woman."⁹² It's also clear that Bair was very cognizant of the dynamics that exist in "male-dominated power structures."⁹³ This type of conflict continued to the end of Bair's term at the FDIC.

In Bair's account, her conflict with the other financial regulators predated the financial crisis, going back to a fight over bank capital requirements. Since 1988 the basic principles for bank capital requirements have been set by an accord promulgated by the Basel Committee on Banking Supervision, a group of domestic bank regulators from major developed nations that usually convenes in Basel, Switzerland.⁹⁴ The principles set forth by the Basel Committee are known as the Basel Capital Accords. The Basel Accords are not treaties and are not legally binding on any country. Instead, they set a soft-law framework that domestic bank regulators use to set legally binding capital requirements.

A second iteration of the Basel Accords, known as Basel II, was promulgated in 2004 (and revised in 2005),⁹⁵ and a third, known as Basel III, came out in 2010.⁹⁶ The basic idea in all the Basel Accords is that a bank should not take on too much debt. Basel's mechanism for regulating leverage is to require banks to hold capital (essentially equity) in ratio to its "risk weighted" assets; riskier assets require more capital.⁹⁷ The major change from Basel I to Basel II was that Basel I

⁹⁰ *Id.* at 98.

⁹¹ *Id.* at 138 (internal quotation marks omitted).

⁹² *Id.* at 89–90 (internal quotation mark omitted).

⁹³ *Id.* at 303. *See generally id.* at 301–07.

⁹⁴ *See* CHRIS BRUMMER, *SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM* 75–77, 213–46 (2012).

⁹⁵ *See* BASEL COMM. ON BANKING SUPERVISION, *BANK FOR INT'L SETTLEMENTS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENTS AND CAPITAL STANDARDS: A REVISED FRAMEWORK* (2004), *archived at* <http://perma.cc/9T3J-88MG>; BASEL COMM. ON BANKING SUPERVISION, *BANK FOR INT'L SETTLEMENTS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENTS AND CAPITAL STANDARDS: A REVISED FRAMEWORK* (2005), *archived at* <http://perma.cc/8VYV-SENV>.

⁹⁶ *See* BRUMMER, *supra* note 94, at 235.

⁹⁷ *Id.* at 214–17, 234–35.

specified the risk weighting of different types of assets, whereas Basel II gave banks the option of determining the risk weighting of their assets (Basel III preserves this option).⁹⁸ In other words, Basel II let banks have much more discretion about how much capital they should hold. Predictably, when allowed to self-regulate, banks thought they needed far less capital and moved to increase leverage.⁹⁹

Bair took office in 2006, after agreement had already been reached on Basel II, but before U.S. domestic implementation had occurred. Bair tried, unsuccessfully, to reopen the discussion on Basel II and to add a requirement of a simple “leverage ratio” of capital to *unweighted* assets.¹⁰⁰ Bair’s opposition, however, helped delay Basel II implementation in the United States.¹⁰¹ As much as any single action, this may well have saved the U.S. financial system from complete collapse in 2008 because U.S. banks still had the higher capital levels required by Basel I when the crisis broke. Bair’s opposition to Basel II did not win her any friends in the bank regulatory world, including from other U.S. bank regulators.¹⁰² She was the proverbial “skunk at the garden party” of self-regulation.¹⁰³

Besides a juicy, colorful portrait of regulatory dysfunction, Bair’s book also presents a new and different story of the bailouts. Bair breaks some new factual ground, directly contradicting versions of events retold in some journalistic accounts¹⁰⁴ and disclosing previously unpublished emails redacted from inspector general reports.¹⁰⁵ Far more significantly, however, Bair presents a substantially different narrative of the institutional story of the crisis.

As Bair sees it, the endgame in the bailouts was about Citigroup, and many of the steps taken in response to the crisis were designed specifically to protect Citi and spare its primary regulators — the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Bank of New York (headed by Geithner until 2009) — from embarrassment.¹⁰⁶ Bair asks, “How much of the decision making was being driven through the prism of the special needs of that one, politically connected institution? Were we throwing trillions of dollars at all of the banks to camouflage its problems?”¹⁰⁷ Thus, Bair explains that

⁹⁸ *Id.* at 216.

⁹⁹ BAIR, *supra* note 48, at 30–31.

¹⁰⁰ *Id.* at 30–34.

¹⁰¹ *Id.* at 37–40.

¹⁰² *Id.* at 35.

¹⁰³ *Id.* at 41 (capitalization omitted).

¹⁰⁴ *Id.* at 100–01.

¹⁰⁵ *See id.* at 207.

¹⁰⁶ *See id.* at 79, 88, 166–73; *see also* Arthur E. Wilmarth, Jr., *Citigroup: A Case Study in Managerial and Regulatory Failures*, 47 *IND. L. REV.* (forthcoming 2014).

¹⁰⁷ BAIR, *supra* note 48, at 6.

the New York Fed's unsuccessful push to have the FDIC guarantee all debt not only of banks, but also of their holding companies and affiliates, "was being driven by Citi's special needs; unlike most banks, which used their holding companies to issue debt, Citi issued its debt through a variety of affiliate structures."¹⁰⁸

Similarly, Bair explains that the New York Fed's support of Citi's attempt to purchase the failing Wachovia bank was really a backdoor way to bail out Citi, camouflaged as a way to help Wachovia.¹⁰⁹ Citi depended heavily on a flighty uninsured foreign deposit base for its funding and was desperate to gain access to Wachovia's balance sheet, which was filled with more stable, insured domestic deposits.¹¹⁰ Allowing Citi to purchase Wachovia would have helped Citi, but it would have exposed the FDIC to significantly greater risk if Citi failed. In other words, the bailouts were not a scientific, technocratic exercise following the Friedman and Schwartz and Bagehot playbooks, but a sweetheart deal between banks and regulators seeking to save face. Bair sees the bailout as a personal matter for regulators like Geithner.¹¹¹

The OCC and the New York Fed were driven to protect Citi out of a combination of institutional pride and personal loyalty:

Both the OCC and NY Fed refused to accept the reality of just how sick the institution was. . . . [Citi] had long been the "premier" charter for both the OCC and the NY Fed. It had a huge international presence, and as such its failure would be not just a domestic but an international embarrassment for those two regulators. What's more, Tim Geithner's mentor and hero, Bob Rubin, had served as the chairman of the organization and . . . had had a big hand in steering it toward the high-risk lending and investment strategies that had led to its downfall. I frequently wonder whether, if Citi had not been in trouble, we would have had those massive bailout programs. So many decisions were made through the prism of that one institution's needs.¹¹²

Geithner and Citi merge as the problem in Bair's story: "Tim seemed to view his job as protecting Citigroup from me, when he should have been worried about protecting the taxpayers from Citi."¹¹³

Bair's long-running fight with Citi gets quite personal, as Bair alleges that Citi, while on federal life support, hired a well-known D.C. dirty-trickster to "blunt" the FDIC in order to get Bair to back off limits on executive compensation.¹¹⁴ Bair implies that Citi was the origin

¹⁰⁸ *Id.* at 117.

¹⁰⁹ *Id.* at 96–98.

¹¹⁰ *Id.* at 98.

¹¹¹ *See id.* at 142.

¹¹² *Id.* at 124–25; *see also id.* at 142–43.

¹¹³ *Id.* at 170.

¹¹⁴ *Id.* at 208; *see also id.* at 207–08.

of a “mud-slinging” story about her family’s finances, which “was one of the most difficult [episodes] of [her] FDIC tenure.”¹¹⁵

The problem, Bair explains, was not simply an overly cozy relationship between bank regulators and Citi but regulatory capture, as the OCC, Office of Thrift Supervision (OTS), and the Fed all saw themselves as advocates for the banking industry, rather than as regulators of the industry.¹¹⁶ This problem manifested itself in the lead-up to the crisis, as the other bank regulators not only fought for lower capital requirements in Basel II, but also refused to get tough with their regulatory charges and enforce predatory lending laws. During the crisis, regulatory capture manifested itself with regulators looking out for their pet institutions: the OTS went to ridiculous lengths to unsuccessfully help Washington Mutual, its largest regulated entity, avoid FDIC receivership; the OCC and the New York Fed repeatedly stretched to help out Citi in particular; and regulatory forbearance was generously dispensed all around.¹¹⁷ In the regulatory reform debate, the regulators again went to bat for their institutions, and then in the robo-signing scandal regarding improper mortgage foreclosures that broke in the fall of 2010,¹¹⁸ the OCC went to great lengths to cover for banks engaged in illegal and fraudulent mortgage servicing acts. The distinct impression one gets from Bair’s book is how deeply broken and dysfunctional the banking regulatory system is.

In *Bull by the Horns*, Bair displays a keen awareness of the distributional consequences of the bailouts. She notes the injustice of bailing out big banks and sophisticated, well-heeled bondholders while forcing “the mother of a soldier in Afghanistan or a policewoman making \$50,000 a year . . . to take losses on their uninsured deposits.”¹¹⁹ Bair sees the banking system as a means to a Main Street end, not as an end in itself; banks are to be rescued to protect Main Street, not because the current banking system is optimal and indispensable. To this end, Bair gives considerable attention to the manqué assistance extended to homeowners, an area in which the FDIC took the lead, despite having authority over few mortgages. (Bair was also one of the few top financial regulatory officials to endorse cramdown.)

¹¹⁵ *Id.* at 307; *see also id.* at 208–11.

¹¹⁶ *See, e.g., id.* at 185, 192, 248–56 (describing OCC’s protection of the banks during the robo-signing scandal). The OCC is the primary prudential regulator of national banks; the OTS was the primary prudential regulator of federally chartered savings associations; and the Fed is the primary prudential regulator of both bank holding companies and state-chartered, Federal Reserve System member banks (“member banks”). The FDIC is the primary prudential regulator of state-chartered, nonmember banks.

¹¹⁷ *Id.* at 76–78.

¹¹⁸ OFFICE OF INSPECTOR GEN., DEP’T OF TREASURY, SAFETY AND SOUNDNESS: OCC’S SUPERVISION OF NATIONAL BANK’S FORECLOSURE PRACTICES 4–5 (2012).

¹¹⁹ BAIR, *supra* note 48, at 100; *see also id.* at 99–100.

Two points jump out. First, Bair observes that the Bush Administration refused to push for a firm commitment from the banks to help homeowners at the time when the Administration had the most leverage: right before the bailouts.¹²⁰ Second, the lack of concern for homeowners continued with little real change in the Obama Administration, despite the political costs. Bair observes that “Larry [Summers] and Tim [Geithner] didn’t seem to care about the political beating the president took on the hundreds of billions of dollars thrown at the big-bank bailouts and AIG bonuses, but when it came to home owners, it was a very different story. I don’t think helping home owners was ever a priority for them.”¹²¹ It was for the FDIC, to Bair’s credit.

Bair’s fights with Geithner were not confined simply to the bailouts. They also extended to the regulatory reform battles in the Dodd-Frank Act. Parts of the Dodd-Frank Act were battles between reformist political constituencies and the banks, but other parts were really interregulatory fights. This was particularly the case on the design of “resolution authority” — the authority of an executive branch agency to liquidate a failing financial company, rather than letting the company be liquidated in a bankruptcy court.

The issues between the FDIC and the Treasury were where such authority would be situated, how an executive-branch resolution mechanism would be funded, and whether it would be flexible enough to enable bailouts as well as liquidations.¹²² The FDIC wanted the Dodd-Frank legislation to expressly prohibit bailouts and to provide it with exclusive resolution authority, prefunded through regular assessments on large financial institutions. The Treasury wanted to preserve the flexibility to conduct bailouts on a case-by-case basis (thus enabling it to pick winners and losers) and to have resolution authority vested in a Treasury-led council of regulators. The Treasury also wanted to be sure that if the FDIC got the sole resolution authority, there would not also be a dedicated, pre-existing fund that would give the FDIC autonomy to exercise the authority and shut down a large bank without the Treasury’s acquiescence.¹²³ Alternative political approaches to bailouts manifested themselves in regulatory turf war.

Financial institutions did not have a dog in this hunt; they did not especially care how they were to be liquidated if they ran into trouble. Funeral arrangements are not a particular concern for financial institutions. Rather, this issue demonstrates regulatory dysfunction: the contours of resolution authority were an interregulatory struggle reflecting institutional power grabs and different views about bailouts

¹²⁰ *See id.* at 116.

¹²¹ *Id.* at 153.

¹²² *Id.* at 196–97.

¹²³ *Id.* at 226–27.

versus liquidation. How much of this fight was truly about principles as opposed to power politics is unclear, however, and the balance between these factors was not necessarily the same at the FDIC and the Treasury.

Perhaps the most remarkable — and troubling — detail that emerges from Bair’s story is how, even while accepting government bailout funds, the banks felt that they were in a position to negotiate with and even defy federal regulators.¹²⁴ Part of this brazenness stemmed from the lack of a unified front from regulators: Bank of America could defy the FDIC and fail to keep a commitment to sell an additional \$3 billion in shares to the market because it had the support of the Fed and OCC. The banks played divide and conquer against their regulators.

Bair’s book concludes with a long list of policy recommendations.¹²⁵ Some of them, like “Raise Capital Requirements,”¹²⁶ are not particularly controversial — or novel. Other recommendations, such as those dealing with the Securities and Exchange Commission (SEC) and the CFTC,¹²⁷ seem to come out of left field given that these agencies scarcely appear in Bair’s book. It should come as no surprise, either, that Bair advocates breaking up the “[m]egainstitutions” because they are too complex.¹²⁸ This complexity makes it difficult to credibly threaten to put megabanks into receivership or bankruptcy when they get in trouble, so bailouts become the only choice. Bair understands that absent a credible threat of bankruptcy or receivership, the too-big-to-fail problem will not disappear.

Bair is more sanguine than others, including me,¹²⁹ about the credibility of the Dodd-Frank Act’s prohibition on bailouts.¹³⁰ As I have noted in prior work, the Treasury and the Fed showed great legal creativity in 2008 and 2009.¹³¹ When the fur is flying in a financial crisis, the normal rule of law is often temporarily suspended, followed by solemn promises of “never again.”¹³² It is unclear if we can ever credibly commit to no more bailouts.¹³³

¹²⁴ *Id.* at 205. Even the negotiations leading to J.P. Morgan’s \$13 billion settlement with the Justice Department evinced this defiance: J.P. Morgan wanted the FDIC to cover the settlement costs related to J.P. Morgan’s acquisition of Washington Mutual. See Devlin Barrett & Dan Fitzpatrick, *J.P. Morgan, U.S. Reach Settlement*, WALL ST. J., Nov. 19, 2013, at A1.

¹²⁵ See BAIR, *supra* note 48, at 323–53.

¹²⁶ *Id.* at 324.

¹²⁷ *Id.* at 341–43.

¹²⁸ *Id.* at 328.

¹²⁹ See Levitin, *supra* note 38, at 439, 477.

¹³⁰ BAIR, *supra* note 48, at 326–28.

¹³¹ See Levitin, *supra* note 38, at 485–86, 497–98.

¹³² Anna Gelpern, *Financial Crisis Containment*, 41 CONN. L. REV. 1051, 1057 (2009) (“[C]ontainment may call for measures . . . that are legally and politically fraught.”).

¹³³ See Levitin, *supra* note 38, at 439.

Where Bair breaks new ground is on her recommendation for eliminating the OCC.¹³⁴ The OCC is the primary prudential regulator for banks with a federally issued national banking charter. Bair proposes that all depositories be regulated by the FDIC and all holding companies and nonbanks be regulated by the Fed. This is not just a matter of bad blood with the OCC, which has repeatedly shown itself to be among the most feckless of financial regulators.¹³⁵ It is with good reason that Bair argues that the FDIC and the Fed will do a better job than the OCC: the FDIC and the Fed are incentivized to protect the deposit insurance fund and to limit lender-of-last-resort exposure.¹³⁶ Indeed, this is probably the single most important and relatively unique prescription in the book, and her argument is quite compelling. It is hard to think of any particular reason to maintain the OCC as a

¹³⁴ See BAIR, *supra* note 48, at 339–41.

¹³⁵ See, e.g., Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. ON REG. 143, 152–55 (2009) (detailing the OCC’s preemption campaign and consumer protection shortcomings); Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the “Business of Banking,”* 63 U. MIAMI L. REV. 1041 (2009) (detailing how the OCC permitted national banks to expand into the derivatives business, which significantly increased their risk exposures); Joe Adler, *Watchdog Blames OCC Supervision for Failure to Catch ‘Robo-Signing’ Scandal*, AM. BANKER (June 1, 2012, 12:07 PM), http://www.americanbanker.com/issues/177_106/occ-robo-signing-foreclosures-1049806-1.html, archived at <http://perma.cc/GMT4-NHC4> (noting problems in the OCC supervision of bank foreclosure process); Kate Davidson, *Treasury Sharply Criticizes OCC’s Preemption Proposal*, AM. BANKER (June 28, 2011, 6:12 PM), http://www.americanbanker.com/issues/176_124/treasury-occ-preemption-1039548-1.html, archived at <http://perma.cc/R7ZE-CF6L> (noting the Treasury General Counsel’s unusual step of writing a public letter to the OCC in opposition to the OCC’s post-Dodd-Frank Act preemption regulations); Jeff Horwitz, *Bank Mortgage Kickback Scheme Thrived Amid Regulatory Inaction*, AM. BANKER (Sept. 16, 2011, 7:46 PM), http://www.americanbanker.com/issues/176_181/mortgages-reinsurance-deals-kickbacks-HUD-1042277-1.html, archived at <http://perma.cc/5Y9L-EYPU> (noting that the OCC permitted banks to have captive mortgage reinsurance affiliates, which led to a kickbacks problem in private mortgage insurance); Jeff Horwitz & Maria Aspan, *How Promontory Financial Became Banking’s Shadow Regulator*, AM. BANKER (Mar. 15, 2013, 5:00 PM), http://www.americanbanker.com/magazine/123_4/how-promontory-financial-became-banking-s-shadow-regulator-1057480-1.html, archived at <http://perma.cc/SVT6-ZCKL> (discussing the close connections between the OCC and bank consultant firm Promontory Financial, which received tremendous fees from the botched “independent” foreclosure review process); Carrick Mollenkamp, *U.S. Senate Report Says Regulator Let HSBC Woes ‘Fester,’* REUTERS (July 16, 2012, 6:29 PM), <http://www.reuters.com/article/2012/07/16/us-hsbc-compliance-senate-occ-idUSBRE86F1A520120716>, archived at <http://perma.cc/5A4T-X8SD> (pointing out the OCC’s failure to address money laundering issues); Barbara A. Rehm, *OCC Bungled Foreclosure Settlement from Start to Finish*, AM. BANKER (Mar. 6, 2013, 6:31 PM), http://www.americanbanker.com/issues/178_45/occ-bungled-foreclosure-settlement-from-start-to-finish-1057304-1.html, archived at <http://perma.cc/G9LN-E9WW> (discussing problems in the robo-signing settlement and foreclosure reviews); Rachel Witkowski, *How Thomas Curry Is Trying to Redeem the OCC*, AM. BANKER (Dec. 23, 2013, 3:25 PM), http://www.americanbanker.com/issues/178_245/how-thomas-curry-is-trying-to-redeem-the-occ-1064530-1.html, archived at <http://perma.cc/E634-AZUC> (discussing “the agency’s battered reputation” and detailing numerous problems including that “the OCC was asleep at the switch” regarding J.P. Morgan Chase’s “London Whale” multi-billion dollar trading debacle).

¹³⁶ BAIR, *supra* note 48, at 341.

separate regulator — it was created as part of a Civil War finance device,¹³⁷ and its *raison d'être* ceased with the creation of the Fed in 1913. The OCC has outlived its usefulness by a good century and should have been put down in 2010.

D. *The Prosecutor*

Bair's depiction of bank regulation as a mixed martial art is confirmed by Neil Barofsky's *Bailout*.¹³⁸ In Barofsky's tale, the author appears as a political ingénue fortuitously tossed into the rough and tumble world of D.C. politics. The book has a touch of *Mr. Smith Goes to Washington*: Barofsky, a thirty-eight-year-old mid-level prosecutor in the U.S. Attorney's Office for the Southern District of New York, is picked to serve as the Special Inspector General for the Troubled Asset Relief Program (SIGTARP).

SIGTARP was one of the two main oversight mechanisms for the \$700 billion in bailout funds (the TARP) appropriated by Congress under the Emergency Economic Stabilization Act.¹³⁹ (The other was Professor (now-Senator) Elizabeth Warren's Congressional Oversight Panel, for which I worked.) SIGTARP's particular mandate was to prevent fraud, waste, and abuse of the TARP funds through criminal and civil investigations, audits, and recommendations regarding program management.¹⁴⁰ SIGTARP did not have authority over the other myriad bailout programs, such as those undertaken by the Fed, that were not part of the TARP. (So much for Bernanke's accountability . . .)

Barofsky quickly learns that in D.C., inspector generals are "way too concerned about how they would be perceived, whether by Congress, the senior management team at the agencies they were supposed to be overseeing, or other IGs."¹⁴¹ Barofsky is rapidly initiated into the petty world of D.C. turf wars: he is assigned some of the worst office space at the Treasury, in an English basement, right next to the Treasury Department cafeteria.¹⁴² His office even reeks from a leaking sewage pipe: "I think the Treasury people stuck dead fish in the rafters," says his deputy.¹⁴³ The message is clear: the Treasury doesn't want Barofsky poking his nose into its activities.

Barofsky doesn't bury the lede in his book. He begins with an astounding prologue relating a conversation he had with the late Herb

¹³⁷ Adam J. Levitin, *Public-Private Risk Sharing in Financial Regulation* (Apr. 5, 2013) (unpublished draft) (on file with the Harvard Law School Library).

¹³⁸ BAROFSKY, *supra* note 63.

¹³⁹ Pub. L. No. 110-343, 122 Stat. 3765 (codified as amended in scattered sections of 12 and 26 U.S.C.).

¹⁴⁰ See 12 U.S.C. § 5231 (2012).

¹⁴¹ BAROFSKY, *supra* note 63, at 52.

¹⁴² *Id.* at 47.

¹⁴³ *Id.* at 136 (internal quotation marks omitted).

Allison, the Assistant Treasury Secretary for Financial Stability (the “bailout tsar”) and former head of Merrill Lynch, TIAA-CREF, and Fannie Mae. Barofsky comes to the meeting shvitzing in wool attire inappropriate for the D.C. heat, while the smooth Allison is able to get the choice seat in the restaurant simply by adopting a “‘Do you know who I am?’ tone.”¹⁴⁴

Allison begins the meeting by gently telling Barofsky that he is destroying his future career prospects by saying the things he has been saying: “[Y]ou’re a young man, just starting out with a family, and obviously this job isn’t going to last forever. Have you thought at all about what you’ll be doing next?”¹⁴⁵ After being rebuffed, Allison changes his approach: “Well, is it an appointment you might be looking for? Something else in government? A judgeship?”¹⁴⁶ After Barofsky demurs, Allison responds, “Well, Neil, it doesn’t have to be that way. It’s not necessarily off the table. All you really have to do is change your tone, just a bit, and things can really change for you. Including with the White House.”¹⁴⁷

Barofsky states in obligatory fashion that he doesn’t think Allison was really threatening or attempting to bribe him,¹⁴⁸ but this disclaimer is all done with a knowing wink at the reader. The only reason to relate the episode is to make the point that Allison was offering him “the gold or the lead.”¹⁴⁹ It’s clear that Barofsky thinks that Allison — and by implication the rest of the Treasury bailout team — is no different from the narco-terrorists he previously prosecuted. (“Yeah, the bullet or the bribe, I think he totally Escobarred me.”¹⁵⁰) This book is about a cop trying to bring a Wall Street mafia to justice, with Barofsky starring as a financial Eliot Ness.

Barofsky’s book, like Bair’s, details the rough-and-tumble bureaucratic infighting over bailouts: media leaks, searches for allies, invocations of the President’s name in vain (in Washington, agency independence notwithstanding, one does not refuse the President¹⁵¹), and yet more expletive-filled tirades from Timothy Geithner, who claims, “I have been the most *fucking* transparent secretary of the Treasury in this country’s entire *fucking* history!”¹⁵²

It’s hard to tell how effective Barofsky himself was as an Inspector General. His office did bring some enforcement actions, but he had

¹⁴⁴ *Id.* at xxii.

¹⁴⁵ *Id.* at xxii–xxiii (internal quotation mark omitted).

¹⁴⁶ *Id.* at xxiv (internal quotation marks omitted).

¹⁴⁷ *Id.* (internal quotation marks omitted).

¹⁴⁸ *Id.* at xxv.

¹⁴⁹ *Id.* (internal quotation mark omitted).

¹⁵⁰ *Id.* (internal quotation marks omitted).

¹⁵¹ *See id.* at 110–11, 118.

¹⁵² *Id.* at 172 (internal quotation mark omitted).

little substantive input on the design of TARP programs. His most important role was as a sharp after-the-fact critic. His efforts at shaping policy were often unsuccessful because of concerted Treasury opposition and dirty tricks: Barofsky was routinely stonewalled by the Treasury and kept in the dark about programs until the last minute.¹⁵³ Moreover, the Treasury would leak anti-SIGTARP lines to the press and Congress,¹⁵⁴ try to stir up bad blood between SIGTARP and the Congressional Oversight Panel,¹⁵⁵ and even attempt to get the Department of Justice to declare that SIGTARP reported to the Treasury Secretary (who could then direct SIGTARP to back off any of its investigations).¹⁵⁶ Despite all of Barofsky's best efforts, however, the bailouts occurred with precious little transparency, and few of his recommendations were ever adopted. Yet his criticisms certainly had a sting to the Treasury at the time, and even in this book they still do, with fresh and important observations.

The most damning and insightful moment in Barofsky's book is his observation that the Home Affordable Modification Program (HAMP), a foreclosure prevention program that paid mortgage servicers incentive bounties for modifying distressed mortgage loans, was never really about helping homeowners. Instead, it was about helping banks earn their way out of insolvency.¹⁵⁷ HAMP mortgage modifications had many patently obvious flaws, to which the Treasury was largely indifferent. For example, the modifications were actually only temporary; after five years, the interest rates on the modified loans would start to rise. Likewise, HAMP did not mandate any forgiveness of principal, despite clear evidence that negative equity was a major factor in foreclosures.¹⁵⁸ But these were only flaws in HAMP when viewed from a Main Street perspective of foreclosure prevention.

HAMP, Barofsky intimates, was designed to delay, rather than prevent, foreclosures. Delay meant that banks could recognize foreclosure losses over time against earnings, rather than face immediate loss recognition, which might have shown some banks to be insolvent and necessitated placing them into receivership. Whether HAMP would actually work to prevent foreclosures was secondary.

¹⁵³ See, e.g., *id.* at 128–29.

¹⁵⁴ E.g., *id.* at 150, 210–11, 214.

¹⁵⁵ See *id.* at 150.

¹⁵⁶ See *id.* at 143–46.

¹⁵⁷ See *id.* at 156–57.

¹⁵⁸ See CONG. OVERSIGHT PANEL, OCTOBER OVERSIGHT REPORT: AN ASSESSMENT OF FORECLOSURE MITIGATION EFFORTS AFTER SIX MONTHS 2–3 (2009).

HAMP was not separate from the bank bailouts; it was an essential part of them. From that perspective, it didn't matter if the modifications failed after a year or so of trial payments or if struggling borrowers placed into doomed trial modifications ended up far worse off, as long as the banks were able to stretch out their pain until their profits returned.¹⁵⁹

HAMP was a program designed to “help foam the runway” for the banks, Treasury Secretary Geithner stated.¹⁶⁰ Even the one component of the bailout that was marketed as helping Main Street was really about helping Wall Street. Critics of HAMP immediately recognized the delayed loss recognition effect of the modifications,¹⁶¹ but Barofsky is the first to charge that the program was never meant to help homeowners. If Barofsky is correct, one wonders how well this was understood in the White House, given the President's repeated comments about the promise of the program, or whether the Treasury team pulled one over on the President, as well as the public.

The Treasury's goals with HAMP also help explain why the Treasury never pushed for “cramdown” legislation to allow mortgages to be modified in bankruptcy without lender consent: cramdown would have forced immediate loss recognition on the banks and would have required more public assistance to the banks, further diluting existing bank shareholders' interests. The Geithner Treasury could not openly oppose cramdown, particularly given President Obama's endorsement of the idea as a *candidate*, but the Treasury's concerns about loss recognition drove the Obama *Administration's* lack of active support of the legislation.

HAMP is also exhibit A in Barofsky's indictment of “Treasury's modus operandi”:

[F]irst, announcements intended to “shock and awe” the media that made for good sound bites but were not particularly well thought out; then, weeks later, scattered and incomplete details that had to be reworked on the fly. And finally, poor program execution that accomplished little, if any, of the originally announced goals.¹⁶²

Not only did HAMP exemplify the seat-of-the-pants management of the bailouts that consistently over-promised and under-delivered, but it also resulted in a sharp political backlash in the form of the “Tea Party” inspired by CNBC anchor Rick Santelli's rant against the newly announced HAMP program: “How many of you people want to pay

¹⁵⁹ BAROFSKY, *supra* note 63, at 157.

¹⁶⁰ *Id.* at 156.

¹⁶¹ See CONG. OVERSIGHT PANEL, DECEMBER OVERSIGHT REPORT: A REVIEW OF TREASURY'S FORECLOSURE PREVENTION PROGRAMS 52 (2010); CONG. OVERSIGHT PANEL, *supra* note 158, at 21.

¹⁶² BAROFSKY, *supra* note 63, at 124.

for your neighbor's mortgage that has an extra bathroom and can't pay their bills? Raise their hands. . . . We're thinking of having a Chicago tea party in July."¹⁶³ As Barofsky notes:

Treasury, by rolling out a hurried and poorly thought out mortgage modification program, had just helped give birth to the Tea Party. Santelli's rant, and the political movement it inspired, hung over the program for the rest of my time in Washington.¹⁶⁴

Indeed, even four years later, the Tea Party phenomenon continues to shape the political landscape in significant ways. One has to wonder how different post-2008 politics would have been if only the Treasury had properly addressed the foreclosure crisis. The entire American political system may be paying the price for the Treasury's protection of financial institutions and their uninsured creditors.

E. The Lobbyist

Bair's and Barofsky's books tell tales of bureaucratic infighting frustrating the governmental process. Lobbyists appear in these books, but they are bit players. Not so in Jeff Connaughton's *The Payoff*. This is a tell-all book about the world of Washington influence peddling. Connaughton was "someone who served in mid-level positions in government and lobbying for more than two decades,"¹⁶⁵ most recently as chief of staff to Senator Ted Kaufman (D-Del.), who himself had served as Senator Joe Biden's chief of staff. Connaughton offers "an insider's view" of Washington financial regulation politics in a coming-of-age story about falling out of love with his political idol and patron Vice President Joe Biden.¹⁶⁶

Connaughton is angry. Very angry. And that's part of what makes *The Payoff* work. Connaughton's gonna say it like it is and doesn't care if he burns all of his professional bridges. We don't learn much that's factually new in the book (other than some mildly embarrassing anecdotes about Vice President Biden), but *The Payoff* is a stinging indictment of financial regulatory politics in D.C. Connaughton's indictment is of an entire class of Professional Democrats (and Professional Republicans) — a D.C. establishment that is neither blue nor red, but "green."¹⁶⁷

The D.C. that Connaughton describes is a world in which favors are done in exchange for professional advancement — leaking information to lobbyists ensures lucrative employment once one leaves the Hill or government agencies. As Connaughton notes, "[i]t's not a tale

¹⁶³ *Id.* at 127 (internal quotation marks omitted).

¹⁶⁴ *Id.*

¹⁶⁵ JEFF CONNAUGHTON, *THE PAYOFF* 10 (2012).

¹⁶⁶ *Id.*

¹⁶⁷ *Id.* at 11.

of bags filled with cash and quid pro quos. It's more subtle than that"¹⁶⁸ Instead, there is an entire self-contained ecosystem of individuals revolving between government-relations positions at banks, trade associations, lobbying firms, and regulatory agencies. This ecosystem of regulators and lobbyists is what Connaughton memorably calls "The Blob."¹⁶⁹ As he explains in a remarkable description:

A king has his retinue, a celebrity his entourage, and Pig-Pen his cloud of dirt. Washington has The Blob. The Blob (it's really called that) refers to the government entities that regulate the finance industry — like the Banking Committee, Treasury Department, and SEC — and the army of Wall Street representatives and lobbyists that continuously surrounds and permeates them. The Blob moves together. Its members are in constant contact by e-mail and phone. They dine, drink, and take vacations together. Not surprisingly, they frequently intermarry. Indeed, a good way to maximize your family income in DC is to specialize in financial issues and marry someone in The Blob. Ideally, you and your spouse take turns: One of you works for a bank, insurance company, or lobbying firm while the other works for a government entity that regulates, or enacts legislation for, the financial industry. Every few years, you reverse roles¹⁷⁰

Against this backdrop, Connaughton doubts that either financial reform or enforcement is really possible. To speak out threatens one's entire personal world for an issue in which there is likely no personal gain. "Party cohesion and the desire to make a munificent living in DC go a long way to enforce silence."¹⁷¹ Fortunately for the reader, Connaughton has broken this code of silence. He has "mutinied" and fled to his own personal "Pitcairn Island" of Savannah, Georgia.¹⁷² Yet the point remains: reform would require a wholesale change in the way D.C. operates, not just politically, but socially.

The financial crisis of 2008 presented a window of opportunity for changing the financial regulatory world, but the Obama Administration squandered its chance by staffing its financial regulatory team with a group of Professional Democrat technocrats, many of them former Clinton Treasury hands. As soon as they were brought in as part of the Obama team, financial regulatory reform was doomed:

The onset of the Great Recession should've been a moment when reformers realized the financial elite's grip on Washington had become too strong, as when Teddy Roosevelt stood up to the trusts and FDR cracked down on Wall Street. Instead, Obama and Biden gave the problem a sideways glance and then delegated the solutions to the same circle of Wall

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 147.

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 12.

¹⁷² *Id.*

Street-Washington technocrats who had brought the financial disaster upon us in the first place.¹⁷³

From the beginning, then, it would seem that Connaughton and Senator Kaufman were on a fool's errand to try and push for game-changing financial regulation like statutory leverage and size limits on U.S. financial institutions. Connaughton and Senator Kaufman can point to little in the way of affirmative legislative accomplishment. Senator Kaufman sponsored legislation with Senator Sherrod Brown (D-Ohio) that would have effectively broken up the big banks by imposing a six percent assets-to-equity ratio on bank holding companies and some nonbanks, limiting bank holding companies to no more than ten percent of insured deposits in the United States, and limiting the size of nondeposit liabilities at financial institutions to two percent of gross domestic product.¹⁷⁴ When the Brown-Kaufman Amendment finally got a floor vote, it was soundly defeated on a sixty-one to thirty vote, opposed by all but three Republican Senators, many Democrats, and the Treasury Department.¹⁷⁵

Senator Kaufman's primary importance was as an independent voice in the Senate, hectoring for financial reform in hearings, in correspondence with regulators, and in the media. The importance of this bully-pulpit role (also effectively used by Kaufman's predecessor as Chair of the Congressional Oversight Panel, then-Professor and now-Senator Warren) should not be dismissed too quickly. While Senator Kaufman's name is not on any legislation that passed, he did affect the tone of the regulatory conversation, and arguably he helped prevent the watering down of a variety of proposed bills and rules. This was possible largely because Senator Kaufman was not running for reelection, which allowed him to focus like a laser on the issue he cared most about: financial regulatory reform.

It would be unfair to have expected much more of Senator Kaufman, whose potential for influence was extremely limited. He was a junior first-term Senator serving out the remainder of Vice President Biden's Senate term. Senator Kaufman did not serve on the Banking Committee, much less have a committee chairmanship. In the seniority-driven Senate, this severely limited what he could do. Still, the limits on what a committed, talented, and un beholden Senator such as Kaufman could achieve sends a disheartening message about the potential for politically driven financial reform.

¹⁷³ *Id.* at 10–11. This critique reemerged in the summer of 2013, in the debate over whether Larry Summers, Democratic technocrat par excellence, should be nominated as Chairman of the Board of Governors of the Federal Reserve.

¹⁷⁴ *See id.* at 227–28.

¹⁷⁵ *See id.* at 228, 243.

A large part of Connaughton's book is devoted to his and Senator Kaufman's quest to ensure criminal prosecutions of major financial institution executives for frauds committed during the financial crisis. Connaughton details his initial hope for effective criminal prosecution with the passage of the Fraud Enforcement and Recovery Act of 2009,¹⁷⁶ which provided for enhanced enforcement of fraud related to financial institutions. The hope was short-lived, however. The Senate Appropriations Committee refused to fund the fraud enforcement program, and Connaughton began to realize that:

The Justice Department seemed to have handed the job of financial-crisis-related fraud to the SEC. [And f]or its part, the SEC seemed to be focusing on resolving allegations through civil-law settlements and comparatively painless monetary fines. . . . [T]his approach, I believe, was the mere semblance of accountability under law.¹⁷⁷

Assistant Attorney General Lanny Breuer's repeated promises of "robust" and "comprehensive" enforcement sounded less and less like Eliot Ness and more like "Kevin Costner reading his lines."¹⁷⁸ To Connaughton, the whole promise of criminal enforcement began to appear nothing more than a charade.

Connaughton rightly notes that there may be several reasons why there have not been serious criminal prosecutions of any corner-suite executives in financial institutions beyond the case of Taylor, Bean & Whitaker CEO Lee Farkas (Who? Exactly.), a prosecution that came out of a Neil Barofsky SIGTARP investigation and that was resisted by the Department of Justice.¹⁷⁹ First, it might be too soon because more investigation may be necessary to determine if crimes were committed; second, delay in investigation may have frustrated prosecution because of spoliation of evidence; and third, there simply might not be any provable criminal conduct.¹⁸⁰

None of these explanations are satisfactory. The "too soon" argument is hard to reconcile with the delay argument. The "too soon" argument is also becoming the "too late" argument, as statutes of limitations run (although the federal statute of limitations for bank fraud is

¹⁷⁶ Pub. L. No. 111-21, 123 Stat. 1617 (codified as amended in scattered sections of 18 and 31 U.S.C.).

¹⁷⁷ CONNAUGHTON, *supra* note 165, at 91.

¹⁷⁸ *Id.* at 92.

¹⁷⁹ BAROFSKY, *supra* note 63, at 104-08.

¹⁸⁰ CONNAUGHTON, *supra* note 165, at 79-80, 86-95.

ten years¹⁸¹). At this point, we should not hold our breath for prosecutions. A March 2014 Department of Justice Inspector General's report found that the Department of Justice had "substantially overstated" its accomplishments in prosecuting mortgage fraud.¹⁸² Indeed, the Inspector General

found that, despite public statements by the [Financial Fraud Enforcement Task Force] and the Department [of Justice] about the importance of pursuing financial frauds cases, including mortgage fraud, the FBI Criminal Investigative Division ranked Complex Financial Crimes as the lowest of the six ranked criminal threats within its area of responsibility, and ranked mortgage fraud as the lowest subcategory threat within the Complex Financial Crimes category [and that] mortgage fraud [was] a low priority, or not listed as a priority, for FBI Field Offices in the locations we visited, including Baltimore, Los Angeles, Miami, and New York.¹⁸³

While it might now be "too late" for some prosecutions, that merely raises the question of why the prosecutions did not happen sooner.

The tougher issue is whether there was provable criminal conduct. The claim that there was no provable criminal conduct is tautological — the evidence of lack of such conduct is the lack of charges. Yet, this claim has never really rung true.¹⁸⁴ Given the sheer scope of financial activity that occurred in the United States in the bubble years, it is hard to believe that there was not some amount of fraud occurring. Connaughton never articulates exactly what sorts of frauds he thinks might have occurred, although it is hardly fair to expect him to identify a specific fraud. Still, likely candidates are warehouse lending frauds like that at Taylor, Bean & Whitaker, accounting frauds, and the knowing provision to investors of false information about the quality of securitized mortgages. Every competent, independent factfinder to examine the crisis has pointed to evidence of fraud. There are strong indications of criminal wrongdoing in the Lehman bankruptcy examiner's report, the Financial Crisis Inquiry Commission's report, and the Permanent

¹⁸¹ See 18 U.S.C. § 3293 (2012).

¹⁸² U.S. DEP'T OF JUSTICE, OFFICE OF THE INSPECTOR GEN., AUDIT OF THE DEPARTMENT OF JUSTICE'S EFFORTS TO ADDRESS MORTGAGE FRAUD, at ii (2014), *archived at* <http://perma.cc/M3Y2-KZH9>.

¹⁸³ *Id.* at 8. Notably, the FBI treats mortgage-backed securities fraud as "securities fraud," not "mortgage fraud," meaning that funds for prosecuting mortgage fraud are not used for investigating mortgage securitization. See *id.* at 2.

¹⁸⁴ See Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REV. BOOKS (Jan. 9, 2014), <http://www.nybooks.com/articles/archives/2014/jan/09/financial-crisis-why-no-executive-prosecutions>, *archived at* <http://perma.cc/VGF3-K5NH> (presenting evidence of possible crimes during the financial crisis).

Subcommittee on Investigation's hearings on Washington Mutual, not to mention the documentary trail unearthed in private securities litigation, some of which is unsealed. Between federal bully statutes like wire fraud and mail fraud and the immense power federal prosecutors have to coerce plea bargains, it is hard to believe that a determined federal prosecutor could not have brought a criminal case against either a bank or its executives.

And yet it is hard to second-guess those with direct access to the information. This appears to be what happened inside the SEC regarding civil prosecutions. Those officials pushing for charges deferred to the judgment of the teams handling the cases, albeit with some incredulity.¹⁸⁵ Additionally, changes in prosecutorial culture may have resulted in prioritization of other types of cases such as insider trading cases, which in turn limited experience in handling financial frauds.¹⁸⁶ Similarly, prosecutors have developed a preference for pursuing firms, rather than individuals, with an eye toward settling for deferred prosecution agreements.¹⁸⁷ As Judge Jed. S. Rakoff has hypothesized, the result is that "you don't go after the companies, at least not criminally, because they are too big to jail; and you don't go after the individuals, because that would involve the kind of years-long investigations that you no longer have the experience or the resources to pursue."¹⁸⁸

Ultimately, Connaughton's book points toward another possibility: for whatever reason, no one ever really intended to investigate, and instead, prosecutors and policymakers hide behind the "too soon," "too late," and "no provable criminal conduct" arguments.¹⁸⁹ Thus, as Connaughton observes, "[d]espite our nearly fanatical dedication, we and other reformers failed. To date, there have been no high-profile Wall Street prosecutions for financial wrongdoing."¹⁹⁰ Connaughton concludes that hectoring for prosecutions is useless: "I knew what we were up against. . . . I'd watched Wall Street flex its hypertrophic muscles. And I'd seen how Wall Street can defeat even the president

¹⁸⁵ Ben Protess & Susanne Craig, *Inside the End of the U.S. Bid to Get Lehman*, N.Y. TIMES, Sept. 9, 2013, at A1.

¹⁸⁶ See Rakoff, *supra* note 184.

¹⁸⁷ See *id.*

¹⁸⁸ *Id.*

¹⁸⁹ Judge Rakoff too discounts the explanations given by federal officials regarding lack of prosecutions. *Id.* ("[T]he Department of Justice has never taken the position that all the top executives involved in the events leading up to the financial crisis were innocent; rather it has offered one or another excuse for not criminally prosecuting them — excuses that, on inspection, appear unconvincing.")

¹⁹⁰ CONNAUGHTON, *supra* note 165, at 9.

of the United States.”¹⁹¹ The point here is that the failure was not one of the regulatory system. It was a failure of the political system. After reading the book, one can understand why Connaughton threw in the towel in disgust and retreated from D.C.

F. *The Professors*

“It’s the capital, stupid!” That’s the argument, in a nutshell, of *The Bankers’ New Clothes*,¹⁹² by Stanford Business School finance professor Anat Admati and German academic economist Martin Hellwig, the Director of the Max Planck Institute for Research on Collective Goods in Bonn. Capital regulation is arguably the single most important issue in bank regulation because the more leveraged banks are (meaning *lower* leverage ratios), the more vulnerable they are to becoming insolvent and invoking the government guarantee. Admati and Hellwig’s book is a bold argument for requiring banks to have more equity capital.¹⁹³ Much more.

Under the Basel III Capital Accords, a heightened set of capital requirements that will go into effect in the United States in 2014, banks will be required to have a leverage ratio of equity to assets of 3%, among other capital requirements.¹⁹⁴ Admati and Hellwig argue that banks should have a leverage ratio of 20% to 30%, which is what they claim the market required before the implicit government guarantee of the financial system.¹⁹⁵ This is an audacious position that represents a significant contribution to the financial regulatory policy debate. Unfortunately, although Admati and Hellwig are on the side of the angels in wanting safer banks, there are serious problems with their argument, which stands on shaky historical grounds and fails to consider the trade-offs and the potential for regulatory arbitrage involved in higher capital requirements.

Admati and Hellwig argue correctly that there is no replacement for capital in terms of creating a safe and stable financial system. The logic undergirding their argument is that banks with more equity can absorb more losses and are therefore less likely to become insolvent, which will help governments avoid having to pick between bailouts

¹⁹¹ *Id.* at 95.

¹⁹² ANAT ADMATI & MARTIN HELLWIG, *THE BANKERS’ NEW CLOTHES* (2013).

¹⁹³ *See id.* at 219.

¹⁹⁴ *See* Implementation of Basel III, 78 Fed. Reg. 55,340 (Sept. 10, 2013) (interim final rule with request for comments); Implementation of Basel III, 78 Fed. Reg. 62,018 (Oct. 11, 2013) (to be codified at 12 C.F.R. pts. 208, 217, 225) (final rule).

¹⁹⁵ *See* ADMATI & HELLWIG, *supra* note 192, at 30–31, 178–79.

and contagious bank failures that harm the real economy.¹⁹⁶ As the financial crisis of 2008 showed, the entire financial system is guaranteed by the federal government, either explicitly or implicitly. “Never again” responses like the Dodd-Frank Act’s orderly liquidation authority are not and never can be credible guaranties against bailouts.¹⁹⁷ Thus we face a world in which bankers have unequal upside benefit and downside risk from their decisions, which incentivizes the pursuit of riskier investment strategies. In the modern world, a highly leveraged financial system will inherently privatize gains and socialize losses beyond capital, so the only thing preventing bailouts is a more robustly capitalized financial system.¹⁹⁸

Higher levels of capitalization can be accomplished only by regulation. By itself, the market will not encourage higher levels of capitalization because banks do not bear the costs of insufficient capitalization. Instead, those costs are externalized on the rest of the banking industry and on the public.¹⁹⁹

Admati and Hellwig want cost internalization and believe it can be best achieved by requiring higher equity requirements in the form of common equity that can be raised either by issuance of more of a bank’s common equity or by retention of earnings in lieu of dividends.²⁰⁰ They are dismissive of alternative methods for bolstering bank capital, particularly proposals for hybrid securities such as contingent convertible capital (so-called “co-co” bonds that convert to equity in certain conditions). Admati and Hellwig derisively characterize co-cos as an “anything but equity” approach that actually increases risk because the conversion of debt to equity can result in a contagion channel by which a crisis can spread to bank creditors.²⁰¹ What’s more, co-cos’ imminent conversion can induce strategic behavior by market participants that can itself further market instability.

Instead, Admati and Hellwig propose a simple, bright-line rule: a 20% to 30% leverage ratio of equity to assets without any risk weighting.²⁰² To put this proposal into perspective, Basel III requires a leverage ratio of only 3% (including off-balance-sheet exposures) in

¹⁹⁶ See *id.* at 219.

¹⁹⁷ See *id.* at 189; Gelpert, *supra* note 132, at 1062–69; Levitin, *supra* note 38, at 439.

¹⁹⁸ See ADMATI & HELLWIG, *supra* note 192, at 179.

¹⁹⁹ See *id.* at 216–17.

²⁰⁰ See *id.* at 182.

²⁰¹ *Id.* at 187–88.

²⁰² *Id.* at 179.

addition to risk-weighted capital ratios.²⁰³ The U.S. implementation of Basel III requires a phased-in 4% leverage ratio (excluding off-balance-sheet exposures, thereby lowering the ratio's denominator), and for banks that engage in their own risk weighting, a 3% leverage ratio (including off-balance-sheet exposures, thereby increasing the ratio's denominator).²⁰⁴ The failed Brown-Kaufman Amendment to the Dodd-Frank Act would have imposed a 6% leverage ratio, as well as limitations on the total liabilities of regulated financial institutions.²⁰⁵ A bipartisan bill sponsored by Senators Brown and David Vitter, introduced in April 2013, would direct federal banking agencies to abandon the Basel risk-based capital approach and phase in a minimum leverage ratio of 8% for smaller banks, defined as covered financial institutions with between \$50 billion and \$500 billion in assets, and 15% for banks with at least \$500 billion in assets.²⁰⁶ All of this is to say that a 20% to 30% leverage ratio is by far the outlier in the policy debate.

It is not clear how seriously Admati and Hellwig regard their specific numbers or whether their point is simply a general call for banks to have greater equity capital. As it is, their claim that banks historically held equity equal to between 20% and 30% of their assets prior to the development of the implicit federal guarantee²⁰⁷ is incorrect. Table 1, below, shows the median, mean, low, and high leverage ratios for the twenty-five largest national banks in the United States in 1900, 1910, and 1920. While the figures are directionally consistent with those cited by Admati and Hellwig, they are also substantially lower than the historical 25% leverage ratio claimed by the authors, whose sole cited source for domestic banks is a newspaper article noting that nearly one century ago commercial banks in New York had around a 15% to 20% ratio of equity to assets.²⁰⁸

²⁰³ See BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS 12, 61, 63 (rev. ed. 2011), archived at <http://perma.cc/8SQD-EEZF>.

²⁰⁴ Implementation of Basel III, 78 Fed. Reg. 62,018, 62,277 (Oct. 11, 2013) (to be codified at 12 C.F.R. § 6.4(c)(2)(iv)(A)–(B)). U.S. regulators have proposed additional supplementary leverage ratios of 6% and 5%, respectively, for global systemically important banks and their holding companies. Enhanced Supplementary Leverage Ratio Standards, 78 Fed. Reg. 51,101, 51,113 (proposed Aug. 20, 2013) (to be codified at 12 C.F.R. § 6.4(c)(1)(iv)(A)–(B)). Currently, eight U.S. firms would be covered by the proposed regulation. *Id.* at 51,111.

²⁰⁵ See *supra* p. 2025.

²⁰⁶ See Terminating Bailouts for Taxpayer Fairness Act of 2013, S. 798, 113th Cong. § 3(a)(1)–(2) (the “TBTF Act” or “Brown-Vitter Act”).

²⁰⁷ See ADMATI & HELLWIG, *supra* note 192, at 30–31.

²⁰⁸ *Id.* at 31 n.26 (citing Allan H. Meltzer, *Banks Need More Capital, Not More Rules*, WALL ST. J., May 17, 2012, at A13).

TABLE 1: LEVERAGE RATIOS (EQUITY:ASSETS) AT THE TWENTY-FIVE LARGEST NATIONAL BANKS, 1900–1920²⁰⁹

YEAR	MEDIAN	MEAN	LOW	HIGH
1900	13%	12%	3%	21%
1910	16%	17%	10%	28%
1920	10%	10%	2%	15%

It is also not clear what relevance any historical figures have to the modern business of banking. The risks and regulation of banking have undergone a wholesale change from the early twentieth century. New financial products exist, banks engage in new lines of business, geographic markets have expanded both domestically and internationally, regulation is much more detailed, and so forth.

Furthermore, the market does not currently require anything like 20% to 30% equity for entities that are not direct beneficiaries of the implicit guarantee of too-big-to-fail banks. Smaller banks are regularly put into FDIC receivership. Yet the market has never demanded anywhere close to 20% to 30% capital from these smaller banks. Likewise, the market never required 20% to 30% equity capital from large investment banks, even though they had a more questionable implicit guarantee, as illustrated by the fate of Drexel Burnham Lambert and Lehman Brothers, both of which ended up in bankruptcy. To be sure, there are indirect benefits to all financial institutions that are counterparties to too-big-to-fail institutions because the obligations owed to the former are effectively guaranteed by the government, but it is hard to attribute current capital levels of not-too-big-to-fail banks to this indirect benefit.

The core of *The Bankers' New Clothes* is not the precise policy prescription, but instead a long-form refutation of numerous arguments

²⁰⁹ The calculations are the author's own, with data from COMPTROLLER OF THE CURRENCY, TREASURY DEP'T, ANNUAL REPORT OF THE COMPTROLLER OF THE CURRENCY TO THE SECOND SESSION OF THE FIFTY-SIXTH CONGRESS OF THE UNITED STATES (1900); COMPTROLLER OF THE CURRENCY, TREASURY DEP'T, ANNUAL REPORT OF THE COMPTROLLER OF THE CURRENCY TO THE THIRD SESSION OF THE SIXTY-FIRST CONGRESS OF THE UNITED STATES (1911); and COMPTROLLER OF THE CURRENCY, TREASURY DEP'T, ANNUAL REPORT OF THE COMPTROLLER OF THE CURRENCY TO THE THIRD SESSION OF THE SIXTY-SIXTH CONGRESS OF THE UNITED STATES (1921). The leverage ratio is computed as the ratio of the sum of "Paid In Capital," "Surplus," and "Undivided Profits," divided by "Total Resources." These figures do not account for the callable capital of national banks, which was equal to their paid-in capital. See generally Howell E. Jackson, Response, *Losses from National Bank Failures During the Great Depression: A Response to Professors Macey and Miller*, 28 WAKE FOREST L. REV. 919 (1993); Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31 (1992).

against requiring greater bank equity capital.²¹⁰ Unfortunately, Admati and Hellwig refuse to engage seriously with some of the strongest arguments against requiring more bank capital, namely that it would raise banks' funding costs, which would:

- make regulated banking less competitive against unregulated shadow banking;
- make U.S. banks less competitive against foreign banks if the United States alone imposed higher capital requirements; and
- limit banks' ability to offer services at current rates.

Admati and Hellwig's response to these arguments is to concede that banks' funding costs would increase because of the diminution in the value of the government subsidy via the implicit guarantee of large financial institutions' debt obligations.²¹¹ Changing the debt-equity mix in the capital structure should not, by itself, change banks' total cost of funds, per the Modigliani-Miller capital structure irrelevance theorem.²¹² An important assumption of the Modigliani-Miller theorem, however, is that there are no bankruptcy costs. Bailouts undermine this assumption because debt and equity are not always treated the same in a bailout. The implicit government guarantee of the debt (but not of the equity) of too-big-to-fail institutions means that increasing the equity percentage of bank funding would entail a concomitant reduction in the subsidization of bank debt both because of the lower percentage of funding from debt and because the increase in equity makes the guarantee's invocation more remote.²¹³ Government guarantees (implicit and explicit) subsidize investment in banks, and this means that the debt-equity mix does matter in terms of banks' cost of funds. The subsidies, however, produce financial instability by encouraging excessive risk-taking because all gains are privatized, while some losses are socialized. Admati and Hellwig believe that this nets out negatively for social welfare, so they have no problem with increasing the funding costs for banks.²¹⁴

Indeed, this is Admati and Hellwig's major point, and it is a tremendously important one: analysis of bank capital requirements should be on a net-social-welfare basis. It cannot be done solely by looking at costs and benefits to banks. Equity capital might be more expensive *for banks*, but not from a net-social-welfare perspective.

²¹⁰ Admati and Hellwig recently released a shorter-form refutation of such arguments, including responses to critiques of their book. See Anat R. Admati & Martin F. Hellwig, *The Parade of the Bankers' New Clothes Continues: 23 Flawed Claims Debunked* (Rock Ctr. for Corp. Governance, Working Paper Series No. 143, 2013), archived at <http://perma.cc/KA7-UETP>.

²¹¹ ADMATI & HELLWIG, *supra* note 192, at 109–10.

²¹² See Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

²¹³ See ADMATI & HELLWIG, *supra* note 192, at 129–47.

²¹⁴ See *id.* at 145–47, 161–66.

Higher equity requirements might be costly to bankers because of reduced returns on equity, but society as a whole would be better off, they claim, because there would be a more stable financial system that would not have to be bailed out.²¹⁵

Is this in fact true? Are implicit guarantees and ex post bailouts really less socially efficient than higher ex ante capital requirements? Is social welfare enhanced by raising banks' funding costs by making the invocation of the government's implicit guarantee more remote? These are empirical questions, and Admati and Hellwig seem to take the answers as self-evident. But if government can bear risk better than private capital, then implicit guarantees might in fact be efficient. Perhaps the subsidization of the financial system is in fact socially efficient by encouraging greater economic growth. Admati and Hellwig's entire argument rides on an empirical assumption; if they are wrong, then their case for higher bank capital collapses.

To make the social-welfare-gain claim, then, Admati and Hellwig have to ignore or dismiss the most obvious downsides from increasing U.S. banks' capital requirements: regulatory arbitrage, both domestically and internationally, and reduced economic growth. Regulatory arbitrage may frustrate whatever stability benefits would obtain from increased capital requirements. The trade-off between a more volatile economic system with greater growth potential and a more stable system with less growth potential is a fundamental question about what sort of society we want.

Regulatory arbitrage may increase if banks' cost of funding is increased, which makes the regulated banking sector less competitive vis-à-vis the unregulated (or less regulated) "shadow banking" sector. Shadow banking is credit intermediation outside of the regular banking system. Such nonbank credit intermediation involves money market mutual funds replacing bank deposits, securitization replacing deposit-funded bank loans, credit default swaps, repo and securities lending replacing secured credit, AAA-rated securitized assets replacing Treasury securities as collateral, and credit derivatives combining with securitization to create synthetic debt securities. If traditional banking becomes less competitive against shadow banking, then banking functions could shift from the regulated sector to the unregulated sector.

Admati and Hellwig's answer is simply to regulate the unregulated sector to end the arbitrage.²¹⁶ It is unclear if this means imposing capital requirements on the shadow banking sector or simply prohibiting certain activities outside of regulated banks. The consequences from

²¹⁵ See *id.* at 145-47.

²¹⁶ See *id.* at 224-26.

either are potentially problematic and are left unaddressed by Admati and Hellwig. Consider, for example, if all mortgage lending had to be financed solely from depositories' balance sheets rather than through securitization. If depositories continued to finance consumer-friendly, long-term fixed-rate mortgages with demand deposits, the result would be an asset-liability duration mismatch that would pose tremendous interest rate risk to the banks, setting up a repeat of the savings and loan crisis. If, on the other hand, depositories simply abandoned long-term fixed-rate mortgages, consumers could lose an important tool for protecting against inflation in their housing expenses.

Likewise, Admati and Hellwig fail to address the problem of international capital regulation arbitrage. In a world where capital easily crosses borders, there is an all-too-real international race-to-the-bottom dynamic in capital standards. Admati and Hellwig never directly address this issue in their book.²¹⁷ They rightly observe that subsidies via implied government guarantees are distortive, but their response is that the United States should "just say no" and decline the invitation to ape foreign subsidization of the banking sector.

This answer does not suffice. U.S. financial institutions, nonfinancial businesses, and consumers have exposure to foreign financial institutions. This means that foreign bank capital requirements cannot just be ignored because the externalities from inadequate capitalization may be felt globally. The fall 2008 collapse of Iceland's banks affected not just Iceland, but also foreign depositors.²¹⁸ The collapse of Lehman Brothers was felt worldwide.²¹⁹ It is not enough for domestic bank regulators to "just say no" to louche foreign capital requirements. Admati and Hellwig seem oblivious to this problem and do not discuss possible (if problematic) solutions to international capital competition, such as ring-fencing U.S. financial markets.

Similarly, Admati and Hellwig refuse to engage with the strongest counter to their claim that higher bank capital requirements would enhance net social welfare: that such requirements could restrict growth. Higher costs of capital for the entire banking industry could result in higher costs and/or less availability of financial services, which in turn could limit economic growth.

Admati and Hellwig never present this argument fairly, much less explain why higher costs of financial services would not affect economic growth. Instead, they dismiss a version of this argument made by Deutsche Bank CEO Josef Ackermann by suggesting that his logic was the same as a British Bankers' Association (BBA) claim that con-

²¹⁷ See *id.* at 194–99.

²¹⁸ See Levitin, *supra* note 38, at 459.

²¹⁹ See *id.* at 457.

fused reserves and capital.²²⁰ By burning the straw man of the BBA's confused claim, Admati and Hellwig avoid grappling with the real gravamen of Ackermann's statement: higher costs of capital will result in less growth. Thus, the trade-off that needs to be considered is one of growth versus stability, and the neat win-win situation that Admati and Hellwig imagine does not really exist. Instead, there are hard political decisions underlying bank regulatory policy.²²¹ Increasing bank capital levels is not the no-brainer that Admati and Hellwig claim it to be.

Implicit in Admati and Hellwig's argument is that high capital requirements will reduce the implied government guarantee and therefore result in credit being priced more efficiently in the economy, which should in turn assure the correct level of growth. In other words, we should seek to have the *correct* level of credit and growth, rather than simply *more* credit and growth. Yet this just begs the question of whether we prefer volatile growth to stability. Admati and Hellwig seem to assume that in the long run, the tortoise of higher capital will beat the hare of subsidization in terms of maximizing social welfare. But is this so? The reader is never told why.

Even if Admati and Hellwig are correct about the net social welfare benefit from higher bank capital requirements, their proposal is not Pareto superior to the current system because not everyone can be made better off without making someone worse off. Herein lies the problem: bank capital reforms have distributional consequences. To wit, a safer banking system would have a concentrated and immediate negative impact on bankers as well as the users of financial services, both of whom would be deprived of the government subsidy — while the social benefits from a more stable financial system are temporally remote and diffuse. This situation presents the classic problem of concentrated versus diffuse interest groups and, as such, is unlikely to result in political reform.²²² Even if Admati and Hellwig are right, the political economy of bank capital requirements is arrayed against them.

Admati and Hellwig recognize this problem, concluding that:

We can have a financial system that works much better for the economy than the current system — without sacrificing anything. But achieving this requires that politicians and regulators focus on the public interest

²²⁰ See ADMATI & HELLWIG, *supra* note 192, at 5–6, 97.

²²¹ Indeed, one might even argue that because government can bear catastrophic risk more efficiently than the private sector, subsidizing growth via implicit guarantees against catastrophic losses actually *increases* net social welfare (albeit with serious distributional ramifications). See Levitin, *supra* note 137.

²²² See generally MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1965).

and carry out the necessary steps. The critical ingredient — still missing — is political will.²²³

The real question, then, is not whether we know how to regulate banks for safety and soundness. Admati and Hellwig think this is actually pretty easy; for all of the complexity of banking regulation, it is not rocket science. Instead, the real question is the political question: how do we ensure a political system that engages in appropriate measures of financial regulation? Unfortunately, Admati and Hellwig offer no insight regarding where to find the “critical ingredient” of political will. Even if they are correct about stability being preferable to volatile growth over the long term, it is the short-term effect that often matters politically. In the short term, growth is more alluring than stability as it offers immediate distributional and hence political benefits, as long as the costs of volatility can be pushed into the future. The time inconsistency of political preferences between growth and stability shades any discussion of bank capital requirements. Admati and Hellwig present a provocative template for taming the banking system but have no solutions for the political system. It is to the problem of financial politics that the next part of this Review Essay turns.

II. FINANCIAL POLITICS

This Part of the Review Essay considers the challenge the financial crisis of 2008 presents to the current system of technocratic regulation by independent agencies. Simply put, the system failed. The question is: “Why?”

Two basic explanatory narratives have developed, as reflected by the books discussed above. The first narrative sees the crisis as the result of a financial system guided by outmoded regulation and struck by a “perfect storm.” The solution this narrative suggests is discrete regulatory updating, and indeed this solution has been the major regulatory response to the crisis.

The second narrative sees the root of the crisis in a captured regulatory system. Regulators had sufficient tools to prevent the crisis but failed even to try to use them and, in fact, exacerbated the crisis through agency-driven deregulation. This capture narrative suggests three basic, if potentially conflicting, regulatory approaches: giving up on technocratic independence and making financial regulation more democratically responsive; redesigning the regulatory system to better insulate regulators from political pressure; and harnessing the rent-seeking impetus of competing interest groups to produce symmetrical and offsetting political pressures that create space for more neutral, technocratic policymaking. This Part explores in turn these various

²²³ ADMATI & HELLWIG, *supra* note 192, at 228.

approaches, their manifestations in post-crisis regulation, and their promises and limitations.

A. The Challenge of 2008 and Its Lessons

In the United States, most financial regulatory policy is carried out by independent agencies. The purpose of agency independence is to free policymaking from political interests, allow it to be set in reliance on objective scientific facts, and avoid the delays and distortions of politics.²²⁴ The contours of the independent agency were shaped by Progressives and New Dealers, who believed that the traditional tripartite political system had come to be dominated by moneyed business interests.²²⁵ Legislatures were not properly aggregating societal preferences because of the undue weight given to concentrated financial interests.²²⁶ Similarly, common law courts failed to ensure proper policy because they tended to protect existing distributions of wealth and power.²²⁷

New Dealers envisioned technocratic regulatory agencies as the antidote to the power of white-shoed titans of industry. The unshackled technocratic power of expert administrative agencies would produce a new age of government freed from the corrupt politics of the legislative system.²²⁸ Thus, the creation of New Deal independent agencies like the SEC, the FDIC, the Federal Home Loan Bank Board (the OTS's predecessor), and the remade Federal Reserve Board was an attempt to change financial regulation and monetary policy from a political system to a scientifically guided one (which Progressives naturally assumed would result in the very policies they favored). Although the current regulatory system includes a pre-New Deal agency (the OCC)

²²⁴ Mark Tushnet, Lecture, *Administrative Law in the 1930s: The Supreme Court's Accommodation of Progressive Legal Theory*, 60 DUKE L.J. 1565, 1566–67 (2011); see also Cass R. Sunstein, *Constitutionalism After the New Deal*, 101 HARV. L. REV. 421, 422–23 (1987).

²²⁵ Sunstein, *supra* note 224, at 423–24.

²²⁶ See *id.* at 424.

²²⁷ *Id.*; see also MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1870–1960*, at 214–15 (1992).

²²⁸ Sunstein, *supra* note 224, at 424; see also MARVER H. BERNSTEIN, *REGULATING BUSINESS BY INDEPENDENT COMMISSION* 36–37 (1955) (“The Progressives had an abiding faith in regulation, expertness, and the capacity of American government to make rational decisions provided experts in the administrative agencies could remain free from partisan political considerations.” *Id.* at 36.). It is important to note that New Deal technocrats were not exactly technocrats in a modern sense of the term. Their expertise was based not on having mastered some irrefragable body of knowledge, but on a hands-on type of experiential expertise. Accordingly, New Deal technocracy was not driven by an intellectual a priori conception about how markets operate, but instead represented an empirical, institutionalist approach to knowledge. See Justin Fox, *How Economics PhDs Took Over the Federal Reserve*, HBR BLOG NETWORK (Feb. 3, 2014, 10:00 AM), <http://blogs.hbr.org/2014/02/how-economics-phds-took-over-the-federal-reserve>, archived at <http://perma.cc/YMK6-PUT7> (discussing change in the background of Federal Reserve Board governors).

and a trio of post–New Deal agencies (the CFTC, the Federal Housing Finance Agency, and the National Credit Union Administration), the basic financial regulatory structure is a New Deal legacy. Since the New Deal, there has been significant criticism of the conceit of agencies operating in an apolitical space,²²⁹ but the idea that independent agencies liberate neutral, technocratic policymaking from the corruption of the political process still drives the contours of the regulatory system.

The financial crisis of 2008 represents a serious challenge to the ideal of a politically insulated, technocratic administrative agency. A regulatory system created under years of technocratic oversight collapsed in spectacular fashion, leaving technocrats bewildered and even panicked.²³⁰ The result was, for many, a crisis of faith in the financial regulatory system and its underlying claims to technocratic or scientific expertise, as evidenced by two populist political movements emerging largely in reaction to the financial crisis: the Tea Party and the Occupy Wall Street movement.²³¹ And yet, while the collapse was painful, the worst was averted, in large part because of the diligent and determined work of those same technocrats. In broad strokes, then, what caused the crisis, and how does that reflect on the soundness of our system of independent, technocratic regulation?

Two distinct narratives of the financial crisis and their respective critiques of the financial regulatory system have emerged: the perfect storm narrative and the regulatory capture narrative.²³²

1. *The Perfect Storm Narrative.* — In the outmoded regulation/perfect storm narrative of the crisis, the dynamic market had out-run the static regulatory system, which was then vulnerable to a “perfect storm” confluence of a housing bubble and highly leveraged financial institutions plus other lesser factors. The development of the “shadow banking” system of securitization, money markets, repo, securities lending, and derivatives meant that the traditional safeguards were no longer adequate.

²²⁹ See Sunstein, *supra* note 224, at 446–52 (discussing the institutional critique of the administrative state).

²³⁰ See PAULSON, *supra* note 4, at 206.

²³¹ See Paul Krugman, *How Did Economists Get It So Wrong?*, N.Y. TIMES, Sept. 6, 2009, at MM36; Robert J. Samuelson, Editorial, *Economists in the Dark*, WASH. POST, Feb. 17, 2014, at A19 (discussing how economics has been discredited by the financial crisis and its aftermath); Paul Krugman, *Economics in the Crisis*, THE CONSCIENCE OF A LIBERAL (Mar. 5, 2012, 8:42 AM), <http://krugman.blogs.nytimes.com/2012/03/05/economics-in-the-crisis>, archived at <http://perma.cc/87YZ-NQAM>; *What Went Wrong with Economics*, ECONOMIST, July 16, 2009, <http://www.economist.com/node/14031376>, archived at <http://perma.cc/CR87-68NT>.

²³² For an earlier take on narratives of the crisis, see Adam J. Levitin, Foreword, *The Crisis Without a Face: Emerging Narratives of the Financial Crisis*, 63 U. MIAMI L. REV. 999 (2009).

The failure of regulation to keep up with financial innovation is a problem observed by Bernanke,²³³ Blinder,²³⁴ and Bair.²³⁵ This critique of financial regulation did not imply any particular failing on behalf of regulators — they lacked the authority to do more. This critique also suggests that the crisis was no one's fault, or that at worst blame could be assigned to previous Congresses for failing to expand regulatory authority to products like credit derivatives. This “perfect storm” was like any meteorological event beyond human control. In this story, there is no cause to lose faith in the regulators. Indeed, Bernanke and Geithner come across as MacGyver-esque creative heroes who saved capitalism using inventive tools.

In the perfect storm story, the problem is a technical one, and one that could be addressed by fairly obvious technical means: update the regulatory system to expand coverage to previously unregulated spaces. This solution does not imply any particular change in the method of regulation, just in its ambit. The details could be confidently outsourced to existing technocrats without changing the structure of the regulatory system, and with these new tools in the hands of technocrats, we can all sleep soundly once more.

Thus, most post-2008 reforms have made regulatory schemes more detailed or expanded existing types of regulation to previously unregulated markets. For example, there are significantly greater federal restrictions on mortgage and credit card lending;²³⁶ most derivatives must now trade through regulated boards of trade (exchanges) or swap execution facilities and must clear via clearinghouses instead of trading over the counter;²³⁷ credit risk retention is required in many securitizations;²³⁸ and mortgage brokers are subject to a licensing requirement.²³⁹ Likewise, the FDIC is given resolution authority to undertake the “orderly liquidation” of entire too-big-to-fail affiliate families, not just depositories.²⁴⁰ The “Volcker Rule,” which prohibits bank holding companies and their subsidiaries from engaging in certain

²³³ See BERNANKE, *supra* note 5, at 50.

²³⁴ See BLINDER, *supra* note 17, at 59–64.

²³⁵ See BAIR, *supra* note 48, at 330.

²³⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 1400–1498, 124 Stat. 1376, 2136–212 (2010) (codified as amended in scattered sections of 12 and 15 U.S.C.); Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734 (codified as amended in scattered sections of 15 U.S.C.).

²³⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act § 723(a)(3) (codified at 7 U.S.C. § 2(h)(1), (8) (2012)) (requiring use of clearinghouses for swaps and requiring that swaps subject to clearing requirements be executed on a board of trade or under a swap exchange facility).

²³⁸ *Id.* § 941 (codified at 15 U.S.C. § 780-11 (2012)).

²³⁹ Secure and Fair Enforcement for Mortgage Licensing Act of 2008, Pub. L. No. 110-289, tit. V, 122 Stat. 2810 (codified as amended at 12 U.S.C. §§ 5101–5116 (2012)).

²⁴⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 201–217 (codified at 12 U.S.C. §§ 5381–5401).

types of proprietary trading and restricts banks from holding more than de minimis ownership interests in certain types of investments,²⁴¹ is conceptually no more than an expansion (or reinvigoration) of long-standing bank activity and asset concentration restrictions.²⁴² Even bank capital requirements were raised,²⁴³ much like levies built higher in anticipation of a tidal surge from a “perfect storm,” although not nearly as much as Admati and Hellwig urge.

Notably, most of these reforms were after-the-fact fixes; little has been done to improve the regulatory system’s ability to anticipate problems and take preventative action.²⁴⁴ The new Financial Stability Oversight Council (FSOC) is tasked with monitoring and responding to systemic risk and is armed with an Office of Financial Research for support.²⁴⁵ The FSOC is unlikely to be effective, however, precisely because it is merely a coordinating council of existing and often squabbling financial regulators. It is unclear why the FSOC’s research arm will do any better than existing regulators in identifying systemic risks. Even if the FSOC succeeds in identifying risks, there is still the question of whether regulators will take preventative action when existing regulators would not have done so individually. Perhaps the FSOC’s coordination mechanism will give regulators cover to pursue actions that they might be reluctant to pursue individually.

All of this is to say that in the outmoded regulation/perfect storm story, the financial regulatory system’s problems are seen as discrete and fixable through an expansion of regulatory authority along pre-existing lines. If financial regulation is merely outdated, then reform should entail an update rather than a system redesign. For the most part, this narrative explains the shape of post-2008 financial reform. Some features, however, can only be explained by the second story: a capture narrative, which points to the need for a system redesign, rather than an update.

2. *The Regulatory Capture Narrative.* — The second story of the crisis accepts that the financial regulatory system was outmoded but

²⁴¹ *Id.* § 619 (codified at 12 U.S.C. § 1851).

²⁴² *See, e.g.*, 12 U.S.C. § 24 (powers of national banks); *id.* § 84 (single-borrower exposure limit for national banks); *id.* § 371c (restrictions on Federal Reserve member banks’ transactions with affiliates).

²⁴³ Implementation of Basel III, 78 Fed. Reg. 55,340 (Sept. 10, 2013) (interim final rule with request for comments); Implementation of Basel III, 78 Fed. Reg. 62,018 (Oct. 11, 2013) (to be codified at 12 C.F.R. pts. 208, 217, 225) (final rule).

²⁴⁴ For different models of regulation that would require preauthorization for innovative financial products, see Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63 (2012), and Eric A. Posner & E. Glen Weyl, *An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First-Century Financial Markets*, 107 NW. U. L. REV. 1307 (2013).

²⁴⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 111–123 (codified at 12 U.S.C. §§ 5314, 5321–5333).

sees the essential failing as being due to regulatory capture. Whereas there is really no one to blame in the first story (or perhaps everyone, meaning no one in particular, is to blame),²⁴⁶ this second story has a villain: feckless or even rogue regulators. The capture critique of financial regulation is that the regulatory system is captured, so regulators will regulate in the interest of the financial institutions, rather than in the public interest. The financial regulation problem is, at its core, a governance problem.

The capture critique of the administrative state in general, or even of financial regulation in particular, is hardly new. Agency capture can happen through various mechanisms including agency reliance on regulated industries for information, availability biases regarding access to decisionmakers, revolving-door employment, groupthink and cascade effects, and social learning.²⁴⁷ It can also happen through regulators all approaching problems with similar methodology, training, and experience, and through social chumminess between regulators and regulated entities.²⁴⁸ Additionally, there is what is termed “cultural,” “social,” or “cognitive” capture, in which regulators “internalize, as if by osmosis, the objectives, interests and perception of reality” of the regulated entities.²⁴⁹ There can also be ideological capture, in which regulators become enthralled by a particular ideological view of how

²⁴⁶ See Dean Starkman, *No, Americans Are Not All to Blame for the Financial Crisis*, NEW REPUBLIC (Mar. 9, 2014), <http://www.newrepublic.com/article/116919/big-lie-haunts-post-crash-economy>, archived at <http://perma.cc/83VB-DZ6G> (identifying an “Everyone-Is-To-Blame” story of the crisis).

²⁴⁷ See, e.g., Mark Seidenfeld, *Bending the Rules: Flexible Regulation and Constraints on Agency Discretion*, 51 ADMIN. L. REV. 429, 464 (1999) (agency reliance on industry for information); Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667, 1713–14 (1975) (agency reliance on industry for information); Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street*, 81 U. CIN. L. REV. 1283, 1407–17 (2013) (reviewing evidence of revolving door in financial regulation); see also Jesse Eisinger, *A Revolving Door in Washington with Spin, but Less Visibility*, N.Y. TIMES, Feb. 21, 2013, at B5 (detailing revolving-door employment between federal agencies and financial services consultancy Promontory Financial Group); Horwitz & Aspan, *supra* note 135 (showing chart of former federal government employment of Promontory Financial Group executives).

²⁴⁸ See Levitin, *supra* note 135, at 159 (noting how regulators may personally benefit through career promotions).

²⁴⁹ Willem H. Buiter, *Central Banks and Financial Crises* 601 (presented at the Federal Reserve Bank of Kansas City’s symposium on “Maintaining Stability in a Changing Financial System,” Aug. 21–23, 2008), archived at <http://perma.cc/6B5C-HCG7>; accord James Kwak, *Cultural Capture and the Financial Crisis*, in PREVENTING REGULATORY CAPTURE 71, 79 (Daniel Carpenter & David A. Moss eds., 2014) (describing cultural capture as “operat[ing] through a set of shared but not explicitly stated understandings” between regulators and regulated entities); Lawrence G. Baxter, Essay, “Capture” in *Financial Regulation: Can We Channel It Toward the Common Good?*, 21 CORNELL J.L. & PUB. POL’Y 175, 183–84 (2011) (noting that cultural and social capture occurs when “the language of regulation is shaped by the common backgrounds, education, experience, and intermingling of the more powerful [regulated] players in the policy formation process,” *id.* at 183).

the world operates (or should operate). All of these are general capture mechanisms, not specific to any agency or field of regulation. In financial regulation, however, there are four unique and particularly problematic regulatory capture mechanisms.

First, prudential bank regulators are under pressure to cater to their regulated institutions' interests because of the ability of banks to shop their charter. A special charter is required to operate a bank. Both the states and the federal government grant banking charters. Prior to the Dodd-Frank Act, both the OCC and OTS issued charters. For federally chartered banks, regulatory authority tracked the charter.²⁵⁰ Attracting charters was critical for OCC and OTS because their budgets came primarily from the assessments levied against the banks; neither agency was subject to congressional appropriations.²⁵¹ Chartering thus determined the OCC's and OTS's regulatory reach and budgets, and because banks can shift their charter, the OCC and OTS were incentivized to compete with each other for chartering business.²⁵² This structure set up a competition for laxity in regulation.

Second, prudential regulators are particularly concerned about preventing institutional failure because their primary mission is ensuring financially sound institutions. In contrast, regulators in other fields, such as the environment, workplace safety, or food and drug safety, have much less direct concern about the financial failure of a regulated firm. For prudential regulators, however, failure of a firm is in some ways their failure. In part this is because of the federal guarantee, but it is also a matter of pride, as underscored by Bair's analysis of the OCC and the Federal Reserve Bank of New York's attempts to bolster Citibank. A bank regulator whose institutions fail is a failure; a bank regulator whose institutions prosper is heralded as a genius (and likely has better post-government employment prospects). Pride and charter shopping encourage prudential regulators to tolerate practices that are short-term revenue positive for banks, even if they raise consumer protection or long-term safety-and-soundness problems.

Third, prudential banking regulators have a closer connection with regulated institutions than that which occurs in most other types of in-

²⁵⁰ For state-chartered banks, primary regulatory authority depends on whether the bank is FDIC insured and whether it is a Federal Reserve System member.

²⁵¹ OFFICE OF THE COMPTROLLER OF THE CURRENCY, ANNUAL REPORT: FISCAL YEAR 2012, at 2, 40. In 2012, ninety-six percent of the OCC's revenues came from assessments; the rest came from interest and rental income. *Id.* at 40.

²⁵² See Levitin, *supra* note 135, at 156–58, 160 (discussing charter shopping and illustrating how Countrywide shifted its charter to obtain more favorable regulation); Andrew Martin, *Does This Bank Watchdog Have a Bite?*, N.Y. TIMES, Mar. 28, 2010, at B1 (illustrating how Capital One shifted its charter to avoid regulation); Jessica Silver-Greenberg, *Small Banks Shift Charters to Avoid U.S. as Regulator*, N.Y. TIMES, Apr. 3, 2012, at B1 (analyzing motives for charter shopping and noting trends pre- and post-Dodd-Frank).

dustries, in part because prudential regulation is often carried out through administrative “soft law” rather than through formal administrative law mechanisms like notice-and-comment rulemaking and adjudication. Regulators frequently engage in supervisory meetings with financial institutions and involve them in regulatory policy discussions.²⁵³ Banking regulators also maintain permanent resident examination teams at the largest banks. These examiners’ presence “bears an uncanny resemblance to those of outside accountants at Enron and WorldCom, who abdicated their regulatory role to become enablers.”²⁵⁴ Indeed, the Federal Reserve Bank of New York even refers to its regular on-site examination teams as “relationship management teams,” suggesting a partnership, rather than a supervisory relationship.²⁵⁵ The New York Fed’s self-study of its financial crisis supervisory failures found that “the Relationship teams become gate-keepers at *their* banks, seeking to control access [by other regulators] to *their* institutions.”²⁵⁶ The relationship between banking regulators and financial institutions is sometimes more symbiotic than supervisory.

Fourth, there is a problem of *legislative* capture that is particularly pronounced in financial services and which can, in turn, shape *agency* capture. The financial services industry exercises considerable political clout, in large part through massive political campaign donations and lobbying.²⁵⁷ It has been “far and away the largest source of campaign contributions to federal candidates and parties”²⁵⁸ and has ranked among the top of all industries in terms of lobbying expenditures since 1998.²⁵⁹ In the 2012 election cycle, the financial services sector, including individuals, gave over \$670 million in campaign contributions.²⁶⁰ As Senator Dick Durbin (D-Ill.) observed the day the cramdown bill was defeated, “[T]he banks — hard to believe in a time when we’re facing a banking crisis that many of the banks created — are still the most powerful lobby on Capitol Hill. And they frankly own

²⁵³ Wilmarth, *supra* note 247, at 1418.

²⁵⁴ Levitin, *supra* note 135, at 159.

²⁵⁵ Wilmarth, *supra* note 247, at 1418.

²⁵⁶ Fed. Reserve Bank of N.Y., Report on Systemic Risk and Bank Supervision 11 (Aug. 18, 2009) (discussion draft) (emphasis added), archived at <http://perma.cc/D6M6-AZ6F>.

²⁵⁷ See Wilmarth, *supra* note 247, at 1363–69.

²⁵⁸ Aaron Kiersh, *Finance/Insurance/Real Estate: Background*, OPENSECRETS.ORG, <http://www.opensecrets.org/industries/background.php?cycle=2012&ind=F> (last updated July 2009), archived at <http://perma.cc/V9J-F6DV>; *Finance/Insurance/Real Estate: Long-Term Contribution Trends*, OPENSECRETS.ORG, <http://www.opensecrets.org/industries/totals.php?cycle=2012&ind=F> (last visited Mar. 30, 2014), archived at <http://perma.cc/5EM4-WKUK>.

²⁵⁹ *Lobbying Spending Database*, OPENSECRETS.ORG, <http://www.opensecrets.org/lobby/top.php?indexType=c> (last visited Mar. 30, 2014), archived at <http://perma.cc/434-T6MD>.

²⁶⁰ *Finance/Insurance/Real Estate: Long-Term Contribution Trends*, *supra* note 258.

the place.”²⁶¹ The financial services industry’s influence over Congress can, in turn, affect regulatory agencies because of congressional oversight of agencies.²⁶² To the extent that agencies internalize the concerns of Congress — as the oversight process intends — legislative capture can effectuate agency capture.

Different financial regulatory agencies displayed different capture pathologies more prominently than others. Capture problems existed along a spectrum ranging from ideological antipathy to regulation at the Greenspan Fed²⁶³ to a more traditional type of cultural capture at the OCC, to a revolving-door problem for leadership at the SEC, to something closer to a corrupt pay-to-play at the OTS, where regulatory exemptions were bartered in exchange for chartering business.²⁶⁴ Despite the differences in the shape of capture among financial regulatory agencies, they were often fellow travelers on the deregulatory path.

Captured financial regulation has numerous ill effects. It enables financial institutions to assume more risk, privatize gains, and socialize losses. It indulges practices by financial institutions that work to the detriment of their customers. And it favors ever more concentration of the financial services industry.

Versions of the capture critique have been made by both the left and the right. On the left, this is a critique that has been made powerfully by academics and politicians alike. Professors Simon Johnson and James Kwak’s *13 Bankers* was a long-form account of the capture of the regulatory system focused on the rise of too-big-to-fail institutions.²⁶⁵ Professors Kathleen C. Engel and Patricia A. McCoy’s *The Subprime Virus* is a masterful account of capture and deregulation in the housing finance market.²⁶⁶ Professor William K. Black’s *The Best Way to Rob a Bank Is to Own One* tells this same story about the 1980s savings and loan crisis.²⁶⁷ A common trope in Elizabeth Warren’s senatorial campaign and in her fight to establish the Consumer

²⁶¹ Glenn Greenwald, *Top Senate Democrat: Bankers “Own” the U.S. Congress*, SALON (Apr. 30, 2009, 5:35 AM), <http://www.salon.com/2009/04/30/ownership>, archived at <http://perma.cc/4R8D-M68J> (emphasis omitted).

²⁶² See J.R. DeShazo & Jody Freeman, *The Congressional Competition to Control Delegated Power*, 81 TEX. L. REV. 1443, 1490 (2003) (noting that congressional oversight actions “can obstruct and delay the agency’s agenda” and influence agency decisions); Einer R. Elhauge, *Does Interest Group Theory Justify More Intrusive Judicial Review?*, 101 YALE L.J. 31, 42 (1991) (“[U]nelected regulators are accountable to the legislature, and are thus indirectly influenced by the interest groups that influence legislators.” (footnote omitted)).

²⁶³ See Brian Knowlton & Michael M. Grynbaum, *Greenspan ‘Shocked’ that Free Markets Are Flawed*, N.Y. TIMES, Oct. 23, 2008, <http://www.nytimes.com/2008/10/23/business/worldbusiness/23iht-gspan.4.17206624.html>, archived at <http://perma.cc/KXT5-X6AJ>.

²⁶⁴ See Levitin, *supra* note 135, at 159–60 (detailing OTS courtship of Countrywide).

²⁶⁵ SIMON JOHNSON & JAMES KWAK, *13 BANKERS* (2010).

²⁶⁶ KATHLEEN C. ENGEL & PATRICIA A. MCCOY, *THE SUBPRIME VIRUS* (2011).

²⁶⁷ WILLIAM K. BLACK, *THE BEST WAY TO ROB A BANK IS TO OWN ONE* (2005).

Financial Protection Bureau (CFPB) was that “the system is rigged” against ordinary people (and by implication in favor of the banks).²⁶⁸ The concern about banks controlling the political system was part of what animated the Occupy Wall Street movement. Admati and Hellwig, Barofsky, and Connaughton all fit neatly within this paradigm, with Admati and Hellwig hinting at a type of intellectual capture, and Barofsky and Connaughton implying worse.

While the systemic capture critique has been most salient on the left, it has also made appearances on the right, which has traditionally been more anti-regulatory and supportive of the financial services industry’s interests. There has long been a right-wing critique of monetary policy as undermining “hard currency.”²⁶⁹ But there are fewer voices on the right critiquing bank regulation per se. One is Thomas Hoenig, currently the Vice Chairman of the FDIC and formerly the President of the Federal Reserve Bank of Kansas City. Hoenig railed against the privatization of gains and socialization of losses well before the financial crisis²⁷⁰ and has repeatedly called for the breakup of the largest financial institutions.²⁷¹ Hoenig’s critique is that the captured regulatory system is just *manqué* capitalism with the result disadvantaging smaller financial institutions. Bair, a Kansas Republican, fits more closely with the Hoenig mold. Notably, the concerns of both Hoenig and Bair are driven by the recognition that the distributional consequences of the current system are not simply the privatization of gains and socialization of losses. The current regulatory system favors Wall Street over Main Street and also has a geographically disparate impact within the financial services industry because it favors large urban money-center banks over the small banks in the rest of the country.

The critiques mounted by the left and the right agree that, fundamentally, regulatory capture implies skewed policy preference vectoring by agencies, because the preferences of the interest groups that have captured the agencies are excessively weighted relative to others’ preferences. Thus, if agencies are captured, they cannot be trusted as objective, neutral fora for policy contestation, irrespective of the formal administrative law procedures to which they must adhere. If

²⁶⁸ Gregory J. Krieg & Elizabeth Hartfield, *Elizabeth Warren: ‘The System Is Rigged,’* ABC NEWS (Sept. 5, 2012), <http://abcnews.go.com/Politics/elizabeth-warren-democratic-national-convention-system-rigged/story?id=17150134>, archived at <http://perma.cc/7X7B-7QPG>.

²⁶⁹ See BERNANKE, *supra* note 5, at 24.

²⁷⁰ See Thomas M. Hoenig, President, Fed. Reserve Bank of Kan. City, *Rethinking Financial Regulation* (Feb. 2, 1996), archived at <http://perma.cc/38DE-V47E>.

²⁷¹ See Thomas M. Hoenig, *No More Welfare for Banks*, WALL ST. J., June 11, 2012, at A13 (arguing that banking organizations should be prohibited from broker-dealer or other trading activities); Joe Adler, *Big Bank Execs Just Don’t Get It: FDIC’s Hoenig*, AM. BANKER (Sept. 19, 2012, 1:14 PM), http://www.americanbanker.com/issues/177_182/fdics-hoenig-reiterates-call-for-big-bank-breakup-1052808-1.html, archived at <http://perma.cc/T7BH-Z7R6>.

agencies are in fact captured, then their claim to authority based on neutral expertise cannot stand.

The existence of administrative law governance procedures hardly undercuts the capture critique. These governance procedures, particularly the rulemaking and adjudication requirements of the Administrative Procedure Act (APA) and the review of proposed regulations by OIRA, do not guarantee politically neutral governance in financial regulation for three reasons. First, much of financial regulation occurs via “soft law” outside of the regulatory ambit of the APA’s notice-and-comment rulemaking and administrative adjudication requirements. Second, most financial regulators are independent agencies and therefore are not subject to OIRA review of rulemakings. And third, the APA and OIRA review do not address the problems of regulatory enforcement inaction and failure to undertake non-mandatory rulemakings. To the extent that capture results in deregulation through agency inaction in the face of market evolution, existing administrative governance procedures are grossly inadequate. Much of financial regulation lacks administrative law’s legitimizing procedural checks, so problems of capture loom particularly large.

It is hard to gainsay the capture critique. Federal regulators had the power to stop *every one* of the problematic banking practices that led to the collapse in 2008.²⁷² And they had a variety of means by which to do so. Federal regulators have wide-ranging formal powers, including increasing regulatory capital requirements for disfavored activities, terminating FDIC insurance, requiring prompt corrective action, and issuing cease-and-desist orders.²⁷³ Federal financial regulators also often exercise power through informal advisory communications to banks. These “advisory” communications are a type of administrative “soft law.” Although they are not formally enforceable, they are functionally binding and are followed by regulated institutions.

Federal regulators’ formal and informal powers extend not only to banks, but also to bank holding companies. Even the insurance company AIG could have been reined in because it was a thrift holding company, subject to regulation by the Federal Reserve. Additionally, the Federal Reserve Board had to approve the regulatory capital treatment for other banks when they engaged in swaps with AIG.²⁷⁴ The Fed had the ability to regulate both AIG and its counterparties.

²⁷² At most, regulators lacked resolution authority, but resolution is about cleaning up after a financial crisis, not preventing one.

²⁷³ 12 U.S.C. § 1818 (2012).

²⁷⁴ Bratton & Levitin, *supra* note 31, at 819 (discussing Federal Reserve Board approval of bank regulatory capital treatment of synthetic collateralized debt obligation swaps with AIG).

Hence, federal regulators did not lack the tools necessary to limit bank leverage and rein in the mortgage market.²⁷⁵ They lacked the motivation. None of the legal creativity on display during the bailouts was exercised pre-crisis except to push for deregulation.²⁷⁶

Capture resulted not only in regulatory non-intervention, but also in active deregulation. In terms of deliberate non-intervention, federal regulators have express statutory authority to prohibit unfair and deceptive acts and practices. The Federal Reserve Board under Alan Greenspan failed to use its power under the Home Ownership and Equity Protection Act of 1994 to place restrictions on predatory mortgage loans, despite a statutory directive to undertake a rulemaking.²⁷⁷ Similarly, the Fed, the OTS, and the National Credit Union Administration failed to use their powers to prohibit unfair and deceptive acts and practices to address abusive credit card lending practices until Congress began to move on the issue in 2008. Regulators lacked motivation, not authority, to rein in risky and unfair practices.

Moreover, federal financial regulators were active enablers of risky and unfair practices. Through opinion letters, rulemaking, and litigation, federal regulators pursued deregulation that enabled banks to undertake riskier and more aggressive activities. The OCC loosened restrictions on bank derivative activities,²⁷⁸ the Federal Reserve Board loosened restrictions on affiliate transactions²⁷⁹ and blessed the regulatory capital treatment of synthetic collateralized debt obligations,²⁸⁰ the OCC and the OTS permitted captive mortgage reinsurance transactions despite (well-founded) concerns of kickbacks,²⁸¹ and the OCC

²⁷⁵ Even though many of the most aggressive mortgage loans were made by nonbanks, nonbanks depend on warehouse lines of credit from depositories, and when these lines were pulled, the nonbank lenders went out of business.

²⁷⁶ See Levitin, *supra* note 38, at 495–98 (noting that after the crisis, but not before, section 13(3) of the Federal Reserve Act became the authority for market intervention).

²⁷⁷ See ENGEL & MCCOY, *supra* note 266, at 194–96.

²⁷⁸ See Omarova, *supra* note 135, at 1044–45.

²⁷⁹ See Omarova, *supra* note 30, at 1689.

²⁸⁰ See Bratton & Levitin, *supra* note 31, at 819.

²⁸¹ See, e.g., Office of the Comptroller of the Currency, Interpretive Letter No. 828 (Apr. 6, 1998), *archived at* <http://perma.cc/4DLF-VYGR> (approving bank-affiliated mortgage reinsurance); Office of Thrift Supervision, Reinsurance of Private Mortgage Insurance for Loans Originated by Affiliates (Nov. 2, 1998), *archived at* <http://perma.cc/DG56-ZUQ7>; Robert M. Jaworski, *The RESPA Soap Opera Continues for Another Year*, 53 BUS. LAW. 995, 1008–09 (1998) (noting Department of Housing and Urban Development concerns that captive mortgage reinsurance arrangements could result in kickbacks to private mortgage insurers for ceding reinsurance business in violation of the Real Estate Settlement Procedures Act); Letter from Nicolas P. Retsinas, Assistant Sec’y for Hous.–Fed. Hous. Comm’r., to Randolph C. Sailer II, Senior Vice President and Gen. Counsel, Amerin Guar. Corp. (Aug. 6, 1997), *archived at* <http://perma.cc/Q8HB-SECA> (same); *CFPB Takes Action Against PHH Corporation for Mortgage Insurance Kickbacks*, CONSUMER FIN. PROT. BUREAU (Jan. 29, 2014), <http://www.consumerfinance.gov/newsroom/cfpb-takes-action-against-phh-corporation-for-mortgage-insurance-kickbacks>, *archived at* <http://perma.cc/5QDU-PURN> (alleging kickbacks paid by private mortgage insurer to bank-affiliated reinsur-

and the OTS waged a campaign to preempt state consumer protection laws (including those relating to mortgage lending) without substituting equivalent federal protections.²⁸²

While the financial regulatory system was undoubtedly outdated in many ways, it is hard to deny that capture played some role, if not the leading role, in the crisis. Too often regulators either failed to act or took affirmative steps that enabled greater risk in the financial system. This pattern of behavior suggests that the real challenge for financial regulation is not in perfecting technical details such as the precise amount of capital required but in taming the politics of financial regulation. Until and unless the capture problem in financial regulation is addressed, it is hard to believe that the financial regulatory system will produce the right technical answers.

To the extent that capture is a problem in financial regulation, the question is what to do about it. Three basic responses can be observed post-crisis. Each is reviewed in turn in the next section. Notably absent have been proposals to reform general administrative law governance provisions to encompass independent agencies and to cover not just formal rulemaking and adjudication, but also regulatory inaction in terms of lack of enforcement or refusal to undertake non-mandatory rulemakings. Such an overhaul of administrative law could be potentially fruitful in combatting capture and restoring greater legitimacy to the financial regulatory system, but there has been no movement in this direction post-crisis, and a consideration of what such an overhaul might look like is beyond the scope of this Review Essay.

B. Responses to Capture

1. *Democratically Responsive Financial Regulation.* — Outside of the United States, the response to technocratic failure has been a shift from technocratic financial regulation by independent agencies to more politically accountable financial regulation.²⁸³ If regulators are captured, exposing them to greater political control is one potential governance solution — provided that the political control is exercised in the public interest. At the very least, a move toward greater political control of regulators is an expressive rebuke of regulatory independence.

Proposals for creating more democratically responsive financial regulation have been largely absent from the U.S. financial reform de-

er in exchange for directing initial mortgage insurance business to the mortgage insurer); Horwitz, *supra* note 135.

²⁸² Levitin, *supra* note 135, at 158.

²⁸³ Stavros Gadinis, *From Independence to Politics in Financial Regulation*, 101 CALIF. L. REV. 327, 332 (2013). This is a move that mirrors historical patterns such as the shift from appointed to elected judges in the wake of past financial crises. See JED HANDELSMAN SHUGERMAN, *THE PEOPLE'S COURTS* 10 (2012).

bate. The United States continues to have one of the most politically insulated financial regulatory systems in the developed world.²⁸⁴ Historically, this was not the case. In the nineteenth century, before the creation of the administrative state, financial regulation and monetary policy were hammered out in the electoral arena and were often the heady stuff of presidential campaigns.²⁸⁵ The renewal of the charter of the Second Bank of the United States was the leading issue in the 1832 presidential election.²⁸⁶ Monetary policy was the source of many of the late-nineteenth-century splinter parties: the Greenback, People's, and Populist Parties.²⁸⁷ In 1896, the thirty-six-year-old William Jennings Bryan won the Democratic nomination in part on the strength of his famous "Cross of Gold" speech at the Democratic convention,²⁸⁸ a rant on both monetary policy and the national banking system that decried the power of "organized wealth."²⁸⁹ The 1908 presidential election, on the heels of the Panic of 1907, featured a debate about deposit insurance, postal banking, and a governmental lender of last resort.²⁹⁰ Painted in broad strokes, then, American financial regulation and monetary policy has moved from being the province of electoral

²⁸⁴ See Gadinis, *supra* note 283, at 358 fig.1.

²⁸⁵ See Nelson W. Aldrich, Chairman, Nat'l Monetary Comm'n, Banking Reform in the United States, Address Before the Academy of Political Science (Oct. 15, 1913), in 4 PROCEEDINGS OF THE ACADEMY OF POLITICAL SCIENCE IN THE CITY OF NEW YORK 31, 50-54 (1913) (reviewing post-Civil War monetary policy in Democratic Party platforms); James A. Barnes, *Myths of the Bryan Campaign*, 34 MISS. VALLEY HIST. REV. 367, 371-73 (1947) (detailing the prominence of revoking the gold standard in late-nineteenth-century political platforms).

²⁸⁶ Bray Hammond, *Jackson, Biddle, and the Bank of the United States*, 7 J. ECON. HIST. 1, 11 (1947).

²⁸⁷ See Aldrich, *supra* note 285, at 51.

²⁸⁸ RICHARD FRANKLIN BENSEL, *PASSION AND PREFERENCES* 1-2 (2008).

²⁸⁹ See WILLIAM JENNINGS BRYAN, 1 SPEECHES OF WILLIAM JENNINGS BRYAN 242 (1909) (referring to "organized wealth" in the Cross of Gold Speech). Some sources quote Bryan as referring to "aggregated wealth" in his Cross of Gold Speech. See, e.g., CHARLES W. CALOMIRIS & STEPHEN H. HABER, *FRAGILE BY DESIGN* 153 (2014). Bryan did not use this formulation in his own published editions of the Cross of Gold Speech, but he did in the published versions of other related speeches. See WILLIAM JENNINGS BRYAN, *LIFE AND SPEECHES OF HON. WM. JENNINGS BRYAN* 281 (1900) (referring to "aggregated wealth" in a February 12, 1898, speech entitled "Lincoln vs. Hamilton"); BRYAN, 1 SPEECHES OF WILLIAM JENNINGS BRYAN, *supra*, at 143 (referring to "the corporate interests of the nation, its moneyed institutions, its aggregations of wealth and capital" in an August 16, 1893, speech entitled "Bimetallism"). Even this 1893 speech is quoted as referring to "aggregated wealth" in some sources. See RICHARD HOFSTADTER, *THE AGE OF REFORM* 65 (1955).

²⁹⁰ DEMOCRATIC PARTY PLATFORM OF 1908 (1908), *archived at* <http://perma.cc/4GQE-WZLN> (calling for a public lender of last resort, a deposit insurance program, and a postal savings bank if deposit insurance were not feasible); REPUBLICAN PARTY PLATFORM OF 1908 (1908), *archived at* <http://perma.cc/3FCR-4M6W> (calling for a postal savings bank and a lender of last resort, but not a public one). Several states adopted deposit insurance systems. Eugene Nelson White, *State-Sponsored Insurance of Bank Deposits in the United States, 1907-1920*, 41 J. ECON. HIST. 537, 537-38 (1981).

politics in the nineteenth century to now being the preserve of technocratic New Deal-era independent agencies.

Few think that nineteenth-century democratic control of financial politics was successful, and in the United States today, no one seriously proposes committing financial regulatory policy directly to the ballot box. Judging by the absence of legislative proposals, there appears to be little support even for less direct measures of political accountability, such as having monetary policy decided by Congress, moving financial regulation from independent agencies to cabinet agencies, or bringing wayward prudential regulators to heel by subjecting them to appropriations.

The closest we have seen to direct calls for greater political accountability are the so-called “Audit the Fed” bill, originally sponsored by Representative Ron Paul (R-Tex.),²⁹¹ and calls from the left for criminal prosecutions of financial industry executives and firms for their behavior during the financial crisis.²⁹² A version of the “Audit the Fed” bill passed in the House with bipartisan support,²⁹³ but it would itself create little in the way of accountability: the bill was more expressive harassment of the Fed than a measure of legislative control. Likewise, criminal prosecutions are not quite the same as political accountability, and calls for prosecution are, at least formally, calls for enforcement of existing law, not for opportunistic political retribution.

Symbolic legislation and prosecutions aside, one can only point to broadly framed and loosely connected political consequences of the financial crisis. Arguably, President Obama’s nomination and election

²⁹¹ Federal Reserve Transparency Act of 2009, H.R. 1207, 111th Cong. (2009). The Federal Reserve Board is already subject to audits by the Government Accounting Office, but the Fed’s nonprivate foreign transactions, monetary policy decisions, and open market transactions are excluded. 31 U.S.C. § 714(b) (2012). The bill would have eliminated these exclusions. However, the Fed was subjected to a one-time audit of its emergency lending programs under the Dodd-Frank Act. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1109, 124 Stat. 1376, 2127 (2010).

²⁹² The Dodd-Frank Act’s Orderly Liquidation Authority arguably invokes some measure of political accountability by requiring action to be taken by the Treasury Secretary in consultation with the President. 12 U.S.C. § 5383(b) (2012). But this accountability is limited by being part of a three-part trigger for placing a financial company into FDIC receivership: a joint supermajority determination of systemic risk by the FDIC and Federal Reserve Board, a set of determinations by the Treasury Secretary in consultation with the President, and a judicial decision in response to a petition filed by the Treasury Secretary. 12 U.S.C. §§ 5382–5383. The systemic risk determination is not required, 12 U.S.C. § 5383(b), which enables invocation of the Orderly Liquidation Authority solely by the Treasury Secretary and President with a judicial check, but it is unlikely that the political branch would act without cover from the independent agencies making a systemic risk determination first.

²⁹³ See H.R. 459, 112th Cong. (2012); *H.R. 459 (112th): Federal Reserve Transparency Act of 2012 (On Motion to Suspend the Rules and Pass, as Amended)*, GOVTRACK, <https://www.govtrack.us/congress/votes/112-2012/h513> (last visited Mar. 30, 2014), archived at <http://perma.cc/3G88-MBZC>.

was partially in response to the 2008 collapse.²⁹⁴ Similarly, both the rise of the Tea Party, resulting in the Democrats' defeat in the 2010 midterm elections, and the inchoate and incoherent Occupy Wall Street movement in 2011 reflected popular outrage at the handling of the bailouts. Yet these measures of popular expression had only indirect effects on financial regulation. They did not ensure the pursuit of any particular policy or change regulatory governance, but instead affected the regulatory gestalt.

The reasons for the lack of interest in a more democratically responsive financial system in the United States are not clear. One possibility is that the claim of scientific policymaking still has some purchase and may resonate better than the idea of putting policy before the ballot box. Elections represent a different form of social ordering than does adjudication of policy disputes by regulatory bodies.²⁹⁵ Whereas agency adjudication of policy is founded on an appeal to rationality,²⁹⁶ elections are an appeal to popular will and do not presume rationality.²⁹⁷ Making financial regulation more politically accountable is thus on some level a rejection of claims that there is a scientific basis for financial regulation. (To be sure, there is certainly space for overlap, given the political and moral value judgments in "scientific" regulation, such as what elements to include in a cost-benefit analysis.) A Know-Nothing rejection of technocracy may go further than a public that is used to being managed by an administrative state is prepared to accept.

A second possibility is that some of the formal differences in political accountability are not in fact meaningful, so no one bothers pursuing them. Is the Secretary of the Treasury in fact any more accountable than the FDIC chair? Popular outrage at the course of the bailouts did not cost Secretary Geithner his job, even if it cost Democrats the 2010 congressional elections. Democratic control over policy is so diluted that accountability via the ballot may be understood as a weak control and might, for that reason, not be pursued.

A third possibility is that use of administrative agencies is a type of "moral avoidance" that allows Congress and the public the luxury of avoiding making contentious moral judgments about policy trade-offs.²⁹⁸ A fourth possibility is that the public believes that for all its flaws, regulation by expert agencies is better than politicized financial regulation and the danger of directing investment to politically favored

²⁹⁴ See JOHN HEILEMANN & MARK HALPERIN, *GAME CHANGE* 379–90 (2010).

²⁹⁵ Lon L. Fuller, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353, 363 (1978).

²⁹⁶ *Id.* at 365.

²⁹⁷ *Id.* at 367.

²⁹⁸ K. Sabeel Rahman, *Governing the Economy: Markets, Experts, and Citizens* 309 (2013) (unpublished Ph.D. dissertation, Harvard University) (on file with author).

constituencies on terms that do not properly reflect investment risk.²⁹⁹ A fifth possibility is that it is unclear who would prevail in a world of more politicized regulation, so risk-averse parties eschew pursuit of more democratic accountability.

Finally, the lack of interest in politicized financial regulation might be because it is hard to imagine financial regulation ever being particularly politically responsive. The political economy of financial regulation does not encourage greater democratic oversight of the regulatory process. Financial regulation pits a concentrated interest group (the financial services industry) against the diffuse public interest; there is not a dependable constituency for public interest-minded financial regulation. As Admati and Hellwig note, “Financial Stability Has No Constituency, but Is Everyone’s Business.”³⁰⁰ With one exception discussed below — state attorneys general — there is little upside for politicians to pursue financial regulation.

There is also a time-inconsistency problem for politicians. Laxer financial regulation may contribute to a short-term boom, but ultimately lead to a longer-term crisis. Politicians with frequent reelection cycles are likely to have short-term policy horizons, discouraging stronger regulation. Indeed, avoidance of the short-term horizons created by frequent elections is one of the arguments for having independent regulators with longer terms of office. And financial regulation is but one of a broader set of electoral issues. Moreover, there is little upside for politicians in pursuing better financial regulation. No one notices financial regulation when it works. There is no reward for doing a good job.

These factors push politicians to generally pursue the bare minimum of regulation necessary to avoid an immediate crisis. To be sure, there are exceptions: anti-bank populism has always had a certain resonance on both the right and left. But the populist resonance of financial regulation is not about the details of financial regulation — which are critically important. Instead, it is about the larger perception of financial industry power.

One exception to political interest in financial regulation is state attorneys general. State attorneys general are elected officials who typically aspire to higher political office. Their personal political ambi-

²⁹⁹ This charge is frequently leveled against government involvement in the housing finance market, be it through the Federal Housing Authority or Fannie Mae and Freddie Mac. Of course, to the extent the supposedly nonpoliticized financial regulatory system does not require enough capital and allows privatized gains and socialized losses, it creates the same problem. The only difference is in the constituencies benefited.

³⁰⁰ ADMATI & HELLWIG, *supra* note 192, at 214.

tions often align with a pro-financial regulatory agenda.³⁰¹ Consumer protection litigation has proven to play well with median voters.³⁰² Likewise, headline-grabbing, populist prosecutions of financial institutions may advance the political careers of attorneys general, as shown by the rise of Eliot Spitzer from New York's Attorney General to Governor on the strength of his "Scourge of Wall Street" reputation.³⁰³ More recently, attorneys general from California, Delaware, and New York took the lead in pushing for more consumer relief as part of the National Mortgage Servicing Settlement, itself an effort spearheaded by state attorneys general.³⁰⁴ Yet state attorneys general can only push for ex post enforcement of a limited range of financial regulations. State attorneys general lack rulemaking tools, and their enforcement tools cannot reach a wide range of critical financial regulatory issues, such as regulatory capital requirements. While state attorneys general may be motivated to pursue financial regulation, they lack the tools to do so.

Despite the lack of enthusiasm for a more politically responsive financial regulatory system, Congress has undertaken periodic financial regulatory reform. But excluding a few deregulatory acts undertaken in periods of stability and growth, Congress basically acts on financial regulation only in response to financial crises and scandals, when there is temporary political pressure to take action of some sort. The Great Depression, the American Stock Exchange scandals of the late 1950s and the Crash of 1962, the inflation of the 1970s, the savings and loan crisis in the 1980s, the Enron and WorldCom accounting scandals in 2001, and the financial collapse of 2008 each induced a major change in financial regulation. Financial regulatory legislation is generally reactive and in the mode of regulatory updating, not regime change.

2. *Reforming the Regulatory Architecture to Mitigate Capture.* — Rather than returning financial regulation to the ballot box, a second approach to the capture problem has been to pursue targeted changes in the architecture of financial regulation to attempt to mitigate capture. Three of these changes appear in the post-crisis reforms: the

³⁰¹ *But see* Nicholas Confessore, *A Campaign Inquiry in Utah Is the Watchdogs' Worst Case*, N.Y. TIMES, Mar. 18, 2014, at A1 (noting allegations of bribery of Utah Attorney General by payday lending industry through illegal campaign contributions).

³⁰² Levitin, *supra* note 135, at 200.

³⁰³ *Id.* at 199–203.

³⁰⁴ Loren Berlin, *National Mortgage Settlement: California, New York Reveal Their Cut*, HUFFINGTON POST (Feb. 9, 2012, 7:08 PM), http://www.huffingtonpost.com/2012/02/09/national-mortgage-settlement_n_1266047.html, archived at <http://perma.cc/6ES-GHYH>; Jennifer Liberto, *Finally, a Foreclosure Settlement (Maybe)*, CNNMONEY (Feb. 3, 2012, 5:19 AM), http://money.cnn.com/2012/02/03/news/economy/mortgage_settlement, archived at <http://perma.cc/EEG3-8DC8>; Jennifer Liberto, *Foreclosure Deal Has 40 States, but Others Balk*, CNNMONEY (Feb. 7, 2012, 7:24 AM), http://money.cnn.com/2012/02/06/news/economy/mortgage_settlement, archived at <http://perma.cc/D2VH-KTHK>;

elimination of the OTS, the rollback of preemption standards, and the creation of the CFPB.

First, the Dodd-Frank Act eliminated the OTS,³⁰⁵ the regulator of federal savings associations, which was perceived as the most hopelessly captured of the financial regulators, always trying to outdo the OCC.³⁰⁶ The OTS's largest charters — AIG, Countrywide, IndyMac, and Washington Mutual — all failed in 2008. These failures made the OTS particularly vulnerable and expendable in the face of congressional ire.

The elimination of the OTS was also a response to capture problems caused by charter shopping.³⁰⁷ Elimination of the OTS did not end the possibility of charter shopping, however. It merely limited the menu of possible charters because banks can still choose between a national bank charter from the OCC and a state charter (resulting in the FDIC or Federal Reserve Board as the primary regulator). Bair's proposal for eliminating the OCC and dividing bank and bank holding company regulation between the FDIC and Federal Reserve Board would solve the charter-shopping problem,³⁰⁸ but the OCC, most of whose biggest charters survived, was never on the congressional chopping block.

Second, the Dodd-Frank Act rolled back the standard for preemption of state consumer protection laws under the National Bank Act and Home Owners Loan Act, the statutes governing federally chartered banks and savings associations. The OTS had claimed field preemption under the Home Owners Loan Act,³⁰⁹ while the OCC had claimed to preempt state laws that “obstruct, impair, or condition a national bank’s ability to fully exercise” its powers, a standard the OCC interpreted to achieve the functional effect of field preemption.³¹⁰ The Dodd-Frank Act provides that there is no field preemption for either statute, only conflict preemption,³¹¹ which is to be evaluated on the basis of whether a state law “prevents or significantly interferes with” the exercise of a national bank’s or federal saving association’s powers.³¹² Dodd-Frank also requires the preemption determination to be

³⁰⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 313, 124 Stat. 1376, 1523 (2010) (codified at 12 U.S.C. § 5413 (2012)).

³⁰⁶ See Levitin, *supra* note 135, at 159–60.

³⁰⁷ See *supra* note 252 and accompanying text.

³⁰⁸ BAIR, *supra* note 48, at 339–41.

³⁰⁹ 12 C.F.R. § 545.2 (2014).

³¹⁰ *Id.* § 7.4007(b)(1); see also *id.* §§ 7.4008, 7.4009, 34.4.

³¹¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 1044, § 5136C(b)(4), 124 Stat. 1376, 2015 (2010) (codified at 12 U.S.C. § 25(b)(4) (2012)); *id.* sec. 1046(a), 124 Stat. at 2017 (codified at 12 U.S.C. § 1465).

³¹² *Id.* sec. 1044, § 5163C(b)(1)(B), 124 Stat. at 2015 (codified at 12 U.S.C. § 25(b)(1)(B)); *id.* sec. 1046(a), § 6(a), 124 Stat. at 2017 (codified at 12 U.S.C. § 1465(a)).

made on a case-by-case basis after consultation with the CFPB,³¹³ to be supported by substantial evidence,³¹⁴ and to be subject to a less deferential standard of review.³¹⁵ Finally, Dodd-Frank provides that there is no preemption of state laws for banks' nonbank subsidiaries or affiliates,³¹⁶ overruling *Watters v. Wachovia Bank, N.A.*,³¹⁷ a 2007 Supreme Court case holding a state mortgage lending law preempted when applied to a state-chartered subsidiary of a national bank. Preemption determinations must be published quarterly and are required to be reviewed every five years.³¹⁸ The Dodd-Frank Act was a sharp congressional repudiation of the OCC and OTS's preemption campaign, which was a very specific manifestation of capture.

Third and most importantly, the Dodd-Frank Act created the CFPB. The CFPB is the first administrative agency to be created with regulatory capture concerns in mind. While the CFPB was designed to address a variety of problems in regulatory architecture,³¹⁹ it was specifically intended to free consumer protection from the particular capture problems that plagued prudential bank regulators: chartering competition and concern about the profitability of individual firms. These issues do not exist for the CFPB because the CFPB does not grant charters, its budget is not tied to bank assessments, and it is not responsible for bank solvency. The CFPB also does not have resident examiner teams — a conscious decision to avoid too much chumminess — which is something the OCC is now considering.³²⁰

The significance of the regulatory change represented by the CFPB can be seen in the ferocity with which its creation was opposed by the financial services industry. Banks pushed back harder against the CFPB than they did against any other financial reform,³²¹ in part because the CFPB threatened to change the capture equation.

³¹³ *Id.* sec. 1044, § 5136C(b)(1)(B), (3)(B), 124 Stat. at 2015 (codified at 12 U.S.C. §§ 25b(b)(1)(B), (b)(3)(B)); *id.* sec. 1046(a), § 6(a), 124 Stat. at 2017 (codified at 12 U.S.C. § 1465(a)).

³¹⁴ *Id.* sec. 1044, § 5136C(c), 124 Stat. at 2016 (codified at 12 U.S.C. § 25b(c)); *id.* sec. 1046(a), § 6(a), 124 Stat. at 2017 (codified at 12 U.S.C. § 1465(a)).

³¹⁵ *Id.* sec. 1044, § 5136C(b)(5)(A), 124 Stat. at 2015–16 (codified at 12 U.S.C. § 25b(b)(5)(A)); *id.* sec. 1046(a), § 6(a), 124 Stat. at 2017 (codified at 12 U.S.C. § 1465(a)).

³¹⁶ *Id.* sec. 1044, § 5136C(b)(2), (e), 124 Stat. at 2015–17 (codified at 12 U.S.C. § 25b(b)(2), (e)); *id.* sec. 1046(a), § 6(a), 124 Stat. at 2017 (codified at 12 U.S.C. § 1465(a)).

³¹⁷ 550 U.S. 1 (2007).

³¹⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act sec. 1044, § 5136C(d), (g), 124 Stat. at 2016–17 (codified at 12 U.S.C. § 25b(d), (g)).

³¹⁹ Adam J. Levitin, *The Consumer Financial Protection Bureau: An Introduction*, 32 REV. BANKING & FIN. L. 321, 329–34 (2013).

³²⁰ Rachel Witkowski, *Examiners-in-Residence Should Be Pulled Out of Megabanks: OCC Report*, AM. BANKER (Dec. 5, 2013, 3:57 PM), http://www.americanbanker.com/issues/178_233/examiners-in-residence-should-be-pulled-out-of-megabanks-occ-report-1064080-1.html, archived at <http://perma.cc/W77-MFBV>.

³²¹ Edmund L. Andrews, *Banks Balk at Agency Meant to Aid Consumers*, N.Y. TIMES, July 1, 2009, at B1 (“Banks and mortgage lenders are placing top priority on killing President Obama’s

The CFPB's structure does not address generic problems of regulatory capture, and indeed, given the CFPB's significant political insulation, this could eventually become a problem. While the CFPB's design eliminated two particularly acute capture problems from consumer financial protection — budget-driven charter competition and regulatory success measured by the profitability of regulated institutions — the CFPB is in many ways a doubling down on the administrative state. The CFPB is an agency with a particularly strong degree of political insulation: it has a unitary director appointed for a five-year term (therefore not corresponding with any single Presidency or Congress) and removable only for cause.³²² The CFPB is budgetarily independent. It is not subject to congressional appropriations but instead, as an independent bureau in the Federal Reserve, receives an inflation-adjusted fixed percentage of the Federal Reserve's 2012 operating budget.³²³ And, as an independent agency, the CFPB need not submit its rulemakings for approval by OIRA (although it is subject to a non-binding OIRA review of certain rulemakings affecting small businesses).³²⁴

Despite this independence, the CFPB is not an agency without accountability. It is still subject to congressional oversight.³²⁵ Its rulemakings and adjudications must still comply with the APA and the Small Business Regulatory Enforcement Fairness Act.³²⁶ It is subject to audits by the Government Accounting Office and the Federal Reserve's Inspector General.³²⁷ And unlike any other agency, its rulemakings are subject to an FSOC veto.³²⁸ The CFPB represents a unique package of agency checks and balances that does not track with pre-existing agency forms, but which represents an attempt to balance oversight with sufficient political insulation to avoid the problem of agency capture via internalization of legislative capture.³²⁹

The decision to double down on political insulation in order to maximize the independence of the agency was an attempt by Congress to commit itself, as irrevocably as possible, to a permanent policy of consumer financial protection. Indeed, added to this is a safeguard

proposal to create a new consumer protection agency . . ."); see also Arthur E. Wilmarth, Jr., *The Financial Services Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau*, 31 REV. BANKING & FIN. L. 881, 886 & nn.14, 15 (2012) (detailing numerous sources regarding strength of bank opposition to CFPB).

³²² Levitin, *supra* note 319, at 340.

³²³ *Id.*

³²⁴ *Id.* at 342, 348–53.

³²⁵ *Id.* at 341, 348.

³²⁶ *Id.* at 348–53.

³²⁷ *Id.* at 342.

³²⁸ *Id.* at 341–42.

³²⁹ *Id.*

against the CFPB itself being captured: state attorneys general have authority to enforce federal consumer protection laws and regulations, albeit with certain limitations.³³⁰ This backup authority both expands the potential enforcement resources available and provides an insurance policy against agency capture by harnessing state-level electoral politics.³³¹ The CFPB is an agency built to resist capture, which may explain the vehemence of the financial services industry's opposition to the agency's very existence even before it undertook any actions.

3. *Harnessing Rent-Seeking to Neutralize Politics.* — Whereas the CFPB pulls away from politics, the lesson from the Durbin Interchange Amendment to the Dodd-Frank Act suggests leaning into the politics of regulation, namely by harnessing the rent-seeking imperative of interest groups to foster symmetrical policy contestations. When a symmetrical policy contest occurs, the result is offsetting political influences, which create the space for something closer to genuinely neutral technocratic regulation.

The Durbin Amendment created a federal regulatory scheme for the interchange or “swipe” fees merchants pay on debit cards by imposing a regulatory price cap on the fees and then requiring competition between payment card networks for processing individual debit transactions, thereby encouraging competition beneath the fee cap.³³² At stake were debit card swipe fees of some \$16 billion in 2010 and the economics of the deposit-account relationship.³³³

The Durbin Amendment's passage shows what happens when there is symmetry in lobbying power. The Durbin Amendment was the result of a clash of Goliaths — the retail industry versus the financial services industry. Normally the lobby for financial regulation consists of underfunded consumer advocates and academics. For the Durbin Amendment, however, merchants provided a powerful, well-heeled force for financial regulation. As a result, retailers were able to push through the price-control regulation of banks with a bipartisan vote (forty-seven Democrats and seventeen Republicans voting yea in the Senate on the Amendment).³³⁴ As Jeff Connaughton observes:

³³⁰ *Id.* at 357–58.

³³¹ Levitin, *supra* note 137, at 199–200.

³³² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1075, 124 Stat. 1376, 2068–74 (2010) (codified at 15 U.S.C. § 16930-2 (2012)). Formally, the Durbin Amendment regulates the interbank interchange fee, but this fee sets the floor for what merchants then pay their banks. See generally Adam J. Levitin, *Cross-Routing: PIN and Signature Debit Interchangeability Under the Durbin Amendment*, LYDIAN J., Dec. 2010, at 16, archived at <http://perma.cc/47KB-8QBZ>.

³³³ Tom Schoenberg, *Swipe-Fee Rule Rejection to Help Merchants at Banks' Cost*, BLOOMBERG (July 31, 2013, 10:03 PM), <http://www.bloomberg.com/news/2013-07-31/fed-s-debit-card-swipe-fee-limits-rejected-by-u-s-judge.html>, archived at <http://perma.cc/B4FZ-UL7C>.

³³⁴ Mark Trumbull, *Debit Card Fees: Senate Votes for Limits, Seeking to Aid Consumers*, CHRISTIAN SCI. MONITOR (May 14, 2010), <http://www.csmonitor.com/Business/2010/0514/Debit>

“That amendment proved that, when big business stands up for itself, Wall Street loses.”³³⁵

It should hardly be surprising that when there is symmetrical lobbying power between interest groups instead of the asymmetric lobbying situation of concentrated financial interests versus diffuse public interests, different results ensue. If equilibrium between competing interest groups can be achieved, the influence of the competing groups can be cancelled out, leaving legislators and regulators space for more neutral policy analysis. Thus, rather than trying to insulate agencies through regulatory design, another response to the capture problem is to “lean in” to the politics and embrace a system of factional contestation in front of both agencies and Congress in which “[a]mbition [is] made to counteract ambition.”³³⁶

The experience of the Durbin Amendment suggests that if we could create symmetrical policy contestations, legislatures and regulators would be free to pursue the public interest. Indeed, the weakness of our government structures may in some circumstances even require us to structure industries to be regulatable and incapable of capture. This approach represents a distinct analysis from tripartism proposals to give public interest groups a more formal voice in regulation in order to recalibrate the balance of influence on policy, and thus avoids all of the problems of determining who actually represents the public interest.³³⁷

A model of this sort of policy equilibrium between competing factions can be found in the politics of Delaware corporate law. The Delaware Chancery is the premier arena for corporate law policy contestation. Corporate law is Delaware’s business.³³⁸ But it will only remain so while Delaware remains an attractive corporate law jurisdiction for both managers and shareholders. If either party gains too much of an ascendancy, Delaware law will cease to be attractive to the other. Professor Mark Roe has thus observed that the threat of federal intervention in corporate governance should a disequilibrium obtain in Delaware constrains the pursuit of a winner-take-all Delaware strategy.³³⁹

-card-fees-Senate-votes-for-limits-seeking-to-aid-consumers, archived at <http://perma.cc/7D5U-M6FK>.

³³⁵ CONNAUGHTON, *supra* note 165, at 245.

³³⁶ THE FEDERALIST NO. 51, at 319 (James Madison) (Clinton Rossiter ed., 2003).

³³⁷ See generally IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION* 54–100 (1992); Ian Ayres & John Braithwaite, *Tripartism: Regulatory Capture and Empowerment*, 16 LAW & SOC. INQUIRY 435 (1991); Lawrence G. Baxter, *Capture Nuances in Financial Regulation*, 47 WAKE FOREST L. REV. 537 (2012); Lawrence G. Baxter, Essay, “*Capture*” in *Financial Regulation: Can We Channel It Toward the Common Good?*, 21 CORNELL J.L. & PUB. POL’Y 175 (2011); Saule T. Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation*, 37 J. CORP. L. 621 (2012).

³³⁸ Cf. FRANK MILLER & LYNN VARLEY, 300, at 22 (1999) (“Spartans, what is your profession?”).

³³⁹ Mark J. Roe, *Delaware’s Politics*, 118 HARV. L. REV. 2491, 2493 (2005).

Indeed, the Delaware Supreme Court carefully manages the equilibrium between managers and shareholders by never letting either group completely win.³⁴⁰

Using symmetrical policy contestations to enable regulation or prevent deregulation is not new in financial regulation, although it has never been a theorized phenomenon. One of the critical, if unremarked-upon effects of the Glass-Steagall Act of 1933³⁴¹ was to create symmetrical policy contests for activity regulations in financial services. The Glass-Steagall Act was the first major New Deal banking act. It effectively broke up the financial services industry into three main lines of business: commercial banking (the taking of deposits and making of loans), investment banking (the underwriting in and dealing of securities), and insurance.³⁴²

Glass-Steagall is generally (and incorrectly) understood as having been about preventing the use of insured deposits for speculative activities.³⁴³ Glass-Steagall did largely prevent speculation with insured deposits, but the Act accomplished more than that. An overlooked benefit, and indeed, the unintended genius of Glass-Steagall, was its political effect, not its prudential effect.³⁴⁴ By splitting up the finan-

³⁴⁰ Robert B. Thompson, *The Power of Shareholders* (2013) (unpublished manuscript) (on file with the Harvard Law School Library).

³⁴¹ Banking Act of 1933, ch. 89, 48 Stat. 162, *repealed by* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

³⁴² *Id.* §§ 16, 20, 21, 32, 48 Stat. 162, 184–85, 188–89, 194.

³⁴³ See, e.g., Dean Baker, *Glass-Steagall Now: Because the Banks Own Washington*, AL JAZEERA (Aug. 5, 2013, 1:46 PM), <http://www.aljazeera.com/indepth/opinion/2013/08/201384183347752450.html>, *archived at* <http://perma.cc/CZ6E-CULT>. The intent of the Glass-Steagall prohibition on affiliation of commercial and investment banks was never actually to protect insured deposits. Geographic variation in credit availability and terms was a major concern prior to the New Deal. Senator Carter Glass's concern about financial conglomerates was that deposits would be used to fund securities speculation in major metropolitan markets to the detriment of local commercial uses. See Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 694 (1987) (discussing the legislative history and intent of the Glass-Steagall separation of commercial and investment banking). After 2008 there have been calls for a twenty-first-century Glass-Steagall Act precisely to reduce the risk of federal bailouts. 21st Century Glass-Steagall Act, S. 1282, 113th Cong. (2013); Elizabeth Warren, Op-Ed., *Scaling Back "Too Big": The 21st Century Glass-Steagall Act Would Reduce the Risk of Another Crash*, BOSTON GLOBE, Sept. 18, 2013, at A11. Thus far, Congress has declined this invitation. Instead, it adopted the "Volcker Rule," which keeps banks intact but prohibits speculation with insured deposits by institutionally separating most purely speculative activities from the taking of insured deposits. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620–31 (2010) (codified at 12 U.S.C. § 1851 (2012)).

³⁴⁴ Public choice theorists have long understood the Glass-Steagall Act as the result of rent-seeking behavior by competing financial industry interest groups. See, e.g., George J. Benston, *The Origins of and Justification for the Glass-Steagall Act*, in UNIVERSAL BANKING 31, 59–63 (Anthony Saunders & Ingo Walter eds., 1996); Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 485, 496 (1971). A similar public choice interpretation has also been advanced regarding the contemporaneous Securities Act of 1933. See Paul G.

cial services industry into commercial banks, investment banks, and insurance companies,³⁴⁵ Glass-Steagall broke up the political power of the financial services industry. Not only were each of the three major branches of the industry less powerful than the industry as a whole, but they were also rivals, fighting with each other for business, and each with its own regulator or regulators sometimes advocating for them. (None of this should gloss over the fact that there were also deep divisions within each industry sector, such as money-center banks versus community banks or banks versus credit unions.)

Thus, while Glass-Steagall held sway, commercial banks fought with investment banks,³⁴⁶ and insurance companies fought with com-

Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEGAL STUD. 1 (2001). The public choice interpretation of Glass-Steagall has been cogently challenged as inconsistent with the historical facts. See, e.g., HELEN A. GARTEN, *US FINANCIAL REGULATION AND THE LEVEL PLAYING FIELD* 19–27 (2001) (detailing the numerous historical inconsistencies of the public choice interpretation); Langevoort, *supra* note 343, at 694. Professor Helen Garten also provides an extended consideration of Glass-Steagall as reflecting ideologically driven reform or as reflecting market developments. GARTEN, *supra*, at 28–39. Yet even if the Glass-Steagall Act was not itself the product of rent-seeking behavior, it does not take away from the fact that Glass-Steagall did have an economic and political effect on the financial services industry.

³⁴⁵ In the decades following the New Deal, most banks were unable to offer insurance because of limitations in the Bank Holding Company Act, ch. 240, 70 Stat. 133 (1956) (codified as amended at 12 U.S.C. §§ 1841–1852).

³⁴⁶ See, e.g., *Clarke v. Sec. Indus. Ass'n*, 479 U.S. 388 (1987) (branching limits on national banks do not prevent them from opening up discount brokerage offices nationwide); *Bd. of Governors of the Fed. Reserve Sys. v. Dimension Fin. Corp.*, 474 U.S. 361 (1986) (striking down Fed rule from 1984 that would treat nonbank banks — those that did not both make commercial loans and take demand deposits — as banks because some were making commercial loans and offering negotiable order of withdrawal (NOW) accounts that operated like checking accounts; Congress responded with the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (codified as amended in scattered sections of 12 and 31 U.S.C.), which limited use of nonbank banks but grandfathered in the existing ones); *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 468 U.S. 207 (1984) (upholding Fed's approval of a bank holding company's purchase of a discount broker); *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 468 U.S. 137 (1984); *Bd. of Governors of the Fed. Reserve Sys. v. Inv. Co. Inst.*, 450 U.S. 46 (1981) (upholding Fed's determination that bank holding companies can act as investment advisers to closed-end investment companies); *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 839 F.2d 47 (2d Cir. 1988) (holding that ineligible securities activities of ten percent of bank affiliate's revenue did not violate Glass-Steagall's "principally engaged" prohibition); *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 821 F.2d 810 (D.C. Cir. 1987) (finding that combined provision of investment advice and securities brokerages by commercial bank did not violate Glass-Steagall Act § 20; this litigation was in response to the OCC and Fed allowing banks to acquire full-service brokerage firms that deal with institutional customers); *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 807 F.2d 1052 (D.C. Cir. 1986) (permitting Federal Reserve member bank to underwrite commercial paper); *Am. Bankers Ass'n v. SEC*, 804 F.2d 739 (D.C. Cir. 1986); *FAIC Sec., Inc. v. United States*, 768 F.2d 352 (D.C. Cir. 1985) (striking down FDIC/FSLIC rule that limited insurance coverage to \$100,000 per broker, per institution, when funds were placed by a broker); *Sec. Indus. Ass'n v. Comptroller of the Currency*, 577 F. Supp. 252 (D.D.C. 1983).

mercial banks.³⁴⁷ In the decades following Glass-Steagall, deregulation attempts by financial regulators were immediately met with well-funded litigation challenges as each of the three industry sectors jealously fought to preserve its turf from encroachment. This meant that attempts by one industry to acquire entities in another industry or to offer functionally similar products and services were routinely contested. Although not always successful, the certainty of litigation itself may have slowed deregulation. Yet private litigation between sectors of the financial services industry was limited to enforcement of formal administrative governance rules. To the extent that agency actions or inactions lay beyond the bounds of administrative law, private litigation could not impede deregulation.

The divided financial services industry may also have created benefits in terms of freeing Congress's hands in financial regulation. The campaign finance influence of the financial services industry was necessarily muted because candidates could take positions antithetical to one or two of the industry sectors and still seek donations from the other sectors. A divided financial services industry allowed Congress and regulators to potentially harness the competitive rent-seeking of different industry sectors. Thus, SEC Chairman William O. Douglas was able to steer the Trust Indenture Act of 1939³⁴⁸ (TIA) through Congress by playing the commercial banks off against the investment banks. Douglas teamed up with the American Bankers Association (the commercial banks' trade association) to negotiate the provisions of the TIA.³⁴⁹ The result was that the commercial banks supported the TIA, which excluded investment banks from the corporate trusteeship business.³⁵⁰ The industrial organization of the financial services industry under Glass-Steagall was a product of regulation, but the industrial organization itself affected the regulatory process, generally in a salutary manner.

³⁴⁷ See, e.g., *NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251 (1995) (upholding Comptroller of the Currency's determination that national banks were authorized to sell annuities under the National Bank Act); *Inv. Co. Inst. v. Camp*, 401 U.S. 617 (1971) (finding national banks prohibited from operating open-end investment companies); *Indep. Bankers Ass'n of Am. v. Heimann*, 613 F.2d 1164 (D.C. Cir. 1979) (finding national banks prohibited from selling credit insurance); *Saxon v. Ga. Ass'n of Indep. Ins. Agents*, 399 F.2d 1010 (5th Cir. 1968) (finding no authority for national banks to sell insurance); *Insurers, Regulators Fret over New Bank Ventures*, BESTWIRE, Jan. 9, 1998 (detailing insurance industry opposition to proposed captive mortgage reinsurance by bank affiliates).

³⁴⁸ Ch. 411, 53 Stat. 1149 (codified as amended at 12 U.S.C. §§ 77aaa-77bbb).

³⁴⁹ JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 196 (1982).

³⁵⁰ *Id.*

Glass-Steagall was never an impermeable wall of separation,³⁵¹ however, and its strictures were slowly eroded until the Gramm-Leach-Bliley Act of 1999 authorized financial holding companies that could have commercial bank, investment bank, and insurance company subsidiaries. Once permitted to conglomerate, the financial services industry ceased its internal bickering and united as an invincible Voltron, resulting in a complete asymmetry in all regulatory policy contestations. The decade after the demise of Glass-Steagall saw nothing but deregulation and the absence of enforcement until the financial crisis of 2008.

The effects of the repeal of Glass-Steagall can be seen in the politics of the regulation of money market mutual funds (MMFs), which experienced a serious run during the 2008 crisis. The SEC has proposed regulations aimed at making MMFs less vulnerable to runs. One of the proposals is to have institutional MMFs use a floating rather than a stable net asset value (NAV) per share,³⁵² which would make institutional MMFs the equivalent of an uninsured bank deposit, just as a large institutional deposit would be. Under the current system of stable \$1.00 per share NAV, MMFs are able to offer higher yields than deposit accounts yet seemingly equivalent risk. Floating NAV would make clear that the higher yields are due to greater risks.

Historically, the banking industry fought against the MMF industry as an unfairly advantaged competitor.³⁵³ If Glass-Steagall were still in place, one would have expected the SEC proposal to be supported by commercial banks because it would level the playing field between MMFs and deposit accounts. Thus, it is not surprising that traditional community-banking trade associations, such as the Wisconsin Bankers Association, have supported the proposed reforms.³⁵⁴

³⁵¹ Glass-Steagall permitted certain affiliations between investment and commercial banking firms, and its prohibitions did not cover thrifts or state-chartered banks that were not Federal Reserve System members.

³⁵² Money Market Fund Reform, Amendments to Form PF, 78 Fed. Reg. 36,834 (proposed June 19, 2013) (to be codified at 17 C.F.R. pts. 210, 230, 239, 270, 274, 279).

³⁵³ See, e.g., *Inv. Co. Inst. v. Camp*, 401 U.S. at 617–25 (prohibiting national banks from operating open-end investment companies); Robert J. Samuelson, *Regan Seeks His Rightful Place Among the Economic Policy Makers*, NAT'L J., Mar. 28, 1981, at 533.

³⁵⁴ See Letter from Rose M. Oswald Poels, President/CEO, Wis. Bankers Ass'n, to Elizabeth M. Murphy, Sec'y, SEC (Sept. 17, 2013), *archived at* <http://perma.cc/B7Z7-D9DJ>. Banking regulators have supported the proposed reforms, particularly through the FSOC, which they dominate. See Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69,455 (proposed Nov. 19, 2012) (proposing recommending that the SEC undertake a rulemaking regarding MMFs). The majority of SEC commissioners had not wanted to proceed with a rulemaking. Minutes of the Financial Stability Oversight Council, Fin. Stability Oversight Council (Nov. 13, 2012), *archived at* <http://perma.cc/UEE4-HXRR>.

It is not clear whether the bank regulators' support for the MMF reforms is because they are channeling the interests of banking industry writ large (only the very largest banks have affiliated MMFs) or instead because they are making a regulatory power grab. The latter seems more

The SEC proposal is opposed, however, by the American Bankers Association, the major trade association for large banks.³⁵⁵ The likely reason for this opposition is that with the repeal of Glass-Steagall, the largest banks all have affiliates that sponsor or manage MMFs. What would have been more symmetrical policy contestation is no longer because of the repeal of Glass-Steagall. To the extent that the SEC has the political space to advance the proposed regulations, it will be doing so by exploiting a different symmetrical interest group divide: that between retail funds, which are exempted from the proposed regulations, and institutional funds, which are not. Managers that have primarily retail (and non-brokered) money market funds, such as those at Fidelity, TIAA-CREF, T. Rowe Price, and Vanguard, are generally supportive of the regulation,³⁵⁶ while managers with primarily or exclusively institutional funds (which also happen to be brokered), such as Federated Investors, are opposed.³⁵⁷ This is not because retail fund managers are necessarily supportive of the regulation per se, but instead reflects a “better their ox get gored than mine” attitude. The retail fund managers understand that the SEC is under significant pressure from the FSO to undertake a rulemaking paring back the use of stable NAV; the current proposal is palatable enough to the retail funds, even if it is not what they would choose in an unconstrained universe.

What we see, then, is that industrial organization lines shape the regulatory politics. In some situations there are pre-existing industry divides that allow regulators to play one interest group against another to produce an offsetting symmetry in policy contestation. Regulators should look at situations where there are evenly matched competing interest groups as opportunities for more successful regulation.

likely given the paucity of bank commentary on the SEC MMF reform proposals. To the extent MMFs are subject to floating NAV, it makes MMFs relatively less attractive to bank deposits as an investment. Shifting funds from MMFs to bank deposits increases the scope of bank regulators' regulatory sway over the economy at the expense of the SEC, which has both prestige and post-government employment benefits for the bank regulators.

³⁵⁵ See Letter from Cecelia A. Calaby, Senior Vice President, Am. Bankers Ass'n, to Elizabeth M. Murphy, Sec'y, SEC (Sept. 17, 2013), *archived at* <http://perma.cc/VRY2-WGQU>.

³⁵⁶ See, e.g., Letter from Edward Bernard, Dir. & Vice President, T. Rowe Price Assocs., Inc., and Joseph Lynagh, Vice President, T. Rowe Price Assocs., Inc., to Elizabeth M. Murphy, Sec'y, SEC (Sept. 17, 2013), *archived at* <http://perma.cc/4SAH-QPZV> (supporting stable NAV for retail, and floating for institutional); Letter from Carol Deckbar, Exec. Vice President, TIAA-CREF Fin. Servs., to Elizabeth M. Murphy, Sec'y, SEC (Sept. 17, 2013), *archived at* <http://perma.cc/45UA-FCX6> (same); Letter from Scott C. Goebel, Senior Vice President, Fidelity Invs., to Elizabeth M. Murphy, Sec'y, SEC (Sept. 16, 2013), *archived at* <http://perma.cc/Z8RR-PVTE> (same); Letter from F. William McNabb III, Chairman & Chief Exec. Officer, Vanguard, to Elizabeth M. Murphy, Sec'y, SEC (Sept. 17, 2013), *archived at* <http://perma.cc/NZP2-8CEQ> (same).

³⁵⁷ Federated Investors submitted no less than fourteen separate comments in opposition to the rulemaking. See *Comments on Proposed Rule: Money Market Fund Reform; Amendments to Form PF*, SEC, <https://www.sec.gov/comments/s7-03-13/s70313.shtml> (last modified Mar. 26, 2014), *archived at* <http://perma.cc/3VSS-XZ3W>.

Such evenly matched contests may not be possible in all circumstances, particularly on consumer protection issues, which necessarily pit concentrated business interests against diffuse consumer interests. For consumer financial protection, capture may be best addressed with a politically insulated independent agency that is tasked solely with a consumer protection mission, as is the case with the CFPB. But for issues related to safety and soundness, such as activity restrictions, there might be benefits from encouraging such policy contestations.

Indeed, the example of Glass-Steagall suggests that creating industry divisions may itself contribute substantially to efforts at combatting capture. The contours of industrial organization are in part a function of regulation. Some industries, such as financial services, telecom, and rail transportation, restrict certain types of organizational affiliations or lines of business for safety-and-soundness or competition concerns. Regulators and policymakers should generally consider industrial organization as one of their regulatory tools. In certain circumstances, creating industry divides that foster symmetrical policy contestations can neutralize lobbying influences and make space for genuinely neutral, technocratic policymaking.

For example, within the financial services industry, it might make sense to formally separate the regulatory regimes for megabanks and community banks in order to create political space for rational regulation of the particular risks created by megabanks. Currently, small community banks frequently support big banks politically, despite being in competition with them.

One would expect small banks to want to encourage greater regulatory burdens for their competition. Surprisingly, however, community banks have cleaved to their larger brethren on many regulatory reform issues. Small banks were opposed to the Durbin Amendment and to the CFPB, despite the burdens of these reforms falling primarily on the big banks. Likewise, community banks and credit unions generally opposed cramdown legislation, even when it was amended to provide an exception for institutions with less than \$10 billion in total consolidated assets. Similarly, community banks spoke out in opposition to a Republican proposal to tax the four megabanks with assets of over \$500 billion.³⁵⁸

It is not clear why small banks support big banks politically, but this support is vital in regulatory reform debates because of the out-sized political power of community banks, particularly in the House of Representatives. Every congressional district has at least one commu-

³⁵⁸ Richard Rubin, *Biggest Banks Said to Face Asset Tax in Republican Plan*, BLOOMBERG (Feb. 25, 2014, 3:48 PM), <http://www.bloomberg.com/news/2014-02-25/biggest-banks-said-to-face-asset-tax-in-republican-plan.html>, archived at <http://perma.cc/HMW6-38T3>.

nity bank based in it, and these banks play important civic and economic roles in their districts, even if their overall national economic role is more limited.

There are already some formal legal distinctions between big and small banks. As of the end of 2013, there were 108 banks in the United States with over \$10 billion in total consolidated assets and 6,704 smaller banks.³⁵⁹ These 108 big banks controlled 81% of the total assets in the U.S. banking system.³⁶⁰ These megabanks are examined by the CFPB and subject to CFPB enforcement actions;³⁶¹ smaller banks are examined for consumer financial law compliance by their prudential regulators, who are also the ones with enforcement powers.³⁶² These megabanks are also the only banks subject to the Durbin Amendment's cap on debit card swipe fees.³⁶³ Banks with less than \$15 billion in total consolidated assets are exempted from the Volcker Rule's prohibition on investments in collateralized debt obligations backed primarily by trust preferred securities.³⁶⁴ And bank holding companies with over \$50 billion in assets are designated as globally systemically important banks and therefore subject to enhanced prudential regulation, including capital and leverage surcharges, resolution plan ("living will") submission, and the most stringent form of annual stress testing.³⁶⁵

Beyond these formal legal differences, big banks are often quite different financially than small banks. Big banks tend to engage in different activities both in their retail lines and as investors. For example, 85% of credit card issuance is by ten large banks.³⁶⁶ Many smaller banks simply do not offer credit cards. In terms of investments, one illustration is that almost 71% of bank investments in col-

³⁵⁹ See *Statistics on Depository Institutions*, FED. DEPOSIT INS. CORP., <http://www2.fdic.gov/SDI/main.asp> (last visited Mar. 30, 2014) (Type of reports: "Dollars/Percent of Assets"; number of Columns: 2; for column 1, "Custom Peer Group," "Create Peer Group," then under "Size or Performance" select "Total Assets" and for "Equal or Greater Than," enter "10000000"; then select "Find," "Select All," then "Criteria"; for column 2: "Standard Peer Group," "All Institutions," "National"; Report Date for both columns is Dec. 31, 2013) (custom peer group of all banks with assets over \$10 billion as of December 31, 2013).

³⁶⁰ Author's calculations based on FDIC Statistics on Depository Institutions. *Id.* (custom peer group of all banks with assets over \$10 billion as of December 31, 2013).

³⁶¹ 12 U.S.C. § 5515 (2012).

³⁶² *Id.* § 5516.

³⁶³ 15 U.S.C. § 16930-2(a)(6)(A) (2012).

³⁶⁴ Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities, 79 Fed. Reg. 5223, 5225 (Jan. 31, 2014) (to be codified in scattered parts of 12 & 17 C.F.R.).

³⁶⁵ 12 U.S.C. § 5365; see also *Oversight of Financial Stability and Data Security: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. (2014) (statement of Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System), archived at <http://perma.cc/G94J-B4JS>.

³⁶⁶ NILSON REPORT, Feb. 2013, at 9.

lateralized loan obligations (CLOs) are from just three megabanks;³⁶⁷ few community banks invest in this asset class.

Likewise, the holding companies of big banks are much more likely to elect to be financial holding companies (and thus able to affiliate more broadly with nonbank financial institutions) than community banks are.³⁶⁸ Small banks do not have securities and insurance affiliates and do not make markets in securities and commodities. And the business models of big banks and small banks are generally different, with small banks emphasizing service and big banks emphasizing technology, convenience of locations, and sometimes pricing.

Potentially, if the distinction between large and small banks were formalized, small banks would cease to be a source of political support for opposition of regulation of large banks. To wit, it would be possible to have separate community bank and megabank charters and even separate regulatory agencies for each. If such an approach managed to cleave small banks from the megabanks, it would have a major impact on the ability to pursue regulation of the big banks.

One of the challenges for research going forward is to discern the circumstances under which encouragement of symmetric policy contestations advances uncaptured regulation. A divided industry with divided regulators may have different effects than a divided industry with a single regulator. Indeed, in the run-up to the 2008 crisis, industry divided and conquered regulators, rather than vice versa. Similarly, encouraging symmetrical policy contestations alone may not be enough; even if evenly matched, the absolute size and strength of the parties to the contestation may matter. A broader research agenda on the workings of regulatory policy contestations would attempt to discern the circumstances in which rent-seeking impulses can be harnessed to advance more neutral regulatory agendas and when rent-seeking merely results in regulatory capture.

CONCLUSION

The lesson from these recent books on the financial crisis is that we are simply having the wrong debate about financial regulation. Scholars and politicians are asking the wrong questions. Debating how much capital should be required or what form it should take is beside the point. This response is treating the acute symptoms of the finan-

³⁶⁷ *Fact Sheet: The CLO Debate Is Just the Latest Wall Street Attack on the Volcker Rule*, BETTER MARKETS (Feb. 26, 2014, 12:58 PM), <https://www.bettermarkets.com/blogs/fact-sheet-clo-debate-just-latest-wall-street-attack-volcker-rule>, archived at <http://perma.cc/YP58-NE56>.

³⁶⁸ There are 490 financial holding companies regulated by the Federal Reserve Board, forty-three of which are foreign entities. See *Financial Holding Companies*, BOARD OF GOVERNORS OF THE FED. RES. SYS., <http://www.federalreserve.gov/bankinforeg/fhc.htm> (last updated Feb. 24, 2014), archived at <http://perma.cc/3HJ8-ETZZ>.

cial regulatory system, not its long-term health. The regulation-by-regulation trench warfare will, at best, produce short-lived victories for pro-regulatory forces that will soon become unwound through financial innovation and deregulation in various forms, ranging from non-enforcement to explicit deregulation by agencies and Congress.

Instead, the financial regulatory debate needs to be about how to change the political environment for regulation. Whether and when this goal is best served by leaning into or pulling back from political contests remains an important question for future research. Yet only by reforming the politics of financial regulation will we achieve lasting financial regulation that achieves the socially optimal balance of stability and growth. Reforming financial politics requires a change in governance structures for financial regulation to account for the myriad ways in which political influence can affect regulation beyond those actions governed by administrative law procedures. The experience of 2008 and its aftermath teaches that those who wish to reform the regulation of the financial system need to concentrate their efforts on reforming its politics.