

# UC Berkeley

## UC Berkeley Electronic Theses and Dissertations

### Title

Charting a Course to Autonomy: Bureaucratic Politics and the Transformation of Wall Street

### Permalink

<https://escholarship.org/uc/item/1xc8x8s7>

### Author

Ryan, Peter Joseph

### Publication Date

2013

Peer reviewed|Thesis/dissertation

**Charting a Course to Autonomy:  
Bureaucratic Politics and the Transformation of Wall Street**

by

Peter Joseph Ryan

A dissertation submitted in partial satisfaction  
of the requirements for the degree of

Doctor of Philosophy

in

Political Science

in the

GRADUATE DIVISION

of the

UNIVERSITY OF CALIFORNIA, BERKELEY

Committee in charge:

Professor Paul Pierson, Chair

Professor J. Nicholas Ziegler

Professor Neil Fligstein

Spring 2013

Charting a Course to Autonomy:  
Bureaucratic Politics and the Transformation of Wall Street

Copyright © 2013

by

Peter Joseph Ryan

## Abstract

Charting a Course to Autonomy:  
Bureaucratic Politics and the Transformation of Wall Street

by

Peter Joseph Ryan  
Doctor of Philosophy in Political Science  
University of California, Berkeley  
Professor Paul Pierson, Chair

Over the past three decades, federal regulators have been at the heart of transformations that have reshaped the financial services industry in the United States and by definition, global markets. It was, for example, the Federal Reserve that initiated and developed risk-based capital standards, rules that are now at the heart of prudential regulation of financial firms across the globe. Federal regulators played a central role in preventing regulation of the emerging ‘over-the-counter’ derivatives market in the late 1980s and early 1990s, actions that later had dramatic consequences during the 2007-2008 financial crisis. The Securities and Exchange Commission took critical decisions regarding the prudential supervision of investment banks, decisions that greatly contributed to the end of the independent investment banking industry in the United States in 2008. Finally regulators played an important role in setting the agenda and shaping the outcomes of the Dodd-Frank Wall Street Reform Act of 2010, the most sweeping and comprehensive piece of legislation affecting the industry since the New Deal.

Yet despite this, the idea that regulators possess *independent* political power is surprisingly controversial. All too often financial regulators are portrayed as ‘captured’ functionaries of the firms they regulate or as ‘prisoners’ of financial markets, assertions that are nevertheless frequently unsupported by rigorous empirics. Amongst political scientists, bureaucratic organizations tend to be treated as mere ‘agents’ that obediently follow the demands of their political principals, yet neither evidence nor logic supports such claims in the area of financial regulation. Finally, even amongst those that argue that autonomous bureaucracies were once possible in the pre-New Deal American state, there is skepticism about whether independent bureaucratic authority is possible in the densely institutionalized and interest-group heavy modern American polity. This project is designed to show that under conditions which pertain to institutional-level financial regulation – low political salience and visibility, high technical complexity, and economic centrality – such autonomy is not only possible in the modern American state, but is in fact ubiquitous. As a result, federal financial regulators have demonstrated not only a tremendous amount of influence over policy and legislative outcomes over the three decades, but they have done so in a manner that suggests that such action has been consistent with their own, differentiated and irreducible preferences.

This influence is exercised primarily through the cultivation of reputation or ‘images’ of

the agency amongst key policymaking audiences. When agencies are perceived to be legitimate policy actors and when audiences believe them to uniquely competent to deal with the policy problem at hand, regulators are often capable of inducing deference to their own preferences from other political and societal actors with different objectives. As a practical matter, however, we can only observe this exercise of influence during periods in which bureaucratic authority is ‘contested’ or challenged. During these periods, we see agencies behave in a strategic manner designed to promote and entrench images that boost their legitimacy and evoke a reputation for competency. Specifically, they seek to forge agreements with transgovernmental counterparts, create partnerships with private-sector actors, alter their public rhetoric in pursuit of expanding or defending their authority.

This project explores these patterns of bureaucratic influence and behavior by examining regulatory policymaking in three main areas: bank capital rules, over-the-counter derivatives, as well as security holding company supervision and capital requirements. It does so by examining the historical development of these policies over time. This approach yields two important benefits. First, as a methodological device, it permits us to distinguish claims of capture, functionalism, or political control from autonomy-based processes. Indeed, while these theories may have explanatory power in later periods, they all too frequently fail to explain earlier critical junctures. Second, temporal analysis further highlights how early actions by regulators tend to create self-reinforcing or path-dependent patterns of power. In the first two cases examined, early decisions led to the empowerment of the Federal Reserve and a reduction in the degree of policy contestation in later eras. In the third case, negative feedback effects from prior actions lead to a diminishment of the authority of the Securities and Exchange Commission over time. In conclusion, this project also looks briefly at evidence of bureaucratic autonomy under “least-likely” conditions: the high-profile 2008-2010 debate that led to the passage of the Dodd-Frank Act.

## Acknowledgements

The genesis of this project occurred in late 2008 when Paul Pierson and myself had our first discussion about the dearth of systematic scholarly attention paid to financial services policy. Since then, I have been extraordinarily fortunate to have had access to someone who is undoubtedly an intellectual powerhouse. In particular, I should note that Paul's capacity to understand big picture puzzles is perhaps unrivaled and, as a result, his theoretical and empirical insights are greatly imprinted upon this project. Of equal importance, however, has been Paul's steadfast support of my academic and career objectives, particularly over this last critical year. I will be forever grateful for his efforts on my behalf and for his strong belief in the value of this project. To my other committee members – Nick Ziegler and Neil Fligstein – I want to extend my deepest gratitude for agreeing to join this effort at what was a later stage in the process. Your expertise and advice has been of tremendous importance in shaping this project for the better.

I also owe a special debt of gratitude to David Karol for his mentorship throughout the years. David was instrumental in me coming to Berkeley, and though this specific project ultimately evolved in a different direction, I will always be thankful for his invaluable advice and support throughout the years. I would like to thank Steve Vogel for his helpful insights regarding this project, along with Bob Kagan and Ann Joseph O'Connell, both of whom also served on my prospectus committee with David and Steve. I would like to thank Sean Gaillmard for his trenchant insights that helped to significantly improve the theoretical portion of this project, as well Jacob Hacker for his insights at an earlier stage in this endeavor. My thanks also go to David Vogel both for his advice on this effort and providing me with the opportunity to work with him on a year-long research project. I am also grateful to faculty I have worked with over the years, including Margaret Weir and Gordon Silverstein, as well as to the valuable advice I received from Eric Schickler and many others. I would be remiss if I did not acknowledge the late and great Nelson Polsby for persuading me to come to Berkeley; it was a privilege to take his American politics seminar, which was undoubtedly one of the highlights of my years in graduate school. Finally, I am extremely grateful to the supportive staff in the Political Science Department who have provided tremendous assistance to me at various points in this process, including Andrea Rex, Gwen Fox, Janet Newhall, and Suzan Nunes.

I would like to extend a special thanks to the UCDC community, which has been my home over the past three years. Above all, I owe a deep debt of gratitude to the Center's former Executive Director Bruce Cain for his mentorship, support, and advice. I am grateful to the always ebullient Janou Gordon, as well as her indomitable predecessor, Pretti Piplani, for their friendship and support. I would like to thank Jim Desveaux for his insightful feedback on this project, as well as Marc Sandalow and Matt Dallek, both of whom have been valuable sources of advice for me on this and other matters. I am very lucky to have had a supportive community of graduate students around me, including Jay Purcell, Lauren

Janes, Phil Wolgin, and Genevieve Lester, all of whom have moved on to bigger and better things. I would particularly like to thank Chloe Thurston for her feedback on this project over the past two years and for working with me on a related collaborative effort. I am also grateful to all of the other faculty and staff at the Center that I have had the privilege of working with over the past three years.

I truly could not have made it through my early years of graduate school without the support of my housemates John Henderson and Devin Caughey. In particular, John's guidance, support, and friendship throughout the years has been invaluable to me. I want to also thank the other member of our Americanist cohort, Sara Chatfield, for her abiding friendship over the past seven years. Ryan Williams: thank you for always being there to listen and offer advice. Kimhouy Tong, Tom Kordel, Catherine Kordel, and Liz Ho: thank you for your love and support over many years. I could not have gotten through the past three years without an amazing group of friends who helped make Washington DC home. To Matt Howell: thanks for your love and support, as well as for keeping me sane through this process with our mental health days! To Kenan Fikri, Rory Adams, Rob Geremia, Dennis Reardon, and Justin Friedman: thank you not only for helping me edit this document, but for being such wonderful and loyal friends.

Finally, I most certainly would not be where I am without my family. I would like to thank my soon-to-be husband, Larry Harte. His love and support over the past four-plus years, and particularly during these last few difficult months, has meant so much to me. He has stuck by me through some very challenging times and I would not have made it to this point without him. I would like to remember my dear late grandmother Stella for her love, guidance, and abiding confidence in me. I owe a tremendous debt to my late godfather Charles and my godmother Bidy for their presence in my life, their support and faith in me. Above all, I want to thank my parents, Michael and Colleen. Not once in thirty years have they ever flinched at making a sacrifice in order to help me achieve my dreams. Without their love, faith, and support I would never have made it to this point in my life. While I can never possibly repay them for all they have done for me, I hope that they take some pride in having made all of this possible.

Peter J. Ryan  
May 2013

*For my parents, Michael and Colleen*



# Contents

<b>List of Figures</b>	<b>vi</b>
<b>Glossary</b>	<b>viii</b>
<b>Acronyms</b>	<b>xi</b>
<b>1 Introduction</b>	<b>1</b>
1.1 The U.S. Financial Sector in an Era of Transformation: A Background . . .	3
1.2 An Overview of the Argument and Structure of the Dissertation . . . . .	13
<b>2 Bureaucratic Autonomy: Logic, Theory, and Design</b>	<b>18</b>
2.1 Introduction . . . . .	18
2.2 Existing Approaches to the Study of Bureaucracies . . . . .	20
2.3 Why Focus on Bureaucracies? . . . . .	27
2.4 An Autonomy-Based Approach . . . . .	30
2.5 Autonomy and Strategic Bureaucratic Behavior . . . . .	44
2.6 Research Design and Methodology . . . . .	52
<b>3 Capital Adequacy and the Contested Authority of the Federal Reserve</b>	<b>57</b>
3.1 Introduction . . . . .	57
3.2 Capital Adequacy: A Brief Primer . . . . .	58
3.3 The Divergent Bureaucratic Approaches to Capital Adequacy Standards . .	60
3.4 The Contested Role of the Federal Reserve . . . . .	64
3.5 The Establishment of Statutory Capital Standards, 1980-1985 . . . . .	71
3.6 The FRB Turns to the Basel Committee . . . . .	85
3.7 Impact of the FRB's Victory on Capital . . . . .	94
3.8 Conclusion . . . . .	100
<b>4 OTC Derivatives and the Absence of Regulation: An Autonomy-Based Explanation</b>	<b>103</b>
4.1 Introduction: A Focus on the Early Stages of the Regulation Debate . . . . .	103

4.2	Derivatives: A Primer . . . . .	106
4.3	The OTC Derivatives Markets in the Late 1980s/Early 1990s . . . . .	110
4.4	The CFTC: Oscillation Between Bystander, Pawn, and Lonely Advocate . .	114
4.5	The Importance of the Federal Reserve’s Preferences and Role in the OTC Debate . . . . .	118
4.6	The SEC’s Cautious Strategy on OTC Derivatives . . . . .	124
4.7	Industry Influence on the Early OTC Debate . . . . .	127
4.8	Early Attempts to Regulate the OTC Markets and their Consequences . . .	129
4.9	The Emergence of a Congressional ‘Threat,’ 1993-1995 . . . . .	132
4.10	The End of the Debate Over Regulation . . . . .	140
4.11	Conclusion . . . . .	142
<b>5</b>	<b>The Transition to a More Contested Authority: Supervision, Capital, and the SEC</b>	<b>146</b>
5.1	Introduction . . . . .	146
5.2	A Profile of the SEC as a Securities Regulator . . . . .	148
5.3	Evaluating Structural Explanations for Growing Contestation . . . . .	152
5.4	A Note on Preference Independence and Capture . . . . .	158
5.5	A Lack of Contestation: Early Episodes Relating to Capital and Consolidated Supervision . . . . .	161
5.6	The Turn to a More Contested Authority in the Mid-1990s . . . . .	170
5.7	The SEC’s Authority in Decline and The Consolidated Supervised Entity Program . . . . .	177
5.8	Conclusion . . . . .	184
<b>6</b>	<b>Conclusion</b>	<b>188</b>
6.1	Summary . . . . .	188
6.2	Contributions and Take-Away Considerations . . . . .	190
6.3	Does Autonomy Still Exist in Financial Policymaking? Evidence from the Dodd-Frank Debate . . . . .	198
6.4	Directions for Future Research . . . . .	205
6.5	Final Thoughts . . . . .	206
	<b>References</b>	<b>207</b>

# List of Figures

1.1	Size of Financial Services and Real Estate Industry Relative to Manufacturing as Percentage of U.S. GDP, 1947-2009 . . . . .	4
1.2	U.S. Financial Firms: Share of Total U.S. Profits and Share of U.S. Market Capitalization, 1970-2010 . . . . .	5
1.3	U.S. Financial Assets Held by Economic Sector, 1981 and 2011 . . . . .	7
1.4	Relative Complexity, Education, and Wages in the Financial Industry, 1910-2010	9
1.5	Top Three U.S. Bank Assets as (a) % of U.S. Commercial Bank Assets (b) % of GDP Compared to Top Three Banks of Other Major Industrialized Countries	11
1.6	Number of Banking Organizations, 1984-2003 . . . . .	12
1.7	Share of Banking Industry Assets by Size Group, 1984 and 2003 . . . . .	12
2.1	Issue Characteristics Associated with Bureaucratic Policy Influence . . . . .	28
2.2	A Graphical Representation of Bureaucratic Autonomy . . . . .	32
2.3	Stylized Typologies of Agencies Based on Authority and Preferences . . . . .	33
2.4	Bureaucratic Preferences: Influences on Each State of Formation . . . . .	34
2.5	Bureaucratic Preferences: Sources and Indicators . . . . .	37
2.6	Bureaucratic Authority: Types, Sources, and Indicators . . . . .	39
2.7	Bureaucratic Authority: Indicators and Information Sources . . . . .	43
2.8	Bureaucratic Strategies: Authority Enhancing Benefits . . . . .	46
3.1	Equity as a Percent of Assets for All Commercial Banks, 1840-1989 . . . . .	72
3.2	Bank Capital Ratios for All U.S. Banks and Large Asset Banks, 1970-1981 .	72
3.3	Bank Failures, 1960-1994 . . . . .	75
3.4	Number of Bank Supervisors By Agency, 1979-1990 . . . . .	76
3.5	Trends in Adoption of Deposit Insurance, 1979-1990 . . . . .	90
3.6	Basel I: Summary of Key Provisions . . . . .	93
4.1	Major Categories of Derivatives . . . . .	108
4.2	Typical Credit Default Swap Transaction . . . . .	110
4.3	Exchange-Traded and OTC Derivatives Global Notional Amounts in U.S. Dollars (Billions), 1988-2011 . . . . .	112

4.4	Credit Exposures from Derivatives and Loans of the Seven Largest U.S. Banks as Percentage of Equity, Year-End 1994 . . . . .	113
4.5	Total Contribution of Derivatives Trading to Total Trading Income, 1993 and 1994 . . . . .	114
4.6	SEC and CFTC Budgets and Staff Totals, 1998-2012 . . . . .	117
5.1	National Equity Market Capitalization as a Percentage of Global Equity Market Capitalization: 1900-2012 . . . . .	153
5.2	Aggregate Market Share of Commercial Banks + Subsidiaries and Investment Banks, 1990-2002 . . . . .	155
5.3	Securities Industry Concentration Based on Total Revenue, 1980-2006 . . . .	157
5.4	Percentage of Securities Industry Revenue Generated by Four Activity Categories, 1991-2006 . . . . .	159
5.5	Major Derivatives Product Companies: Date of Creation and Parent Company	163
5.6	SEC Fees Collected and Appropriated Funding, 1991-2001 . . . . .	179

# Glossary

**American Bankers Association** The ABA has traditionally been the major trade association for the banking industry; most banks and bank holding companies are members of the organization. However, the ABA has generally been considered to be more closely aligned with the interests of larger banks. The group was and continues to be focused on government relations, and also provides extensive professional training and development.

**Association of Bank Holding Companies** Also known as the Association of Registered Bank Holding Companies, the ABHC was a trade association founded in 1958 to represent bank holding company (BHC) interests. Since bank holding companies tended to be large asset institutions, the views of the organization tended to align with those of the major banks. However, in contrast to the Association of Reserve City Bankers, the organization was primarily focused on government relations. In 1993, the organization merged with the Reserve City Bankers to form The Bankers Roundtable, which was later renamed the Financial Services Roundtable in 2000.

**Association of Reserve City Bankers** A professional, networking, and research focused organization comprised of approximately 400 executives from major commercial and bank holding companies (BHCs). In contrast with the American Bankers Association (ABA) and the Association of Bank Holding Companies (ABHC), the group was not focused on government relations but rather on education, research, and professional development. In 1993, the organization merged with the lobbying-focused Association of Bank Holding Companies to form The Bankers Roundtable, which was later renamed the Financial Services Roundtable in 2000.

**Bank Holding Company** A bank holding company is a company that owns more than one or more commercial bank; that is a bank that accepts deposits and makes business loans. Bank holding companies, which tend to be larger asset institutions, are regulated by the Federal Reserve Board under the Bank Holding Company Act of 1956.

**Consolidated Supervised Entity Program** A voluntary regulatory scheme of securities holding company oversight created by the SEC in 2004 in response to the E.U. Financial Conglomerates Directive. The program permitted major investment banks to hold significantly lower levels of leverage than permitted by the SEC's existing Net Capital Rule. See Chapter 5 for more on its significance.

**Derivatives Policy Group** A group of major securities company derivative dealers created at the suggestion of SEC Chairman Arthur Levitt in 1994. The group produced an influential report known as the *Framework for Voluntary Oversight* in 1995. Its importance in boosting the SEC's authority is discussed in detail in Chapter 5.

**discount window** A facility that allows depository institutions that are members of the Federal Reserve System to borrow money from the Federal Reserve Banks on a short-term basis in order to meet

temporary shortages of liquidity that result from internal and external ‘disruptions.’ Credit is typically made available to banks on an overnight basis, but can be made for longer periods under emergency circumstances. The discount window is designed to ensure continued liquidity in the banking system and is an important tool of monetary policy. 63, 79, 148, 184

**Federal Open Markets Committee** A committee within the Federal Reserve System that makes decisions regarding open market operations (i.e. the buying and selling of U.S. Treasury securities). Since these decisions have the effect of shifting market interest rates and the growth of the money supply, the committee is the key monetary policymaking body in the United States. It is comprised of the Federal Reserve Board of Governors, the president of the Federal Reserve Bank of New York, and four of the remaining eleven Federal Reserve Bank presidents, who sit on the committee on a rotational basis.

**Financial Services Authority (U.K.)** The successor to the Securities and Investment Board (SIB), the FSA was the government authorized private sector regulatory authority in the United Kingdom. It was created in 2001 and abolished in April 2013..

**Group of Thirty** Formally the Group of Thirty Consultative Group on International Economic and Monetary Affairs. A global organization of prominent individuals in the economics and finance professions founded in 1978 that makes recommendations to public and private sector actors on a range of financial regulatory issues. Notably the organization has throughout its history included a number of former and current members of the Federal Reserve and the two are seen as closely linked. The G-30 played a prominent role in the development of ‘best-practice’ standards for traders of OTC derivatives in 1993/4, a development that was important in helping to preempt regulation of such products by Congress in 1994 (see chapter 5).

**Independent Community Bankers Association** A trade association representing small asset commercial banks (as of 2012, 59% of its members had assets ranging from \$100 million to \$1 billion, while 32% had assets less than \$100 million). Note that until March 1999, the organization was known as the Independent Bankers Association of America (IBAA); however, the acronym “ICBA” is used throughout the text to ensure consistency..

**Internal-Ratings-Based Approach** Proprietary bank models that typically use “value-at-risk” approaches to assess the risk of default by counterparties and calculate capital requirements appropriate to those credit risks. This approach was strongly supported by the Federal Reserve Board during the Basel II negotiations.

**International Swaps and Derivatives Association** Founded in 1985 as the International Swap Dealers Association, the ISDA is the major trade association for dealers of OTC derivatives (though its membership also includes end-users). The ISDA acts as a de-facto industry regulator, setting standards for OTC contracts, most notably in the form of the ISDA Master Agreement. The ISDA also acts as an important lobbying organization on behalf of its membership. It opposed efforts to regulate the OTC industry in the 1990s.

**Risk Weighted Asset Approach** An approach to the calculation of bank capital that weights assets according to risk. This approach, which was strongly advocated for by the Federal Reserve Board was the foundation for the Basel I and Basel II Accords. However, they differed in how risks were calculated, with Basel I agreement using regulator determined ‘risk buckets’ and the Basel II agreement using an IRB approach.

**Value-at-Risk** The concept of value-at-risk at a basic level refers to the amount of money that an institution is at risk of losing should the price of an asset - such as a loan or a security - go down. In practice, financial institutions typically base their VaR models on a 95 percent confidence interval and evaluate risk based largely on recent past performance. The development of complex VaR models was an important development in the 1990s and affected debates around both bank capital adequacy (Basel II) and regulation of the emerging OTC derivatives markets.

**Value-at-Risk Approach** Value-at-Risk or VaR refers to a modeling approach used by financial institutions and others to determine the losses that the institution would incur should the price of an asset - such as a loan or a security - decline. It's use as a method for determining risk-based capital standards in the Basel II and III agreements has provoked controversy (see chapter 3).

# Acronyms

- ABA** American Bankers Association. 12, 65–70, 78, 80, 81, 127, 128, 134, *Glossary*: American Bankers Association
- ABHC** Association of Bank Holding Companies. 65–67, 69, 70, 78, 80, 83, 127, 128, *Glossary*: Association of Bank Holding Companies
- ARCB** Association of Reserve City Bankers. 80, 81, *Glossary*: Association of Reserve City Bankers
- BHC** Bank Holding Company. 57, 61, 62, 65–67, 70, 79, 94, 121, 148, 152, 172, 174, 178, 182, 184, 186, *Glossary*: Bank Holding Company
- BIS** Bank for International Settlements. 85, 86, 121, 123, 126
- CBO** Congressional Budget Office. 41
- CBOE** Chicago Board Options Exchange. 107, 109
- CBOT** Chicago Board of Trade. 106, 109
- CDO** Collateralized Debt Obligation. 109
- CDS** Credit Default Swap. 109
- CEA** Commodity Exchange Act of 1936. 109, 115, 119, 126, 130, 131, 143, 144
- CFMA** Commodity Futures Modernization Act. 144
- CFPB** Consumer Financial Protection Bureau. 51
- CFTC** Commodities Futures Trading Commission. 10, 16, 36, 49, 53–55, 102, 105, 106, 114–121, 123–126, 128–131, 135, 142–145, 150, 176, 184
- CFTCA** Commodity Futures Trading Commission Act. 109, 115, 116, 118, 125, 126
- CSE** Consolidated Supervised Entity. 148, 158, 170, 177, 180–186, *Glossary*: Consolidated Supervised Entity Program
- DPC** Derivatives Product Company. 163, 170, 171, 174, 176–178, 180, 181
- DPG** Derivatives Policy Group. 49, 50, 170, 174–177, 181, 185, 188, *Glossary*: Derivatives Policy Group
- FASB** Financial Accounting Standards Board. 49, 50, 151
- FDIC** Federal Deposit Insurance Corporation. 10, 35, 36, 43, 48, 53, 54, 57, 58, 61–71, 75–79, 81–86, 88, 90–94, 96–101, 145, 188



**FFIEC** Federal Financial Institutions Examination Council. 62, 76

**FHC** Financial Holding Company. 172–174, 178, 182, 184, 186

**FHLBB** Federal Home Loan Bank Board. 82

**FOMC** Federal Open Markets Committee. 36, 79, 106, 120, 121, *Glossary*: Federal Open Markets Committee

**FRB** Federal Reserve Board. 1, 2, 10, 15, 16, 53, 57, 58, 61–70, 76–81, 83–102, 105, 112, 114–116, 118–123, 126–133, 135–140, 142, 144, 147, 152, 154, 156, 165, 167, 169, 170, 172, 173, 175–178, 182, 183, 185, 186

**FSA** Financial Services Authority. 148, 150, 181–183, 186, *Glossary*: Financial Services Authority (U.K.)

**FSLIC** Federal Savings and Loan Insurance Corporation. 82

**G-30** Group of Thirty. 122, 123, 136–138, 142, 175, 176, *Glossary*: G-30

**GAO** General Accounting Office. 115, 125, 126, 128, 133, 134, 139, 141, 143, 179, 180

**GSE** Government-Sponsored Enterprises. 5

**IASB** International Accounting Standards Board. 49

**ICBA** Independent Community Bankers Association. 80, 83, 85, 98, *Glossary*: Independent Community Bankers Association

**ILSA** International Lending Supervision Act. 78, 88, 92, 101

**IOSCO** International Organization of Securities Commissions. 49, 163, 166–169, 181

**IPO** Initial Public Offering. 154

**IRB** Internal-Ratings-Based Approach. 96–101, 122, 123, 180, *Glossary*: Internal-Ratings-Based Approach

**ISDA** International Swaps and Derivatives Association. 106, 127, 128, 141, 143, *Glossary*: International Swaps and Derivatives Association

**MBS** Mortgage-Backed Securities. 2

**NYSE** New York Stock Exchange. 111, 130, 151, 164

**OCC** Office of the Comptroller of the Currency. 57, 61–70, 76–79, 81, 86, 91, 92, 94, 99–101, 129, 133–135

**OMB** Office of Management and Budget. 41, 67, 115

**RWA** Risk-Weighted Asset Approach. 58, 61, 62, 64, 76, 88–93, 95, 97, 98, 100, 123, 169, *Glossary*: Risk Weighted Asset Approach

**SEC** Securities and Exchanges Commission. 1, 2, 10, 16, 20, 24, 36, 45, 49–51, 53–55, 102, 104, 105, 115, 116, 118, 119, 121, 123–127, 130, 131, 133, 134, 139, 140, 142–154, 156–186

**SIB** Securities and Investment Board. 162, 167–170, 181

**SPV** Special Purpose Vehicle. 163, 164

**SRO** Self-Regulatory Organization. 151, 152, 176, 188

**VaR** Value-at-Risk. 8, 35, 96, 180–182, *Glossary*:

# 1 | Introduction

Writing in 1986, Merton Miller opined that “... the word revolution is entirely appropriate for describing the changes in financial institutions... that have occurred in the past twenty years” (Miller, 1986, 437). In 1970, commercial banking was – as it had been since the early New Deal Era – treated much like a “regulated utility, enjoying moderate profits with little risk and low competition” (Johnson and Kwak, 2010, 35). Deposits were the primary source of funds for banks and competition for those funds was tightly regulated by the Federal Reserve Board (FRB)’s Regulation Q, which set a cap on the interest that depository institutions could pay on savings accounts. In turn, these institutions used these deposits to provide a limited range of consumer loans, earning their profits in the spread between the interest paid on savings deposits and interest earned on loans to businesses and consumers. The more speculative securities industry, walled off from commercial banking by the Glass-Steagall Act, was nevertheless strictly regulated by a disclosure-based regime enforced by the Securities and Exchange Commission (SEC). Trading in derivatives was largely the domain of producers and end-users of agricultural products, an activity with marginal relevance to the broader world of finance. In short, this was a period in which the world of finance was delimited, stable, and relatively easy to understand. At the same time, the regulatory framework that governed the sector was highly proscriptive and focused principally on maintaining anti-competitive barriers.

Yet radical changes began to occur in the early 1970s, changes that would accelerate in pace over the next two decades. These transformations were brought about through a mix of economic volatility, rampant inflation, high interest rates, technological innovation, as well as a radical reorientation of the New Deal regulatory structure. Commercial banks, for example, faced unprecedented ‘disintermediation’ as depositors turned to new, higher yielding capital market investment vehicles such as money market funds while firms increasingly opted to raise money in the equity and bond markets rather than obtain financing from banks. Competition increased in the securities sector, along with instability in the stock market. In part this instability owed to another development: the emergence of ‘financial derivatives’ – instruments based on the value of an underlying asset, such as corporate stock, an index, such as the Dow Jones Industrial Average, or a reference rate, such as a currency. The market for unregulated ‘over-the-counter’ derivatives expanded particularly rapidly thanks to their value as risk management tools, their customizability, and the lucra-

tive fees that banks earned by dealing in such products. As competition increased and access to the capital markets became easier, the number of credit products available to ordinary consumers grew, while their cost dramatically decreased. As a result, the ‘real economy’ – households, non-financial firms, and government entities – increasingly turned to the financial industry as a way to compensate, respectively, for low wage growth, decreasing corporate profits, and to finance rising deficits. In short, this period marked what many have termed the ‘financialization’ of the U.S. economy.

These finance-driven economic transformations occurred in large part because of the active role played by policymakers, particularly federal financial regulators. Some of the changes were deregulatory: lawmakers and regulators began to dismantle the old anti-competitive regulatory edifice piece-by-piece, beginning with Regulation Q, followed by a general end to restrictions on the types of depository products banks could offer, a relaxation of inter-state branching barriers, and slowly unravelling the Glass-Steagall separation between commercial and investment banking. On the other hand, regulatory agencies led the charge to create new rules in the 1980s, most notably risk-weighted capital standards, that served as new prudential tools in an era of growing competition. These changes, advocated for most forcefully by the FRB, created powerful incentives for banks and later for securities companies to increase their exposure to certain markets – such as the mortgage-backed securities (MBS) and OTC derivatives markets – with consequences that would later be felt in the 2008 financial crisis. Other changes, such as the SEC’s embrace of ‘mark-to-market’ accounting in the early 1990s, were neither deregulatory or re-regulatory, but had profound consequences for market stability and the solvency of commercial banks in the latter part of the 2000s. There was also a vigorous and lengthy campaign led by the Federal Reserve to prevent Congress or other actors from imposing new rules on the OTC derivatives markets in the late 1980s and early 1990s, removing legal and political obstacles that facilitated the rapid growth of that industry in the late 1990s and 2000s. In short, regulatory agencies were the drivers of many of the most important transformations that occurred in the financial industry from the early 1970s onwards.

This introduction is designed primarily to provide some stylized facts about the U.S. financial industry between the early 1970s and the late 2000s, and their implications for the bureaucratic autonomy argument advanced in this project. First, I illustrate the growth in the financial services industry that occurred from the 1970s onwards as well as some of the hypothesized causes of this trend towards ‘financialization.’ As I note, the growing size and centrality of the financial services industry had important implications for the conduct of policymaking. Specifically, it increased the costs of sub-optimal delegation of decision making to industry groups and increased the likelihood of political deference to bureaucratic actors. I furthermore detail how financial innovation and the growth of the industry dramatically increased the complexity of public policy, creating informational asymmetries that favored regulators over politicians, particularly the Federal Reserve. In addition, I include a brief note on the relatively high degree of industry fragmentation in the financial services

sector in the United States. Such fragmentation, which still persists today despite significant consolidation over the past thirty years, should cause us to be more skeptical of commonplace claims of industry ‘capture’ or structural power. Second, I provide an overview of the argument advanced in this project. After highlighting the empirical weaknesses inherent in the industry capture hypothesis (amongst other theories of policy change), I present my alternative thesis: that under conditions of low political salience, visibility, high complexity, and economic centrality – conditions met in the cases examined in this project – bureaucratic actors with independent preferences can affect policy outcomes. Furthermore, I contend that such actors pursue distinct strategic behaviors when their authority is contested, actions designed to entrench and enlarge their influence for later debates in often path dependent ways. In conclusion, I provide a sketch of the chapters that follow.

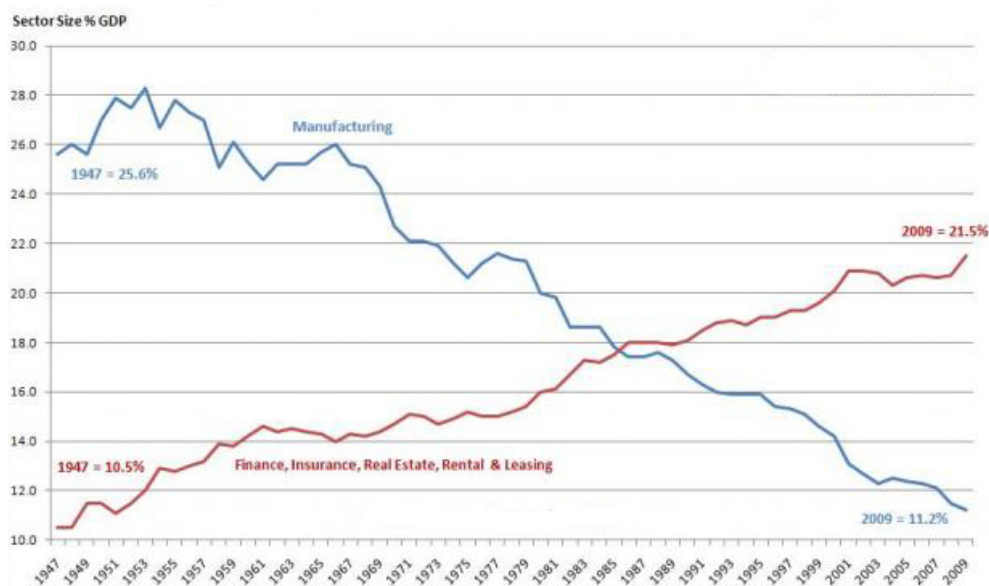
## 1.1 The U.S. Financial Sector in an Era of Transformation: A Background

### 1.1.1 The Financialization of the U.S. Economy

The size and salience of the financial industry relative to the ‘real’ U.S. economy has been growing almost continuously over the course of the past forty years, a trend that has been widely labelled ‘financialization.’ More formally, Epstein (2001, 1) characterizes financialization as “the increasing role of financial motives, financial markets, financial actors, and financial institutions in the operation of the domestic and international economies.” This broad definition encompasses many sub-phenomena. One is simply the growth of financial trading and the spread of new financial instruments (Sassen, 2001). Another refers to shifts in non-financial firms towards the ‘shareholder value conception of control,’ in which corporations increasingly engaged in financial engineering in order to make their balance sheets attractive to potential equity investors and deliver higher returns to their stock holders (Fligstein, 1990, 2001). A related trend also saw many large non financial firms – such as General Electric, Sears, General Motors, and Ford – establish financial subsidiaries that “eventually became financial behemoths that overshadowed... the activities of the parent firm’ (Krippner, 2011, 29). Financialization has furthermore been evident in the increasing indebtedness of government entities, firms, and households, debt that was incurred as those entities took advantage of cheaper and more widely available credit (see figure 1.3; Palley 2007). In turn, it has been argued that a hallmark of financialization has also been growing economic inequality, as income is increasingly transferred to the financial sector in the form of fees and interest payments (Montgomerie 2009; see in general Krippner 2011).

While each of these phenomena highlight important features and consequences of financialization, the broad trend can be captured by more standard metrics. The conventional approach to tracking structural changes in the economy is to examine changes in the contri-

Figure 1.1: Size of Financial Services and Real Estate Industry Relative to Manufacturing as Percentage of U.S. GDP, 1947-2009

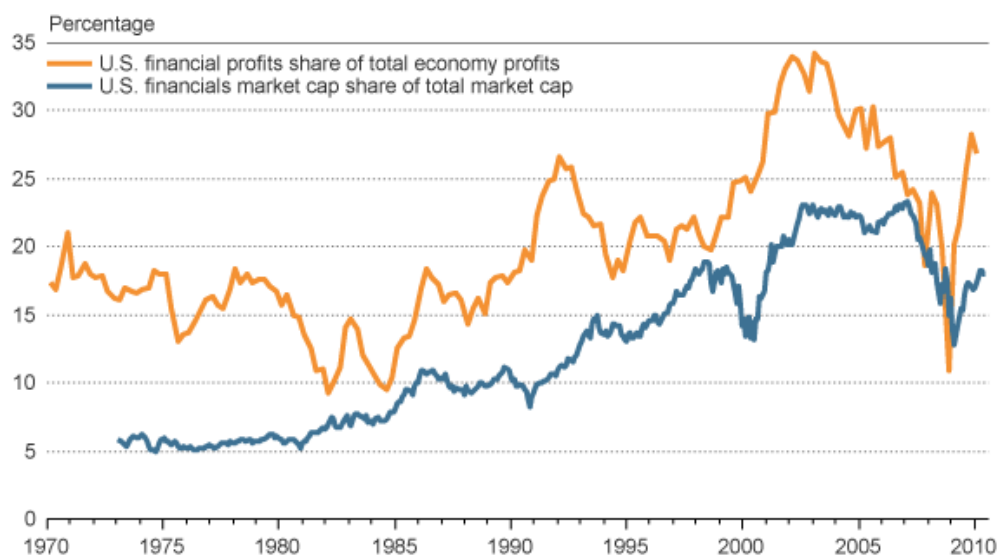


Source: Global Macro (2011)

bution of different sectors to GDP (Krippner, 2005, 177). Adopting this metric, figure 1.1 shows that while the contribution of manufacturing (the core of the ‘real’ economy) to U.S. economic output has declined dramatically in the post-war era, the contribution of “FIRE” – Finance, Insurance, and Real Estate – has more than doubled during the post-war era<sup>1</sup>. In particular, growth in the sector increased significantly during two periods: 1979 to 1987, and in the sixteen years following 1992 (these trends furthermore hold if the real estate sector is excluded from the analysis – see Krippner 2005, 179). An alternative way of looking at the growing centrality of finance is to examine where profits are generated in the U.S. economy (Krippner, 2011, 27). As figure 1.2, profit data is significantly more volatile than the share of GDP figures; for example, even as the portion of economic output produced by the FIRE sector was increasing in the late 1970s and early 1980s, the total share of economic profits produced by finance (here defined only as financial and insurance companies) was declining. After growth in the later 1980s and early 1990s, profits again declined with the rise of interest rates in 1994 before dramatically increasing in the late 1990s and early 2000s, almost reaching 35 percent of all profits generated in the economy between 2002 and 2004. Despite

<sup>1</sup>As Krippner (2005, 179) notes, it is convention that finance and real estate are reported as a single entity since both share similar characteristics and the boundaries between the two are ambiguous.

Figure 1.2: U.S. Financial Firms: Share of Total U.S. Profits and Share of U.S. Market Capitalization, 1970-2010



Source: Reuters (2010).

its volatility, this data, along with the measure of market capitalization of U.S. financial firms included in figure 1.2, unmistakably paint the same trend: a secular growth in the contribution of finance to the U.S. economy from the early 1980s onwards<sup>2</sup>.

A final way to capture financialization is to examine which sectors hold financial assets in the economy. Figure 1.3 provides an illustration of the asset holdings of the financial sector relative to other sectors and U.S. GDP for both 1981 (on top) and 2011 (on the bottom). There are three important takeaways from this diagram. First, the asset holdings of financial firms have increased as a proportion of total assets held in the United States, going from 34 percent to 44 percent of all assets held. Second, despite the fact that the size of bank asset holdings have grown to equal GDP, those holdings now make up a proportionately smaller share of the financial sector than they did in 1981, a fact which reflects the more rapid growth of other financial entities such as investment funds and government-sponsored enterprises (GSE) such as Fannie Mae and Freddie Mac. Indeed it is important to note that the U.S. financial sector, despite its growing centrality and economic importance in the aggregate, is actually quite fragmented (see section below). Finally, as Lester (2012) notes,

<sup>2</sup>A similar, though less volatile metric is used by Philippon (2012): income earned by financial companies as a proportion of GDP. See Philippon (2012, 2) for an explanation of how this measure is calculated.

total financial claims (that is assets) were less than 5 times GDP in 1981, but had grown to greater than 10 times GDP in 2011. This captures the aspect of financialization mentioned previously: the growing indebtedness that has resulted from easier access to credit.

In short then “[i]t is difficult to escape the impression that we live in a world of finance” (Krippner, 2005, 173). A critical evaluation of the causes of financialization are beyond the scope of this brief overview. However, most scholars acknowledge that it initially grew as a response to the economic and trading uncertainties that arose in the early 1970s following the collapse of the Bretton Woods system (Arrighi, 1994; Helleiner, 1994), as well as the imposition of high and volatile interest rates later that decade (Krippner 2011, Chapter 5). Beyond these initial triggering events, the ongoing growth in government debt spending and the hostile takeover movement of the 1980s, both of which fueled a demand for credit and speculation (Orhangazi, 2008), as well the rise of financial innovation and the generally deregulatory nature of government policy, have also been widely cited as key causal factors. Irrespective of the precise mix of these explanatory variables, financialization has unquestionably had an important impact on the public policy debate in at least one way that is salient for the analysis that follows. As is discussed in greater length in Chapter 2, the centrality of the financial industry to economic growth raises the political costs of suboptimal public policy decision making for elected officials. Since there are high barriers to politicians acquiring the necessary information to make informed decisions about public policy in this area (see below), they have strong incentives to delegate that function to those with greater interests or expertise, typically either industry groups or regulators. Given that suboptimal collective policy outcomes are perceived as being more likely following delegation to a particularized interest or sets of interests, legislators and other elected officials therefore are, *ceteris paribus*, more likely to defer to the preferences of bureaucratic actors. In this way then, financialization – perhaps counterintuitively – helps to explain the patterns of bureaucratic autonomy detailed in the chapters that follow.

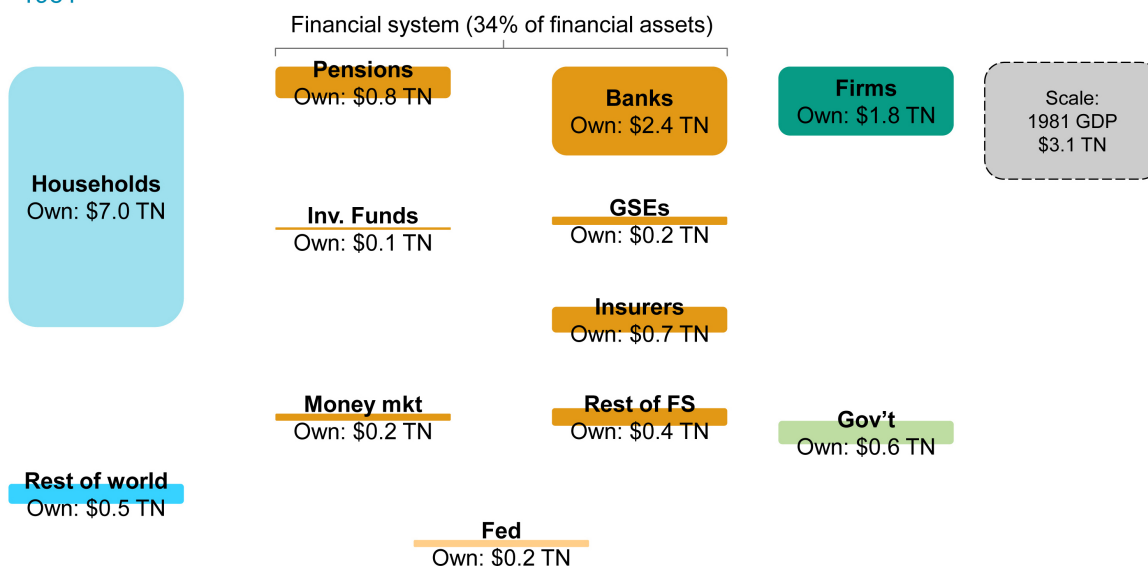
### 1.1.2 The Rise of Financial Innovation and Complexity

The growth in the size of the financial sector was related, in part, to the process of financial “innovation” that occurred between the 1970s and 1990s (see Tufano 2003, Frame and White 2004), processes driven by both technological changes and advances in modern theories of finance (MacKenzie, 2006). For example, the introduction of automated teller machines (ATMs) accelerated movement towards inter-state banking and allowed banks to reduce their overhead costs (Saloner and Shepard, 1995). Money market funds offered retail customers a securities-based alternative to bank deposits, leading to ‘disintermediation’ in the 1970s (White, 2000). The creation of universal credit scores and reporting allowed banks to assess their risks more accurately, offer loans to a broader array of consumers, and reduced lending costs (Akhavain et al., 2005). The widespread increase in asset-backed securitization, a process linked to universal credit reporting, provided an opportunity for lending institu-

Figure 1.3: U.S. Financial Assets Held by Economic Sector, 1981 and 2011

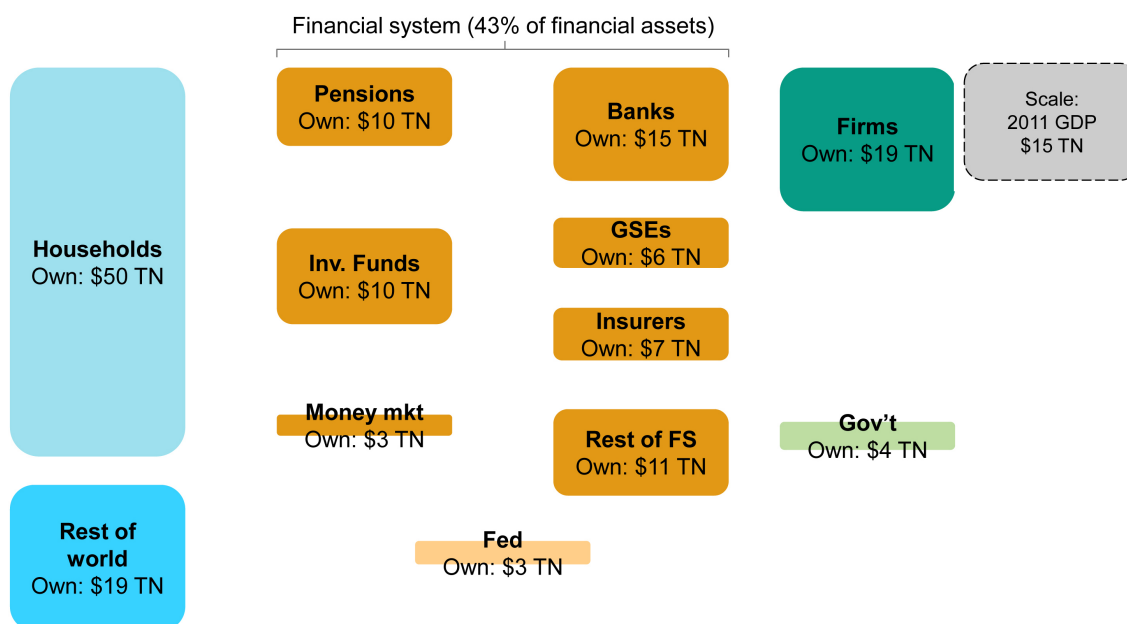
**Financial assets held, by economic sector**

1981



**Financial assets held, by economic sector**

2011



Source: Lester (2012). Note that “GSEs” refer to “government sponsored entities”; “Fed” refers to assets held by the Federal Reserve; “inv funds” refers to “investment funds” “money mkt” refers to money market funds; “rest of FS” refers to “rest of the financial system.”



tions to sell portions of their assets and therefore transfer or share risks; it also proved to be a lucrative source of income for institutions that pooled loans to sell as securities. In turn, securitization dramatically increased the availability of consumer credit (see Wolfe 2000). As I discuss in Chapter 4, the creation of new derivative products such as swaps permitted banks and non-banks alike to hedge (that is, reduce exposure to) changes in interest-rates, currency fluctuations, and the risks of debtor default. Likewise, the widespread adoption of risk management techniques such as value-at-risk (VaR) models permitted financial institutions to more accurately assess credit risks and therefore engage in trading designed to hedge against those risks (see Chapters 3 and 4).

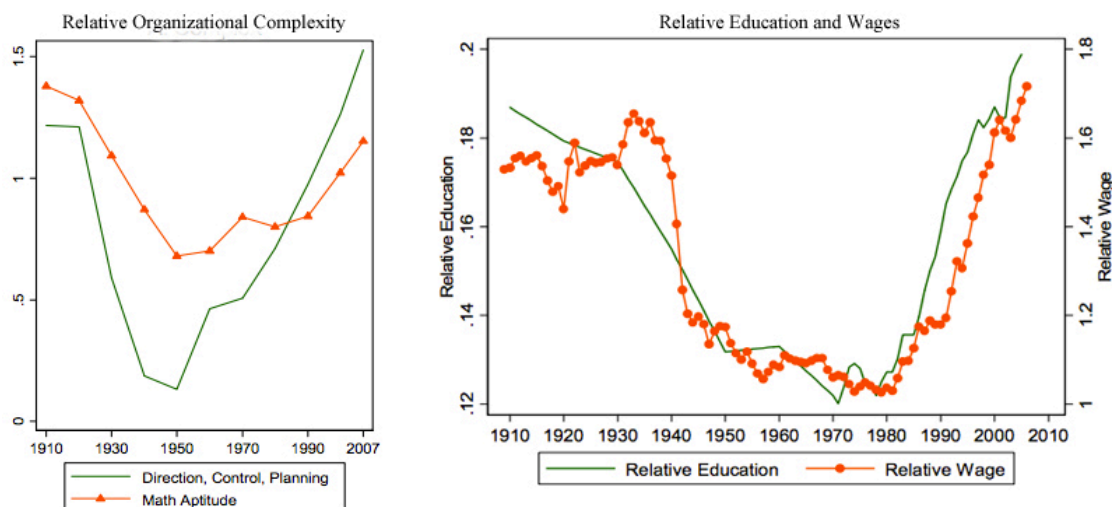
Most of these innovations, however, also served to increase the complexity and opaqueness of financial products, institutions, and markets (Schwarcz, 2009). Certain types of products, such as over-the-counter (OTC) derivatives, collateralized debt obligation (CDO)s, and repurchase agreements (or ‘repos’) often not only contain complex mixes of instruments and payment schedules, but are also traded in markets in which pricing information and the identity of counterparties is frequently unclear (Gorton 2008; see later chapters for explanations of these products and markets). Likewise, commercial and investment banks have held significant portions of their assets in so-called ‘special purpose vehicles’ (SPV)s that are not typically included on the institution’s balance sheet, making it difficult for investors to evaluate the risks associated with those investments (Bartlett, 2010). Even when information is readily available, the size and complex interconnectedness of financial institutions simply create an “informational thicket” (Bartlett, 2010, 31) that makes it “extremely (if not prohibitively) costly to acquire, filter, manipulate, or analyze” such data (Awrey, 2011, 22)<sup>3</sup>. Beyond these issues, the fact that financial institutions are increasingly interconnected with one another through their counterparty arrangements, combined with the increasing adoption of ‘mark-to-market’ valuations of assets (see Chapter 5), means that institutions are exposed to a vast range of credit and market risks that are extraordinarily difficult to monitor. In short, as Awrey (2011, 23) notes, because new “instruments facilitate the reconstitution and redistribution or risk within the financial system (often via transactions within relatively opaque markets), they obscure the location, nature, and extent of ultimate exposures” (see also Schwarcz 2004, 10).

The complexity of these new products and markets creates an extraordinarily high information barrier for non-experts. For example, advanced quantitative training is typically required for anyone designing and interpreting sophisticated credit risk models; similarly,

---

<sup>3</sup>To make this point more concretely, Bartlett (2010, 4) gives the following example “Valuing even a single CDO investment – let alone a portfolio of such investments – requires a multi-faceted analysis of a considerable amount of both legal and financial data, ranging from an estimation of the default and prepayment risks of hundreds (potentially thousands) of underlying assets, analysis of the particular over-collateralization and subordination provisions attached to particular tranches of CDO securities, and an assessment of potential counterparty risk of the CDO’s various hedge counterparties.”

Figure 1.4: Relative Complexity, Education, and Wages in the Financial Industry, 1910-2010



*Source:* Philippon and Reshef (2012, 37,42). The figure on the left is based on task intensity data generated by the Dictionary of Occupational Titles; direction, control, and planning measure the degree of decision making complexity, while math aptitude measures analytical thinking (Philippon and Reshef, 2012, 10). Education is based on the sectoral share of workers with college-level education or above relative to non-farm private sector workers (wages are also calculated on this basis).

such skills (and lengthy experience) are critical in originating and distributing pooled products such as mortgage backed securities (see Awrey 2011, 18-19; Hu 1993). Indeed, as Philippon and Reshef (2012, 9) observe, analytical complexity for finance professionals has increased dramatically over the past five decades. As the left hand side of figure 1.4 shows, the relative analytical complexity (compared to the task intensities of other private sector professions) for financial workers experienced significant, if steady, growth in the post-war era<sup>4</sup>. In the same paper, the authors also examine the share of workers in the financial industry with higher level degrees relative to other non-farm private sector occupations, an alternative metric for assessing the level of skills required for finance professionals. As the right hand side of figure 1.4 illustrates, relative education levels (along with wages) begin to increase sharply in the late 1970s and even more dramatically in the 1990s. In short, as these diagrams vividly illustrate, the finance industry has become a high skill, high complexity (and high wage) sector over the past forty years in particular, a development that has unsurprisingly paralleled the growth in financial innovation.

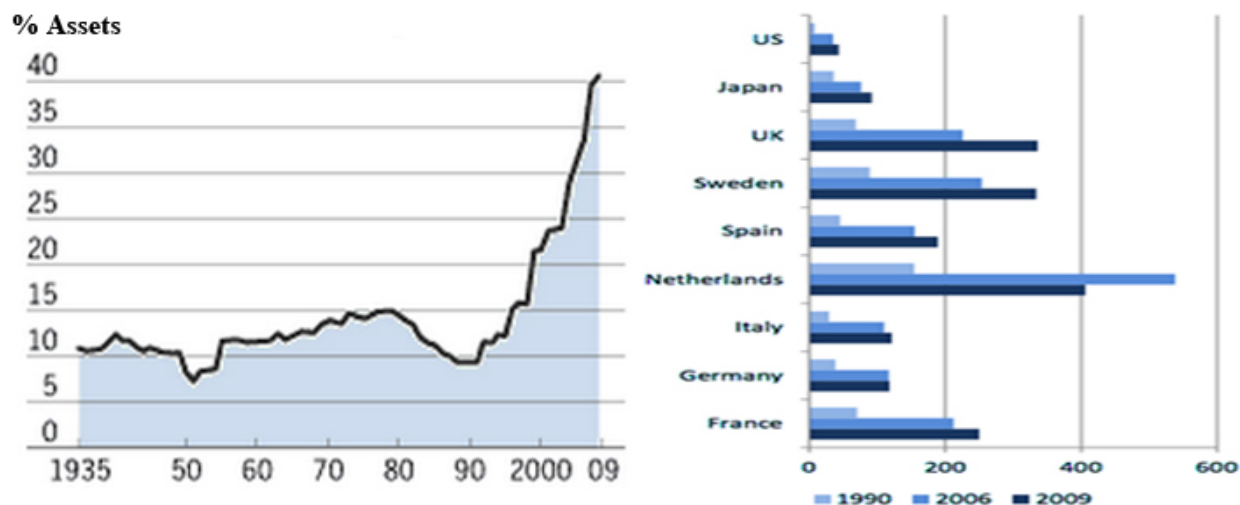
<sup>4</sup>The metrics used to calculate complexity are based both on measures of math aptitude and decision making skills such as direction, control, and planning (see Philippon and Reshef 2012, 9-11, for a full account of how this data was assembled).

What has this high (and growing) level of complexity meant for policymakers? First, small front-line regulatory agencies such as the Commodity Futures Trading Commission (CFTC), the SEC, and the Federal Deposit Insurance Corporation (FDIC) were faced with new challenges because of this environment, particularly in their inability to retain the skilled talent capable of monitoring increasingly complex institutions and opaque markets (e.g. Markham 2009-2010, Karmel 2009). Second, it advantaged the FRB in a relative sense, since it possessed both greater resources and staff with strong quantitative backgrounds; as a result, it was far more capable of both overseeing these increasingly complex markets and interpreting internal bank risk models. Third, and of particular theoretical importance here, this growing complexity made it even more difficult for lawmakers to monitor markets *and* the discretionary actions taken by regulators in relation to these markets. As I argue in Chapter 2, high complexity raises the costs of information acquisition for non-specialists such as legislators, and also helps to reduce political saliency and visibility. As a result, high levels of complexity help to render a pattern of political deference to both industry groups and bureaucratic institutions; however, as noted above, deference towards the latter is more likely when the sector being regulated is also economically central, since delegation of policymaking to particularized groups is more likely to result in suboptimal collective outcomes. Given that these conditions are all met in institutional-level financial regulation, it is unsurprising that such patterns of deference to bureaucratic actors were common. This is particularly true in the case of the Federal Reserve, given its broad legitimacy and reputation for methodological sophistication.

### 1.1.3 The Fragmented U.S. Financial Industry

As figures 1.5, 1.6, and 1.7 all show, the U.S. financial industry became increasingly concentrated in the period from the mid-1980s through the late 2000s. For example, as Jones and Critchfield (2005, 4) note, by the end of 1984 there were 15,084 banking and thrift (savings and loan) institutions; by the end of the year 2003, that number had declined by almost 48 percent to 7,842, with almost all of the decline coming from the small, community bank sector (institutions with assets of less than \$100 million). Figure 1.5 shows that the share of bank industry assets held by the three largest U.S. banks has climbed from approximately 15 percent in the early 1980s to almost 40 percent by 2009. Similarly, in 1984, the share of bank assets held by banks with assets of greater than \$10 billion – the traditional definition of a large institution – was 42 percent; by 2003, it had increased to 73 percent. In fact, irrespective of the metric used – number of banks, asset concentration, deposit size, or risk exposure – it is unquestionable that the U.S. banking industry has become more consolidated over time (Hughes et al., 1999; Berger, 2003). This growth has been variously attributed to competitive pressures, deregulation (the removal of intra-industry and inter-state prohibitions), technological advances such as ATMs, and separate microeconomic pressures that encouraged increased merger activity (see Berger 2003, Jones and Critchfield 2005 for a com-

Figure 1.5: Top Three U.S. Bank Assets as (a) % of U.S. Commercial Bank Assets (b) % of GDP Compared to Top Three Banks of Other Major Industrialized Countries

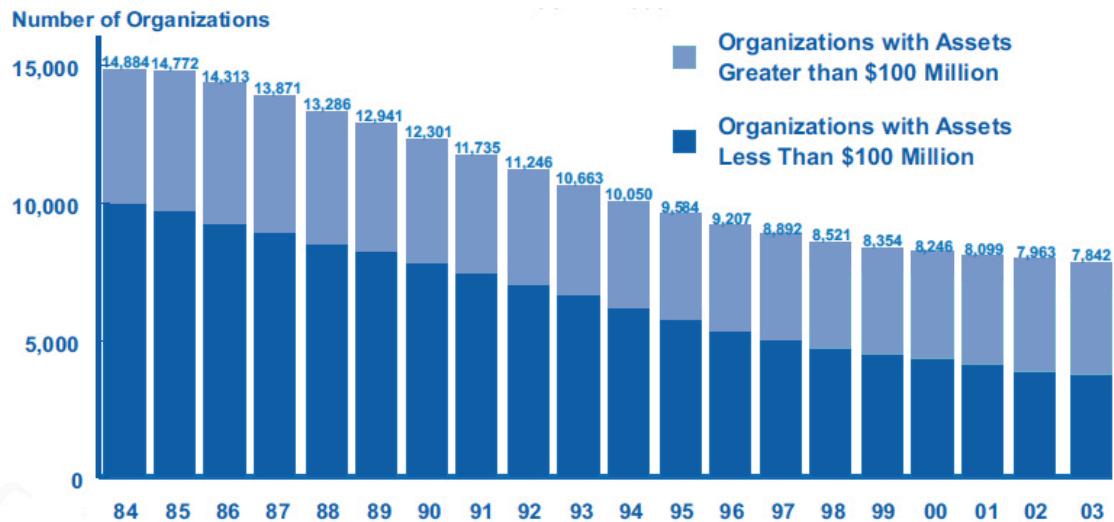


Source: (a) Wolf (2010), (b) Veron (2012). The Y axis in the diagram on the left represents percentage of U.S. bank assets held by the three largest banks over time. The X axis on the right represents the assets of the top three banks in each country as a percentage of that country's GDP.

prehensive review of these potential causes).

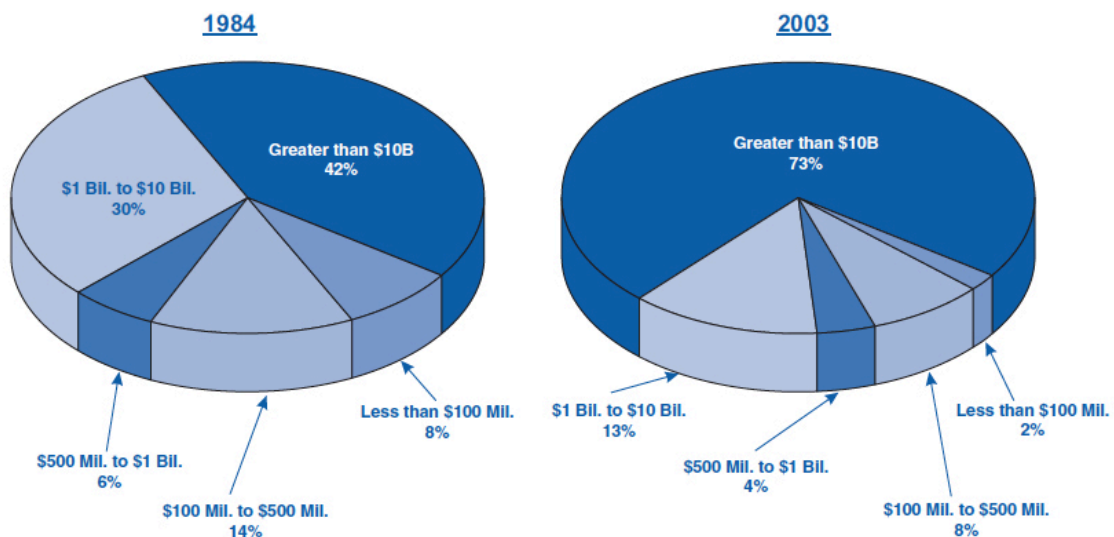
However, these diagrams also clearly show that bank concentration is a recent phenomenon. In fact, for most of the period examined in this project, the banking sector, whether measured in terms of asset concentration or number of institutions, was actually extraordinarily fragmented (Berger et al., 1995). As figure 1.5 in particular shows, the consolidation trend in U.S. banks was most pronounced in the mid-to-late 1990s, as formal barriers to mergers and acquisitions between banks and securities companies were removed. Figures 1.6 and 1.7 show that the industry *still* remains surprisingly fragmented, even if the trend has been towards asset and institutional consolidation. Perhaps most revealing of all, when compared against the assets as a percentage of GDP of the top three banks of other major industrialized countries (figure 1.5), the major U.S. banks look surprisingly small not only in 1990, but in 2006 and 2009 (Veron, 2012). In fact, even today, after over two decades of rapid consolidation, the top five U.S. banks hold just 56 percent of all bank assets relative to GDP, compared to the G7 industrialized nation average of 164 percent and the United Kingdom average of 309 percent (Chakravorti, 2012, 4). Although this data, which is based only on banking, is not strictly representative of the degree of concentration across all financial sectors, it clearly highlights the fact that the U.S. industry was – and to a surprising extent continues to be – relatively fragmented.

Figure 1.6: Number of Banking Organizations, 1984-2003



Source: Jones and Critchfield (2005, 36)

Figure 1.7: Share of Banking Industry Assets by Size Group, 1984 and 2003



Source: Jones and Critchfield (2005, 40)

The fragmented structure of the financial services industry is an important background presence in many of the policy debates discussed in this dissertation. Even as the industry was expanding in the aggregate, it remained divided between commercial banks, securities firms, and insurance companies; moreover, the banking industry in particular was deeply divided between small commercial banks and thrifts on the one hand – sectors which retained significant political influence – and representatives of larger banking entities such as the American Bankers Association (ABA) on the other. These divisions reduced the sector’s overall influence, both during the 1980s and 1990s (Krause, 1997), as well as during the more recent financial reform debate that ultimately led to the passage of the Dodd-Frank Act (Helleiner and Pagliari, 2011, 179). Indeed, as the following chapters (in particular Chapter 3) demonstrate, there is often significant heterogeneity of preferences amongst representatives of the industry – divisions which clearly do diminish their influence on the policymaking process. This suggests that instrumental or structural industry influence is significantly weaker than we might expect in other industries, where concentration of size and interests are far higher (Chakravorti, 2012, 5).

## 1.2 An Overview of the Argument and Structure of the Dissertation

There is little question that public policies – whether they were explicitly deregulatory, ‘neutral’ rule changes, decisions to permit policy ‘drift,’ or attempts to increase regulatory stringency – were critical in transforming the financial services industry in the United States (e.g. see Llewellyn 1989, Pozen 2010, Krippner 2011). The less settled question is what influenced the formation of these policies in the first place? For many, the actions taken by regulators and legislators, particularly in areas such as OTC derivatives, are considered to almost be *prima facie* examples of the regulatory ‘capture’ thesis. This concept, first alluded to by Marver Bernstein (Bernstein, 1955) and later developed into a unified theory by George Stigler (Stigler, 1971), as well as series of other scholars that followed in his footsteps (e.g. Peltzman 1976; Becker 1983), stated that particularized groups ‘acquire’ legislators and regulators, redirecting public policy from a predefined ‘public interest’ towards their own goals. Carpenter and Moss (2013, 6) observe that “as the financial crisis of 2007-2009 unfolded, we began to notice some common features of the dozens (if not hundreds) of claims being made about captured regulatory agencies”; indeed, there is almost an endless list of recent publications that explicitly claim or imply some form of ‘capture’ in the financial services industry (e.g. Johnson and Kwak 2010; Stiglitz 2010; Roubini and Mihm 2010; McLean and Nocera 2010). However, as Carpenter and Moss (2013, 6) continue to note “[t]he claims had the benefit of seeming to resonate with the unfolding story, yet a disturbing commonality among them was a lack of solid evidence.” Indeed, claims of capture all too often fail to identify the mechanisms through which it is hypothesized to occur. Put differently, such

narratives often get the ‘intent’ of industry groups correct, but fail to identify the ‘actions’ that actually shifted public policy (see Carpenter and Moss 2013, 17-19). Indeed as I show, while undoubtedly many of the policy changes that occurred between the 1970s and 1990s benefitted the industry, that industry was often divided and its political organization far weaker in earlier periods than in later eras. Moreover, there are many instances in which industry groups both directly opposed key policy decisions made by regulators and subsequently lost those battles, again casting doubt on the capture thesis.

If industry capture does not adequately explain shifts in public policy, what does? Some scholars advance a structural argument – a variant on capture in which business power is collectively proposed to influence outcomes in a rather automated fashion, leading to a so-called ‘race to the bottom’ in regulatory standards. Others have suggested a functionalist approach in which regulators are forced to coordinate with each other due to globalization. However, as I detail in each chapter, the logic behind these theories is simply not supported by the empirical evidence. Although not prominent in accounts of financial public policy-making, political scientists have, over the past three decades, been increasingly focused on the concept of ‘political control’ based on ‘principal-agent’ models. These theories suggest that even when regulators make critical public policy decisions, they do so because of the influence of elected officials, specifically Members of Congress (who in turn are presumably influenced by industry groups). Yet, this sort of account does not mesh well with the fact that regulators consistently initiated and drove forward many of the most critical policy changes – such as on capital adequacy and OTC derivatives – in the absence of any pressure or involvement from Congress. In fact, as I argue, elected officials have very few incentives to engage in the sort of information acquisition necessary to hold regulators to account or to initiate policy themselves. Specifically, institutional-level financial regulation is marked by four features: low political salience, low visibility, high complexity, and economic centrality. As has already been discussed, the latter two characteristics empower bureaucrats relative to politicians and interest groups; the first two diminish the electoral incentives for political officials to invest in the acquisition of expertise, weakening their influence further.

Given the dearth of concrete evidence supporting capture, and the logical flaws with these other approaches, I propose an alternative theory based on the concept of “bureaucratic autonomy” (discussed at length in Chapter 2). First, I contend that bureaucratic actors often hold policy-specific preferences that are independently generated and typically founded upon their long-standing mission or beliefs about their distinctive competencies. Furthermore, regulators who are broadly considered to be legitimate and competent within the policy space under discussion prove able to frequently influence major public policy outcomes in ways that cannot easily be reversed, both through their ability to set the political agenda and by exercising direct pressure on other actors (fellow regulators, interest groups, and Congress) to defer to their preferences. When these conditions of preference independence and demonstrated public policy influence are met, we can conclude that the agency is highly ‘autonomous’ in that policy space. Second, this project examines the mechanisms of

such influence. Specifically, I focus on the strategies bureaucracies adopt in order to advance their authority, strategies that are only visible when their authority is, to some significant degree, ‘contested.’ They include transgovernmental cooperation, public-private sector collaboration, changes in rhetoric, as well as minor changes in their regulatory and enforcement behaviors. By engaging in such strategic behavior, I demonstrate how bureaucracies often succeed in winning short-term policy battles, as well as entrenching their long-term policy objectives by creating path-dependent power and institutional dynamics (I also demonstrate, however, that negative power path dependency can occur).

In Chapters 3, 4, and 5 I demonstrate how both the exercise and pursuit of bureaucratic autonomy helped to shape patterns of public policy in three key areas. Chapter 3 focuses principally on the role played by the FRB in the development of risk-based capital adequacy standards between the 1970s and the early 2000s. The chapter begins by noting that risk-based capital standards were an integral part of the agency’s supervisory framework dating back to the 1950s, and highlights the connection between such an approach and its broad mission. The rest of the chapter outlines how the FRB overcame the opposition of regulators, interest groups, and politicians that contested both its role as a bank supervisor as well as its pursuit of risk-based capital standards. Specifically, it details how the FRB made strategic use of rhetoric designed to highlight its political legitimacy and competence, as well transgovernmental collaboration in the form of the Basel Committee on Banking Supervision, to further its authority in this policy area. These efforts helped to dramatically reshape the regulatory framework governing the banking industry; indeed today risk-based capital standards are *the* central prudential tool for bank supervisors both in the United States and across the globe. It furthermore permanently shifted the power dynamics on the issue in a ‘path dependent’ manner; as the chapter demonstrates, the FRB faced little domestic or international contestation when it sought to renegotiate the Basel Capital Accord in the late 1990s, showing how its earlier actions had permanently shifted the power dynamics in its favor on issues relating to capital adequacy and banking supervision more generally.

In Chapter 4, I examine the factors that influenced the development of policy in relation to OTC derivatives, with a focus on an earlier era in which both that market and the policy responses to it were still in flux. I demonstrate that senior officials in the Federal Reserve forcefully fought against efforts to regulate the market from the mid-to-late 1980s onwards, based on a belief that these instruments would allow banks to more effectively manage their risk exposures. At the same time, the agency clearly understood the risks attached to these opaque products, believing nevertheless that it possessed the necessary internal supervisory systems and competency to monitor bank behavior effectively. I contend that these preferences were independent of those held by industry actors primarily because such groups were not politically well-organized or heavily focused on OTC policy until the mid-1990s. I demonstrate how the Federal Reserve leveraged its discretionary authority, employed rhetoric, and engaged in informal international collaboration to increase its leverage in the policy debate and entrench its power relative to those of its potential rivals. Those



potential rivals – the CFTC and the SEC – are also discussed in some detail in this chapter. I demonstrate how the CFTC’s status as a regulator was highly contested and its preferences dependent on the personality of its leadership, factors which suggest it lacked autonomy. Indeed, despite its role as the functional regulator of derivative products, it was consistently sidelined in regulatory debates. The SEC is seen as an actor with distinct preferences and favoring some enhanced form of market oversight. Unlike the Federal Reserve, however, it takes a more cautious approach to boosting its authority, displaying a notable reticence about congressional proposals that would have granted it broader oversight responsibility over these markets. This highlights the fact that while agencies act strategically to advance their influence, they also seek to protect their existing authority; in this case, oversight of such a complex market would have been an impossible mandate for this small agency, potentially damaging its reputation.

Chapter 5 focuses on the politics of two interrelated prudential regulatory policies – securities holding company supervision and capital standards – and the role of the SEC in their development between the early 1990s and the mid-2000s. Specifically, it examines the SEC’s response to growing contestation of its authority, giving us an important insight into patterns of strategic bureaucratic behavior. In the early 1990s, the SEC enjoyed an unusually high degree of political deference, suggesting its authority was largely uncontested. In this climate, and motivated by its “disclosure-enforcement” mission, the SEC rejected the concept of prudential consolidated supervision of major securities firms as a mandate that was neither necessary nor desirable. It also spurned transgovernmental cooperation on the issue of common capital standards, refusing to bind itself to a regime it felt was subpar to its own Net Capital Rule for broker-dealers. However, by the mid-1990s, its authority was subjected to greater challenge as securities firms become more involved in unregulated OTC derivatives trading activities and as the prospect of the FRB becoming a “consolidated supervisor” became ever more likely. In this environment, the agency was forced to turn to collaborative efforts with the private sector in order to project an image of itself as a competent prudential supervisor in order to protect its authority as the primary regulator of major securities firms. These efforts culminated in the ill-fated Consolidated Supervised Entity (CSE) program that was widely seen as contributing to the collapse of an independent investment banking industry in the United States. This chapter vividly underscores that bureaucratic organizations behave differently under conditions of contestation and non-contestation. Beyond this, it also demonstrates that agencies are not pure ‘turf maximizers’ and reinforces the path dependency element of this project, allowing us to observe how early decisions by the agency created negative feedback dynamics that helped to undermine the agency’s authority.

In conclusion, I draw out some of the key ‘takeaways’ from this project. First, I detail how this project builds upon Daniel Carpenter’s bureaucratic autonomy framework in important ways, in part through clarification of theory and application, and in part by providing a clearer framework for scholars seeking to conduct bureaucracy-centered research in the

future. The salience of path dependent power dynamics is discussed together with an evaluation of the potential challenge posed by “cultural capture” arguments. The chapter also examines vignettes involving the FDIC during the Dodd-Frank Act financial reform debate, the objective of which is to demonstrate that autonomy dynamics still persist today, even under the unlikeliest of circumstances. Finally, there is a brief discussion regarding future avenues for research, as well as some concluding thoughts.

## 2 | Bureaucratic Autonomy: Logic, Theory, and Design

### 2.1 Introduction

The notion that bureaucracies exercise political power is surprisingly controversial. A wide range of scholars from divergent methodological, substantive, and disciplinary backgrounds have tended to treat bureaucratic organizations as pawns in larger strategic contests between competing political interests, as ‘captured’ functionaries of the industries they regulate, or as ‘prisoners’ of financial markets. Even the principal proponent of what I have referred to as “bureaucratic autonomy” – Daniel Carpenter – has argued that expansive bureaucratic power is a distinct characteristic of an era in which the American state was both nebulous and incipient, a phenomenon that cannot be repeated in the institutionally dense and interest group rich environment of modern American politics (Carpenter, 2001a, 366). This project will show that “autonomy” – that is the ability to exercise independent influence over public policy outcomes in ways that cannot easily be reversed – is not only possible in the modern American state but, at least within the realm of financial services policymaking, is actually remarkably ubiquitous.

This chapter first of all examines the alternative approaches to understanding the political role of bureaucracies put forward by proponents of instrumental group influence, structural group power, market functionalists, and those in the principal-agent tradition or “congressional dominance” tradition. While each of these approaches undoubtedly makes important contributions to our understanding of the strategic environment in which policy is made and bureaucracies operate, each also appears to pay scant attention to the fact that government bureaucracies are also political actors with preferences and resources of their own, and are capable of influencing the institutional and policy environment around them. Instrumental, structural, and functionalist accounts in particular overstate the unity and uniformity of groups and markets, a fact that dramatically weakens the explanatory purchase of such theories. Moreover all of these theories ignore the compelling empirical evidence that suggests regulators – at least within the financial services policymaking dimension – have been the initiators and drivers of policy change over the past forty years.

Perhaps most important, there are certain conditions – all of which apply to institutional-level<sup>1</sup> financial policymaking – that logically suggest we should see patterns of deference by elected officials to bureaucrats over particularized interests, conditions that when met greatly attenuate the foundations of the structural and congressional dominance approaches. In short, the low political saliency and visibility of policymaking in this area, combined with high levels of technical complexity, reduce the incentives for elected officials to invest time and resources into expertise acquirement, forcing them to outsource policymaking to other entities. As the financial services sector has become an ever more central part of the broader economy, so do the risks of poor decision making, risks that would be heightened by outsourcing policymaking to particularized groups. It is for these reasons, therefore, that elected officials will typically show high levels of deference to those bureaucratic actors considered legitimate and highly competent, even when doing so may contradict the wishes of important constituencies and, on occasion, their own preferences.

The rest of this chapter focuses on the development of the theory of bureaucratic autonomy. This study assesses covariation between the explanatory variable – levels of autonomy – and the dependent variable – policy outcomes. However, it is equally focused on processes and causal mechanisms, specifically the strategic responses of agencies to the ‘contestation’ of their authority, which enable us to observe the exercise of bureaucratic authority. I begin first by breaking down the core concept of autonomy into its component parts: independent preferences and authority. I discuss the types of preferences that are of theoretical interest to this study and outline strategies to help determine the ‘irreducibility’ or independence of agency preferences. Authority, the other dimension of autonomy, is also reduced to its component parts: discretionary influence, policy influence, and ‘irreversibility.’ In particular, I focus on the role of ‘beliefs,’ ‘images,’ or ‘reputations’ as a source of influence and irreversibility for agencies, and detail indicators and sources for observing authority.

In turn, this allows us to make judgments about the degree to which an agency’s authority is ‘contested’ or ‘uncontested’ by members of the policy community, conditions that affect the bureaucratic actor’s strategic behavior. During periods of contestation, bureaucracies, motivated to advance and protect their authority, engage in distinctive strategic behaviors designed to enhance their reputation for legitimacy and competence. These behaviors include efforts to engage in ‘give-and-take’ forms of transgovernmental collaboration, partnerships with private sector actors, shifts in rhetoric, and symbolic changes in its regulatory and enforcement actions. By contrast, during periods of non-contestation the incentives to take these strategic steps is far lower and thus we will rarely observe agencies engaging in this sort

---

<sup>1</sup>“Institutional-level” refers to policies that do not *directly* impact on consumers but rather affect financial institutions, as well as large, sophisticated investors such as hedge or mutual funds. These policies are the subject of this dissertation. By contrast, “consumer-level” financial policies refer to issues that directly affect consumers. Examples of such consumer-level issues are credit card, ATM, or checking fees and rules governing qualifications for mortgage products.

of strategic behavior. Finally in this chapter, I discuss the comparative-historical design, the narrative-based methodology, and the case selection approach of this study.

## 2.2 Existing Approaches to the Study of Bureaucracies

### 2.2.1 Instrumental Group Power or ‘Capture’

Scholars have long been interested in the political influence of interest groups, in part out of a concern that private interests all too often appeared to triumph over a perceived "public good" (Bentley, 1908; Odegard, 1928; Schattschneider, 1935). This concern was later resurrected by critics of pluralism and developed into theories of ‘capture’ or ‘rent-seeking,’ approaches that have become “perhaps the dominant account of regulatory policy” (Carpenter, 2010c, 40). The roots of these schools can be found in Olson’s (1965) identification of the advantages enjoyed by concentrated interests. Building upon this, Lowi (1969) contended that much government policy was made via producer-dominated subsystems known as “iron triangles” in which regulators and legislators have strong incentives to satisfy the demands of the businesses they regulate. This led Stigler (1971) to extend this logic yet further, arguing that regulators and legislators are “acquired by the industry” and operate regulatory regimes primarily for their benefit, typically through the provision of direct subsidies and the creation of market entry barriers. In return, industry provides a range of largely pecuniary benefits to these government officials, such as campaign contributions and post-government employment. Under these conditions, regulators are effectively ‘captured’ and act simply as functionaries for their clients in public policy debates (Becker, 1983). As a result, the policy preferences of bureaucracies (and legislators) are largely irrelevant in determining policy outcomes; indeed, as Meier (1985) contends, we need only look at the preferences and actions of competing financial industry interests to understand regulatory outcomes.

Claims that legislators (Hendrickson, 2001; Suarez and Kolodny, 2011) and regulators (Underhill, 2010; Rosenbluth and Schaap, 2003) are ‘captured’ by instrumentally powerful financial services industry interests are commonplace in political science and legal scholarship. The thesis is similarly ubiquitous in popular intellectual accounts of events leading up to the 2008 financial crisis (e.g. Johnson and Kwak 2010; Stiglitz 2010; Roubini and Mihm 2010; McLean and Nocera 2010). Amongst the claims that have their roots in this thesis is the notion of the “revolving door.” While there is little question that a significant movement of personnel between government and industry in the financial sector (Seabrooke and Tsingou, 2009; Sorkin, 2011), tests of these hypotheses in other situations have not found a relationship between behavior in public office and private sector employment (Gormley, 1979; Cohen, 1986). Indeed a recent study found the revolving door has no discernible impact on Securities and Exchange Commission (SEC) enforcement efforts (deHaan et al., 2012). A second contention is that campaign contributions influence legislative outcomes. Much like the revolving door, there is little question that the financial industry makes sub-

stantial contributions to federal candidates: in 2010, \$56,090,427 was donated to incumbent congressional members by financial services firms and interest groups (Lipman, 2011, 4), outweighing any other sector. Yet, studies analyzing the effects of campaign contributions in general (Wright, 1990) and in the financial services sector specifically (Stratmann, 2002) have found mixed results and others have argued that there is conflicting evidence about the actual effects, if any, of campaign contributions (Ansolabehere et al., 2003). Finally, many claim that financial industry lobbying activity affects policy outcomes. Although Appolonio et al. (2008) record significant evidence of the extent of lobbying by the industry, Drutman (2010), examining lobbying activity surrounding the legislative debate over the Dodd-Frank Wall Street Reform Act, argues such activity is mostly about working with allies and providing them with information. More broadly, the capture approach does a poor job of explaining the trend towards “pro-competitive” deregulation in the 1970s and 1980s in particular (Quirk, 1981; Derthick and Quirk, 1985), while the literature on business influence over bureaucratic decision making has found decidedly mixed results (Meier and Bohte, 2007).

Ultimately the main problem with most capture studies is their inattentiveness to not only evidence, but research design. Carpenter and Moss (2013, 15), in the most extensive study of the concept to date, define regulatory capture as “the result or process by which regulation, in law or application, is consistently or repeatedly directed away from the public interest and toward the interests of the regulated industry, by the intent and action of the industry itself.” The authors note that while studies may be correct about the “intent” of actors, they fail to adequately specify the other two key parts of this definition: that is the “public interest” and “action of the industry.” The first of these – defining a collective or public interest – is an inherently difficult task. The biggest problem, as Quirk (1981, 4) observes, is that it often leads authors to substitute their own normative views: “allegation[s] of industry influence usually rest on an (often unstated) assumption about what the agency would have done in the absence of industry influence – an assumption that tends to derive from what the critic thinks *should* have been done.” One potential solution would be for studies to spend time constructing and justifying a “defeasible” model of public interest (Carpenter and Moss, 2013, 15-17); however, very few have yet to do so. The second problem is even more commonplace: if industry “intent” – which itself is often not carefully identified – is aligned with favorable outcomes, capture is simply assumed. A group may have preferences for a particular policy and that policy may be enacted; however if they are politically disorganized and/or there is little evidence of their lobbying for policy change, then we should treat claims of capture with deep skepticism, since there was no obvious mechanism through which the group could have influenced the public policy outcome. Even then, as Carpenter and Ting (2007) note, regulators or legislators could (and often do) make decisions favoring particular business interests for reasons – such as a concern with their reputation for competence – that are wholly unrelated to direct or indirect business influence. The only way to gain leverage over issues of intent and action then are to pay careful attention to both the preferences and behavior of all the key actors – groups, legislators, and regulators – an analysis that,

additionally, almost certainly must be conducted over time<sup>2</sup>.

### 2.2.2 Structural and Functionalist Accounts

Structural and functionalist accounts, although different in important respects, both essentially view regulatory behavior and policymaking, particularly in the financial services industry, as responses to forces of globalization. In one case, business interests are forcing regulators to reduce regulatory barriers across the globe, while in the other regulators are responding in an almost automated manner to market changes, seeking to reduce regulatory barriers and coordinate with their counterparts internationally on common standards. So-called “structural” explanations (Hacker and Pierson, 2002) have much in common with Lindblom’s famous assertion that the market acts as a “prison” for policymakers; given the ability of business to control the means of production and investment, policymakers that failed to promote profitability in the private sector would be quickly punished electorally as voters lost jobs and standards of living decreased (Lindblom, 1977). As a result, business occupied a “privileged position” in policymaking, though it exercised this influence rather “automatically and apolitically” (Hacker and Pierson, 2002, 281).

The most common form of structural business argument can be found in regulatory competition theories. Structural accounts typically suggest that the combined power of businesses – particularly businesses with the ability to move capital easily, such as large financial firms – will produce a global “race to the bottom” in standards as regulators and legislators loosen regulatory standards in order to retain global competitiveness (Kane 1989, 1999; Cerny 1994; but see Vogel 1995; Choi and Guzman 1997 for critiques of this view). Others have employed a functionalist logic, claiming in an era of growing international market interdependence, policymakers will – rather apolitically – seek to reduce the increasing costs of regulatory heterogeneity by coordinating on common standards and improving market efficiency (Keohane, 1984; Trachtman, 1991; Friedman, 1994; Simmons, 2001). Both therefore assign little agency to regulators themselves; while no single interest may have ‘captured’ them under these approaches, bureaucrats are still effectively functionaries of the industry as a collectivity or of market forces more generally.

The main prediction of both theories is that we will observe convergence or standardization between national regulatory regimes over time. Yet it is still true as Gadinis (2008, 449) notes, that “countries’ financial laws remain characteristically heterogeneous, despite exponential growth in international financial activity” and that although “coordination efforts have succeeded in some regulatory areas, they have stalled in others despite strong efficiency arguments for a coordinated regime.” It is unclear, for example, why bank regulators have chosen to focus on solvency risks in the form of capital adequacy standards

---

<sup>2</sup>I address the more opaque concept of “cultural capture” in the Chapter 6.

while ignoring liquidity risks (see chapter 3). More broadly, this heterogeneity across issue areas that would otherwise appear to benefit from coordination belies predictions both of a ‘race-to-the-bottom’ (or a ‘race-to-the-top’). Likewise, theories that claim that regulators will automatically seek to manage systemic risk or improve efficiency do not do a good job of explaining when and why regulators choose not to cooperate with one another, e.g. the reluctance of Japanese regulators to agree to the original Basel Accords on capital standards, despite having arguably the most exposure to risk at the time (Singer, 2004, 550). Both structural and functionalist theories also fail to pay sufficient attention to domestic political factors, such as the fact that interest groups may favor protection against external market pressures (Berger, 2000) and that interests within the financial sector are extremely heterogeneous (Krause, 1997)<sup>3</sup>. Moreover, both are premised on the idea that policymakers will always receive what are often abstract market messages, an assumption that is highly questionable (Hacker and Pierson, 2002).

Equally as important, these accounts ignore the fact that the external market constraints on policymakers vary with the degree of liquidity and the size of investment pools present in their markets (Gadinis, 2008, 457). When a jurisdiction’s market is globally dominant, firms within it already have access to the deepest and most well-developed capital markets, and therefore have little reason to transfer their operations to smaller or less liquid foreign markets where the costs of investment are higher, as several scholars have noted (Drezner, 2007; Posner, 2010; Simmons, 2001)<sup>4</sup>. As a result, there are fairly weak domestic industry or investor pressures on policymakers within the *dominant* market to change their regulatory structures to respond to competitiveness pressures emerging from other markets. For the bulk of the time period studied in this project, the dominant capital and, to a less extent, commercial banking market was the United States (Pagano et al. 2002; Gadinis 2008; Hemel 2011; see chapter 3 for more detail). Under these conditions, the explanatory power of both structural and functionalist theories is significantly attenuated.

Differentials in regulatory expertise also provide a final reason to be skeptical of structural and functionalist accounts. As Simmons (2001, 594) notes, much of the world’s regulatory

---

<sup>3</sup>As Helleiner and Pagliari (2011, 179) notes, the most recent financial crisis has underscored the depth of divisions within the financial industry, “divisions that reduced the sector’s overall influence.” To take just two examples: banks demanded stricter regulation of credit-ratings agencies which were opposed by both the agencies and many investors while accountants and investors opposed reforms to mark-to-market accounting that banks strongly favored.

<sup>4</sup>Liquidity in capital markets “is the assurance that investors will be able to sell or buy stock at any time for the price offered in the market at the time.” Liquidity increases as the number of investors that are willing to buy or sell securities increases. In turn, this leads to a growth in the volume of trading in the exchange markets, reducing the price differential charged by brokers for buying versus selling a security at the same time (the bid-ask spread). As a result, markets that have greater liquidity (that is, investment) will also have higher trading activity, reducing bid-ask spreads and therefore lowering the cost of investment. See Poser (2001), Madhavan (2000) for more detailed explanations of these processes.



expertise is located in the United States. “What has come to be known globally as “best practices” in supervision and regulation usually emanate from [the United States and the United Kingdom].” While it is difficult to quantify how large a factor this institutional regard or “soft power” has been, scholars report that other regulators and practitioners claim it to be an important motivation for their willingness to defer to or coordinate with U.S. based authorities (Raustiala, 2002). Veron et al. (2006, 169-170) reach a similar conclusion, noting that the “the United States’ predominance in global financial regulation does not result solely from the sheer size of its markets.” They suggest instead that the SEC has become “the world’s de facto [securities] regulator” thanks to its expertise and reputation (Veron et al., 2006, 170). Thus even when their global dominance is contested, these institutional reputations may have been an important asset for U.S. regulators, insulating them somewhat from the competitiveness pressures of globalization. In conclusion, while none of this implies that competitiveness or functionalist concerns have not impacted regulatory preferences and behavior, the continued heterogeneity in national regulations and unique position of U.S. regulators in the global financial markets strongly suggests such explanations are incomplete accounts of regulatory behavior.

### 2.2.3 Principal-Agent Accounts

Political scientists have long been motivated by an important normative concern: how to maintain *political control* over unelected bureaucrats while still benefitting from the efficiency gains achieved through delegation to specialists (Eisenstadt, 1965; Hyneman, 1950; Kaufman, 1956; Wilson, 1887). The emergence of rational-choice institutionalism as a dominant force in political science in the 1980s led to a renewed focus on political control, spawning an extensive literature that examined the mechanisms and conditions under which political principals (notably the legislature) could exercise control over their bureaucratic agents (Moe, 2012; Whittington and Carpenter, 2003). Indeed, the principal-agent perspective has, since the early 1980s, emerged as the dominant paradigm for studying public bureaucracies, particularly amongst scholars in the American subfield. Although definitions have varied as the literature has evolved, bureaucratic power, if it is acknowledged to exist in any meaningful sense at all, is taken to be a derivative of the authority given to it by political principals. As one definition describes it, bureaucratic power in such models simply implies “the extent to which agencies can implement outcomes that diverge from the preferred policies of their principals, without being punished *ex ante* or *ex post*” (Caughey et al., 2009, 4). Since bureaucratic power is purely derivative of the grant given to it by political principals, the attention of principal-agent scholars is not on bureaucracies *per se*, but on the ways in which principals can exercise control over such organizations and the conditions that influence the degree of discretion granted to the agency.

The early ‘political control’ or ‘congressional dominance’ literature claimed that bureaucratic behavior was effectively constrained by Congress through a powerful combination

of oversight hearings, budgetary controls, and jurisdictional threats (Weingast and Moran, 1983; Weingast, 1981, 1984) or by delegating oversight to constituency groups who would raise “fire alarms” when bureaucracies strayed or shirked from the preferences of their principals (McCubbins and Schwartz, 1984). Given that agencies anticipated the use of these weapons, they would invariably comply with congressional preferences (Barke and Riker, 1982; Fiorina, 1981). This approach to control, with its focus on *ex-post* mechanisms, was widely critiqued for ignoring the goals, strategies, and resources of bureaucrats. In particular, many argued that bureaucracies possessed important first-mover advantages through the ability to introduce regulations that would be difficult to reverse after the fact. Moreover, it was noted that bureaucracies accumulate expertise and private information not available to political principals, an asymmetry that over time would make it very difficult for Congress or any other principal to exercise control (Altfeld and Miller, 1984; Moe, 1987; McCubbins et al., 1987; Wilson, 1980).

Scholars thus began to focus on ways in which principals, specifically the “enacting coalition” of politicians and their interest group allies, could design agencies *ex ante* to ensure compliance with their preferences and avoid bureaucratic “drift” over time (McCubbins et al., 1987; McCubbins and Weingast, 1989). This perspective, also known as the “procedural” thesis, argued that legislators “stacked the deck” when creating agencies, forcing them to take account of the views of groups within the enacting coalition when making policy and setting rules, and assigning vigorous burdens of proof on either the agency or groups opposed to the creation of the regulatory regime. In effect, the agency was viewed as operating on “autopilot,” remaining broadly compliant with the preferences of the enacting coalition (McCubbins and Weingast, 1989). While other scholars also focused on agency creation as critical in establishing control, they began to acknowledge that principals faced trade-offs between control and expertise in establishing agencies, particularly if they wanted to ensure that the agency they were creating would be able to respond to changing circumstances and be protected from future political interference (Moe 1987, Horn 1995). As such, these “structural” scholars argued that principals had to grant some discretion or “power” to the agents. Discretion in this context refers to the “leeway an actor has within a given sphere of decision making” (Caughey et al., 2009, 4) and typically refers to specific forms of implementation or technical decision-making. Vitaly, discretion is part of the contractual arrangement between politicians and an agency they establish; it is not, therefore, something that the bureaucracy itself can expand or alter over time.

Yet even with this revision, there are two major flaws in these models. Much like the instrumental, structural, and functionalist approaches to bureaucratic behavior, agency preferences are still viewed as derivative of those of other actors, whether it be the enacting coalition, the current Congress, or some combination of political principals. This contradicts a vast amount of public administration research which has clearly demonstrated that agencies and their staffs do have distinct, independent preferences over policy outcomes. For example, the literature on public service motivation tells us that individuals joining agencies

are often “policy-motivated” “zealots” that “self-select” into agencies that conform to those views (Gailmard and Patty, 2007). We also know that under certain conditions those views may be reinforced by an internal culture of commitment to or recognition of the agency’s distinctive mission (Perry, 1997; Paarlberg and Perry, 2007; Moynihan and Pandey, 2007). Finally, and most important, many scholars have demonstrated not only that agencies hold independent policy preferences, but that they frequently act upon those preferences in public policy debates and in regulatory decision-making, even in the face of opposition from political principals and other groups (Feldman, 1989; Golden, 2000; Aberbach and Rockman, 2000).

The second flaw concerns the concept of ‘influence.’ It is true that, aside from a political control literature that has often tended to reduce bureaucracies to compliant automatons, the literature on discretion has made valuable contributions in helping us understand the circumstances under which bureaucracies exercise greater authority over policymaking. We know, for example, that agencies with preferences that are more closely allied with those of their principals will enjoy relatively greater influence in policy implementation (Epstein and O’Halloran, 1994, 1999; Bendor and Meirowitz, 2004). Models have also demonstrated that the presence of multiple principles provides greater opportunities for agencies to pursue their own preferences (Volden, 2002; Huber and Shipan, 2002). Scholars have noted that discretionary authority is wider when policy complexity rises and the need for expertise is greater (Bawn, 1995). Gailmard and Patty (2007, 2012) have, for example, argued that policy-motivated bureaucrats are induced to invest in expertise development by new grants of discretion, a fact that may rationally compel principals to grant broader discretionary influence to agencies over time. However, each of these models is discussing ‘discretion,’ which refers to formal legal grants of authority and mostly refers to influence exercised in the context of policy implementation.

Few scholars – Moe (2006) being a notable exception – have begun to explicitly incorporate the idea that agencies are political actors capable of exerting influence over political outcomes. Moreover none has yet to do so in the context of major legislative debates, a fact that is unusual given that we know new delegations of authority are typically granted to *existing* rather than *ex nihilo* agencies (Epstein and O’Halloran, 1999), which suggests that they are likely to play a significant role in these sorts of significant policy debates. Indeed we already know from a range of empirical works that agencies frequently set the broad policy agenda and influence the content of legislation within the financial regulatory policy domain (Khademian, 1992, 1996; Tsingou, 2003; Coffee, 1995; Goodman, 2008; Roig-Franzia, 2009). As such, existing delegation-based models, while valuable in helping us understand discretion in policy implementation, are of limited usefulness in explaining bureaucratic influence over broader policy outcomes since they do not countenance the possibility that agencies are able to renegotiate their ‘delegation contract’ – that is expand their influence over policy beyond the pre-defined discretionary zone agreed to by Congress – either in *de facto* terms or *de jure* through legislation. It is this broader policy and legislative influence that distinguishes

‘autonomy’ from discretion and is the focus of the rest of this project.

## 2.3 Why Focus on Bureaucracies?

Instrumental group power, structural business, and market functionalism accounts all discount the role of bureaucracies, seeing their preferences as derivative and their role as distinctly reactive rather than proactive. Much the same can be said of both the principal-agent literature, which sees agency preferences as reflective of congressional mandates and their influence as confined to the discretionary zone of policy implementation. However empirically there is little doubt that regulators have been at the heart of the dramatic financial services policy changes that have occurred over the past forty years, both at the domestic level and internationally (Zaring, 2005). Moreover, existing research simply does not support the idea that Congress has exerted anything more than intermittent influence over policy change over the past forty years. In part this is because congressional sentiment has often been inconsistent on issues of financial regulation (Singer, 2004, 552), likely reflecting the heterogeneity of views amongst investors and firms (see above). Perhaps more important, it also reflects a lack of electoral salience and public interest in the issues being considered. In general terms, the types of institutional-level issues discussed in this project, such as capital adequacy rules, derivatives policy, or consolidated entity supervision, share four general features: low electoral salience and visibility, high levels of technical complexity, and economic centrality. The first three conditions lower the incentives for elected officials to acquire the expertise and information necessary to effectively craft policy. The final condition – economic centrality – ensures that there are high costs of making suboptimal policy or ‘outsourcing’ policymaking to particularized groups. Taken together with the heterogeneity of interests in the financial services industry, these factors help to explain a) why claims of industry power and congressional dominance are overstated and b) why bureaucratic agencies will enjoy unusually large degree of deference and independence or more simply ‘autonomy.’

In brief, electorally salient issues are those that politicians perceive as being most important to their constituents (Ringquist et al., 2003, 144). Given our assumption that public officials are motivated principally by reelection (Mayhew, 1974; Fiorina, 1989), it is widely thought that politicians are more motivated to acquire their own expertise in issue areas that voters care about in order to reduce policy uncertainty that might arise from entrusting too much authority to bureaucratic agents (Calvert et al., 1989; Gormley, 1989; Bawn, 1997). Low levels of salience, by contrast, lead to lower expertise acquisition, “less electioneering and grandstanding,” and greater levels of “political-bureaucratic cooperation” (Ringquist et al. 2003, 145; see also Ripley and Franklin 1986). Non-consumer financial regulatory issues are not only ranked far lower than other major economic and social policy issues typically identified as being important by voters, they are often not identified at all. Moreover, even when voters can identify general priorities – such as a desire to curb Wall Street risk taking – they can rarely express clear preferences in public opinion polling on specific topics (Brush,

Figure 2.1: Issue Characteristics Associated with Bureaucratic Policy Influence

<b>Issue Characteristics</b>	<b>Bureaucratic Influence</b>	<b>Interest Group Influence</b>	<b>Congressional Incentives to Exercise Influence</b>
LOW Political Saliency	<b>Strong</b>	Strong	Weak
LOW Political Visibility	<b>Strong</b>	Strong	Weak
HIGH Complexity	<b>Strong</b>	Strong	Weak
HIGH Economic Importance	<b>Strong</b>	Weak	Strong

2010).

Closely linked to saliency is ‘visibility’ or the ability of voters (and even many organized groups) to trace perceived effects back to decision-makers. Specifically, voters must be able to a) perceive an effect, b) identify an associated government action, and c) further link that to decisions (or non-decisions) made by a legislator or other public actor (Arnold, 1990, 47). Even if voters are capable of identifying the effect of a regulatory action – for example, reduced access to credit – they rarely can make the second order link to a public policy – for example, a decision to raise capital adequacy standards that reduced the capacity of banks to make credit available. Even if voters could make those links, very little day-to-day policy-making is in the hands of lawmakers in any event. In short, then, given that non-consumer financial regulation issues tend to be low salience and low-visibility in electoral terms, they offer few opportunities for credit claiming amongst politicians (Hill and Williams, 1993; Kelman, 1987) and therefore little incentive for elected officials to invest time in monitoring agencies, acquiring expertise, or developing their own preferences on key issues.

Policymaking of the kind described in this study is also characterized by a high degree of “complexity”; that is, individuals require relatively high degrees of specialized technical knowledge in order to interpret and craft policy. In general, such high levels of technical complexity are widely associated with expanded room for bureaucratic influence for three reasons. First, agencies, by virtue of their concentration on a discrete set of policy issues, expertise built through skills and experience, long-term institutional knowledge, and daily interactions with a diverse array of parties affected or otherwise interested in regulation, are simply likely to possess superior information relative to other actors in the policy subsystem, particularly political principals (Bendor et al., 1987; Bawn, 1995; Epstein and O’Halloran,

1999; Gailmard, 2002; Volden, 2002; Huber and McCarty, 2004). Second, high levels of complexity pose significant intellectual barriers to entry for Members of Congress “particularly for those lawmakers that are not part of the closed subsystems that often characterize complex policy areas” (Ringquist et al. 2003, 146; see also Baumgartner and Jones 1993). Finally, highly complex policy areas make it difficult for Members to claim credit, thus further reducing their incentives to invest the significant time and resources into knowledge acquisition (Hall, 1993; Kelman, 1987). These information asymmetries produce greater levels of uncertainty over the effects of policies amongst elected officials (Bawn, 1997), which together with the substantial barriers to expertise acquirement, render them highly reliant on bureaucratic agencies for guidance and support.

While electoral salience, visibility, and technical complexity are all important preconditions for bureaucratic autonomy, to varying degrees they also appear to favor a policy environment in which concentrated industry interests might play a significant role in policy-making. It is the final condition – economic centrality – that suggests patterns of bureaucratic influence are perhaps more likely to predominate. As the events of late 2008 illustrated, the financial sector is vital to the broader economy, particularly as the intermediary of credit and investment. Moreover, the industry has grown dramatically as a share of the overall real economy since the early 1980s (Hacker and Pierson, 2010, 192-193). As a result of its centrality and size, regulation of this industry is critical to overall economic growth and social stability. This raises the electoral costs of sub-optimal policy outcomes for elected officials even when the specific policy issues under discussion – bank resolutions or capital adequacy standards, for example – are neither electorally salient nor visible. As a result, there are potentially high electoral costs to ‘outsourcing’ policymaking to organized groups with narrow interests. Yet, simultaneously, given complexity, low visibility, and low electoral salience, there are few incentives for elected officials to invest in their own expertise. As a result, there are good reasons to believe that financial regulators will exercise tremendous discretionary and policy influence relative to agencies operating in less complex or salient policy domains (this is consistent with Epstein and O’Halloran 1994, who similarly conclude that bureaucratic influence is greater when the consequences of poor policy choices are greater).

The empirical evidence that I will present in this project will a) show that financial regulators have both initiated and driven many of the most important policy changes over the last forty years, b) suggest that Members of Congress have behaved in reactive ways and hold weak preferences on most financial policy issues, and c) illustrate that interest groups have diverse preferences that often conflict with one another, thus weakening their influence. However, just as important is the compelling logic presented here that supports the idea that bureaucracies exercise genuinely independent influence in this process, suggesting that claims of ‘capture,’ market pressure, and congressional dominance are either incorrect or overstated. This certainly does not mean that we should be inattentive to the preferences of legislators or the possibility that regulator preferences are an ‘anticipated reaction’ to Congressional

wishes (part of the so-called “second face” of power)<sup>5</sup>. However, both existing empirical evidence and the potent combination of low political visibility, saliency, policy complexity, and economic importance indicate that regulators will have wide latitude to pursue their policy objectives both at the domestic and international levels.

## 2.4 An Autonomy-Based Approach

### 2.4.1 Conceptualizing Autonomy

Neither traditional interest-based accounts, market functionalism, nor the principal-agent approaches to understanding bureaucratic behavior satisfactorily explain the apparent ubiquity of independent bureaucratic power in the financial services policy domain. It is for this reason that this project is centered on the concept of *autonomy*. Autonomy as a concept implies an independence of preferences and an ability to realize those preferences. While autonomy clearly implies an ability of an actor “to translat[e] its preferences into authoritative actions” (Nordlinger, 1981, 19), what distinguishes the concept from alternatives such as “discretion” or “influence” is its emphasis on the independence of those preferences. As Christman (2008, 1) states “to be autonomous is... to be directed by considerations, desires, conditions, and characteristics that are not simply imposed externally upon one, but are part of what can be considered one’s authentic self.” Transferring this concept to a collectivity – in this case the state – Skocpol (1985, 9) similarly emphasizes that to be autonomous means being able to “formulate and pursue goals that are not simply reflective of the demands of interest of social groups, classes, or society” (see also Evans 1995).

Although the term has been applied to bureaucratic organizations by principal-agent scholars and by students of European government agencies, these literatures largely use the term in reference to political and/or formal legal discretion (see Caughey et al. 2009 for an overview). As such, they suffer from the problems identified above: that is, they either assume preferences to be derivative of political actors or are largely inattentive to them, while likewise failing to recognize that agents have the ability to renegotiate their existing delegation contracts. By contrast, Daniel Carpenter’s definitions of the concept in his landmark book, *The Forging of Bureaucratic Autonomy*, proves more faithful to the background concept. In short, Carpenter suggests two closely related definitions. First he claims that bu-

---

<sup>5</sup>That is we need to know that if agency A takes policy position X, it did so because it reflected its own *a priori* preference for X, not because it was induced or otherwise compelled to do so by another actor. In the first case, agency A can be seen as possessing the independence necessary (but not sufficient) for autonomy; in the second, the agency is effectively captured by another entity, reactions that either reflect a “strategic” accommodation to reality or are otherwise “induced” by others in non-visible ways. See Hacker and Pierson (2002, 283).

reaucratic autonomy exists “when politically differentiated agencies take sustained patterns of action, actions that will not be checked or reversed by elected authorities, organized interests, or courts” (Carpenter, 2001a, 14). Second, he similarly defines autonomy as occurring when agencies “take actions consistent with their own wishes, actions to which politicians and organized interests defer even though they would prefer that other actions (or no action at all) be taken” (Carpenter, 2001a, 4).

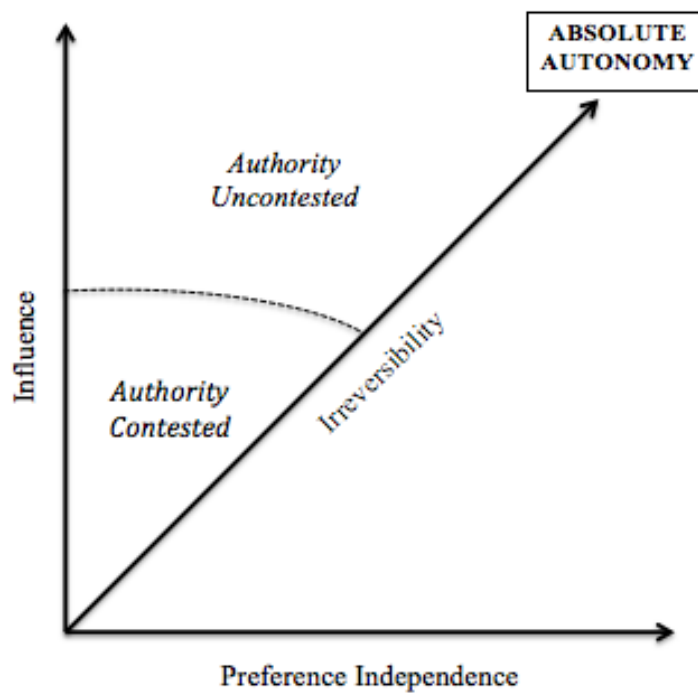
Both of these formulations of the concept imply that preferences must be ‘irreducible’ or independent of other societal and political interests (Carpenter, 2001a, 14). However the definitions differ slightly in their treatment of what I term ‘authority.’ The first refers to the *irreversibility* of authority. Citing this definition, Buthe (2010, 7) suggests irreversibility to mean that the “agent is largely “safe” from the risk that ordinary political changes, such as a change in legislative majority, would result in the agent’s regulatory decisions being overturned or its grant of authority revoked.” Irreversibility therefore refers to existing authority within a given policy space, a term that is closely linked to jurisdiction but that also encompasses its political and moral authority. Irreversibility logically suggests that the agency is capable of producing ‘anticipated reactions’ amongst other actors that prevent them from questioning or challenging the agency’s current authority (see Bachrach and Baratz 1962). As a result, we should expect to observe relatively low levels of open conflict when irreversibility is high.

The second of Carpenter’s definitions is broader, referring to what might be more traditionally thought of as constituting ‘power’ or ‘influence.’ That is, employing Dahl’s (1957, 202) well-known formulation, bureaucratic actor A has influence over actor B “to the extent that he can get B to do something that B would not otherwise do.” Influence also implies that bureaucratic actor A has the ability to structure the policy choices available for other actors, i.e. to set the agenda. Although influence and irreversibility are, as an empirical matter, highly correlated, they do reveal two different dimensions of bureaucratic authority. One refers to the *existing* authority of the agency, while the other, which I simply term ‘influence,’ refers to the ability to the agency to *expand* its authority through the enactment of new policies or the creation of new institutions. When both irreversibility and influence are high, the agency’s authority will be largely “uncontested” by other actors – politicians, groups, and the courts; when both are low, its authority will be widely ‘contested.’ However, a high degree of ‘autonomy’ can only be said to exist when both authority (influence and irreversibility) are largely uncontested *and* the agency’s preferences are independent of other political and societal actors. These sub-components of the concept of bureaucratic autonomy are illustrated in Figure 2.1.

It is particularly important to highlight three additional points. First, in theory, an agency with largely uncontested authority may lack preferences that are independent of other political and societal actors; in effect, then, such an agency would be ‘captured’ by others. Although empirically such a correlation is uncommon, since the perception of capture would almost certainly greatly attenuate the agency’s authority, it underscores why, as



Figure 2.2: A Graphical Representation of Bureaucratic Autonomy

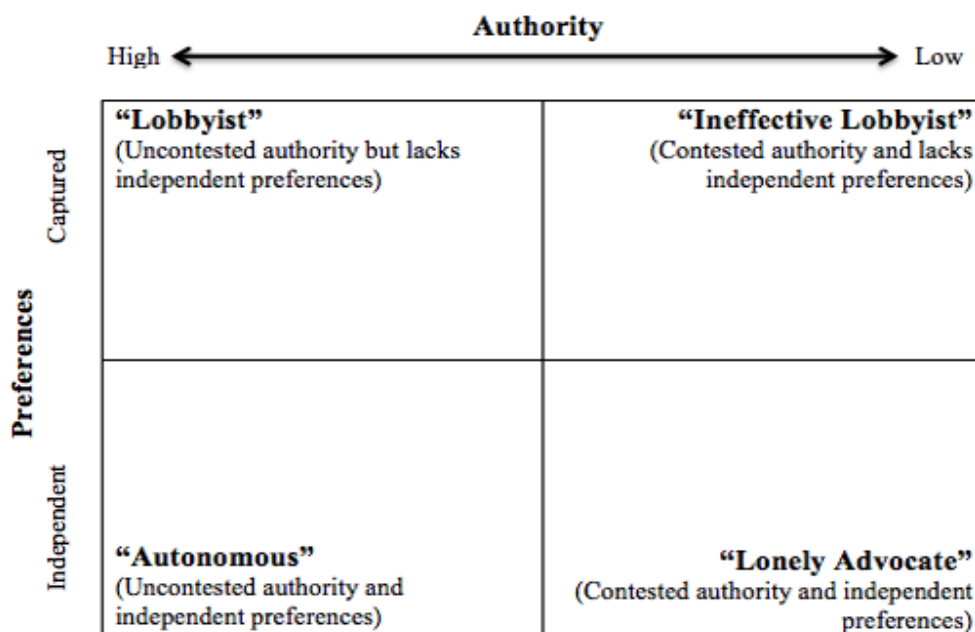


a first order condition, it is important to establish that preferences are independent of other actors.<sup>6</sup> Second, although all bureaucratic preferences will obviously be influenced by political and societal forces, we can make the simplifying assumption that such preferences are, in fact, independent if they are irreducible to the preferences of other actors (that is, they are differentiated in some manner) and are consistent with the agency’s broad mission (see below for discussion). This means that here I treat preferences as being dichotomous: they are either independent or ‘captured.’ Finally, bureaucratic authority will never be absolute in practice. In reality, bureaucratic authority is both shared with other actors and bounded by other institutions (Krause, 2012). Thus while there may be indicators that suggest a threshold exists between authority that is ‘contested’ and ‘uncontested’ (see later), in reality authority is a continuous variable. These points are illustrated in the stylized examples of agency type presented in Figure 2.2.

---

<sup>6</sup>This follows Skocpol’s (1985, 9) admonition that unless “independent goal formation occurs, there is little need to talk about states as important actors [or to] explore the “capacities” of states to implement official goals.”

Figure 2.3: Stylized Typologies of Agencies Based on Authority and Preferences



## 2.4.2 Preferences

### A Focus on Mission Objectives and Strategic Policy Preferences

In the first place, it is important to be clear about the types of preferences that are both theoretically relevant and empirically observable. All actors, whether individuals or collectivities, possess fundamental preferences that are closely tied to their basic interests. At the universal level, this ‘preference’ is for survival; translated subjectively to a bureaucratic organization, the fundamental interest is to maximize autonomy, since it presents such entities with their best chance of long-term survival. However bureaucratic actors do not, any more than individuals, spend the bulk of their time constantly thinking in terms of ‘survival’ or ‘autonomy,’ even though that represents their ‘fundamental preference’<sup>7</sup>. Rather, the strategic behavior of agencies is dictated by lower order preferences that are determined

<sup>7</sup>Collective institutions obviously contain individuals with heterogeneous preferences. However those in policy making positions within the agency are likely to see their personal preferences – whether ideological, pecuniary, or for career advancement – closely aligned to the success of the agency (Carpenter, 2001a). This is consistent with other arguments that proximate goals take precedence even when the ultimate goals may differ significantly, e.g. the reelection incentive for Members of Congress; see Mayhew (1973). However, see Kaufman (2008, 259) and Gailmard and Patty (2007) for counter views on the incentives motivating bureaucrats.

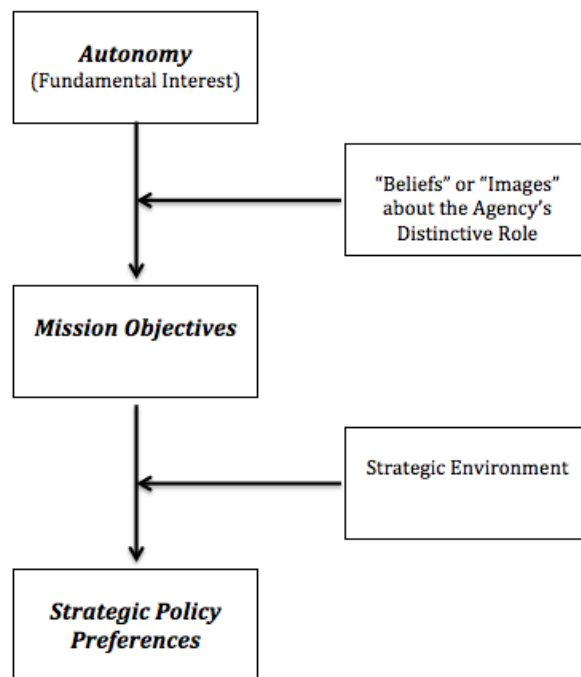


Figure 2.4: Bureaucratic Preferences: Influences on Each State of Formation

not only by these fundamental interests, but also by their causal and normative beliefs<sup>8</sup> as well as the strategic environment around them (see figure 2.4). Since we are concerned with the motivations for strategic behavior, and given that these preferences are both more easily observable, those preferences are the focus here.

Adapting Woll’s (2005) classification scheme, I argue that these preferences can be broken down into two categories: pre-strategic mission objectives and narrower strategic policy preferences. The agency’s mission is informed by the images (or beliefs) that the members of the agency hold about their organization and its place in the world, something that I describe as a “mission.” An organizational mission may be understood as a worldview that “serves to separate it from other organizations..., provides members of the organization with an identification, a motivation for their work, a context for understanding new mandates or responsibilities, and a means to integrate the work of the organization.” Missions are developed through long-term institutionalization, and are “honed and sustained as much by

---

<sup>8</sup>As Somers (1996) notes, “interests are not given unambiguously by the world but must be interpreted”; instead, preferences are “developed through a process in which the actors attempt to interpret the world and their situation in it.” It is at this point in the formation of preferences that beliefs or ‘world views’ become important. For more on the role of ‘ideas’ in shaping preferences, see, for example, Hall (1993) and Blyth (2002).

imposed mandates and external expectations for performance, as by the priorities of the implementing personnel and dominant professional groups who have a stake in its success.”

Agency missions therefore act much like “ideas,” “beliefs,” “images,” or “mental models”; that is they “guid[e] and constrain processes of reasoning, data-gathering, and interpretation” (Jacobs 2009, 256; similarly see Berman 1998; Blyth 2002). Although these images or beliefs may admittedly be either unclear or perceived differently by different members of an organization, they more often than not they act as a powerful force in shaping the collective entity’s policy preferences and behavior. The Federal Deposit Insurance Corporation’s (FDIC) distinctive mission, for example, is widely acknowledged to be ensuring the solvency of the Bank Insurance Fund (Khademian, 1995, 1996), which in turn is achieved through the reduction of risk in the banking system and effective resolutions of bank failures. This, in turn, produces what many commentators have noted is a ‘conservative’ or risk-averse approach to policy-specific issues in the area of bank regulation, such as capital standards policy or open-ended government support to financial institutions.

Missions are also deeply intertwined with perceptions of an agency’s “distinct competence.” This means that in addition to these broad public policy preferences, agencies will have biases towards policies that use methods that align with their existing expertise and knowledge. Since the FDIC’s expertise is concentrated in the relatively low-tech areas of supervision and resolutions, it is likely to disfavor policies that it would find difficult to implement, such as the oversight of complex mathematical value-at-risk (VaR) models for evaluating capital standards (see Chapter 3). These internal images or beliefs about an agency’s mission and distinct competency are important influences on decisions to pursue policy preferences. When they are both clear and fairly consistent over time, it is a good, if insufficient, indicator that the agency’s preferences are likely to be independent of other political and societal actors, particularly if those actors’ own mission preferences shift over the same time period.

Ultimately, however, we also need to examine the concrete policy preferences of bureaucratic actors. By this I refer to their preferences on specific public policy issues, such as their position on capital standards for banks or accounting rules for public corporations. These concrete policy preferences are informed by the agency’s fundamental interest or preference for autonomy maximization, its mission objectives, *as well as* the strategic environment in which it operates<sup>9</sup> The ‘strategic’ component that comes into play in the formation of policy preferences reflects multiple factors: a lack of information in a given situation (Goodin, 1982), an oversupply of information (leading the agency to ‘satisfice’ on an acceptable rather than an optimal solution – see Simon 1982), or an accounting of the policy preferences of

---

<sup>9</sup>Indeed, even ideational scholars recognize the strategic component of policy preferences. Jacobs (2009, 2259) notes, for example, that “actors’ mental models do not mechanically determine their policy and institutional preferences... The comprehensively rational decision maker must first reason through and process information about the probability and utility of each potential outcome of the available options.”

other actors operating in the policy space. The fact that policy goals are strategic and thus influenced in part by outside preferences does not, however, mean that they fail the independence test necessary for autonomy; as I explain below, provided that the agency's preferences remain distinctive from any single actor over time, we can reasonably assume independence even in the absence of more direct evidence, such as records of internal deliberations.

### Identifying Preferences and Confirming Independence

Given that pre-strategic mission objectives and strategic policy preferences are of greatest import, how do we observe them and how can we ascertain that they are 'independent' of other political and societal actors? In terms of observation, there is no perfect method to record actor preferences, since all communications, whether they be public or private, are in some way modulated for the consumption of others. The closest approximation to 'true' preferences can be found, however, in internal dialogue between senior policy-making members of the organization. Meeting minutes, transcripts, and private correspondence are more likely to capture 'sincere preferences' rather than statements issued for public consumption (see Jacobs 2009, 263).

In the cases under examination here, the closest approximation we have to private communications during this time period are records available from the Federal Reserve Board, which publishes all minutes and transcripts of Federal Open Markets Committee (FOMC) meetings<sup>10</sup>. FOMC meetings, however, do not deal heavily with regulatory issues, since their main purpose is discussion of monetary policy; meeting transcripts of the Board of Governors of the Federal Reserve, which does set regulatory policy, are not publicly available during the period under study here. Other agencies, including the SEC, the FDIC, and the CFTC, conduct both open and closed meetings, though the transcripts of closed meetings are not currently publicly available. Internal communications of these agencies on key topics are not readily available at this time absent Freedom of Information Act requests.

There are, however, other publicly available sources that can, taken together, provide us with a strong sense of agency preferences. Speeches and testimony are certainly targeted towards public consumption, but one should expect over time to observe consistent patterns in agency preferences on policy issues that reflect their broader mission. The Federal Reserve Board, the regional Federal Reserve banks, and the FDIC frequently publish research reports that, to varying degrees, reflect the policy thinking of senior members of each agency. Secondary evidence, ranging from trade media reports, such as those found in *American Banker* or in interest group journals, such as the *ABA Journal*, the *Savings and Loan Journal*, as well as academic accounts, give us strong indications of policy preferences, again particularly when those preferences are consistent over time. These types of sources are listed in figure

---

<sup>10</sup>The meeting transcripts are published with a 5-year lag, meaning that the records available as of this writing only date until 2007.

Figure 2.5: Bureaucratic Preferences: Sources and Indicators

<b>Indicators</b>	<b>Information Sources</b>
<ul style="list-style-type: none"> <li>• Policy preferences differ in non-trivial manner from those of other actors</li> <li>• Policy preferences differ in the degree of intensity</li> <li>• Agency preferences precede expressions of preferences by other key actors</li> <li>• Preferences are consistent with mission objectives</li> <li>• Evidence that arrived at through a deliberative process</li> </ul>	<ul style="list-style-type: none"> <li>• Transcripts of private meetings of agency's policymaking body</li> <li>• Press Releases</li> <li>• Speeches by senior officials</li> <li>• Congressional testimony</li> <li>• Official reports</li> <li>• Academic or press commentary</li> </ul>

2.5.

Even if we can clearly identify mission objectives and policy preferences through private deliberations or from other sources, we must ascertain that bureaucratic preferences are independent from other political and societal actors as a prerequisite to determining autonomy in the policy area. That is, we need to know that if agency A takes policy position X, it did so because it reflected its own *a priori* preference for X, not because it was induced or otherwise compelled to do so by another actor, a phenomenon also known as ‘anticipated reaction’ (Bachrach and Baratz 1962; see also Hacker and Pierson 2002, 283). One solution is offered by Caughey et al. (2009, 14), who claim that “what matters is that an agency’s preferences be formed through a process that *could potentially* have yielded differentiated preferences – not that the agency’s preferences actually diverge[d] from those of any particular... actor” [emphasis added]. Although a useful potential indicator, this procedural definition is insufficient to demonstrate independence. Moreover, it ignores the fact that even agencies with a high degree of autonomy in one area may hold ‘captured’ preferences in other areas (most likely those that are less central to their mission).

Therefore, I suggest an alternative set of indicators (see figure 2.5). First, we must identify the *ex ante* preferences of all the actors concerned and show how those preferences change over time (Hacker and Pierson 2002; Pierson 2004). Second, to be confident of independence, we must ensure that bureaucratic preferences are distinctive from those of any

other single actor over time<sup>11</sup>. Third, we need to be attentive to differences in intensity; even when actors *a priori* agree on a policy objective, they will differ on the priority they assign to it, their willingness to place it on the political agenda, and the resources they devote to pursuing it. Thus even when two actors, A and B, agree on a proposal, the fact that A is the driving force behind a proposal strongly suggests that it is pursuing that action for its own self-motivated reasons, not because of the influence of B. Finally, as a check on independence, we need to ensure that preferences are both consistent with the agency's mission objectives and, if possible, verify that they were arrived at through a deliberative process (this latter indicator can only be observed when we have access to private transcripts or records). By carefully identifying *ex ante* preferences, tracing their development over time, and observing divergence in substance and intensity, we can make reasonable judgments regarding the independence or lack thereof of agency preferences.

### 2.4.3 Authority

Bureaucratic authority is based on the *influence* of an agency and the *irreversibility* of both its policy decisions and its jurisdiction. The determinants of both components of authority are similar, and are a mix of formal legal authority, capacity (based on the resources available to an agency), and, perhaps of greatest importance, the images, beliefs, or reputations held about the agency by other political and societal actors<sup>12</sup>. Formal legal authority and capacity are useful measures of the agency's ability to perform its existing, discretionary functions of regulation and enforcement. By contrast, when exploring the ability of an agency to either change policy outside of its current formal discretionary boundary or prevent contestation by rivals – which, as Carpenter (2001a, 15) reminds us, are far stronger indicators of autonomy than the simple exercise of discretionary authority – we must instead look to external organizational images or reputations. These images are held by key political and societal actors within the policy relevant community, actors whose support or acquiescence is required by the agency to achieve policy change and prevent policy reversal. The sources and indicators of authority are summarized in figure 2.6.

#### Sources and Indicators of Discretionary Influence

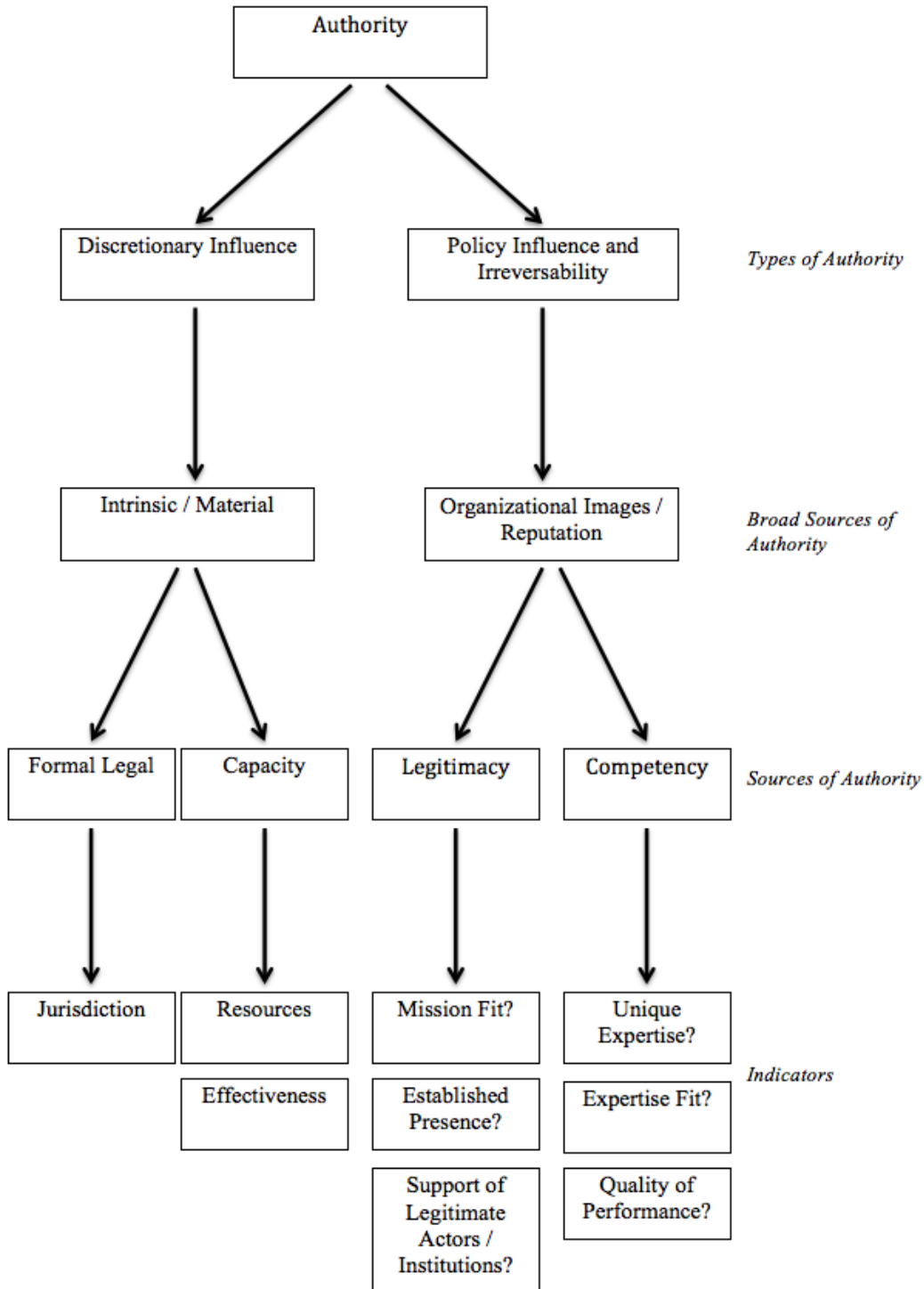
Discretionary influence is, as defined above, an “agent's ability to take decisions without interference from, or detailed review by, [its] principal” (Buthe, 2010, 6). In short, it refers

---

<sup>11</sup>This *divergence* over time should not, however, be confused with *conflict*. Outright opposition from Members of Congress, an array of powerful interest groups, or the courts would surely make it impossible for the agency to achieve its policy goals. See Carpenter (2001a, 15,34).

<sup>12</sup>I follow Carpenter (2010c, 46) by using all three of these phrases as substitutes for each other, since each conveys the same set of symbolic impressions about organizations.

Figure 2.6: Bureaucratic Authority: Types, Sources, and Indicators





both the extent to which agencies can “make legislative-like policy decisions” (that is legally-binding regulation) and its ability to enforce those decisions (Bryner, 1987, 6). Discretion therefore refers narrowly to the portion of authority that an agency exercises in fulfillment of its legally proscribed mandate rather than its ability to prevent challenges to its authority or to expand its authority beyond the discretionary “zone of acceptance” set by principals and stakeholders (Meier 1985; see also Calvert et al. 1989; Hammond and Knott 1996). Discretionary authority is closely linked to *de jure* jurisdiction and the formal mandate, tasks, and relationships with principals and stakeholders detailed in its delegation contract (Huber and Shipan, 2002; Kiewiet and McCubbins, 1991).

Beyond jurisdiction and structure, discretionary influence is also determined by the *capacity* of an agency to carry out its tasks. Capacity, in turn, is founded on the resources available to an agency, as well as its ability to effectively employ those resources. Scholars have shown, for example, that greater financial resources and independence are important for increasing discretionary authority (Verhoest et al., 2004). Expertise, which is attained through large numbers of highly trained and experienced staff members (Meier and Bohte, 2007), is also a critical resource, allowing the agency to expand the zone of acceptable discretion by increasing the information asymmetry with its political principals – a phenomenon that numerous studies spanning a wide range of jurisdictions, policies, and time periods have demonstrated (Rourke, 1984; Khademian, 1996; Carpenter, 2001b). Finally the ability to effectively deploy these resources is based on a series of factors, including the degree of internal agency cohesion (Groenleer, 2009; Meier and Bohte, 2007), particularly amongst its leadership (Schein, 2004; Selznick, 1957; Boin and Christensen, 2008).

### **Sources and Indicators of Policy Influence and Irreversibility**

As Carpenter (2001a, 17) notes, discretionary influence “is only a bare tendril of autonomy... Discretion is part of a contractual arrangement between politicians and an agency they establish... Bureaucratic autonomy, by contrast, is external to a contract.” It is the broader ability of agencies to become active players in setting the broad policy agenda, establishing new institutional arrangements, and influencing statutory decision-making that is a more meaningful indicator of autonomy than discretionary influence (Carpenter, 2010c, 55). I therefore refer to ‘policy influence’ to designate this broader category. Both policy influence and irreversibility are determined less directly by the measures of discretionary influence listed above and more by beliefs, images, or reputations held by political and societal actors about the agency. Such reputations are sets of images or “beliefs about the unique or separable capacities, roles, and obligations of an organization,” as well as its “intentions, history, and mission” images that are embedded in what Carpenter and Krause (2012, 27) refer to as a “network of multiple audiences.” These “organizational reputations animate, empower, and constrain the manifold agencies of government,” and as a result “can expand or deflate the legal authority that agencies exercise by virtue of law and delegation” (Carpenter, 2010c,

33).

Why are reputations a more meaningful measure of bureaucratic policy influence and irreversibility than ‘intrinsic’ characteristics, such as those listed previously, or other measures, such as the degree of jurisdictional competition? In short, this owes to the fact that outside of the narrow discretionary zone, bureaucratic organizations cannot compel actors to follow their commands by virtue of legal authority or the capacity to enforce its decisions. Rather, they can only do so by leveraging beliefs or images about their agency – specifically its legitimacy as a policymaker, as well as beliefs about its unique expertise and perceptions of competence – amongst those audiences whose approval or acquiescence is required to enact policy change or ensure irreversibility. Indeed, as the organizational scholar Robert Presthus reminds us, authority “is not a static, immutable quality that some people have while others do not. Rather it is a subtle *interrelationship* whose consequences are defined by everyone concerned” (Presthus 1960, 87; emphasis added). In other words, authority, at least outside of the discretionary zone, is ultimately relational and therefore based on external reputation or images.

While obviously correlated, such reputations are not, as some have argued (Caughey et al., 2009), simply reducible to the more ‘intrinsic’ indicators of organizational influence listed above. What the external policy community observes about an agency is “not a perfectly tuned or visible reality of an agency” but rather “an image that embeds considerable uncertainty and ambiguity” (Carpenter and Krause 2012, 27; see also Gioia et al. 2000) that does vary to some extent across audiences. External images are moreover not “fully chosen by an organization or its leaders” or simply determined “by *ex ante* modeling of organizational structure”; rather they are equally shaped “by an organization’s audiences” and “*ex post* responses to events” (Carpenter, 2010c, 51). That is, in addition to subjective differences in perception, images of agencies are further shaped by crises or scandals, and can often lag legal changes or altered capacity within the agency. Thus while the idea that “beliefs are all we have” (Carpenter and Krause, 2012, 31) when it comes to measuring agency influence may be an exaggeration, reputations are clearly *the* key indicator of policy influence and irreversibility.

Indeed, although some have argued that reputations are a limited and unstable basis for authority (e.g. Roberts 2006), many scholars have found that certain forms of organizational reputation are both enduring and critical in explaining policy outcomes. Daniel Carpenter’s (2001a) work on the history of four executive departments during the period between the Civil War and the New Deal demonstrated that long-term reputation-building by agencies was more critical than legal mandates to the establishment of authority and autonomy. In more contemporary work on the role of reputations, MacDonald and Franko (2007) and MacDonald (2010) find that general beliefs about agencies are important in determining new allocations of authority to agencies. Similarly, Krause and Douglas (2005) find that reputation effects account for the similarities in the fiscal and economic projections made by both the Office of Management and Budget (OMB) and the Congressional Budget Office

(CBO). Carpenter (2002) further finds that reputation concerns account both for the generally slow Federal Drug Administration (FDA) approval process for pharmaceutical products, as well as decreased drug review periods following public criticism.

Given that images, beliefs, or reputations are important indicators of policy influence and irreversibility, the next question is what types of reputations matter? An almost endless array of organizational images may exist amongst members of the policy community. However, the most important are those that are “relatively stable, long-term, collective judgments” (Gioia et al. 2000, 67; see also Fombrun 1996). Carpenter (2010c, 46-47) suggests four broad categories of politically relevant, widely held, and relatively stable reputations: “performative,” which is based on perceptions of capacity and effectiveness; “moral,” which refers to impressions of the agency’s ethical behavior and the morality of their policy objectives; “technical,” centered on the idea that the agency possesses the appropriate expertise for the problem at hand; and “legal-procedural” images that are built on perceptions that the agency has followed commonly recognized norms of deliberation or procedure. While these categories are useful, they can be simplified into two categories of organizational imagery: one based on the ‘legitimacy’ of the organization’s presence in the policy debate and the other based on perceptions of its competency.

Legitimacy is built on the belief that the agency has a unique and central role to play within the specific policy space. In turn, this is based on beliefs about the organization’s mission and experience, in addition to perceptions of its relationship with other actors that are widely considered to be legitimate. In practice this means that the closer the alignment between an agency’s mission and the policy area under discussion, the more likely one will be to observe references to the legitimacy of the agency’s role and, in turn, its policy influence (see Khademian 1995; Wilson 1989; Kaufman 1960 for similar discussions of the role of mission in building legitimacy). The history and experience component of legitimacy reflects a form of path dependency that is both institutional and ‘cognitive’: as Pierson (2004, Chapter 1) discusses, high fixed costs, learning and coordination effects, as well as adaptive expectations, all contribute to positive feedback processes that make it progressively more difficult to alter institutional structures and relationships over time<sup>13</sup>. Therefore, the longer the agency has been in existence and has had a role in the development of policy in the area under examination, the more likely it is to be perceived as having policy legitimacy. Finally, when an agency is perceived to be closely associated with, or have the endorsement of, other actors that are widely considered legitimate, much of that legitimacy will in turn transfer to the agency itself. Indeed when agencies pursue transgovernmental and public-private col-

---

<sup>13</sup>Over time, audiences may see the agency as a natural part of the policy debate and may not be able to conceive of other organizations performing the agency’s tasks. This may occur in part because of their existing “mental models” about the agency and the policy space, leading audiences to absorb information that tends to confirm their existing worldview while discounting information that does not. See, in general, North (1990); Arthur (1994); Jacobs (2009)

Figure 2.7: Bureaucratic Authority: Indicators and Information Sources

<b>Indicators</b>	<b>Information Sources</b>
<p><b>Discretionary:</b></p> <ul style="list-style-type: none"> <li>• Formal jurisdiction</li> <li>• Size of staff</li> <li>• Professional and educational background of staff</li> <li>• Independence and size of budget</li> <li>• Degree of internal cohesion</li> </ul> <p><b>Policy Influence and Irreversibility:</b></p> <ul style="list-style-type: none"> <li>• Degree policy area perceived to fit agency’s mission</li> <li>• Length of involvement in policy arena</li> <li>• Support/alliance with other legitimate actors</li> <li>• Perceptions of unique/differentiated expertise</li> <li>• Perception that agency expertise is well fitted to policy problem</li> <li>• Assessments of quality of performance</li> </ul>	<p><b>Discretionary:</b></p> <ul style="list-style-type: none"> <li>• Statutes</li> <li>• Official or third-party reports detailing funding, staff turnover, staff levels, and backgrounds</li> <li>• Congressional testimony</li> <li>• Academic and press commentary</li> </ul> <p><b>Policy Influence and Irreversibility:</b></p> <ul style="list-style-type: none"> <li>• Press releases, speeches, and congressional hearing comments by Members of Congress</li> <li>• Official government reports (e.g. GAO, CRS)</li> <li>• Press releases, speeches, congressional testimony, and reports issued by interest groups</li> <li>• Media commentary, particularly in financial trade media</li> <li>• Court filings and opinions</li> </ul>

laboration efforts (discussed below), it is often with a mind to using the legitimacy of other institutions to boost its own position in future policy debates.

Second is the question of whether the agency is ‘up to the job,’ both objectively and relative to its peers. This is a category of images that I describe as competency-based and largely reflects an amalgam of the “performative” and “technical” categories listed above (see Hecl 1975, Rourke 1992, Krause and Douglas 2005, Krause and Corder 2007 for other definitions of competency-based reputations). When members of the policy community acknowledge that the agency has a proven track record of general competence, recognize the strong alignment between the technical skills or expertise of the agency and the area under discussion, and observe that such expertise is “unique” or otherwise differentiated from that of other public organizations, we are likely to see increased policy influence and irreversibility. The importance of the point is noted by Carpenter (2001b, 5,17), who suggests that if “an agent can establish a reputation for professionalism” and a unique ability “to create solutions and provide services found nowhere else in the polity,” then the agent should be particularly well able to build a political coalition that is broader than a temporary partisan majority or “a single class or interest group.” Agencies behave strategically in order to enhance images of their competency. Specifically, bureaucratic organizations promote policies that place greater value on their distinctive expertise and serve to disadvantage their competitors. For example, the Federal Reserve with its strong cadre of economist-trained staff,

has traditionally promoted a far more technically sophisticated and self-regulating approach to bank capital rule making than the FDIC, whose staff lack similar qualifications and whose expertise lies more in traditional, on the ground bank examination (see chapters 3 and 4). The indicators of authority discussed here are summarized again in Figure 2.7, along with a list of data sources.

Finally, what constitutes the policy ‘community’? Clearly the most important participants or ‘audiences’ in that community are lawmakers, since they have the formal authority to revoke their existing authority. However it also includes interest groups, professional organizations, those in academia, media commentators (particularly the business and trade media that pays closest attention to regulatory issues), and rival bureaucratic or private sector regulatory organizations. All of these actors exercise influence over policy outcomes and their acceptance or deference to the agency’s policy preferences is required to achieve policy influence and irreversibility. On occasion, it may also involve the public, but the low saliency, visibility, and complexity of financial regulatory issues suggests that they neither hold well-developed images of the key regulatory agencies nor are likely to be of particular import in determining policy outcomes. These varied audiences need not, and most likely will not, agree completely in their perceptions of agency legitimacy and competency (Carpenter, 2010c; Carpenter and Krause, 2012). However, taken together, we can begin to construct a narrative about the degree of an agency’s policy influence and irreversibility and make conclusions about the degree of contestation that exists in the policy space. It also helps us in the separate task, discussed in the sections below, of distinguishing between periods of relative non-contestation and eras in which bureaucratic authority is subject to greater challenge.

## 2.5 Autonomy and Strategic Bureaucratic Behavior

### 2.5.1 How Reputation and Authority Contestation Impact Strategy

Bureaucratic organizations logically behave in ways designed to advance their interest – the expansion or preservation of their autonomy – as well as their lower order mission-based and strategic policy preferences. As strategic actors, bureaucracies will, to the extent that they can, seek to shape images or beliefs about their organization within the policy community in order to increase their policy influence and ensure the irreversibility of their authority. This means engaging in actions that are designed to boost their image as a legitimate policy actor and their reputation for competence. In general, then, we would expect bureaucracies to make alliances or forge agreements with actors or institutions perceived as possessing ‘legitimacy.’ We would also expect them to be selective in their pursuit of additional responsibilities rather than being the pure “turf” maximizers they are often portrayed as being. As Carpenter (2005, 60) writes, “[m]ost federal bureaucracies do not maximize budgets, and they do not uniformly expand their turf. Federal officials are instead “maximizers” of their

reputation, esteem, and their autonomy.” Put differently, turf expansion can dull perceptions of a clear mission and distinctive or unique competency, potentially opening the agency up to reputation-damaging criticism that it is undermining its core mission or over-extending itself. Constant jurisdictional aggregation, along with increasing organizational size and diversity of tasks can dilute the projection of a clear mission to employees, weakening the potential for preference independence, as well as the cohesiveness and effective leadership needed to perform its discretionary functions. The addition of new responsibilities, particularly when those new responsibilities do not draw upon the agency’s distinctive capacity and experience, also raises the danger of the agency making policy or administrative mistakes (Meier and Bohte, 2007; Levitt, 1988), thus hurting its reputation for competency.

Therefore, we should not expect to observe agencies blindly seeking increased jurisdiction. Instead, they will seek to increase their policy influence and irreversibility principally in those areas that are closely tied to their current mission, since to pursue goals beyond that mission would hurt perceptions of their legitimacy. They are also attentive to the reputation-based risks that could arise from failure to successfully implement or administer a new program; for that reason, agencies are frequently reluctant to accept new mandates that they feel they do not have the capacity to implement. For example, as shown in chapter 4, the SEC proved highly reluctant to seek additional authority to regulate the emerging over-the-counter derivative market during the early-to-mid-1990s in part because of a lack of resources and knowledge about these emerging markets (see also Faerman et al. 2001). Similarly, as I discuss in chapter 5, the SEC, which traditionally had been a “disclosure-enforcement” agency, proved reluctant to seek additional authority over large securities firms, authority which would have transformed it into more of a prudential (or ‘safety and soundness’) supervisor in the mould of its banking counterparts.

More specifically, I identify four types of strategies that agencies pursue to enhance or protect their autonomy and achieve their policy preferences. First, agencies engage in ‘transgovernmental’ or international inter-regulator collaboration. Such collaboration serves to boost their legitimacy by associating them with international ‘best practice’ standards and enabling them to portray their favored policy goals as representative of an international consensus. It also can serve to reset the domestic agenda, permanently shift the institutional decision-making forum to one more favorable to the agency, preempt rival agencies from entering into similar arrangements, and enhance their discretionary capacity, with knock-on effects on perceptions of their competence. Second, regulators will often initiate and direct collaborative efforts with private sector actors, efforts that range from the creation of formal, quasi-regulatory institutions to informal working groups. These efforts also allow regulators to pursue policy preferences under the appearance of apolitical efforts to formulate best practice standards, boosting the legitimacy of those positions. This legitimacy is further boosted by the co-option of potential critics in the private sector. Such efforts also serve to boost the agency’s knowledge and expertise without straining its resources. Third, agencies strategically alter their rhetoric, promoting greater discussion of the policy space in

Figure 2.8: Bureaucratic Strategies: Authority Enhancing Benefits

Strategic Response	Main Benefits
Transgovernmental Collaboration	<ul style="list-style-type: none"> <li>• Appearance of “global consensus”</li> <li>• Appearance that standards are “best practice”</li> <li>• Depoliticization</li> <li>• Can reset domestic agenda</li> <li>• Preempt collaboration by rivals</li> <li>• Can build capacity</li> </ul>
Public-Private Collaboration	<ul style="list-style-type: none"> <li>• Appearance that standards are “best practice”</li> <li>• Depoliticization</li> <li>• Cooption of private sector actors</li> <li>• Can build capacity</li> <li>• Attenuate accountability, particularly important if not a core competence</li> </ul>
Shifts in Public Rhetoric	<ul style="list-style-type: none"> <li>• Remind audiences of experience</li> <li>• Draw attention to specific or differentiated expertise</li> </ul>
Symbolic Shifts in Regulation and Enforcement	<ul style="list-style-type: none"> <li>• Highlight effectiveness or competency</li> <li>• Defuse criticism without conceding policy preferences</li> </ul>

which their authority is being contested in order to highlight its connection to their mission, background and expertise. Finally, agencies make *symbolic* changes in their discretionary rule making and enforcement behavior in order promote images of them as competent and protect their legitimacy. The specific benefits from each type of strategy are summarized in figure 2.8.

### 2.5.2 Identifying Transitions Between Periods of Contestation and Non-Contestation

Bureaucracies that already have uncontested authority in a policy domain are unlikely to be motivated to engage in these forms of strategic behavior, since their legitimacy is largely unquestioned and their reputation for competence already high. By contrast, as an organization’s authority becomes increasingly contested, it will have greater incentives to pursue these approaches. Therefore, empirically, we are only likely to observe such forms of strategic behavior when authority is *contested*. This presents a dilemma for this project. We are

concerned here with identifying the covariance between levels of autonomy and policy outcomes, with the theoretical assumption that high autonomy leads to policy outcomes closer to the agency's preferred policy preference. In order to make a causal connection, we need to observe the mechanisms through which bureaucratic authority is exerted (see section on research design below). However, by definition, these mechanisms are only visible during periods of contestation. How then do we know that authority is being exercised in periods of non-contestation if we cannot observe its exercise? Moreover, the issue of observational equivalence arises: a lack of open conflict could also be associated with an organization that possessed such little autonomy and/or was so completely captured as to not provoke any open conflict (owing to anticipated reactions or ideological capture; e.g. see Bachrach and Baratz 1962; Lukes 1974; Gaventa 1980).

These observational problems can, however, be largely overcome through over-time analysis that compares such eras of relative non-contestation to preceding or succeeding periods in which autonomy was more openly contested. These secular transitions inevitably require some subjective judgment to identify. These judgments include, for example, determinations about what constitutes 'persistent' criticism and which 'threats' to discretion are serious. Access to private transcripts of internal meetings or interviews with contemporary senior officials are useful ways to construct a narrative about internal perceptions of contestation and therefore help us identify the transition to these periods. While used where possible, as I have already discussed, there is limited access to these sources. Therefore, I rely largely on the public indicators of contestation from congressional and interest group statements, contemporary commentary in the business media and academic journals, and changed patterns of behavior by the agencies themselves to distinguish between periods of low or uncontested autonomy and contestation. This need to carefully identify these transitions is particularly important in the cases of financial reporting standards and capital rules for securities firms discussed later in this dissertation, since periods of non-contestation precede periods of contestation in both cases. By contrast, the problem is largely moot when there are obvious indicators of contestation. When multiple bureaucratic actors can claim to have a legitimate role and competency in the policymaking area, which will invariably happen when jurisdiction has been shared over a long period of time, then we can easily conclude that the agency's authority is contested. For example, in the case of bank capital regulation, contestation is apparent from the outset of the period under examination owing to long-standing, well-documented challenges by other bureaucracies or powerful groups to the authority of the agencies discussed.

### 2.5.3 Transgovernmental Collaboration

'Transgovernmental' collaboration between regulators has been described as the "defining feature of contemporary global governance" (Bach and Newman, 2010, 505). As Buthe and Mattli (2011, 21-22) define it, transgovernmental collaboration involves "public officials from



two or more countries, charged with similar tasks” who form “establish regular contacts directly with each other, without going through the traditional channels and political hierarchies of international diplomacy.” This form of cooperation, much of which is informal and reliant on agreement to common ‘principles’ and the creation of ‘best practice’ standards (Zaring, 2005, 548-549), is occurring across a wide range of issue dimensions (Epstein, 2002). However “nowhere is internationalization of administration more clear than in the area of financial regulation” (Zaring, 2005, 549). To an unusual degree, the financial industry is governed by a set of principles and soft rules informally agreed by national regulators, often in close consultation with private sector organizations. Regulators have increased their bilateral engagement with each other in order to increase harmonization between national standards, share information on ‘best practices’ (Drezner, 2007, 139), and enhance the quality of their enforcement efforts. They have also created a range of multilateral, regulator-centered organizations to help better coordinate these efforts and set common standards, such as the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO). The standards developed through these cooperative efforts have radically reshaped the governance of the global financial industry over the past quarter of a century, perhaps most notably in relation to capital adequacy standards for financial institutions.

Drawing upon the logic of the “two-level game” (Putnam, 1988)<sup>14</sup>, I contend that these institutions and agreements are largely a function of domestic political considerations. Specifically, when an agency’s authority is contested it is likely to engage in what I characterize as ‘give-and-take’ forms of transgovernmental collaboration (see chapter 3 for a more detailed explanation of these definitions). Why? Although benefits will vary from agreement-to-agreement, in general there are five main ways in which cooperation can enhance a regulator’s domestic authority. First, transgovernmental cooperation can bestow credibility and legitimacy both upon the agency and on its policy preferences in the eyes of domestic audiences. Cooperation agreements of this kind are typically presented to domestic audiences with the imprimatur of global ‘consensus’ (at least amongst developed nations) and/or as ‘best practice’ standards (Zaring, 2005, 531), both of which make it far more difficult for those lacking the appropriate technical expertise to question such judgments. It furthermore adds to the regulator’s reputation as being ‘cutting-edge’ and ‘competent,’ both of which can enhance its reputation for competence and expertise.

Second, cooperation helps to reconfigure the domestic agenda. An agreement at the in-

---

<sup>14</sup>In a two-level game, political leaders engage in international collaboration as a way of achieving policy outcomes that would be unattainable based on the current domestic political structure. This point is explained further in chapter 3. This motivation for transgovernmentalism also draws upon Schattschneider’s insight that there are multiple institutional “venues” in which political organizations can pursue their policy objectives. As Pierson (2004, 164) further explains, the presence of multiple venues means that “actors who are disadvantaged in one institutional venue often have incentives to pursue a shift in political activity to alternative venues.”

ternational level immediately constrains the range of agenda options by creating a dynamic in which the international policy must be approved or disapproved (this happened with the FDIC's proposal for a risk-based deposit insurance premium, which was quickly forgotten after the signing of the Basel I Accord; see Chapter 3). Of course, given that an internationally agreed upon policy can usually be framed as consensual and as best practice, the likelihood is that other actors will be induced to accept it. Third, if cooperation is iterative, it can permanently change the location in which decisions are made to one more favorable to the regulator (e.g. the Basel Committee or the International Accounting Standards Board (IASB)), thus attenuating political influence over policy in the future. Fourth, regulators may engage in cooperation to preempt similar attempts by rival governmental bodies or private entities. Finally, cooperation can build capacity, principally through the sharing of information and in improving enforcement (Raustiala, 2002). Both of these improve the agency's reputation as competent and effective, again enhancing its autonomy.

### 2.5.4 Public-Private Collaboration

Private sector organizations and initiatives have become increasingly ubiquitous in the governance of the financial sector, both at the domestic and international levels (Abbott and Snidal, 2009; Buthe and Mattli, 2011). Many of these organizations are purely private sector initiatives that, *post-hoc*, tend to receive a form of tacit licensing recognition by government agencies. However, a great many ostensibly private sector initiatives are, in fact, created by regulators and are shaped by ongoing agency collaboration (Faerman et al., 2001). There are a great many examples of such regulator-sponsored public-private collaborative efforts. At the domestic level, the Financial Accounting Standards Board (FASB) acts largely as an agent of the SEC, which retains jurisdictional authority over the setting of accounting standards. At the international level, the structure of both the IASB and the International Organization of Securities Commissions (IOSCO) both owe their creation to the SEC, which remains a key player in their governance structures. However, regulator sponsored public-private collaboration does not always lead to the creation of a free-standing organization. For example, the SEC and to a lesser degree, the Federal Reserve and CFTC, were instrumental in creating the less formalized Derivatives Policy Group (DPG) and its successor, the Counterparty Risk Management Policy Group (see chapter 5). Regulators may also informally sponsor and participate in certain private sector standard-setting organizations. A prime example of this is the Group of Thirty Consultative Group on International Economic and Monetary Affairs (G-30); current and former Federal Reserve officials were heavily represented within the Group, and the agency strongly endorsed its efforts to set standards regarding swap derivatives in the mid-1990s.

It may appear counterintuitive that an autonomy-seeking bureaucracy would choose to collaborate with private actors rather than impose new rules or, when such authority is lacking, lobby Congress for additional discretion. Yet there are logical incentives for autonomy-

seeking bureaucracies to engage in such collaboration. First, much as upward delegation in transgovernmental collaboration is often motivated by a desire to depoliticize policy, the decision to delegate to public-private initiatives is often about creating an image of technical, apolitical standard setting process. Since these regulators get to ‘stack-the-deck’ of such initiatives, their preferred policy outcomes are likely to be realized (though over the longer-term such organizations, as with most bureaucracies, may develop their own autonomy). In turn, this grants the legitimacy of best practice standards to their policy preferences and can help in setting the public policy agenda. Second, public-private cooperation, by definition, involves co-optation of private sector actors by regulators. This serves to blunt potential criticism from regulatees about the implementation of policy and thus strengthens the legitimacy of the agency’s role in the policy debate. While such collaboration could theoretically have the reverse co-optive effect – capture of regulators by regulatees – the bulk of empirical evidence that I present in later chapters does not support this conclusion, primarily because such initiatives typically come into existence owing to the sponsorship of a regulator and pursue policy goals that correlate with long-held agency preferences.

Third, public-private collaboration can improve the agency’s reputation for competence by building up capacity. Specifically, it can improve efficiency through specialization (Epstein and O’Halloran, 1999, 48) and can be an “effective substitute for the acquisition of expertise” (Alt and Alesina, 1996, 658). The decision by the SEC to delegate day-to-day oversight of the public accounting profession and standard setting to FASB has often been portrayed as an attempt to obtain these benefits in the face of limited resources (Buthe, 2010; Van Riper, 1994). Its decision to form the DPG, similarly permitted it to gather greater information about the OTC derivatives positions of securities dealers while averting the need to request consolidated supervisory authority from Congress (see Chapter 5). Finally, it is a way to increase autonomy while attenuating accountability for policy failures. This incentive is higher when the policy area that is outside the core competence of the agency (and therefore the likelihood of failure greater), would detract limited resources from implementing its core mission, and/or when autonomy is contested by competing bureaucracies. Under these circumstances, the risk of policy failure is high, as is the potential for antagonizing regulatory competitors. The SEC’s decision not to legislatively push for the authority to conduct prudential oversight of securities holding companies but rather create the DPG and the Consolidated Supervised Entity (CSE) program typifies this cautious approach to autonomy expansion (detailed in Chapter 5). By weakening the accountability link to the agency, it can protect its policy legitimacy and reputation for competency in the case of policy failures.

### **2.5.5 Other Strategic Responses to Contestation**

Contestation may also lead agencies to modify their behavior in other ways. Given our assumption that authority rests on images or reputations of legitimacy and competency, we

would expect to observe changes in the rhetoric of agencies (Carpenter, 2010b, 833). Criticism by Members of Congress, groups, or the media will lead to modifications in the agency's public presentation of its position. Rhetorical changes do not imply changes in policy positions, but rather imply that agencies give greater prominence to the policies in their public communications, and draw the attention of audiences to their experience or expertise on the subject. Carpenter (2010b) finds, for example, that Federal Reserve officials began to promote the agency's consumer protection work during the financial reform debate owing to criticism of its oversight failures in the run-up to the 2008 crisis and the threat to its supervisory function posed by the potential creation of a new, powerful consumer-protection agency<sup>15</sup>. Similarly, the Federal Reserve, which had largely been silent on revisions to liquidity standards for banks, began to discuss the importance of reserve (liquidity) requirements to its broader mission and promoted its efforts to reach agreement on a set of global standards in the forthcoming Basel III negotiations. This followed criticism that existing requirements had contributed collapse of several financial institutions, most prominently Lehman Brothers (see chapter 4).

An agency may also make 'symbolic' changes in its discretionary behavior; that is, they may make modifications to regulations or alter their enforcement behavior in a way that reasserts its legitimacy and reputation for competency. Such changes are, in effect, extensions of the rhetorical shifts the agency may make in response to contestation (Carpenter, 2010b, 834) and do not represent shifts in underlying policy objectives. For example, an agency that has been subject to criticism that it has failed to enforce a provision of the law vigorously may decide to increase its announced enforcement actions for a period of time in order to reinforce images of its effectiveness and competency as an organization. Bureaucracies may also respond to contestation by making temporary shifts in policy. The SEC, for example, eased the requirements of its "fair-value" accounting rule – which requires publicly traded companies to record asset values at current market rates – following vigorous criticism by banking groups and the Federal Reserve, as well as threats to alter the rule legislatively by Members of Congress (Grim, 2009; Nolke, 2010)<sup>16</sup>. However, the SEC ultimately refused to suspend the rule that despite this pressure and the substantive changes it made to it were widely considered to be minor (Sanati, 2009).

---

<sup>15</sup>That agency – the Consumer Financial Protection Bureau (CFPB) – was ultimately created under the Dodd-Frank Wall Street Reform Act. The CFPB is technically a bureau within the Federal Reserve but the Board has no authority over it.

<sup>16</sup>The concern was that the rule could force many publicly traded banks into insolvency. See chapter 6 for more on this episode.

## 2.6 Research Design and Methodology

### Design

In terms of design, this study assesses covariation between the independent variable – levels of autonomy (which in turn is comprised of independent preferences and authority) - and the dependent variable – policy outcomes. In order to demonstrate the causal link between these variables, it also seeks to identify processes and causal mechanisms in the form of bureaucratic strategic behavior that occurs under conditions of authority contestation<sup>17</sup>. It does so both within and across its units of analysis – bureaucratic agencies, legislators, interest groups - both synchronically (at specific times) and diachronically (that is over time). In quantitative studies, this approach would be labelled as being a “hierarchical time series” analysis; given the qualitative nature of this study, it may be better characterized as being “comparative-historical” (Gerring, 2004, 343) or a “narrative panel analysis” as Carpenter (2001a, 35) characterizes it. It is furthermore important to note that this project takes a “mid-range” theory approach; it examines a limited range of cases that are unified within a broad policy space, in this case financial policymaking in the United States, and over a discrete period of time, one that begins as the banking and securities begin to experience significant structural change in the late-1970s. As such, and in contrast to classic rational-choice designs, this project does not make “universal” claims about the role of bureaucracies, though it does identify many of the key criteria necessary for bureaucracies to possess independent authority (that is, ‘autonomy’) and many of the common strategies that they adopt to protect or advance their authority<sup>18</sup>. The fact that this study is bound in scope and time allows us to reasonably assume causal homogeneity; that is “the assumption that, other things being equal, a given set of values for the explanatory variable always produces the same expected value for the dependent variables within a given set of cases” (Seawright and Gerring, 2008, 296). By adopting a ‘process-tracing’ account and thereby identifying not only outcomes but the detailed causal processes that led to them, we can be furthermore confident that the causal homogeneity condition has been met (Munck, 2004, 110).

### Temporal Analysis and Path Dependence

The over-time analysis in this project is perhaps its most important methodological feature for a number of reasons. First, as discussed previously, an over-time analysis can help us overcome observational problems inherent in identifying transitions between periods of non-contestation and periods in which autonomy was more openly contested. Second, temporal analysis aids in the identification of preferences by better positioning us to observe the se-

---

<sup>17</sup>In this way, “strategies” represent an “intervening variable” in this study.

<sup>18</sup>See Thelen (1999, 373) for a more in-depth discussion of the traditional differences in causal scope between rational-choice and historical institutionalist scholars.

quencing of public support or opposition to a policy. That is, when a regulatory agency (or senior officials thereof) make statements that *precede* those of other key actors, such as a trade association or another regulator, we can be more confident that its preferences were arrived at independently. Moreover, since consistency in preferences is also an important indicator of independence, it is vital that we examine policy statements over a significant period of time; if views were to change drastically, for example, with a change of leadership, that would be a strong indicator that the agency lacked the ability to form its own independent preferences in a manner consistent with a long-standing mission and distinct competency. By contrast, an agency that held clear policy preferences from an early stage of a debate and that remained consistent most likely had formed those preferences independently. Finally, an over-time analysis helps us determine if there are or are not noticeable shifts in the intensity of preferences over time, another key indicator of independence.

Temporal analysis helps us furthermore establish relationships between sequences of events. One of the key insights in this project is that regulators pursue strategies designed to bolster and enlarge their authority not just in the short-term, but with a view to the long-term; in other words, they are capable of behaving in a strategic and not simply a tactical manner. This means that agencies adopt strategies designed to create ‘self-reinforcement’ or ‘positive feedback’ loops that lead to path dependence (Pierson, 2004). A prime example of this is international collaboration on capital standards via the Basel Committee; by successfully establishing a precedent that decision-making on capital issues occur via that body, it helped to dramatically alter the incentives and expectations for domestic actors in future debates. Indeed, by the time the FRB proposed radical changes to capital standards in the mid-to-late 1990s, there was little domestic challenge to the now widely accepted notion that changes would be made first and foremost using the Basel institutional framework. These path dependent dynamics can be seen not just in institutional development, but also in power relationships (Pierson, 2013). The Basel Accord sent a powerful signal to other actors that the international community endorsed the FRB’s approach to risk-based capital standards; it shifted the arena permanently to one in which that agency was significantly more powerful; and it marginalized those, such as the FDIC, who had opposed risk-based standards.

On the issue of over-the-counter (OTC) derivatives, the Federal Reserve also sought to weaken potential proponents of regulation, ensuring at an early stage that its regulatory opponents remained divided and were deprived of political resources, while also promoting its vision as part of an international consensus, the goal of which was to marginalize opposing views. By the mid-1990s, these efforts – amongst others – had created a “spiral of silence” (Noelle-Neumann 1974; see Pierson 2013, 10)<sup>19</sup> where outright advocacy for regula-

---

<sup>19</sup>As originally formulated, this term was applied to the need for social conformity, however the logic here is similar: it becomes more costly to express views on the subject as a set of views become more widespread. See Pierson (2013, 10) for a fuller explanation.

tion – such as that briefly adopted by the CFTC in 1998 – was not tolerated. Conversely, in Chapter 5, I show that the SEC’s missed opportunity to seek consolidated supervisory jurisdiction during a period in which its authority was largely unchallenged created a *negative* feedback dynamic. For example, it meant that the the SEC had no incentive to build the expertise necessary to conduct such supervision, nor was it in a position to compel the major investment banks to share information about their emerging derivatives activities. Without the experience of conducting prudential oversight, few could conceive of the agency as a possible consolidated supervisor. These dynamics ultimately contributed to its loss of authority as the primary regulator of major securities firms. Its actions over-time also had a path-dependent ‘signaling’ effect (Pierson, 2013, 9). As time went on, the SEC’s increasing willingness to relax its regulatory standards sent signals that its influence was waning, which may have emboldened the major investment banks to push the agency further towards their policy preferences; in short, this represents a negative colliery of the “victory as a signal” hypothesis put forward by Pierson (2013, 9). In sum, these positive and negative feedback dynamics can only be identified by examining over-time sequencing of events.

The importance of path dependent power dynamics also informs this study’s focus on earlier, rather than later, policy episodes. Specifically, events or decisions that may have appeared of minor significance at the time often have an outsized impact on later developments by foreclosing certain options over others (Pierson, 2004). For example, the decision by the Federal Reserve to adopt a risk-based approach to calculating bank capital in the 1950s, a decision with little real-world impact over the proceeding two decades, powerfully shaped its preferences in critical later debates. In another instance, the fact that formal capital standards had been introduced prior to the FDIC’s proposal for risk-based deposit insurance reduced the likelihood of the latter proposal succeeding, simply because of the investments made in supervisory regimes focused on capital adequacy. The decision to permit futures exchanges to trade OTC derivatives in 1992 – a little noticed change – cleaved that group away from the CFTC in policy debates two years later. The opposition of the SEC to international capital standards for securities firms in the early 1990s proved a missed opportunity, since it made it more difficult for it to later gain consolidated oversight authority over the derivatives-trading special-purpose vehicles of broker-dealers. By contrast, later episodes, while often attracting more attention, frequently serve to highlight a power or institutional dynamic that has already long been in place. For example, the 1998 debate over the CFTC’s ‘concept release,’ which proposed regulating classes of OTC derivatives, underscored the by-then politically dominant position of the Federal Reserve, its allies, and their opposition to regulation. Therefore, our focus must be on “a series of occurrences or events,” particularly early events, rather than simply “a set of relations between variables” in a single episode (Mohr, 1982, 54) if we are to truly understand authority dynamics and patterns of contestation.

### Counterfactual Reasoning

Complimental to the temporal and sequencing approaches adopted in this study, I also make implicit use of counterfactual reasoning. As de Mesquita (1996, 229) argues, “we cannot understand what happened in reality without understanding what did not happen but might have happened under other circumstances.” Indeed counterfactual logics are central to theory development and the generation of causal inference in the social sciences, though their use is often implicit (Fearon, 1991). A counterfactual can be defined as a “subjective conditional in which the antecedent is known or supposed for purposes of argument to be false” (Tetlock and Belkin, 1996, 4). Put more simply, a counterfactual is carefully constructed thought experiment in which the researcher specifies conditions under which the absence (or modification) of cause X would have produced an outcome different to the observed Y. In this study, I consistently consider how the mechanisms or outcomes would have logically looked a) in the absence of an autonomous bureaucracy and b) under conditions in which the functionalist, structural, or congressional dominance theories held true<sup>20</sup>.

### Case Selection and Generalizability

The ‘cases’ in this study refer to the policy spaces in which different configurations of bureaucratic, as well as other political and societal, actors seek to influence. Specifically, the development of policy in each of these areas is considered a ‘case’ for the purposes of this study: bank capital rules; over-the-counter (OTC) derivatives regulation; and policy relating to the supervision and capital requirements of securities holding companies. Given the small-N, a random selection strategy would have almost certainly produced biased results that may have yielded cases with only extreme values of the independent variable Seawright and Gerring (2008, 295)<sup>21</sup>. The cases were therefore purposively selected to maximize variation on the independent variable, a case method that approximates the “diverse” case strategy outlined by Seawright and Gerring (2008, 300-301).

These variations are both intra-case and across cases. In terms of in-case variation, we often observe differences in the degree of autonomy amongst bureaucracies operating within the given policy space. More important, even when the case study focuses on a single

---

<sup>20</sup>This counterfactual approach bears similarity to that adopted by Carpenter (2001a, 35). It should be noted, however, that the use of counterfactual reasoning has been criticized. For an overview of this debate, see Morgan and Winship (2007).

<sup>21</sup>For example, random selection of just five cases might produce extreme values on the dependent variable, e.g. only producing cases in which autonomy levels are high. Aside from the bias this would create, it would also create two practical problems in this study: we would be unable to observe the strategic reactions of agencies to authority contestation and, even more profoundly in this example, we actually would not be able to observe the state of high autonomy, since we would be unable to observe periods of authority contestation.



bureaucratic actor, there is significant variance in the authority that the agency possesses over time. Second, there is important variation between the cases. Specifically, there is variance in the explanatory variable of autonomy. In the case of supervision and capital standards for securities holding companies, the autonomy of the SEC is high during portions of the period under examination. In the OTC derivatives case, one actor – the CFTC – possesses low levels of autonomy, based both on its lack of preference independence and authority. In the remaining cases, the bureaucratic actors' authority is contested to varying degrees but their preferences largely independent, thus representing a median between the extreme values of the explanatory variable observed in the other cases. By choosing a range of cases that display a full range of variation, we are likely to enhance the representativeness of the sample of cases and therefore the generalizability of the theory presented here (Gerring, 2008).

# 3 | Capital Adequacy and the Contested Authority of the Federal Reserve

## 3.1 Introduction

Capital adequacy has, by most estimates, become *the* defining prudential regulatory tool for bank supervisors across the globe. Similarly, there is now universal acceptance of the idea that the adequacy of bank capital should be assessed relative to the *risk* that the value of its assets will decline owing to debtor default. However, few would have predicted these outcomes in the late 1970s. Capital had traditionally been just one of many informal, qualitative assessment tools used by the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) examiners in the United States to measure the health of banks; it had no basis in law. Moreover, in this regard, the United States was fairly unusual; just three other major industrialized countries used capital guidelines as a metric to assess bank safety and soundness until 1979. The idea of linking capital adequacy to asset risk had been pioneered by the FRB in the 1950s but was largely ignored by the other two major regulators and virtually unheard of internationally.

Not coincidentally, the 1970s and 1980s were periods in which the supervisory authority of the main advocate for a stand-alone, risk based standard – the FRB – was severely contested. The Reagan administration, Congress, industry trade associations, and both the OCC and FDIC tried on various occasions to strip the agency of all or most of its jurisdiction over Bank Holding Company (BHC)’s and state-member banks of the Federal Reserve System. Its authority was equally as contested on the narrower issue of capital adequacy. Its attempts to establish capital as a standalone, quantitative ratio were resisted by the two other regulators throughout the late 1970s and early 1980s, given the preferences of both for more qualitative-oriented evidence derived from on-site examinations. Likewise, when it sought to establish in law its long-standing supervisory practice of evaluating the risk of bank assets in determining capital adequacy, the FDIC, OCC, and the major trade associations all fought the FRB vigorously, while many in Congress expressed support for the FDIC’s plan for an alternative, risk-based bank insurance premium.

The FRB responded first through strategic use of rhetoric. By connecting its bank su-

pervisory mission to its largely uncontested monetary policy function, it forestalled efforts to remove its regulatory authority. It similarly leveraged its political legitimacy to successfully establish capital standards as a stand-alone metric with regulatory force, part of a broader effort to deemphasize on-site examinations as a prudential tool. Most importantly, it used a transgovernmental body comprised principally of fellow central bankers – the Basel Committee on Banking Supervision – to advance its objective of establishing a uniform risk weighted asset (RWA) standard. By doing so, it permanently shifted the locus of decision-making on capital adequacy to that body. This fact, combined with the policy effects of the first Basel Accord, created a path dependency that effectively empowered the FRB in subsequent debates and allowed it to successfully advocate for a new regime for assessing risk based on proprietary internal bank models. In short, the contemporary centrality of capital adequacy in the global financial regulatory architecture, as well as its reliance on asset risk assessment, owe much to the preferences and strategic actions of a single U.S. federal agency – the FRB – actions which, in turn, were shaped by the fact that its authority was contested. Moreover, the apparent independence of preferences and expansion of authority documented here clearly indicate that the FRB possessed significant *bureaucratic autonomy*.

After the brief primer on capital below, this chapter discusses these developments. It first examines the history of capital adequacy standards in the United States and the preferences of the major banking regulators before turning to episodes that illustrate the contested authority of the FRB in the early 1980s, with a particular focus on the conflicts surrounding Vice President Bush’s Task Group on the Regulation of Financial Services. The rest of the chapter focuses primarily on how the FRB strategically advanced its policy preferences on the issue of capital adequacy in the face of contestation, first examining its efforts to establish common capital standards and later its campaign to have such standards calculated on the basis of risk-weighted assets. In particular, the chapter examines its successful battle against the FDIC’s competing risk-based insurance proposal and its attempts to move the regulatory regime away from on-site CAMEL examinations. The rest of the chapter focuses on the FRB’s role in the first Basel Accord and the subsequent impact of that agreement on the Basel II negotiations.

### 3.2 Capital Adequacy: A Brief Primer

A firm’s capital may be defined as “the portion of its assets which have no associated contractual commitment for repayment” (Elliott, 2010b, 1), that is, reserves of fairly liquid assets that do not need to be repaid and can be used to pay creditors in the event of unexpected losses. To use a simple analogy, a firm’s capital in its purest form bears some similarities to “money under the mattress” that can be used to pay costs arising from unforeseen events (Singer, 2007, 16). Maintaining sufficient levels of capital is important for *any* corporation. Capital provides a buffer against a firm’s losses, reducing the risk of insolvency (and potentially bankruptcy) that might occur upon an unexpected loss. It also offers greater

protection to creditors in the event that the institution does collapse, increasing the chances that they will be able to recoup their investments. Finally, most scholars and investors believe that the incentives for engaging in excessive risk-taking are attenuated in firms with strong levels of capitalization (Tarullo, 2008; Santos, 2001). On the other hand, there is a cost to holding capital: capital that is retained by a firm is money not being utilized for productive investment and therefore profit. As such, despite the risk-attenuating benefits of being adequately capitalized, there are strong incentives for corporate executives to seek to minimize their firm's capital levels (Tarullo, 2008, 18).

Despite these incentives capital levels of firms in most industries are not subject to government oversight and regulation. The decision to regulate bank capital levels has been justified on the basis of additional prudential conditions that uniquely pertain to financial institutions. First, whether as insurer of deposits or lender of last resort, the government is potentially the largest creditor of the bank and therefore has a strong financial interest in maintaining the bank's continued solvency and forcing shareholders to absorb losses in the event of a bank's failure (Maisel, 1981). Second, the perception that the government will "bail-out" large financial firms and the public guarantee of deposits reduces the market discipline that would otherwise compel firms to hold capital (Demirguc-Kunt and Kane, 2002). Third, market discipline is also weak because the asymmetry of information between those running banks and those investing in them is far higher than for most corporations, since bank "assets are notoriously difficult for outsiders to evaluate" (Tarullo, 2008, 19). Finally, the collapse of a financial institution can produce broad systemic risks to the economy (Singer, 2007, 17). Thus there is a strong theoretical case for some form of government involvement in setting the capital levels of financial firms. The nature of that involvement and the criteria it uses to set such standards are, of course, matters of considerable debate.

In short, these debates revolve around two issues: what constitutes capital and how much capital a bank should be required to hold. Common stock – that is the money invested in the company by its owners through the purchase of shares – is widely considered 'purest' form of capital since there is no requirement to pay it back, no legal obligation to pay interest to shareholders, and since it has the lowest priority for repayment in the event of bankruptcy, i.e. all of the bank's depositors and creditors must be repaid first (Elliott, 2010b, 3). Beyond common stock, however, there is widespread disagreement over what counts as "capital" and, equally as important, how much of it a bank should hold (Norton, 1988-1989, 1302). For example, "preferred stock," which, like a loan made by a creditor, has a fixed claim on the assets of the company and entails an agreed dividend rate (much like the interest rate on a loan) is nevertheless often counted as capital by regulators because of its low repayment priority in bankruptcies and the minimal penalties entailed for failing to pay dividends. However much depends on when, if ever, the bank must repay the preferred stock holders' investment and other specific terms of the preferred stock agreement (Elliott, 2010b, 3).

Definitions of capital become infinitely more complicated and contested thereafter. For example, certain forms of debt resemble preferred stock and are therefore sometimes counted

as capital. Long-term “subordinated” debt instruments may fall into this category, since they have a lower claim on bank assets in the event of bankruptcy than any other form of debt (hence they are “subordinated” to debt that is “senior”) and have long or even perpetual life terms, meaning that they either have a maturity date far in the future or no maturity date at all. How “equity like” these loans are depends on the time period for repayment and whether interest can be deferred under some circumstances, and there is little consensus on where those lines should be drawn (see Evanoff and Wall 2000). Finally, certain accounting reserves, such as “loan loss reserves” sometimes count as capital. These reserves are liabilities placed on a firm’s balance sheet and usually reflect the *expectation* of losses on a *specific* loan or investment. Since capital is ultimately a buffer against the possibility of *unexpected* losses resulting from, say, a financial downturn, the inclusion of such reserves in regulatory capital requirements depends on the generality of the risks against which they are designed to protect (Elliott, 2010b, 5).

There are also widely varying views on how much capital a bank should hold, disputes that are at the heart of the conflicts discussed in this chapter. As Norton (1988-1989, 1309) notes, “capital is a meaningless concept except as it relates to such other factors as institutional size or type, or to elements of the bank balance sheet susceptible to causing sudden or sustained losses. In this sense... the notion of capital is relational.” Therefore, there have been vigorous debates over the relevant baseline for determining appropriate capital levels. Should capital be determined with reference to the total assets of bank? Should it instead take into account the riskiness of some assets, allowing banks to hold less capital against low-risk assets (such as U.S. Treasuries) and forcing them to keep greater amounts of capital against riskier investments? And if so, how and who determines which assets are “riskier” than others? Similarly, regulators, legislators, interest groups, and commentators have debated whether capital ratios should be a standalone, primary measure of bank health, or whether they should they be taken into account as part of more holistic measures of performance and risk. They have also frequently clashed over the treatment of different types of banks. For example, should large multinational institutions be treated differently to small community banks and if so how? In sum, given the opportunity cost of holding capital both for firms and for the economy as a whole, combined with the ambiguous definition of capital and the disputed baseline for determining adequacy, it is perhaps unsurprising that conflicts over capital have been amongst the most important and contentious in U.S. financial regulation over the past forty years.

### 3.3 The Divergent Bureaucratic Approaches to Capital Adequacy Standards

Despite the preceding discussion and the contemporary fact that capital standards are the principal form of banking regulation internationally (Wood, 2005; Singer, 2007; Tarullo,

2008), it is notable that most developed countries – including the United States – did not impose rules mandating minimum capital levels until the 1980s (Norton, 1995). Instead, as Norton (1988-1989, 1316) notes, the regulatory interest in capital standards “was largely internalized in non rule-oriented examination of supervisory practices of the U.S. bank regulators.” Therefore capital levels were simply one of several internal metrics used by bank examiners to assess the health of depository institutions. During the post-war era, the three principal banking regulators – the OCC, the FDIC, and the FRB – began to experiment with different, non-rule based capital standards. Both the OCC and the FRB focused on the ratio of capital to risk-assets, which were defined rather simply as total assets less cash and government securities. By contrast, the FDIC developed a standard that relied on a ratio of capital-to-total assets, a standard that today is more commonly known as a “leverage ratio.” During the 1950s, the FRB began to refine this approach, assigning risk weights to categories of assets in calculating the capital ratio, a forerunner of the RWA approach for which it would later become the leading advocate (Orgler and Wolkowitz, 1976; Hempel, 1976)<sup>1</sup>. In 1972 the FRB further refined these categories (Norton, 1988-1989, 1317). By contrast, the FDIC continued to informally employ a leverage ratio (with “capital” based almost exclusively on common equity) as one test amongst many it used to evaluate risk, while the OCC actually “disclaimed a reliance on capital ratios until 1971” and even then made clear that they were “only a helpful indicator of potential problems at national banks” (Tarullo, 2008, 30).

A number of important points should be noted about these divergent approaches to capital adequacy. First, prior to the 1970s, the FDIC’s and OCC’s supervisory treatment of bank capital had far greater practical impact than the approach used by FRB supervisors. This owed to the fact that the FRB was only the primary regulator for the relatively small number of state banks that were members of the Federal Reserve System and that were also not insured by the FDIC; indeed, in 1970 the FRB only regulated 1166 state-chartered banks with assets of \$117 million compared to the 13,478 banks with combined assets of \$526 billion overseen by the FDIC (Norton, 1988-1989, 1318). It was only when the Bank Holding Company (BHC) form of bank ownership became increasingly dominant in the 1970s<sup>2</sup> that the Federal Reserve’s influence over bank regulation also began to increase<sup>3</sup>. As a result of this, the views of the other two agencies – both of which were reluctant to elevate capital adequacy above other measures of bank risk – tended to predominate in policymaking discussions over the issue prior to the 1980s. Most importantly, when Congress established the

---

<sup>1</sup>The Federal Reserve District Bank of New York originally developed the risk asset-based approach. In 1956, the FRB broadly adopted this methodology. See Norton (1988-1989, 1317).

<sup>2</sup>The FRB was made the primary regulator of holding companies under the 1956 Bank Holding Company Act.

<sup>3</sup>By 1987, for example, there were 6,600 BHCs controlling assets of \$1,800 billion. See Norton (1988-1989, 1318).

Federal Financial Institutions Examination Council (FFIEC) in 1978 to harmonize supervisory guidelines<sup>4</sup>, the preferences of both the OCC and FDIC for a holistic approach that attributed equal weight to other factors such as quality of management and earnings, won out over the Federal Reserve's desire for a rules-based capital standard. The result was the establishment of the *Uniform Interagency Bank Rating System*, more commonly known as "CAMEL," a system that in many ways would conflict with the FRB's desire to place RWA capital standards at the heart of banking regulation<sup>5</sup>.

Second, the FRB was invested from the 1950s onwards in the idea a) of a stand-alone capital ratio and b) that the ratio should be based on a risk-weighted capital adequacy approach. As a result, there were "increasing returns" from continuing to use this system. For example, for decades the Board's supervisory staff were required to use the RWA approach when evaluating the health of depository institutions, meaning that self-perpetuating learning effects were occurring and increasing the cost of shifting to an alternative model. Moreover, the positive feedback effects of this approach created a path dependency in the collective understandings or beliefs about capital adequacy within the FRB; indeed, at least one study of bank examiners from the three agencies noted that Board examiners saw capital and risk-weighting as more central to their assessments than those from the other two regulators (Khademian, 1996). Therefore the RWA approach came to be part of the agency's beliefs about its distinctive competency; it also came to be associated with it by other members of the policy community for many years before the issue of rules-based capital standards became a topic of discussion (e.g. a 1980 trade journal article noted industry representatives referring to the FRB's long history of using the risk approach. See *American Banker* 1980). The RWA was also closely associated with the broader sense within the agency that its supervisory policies were methodologically superior to those adopted by the other regulators, and its belief that quantitative, stand-alone metrics were superior to the "qualitative judgments" preferred by the OCC and, in particular, the FDIC (Volcker, 1984).

By contrast, the OCC and FDIC preferences for a more holistic approach reflected their own distinct experiences and expertise. The OCC had invested heavily in developing the forerunner to the CAMEL system in the 1970s and thus increasing returns dynamics made it reluctant to embrace a separate capital-focused regime. More fundamentally, OCC examiners traditionally "have exercised significant discretion in the field" and the agency has prioritized the "independent judgment of the field examiner," a discretion that is designed to achieve flexibility in the implementation of rules in order to balance competing demands of risk-attenuation and ensuring competitiveness (Khademian, 1995, 45). The FDIC has also long emphasized on-site bank examinations and the bank examiner profession has tradition-

---

<sup>4</sup>The FFIEC's membership consisted of the heads of the three major banking regulators.

<sup>5</sup>CAMEL is an acronym that stands for a bank's capital adequacy (C), asset quality (A), management skills (M), earnings (E), and liquidity (L). Banks rated 1 are considered to be at the lowest risk of insolvency; banks rated at 5 are considered to be at the highest risk.

ally dominated the agency. In contrast to the OCC, however, this focus on holistic, on-site examinations was not about encouraging flexibility but ensuring that supervision was thorough and all risks were properly identified. Thus for different reasons there was a preference for a regime that placed greater weight on on-site, case-specific bank examination findings over standardized and inflexible metrics.

This preference for a holistic approach was further reinforced by the differences in expertise and methodological backgrounds between the staffs of the three agencies. The clout and dominance of professional examiners within the OCC and FDIC contrasted with the ubiquity of economics-trained financial analysts within the FRB's banking and supervision division. As such, the OCC and to a lesser degree the FDIC were not only disinclined to favor a formal ratio that would deemphasize the qualitative judgments of examiners, they were also lacked much of the capacity to implement the more technically sophisticated approach advocated by the FRB. In later disputes over capital adequacy standards, these distinctive competences of each agency continued to shape their policy preferences in important ways, with each favoring policies that reflected its own unique experience and expertise.

Third, each agency's preferences closely aligned with their mission objectives. The Federal Reserve's *principal* mission, as expressed in a 1984 article written by then Chairman Paul A. Volcker, was to "assure stable and smoothly functioning financial and payments system." This mission was to be fulfilled by a) ensuring the safety and reliability of funds transfers amongst banks and others on a day-to-day basis, b) providing the ultimate source of liquidity to the economy through the mechanism of the discount window, and c) regulating and supervising key sectors of the financial markets, both domestic and international (Volcker, 1984, 548). The Federal Reserve also has a second, monetary policy focused mission, with its dual objectives of maximizing employment (and hence economic growth) while controlling inflation. Thus, in short, the Board is concerned both with ensuring that the financial system remains stable and maximizing non-inflationary economic growth.

From the 1970s onwards, capital standards became the central tool for ensuring the safety and reliability of fund transfers between banks (the payments system) and thus became increasingly vital to ensuring financial stability, one of the Federal Reserve's mission objectives. As Volcker noted, ensuring appropriate levels of capital and liquidity was vital if the banking system were to be able to "absorb shocks originating inside or outside the banking system and respond effectively to monetary policy decisions," specifically decisions to stimulate the economy through the lowering of interest rates (Volcker, 1984, 547). In short, capital requirements were an essential part of the Federal Reserve's mission of promoting growth and stability. Risk-weighted standards, in the view of the FRB, were superior to leverage ratios since a well-designed risk-based system increases the stability enhancing benefits of capital by providing a disincentive for banks to invest in riskier assets. At the same time it also has the potential to improve capital efficiency; that is, a bank with safer assets would not need to hold as much capital, freeing those funds for additional credit provision in the economy, thus boosting growth. As such, an RWA approach is – at least in theory – consistent with



the dual goals of stability and economic growth.

The opposition of the OCC to formal standards, by contrast, had much to do with its own dual mandate: to promote “safety and soundness” but also to ensure that national banks remained competitive with state banks. In contrast to the FRB and the FDIC, the OCC must to some extent ‘compete’ with the states for chartering ‘business’ and its policy preferences thus often reflect the competitiveness concerns of its regulatees (Carron, 1984, 16)<sup>6</sup>. As a result, the OCC favored a system that promoted flexibility and discretion in order to allow it to better address competitiveness concerns. Although the FDIC also favored the CAMEL approach and was reticent to embrace a rules-based standard, it was more open to the idea of using a capital ratio in its supervisory guidelines than the OCC. However, its choice of standard – the leverage ratio – was in practice often more conservative than the RWA approach, as was its emphasis on the idea that capital only constituted “equity capital” (Norton, 1988-1989, 1323)<sup>7</sup>. This reflected its mission of protecting the Bank Insurance Fund at all costs (see Khademian 1995, 1996). Echoing this point, Palsey (1990, 283) observes that while “the FDIC has supervisory and regulatory responsibility over state nonmember banks [it] views insurance protection as its primary goal” and as a result “has a tendency to be too cautious and overly concerned about the risks a bank may take.” Indeed, this relatively conservative approach to risk was reflected in subsequent debates about capital adequacy in the 1980s (Norton, 1988-1989, 1323) and evident in the debates surrounding the Basel II and III agreements (see later).

### 3.4 The Contested Role of the Federal Reserve

The FRB was the principal driver of the post-1980 changes in the U.S. capital adequacy regime, changes that transformed capital from one of several, informal supervisory indicators into globally binding set of rules that are now widely seen to be at the very core of modern banking regulation. However, in the 1970s and early 1980s, such an outcome appeared unlikely. The FRB’s authority was subjected to a series of assaults from other key actors in the policy community, not only on the issue of capital standards but even more fundamentally with regard to its continued role as a regulator and supervisor of the banking industry. These threats emanated from an often coordinated assemblage of actors: the FDIC and the OCC, congressional committees, the administration, and the major banking trade groups,

---

<sup>6</sup>As a result of this and other factors, the OCC should be thought of as somewhat closer to the typology of a “captured” agency than either the FRB or the FDIC.

<sup>7</sup>Equity capital refers to common stock and a variety of other equity-like instruments such as perpetual preferred stock, capital surpluses, undivided or retained profits, contingency and other capital reserves, and reserves for debt losses. Other instruments, such as subordinated notes, which the FRB and OCC included in their definition of capital are not available to absorb losses except in an actual liquidation and required banks to make mandatory interest payments. See Norton (1988-1989, 1323) for more.

particularly those dominated by large asset banks such as the American Bankers Association (ABA) and the Association of Bank Holding Companies (ABHC). The FRB responded to these threats in three principal ways. First, it used public and private rhetoric to evoke the connection between its largely uncontested monetary policy function and its supervisory role in effort to boost its legitimacy. Second, it threatened to withdraw its much need support for bank deregulation legislation unless the administration and major trade organizations desisted from their campaign to strip it of its supervisory role. Finally, and most important, it pursued an ambitious transgovernmental collaboration effort designed to raise capital standards to a position of predominance within the U.S. regulatory schema. This was an effort that was designed to bolster its own legitimacy as a banking regulator, improve images of its competency by presenting the agency's approach as "cutting edge" and "best practice," and circumvent domestic opponents by resetting the agenda. As a result of these strategic actions, together with the growing trend of banks to form themselves into BHCs, the FRB went from the poor relation amongst bank supervisors to *primus inter pares*.

Contestation between the three major regulators had a long history dating back to the 1920s and 1930s (Robertson, 1968, 116). The 1960s and 1970s in particular were marked by sustained disputes between the FRB and the OCC. As Pasley (1990, 285-287) notes, the OCC was intent on pursuing a liberalization agenda that brought it into constant conflict with the FRB. In addition to proposing that national banks be able to invest in corporate securities and underwrite municipal bonds, the OCC, as aforementioned, was also committed to a policy of deemphasizing capital requirements, a commitment that was widely viewed as part of this broader liberalization agenda (Robertson, 1968). In the 1970s, there was a growing breakdown in communication between the agencies, with the OCC in particular refusing to share information it had collected in its bank examinations with the other two agencies. Indeed, the collapse of Franklin National Bank and Trust in 1974 was in part attributed the OCC's failure to share information about problem banks with the FRB and FDIC, both of whom would have been a position to provide financial assistance to keep Franklin afloat (Carron, 1984).

These conflicts, amongst others, contributed to a torrent of congressional commissions, reports, and legislation that sought to streamline and consolidate the functions of the three principal banking regulators between the early 1970s and mid-1980s. Despite evidence of regulatory failures at the OCC, it was still the primary regulator of almost all large asset banks during this era, in contrast to the FRB, which was still only the primary regulator of the comparatively small number of BHCs<sup>8</sup>. This fact was reflected in the reports and legislation that emerged. Indeed, in the 1970s three major initiatives recommended a reduction in

---

<sup>8</sup>The FRB also had authority to inspect national banks, since they were automatically members of the Federal Reserve System, though it did not have the direct power to make regulations affecting their activities. The FRB also had the same authority with respect to state banks that had opted to become members of the Reserve System.

or complete transfer of the Federal Reserve's discretionary authority over bank supervision. The President's Commission on Financial Structure and Regulation, more commonly known as the Hunt Commission, would have allowed the Federal Reserve to retain supervisory authority over BHCs, but stripped it of its other supervisory functions. In 1975, various Senate Banking Committee papers and the House-sponsored Financial Institutions and the Nation's Economy (FINE) study recommended that the Federal Reserve's supervisory functions be transferred to a new regulator, in the former case to the FDIC and in the latter case to a new agency. Finally, in 1979, the Consolidated Banking Regulation Act recommended consolidation of supervision functions in a new five-member Federal Bank Commission (see Carron 1984 for a comprehensive overview of these initiatives).

While there were conflicts between the regulators and threats to the FRB's supervisory role throughout the 1960s and 1970s, the most sustained period of contestation occurred in the early-to-mid 1980s. The Reagan administration's government efficiency mission, designed to reduce regulation on business (Noble, 1983) provided the opening for a more serious assault by the OCC, FDIC, and the major trade associations on the FRB's continued status as a banking regulator. In May 1982, President Reagan established the Private Sector Survey on Cost Control, otherwise known as the 'Grace Commission' (after its chairman J. Peter Grace), to assess ways in which government efficiency could be improved and costs controlled (for more, see Goodsell 1984). In early 1983, the Commission issued its preliminary recommendations in the area of financial services regulation, concluding that efficiency would be enhanced through the creation of a single federal banking commission. However, likely in recognition of the fact that such dramatic consolidation was unlikely to occur, it recommended that as a second option the bank supervisory functions of the Federal Reserve be transferred to the OCC (Rosenstein, 1983a). Thus in keeping with previous reports and legislation from the previous decade, the Grace Commission concluded that the FRB's continued involvement in banking supervision and regulation was undesirable.

While the decision processes that led the Commission to make the recommendation are unclear, it is notable how enthusiastically its conclusions were received by other key members of the policy community. Both the ABHC and the ABA, organizations that represented large-asset banks, immediately endorsed the proposals (Rosenstein, 1983a). The ABA in fact officially adopted the policy position at its leadership conference in September 1983 that the Federal Reserve's "regulatory role should be focused strictly on monetary policy formulation and implementation" which could in turn only be achieved "through elimination of the burden of regulatory and supervisory responsibilities not necessary to the conduct of monetary policy" (Rosenstein, 1983b). The opposition of the ABA and ABHC to the continued involvement of the Federal Reserve in banking regulation reflected a growing antagonism of larger-asset banks. This antagonism was based in part on a perception, as Carrington (1984) notes, that the Federal Reserve had been "the most conservative of bank regulators" on the issue of expanding bank powers to new areas, such as securities underwriting, particularly relative to the OCC, which was widely considered to favor broad liberalization. Both groups

were also concerned that the FRB was abusing its monopoly in the payments system. As the *ABA Banking Journal* noted, its member treated Federal Reserve officials with “hostility” at its annual National Operations and Automation Conferences in 1982 and 1983, concerned that the agency was overcharging for payment services it provided to banks, such as check clearing (Streeter, 1983). Finally, both groups viewed the OCC as more sympathetic to their competitiveness concerns arising from the imposition of new minimum capital standards (see below for more). Indeed large-asset banks strongly favored a “shift of authority to.... a jazzed-up comptroller” throughout much of the 1980s, a move which would, it was thought, “have the effect of placing the banks under more liberal supervision” (Noble, 1983).

### 3.4.1 The Bush Task Group

Whether prompted by the hostility of trade groups, a series of banking crises in the early 1980s (see below), or a general desire to cut and simplify government, the Reagan administration established a second task group in December 1982 with an exclusive focus on reforming the financial regulatory structure. The Task Group on Regulation of Financial Services represented a far more serious attempt to tackle the issue of reform and consolidation than the Grace Commission, as its composition indicates. It was headed by Vice President George H.W. Bush, and consisted of the heads of all of the federal banking agencies, the Treasury Secretary, Attorney General, and Director of the OMB (Rosenstein, 1983a). In October 1983, initial media reports were beginning to indicate that the Bush Task Group would recommend the consolidation of banking regulation into a five-member federal banking commission. However, as Noble (1983) reported, by December 1983 the Task Group was instead planning to recommend the transfer of almost all of the FRB’s supervisory and regulatory functions to a renamed Federal Banking Agency (essentially a renamed OCC; the agency would become the primary regulator of most of the then 4,500 BHCs) and to the FDIC (the agency would supervise the remaining 1,100 state banks that were members of the Federal Reserve System), either leaving the FRB with authority over the 20 largest BHCs or possibly no jurisdiction at all. Reports also talked of an “adversarial” relationship between the Bush staff and Federal Reserve Chairman Paul A. Volcker’s team. Indeed, by January 1984, the *New York Times* described Chairman Volcker as being “isolated” on the committee, while another report claimed that the Task Group was readying by a “12 to 1” margin “recommendations that would strip the Fed of much or all of its supervisory powers” (Trigaux, 1984).

This effort, which was characterized by one observer as “a well-organized plan to push the Fed out of bank supervision” (quoted in Carrington 1984), reflected not only the views of the major trade associations, but the increasingly deep-seated opposition of both the OCC and the FDIC to a continued regulatory role for the FRB. In part this was premised on the perception amongst staff at all levels at the FDIC and the OCC that the Federal Reserve had adopted a particularly “imperious” attitude towards them in discussions over common regulatory standards and in sharing supervisory information. As Gerald Lowrie, the former

director of government relations for the ABA characterized it, “[t]he Fed’s attitude, stemming from its omnipotence on monetary policy, carries over into its bank-regulatory actions and sometimes is translated as arrogance” (Langley, 1985). Amongst the many examples of this alleged behavior was the decision by the FRB in December 1983 to expand its definition of a “bank” to include certain institutions often known as “non-bank banks” – a move that was denounced by the Comptroller. As one banking industry consultant – in an admittedly hyperbolic statement – claimed following that particular episode, “the other regulators have had it with [the Federal Reserve’s] tyranny” (quoted in Carrington 1984). These deep-seated institutional rivalries, which were present at all levels, were exacerbated in this period by the “strong personalities and philosophies of the individuals heading th[e] agencies,” leading to extraordinary scenes in which the three agency heads were reported to have frequently engaged in “yelling, bickering, and wild accusations” during meetings of the Bush Task Group (Langley, 1985).

More fundamentally than these minor turf wars and personality clashes, the three agencies had distinctively different views on a range of issues that had caused them to clash with one another. Specifically, the OCC and the FDIC had formed an alliance on the issue of expanding bank powers. Both the Comptroller, C. Todd Conover, and the FDIC Chairman, William Isaac, were largely in agreement that banks should be able to offer more services and engage in some aspects of the securities business, despite the traditionally more conservative preferences of the latter agency and the ambivalence of many of the smaller banks its represented (Langley, 1985). This alliance continued between their successors, L. William Seidman and Robert L. Clarke (Easton, 1986a). However, beyond the issue of liberalizing bank powers and disputes over capital (discussed previously and below), the agencies had deep disagreements on an array of other issues (Langley, 1985). For example, the FRB encouraged U.S. banks to continue purchasing the sovereign debt of developing nations to encourage global growth and hence U.S. exports; the other two regulators opposed this as risky. The OCC and FDIC wanted to boost the amount of information banks would have to make available to investors regarding the performance of their loan portfolios; the FRB opposed these disclosure requirements. The three agencies were increasingly disagreeing on the standards to be used in bank examinations and solutions to problems at individual banks. These reasons, amongst others, help to explain why the early-to-mid 1980s had become a period of pronounced animosity and conflict between the banking regulators, and why the OCC and FDIC fought vigorously to attenuate the FRB’s discretionary influence.

The FRB and Volcker in particular responded to these immediate threats by using public and private rhetoric designed to draw the connection between its largely uncontested monetary policy function and its role as a banking regulator. Chairman Volcker, addressing the ABA’s annual convention in 1983 made this link explicit, claiming “any so-called ‘reform’ that had the effect of crippling the ability of the Federal Reserve to carry out its basic central banking responsibilities would be unacceptable.” He continued, arguing that “those responsibilities encompass effective influence on, and an active presence in, those supervi-

sory, regulatory, and operations areas critical to the stability of the banking and payments system. Lest there be any doubt in your minds, those concerns cannot, in my judgment, be met simply by receipt of information from other agencies” (Rosenstein, 1983b). In a paper that was circulated to the Task Group in December 1983, Volcker invoked the image of other countries, noting that the central banks in many industrial countries as well as those in developing countries had responsibility for bank supervision (Volcker, 1984, 553-557). He reiterated these points to his counterparts and leading industry figures; as Noble (1983) reported, “in private conversations he has argued that the central bank’s responsibility for managing the money supply and maintaining the stability of the financial system requires it to keep supervision of state-chartered banks and of holding companies.”

In January 1984, just as the Bush Task Group was beginning to address the issue of the Federal Reserve’s supervisory role, Volcker asked to make a speech at a meeting of the leading banking trade associations sixty senior bank executives. In his speech, he echoed earlier statements emphasizing the links between the Federal Reserve’s monetary policy and supervisory functions: “The idea that something called monetary policy - presumably encompassing concern about some abstractions labeled monetary aggregates - can be separated from concerns about the strength and nature of the institutions that actually supply and manage the money supply and of the payments system itself strikes me on its face as illogical.” However, during the private portions of the meeting, he also leveraged his agency’s legitimacy in another way, reminding the attendees, who had convened to try to reach agreement on their legislative “wish lists” for the upcoming congressional session, that they would achieve little on the issue of expanded bank powers without his agency’s support or at least acquiescence. One attendee characterized this “‘as a strategic use of leverage by the Fed before the banking industry’s upcoming campaign with Congress” (Trigaux, 1984); another as “some quick, heavy politicking to persuade the ABA to modify its position” (Carrington, 1984). While the ABA and the ABHC did not modify their formal position on removing the agency’s supervisory and regulatory functions, their criticism of the agency was significantly less vocal in 1984 (e.g. see Noble 1984a). While it is impossible to say for certain without access to confidential records, this may have reflected a shift in strategy brought about by the rhetorical pressure placed upon them by Volcker and lobbying by the agency.

Volcker also leveraged the legitimacy of his agency to persuade Treasury Secretary Donald Regan, a pivotal actor in the Task Group, to back away from the proposal to strip the FRB of its supervisory role. Since the administration was planning to pressure Congress to pass a bill authorizing expanded bank powers in conjunction with the regulatory reorganization bill it would propose, and since the staunch opposition from Volcker – who as the key monetary policymaker in the country carried significant weight with members of both parties – would have “cast a long shadow over any... package that the administration might send to Capital Hill,” it became clear to Regan that the Task Group proposal would have to be mended (see Carrington 1984 for a full account of Volcker and Regan’s discussions). In a deal agreed to between Regan and Volcker, the FRB would retain control of the 50 largest BHCs

and would become the primary supervisor of the 9,000 state banks then supervised by the FDIC. Moreover, it would have the authority to veto regulatory decisions made by the new banking agency (i.e. the OCC) that expanded bank powers (Noble, 1984a). In short, this agreement represented a significant victory for the FRB. Indeed, in February the Bush task force agreed to a plan that largely reflected this agreement (Albert, 1984). As Rosenstein (1985b) reported “it is widely known that Federal Reserve Board Chairman Paul A. Volcker blocked moves within the Bush panel’s deliberations to curtail the Fed’s supervisory role”; others observed that the FRB was “clear victor in what developed into an intense battle” (Albert, 1984). In short, there is little doubt that Volcker’s campaign protected much of its discretionary influence over the banking industry and in important ways had the potential to expand it.

Despite this victory, the FRB’s position still faced threats. The Senate Banking Committee Chairman Jake Garn (R-UT) maintained that he was “not supportive of the Fed regulating banks,” echoing the opposition of the ABA and the ABHC who argued once again that “the Fed should do monetary policy” only (Chell 1984; notably, however, the ABA also stated that they were “keeping [their] options open” with regard to the plan, suggesting their opposition was somewhat muted. See Noble 1984a). Congress did not actually turn to the issue until after 1984 elections. In March 1985, the FDIC Chairman William Issac denounced the continued role of the FRB in bank supervision, stating that his agency believed that “the current and even the proposed [in the Bush report] level of [Federal Reserve] involvement is unnecessary, inefficient, and unwise” (Rosenstein, 1985a). Representative Doug Barnard (D-GA), whose House Government Operations Subcommittee had partial jurisdiction over any potential reallocation of authority, appeared sympathetic to Issac’s viewpoint in that hearing, suggesting that it would have to look carefully at the FRB’s role when considering action on the Bush task force report (Rosenstein, 1985a). Once again, Volcker testified that the Federal Reserve needed a strong, continuing role in bank supervision “in order to insure the stability of the financial and payments system” (Rosenstein, 1985b). Ultimately, however, Congress did not act on the Task Group’s report, which became mired in Senator Garn’s refusal to move a bill to the floor that did not include expanded powers for banks. However, these hearings suggest that had a comprehensive bill been possible in 1985, the FRB’s authority may once again have been threatened.

The vigorous debate over the FRB’s continued role in banking regulation and supervision that began in the 1970s and reached its crescendo in 1984 with the publication of the Bush Task Group’s report demonstrates the degree to which the agency’s authority was contested by almost every stakeholder in the policy community. These factors, combined with the disputes surrounding capital standards previously discussed as well as those discussed in the next section, unambiguously paint a portrait of an agency under attack. The agency succeeded in beating back those who sought to remove it from banking regulation altogether, primarily by leveraging its monetary policy legitimacy in its public and private rhetoric, and in the process also threatening to derail legislation that was a higher priority for the admin-

istration and trade groups. It would return to these rhetorical tactics in the debate over risk-based capital standards, particularly as part of its effort to defeat a competing FDIC proposal to impose a risk-based deposit insurance premium. Moreover, in the early 1980s, it also began to turn its attention to an international gathering of central bankers known as the Basel Committee as a way to achieve its policy objectives with regard to capital, a venue which – on that one issue at least – had the potential to free it permanently from incessant domestic infighting and opposition.

## 3.5 The Establishment of Statutory Capital Standards, 1980-1985

### 3.5.1 Background

As section 3.2 discussed, capital standards had traditionally been just one of many informal metrics used by bank supervisors. However, in the early 1980s, it emerged as an increasingly important, stand alone regulatory tool. Although the strategic actions of the Federal Reserve were critical in establishing the centrality of capital ratios and particularly capital ratios based on asset risk, structural conditions provided the opening that the agency needed to advance its agenda. In the first place, capital levels were declining to a degree that many found worrying. As figure 3.1 illustrates, banks entered the 1980s with the lowest levels of capital in twenty years<sup>9</sup>. While the decline in the 1970s was relatively modest – 11 percent between 1970 and 1980 – there was a far sharper decline in capital levels amongst the largest banks, as illustrated by figure 3.2. Capital levels at the 17 largest multinational banks declined by approximately 25 percent, while the capital levels of a broader group of large asset institutions (defined as those with assets greater than \$5 billion) declined by 21 percent (see Tarullo 2008, 31-33 for more). This raised fears about systemic dangers arising from the failure of a large bank, fears that appeared to be confirmed in 1974 with the collapse of the Herstatt Bank in Germany and Franklin National Bank in the United States, both large asset institutions with significant foreign exchange exposure (see Dale 1984; Spero 1980 for more).

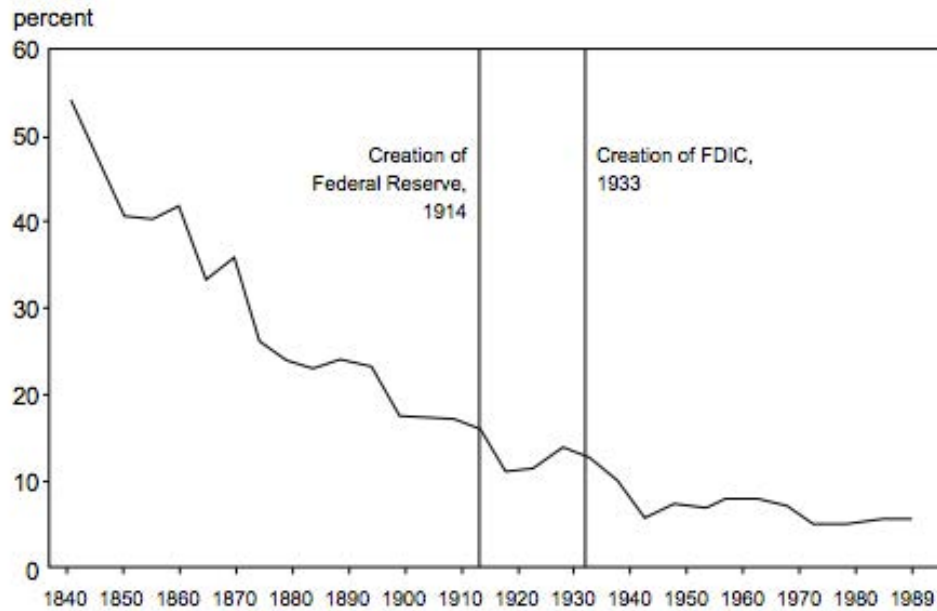
What prompted this decline in capital levels? Macroeconomic conditions in the 1970s were one important reason. The collapse of the Bretton Woods system and the increase in exchange rate volatility that followed led to bank losses on foreign transactions and hurt capital levels as a result. The recession of 1974-75, the oil embargo, and the ‘stagflation’ of the late 1970s led to even greater bank losses and therefore lower capital levels. All of these

---

<sup>9</sup>Much of the broader historical decline in figure 3.1 reflects positive changes, such as the creation of the Federal Deposit Insurance scheme, as well as the post-war economic boom in lending. See Tarullo (2008, 31).



Figure 3.1: Equity as a Percent of Assets for All Commercial Banks, 1840-1989



Source: U.S. Department of the Treasury (1991)

Figure 3.2: Bank Capital Ratios for All U.S. Banks and Large Asset Banks, 1970-1981

Year	Banks with assets		
	All banks	over \$5 billion	17 largest banks
1970	6.58	5.34	5.15
1971	6.32	5.10	4.91
1972	5.95	4.71	4.43
1973	5.67	4.14	3.82
1974	5.65	3.82	3.49
1975	5.87	4.13	3.94
1976	6.11	4.51	4.00
1977	5.92	4.32	3.86
1978	5.80	4.13	3.76
1979	5.75	4.03	3.61
1980	5.80	4.12	3.69
1981	5.83	4.21	3.83

Source: Tarullo (2008, 32)

events contributed directly or indirectly to higher default rates (particularly on foreign loans) and an erosion in the profitability of loans that were still being serviced (primarily because rampant inflation was diminishing the value of interest earned on loans. See Tarullo 2008, 33). Perhaps more importantly, these economic shifts interacted with changes in technology in ways that put immense competitive pressure on commercial banks (Berger et al., 1995). For example, business loans had traditionally been an important component of commercial banks' margins from lending. However, in the 1970s, many companies began to turn to the commercial paper and bond markets to, respectively, raise short and long-term funds, since credit was more easily available and at a lower cost in many instances. As a result, the commercial bank share of total non-financial borrowing declined from 36% in 1974 to 24% in 1986 (Edwards, 1993, 28). Similarly, savers, faced with a protracted period of high inflation, began transferring their money to new types of accounts based on securities and bonds, such as money market accounts and mutual funds. These investment vehicles promised significantly higher returns than traditional savings accounts offered by commercial banks (Tarullo, 2008, 35).

This growing 'disintermediation' had three effects. First, it caused banks to simply lend more, which depleted capital levels in itself. Second, it led banks to make riskier investments. Institutions began to reduce credit standards for loans to both businesses and individuals, and large banks began looking to earn profits by investing in higher yielding, but riskier, developing country sovereign debt (Edwards, 1993, 33-34). Large banks also began to engage in increasing amounts of so-called activity as a result of securitization, a fact that hid much of their credit risk exposure<sup>10</sup>. As a result, all depository institutions, though especially large multinational banks, began to assume far more portfolio risk than small institutions in the late 1970s-to-mid-1980s (Demsetz and Strahan, 1995). Finally, it led commercial banks to lobby for changes to the Depression Era regulatory structure that restricted "the activities, investments, and business of banks" (Tarullo, 2008). The deregulation of the banking industry led to an increased rate of bank failures, highlighting the need for a new set of prudential regulatory tools.

Until the 1970s, the New Deal regulatory structure had proven quite successful in attenuating risk and thus had obviated the need for other forms of prudential regulation such as formal, standalone capital requirements. For example, the Federal Reserve's Regulation Q limited the interest rate banks could pay on deposits and therefore had restrained price competition in banking, reducing pressures on banks to make riskier investments. The Glass-Steagall Act prohibited investment banks from engaging in commercial banking activities (deposit-taking and lending), while the McFadden Act<sup>11</sup> and state regulations prohibited

---

<sup>10</sup>Although trading in derivatives products is now a major component of banks' activity, it was not in the 1980s. See Chapter 4 for more.

<sup>11</sup>The McFadden Act, passed in 1927, prohibited nationally chartered banks from interstate branching; like state banks, national banks could only branch in the state in which they were located, unless that

interstate banking (Economides et al., 1996), both of which arguably limited the opportunity for risk taking. However, in the 1970s, these restrictions had become burdens on banks which found that they were impeding their ability to compete with securities firms and ‘non-bank banks’ offering alternative credit and investment services (Moulton, 1985)<sup>12</sup>. Partly owing to these competitive pressures, there was a period in which many traditional bank regulatory devices were relaxed or removed, beginning with the phasing out of limits on interest rates in 1980, allowing banks to offer money-market accounts, and offer commercial paper. Throughout the 1980s, regulators continued to administratively loosen restrictions on the involvement of commercial banks in securities underwriting and trading (see Wilmarth 2002 for an a comprehensive account of this process). During the late 1970s and 1980s, states also began to dismantle barriers to inter-state banking (Kane, 1996).

Removal of so many elements of the old regulatory approach freed banks to compete with other banks and with non-banks; however “it also freed banks to fail in these new endeavors” by creating a gap in prudential regulation (Tarullo, 2008, 35). From 1960 to 1980 bank failures averaged less than ten per year. Beginning in the early 1980s, however, that figure began to dramatically climb, reaching nearly 200 per year by 1985 (see figure 3.3 below). While the causes of this increasing rate of bank failure were doubtless due to a wide variety of factors (see Singer 2007, 45), the removal of anti-competitive barriers at least partly contributed (FDIC, 1997, 9-11), as did the decline in overall capital levels and liquidity. Thus while deregulation yielded many efficiency benefits, it also produced costs in the form of increased systemic risk and taxpayer funded assistance. A freer financial marketplace ironically increased the political demand for a new set of prudential rules (a point more broadly made by Vogel (1996), who documents how the international trend towards the deregulation of competitive barriers in the financial services sector was accompanied by the imposition of new forms of government or private sector regulation).

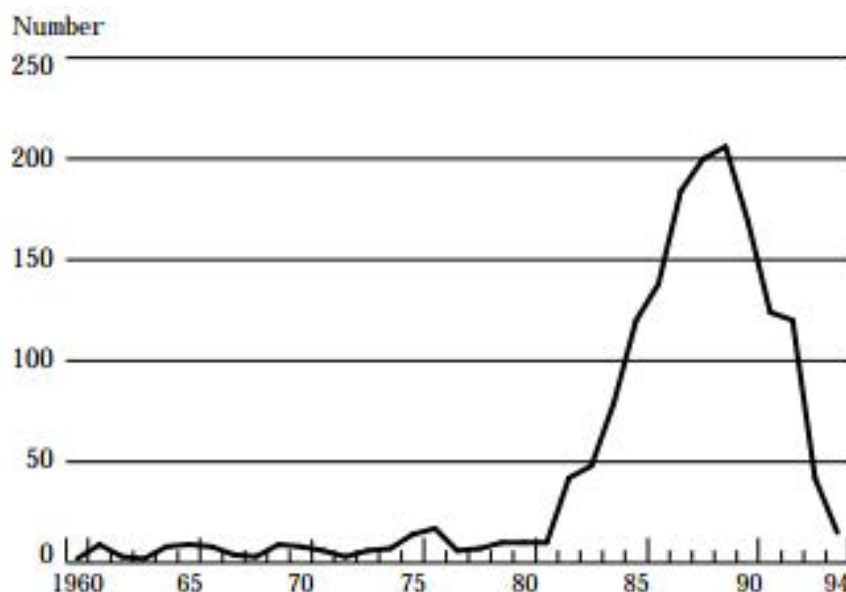
While *some* form of new prudential regime was clearly necessary, there was far from universal agreement on what that regime should look like. There were at least two approaches that were either widely used or frequently discussed as alternatives to fill the prudential regulation gap. Building upon the existing CAMEL framework, with its focus on a broad range of indicators of bank health, including capital, liquidity, and earnings, was one approach and favored by the FDIC (Hemel, 2011, 234-235). Likewise, a variety of scholars, commentators,

---

state permitted branching in other states (and until 1976, no state permitted interstate branching). The provision of the McFadden Act that prohibited interstate branching was repealed by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. See Kane (1996) for a more in depth discussion.

<sup>12</sup>‘Non-bank banks’ are institutions that offer either lending services or depositing services, but not both. The Bank Holding Company Act of 1956 prohibited nonbank companies from owing banks as subsidiaries, but defined a bank as an institution that accepted deposits and made loans; therefore by not offering one of these services, such institutions could evade many regulatory requirements imposed on depository institutions. See Moulton (1985) for a contemporary account.

Figure 3.3: Bank Failures, 1960-1994



*Source:* Federal Deposit Insurance Corporation (1993)

legislators, and the FDIC had argued in favor of a risk-based deposit insurance premium (see below). Indeed, many economists argued that such an approach was a more efficient method of regulation than capital standards (see Santos 2001, 50-51 for an overview of this literature; see Buser et al. 1981; Chan et al. 1992 for counterarguments). Other measures, though less prominent than the risk-based premium proposal at the time, could have become central to the new prudential regime. Some argued that banks should be required to issue subordinated debt instead of raising equity (since bond holders have incentives to reduce risks that equity holders may not; see Wall 1989). Others suggested extending the liability of bank shareholders (e.g. Esty 1998) or requiring banks to obtain private co-insurance (based on similar principles to the risk-based public premium; see Nagarajan and Sealey 1997 for a review of this proposal). A stand-alone capital ratio based on a RWA approach ultimately became the cornerstone of this new system, both in the United States and internationally (Santos, 2001; Wood, 2005; Singer, 2007). As discussed below, this outcome was determined to a significant degree not merely by the structural environment or theoretical logic, but by the strategic behavior of the FRB to advance its long-held preferences on the subject.

Figure 3.4: Number of Bank Supervisors By Agency, 1979-1990

<b>Year</b>	<b>FDIC</b>	<b>OCC</b>	<b>FRB</b>
1979	1,713	2,151	805
1984	1,389	1,722	820
1990	2,645	1,907	1,025

*Source:* Federal Deposit Insurance Corporation (1997, 57)

### 3.5.2 The Debate Over Capital Standards

Traditionally, as aforementioned, both the OCC and FDIC had emphasized the superiority of on-site examinations over off-site, quantitative metrics, a philosophy reflected in the CAMEL standards agreed to in 1978. However, both agencies were forced to shift their approach to bank monitoring as budgets were cut; both the Carter and Reagan administrations placed restrictions on federal hiring, forcing the two agencies to freeze examiner levels in 1981 (FDIC, 1997, 56). As figure 3.4 shows, the number of bank examiners at the FDIC declined by 19 percent between 1979 and 1984, while there was a 20 percent decline in bank examiners at the OCC during the same period (notably, there was no decline at the FRB). As a result, the average length of time between examinations increased from 379 days to 609 days, an increase almost entirely attributable to examinations conducted by the FDIC and OCC (FDIC, 1997, 57). This diminished the effectiveness of the CAMEL ratings, since they often failed to reflect current risk levels at banks (Cole and Gunther, 1995). In this climate, both agencies had to accept that off-site metrics would have to play a larger role in determinations of bank health.

Partly in recognition of this new reality, the FFIEC established a task force in 1979 to examine the possibility of establishing a uniform legal definition of capital. Although strongly resisted by the banking trade associations (Carson, 1980; Rosenstein, 1980), the task force proposed a series of recommendations that would constitute “guidelines” for supervisors. It would create two tiers of capital: a “primary” tier, comprised mostly of equity-like instruments and loan-loss reserves, and a “secondary” tier, made up of subordinated debt and similar types of instrument (Ehlen, 1983, 54). Capital levels would be based on a ratio to total assets, with different minimum levels for multinational, regional, and community banks (Rosenstein, 1980). In December 1981, the FRB and the OCC released a statement announcing their intention to implement key aspects of the proposal, setting minimum primary capital levels at regional banks (assets between \$1 billion and \$15 billion) at 5 percent

and at 6 percent for smaller community banks<sup>13</sup> (Release, 1981). The 17 multinational banks were not to be subject to a capital requirement, but rather were to be treated on a case-by-case basis (though was the clear implication that unless they improved their capital positions, formal minimum levels would be imposed on them. See Reinicke 1995, 140).

The establishment of public capital standards was a victory for the FRB. However it was not an unequivocal one. First, as Norton (1988-1989, 1322) notes, the joint statement with the OCC made clear that it was not abandoning its “historical practices of evaluating capital adequacy on an institution-by-institution basis and that capital adequacy was more of a qualitative than quantitative determination” alongside the other metrics included in the CAMEL ratings. The OCC was therefore still reluctant to embrace a stand-alone, quantitative ratio (see Heggstad and King 1982). Second, the capital ratio was not a regulation *per se* but a “guideline” that the agencies could use as justification when issuing “cease and desist” orders requiring banks to take ameliorative measures; in fact, a major court decision later determined that the OCC acted *ultra vires* in using capital requirements as a justification for action against a national bank<sup>14</sup>. Third, the FDIC, which did agree to set a minimum ratio, refused to endorse the joint statement by the other two regulators. Instead, the agency, which similarly emphasized the qualitative nature of capital standards as one of many metrics, made a separate proposal for a 6 percent ratio of equity capital to total assets regardless of size and a 5 percent minimum acceptable ratio (Norton, 1988-1989, 1323). As the agency’s Chairman, William Isaac noted, it had long held that capital should only be based on equity-like instruments and that it was unfair to treat institutions differently based on size (Battey, 1981). The ambivalence of the OCC to a stand-alone ratio, the legal ambiguity over the standards, and the hostility of the FDIC to the idea of including non-equity capital meant that the battle to establish formal capital levels, let alone capital levels based on risk-assets, was going to be a difficult one for the FRB.

The “less-developed-country” (LDC) debt crisis, which reached its peak in 1983 as 27 countries sought to restructure their existing sovereign debt, fueled widespread concern about the health of multinational U.S. banks, which had heavy exposure to such debt; it also provided another impetus for an entrenchment of formal capital requirements. As congressional criticism of regulators’ failure to curtail bank exposure to LDC debt escalated, the FRB and the OCC announced their decision to apply the 1981 minimum capital requirements for regional banks to 17 multinational banks previously excluded (Reinicke, 1995), a move

---

<sup>13</sup>To be “adequately capitalized” and avoid additional regulatory scrutiny, however, all banks had to maintain at least a 6.5 percent capital to total assets ratio.

<sup>14</sup>In February 1983, the Fifth Circuit Court of Appeals ruled in *First National Bank of Bellaire v. Comptroller of the Currency*, 697 F.2d 674 (5th Cir. 1983), that the Comptroller’s “cease and desist” order to Bellaire requiring them to increase their capital levels to a minimum of seven percent of its total assets was beyond the scope of its statutory authority under the Federal Deposit Insurance Act. See Norton (1988-1989, 1324) for more.

that was vigorously opposed by the ABA and other trade organizations (Singer, 2007, 48). Congressional criticism of regulatory failures combined with the opportunity provided by a controversial bill to extend the U.S. shareholding in the International Monetary Fund (IMF) by \$8.4 billion, ironically created an opportunity to push Congress to grant regulators authority to set capital standards. Chairman Volcker asked Congress in February 1983 to build upon existing capital guidelines while retaining flexibility for regulators to set standards; indeed Volcker emphasized in testimony before Congress that a lack of capital at multinational banks had contributed to the ongoing crisis (Smith, 1984, 431). With the added weight of the *Bellaire* decision and in the face of opposition from the ABA and ABHC, Congress passed the International Lending Supervision Act (ILSA), which required regulators to set statutory minimum capital levels for all banks, including the previously exempt multinational banks that were now the source of significant anxiety. The LDC crisis and the *Bellaire* decision had therefore effectively ended the debate over a stand-alone capital standard.

### 3.5.3 The Battle For Risk-Based Standards

This effective victory for the FRB led to a new stage in the debate. With stand-alone capital ratios now entrenched in law, the FRB had a new objective: to ensure that capital standards reflected the risk-based approach that it has long used informally as a guide in its supervisory efforts. The FRB had already secured a reference to risk in an amendment to the 1981 guidelines (agreed to by all three regulators largely due to the ongoing concern about the quality of LDC debt). The amendment stated that “those banking organizations that have a higher than average percentage of their assets exposed to risk, or have a higher than average amount of off-balance sheet risk, may be expected to hold additional primary capital to compensate for this risk” (1983). The issue of asset risk soon came to the fore when Continental Illinois National Bank and Trust, which at the time was one of the ten largest banks in the United States, collapsed in part because of its aggressive loan portfolio and in part owing to high risk oil and natural gas company loans purchased from another failed institution, Penn Square. The FDIC responded to the crisis by providing insurance guarantees to *all* creditors of the bank, while the Federal Reserve provided substantial assistance, allowing the bank to access its emergency discount window (see Wall and Peterson 1990 and Swary 1986 for a comprehensive overview of this episode).

The Continental Illinois episode clearly underscored the need to curtail high risk activity, especially in large asset banks and BHCs. The FDIC-administered Bank Insurance Fund was severely strained by the \$4.5 billion resource package and ongoing liquidity support, which raised the specter of insolvency (Singer, 2007, 48). Both the OCC and FRB were criticized for failing to recognize the problems at Continental earlier<sup>15</sup>. As a result, all three

---

<sup>15</sup>Continental Illinois was both a national bank and was owned by a BHC; as a result, both regulators had oversight responsibility for the institution.

regulators had incentives to develop a regulatory framework that differentiated banks based on risk. The FRB's preference for a risk-based capital approach was well known; a version of this approach, which assigned different risk weights to assets according to the type of investment, had informally been used by FRB supervisors since the mid-1950s (see Section 3.3). By mid-1984, the idea of a statutory risk-based capital standard was gathering steam within the Federal Reserve. The FRB Chairman Paul Volcker brought up the idea of a mandatory risk-based standard to his colleagues in a Federal Open Markets Committee (FOMC) meeting, suggesting that such a framework would help to rein in the excess risk-taking by large multinational institutions (Fed, 1984b, 56). This followed other discussions that had raised concerns about the issue of off-balance sheet assets and worry that current ratios were not adequately reflecting the risk involved in these investments (e.g. comments of Frank Morris, the President of the Reserve Bank of Boston, in January 1984. See Fed 1984a, 20).

In July 1985, Chairman Volcker formally proposed that capital requirements be modified to reflect the asset risk of bank investments. He pointed in particular to the increase in off-balance-sheet claims, such as standby letters of credit, which he contended increased risk to the health of banks not accounted for by the current capital standards (Langley and McGinley, 1985). Specifically, Volcker stated that the current capital requirements failed to take into account the "condition and activities of the bank" and that banks "may well need a higher ratio, depending upon the kind of risks they undertake." He continued that:

*we should supplement the overall minimum capital ratio with what might be thought of as a more sophisticated approach of assessing different kinds of balance sheet and off-balance sheet risks with respect to capital need, and... superimposing that kind of analysis on top of a rough and ready minimal overall capital ratio* (Federal Reserve's Second Monetary Policy Report, 1985, 111-112).

In January 1986, the FRB issued proposals for a risk-based capital standard that it argued reflected "the growth and change in the nature of risks to which banking organizations have become exposed." (Forde, 1986a). It divided assets into four broad categories – or 'risk buckets' – and assigned each category a weight ranging from 0 percent to safe liquid instruments (such as cash) to 100 percent for commercial loans. However, at this point the plans were only intended, at least at first, to be a *supplemental* requirement to the existing minimum capital requirement of 6 percent (Norton, 1988-1989, 1334).

The proposal received mixed reactions within the policy community. The ABA and ABHC were opposed to the plan, though they claimed to support a risk-based proposal in "principal." In reaction, the ABA proposed a voluntary, industry-developed effort to craft capital guidelines based on risk, which they argued would be preferable to the risk bucket approach advocated by the FRB (Easton, 1986c). A voluntary approach reflected their view that risk-based capital should be used as "an effective management tool rather than as a required regulatory guideline." In reality, however, their concern was that risk-based standards would target their generally higher risk (and higher profit) off-balance sheet activities,



which were currently not used by regulators to calculate minimum capital levels, resulting in higher overall capital levels. Indeed, as the ABA stated, the FRB's approach would "reduce the ability of banks to lend to certain types of businesses considered high-risk" and "make the industry less competitive with financial institutions that wouldn't have to meet such standards" (Nash 1986; see also Kapstein 1992, 280). The Association of Reserve City Bankers (ARCB), a group representing the executives of larger institutions, took a more conciliatory tone towards the proposal, suggesting that it was as "an important step in the right direction." However, the group wanted to establish more finely grained distinctions between the risk categories (Easton, 1986c)<sup>16</sup> and, perhaps more important, wanted risk-based capital standards to be "the sole guideline" in determining capital levels (Forde, 1986a).

The Reagan administration also opposed the effort. The Justice Department, in their formal comments on the proposal, expressed concern about significant losses at banks with loan portfolios that were heavily weighted towards the farm and energy sectors; as such, they wanted regulators to focus on "the degree of diversification of assets" rather than the FRB's risk bucket approach, which they argued would do nothing to discourage such lending behavior (Easton, 1986c). Representative Doug Barnard, the Chairman of the Financial Institutions Subcommittee in the House of Representatives, was concerned that the proposal "may materially increase the incentive for banks to take exposed investment positions in government and agency securities" leading, in effect, to a dangerous concentration of lending in certain sectors (Easton, 1986c). Smaller banks, represented by the Independent Community Bankers Association (ICBA), were less concerned about the risk-based proposal since, as they noted, "it deals primarily with off-balance sheet risk items, and smaller banks don't have too many of them." While larger-asset bank organizations favored greater refinement in the main "standard risk" category (which was weighted at a 100 percent and included most types of investments), the ICBA vigorously opposed such category refinement, which they argued was "unworkable and would most likely lead to problems of credit allocation" (Nash, 1986). Moreover, for much of this period, smaller banks favored a competing risk-based deposit insurance premium proposed by the FDIC, which also contributed to their initial opposition (Naylor 1986; see also below).

The OCC decided to support a risk-based approach. However, they went further than the FRB and proposed that the 6 percent total capital to assets minimum standard be replaced with a risk-based approach, rather than the latter simply being used as a supplementary indicator (Easton, 1986b). This plan, unlike the FRB plan, would be unlikely to result in an increase in capital levels amongst large banks, and might even lead to a decrease in overall capital. Unsurprisingly, the ABA and the ARCB viewed this plan more favorably as a result, noting that, in fact, banks holding lower risk assets might be able to *reduce* their minimum

---

<sup>16</sup>Specifically, they wanted "investment grade" loans to have a 60 percent weight in contrast to the "standard risk" loan weighting of 100 percent

capital levels (Trigaux, 1986b). The FRB, however, strongly resisted this effort (Easton, 1986b), since their effort was designed in large part to increase the stringency of capital requirements. In sharp contrast to the Comptroller's embrace of the risk-based concept (if not the FRB's actual proposal), the FDIC ambiguously opposed the effort. The agency's chairman, William Issac, had previously questioned the idea of risk-based standards, suggesting that they could lead to regulatory arbitrage as banks divested from higher weighted asset classes to lower weighted classes (Langley and McGinley, 1985). His successor, William Seidman expressed his outright opposition in November 1985, noting that "when you get into the question of risk and capital, you get into difficult ground" and questioned whether regulators were capable of doing a better job of quantitatively evaluating the riskiness of bank assets than private organizations (Fraust, 1985).

The FDIC's opposition was premised on three factors. In the first place, the agency, which had otherwise grown comfortable with the concept of a stand-alone capital ratio, had proposed that the minimum leverage ratio be dramatically increased to 9 to 11 percent, in line with recommendations issued by a Council on Economic Affairs Working Group (Forde, 1985). The FDIC suspected, in contrast to the industry trade associations, that the risk-based standard were actually designed to *lower* the effective rate of capital at large-asset banks, a belief that ran counter to its own proposal for higher retained capital. This suspicion was backed by an FDIC-commissioned study released in April 1986 that showed that risk-based standards would indeed help larger banks, not smaller ones as had been widely assumed (Easton, 1986b). The FDIC was also concerned about the composition of bank capital, resisting the FRB's proposal in part because of its desire to promote the use of subordinated debt as capital. Third, it viewed risk-based standards as an attempt to further undermine its on-site examination approach to supervision. Indeed, the agency's 1986 regulations implementing new capital requirements stated "the appropriate minimum capital ratios for an individual bank cannot be determined solely through the application of a rigid mathematical formula" but instead must be "necessarily based in part on subjective judgment grounded in agency expertise" (12 C.F.R. §3.11 (1986); this same language was found in the OCC regulations). Fourth, a new risk-weighted scheme would also impose disproportionately higher retraining and technology updating costs on the smaller agency, given its status as the primary federal regulator for most of the nation's banks (Hemel, 2011, 235). Above all else, the FDIC opposed the plan because it was a competitor to its own already well-developed proposal for a risk-based deposit insurance premium based on the on-site CAMEL system (Kapstein 1992, 279; Fraust 1985).

### 3.5.4 A Competing Approach: Risk-Based Deposit Insurance and CAMEL

In 1982, the Federal Home Loan Bank Board (FHLBB), which administered the Federal Savings and Loan Insurance Corporation (FSLIC) – an entity that insured savings and loan

(S&L) institutions – proposed risk-based insurance as a potential solution to the problems arising from the growing rate of S&L failures (Conte, 1982). Specifically, the Board favored a risk-based insurance scheme based on the expectation that it would increase revenue and thus protect it against the FSLIC against the growing risk of insolvency, while also imposing discipline on S&Ls that purchased riskier assets. Versions of this risk-based insurance approach were also gaining traction in academia and in the media (Kapstein 1992, 277; see also Dale 1984, 180-181). For example, Perry Quick, a prominent economist in the Carter and Reagan administrations, wrote in the *New York Times* that the deposit insurance scheme should charge risk-adjusted premiums for all deposits greater than \$100,000 at large banks (Quick, 1984). Other academics and commentators favored the idea, but argued that such a system would only work if market mechanisms were used to price asset risk (Baer, 1985; Ely, 1985). As Kapstein (1992, 277) notes, the most widely debated insurance proposal came from the leading international economist Herbert Grubel, who proposed a transnational system of deposit insurance based on the risk-based approach (Grubel, 1979).

Given that a risk-based approach to deposit insurance would potentially enhance the solvency of the Bank Insurance Fund (the FDIC’s core mission) and contain risk, and given that discussing the approach would shift the debate to an area in which the FDIC was uniquely competent, the agency unsurprisingly embraced the idea. After years of study, the FDIC Chairman William Issac formally proposed a new risk-based deposit insurance scheme in 1984. Under the proposal, an institution with “above normal” risk would be charged an annual premium that was double the regular premium (see FDIC 1985, Hirschhorn 1986 for more details). The calculation of ‘risk’ was also important. It would be based on the existing CAMEL ratings system, which the FDIC had heavily invested since its creation in 1979 (Yang, 1986), though it would be supplemented with quantitative risk models. The preference for determining risk based on CAMEL once again reflected the FDIC’s traditional distinctive competency: its highly experienced and professional bank examiners (Khademian, 1996, 27). In short then, a risk-based insurance scheme based on CAMEL aligned closely with the FDIC’s mission and distinctive competence. However, in an era in which its supervisory staff were being cut back, the decision to propose a scheme that utilized on-site examination data rather than quantitative evaluations of asset risk was one factor that ultimately undermined the plan.

The deposit insurance premium concept had far more widespread support on Capitol Hill and in the Reagan Administration than the FRB’s risk-based capital proposal. For example, the Ranking Minority Member on the Senate Banking Committee, Senator William Proxmire (D-WI), broadly supported the measure, though his immediate focus in late 1984 was introducing a bill that would charge higher insurance premiums to banks with significant holdings of foreign deposits, which were seen as particularly risky in the wake of the Continental Illinois collapse. Although the FDIC supported that proposal, it lobbied for it to be linked to its broader risk-based premium proposal (Noble, 1984b). The Chairman of the Committee, Senator Jake Garn (R-UT), also supported the proposal and ultimately

included it as part of a comprehensive bill dealing with banking deregulation in 1986 (American Banker, 1986). In December 1984, the Treasury Department also proposed a risk-based premium modeled on Chairman Issac's plan in addition to a separate plan that would impose risk premiums on foreign deposits (Langley, 1984). The banking industry was more divided. In November 1985, the FDIC released a survey showing that 80 percent of banks supported the proposal, though many were critical of the proposed basis for evaluating risk (Fraust, 1985). The ICBA was initially supportive, particularly charging banks for their holdings of foreign deposits (which would mainly impact larger banks) (Naylor, 1986). By contrast, the ABHC expressed concern that the "authority the FDIC sought for risk-based premiums was simply too broad" meaning that they "could simply come in and classify anything as a risk and require higher premiums" (Garsson and Naylor, 1986)<sup>17</sup>.

The Federal Reserve was also strongly opposed to the proposal (Hershey, 1985). Chairman Volcker testified at a congressional hearing in September 1985 that while the idea, which obviously bore some correlation in principle with risk-variable capital standards, appeared "logical and attractive," there were significant practical problems with such an approach (Volcker, 1985, 16). Specifically, he argued that the differentials in premiums would have to be "fairly wide" to be effective and that the current CAMEL rating approach used by the FDIC was an inappropriate tool for risk calculation. In part this was because he did not believe "premiums could be 'fine-tuned' before problems in fact emerge" (Naylor, 1985b). More broadly, however, he critiqued an over reliance on on-site examinations, suggesting that:

... there would be great drawbacks to basing premiums on the already difficult and inherently qualitative, judgments contained in bank examinations. Such judgments are fallible and our forecasting ability is limited. To reflect those judgments routinely in large public notice and higher costs, could well diminish the prospects for effective remedial action [to improve the financial condition of the institution] Volcker (1985, 18).

As these comments highlight, Volcker was implicitly contrasting the strengths of the Federal Reserve's capital plan, which relied on far more objective, quantitative measures of risk, relative to the proposed CAMEL-based, on-site risk-assessment approach advocated by the FDIC.

From a political perspective, the risk-based insurance premium was problematic for the FRB. While there may undoubtedly have been genuine policy concerns about the proposal, for example that risk-based premiums would weaken already struggling banks, more importantly it was having the effect of crowding out space on the legislative calendar for consideration of the Federal Reserve's risk-based capital plan. This was a particular problem given

---

<sup>17</sup>In comments to the FDIC regarding the proposal, many banks had expressed a concern that CAMEL rating were "too subjective... and are arrived at differently by different regulatory agencies" (Fraust, 1985).

that tax reform that was already consuming the time of many key legislators, as was the issue of financial services deregulation (Trigaux, 1986a). Indeed, Senator Garn had already signaled an unwillingness to advance other banking issues in the absence of an agreement on expanded powers for financial institutions (Ryan and Thurston, 2012). Moreover, the FDIC had been actively promoting the risk-variable insurance premium as a viable alternative and had vigorously opposed the FRB's own plan. The agency had issued reports, lobbied Members of Congress, and testified about the relative superiority of the risk-based premium (Fraust, 1985). It had also sought the support of banks, particularly smaller community banks, for the proposal. Indeed Chairman Isaac sent a letter to all FDIC insured banks which extolled the virtues of the deposit scheme and implicitly criticized the quantitative targets preferred by the FRB, noting "the interagency uniform bank rating system [CAMEL] based on individual bank examinations is the best available measure of risk. It is the result of extensive on-site investigation and can incorporate evaluations of many critical factors which cannot be adequately considered by any other technique" (Isaac, 1985). Ultimately then, the risk-based premium and its emphasis on on-site examinations represented a distinctly different vision of banking supervision than the one proposed by the FRB; as such, it posed a threat to the future of a risk-based capital plan.

However, the FDIC plan ultimately went nowhere<sup>18</sup>. The cutbacks in the FDIC's examination staff numbers were one factor that weighed on legislators. There was also a widespread perception that the agency was simply not capable of implementing with the risk-based deposit insurance scheme because of doubts that the agency's staff possessed the technical skills necessary to supplement on-site examinations with more complex quantitative modeling (Naylor, 1985a). Indeed, Isaac himself later (after he had left his post as Chairman) admitted that "such a system would, however, entail unrealistic data requirements and require risk quantification techniques not currently available [to the FDIC]" (quoted in Naylor 1985a). Other external influences also had an effect. In early 1986, the previously supportive ICBA withdrew its support, instead conditionally endorsing the *concept* of risk-based capital requirements, though on the condition that "any risk-based capital measure be based on asset concentrations, loan portfolio diversification, and interest rate risk" (Naylor, 1986). Finally, even though Senator Garn included a provision for a risk-based premium (and notably excluded the FRB's proposal) from his comprehensive bank deregulation bill in June 1986 (American Banker, 1986), that bill ultimately failed thanks to a combination of FRB opposition to a variety of provisions and growing hostility of the major banking groups, which had become increasingly concerned about unrelated provisions on bank powers (Naylor, 1986).

However, the failure of the FDIC scheme also owed to another factor. With its domestic authority contested, both in general and on the issue of risk-based standards, the FRB turned

---

<sup>18</sup>It should be noted that a far more limited form of risk-based insurance premiums were introduced under the Federal Deposit Insurance Corporation Improvement Act of 1991, primarily as a way of raising revenue for the Bank Insurance Fund (BIF). See Cornett et al. (1998) for more details.

to international collaboration as a way of resetting the domestic agenda and promoting the idea of risk-based standards as international “best practice.” Moreover, by institutionalizing capital standards as the central prudential tool for regulators across the globe, it could once-and-for-all establish its supervisory authority domestically. The venue for this collaboration – the Basel Committee on Banking Supervision – was naturally favorable terrain for the FRB, since it was dominated by fellow central bankers and given its undoubted status within that community as *primes inter pares*. As favorable as this environment was the the FRB, it was equally unfavorable to the FDIC, which lacked counterparts and therefore natural allies in many of the member countries. As such, by 1988 the FRB had easily outflanked the FDIC, institutionalizing a statutory risk-based standard in the United States (to take effect in 1992), relegating the assessments generated by on-site bank examinations to a clearly secondary status, and effectively killing the viability of the only serious alternative to its proposal, the risk-based insurance premium. Perhaps even more important, it set off path dependent dynamics that would empower the FRB in future revisions to the capital rules framework.

## 3.6 The FRB Turns to the Basel Committee

### 3.6.1 Background

The Committee on Banking Supervision, hereafter known as the Basel Committee, was created in 1974 as an informal committee of central bankers under the auspices of the Bank for International Settlements (BIS). The immediate reason for the creation of the committee was the collapse of the massive Franklin National and Herstatt Banks (see above); in order to prevent the collapse of subsidiaries of both international banks and therefore “avert a crisis of confidence in the international banking system,” the central bankers had to coordinate closely with one another to provide emergency assistance (Spero, 1980, 154). However, regulators recognized the need for some form of standing forum where common problems could be discussed, data on the international banking system could be shared, and convergence of rules achieved where possible (Johnson 1983, 24; Wood 2005, 46). The creation of the committee was largely a result of pressure from the Bank of England and the Federal Reserve, “an axis of cooperation... that was to prove pivotal in the future development of international regulatory cooperation (Wood 2005, 43; for comprehensive histories of the creation of the Basel Committee, see Kapstein 1989; Reinicke 1995; Braithwaite and Drahos 2000). Beyond these two key countries, the Committee included representatives of the “G-10 nations” – Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, and Sweden – in addition to Switzerland, Luxembourg, and Spain. Each country was represented on the committee by its central bank and its principal banking regulator. In the case of the U.S., the FRB acted as the sole U.S. representative until 1982, when the FDIC and OCC were assigned seats. However, ultimate approval authority for policy decisions rested with central

bankers since the Committee was (and is) an organ of the BIS (Wood, 2005, 47).

Neither the Committee nor the Board of Governors of the BIS has any direct regulatory authority. Instead, cooperation occurs on an informal basis, relying on largely consensual agreement to common ‘principles’ and the creation of ‘best practice’ standards (the informality of such bodies is a common feature in transgovernmental financial regulatory collaboration (see Zaring 2005, 548-549 and Drezner 2007, 139). Nevertheless, the Committee quickly emerged as an important and influential actor on international regulation of the banking sector<sup>19</sup>. In the first place, this influence is derived from its effects on its powerful members. As Wood (2005, 47) notes, “the work of the committee has served to spur national reform, even in the absence of negotiated agreements” primarily because of its leading role in tracking potential problems and encouraging information sharing amongst its members, both of which contribute to convergence in key areas. Second, by interacting closely with one another on a regular basis, the members of the Committee have forged a “true international network for banking regulators” or, as Kapstein characterizes it, an “epistemic community” that not only shares information, but more importantly shares common beliefs about the international banking sector (Johnson 1983, 26 make similar points, though emphasizes the social connections between members). Thus, by forging closer connections between its members, it has achieved a degree of convergence in beliefs and regulatory outcomes, at least amongst developed nations.

The power of the Basel Committee is also derived from its impact on national policy communities that exist beyond its confines. By its very nature, research and agreements that emerge from the Committee were frequently portrayed as reflecting a global ‘consensus’ and as embodying ‘best practice’ standards that all countries should aspire to emulate (Zaring, 2005, 531). As a result, this makes it difficult for domestic audiences to question the judgments reached, particularly when the matters agreed are presented as largely technical and apolitical. Perhaps as a consequence, Committee agreements have also been remarkably important in helping to set domestic regulatory agendas, as several accounts make clear (e.g. Tarullo 2008; Wood 2005; Singer 2007; Herring 2007). The iterative nature of cooperation in certain areas – such as capital standards – definitively shifted the locus of decision making on those subjects to the Committee, at least until the past few years<sup>20</sup>. The Committee also

---

<sup>19</sup>The first major agreement reached by the Committee was the Basel Concordat of 1975, which created a set of rules for supervision and provision of emergency assistance to banks operating in foreign jurisdictions. In short, it established the principle that the parent bank should be held responsible for financial difficulties at overseas subsidiaries, which, by implication, meant that the parent company’s central bank should act as lender of last resort. For more see Wood (2005, Chapter 3).

<sup>20</sup>The 2009-2010 debate over capital standards that took place as part of the financial reform legislation in Congress proves that domestic politics does still matter (the Dodd-Frank Bill includes a provision known as the ‘Collins Amendment’ that places floors on capital levels. See Chapter 6 for more.). In addition, there is some evidence that domestic protectionism in the area of capital and liquidity standards is growing – see Borak (2013) for more.

strengthens the political influence of its Members and therefore the influence of Committee agreements. For example, by sharing knowledge and experiences with one another, regulators enhance their expertise and enforcement capacity, thus helping to build political capital in domestic regulatory debates (Raustiala, 2002).

All histories of the Basel Committee paint a portrait of the FRB, often acting in concert with the Bank of England, as the dominant actor within the institution (e.g. Kapstein 1989, 1992; Wood 2005). This fact should not be surprising; the U.S. was the predominant global banking and securities market for most of this period and the Federal Reserve was – and indeed remains – the world’s preeminent arbiter of monetary policy, a fact that was doubtless not lost on an organization composed primarily of central bankers (Hemel, 2011). Both Chairman Volcker and his successor, Alan Greenspan, were also personally held in high esteem by their colleagues (Kapstein, 1992; Nuxoll, 1999). Given the influence of the Basel Committee as an institution and its dominance within it, it is hardly surprising that the FRB turned to it as a strategic support in its domestic battle over capital standards.

### **3.6.2 The FRB’s Early Efforts to Reach a Common Position on Risk-Based Capital: Opportunities and Challenges**

The other members of the Basel Committee had historically placed “even less emphasis on bank capital than had the United States” (Tarullo 2008, 40; Norton 1995). However, beginning in 1980, the FRB in particular began to pressure its counterparts to harmonize divergent regulatory approaches to capital amongst the Basel Committee member countries (Wood, 2005, 74). That year, largely at the instance of Chairman Volcker (Kapstein, 1992, 274), the Committee issued a statement that called for greater research on the international payments system and capital adequacy levels at global banks; more importantly the Committee stated that, at least informally, it should work towards a “greater convergence among its members with regard to national definitions of bank capital for supervisory purposes” (Basel Committee, 1981, 7). In 1982, the Committee published a further report setting out an agenda for its future work. Specifically, it stated that the Committee would work towards achieving a “common view” on capital levels, particularly focusing on the role of subordinated instruments (which, as aforementioned, were instruments that the FRB strongly favored for inclusion in regulatory definitions of capital, in contrast to the FDIC). In addition, the Committee would examine the types of ratios of assets to capital that should be included in such a common approach, marking the first specific reference to the concept of “risk asset ratios” (Basel Committee, 1982, 4). Therefore, well before Congress passed the ILSA, the FRB was pushing its colleagues to embrace a common approach to capital, ideally one based on risk.

Whether as a result of these efforts or not, a number of the other representative central bankers and regulators on the Committee began to focus more heavily on capital ratios in their prudential regulation of the banking industry in the early 1980s. The United Kingdom and Switzerland established formal capital ratios in 1981, and each one took at least some



account of risk (particularly the Swiss, who established a 15-asset-category risk weighting system, which essentially represented a more finely graduated model of the one that the FRB had used since the 1950s. See Tarullo 2008, 41). Germany incorporated capital ratios into its domestic banking law in 1985, again taking account of risk weights in a very limited way. Indeed, by 1985, with the important exceptions of Japan and Italy (neither of which offered any formal guidance on capital ratios or risk assets), nine of the thirteen member countries had incorporated at least some reference to risk in their capital guidelines. This trend can be explained by multiple convergent factors: for example, the 1977 Banking Coordination Directive issued by the Council of the European Economic Community (EEC) had called for the establishment of capital ratios for “observation purposes” (i.e. as supervisory guidelines). This Directive doubtless influenced many regulators, as did the competitive pressures and concerns arising from the LDC debt crisis (see Norton 1988-1989, 1340; Singer 2007, Chapter 4). At the same time, this development may have occurred because of the emergence of an “epistemic community” within the Basel Committee or simply as a result of the influence of the FRB (Wood 2005, 74; see also Kapstein 1989, 1992). Regardless of the source of the shift, the embrace of capital ratios and the openness to standards that took account of risk ultimately proved fortuitous to the FRB in its domestic advocacy for an RWA approach in the United States.

The FRB’s effort to harmonize standards was given a further boost by the passage of the ILSA. The Act had included a provision calling for, though not mandating, greater international cooperation between U.S. regulators and their foreign counterparts, particularly on the issue of bank capital standards<sup>21</sup>. The inclusion of this provision was almost certainly thanks to the efforts of the FRB, and particularly its Chairman, Paul Volcker. As Wood (2005, 72) notes, during the discussions that led to the Act, Volcker emerged as the leading advocate for international coordination of capital standards. Volcker employed the Basel Committee’s research on international banking to make his argument to lawmakers, noting that U.S. banks’ exposure to foreign assets had increased dramatically since the early 1970s, with many of the largest banks holding more than 50 percent of their assets overseas and generating the bulk of their revenue from their foreign transactions (see Kapstein 1989, 323-347). The FRB Chairman furthermore justified this need for international coordination by appealing to lawmakers’ sensitivity to U.S. banks’ international competitiveness. For example, Volcker suggested in testimony (quoted in Reinicke 1998, 107):

This is an area where it is important, to the degree possible, to have a common international approach... I would also note that – not as any kind of excuse, but

---

<sup>21</sup>The language in the Act directed the FRB and the Treasury Department to “encourage governments, central banks, and regulatory authorities of other major banking countries to work toward maintaining, and where appropriate, strengthening the capital bases of banking institutions involved in international lending. See 12 U.S.C. §3907(b)(3)(C)(Supp. IV 1986).

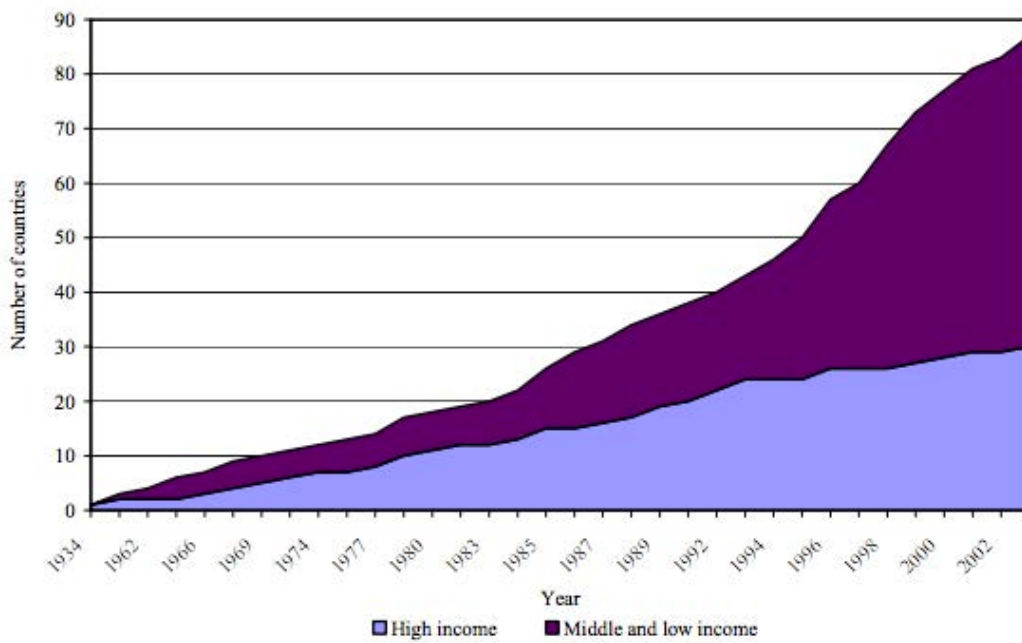
as a fact – banks undoubtedly have felt under very heavy pressure internationally, and carrying more capital is a cost.

Finally, Volcker suggested that including language in the Act would give a congressional “imprimatur” to its existing efforts to harmonize standards, signaling domestic political support for its existing harmonization efforts (Norton, 1988-1989, 1326).

Progress towards such standards appeared to be accelerating when the G-10 central bank governors approved a framework that would eventually lead to “functional equivalence” amongst the member countries on the issue of capital measurement and ultimately the baseline to be used in determining quantitative measures of adequacy. However, at that point, negotiations hit a roadblock. In March 1984, Chairman Volcker made a formal presentation at the Basel Committee seeking convergence in capital standards based on a RWA approach (Tarullo, 2008, 50). According to Kapstein (1994, 108), the speech was “greeted with a yawn” by his colleagues, many of whom were becoming increasingly conscious of the negative domestic political reaction to their efforts (particularly from the banking industry) and aware of the immense resources that would be required to implement a harmonized system (Wood, 2005, 74). As specific common approaches were developed throughout 1984, it became clear that while members agreed on “the crucial role of bank capital in restoring public confidence in the payments system, and... that capital levels should not be allowed to drop any further” they could not agree on “a common policy project to achieve a single standard” (Kapstein 1992, 276 based on an interview with Federal Reserve official). For the following two years, the FRB and the Bank of England were forced to quietly lobby for changes and give time for further development of a comprehensive risk-based proposal to occur (the two regulators organized collaborative events and working groups to generate detailed plans. See Kapstein 1992, 278-279).

Coincidentally, it was during this period that the FDIC proposal presented its greatest threat to the FRB’s preferences domestically. If the FRB was clearly using the Basel Committee to increase its domestic leverage on the issue of RWA capital standards, why did the FDIC not similarly attempt to use the Basel Committee, or another transgovernmental forum, to achieve their policy objectives? After all, the concept of an international deposit insurance fund, advanced by Herbert Grubel (Grubel, 1979), had considerable traction within academia, the press, and even in parts of Congress (Kapstein, 1992, 277). The answer is two-fold. First, the Basel Committee was, as aforementioned, dominated by central bankers, a naturally sympathetic constituency for the FRB. Second, and more important, the FDIC simply lacked natural allies. Amongst the Basel Committee members, just five countries – France, Germany, Belgium, Japan, Canada, and Spain – had established a deposit insurance system prior to 1980; by 1985, the United Kingdom and Switzerland had also set up forms of a deposit insurance system (see Demirguc-Kunt et al. 2005). However these deposit insurance schemes were often administered by a consolidated regulator with more diverse interests and constituents than the FDIC (Demirguc-Kunt and Kane, 2002). Similarly, there was wide variance in the coverage and nature of insurance funds (perma-

Figure 3.5: Trends in Adoption of Deposit Insurance, 1979-1990



Source: Demirguc-Kunt et al. (2005, 17)

ment versus non-permanent) between those countries (Garcia, 1999). Finally, there were few other places for the FDIC to look to achieve cooperation. As Figure 3.5 shows, by 1985 just twenty-two countries had any form of bank deposit insurance, and most of these countries had only recently adopted such schemes (Demirguc-Kunt et al., 2005). In short, the FDIC was unable to exploit international collaboration as a strategic tool and take advantage of the stall in the Basel capital negotiations, a fact that rendered its own plan unviable in that forum.

### 3.6.3 Reaching an Accord, 1986-1988

By 1986, the FRB decided to apply pressure to the Basel Committee to reach an agreement. In July 1986, Volcker announced that he and his Bank of England counterpart, Robin-Leigh Pemberton, were negotiating a bilateral agreement on a common capital adequacy standard. Both regulators shared an interest in reaching an accord; the Bank of England was already using a risk-based approach in its standards, and the FRB had worked closely with it before proposing its own RWA approach to Congress in 1986 (Bardos, 1987-1988, 27-28). The Bank of England also desperately needed an agreement at Basel given the increasing exposure of the City of London then, as now, the financial hub of Europe, to international banking crises and the growing competitive disadvantage its banks were facing relative to Japanese banks, which were not subject to capital requirements. Unsurprisingly then, the strategic effort by both regulators succeeded in producing a bilateral accord in early 1987. The agreement created two tiers of capital – “base primary” and “limited primary” – that were closely related to the “primary” and “total” capital distinctions that the FRB and OCC had been using since 1981 (see Bardos 1987-1988, 27-28). It also created five weighted categories of risk assets that closely tracked the FRB’s 1986 U.S. domestic proposal (Norton 1988-1989, 1343; the agreement also made clear that these standards would not replace existing leverage ratios, which was consistent with the FRB’s domestic position). While the agreement was merely a “consultative document,” the two regulators intimated that they might apply these standards to foreign banks either seeking to acquire banks in their jurisdictions or operate directly (both agency heads publicly suggested they were considering “mandated reciprocity” in the early portion of 1987; Reinicke 1995, 169; see also Wood 1996).

This alliance between the FRB and the Bank of England had two critical effects on both the domestic and international debate. For the other members of the Basel Committee, the combined size of both countries’ banking markets, the other members of the Basel Committee were left with little choice but to reopen negotiations over a common standard (Singer, 2004, 546). In particular, Japanese officials, who had been up until that point had been most resistant to an agreement (since their banks, which were at that point not subject to capital requirements, had the most to lose), were extremely worried about being left out of any common agreement (Duffy, 1987). As a result, the Japanese delegation agreed to open three-way talks with the FRB and the Bank of England. Although the negotiations were

difficult and required some important concessions to the Japanese on the issue of ‘hidden reserves’ (corporate equity held by banks, a practice far more common in Japan than in the U.S. or U.K.), an agreement was reached in September 1987 that effectively retained the core elements of the bilateral agreement (Wood, 1996). The tripartite accord had the “desired effect of hastening a broader agreement” amongst the Basel Committee membership (Wood, 2005, 78). Indeed, on December 10 1987, the Committee announced that it had reached an agreement on a plan for the “international convergence of capital measurements and capital standards” (Basel Committee, 1987). Although the final version of the accord required significant concessions and was “not simply coerced” (Kapstein, 1992, 282), it was nevertheless a document that at its core reflected the RWA approach and definitions of capital long favored by the FRB. The key provisions of the Accord are summarized in Figure 3.6 (see also Herring 2007, 3-5; Tarullo 2008, Chapter 3; Wood 2005, 79-83).

More important for the purposes of the discussion here, the decision by the FRB to form an alliance with the Bank of England and, more generally, engage with its colleagues at the Basel Committee, had a profound effect on the domestic debate. The FRB had kept the OCC, the FDIC, and key Members of Congress informed about its negotiations with the Bank of England. By 1986, the OCC had accepted the principle of a risk-based standard (see above), while Congress had shown a deference to the FRB’s international efforts in the ILSA and subsequently in hearings throughout 1986 and 1987. More importantly, it was clear that other key policy actors – particularly the OCC and the Congress – would also be willing to defer to the joint initiative, in large part because it would carry the imprimatur of a global best practice standard. The large asset trade associations remained opposed to risk-based standards – one Volcker advisor characterized the representatives of the largest banks as being “pain in the ass” during the Basel negotiations (Wood, 2005, 75), their concerns were eased by the promise that the agreement would increase competitive equality (Wood, 1996)<sup>22</sup>. Moreover, in 1987-88, the major trade associations were distracted with a series of viable bank deregulation bills being discussed in Congress and thus had little time to focus on the ongoing Basel negotiations. Indeed, between the late 1986-1988 period, there were only a handful of public comments on the ongoing Basel negotiations from these organizations.

This left the FDIC effectively isolated in its opposition to risk-based standards and the FRB’s embrace of a more liberal definition of capital. Once the FRB and the Bank of England began negotiations, it was obvious that risk-based standards were about to become the internationally accepted best practice approach to prudential regulation and that its own risk-based deposit proposal was losing support domestically. At this point, the agency faced a choice: work with its colleagues at Basel and have some impact on the ultimate terms of an agreement (most likely in terms of the definition of capital) or face the prospect

---

<sup>22</sup>Whether the Accord actually achieved this goal is, however, a matter for debate. See Tarullo (2008, 76-77) for an overview of studies that assessed the impact of the Basel Accord on international competition.

Figure 3.6: Basel I: Summary of Key Provisions

<b>'Tier 1'/Primary Capital</b>	Common Stock Disclosed Reserves
<b>'Tier 2'/Secondary Capital</b>	General Loan Loss Reserves Hybrid (debt/equity) Instruments Subordinated Debt
<b>Tier 1 Minimum Ratio of Capital to RWA</b>	2%
<b>Tier 2 Minimum Ratio of Capital to RWA</b>	4%
<b>Total Minimum Ratio of Capital to RWA</b>	8%
<b>Risk Weight Asset Calculation</b>	0%: Cash Like Instruments, Government Securities 20%: Debts of International Institutions 50%: Secured Mortgages 100%: All Other Investments/Loans

of opposition to the international consensus and consequent isolation at home. If this was the 'stick' to force the FDIC to accept the RWA principle, there was also a 'carrot' to get it to that point. The FDIC had worked closely with the Bank of England on several major issues dating back to the Franklin National resolution in 1974 and had developed a relationship of trust with them (Wood, 2005, 43). As a result, when the Bank of England presented its extensive research on the effects of their risk-based capital standards to the FDIC, the latter, while still skeptical about the technical feasibility of implementation in the U.S., proved receptive to the broader message (Kapstein, 1992, 279). Whether it was the prospect of isolation, the failure of its own risk-based insurance proposal, or the institutional relationship with the Bank of England, in late 1986, Chairman Seidman conceded that a risk-based standard made sense in principle and that "an international standard for capital would be most welcome, since it is difficult to make valid comparisons when every country counts it differently" (Seidman, 1986, 78). This shift in position represented the most important victory of all for the FRB, removing the last major domestic hurdle to the implementation of its RWA approach. Indeed by the end of 1988, all three regulators had adopted final rules implementing the Basel Accord guidelines, and full implementation occurred by the end of 1992 (Getter 2012, 2; a summary of the key provisions of the Basel Accord can be found in figure 3.6).

## 3.7 Impact of the FRB's Victory on Capital

### 3.7.1 Institutional and Policy Impacts of the Accord

The Basel I agreement (as it has since come to be known), though theoretically nothing more than a supervisory guideline, in fact represented “the cornerstone of a new regulatory order” in international banking (Wood, 2005, 83). The Accord shifted the locus of decision making with regard to capital perceptibly, and to some extent permanently (Tarullo, 2008, 84); such issues were, in the future, to be shaped at the transgovernmental level and specifically under the guise of the Basel Committee. As capital became *the* central prudential regulatory tool for national regulators, the Basel Committee by default became the leading “central organ of international financial governance” (Wood, 2005, 96). This was reflected not only by the fact that the Committee was the primary forum for discussion of new capital standards, but by its emergence as prolific research and proselytizing body on a wide range of subjects related to financial governance. Indeed, the Committee published over eight times as many reports in the fourteen years following the passage of the Accord as it had done in the previous sixteen years of its existence, suggesting that the Basel community of central bankers and regulators felt increasingly empowered (see Norton 1995, Chapter 2).

The Accord also had a profound effect on the domestic policymaking landscape. The shift in the locus of agenda-setting and decision-making to an institution dominated by central bankers naturally bolstered the domestic influence of the FRB in subsequent debates (see below; Herring 2007); conversely, the lack of influence that the FDIC and the OCC exercised weakened their ability to influence outcomes<sup>23</sup>. Equally as important, the Accord helped to establish an image of the FRB within the domestic policy community as the preeminent figure amongst the regulatory community and the leading promoter of internationally accepted ‘best practice’ standards (Hemel, 2011). Amongst members of the Basel Committee, the FRB’s role in the first agreement established an expectation that they would drive the agenda on any future revisions (Wood, 2005, 129); indeed, throughout the 1990s, the FRB was the driving force behind the creation of a new alternative to Basel I based on internal bank credit risk models. In addition to these path dependent impacts of the Accord, two other factors greatly empowered the FRB in these subsequent debates. First structural shifts in the industry towards consolidation had led the BHC structure to become the dominant form of bank organization, with a consequent dramatic increase in the FRB’s discretionary influence (Tarullo, 2008, 30). Second, the economic expansion that began in the mid-1990s helped to produce an unprecedented climate of political deference to the FRB and its Chairman, Alan Greenspan (e.g. see Chapter 4; see also Goodman 2008; Johnson and Kwak 2010).

From a policy perspective, the Accord had profound impacts that reshaped the banking

---

<sup>23</sup>The generally marginalized position of the FDIC and OCC within the Basel Committee is a theme noted in former FDIC Chairman Shelia Bair’s book *Bull By the Horns*. See Bair (2012, Chapters 3, 22).

industry and the nature of prudential regulation. It did, unquestionably, raise capital levels across the developed world (Jackson et al., 1999, 6)<sup>24</sup>. However its effects were far more wide reaching than that. For example, it accelerated the banking consolidation trend that began to occur in the 1980s; the emphasis on quality of capital, rather than simply on the size of assets, effectively disadvantaged smaller banks with specific loan concentrations (Llewellyn, 1989, 46). When added to the decision not to impose capital requirements on ‘non-bank’ banks, a decision that increased competitive inequalities for depository institutions, the Accord produced strong incentives for banks to consolidate to achieve capital diversity and economies of scale (Wood, 2005, 90). Since the agreement forced banks to hold more capital as their asset size and risk increased, it also diminished the incentives for asset growth (achieved through lending) and instead encouraged banks to generate income from fee-based financial transactions, a development that contributed to the exponential growth in the lucrative securitization industry from the early 1990s onwards (Jackson, 1995-1996).

Basel I also encouraged the use of risk spreading devices, most notably credit derivatives, greatly contributing to the exponential growth in that market that began in the early-to-mid-1990s (Tarullo 2008, 74; see Chapter 4 for a more detailed discussion). Finally there was a concern – ironically expressed most vocally by the FRB and its Chairman Alan Greenspan in the mid-1990s – that Basel I encouraged regulatory arbitrage. In short, the “fairly arbitrary” nature of the risk bucket approach allows “many assets with dissimilar actual or “economic” risks [to be] assigned the same risk weight” (Tarullo, 2008, 80). For example, under Basel I, banks actually had an incentive to lend to less creditworthy commercial customers, since they would earn higher rates of return and still only be required to hold the same amount of capital as they would against a loan to a highly creditworthy corporation. For a variety of reasons, securitization of assets – a phenomenon not addressed directly by the Accord – incentivized banks to retain less creditworthy tranches of securities *and* permitted them reduce their capital requirements significantly at the same time (Jones, 2000, 52-54)<sup>25</sup>. Other forms of arbitrage, leading to similar pro-risk outcomes, have also been attributed to the Accord (see Jackson et al. 1999, 25; Herring 2007, 272)<sup>26</sup>. In short then, the FRB’s decision to pursue a RWA approach to capital profoundly shifted the institutional, political, and structural

---

<sup>24</sup>However, as Tarullo (2008, 69) notes, some of this increase in capital was achieved through creative regulatory interpretations that permitted “innovative capital instruments” to be counted as tier 1 capital. See BIS1998 for a full list of these instruments.

<sup>25</sup>When a bank or other financial institution securitizes a loan, they are likely to retain the highest yielding (but least creditworthy) tranches of that pool of loans. Because all of the loans were assigned the same weight for RWA purposes, offloading the less creditworthy loans reduces the need to hold capital. However the actual economic risk stays the same, since the loans retained by the bank were the ones most likely to result in losses in the first place.

<sup>26</sup>Although not a prominent concern at the time, as figure 3.6 illustrates, the decision to assign a 50 percent weighting to mortgage loans and therefore mortgage-backed securities also encouraged banks to become more active in the home lending market, with obvious knock-on effects in the 2007-2008 financial crisis.



landscape of financial services regulation worldwide.

### 3.7.2 Impact on Basel II Debate

#### The FRB Puts an Internal-Risk-Based Approach On the Agenda

In order to illustrate these longer-term institutional and policy impacts, it is worth briefly turning to the debate over revisions to the Basel Accord. The criticisms of the Accord had contributed to a series of amendments, largely initiated by the FRB, in the early-to-mid 1990s (Wood, 2005, 125). These amendments incorporated sensitivity to market risk in risk-weightings and, in a particularly notable revision in January 1996, permitted banks to use their own internal credit risk models, under limited circumstances (see Basel Committee 1996). Nevertheless, there was little groundswell for a fundamental revision of the ‘risk bucket’ capital to asset ratio framework, as typified by the comments of the 1988 comments by the Chairman of the Basel Committee, Tom de Swaan, which emphasized working within the current basic framework laid down by Basel I (deSwaan, 1998). Likewise, no other U.S. regulator or Basel Committee member had suggested fundamental revision of the Accord and a review of public comments by the Comptroller and FDIC Chairman from 1990-1998 gives no indication that they were thinking of a fundamental reassessment (this review is confirmed by Tarullo 2008, 90, who makes a similar observation).

However there was one actor willing to publicly and frequently call attention to the deficiencies in the Basel I Accord: the FRB, ironically its one-time champion. As early as May 1996, FRB Chairman Alan Greenspan contended that deficiencies in the Basel agreement were becoming “ever more evident” and that “the marketplace has become much more complicated in ways that risk-based rules cannot handle” (Greenspan, 1996, 14). He also began to draw attention to the benefits of bank-generated internal ratings approaches based on “value-at-risk” (VaR) models (Seiberg 1996; Tarullo 2008, 89)<sup>27</sup>. By 1998, a cascade of FRB officials were calling for reform. Laurence Meyer, an FRB governor, argued that regulatory arbitrage was making the Accord “increasingly less meaningful and progressively undermined,” while noting that securitization and credit derivatives had led to a growing divergence between regulatory capital requirements and actual credit risks (Meyer, 1998). Throughout 1998, Greenspan gave speeches calling for change and an adoption of an internal-ratings-based (IRB) approach (Harris, 1998); indeed in one speech he referred to the Basel I agreement as “obsolescent” (Rehm, 1999a).

Greenspan created a Federal Reserve task force to examine the incorporation of internal models into regulatory capital ratings. That task force reported back in 1998, arguing that that internal bank models could be used to set the formal capital requirements for at least

---

<sup>27</sup>“Value at risk” as a concept simply refers to the amount of money that an institution is at risk of losing should should the price of an asset - such as a loan or a security - go down.

some assets (Seiberg, 1998). Greenspan now pushed for implementation of this approach, arguing that regulators “must try to embrace the internal models of banking organizations to create in fact the capital requirements to meet the risks they face” (quoted in Rehm 1999a). At the same time, his colleague, William J. McDonough, the president of the New York Federal Reserve, became chairman of the Basel Committee in June 1998. In September 1998, he gave a speech calling for “major effort” to overhaul the Basel Accord and claimed that the Committee recognized “the need to move expeditiously, and to make significant progress in the next one to two years.” He also questioned the “sophisticated arbitrage strategies” used by banks, and noted the strengths of bank credit risk models, without explicitly endorsing them (quotes cited in Tarullo 2008, 91-92). McDonough established a Steering Group on the Future of Capital, to report back to the full Committee on a reform proposal. Clearly the Federal Reserve supported reform that would replace the existing RWA categories with ones determined by an IRB approach.

A detailed assessment of why the FRB was committed to this approach is beyond the scope of this brief discussion. However there are at least three plausible explanations. First, as has already been discussed, the Accord simply no longer made sense and was potentially *increasing* systemic risks; a crisis that could be attributed to Basel I would therefore have negative consequences for the FRB’s reputation for competence given its close association with the agreement. Second, despite their public enthusiasm for IRB models, the FRB was privately concerned about the accuracy of the models (Tarullo, 2008, 102). Indeed, a study conducted by two Federal Reserve economists found that risk rating systems at U.S. banks were actually significantly less advanced than had been widely assumed (Treacy and Carey, 1998). The embrace of such models was widely seen by Federal Reserve officials as “the most effective way to incentivize banks to make the desired improvements [in their IRB systems]... was to tie the bank’s internal processes to regulatory capital requirements” (Tarullo, 2008, 102). Third, the IRB approach was at least broadly consistent with the FRB’s broader monetary policy objectives i.e. keeping interest rates low to encourage growth. Specifically an IRB approach could potentially lead to a decline of 20-30 percent from the current RWA capital requirements (Basel Committee, 2001, Paragraph 48). Irrespective of its motives, its policy preferences were clear from an early point in the process, in contrast to other key domestic and international actors.

### Reaching an Agreement

Until the FRB announced its intent to bring about a fundamental revision of the Basel Accord, none of the other U.S. bank regulators had said much about the subject (Tarullo, 2008, 90). However, Comptroller of the Currency Eugene Ludwig had expressed “misgivings about letting financial institutions in effect set their own capital levels” in a 1997 speech (Ludwig, 1997). Once the FRB’s plan to propose an IRB approach were clear, the FDIC, first under Chairman Donna Tanoue and then under Bush-appointed Don Powell, made clear

their opposition in public and private comments (Bair, 2012, 31). Indeed in May 1999, an FDIC report noted “serious deficiencies in the proposals that regulators use the banks’ own internal risk management models in setting capital requirements.” (Nuxoll, 1999, 27). There was reticence too amongst the FRB’s colleagues on the Basel Committee, as expressed by its former head Tom deSwaan (see above). Even the FRB’s old ally, the Bank of England, had been cautious on the issue of IRB; indeed, its head of banking supervision argued in 1997 that internal models would only be viable replacements for the existing RWA approach “in five [or] ten years” at the earliest (Graham, 1997).

Despite this domestic opposition and the continued reticence from many members of the committee towards the FRB proposal, there was an increasing recognition that some form of significant change was needed (Jackson et al., 1999, 100). The coupling of a recognition of the need for reform with a reluctance to embrace an IRB approach was reflected in a 1999 consultative document issued by the committee which suggested, in addition to other changes to the definition of capital itself, that risk weights for assets be assessed not using an IRB approach, but instead by employing ratings from “external credit assessment institutions” such as Moody’s or Standard & Poor’s. The consultative document did state that the Committee intended to issue further recommendations on the use of IRB (Basel Committee, 1999, Paragraph 7); however, it was clear that there had been little progress towards that goal (Rehm, 1999b). In any event, few observers felt that the external credit rating approach would work; as Comptroller John D. Hawke stated in 1999, he did “not believe the external ratings approach alone will go very far in solving the problems of the current accord” (Hawke, 1999) in large part because many borrowers simply did not have agency credit ratings and because the sovereign ratings applied by the agencies had proved unreliable during the preceding year’s Asian debt crisis (Tarullo, 2008, 97-98). In fact, for a variety of reasons, the ratings agencies themselves ultimately came out against the proposal, effectively ending its viability (Garver, 2000).

In order to move the process along, by late 1999 the FRB became increasingly strident in its instance on a IRB approach (Wood, 2005, 144). At the same time, Chairman Greenspan invited major U.S. banks to pay close attention to the work of the committee and to work to “influence the eventual outcome of the deliberations” (Greenspan, 1999a). While it was clear that the FRB’s call for a fundamental revision had taken hold, it needed to form alliances to secure adoption of an IRB approach. Multinational banks, despite some reticence about the costs of updating their existing IRB systems and a concern about the complexity of some of the proposed rules (Herring, 2007, 424-426), were clearly enthusiastic about the prospect of using their own credit models, which they felt had the potential to reduce their overall capital burden (Tarullo, 2008, 101). Other Basel countries wanted to exclude these banking interests and their international trade association, the Institute for International Finance (IIF), from the negotiations (Graham, 1999). So too did the FDIC and representatives of smaller banks in the United States, such as the ICBA (Herring, 2007). However, Greenspan insisted they be formally included in the discussions and thus mid-2000 formal consultations

opened with the IIF, the major country trade associations, and representatives of multinational banks.

The failure of the external ratings option, combined with the FRB becoming “more assertive in championing the IRB approach” and the entry of the banking trade associations into the discussions appeared to build inexorable momentum for an adoption of the IRB approach (Tarullo, 2008, 104). Indeed, the main sources of opposition – the German delegation and the FDIC – appeared to fade away as a consensus position began to build in the Committee (Wood, 2005, 143). In June 2000, McDonough stated publicly that the Committee was “more committed than ever to an internal-ratings-based approach” (McDonough, 2000). In January 2001, the Committee issued a 450 page long and technically complex document was intended to be “a starting point for additional dialogue” (Basel Committee, 2001, 53). Nevertheless, it did lay the basis for the ultimate Basel II agreement, suggesting that three different approaches to capital adequacy be adopted. The first was an A-IRB approach for a handful of major banks that met specific risk and disclosure criteria, which would allow for widespread use of IRB models for capital purposes. A second pillar, F-IRB, permitted banks that opted in to use IRB on a more limited basis, while a standardized approach simply increased the number of risk categories under the existing Basel I scheme (see Herring 2007, Tarullo 2008, 107-112).

The emerging plan was subject to a “mild backlash” from Members of Congress and the other two banking regulators (Tarullo, 2008, 127). Senator Richard Shelby (R-AL) and Paul Sarbanes (D-MD), who were later to become Chair and Ranking Member of the Senate Banking Committee after the final agreement on Basel II was reached, expressed concerns that the emerging IRB approach would diminish safety and soundness (Heller, 2003). Both the OCC and the FDIC were increasingly vocal in their opposition. In general, while the OCC had become more favorable to reform since the late 1990s, it felt that the emerging proposals were excessively complex and would be difficult to implement. The Comptroller, John Hawke, became increasingly outspoken about this concern in press interviews, speeches, and congressional appearances (Tarullo, 2008, 119). For example, in a House hearing in February 2003 he argued both that the agreement was “infinitely more complex than it needs to be” and that the U.S. should adopt a go-slow approach to implementation of the plan (Garver, 2003a). The FDIC Chairman, Don Powell, objected not only to the complexity of the planned A-IRB scheme for large banks, which would enable those institutions to reduce their net bank capital. Later, Mr. Powell complained that the plan was “being rushed into place, with discussions of significant alternatives now virtually ruled out by the timeline and by the international collaborative nature of the project” (Garver, 2003b).

However, despite this panoply of opposition, on June 24 2004, the ‘Basel II’ Accord was agreed to by all members of the Committee (Basel Committee, 2004). Although it was

forced to compromise on a range of minor issues<sup>28</sup> and problems admittedly bedeviled the domestic implementation of Basel II (see Herring 2007 for a comprehensive account), the Basel II Accord nevertheless marked another victory for the FRB. In many ways, despite the lengthy timeframe it took to reach an agreement, the process suggests that the FRB was in a far less contested position than it had been in the early-to-mid 1980s. It was able to single-handedly set the agenda for a new accord without any significant opposition domestically or internationally. It was able to overcome opposition within the Committee without fundamental compromises on the issue of an IRB approach, though admittedly this was achieved in alliance with the banking industry. Finally, despite opposition from key Members of Congress and the other two major regulators, U.S. adoption of the Accord never appeared to be seriously in question. In short, the FRB's victory reflected a form of path dependency: the effects of the initial RWA approach created the conditions that led to the viability of an IRB alternative, while the movement to decision-making in Basel locked in that pattern of transgovernmentalism. At the same time, the role played by the FRB in the original Accord earned it a reputation for deal-making and as the leading global authority on best practices. Combined with the broader political deference it enjoyed in the late 1990s, it is therefore perhaps not surprising that Basel II represented a clear win for the FRB.

### 3.8 Conclusion

This chapter has demonstrated that a single bureaucratic actor – the FRB – possessed long-held preferences on the issue of capital adequacy that were closely tied to its mission and distinctive competency. Faced with a climate in which its authority was contested, we have seen that the agency responded strategically first by invoking the connection between its monetary policy function and its role as a bank supervisor, effectively preventing attempts to remove or dramatically dilute its regulatory authority. The chapter has also illustrated how the FRB successfully fought to establish capital standards as a stand-alone metric with regulatory force and managed to deemphasize the more qualitative on-site examinations based on the CAMEL system favored by the FDIC and the OCC. It further underscored how the FRB strategically used the Basel Committee to advance its objective of establishing a uniform RWA standard and as a mechanism to prevent alternative policy proposals, such as the FDIC's risk-based premium plan, from gaining traction. As has been noted in the preceding two sections, the successful conclusion of the Basel I Accord had a lasting effect on how capital adequacy policy, and by extension bank regulatory policy in general, was determined. The institutional and policy impacts of the Basel Accord helped to empower

---

<sup>28</sup>One relatively high profile if relatively marginal compromise was an agreement between the FRB and the German delegation to reduce the risk weight assigned to commercial real estate bonds and lending to small and medium-sized enterprises (Prabhakar, 2012, 18).

the FRB in subsequent debates. As a result, the FRB was in a far stronger position by the late 1990s to insist upon a new regime that used IRB approach to calculating adequacy. In short then, an agency with independent preferences behaved strategically and successfully expanded its authority or, to put it differently, achieved a significant measure of *bureaucratic autonomy*.

A key feature of this chapter was the degree to which many of the developments reflected institutional and power path dependency. The policy preferences of each of the three main regulatory actors were shaped by relatively informal supervisory practices that had been implemented – in some cases – decades earlier. This created an increasing returns dynamic that made it difficult for senior policymakers in those agencies to conceive of alternative approaches. The ability of the FRB to reach a deal with the OCC on capital ratios set in motion a growing investment by regulators, legislators, and banks in the concept of formal capital ratios, one of many factors that undermined the FDIC's alternative risk-based insurance plan proposed when it was proposed four years later. Perhaps most of all, the Basel Committee represented an attempt by the FRB to permanently shift the locus of policy debate to an institutional setting in which it exercised tremendous influence. The success of that agreement not only ensured that it would be the forum for future regulatory debate, but moreover accrued legitimacy and influence to the FRB, as vividly illustrated by the negotiations over Basel II. This again underscores the fact that strategic regulators seek not only to win short-term battles, but attempt to expand and preserve their authority in the long-term by setting in motion path dependent dynamics.

It is certainly true that the events presented here could be explained using different theoretical lenses. Political control theorists might note that at critical points Congress appeared to place pressure on regulators, most notably in the case of the ILSA in 1983. However, the ILSA effectively endorsed the existing positions of the FRB – that regulators agree to a common capital standard with regulatory force and that they pursue agreement on capital adequacy at the international level – and was, in fact, shaped in large part by Chairman Volcker. Beyond this, Congress plays a marginal and largely reactive role in the episodes detailed above. Instrumental accounts doubtless would point out that the Basel II Accord delivered an outcome that in broad measure was one that that multinational banks had lobbied hard for. This ignores the fact that the FRB proposed such changes long before the major banking organizations became involved in the process, involvement which, in any event, was encouraged by the FRB. In other cases we see banking groups divided amongst themselves and in some cases, such as the attempt to remove the FRB's supervisory authority, being wholly unsuccessful in their efforts. As a result, while both the political control and instrumental group power approaches likely explain some aspects of the episodes discussed here, the evidence in support of such claims is mixed at best.

Others would claim that global cooperation on capital adequacy was a response to structural and functionalist pressures. However, such arguments appear far weaker when we compare capital adequacy to the issue of liquidity. Capital risks and liquidity risks are very

similar: the former refers to what might be termed ‘solvency’ risk – the probability that banks will have insufficient assets to cover their liabilities – while the latter refers to the likelihood that a bank will be unable to pay its debts as they come due owing to insufficient liquid or ‘cash-like’ assets. Conceptually then, the only difference between capital and liquidity is the ease and time it takes to convert the asset under discussion to cash. More importantly, liquidity shortfalls at banks have led to numerous banking crises (Elliott, 2010b); indeed, it was a liquidity crisis that led directly to the collapse of Lehman Brothers in September 2008. When the investors in the overnight ‘repo’ markets<sup>29</sup>, which provide short-term financing to financial institutions, lost faith in Lehman’s ability to repay its short-term debts, the investment bank collapsed. Had Lehman had a greater liquidity safety net, it might have survived long enough to avert much of the ensuing crisis that followed its collapse (see Kling 2009).

Likewise, differences in liquidity standards also contribute to competitive inequalities between banks operating across multiple national jurisdictions (Hemel, 2011, 239). In fact ‘reserve’ or liquidity requirements on U.S. banks were higher than any other major industrialized country, with the exception of Germany, until 2008 (Sellon and Weiner, 1996); indeed, many countries lacked *any* formal liquidity mandate (Elliott, 2010a, 7). These higher reserve requirements imposed costs on U.S. banks that hurt their overall ability to compete (Demirguc-Kunt and Huizinga, 1999), while lower (or non-existent) liquidity standards at major foreign banks created global systemic risks (Neri, 2012). Therefore, if there were functionalist or structural pressures for global cooperation on capital, why not on liquidity?<sup>30</sup> The answer, in large part, may lie in the fact that the FRB’s has long set ‘reserve’ or liquidity standards for all banks, a function that has rarely been contested given its close connection to monetary policy. Therefore, in the absence of contestation, there were simply no pressures to engage in international collaboration.

The following chapter discusses a subject that was in many ways was (and is) linked to the risk-based capital adequacy debate: the regulation of “over-the-counter” (OTC) derivatives. As the chapter will demonstrate, the preferences and actions of the Federal Reserve were once again central to shaping U.S. policy on the issue. Viewing such products as important hedging devices and confident in its own ability to oversee bank risk exposures to OTC trading, it consistently and assuredly opposed to any form of direct regulation of the OTC markets. Its strategic actions, combined with the weakness of the functional regulator of derivatives, the CFTC, as well as the reticence of the SEC to assume greater jurisdictional responsibility, permitted it win crucial early policy debates that effectively foreclosed the political possibility of regulation by the mid-1990s.

---

<sup>29</sup>‘Repo’ refers to ‘repurchase agreements.’ Banks once generated most of their liquidity from deposits; however today most of it is derived from these short-term, overnight “repo” markets

<sup>30</sup>Agreement was reached on new global standards as part of the Basel III Accord. See Ryan (2012b) for more.

## 4 | OTC Derivatives and the Absence of Regulation: An Autonomy-Based Explanation

### 4.1 Introduction: A Focus on the Early Stages of the Regulation Debate

Derivatives, financial instruments whose value is based on an underlying asset, have been characterized as many things. To some, they are “shock absorber[s]” that have reduced risks for financial and non-financial companies alike, thus promoting investment and economic growth (quoted in D’Souza et al. 2009-2010). In 1999, the most famous proponent of these instruments – former Chairman of the Federal Reserve Alan Greenspan – characterized their growth as “[b]y far the most significant event in finance during the past decade” (Greenspan, 1999b), later suggesting that “over-the-counter” (OTC) derivatives had contributed to the “development of a far more flexible, efficient, and resilient financial system than existed just a quarter-century ago” (quoted in Berry 2003). On the other hand, skeptics have suggested that such products are inherently risky and subject to manipulation; one commentator colorfully compared the trading of OTC derivatives to “the middle age practice of alchemy, by which practitioners attempted to convert lead into gold” (Kim, 2008, 706). Perhaps most famously, investor Warren Buffet characterized them as “financial weapons of mass destruction” in 2002 (quoted in Berry 2003). In the years following the 2008 financial crisis, these contrasting views regarding the economic utility and risks attached to OTC derivatives have been subject of significant public debate.

Irrespective of one’s views about derivatives themselves, we do know certain key facts. One is that by October 2008, the notional value of outstanding OTC derivatives contracts was estimated to be in excess of \$600 trillion (Greenberger, 2011, 10). Even using a more conservative baseline based on actual amounts at risk in the event of counterparty default, that figure was \$55 trillion, approximately equal to global GDP that year (Sirri, 2008). Second, despite its size and the extensive exposure of every major U.S. financial institution to OTC derivatives, trading in these products had effectively been unregulated since they



first emerged in the early 1980s. As Christopher Cox, then Chairman of the SEC noted in hearings before the Senate Banking Committee after the 2008 financial crisis, the OTC derivatives market was a “regulatory black hole”; discussing one particular subset of derivatives – credit default swap (CDS) – Cox emphasized that this “\$58 trillion notional market... *is regulated by no one*. Neither the Securities and Exchange Commission (SEC) nor any regulator has authority over the CDS market, even to require minimum disclosure to the market” (emphasis added; Cox 2008). Third, while the consequences of earlier decisions to almost completely exempt the sector from government oversight have been debated at length elsewhere (for example, Greenberger 2011; Levine 2012; Partnoy and Skeel 2006-2007), we do know that even previously ardent opponents of regulation – such as Greenspan – now acknowledge that at least some of those decisions were “mistakes” (Andrews, 2008).

This chapter therefore seeks to shed light on how and why an industry of such size and risk came to be unregulated in the first place. The best way to find an answer to that question is to examine the origins of the OTC markets and the early public debates about their regulation. To illustrate why this is important, compare the market and the politics surrounding it in the late 1990s and early 2000s with a decade earlier. Between 1997 and 2006, the industry grew at an exponential pace, as did its political influence, both of which make it difficult to rule out claims of structural or instrumental group influence. However, by turning our attention to an earlier period, we instead find a new, fragmented, and politically disorganized industry that was far less likely to have exerted determinative influence on public policy makers. Likewise, it is difficult to escape the fact that some public officials in the late 1990s and early-to-mid 2000s, impressed by the coincidence of rapid economic growth and deregulation, may have been vulnerable to “ideological” or “cultural” capture by private interests, effectively internalizing policy preferences that aligned with those of the industry (see Kwak 2013 for a full discussion; note the collary to arguments about a ‘third face of power’; see Gaventa 1980). However, such claims are empirically suspect in earlier eras, given that we have clear evidence that regulators, legislators, and industry members frequently disagreed about public policy objectives. In short then, by confining the bulk of the analysis to the period between the mid-1980s and mid-1990s, when the market for the most popular form of OTC derivative – swaps – emerged and a debate over regulation ensued, we can better identify the critical decisions and actors that set the trajectory for future developments.

Based on the evidence presented here, I contend that the preferences and actions of regulators, particularly the Federal Reserve, were critically important in shaping the development of the OTC industry and in stacking the deck against futures attempts at regulation. Specifically, I demonstrate that senior policy officials within the Federal Reserve, led by Chairman Greenspan, were at an early stage both largely aware of the risks of OTC derivatives trading and adamantly against any regulatory solution that would inhibit its growth. The Federal Reserve instead believed that improvements to their existing supervisory structures and industry self-regulation based on ‘best practice’ standards were the most effective solutions to

the problem of institutional and systemic market risk. These preferences, which predated the large-scale expansion of the market and the era of significant industry influence, were moreover closely tied to its core regulatory objective, the promotion of risk-based capital standards as the primary prudential tool for government, as well as its clear belief in the relative sophistication of its research and supervisory staff. It was critical in thwarting a 1987 attempt by the Commodity Futures Trading Commission (CFTC) to regulate swaps and helped to prevent an aggregation of authority by the more formidable Securities and Exchange Commission (SEC). It again played an important role in the broad swap exemption the CFTC issued in January 1993. Finally, the Federal Reserve was perhaps *the* critical actor in the 1993-1994 congressional debate over derivatives regulation, employing rhetoric and drawing upon its transgovernmental associations to bolster its case for industry self-regulation.

By contrast, the principal functional regulator of derivatives products, the CFTC, appears as a small and politically contested actor with preferences that is dependent, at various times, on the regulated futures industry and on the personality of its Chairman; as such, it clearly does not meet the threshold of an ‘autonomous’ agency. The weakness of the CFTC – illustrated by the failure of its policy initiatives and sidelining in the debate after 1992 – also had a major impact, since the functional derivatives regulator would have been the most obvious source of contestation for the FRB and others that opposed regulation. Finally, I examine the role played by the SEC. The agency, which oversees a disclosure-based and rules-oriented securities regulatory regime, had a strong interest in this debate. It was concerned about the absence of oversight over equity-based derivatives and the lack of transparency in the opaque OTC market, since both had an impact on its core securities focused mission. Yet, it lacked the breath of the Federal Reserve’s political influence or the resources necessary to effectively monitor these markets alone. Thus when discussions turned to mergers between it and the CFTC, or proposals were made that would give it significant jurisdictional authority over the OTC markets, the agency displayed reticence out of concern that assuming such extra responsibilities might hurt its reputation and therefore its core mission. As such, the SEC, despite its residual concerns and significant political authority, also largely stood aside in this debate.

The chapter that follows begins with a basic primer on types of derivatives and the differences between the exchange-traded and OTC markets. I then describe the market as it existed in the late 1980s and early 1990s and explain its growth; this is done also to underscore the relatively small size of the industry at the time, a fact that would cause us to question functionalist or structuralist explanations of early regulatory efforts. A background and detailed discussion of the preferences of the three agencies in this study – the CFTC, the Federal Reserve<sup>1</sup>, and the SEC – follows, as does an assessment of industry influence on the

---

<sup>1</sup>The term ‘Federal Reserve’ is often, though not always, used in place of ‘Federal Reserve Board’ (FRB) in much of this chapter. This nomenclature distinction reflects the fact that many of the key officials in

early OTC regulation debate (focusing particularly on the role of the International Swaps and Derivatives Association (ISDA)). The chapter then examines early attempts to regulate the OTC markets and the 1993-1994 legislative debate, with a focus on the strategic actions of the three regulators. In the conclusion, I briefly discuss the impact of these earlier actions on the 1998 proposal by the CFTC to regulate the market and the subsequent passage of the Commodity Futures Modernization Act in 2000. I also address in more depth the cultural capture argument.

### 4.2 Derivatives: A Primer

At the simplest level, a derivative is a bilateral contract between two ‘counterparties,’ the value of which is *derived* from the value of an underlying value of an asset (securities, bonds, or commodities), a reference rate (an interest or currency exchange rate), or an index level, such as the Dow Jones Industrial Average (Culp, 1995). In turn, all derivative contracts can be broken down into four basic types: futures, forwards, options, and swaps. Both futures and forwards obligate one of the parties to buy or sell a specific amount or a specific value of an underlying asset, reference rate, or index at a specified point in the future, which may or may not also involve the payment of periodic fees to the seller (GAO, 1994a, 5). For example, United Airlines, concerned about fluctuations in the price of jet fuel, may wish to control that risk (i.e. hedge) by agreeing to a forward or future contract with a supplier that locks in the price they will pay for fuel over a specified time period in the future. Although conceptually identical, futures and forwards differ in two respects. First, futures are exchange-traded derivatives – contracts traded on exchanges such as the Chicago Board of Trade (CBOT) – while forwards are privately negotiated contracts arranged in the so-called “over-the-counter” (OTC) market. Second forwards, because they are privately negotiated contracts, are customized to the needs of the two parties and often involve more complex agreements based on multiple assets, reference rates, or indices (see Kramer 2004, 418-419, for a more detailed breakdown of the differences between these contracts)<sup>2</sup>.

---

this debate were not members of the Board but of the ‘Federal Reserve System’ e.g. the President of the Federal Reserve Bank of New York, and Reserve Bank Presidents that sat on the Federal Open Markets Committee (FOMC).

<sup>2</sup>Traditionally, most derivatives were based on agricultural products such as wheat; indeed “forward contracts” between suppliers of agricultural products and purchasers have existed for hundreds of years (Kramer, 2004, 413-414). These types of contracts helped protect farmers against what were often dramatic price fluctuations in the price of commodities such as grain; however, these pre-exchange markets were also highly manipulable by speculative short sellers. When the price of grain declined after World War I, the farming lobby and others blamed speculation and placed political pressure on the federal government to regulate their forward contracts. Whether as a result of these efforts or not, the Grain Futures Act of 1921 instituted regulation of “futures” for the first time. In 1936, Congress replaced the Grain Futures Act with the Commodity Exchange Act, which effectively prohibited trading of contracts that resulted in the future “pur-

Options contracts bear some similarities with forwards and futures. However, in this form of contract, one counterparty obtains the right, but *not the obligation*, to buy or sell the underlying instrument from the other party at future point in time at an agreed upon price. In return, the party selling the asset, reference rate, or index is paid a premium (much like insurance premiums or loan interest) by the purchaser of the option (see Kolb 1995 for a detailed explanation). Thus, in the example above, United Airlines may decide not to purchase jet fuel at the agreed upon price (presumably because the current market price is lower than the contract price); in that case, the airline places a “call” order, indicating that they have elected not to buy the fuel<sup>3</sup>. In addition, a special subcategory of options, known as ‘futures options’ or ‘forward options’ are contracts where the underlying financial instrument is a future (therefore making it a derivative based on a derivative (see Kramer 2004, 422-423 for a background on these types of contracts). Options contracts may be traded on options exchanges, such as the Chicago Board Options Exchange (CBOE), and, depending on the type of contract, stock exchanges; less standardized options with more complex terms are typically traded on the OTC markets in much the same way as forward contracts.

The final category of derivatives are swaps, contracts which are only traded on the OTC markets<sup>4</sup>. At a basic level, swaps are simply agreements in which two counterparties with complementary needs to exchange periodic payments with each other based on changes in underlying assets, rates, or indices. While forwards, futures, and options have long existed and been subject to regulation, the first known swap – a currency swap between IBM and the World Bank – was conducted in 1981 (Tett, 2009, 22). Most of the earliest swap agreements were, however, interest rate swaps (Karol, 1995; Forde, 1986b). In a typical interest rate swap, a bank may seek to hedge its interest rate risk; this risk typically would exist because it holds a large portfolio of variable interest assets (such as mortgages) while most of its liabilities (such as deposits) are paid on the basis of fixed rates. If the bank believes rates are going to decline (which would hurt its revenue), it could enter into an agreement with another entity (such as a bank with a different type of portfolio) to swap their interest payments and receipts (GAO, 1994a, 5). Thus, while the actual loans and deposits remain on the bank’s balance sheet, its makes payments and receives receipts as if it owned the other bank’s portfolio. As a result, swaps are often referred to as ‘synthetic’ products (Tett,

---

chase or sale of a commodity,” though the definition of “commodity” applied fairly narrowly to agricultural products until the early 1970s, when precious metals were also added. The definition of “commodity” and therefore “futures” was later extended (see below). See Kramer (2004) for an overview and Romano (1997) for a comprehensive history of the development of the futures markets.

<sup>3</sup>If United Airlines decided to purchase the fuel at the agreed upon price at the agreed time, it would place a “put” order. See Kolb (1995) for more examples of these forms of contracts.

<sup>4</sup>Given the exponential growth of the swaps market in the 1980s (see next section), it was often used by commentators as a synonym for the entire OTC marketplace.

Figure 4.1: Major Categories of Derivatives

<b>Derivative</b>	<b>Trading Market</b>	<b>Definition</b>	<b>Example</b>
<b>Futures</b>	Futures Exchanges	Contract that obligates one party to buy or sell specific amount or value of an underlying asset, reference rate, or index at specified future date.	Airline wishes to hedge against the risk of jet fuel increasing, agrees to purchase fuel at a specified time from supplier at a rate or rates defined by the contract.
<b>Forwards</b>	OTC Markets		
<b>Options</b>	Options and Some Stock Exchanges/ OTC Markets	Contract that grants purchasers the right, but not the obligation, to buy or sell as specific underlying instrument at a particular price within a specified period of time.	As above, except the airline is concerned that market prices could also drop significantly in the future. Therefore airline takes out option contract with supplier and pays it an agreed premium during term of contract.
<b>Swaps</b>	OTC Markets	Contract that requires two counterparties to either a) swap their payments on an underlying instrument or b) in case of a credit default swap, causes one party to pay a premium to the other in return for default protection coverage.	Bank with an imbalance of fixed interest rate liabilities and variable rate assets wishes to hedge against possibility of rates going down. Agrees to swap some of its payments and receipts with another institution.

Adapted from GAO (1994a, 5).

2009, 22)<sup>5</sup>.

Besides these four categories of derivatives, a particular subset of OTC instruments that began to emerge in the mid-1990s: credit derivatives (see Tett 2009, 30 for a detailed account of how these products were created). These instruments may be forwards, options, swaps, or a combination of all three (Scheerer, 2000). Nevertheless, all credit derivatives essentially involve some form of transfer of default risk between two counterparties (Scheerer, 2000, 150-151). By far the most widely used credit derivative instrument is a swap known as a credit default swap (CDS) (Pagliari, 2013, 128). In a typical CDS contract – as illustrated in figure 4.2 – an institution, concerned about the potential for default in a portfolio of loans that it holds, may purchase a CDS contract in order to protect itself against this default risk (typically from another financial institution). The seller of the CDS contract agrees to make the bank whole on the face value or “notional” amount of the loan in the event that a specified “credit event” occurs (such events may include the bankruptcy or default of a debtor, or debt restructuring)<sup>6</sup>. In return, as in most derivative contracts, the buyer makes periodic payments to the seller (for more, see Chander and Costa 2010 and Scheerer 2000, 156-157). CDS contracts are often taken out against a pooled securities known as CDOs, in which case the swap is known as a ‘synthetic CDO.’ Like all derivatives, neither counterparty to a CDS need necessarily own the underlying asset (the loan, ‘tranche’ of a CDO; this fact has attracted criticism<sup>7</sup>.

As aforementioned, derivatives are traded generally in one of two ways: via exchanges or in the OTC markets. Futures contracts and future options are legally required under the terms of the Commodity Exchange Act of 1936 (CEA) and Commodity Futures Trading Commission Act (CFTCA) to trade on an exchange such as the CBOT or the Chicago Mercantile Exchange (CME), while securities-based options (that is options to buy corporate stock) are traded on the CBOE, as well as the Philadelphia and American Stock Exchanges (Culp, 2000, 265). These contracts generally have standardized contractual terms; moreover, only certain types of commodities or rates are traded, since daily trading activity must be high in order to supply a liquid market (see Hu 1993, 1465). Unlike stock exchanges, participants in these markets are institutional investors such as commercial banks, investment

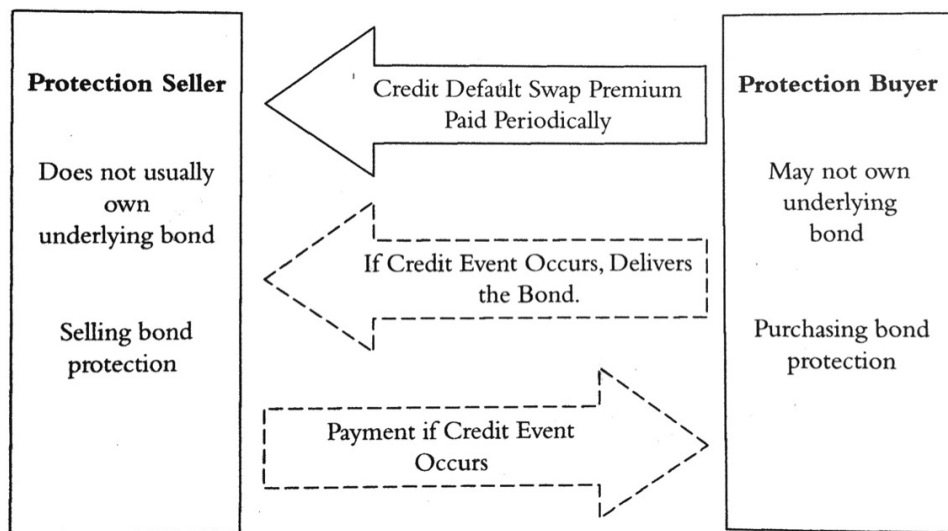
---

<sup>5</sup>Although all swaps are ‘synthetic’ in the sense that the counterparties do not own the underlying asset that they are exposed to, the term has come to be closely identified with ‘synthetic collateralized debt obligations’ (synthetic CDOs). CDOs are pools of securities (such as mortgages); synthetic CDOs are collections of credit default swaps whose underlying instrument is a CDO. See Stulz (2009, 11) for a detailed explanation.

<sup>6</sup>Under such circumstances, the seller of the CDS takes possession of the underlying instrument e.g. a portfolio of mortgage securities.

<sup>7</sup>Since the purchaser of a credit derivative does not need to own the underlying instrument, some have described them as a form of “legalized gambling” (quoted in Harrington 2008), while other prominent figures have warned of their systemic dangers e.g. Warren Buffet’s famous characterization of them as “financial weapons of mass destruction. See also Duffie 2008; Partnoy and Skeel 2006-2007 for similar points of view.

Figure 4.2: Typical Credit Default Swap Transaction



Source: Pozen (2010, 70). Note again that the protection buyer does not need to own the underlying bond, in which case it would not, in fact, deliver the bond when the credit event occurs.

banks, insurance companies or specialized futures dealers known as Futures Commission Merchants (FCMs; for more on structure of exchange markets, see Banks 2005). The OTC markets are comprised of two types of actors: dealers and end users. Dealers have always almost exclusively been large commercial banks and securities firms, both for historical reasons (see below) and practically because trading in derivatives requires institutions with strong credit standing, capitalization, financial expertise, and access to information about a wide variety of end users that can be matched with one another, characteristics that even major non-financial corporations tend to lack (Singher 1994, 1404; Culp 2000, 265). Dealers may act purely as brokers (as they did in the early development of the OTC markets - see G-30 1993, 34) or may also act as one of the counterparties to a transaction. End users are a more diverse array of actors and include a vast array of corporate, governmental, and financial institutions (for examples see Gibson 2007).

### 4.3 The OTC Derivatives Markets in the Late 1980s/Early 1990s

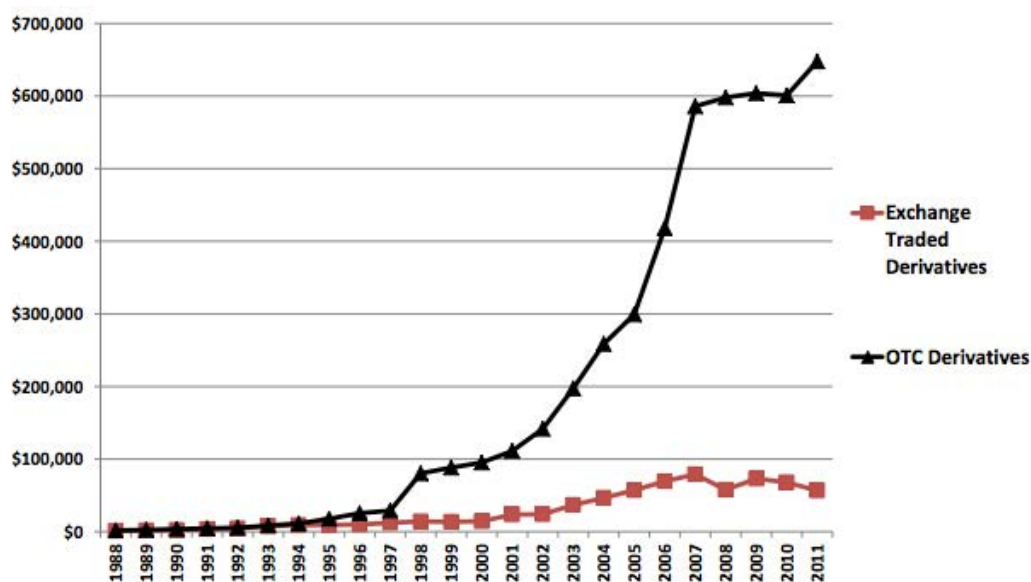
Following the first publicized swap transaction in 1981, the small OTC market expanded rapidly. By the end of 1982, there were \$3 billion in interest rate swaps outstanding globally; by the end of 1984, this figure had grown to \$90 billion (Hu, 1989, 363-364). The

growth continued thereafter. By 1987, the notional amounts of OTC derivatives contracts globally outstanding stood at approximately \$900 billion and within a year the market had expanded to a notional figure of \$1.3 trillion (Hu, 1989, 337). By the end of 1990, total outstanding OTC derivatives contract were notionally worth \$3.4 trillion dollars, exceeding the value of exchange traded derivatives, which had also grown rapidly (McCaffrey, 2012, 2). In fact, by the end of 1991, the global value of OTC contracts outstanding was by one measure greater than the value of all corporations listed on the New York Stock Exchange (NYSE) and Tokyo Stock Exchanges (Hu, 1993, 1459). While these notional figures provide insight into the growth in the market over time (see figure 4.3), they are also misleading; in real terms, the market was actually relatively small until the mid-1990s. This is because swaps, unlike contracts to buy or sell stocks or bonds, do not involve an exchange of the underlying principal (hence the principal is referred to as a “notional principle”); rather the notional principal is used solely as a metric to calculate the periodic cash payments between the parties. Vitally, it ignores the actual credit exposure of the parties involved (i.e. the amount at risk), nor the cash-flow between them (see Edwards 1996, 126-130, Gibson 2007 for a discussion of these issues). Indeed, when we use “gross credit exposure” as a measure of market size (today regulators’ primary metric is the less conservative “net credit exposure” - see OCC 2012, 3), the size of the market at the end of 1992 was just \$84 billion or 1 percent of the \$14.4 trillion gross credit exposure that existed in the global bond markets at the time (Edwards, 1996, 129).

Another way to think about the market as it stood in the late 1980s to early 1990s would be to look at the gross derivative exposures of just the seven largest bank derivatives dealers and compare them with the exposures in their loan portfolios (see figure 4.4). Even by the end of 1994, the exposures of these major dealers were less than a quarter of their exposure to other loans on their books and in most cases approximately equal to the capital levels held by the banks (Edwards, 1996, 129). While there is no question then that the industry was rapidly expanding during this era and that these figures are objectively significant, it also highlights the fact that the OTC markets were, prior to the mid-1990s, still relatively contained. In fact, as figure 4.3 shows, the truly dramatic expansion of the OTC market occurred after 1996. This fact raises the bar for functionalist or structuralist explanations of the public policy response between the mid-1980s and mid-1990s, since the systemic risks of an OTC market failure simply were not as pronounced during this period (these arguments are weakened in any event by the failure of policymakers to coordinate on a regulatory response to contain risk in the late 1990s and 2000s, a key prediction of functionalist arguments). Second, and far more important, it also weakens the implicit structuralist accounts that many have advanced to explain the failure of policymakers to regulate these markets. As will be shown in this chapter, many of the most critical decisions and non-decisions regarding U.S. OTC derivatives policy were made prior to 1995, a period in which the market itself was still contained and therefore incapable of exerting significant structural influence, particularly on otherwise powerful actors such as the FRB.



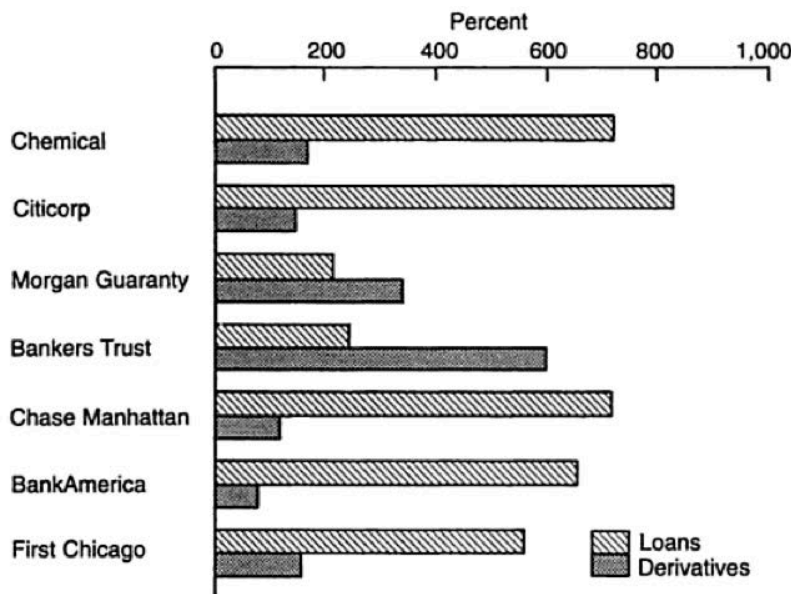
Figure 4.3: Exchange-Traded and OTC Derivatives Global Notional Amounts in U.S. Dollars (Billions), 1988-2011



Source: McCaffrey (2012, 2) and BIS (2012).

Nevertheless, the OTC markets were clearly growing in size. Why? In the first place, these products simply offered significant benefits to end users. Derivatives in general are far cheaper than purchasing the underlying asset itself, while OTC derivatives incur lower transaction costs because of the absence of exchange and other fees. More important, as Hu (1993, 1466) notes, derivatives enable end-user to transfer or modulate market risks (i.e. ‘hedge’), a feature that became more attractive as those risks – such as interest rate and currency fluctuations – increased in the late 1970s and 1980s (see Shiller 1988 for more background). Second, methodological and technological advances enabled the rapid expansion of these markets. The development of the Black-Scholes option pricing model, which generated an exact theoretical market value for an option, helped to greatly reduce the market risks for sellers of options (that is, the market prices will fall below the agreed price in the contract; explanations of the model and its effect on the market can be found in Bernstein 2005, Chapter 14). This model and further advances built on it provided “the conceptual breakthrough that allowed the OTC derivatives market to emerge” and removed the “obstacles to a bank’s engaging in a broad range of derivatives transactions (Hu 1993, 1469; for a more detailed explanation, see Litzenberger 1992). Added to this, rapid improvements in computer technology in the early 1980s allowed for real-time data feeds, large databases, and complex mathematical calculations, all of which were necessary for large scale OTC derivatives trading (see Hu 1989). As a result, the OTC market had become a “a hothouse

Figure 4.4: Credit Exposures from Derivatives and Loans of the Seven Largest U.S. Banks as Percentage of Equity, Year-End 1994



Source: Edwards (1996, 129)

for world financial innovation [and] complex, state-of-the-art products of Wall Street “rocket scientists”” (Hu, 1993, 1459)<sup>8</sup>.

Beyond the benefits derived from hedging and the methodological advances that made market expansion possible, there was another another factor boosting the growth of the market. Major dealers, such as commercial banks, earned lucrative ‘dealer spreads’ and charged fees for structuring OTC products (see Fromson 1995 for a full account of how these were generated). These spreads (essentially markups over the market price, since the products were not market traded; Whalen 2008, 224) and fees became an important source of revenue for U.S. commercial banks, which, as discussed in chapter 3, had otherwise experienced increased competition and declining margins from their traditional banking activities (Darby, 1994). Moreover, because OTC derivatives such as swaps could be constructed without the bank actually purchasing the underlying collateral, they involved no upfront cash investment,

<sup>8</sup>This refers to the increasingly advanced quantitative modeling that was required to effectively hedge risks and generate profits in finance in general and particularly in OTC derivatives trading. This fact led Wall Street firms to increasingly hire mathematicians and physical scientists that possessed that type of skill set (hence the frequent references in reporting at the time to “rocket scientists”). For more, see Hu (1989, 338-340).

Figure 4.5: Total Contribution of Derivatives Trading to Total Trading Income, 1993 and 1994

	1993	Percent	1994	Percent
Chase	201	28	108	15
Chemical	453	42	391	61
Citicorp	800	27	400	29
J. P. Morgan	797	39	663	65
Total/Average	2,251	34	1,562	42

Source: Edwards (1996, 140)

a fact that further boosted bank profits compared with other more traditional investment activities (Stulz, 2004, 185). Unsurprisingly then, as figure 4.5 shows, derivatives trading (OTC and exchange based) comprised a significant and largely growing percentage of the total trading income of major U.S. commercial banks in the early 1990s. When combined with the perception amongst market participants, shared by the FRB, that the swap market had grown precisely because it was largely unregulated (see Hu 1989, 365 for contemporary quotes from traders and banking executives), it is unsurprising that major commercial banks had an interest in preventing market regulation. However, as I discuss in section 4.7 and throughout this chapter, this *intent* was not reflected in sustained *action* by these banks to influence policy decisions, at least not in the late 1980s and early 1990s when the market was still in its early stage of development. As a result, the most critical decisions regarding regulation of the OTC markets in the late 1980s and early 1990s were to a significant degree made independently by key regulators and lawmakers, a statement that is particularly true in the case of the FRB.

#### 4.4 The CFTC: Oscillation Between Bystander, Pawn, and Lonely Advocate

In a 2009 *PBS* documentary that discussed the fights over OTC derivative regulation in the 1990s, Daniel Waldman, the former CFTC General Counsel, admitted that the agency he served was widely perceived to be a “sleeping, small, not terribly significant agency” (quoted in Frontline 2009). Indeed, despite the fact that the agency is the principal regulator of exchange-traded derivatives and should therefore theoretically have been the leader in crafting a policy response to the emergence of the OTC market, it instead oscillated between being a seemingly irrelevant bystander, a compliant pawn in a strategic chess game dominated by more powerful regulators, and a lonely advocate seeking more stringent regu-

lation. In order to understand the marginal role played by the CFTC, it is important to give some background. Following market turmoil and a series of commodity related scandals in the early 1970s, Congress established the CFTC as the “the futures industry analogue to the SEC,” replacing its largely discredited predecessor, the Commodity Exchange Authority (see Romano 1997; Markham 1986 for a full account of this episode). The Commodity Futures Trading Commission Act (CFTCA) of 1974 empowered the agency, principally by expanding the scope of the Commodities Exchange Act (CEA) to encompass all commodities, including financial based derivatives that had coincidentally begun to be traded at that time (though the CFTC was permitted to issue exemptions). The agency was also given broad powers, including inductive authority to stop violations and impose significant civil penalties on participants in the futures markets. In short, the new agency appeared set to succeed where its predecessor failed.

However, problems plagued the agency from the beginning. The CFTC’s authority “over futures markets was challenged by other agencies with jurisdiction over the underlying financial instruments or market participants” (Romano, 1997, 353). The first sign of this occurred before the agency was even created. The FRB and the Treasury Department pushed Congress to adopt a broad exemption from the CFTCA for so-called “hybrid” instruments (financial products that combine elements of debt and securities); they did so in large part because commercial banks were heavily involved in trading contracts at the time, which were widely considered to be vulnerable to regulation under the CFTCA’s expanded definition of a “commodity” (Coffee, 1995, 458-459). More important, a turf war with the SEC ensued over futures products based on registered securities, battles which began almost immediately after the agency was created when the CFTC declared that certificates could also be traded on futures exchanges (Markham, 2009-2010, 569-570). The conflict over securities-based futures continued to be waged throughout the 1970s and 1980s, with the SEC consistently exploiting the opportunity provided by periodic CFTC reauthorizations to ask Congress to remove jurisdiction from the CFTC (detailed accounts of this history can be found throughout Romano 1997, Coffee 1995, Markham 2009-2010, and Karmel 2009).

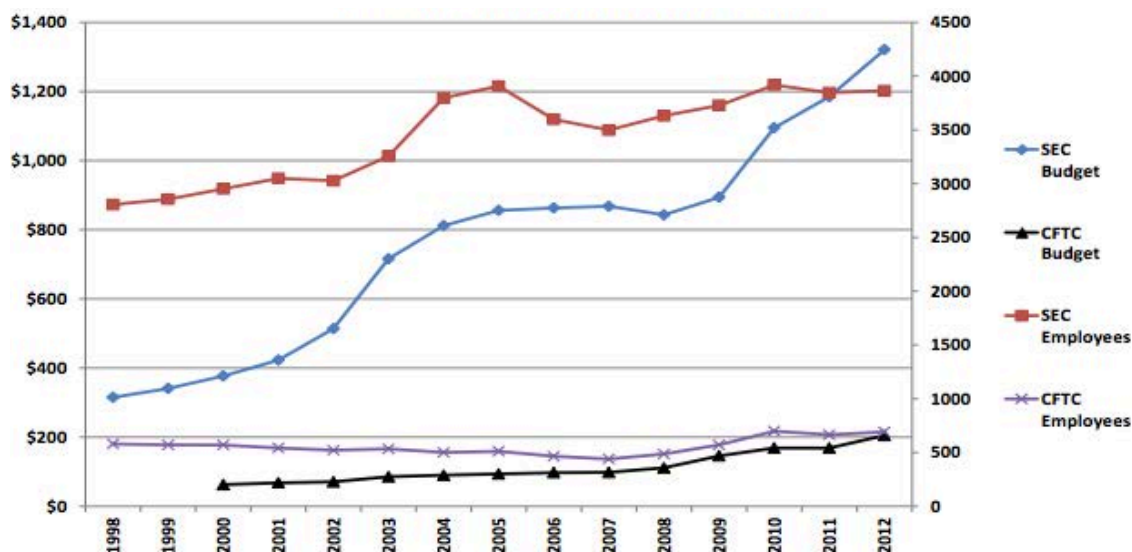
These challenges to the agency’s authority were compounded by a series of early policy and enforcement failures that tarnished its reputation. In the early 1970s, the SEC had shut down OTC commodity options firms that were engaged in widespread fraudulent activity; however, under the terms of the CFTCA, the CFTC now had jurisdiction over these firms. In contrast to the SEC with its large and experienced enforcement team, the CFTC proved “powerless to stop” the fraudulent activities and then was widely perceived as overreacting by imposing a temporary ban on all trading on commodity options, an act that attracted widespread criticism. (Markham, 2009-2010, 568). A series of other crises followed: a massive manipulation of potato futures, soybean contracts, and silver futures all damaged the reputation of the fledgling agency, with a widespread perception developing that it lacked in competency relative to the far more experienced and prosecutorial driven SEC (see Markham 2009-2010, 568). Indeed in 1978, a Government Accountability Office (GAO) report, com-

missioned in the lead up to the agency's first reauthorization hearings, was highly critical of the CFTC's overall performance and recommended that its authority "over futures contracts written on all securities" be transferred to the SEC (GAO, 1978, 11-14); the Carter administration OMB went further, and recommended replacing the agency in its entirety and transferring many of its functions to the SEC (Markham, 1986, 99-100). As is discussed in section 4.8, the agency was also subject to widespread criticism in the wake of the 1987 stock market crash, criticism that had an impact on its attempts to regulate the emerging swaps markets (see also Karmel 2009, 14-16).

This contestation of the CFTC's authority was largely a function of four related factors. First "[it] was a small agency that did not have the resources to police the commodity markets effectively" (Markham, 2009-2010, 567). Indeed as figure 4.6 (which covers more recent years) shows, until very recently the agency was chronically starved of funds and understaffed relative to the SEC. Second, partly because it lacked capacity and expertise in enforcement possessed by the SEC, the CFTC decided to base its discretionary activity on a 'principles-based' rather than a 'rules-based' approach, a fact that further reinforced its reputation as a lax enforcer (Karmel, 2009, 12). Third, by including an exemptive power in original CFTCA, the agency was left consistently vulnerable to political pressure from other agencies, industry groups, and ultimately in some cases by Congress; the indeed, the CFTC frequently exempted products following outside pressure (see later; see also Culp 2000, 270-271). Finally, as has been mentioned, the agency was subject to periodic reauthorizations – in other words, it was technically a "sunset agency" (Romano, 1997, 353). This provided frequent opportunities for those contesting the CFTC's authority – particularly the SEC and later the FRB – to attack the agency and seek to alter its jurisdiction. In sum, the agency was endowed with a formal discretionary mandate that permitted it to effectively declare any derivative product a "commodity" and thus subject to its regulatory oversight. While this fact should have enabled it to regulate OTC derivatives if it chose to – it neither had the internal capacity nor the political authority to do so.

Given its lack of authority, the preferences of the CFTC on the issue of OTC derivatives regulation are perhaps less important than those of other actors. In any event, while it is difficult to make firm conclusions, those preferences appear to lack true independence. In the 1980s, the pro-regulation tendencies of the CFTC appeared to be closely aligned with those of the futures exchanges, which were naturally in direct competition with OTC traders for derivatives business (though this alignment appeared to breakdown following criticism from the futures exchanges in the 1990s; see Romano 1997 for a full discussion). While this in itself does not suggest 'capture' – indeed I show below that the alignment between the preferences of the FRB and commercial banks does not represent instrumental capture – the fact that the futures exchanges were heavily involved in lobbying efforts in the mid-1980s on this issue and other positions taken by the CFTC adopted is noteworthy. Second, in the late 1980s and 1990s the preferences of the CFTC instead appeared to oscillate wildly and was largely driven by the personality of its leader. For example, Wendy Gramm was a known to

Figure 4.6: SEC and CFTC Budgets and Staff Totals, 1998-2012



Source: McCaffrey (2012, 25). Budget levels are indicated on the left axis; staff totals on the right. This chart is illustrative of differences in resources between the agencies since figures are not consistently available for earlier years.

be ideologically sympathetic to the notion that regulation would inhibit the development of the industry<sup>9</sup>. Others have further implied that Gramm herself may have been ‘captured’ by the industry, particularly in light of her last minute order granting the energy derivatives company, Enron, an exception and her subsequent joining of the Enron Board (Hacker and Pierson, 2011, 69). By contrast, Brooksley Born was known for her strong enforcement credentials and pro-regulation sympathies (see conclusion). These swings suggest an agency that lacked deeply rooted, independent policy preferences. In short, both owing to its lack of authority and doubts about the independence of its preferences, the CFTC appears to have not been an autonomous actor in the OTC debate.

<sup>9</sup>For example, in an Op-Ed written for the *American Banker* in 1992, Gramm dismissed concerns about risk in the market and the absence of regulation, arguing that “markets used by sophisticated, informed institutions tend to develop their own system of safeguards and protections” and that a regulator’s first job was to “allow innovation.” Moreover, she implored regulators and legislators not to “pull up everything green just because it might be a weed. It could grow into a flower” (Gramm, 1992).

## 4.5 The Importance of the Federal Reserve's Preferences and Role in the OTC Debate

In 2003, when FRB Chairman Alan Greenspan responded to Warren Buffet's famous assertion that OTC derivatives were "financial weapons of mass destruction," he stated with absolute surety that "These increasingly complex financial instruments have especially contributed... to the development of a far more flexible, efficient, and resilient financial system than existed just a quarter-century ago" (quoted in Berry 2003). His strong statement of faith in the OTC markets was not surprising; the FRB and Greenspan had, over the previous twelve years, played a critical role in promoting the use of these products by banks and had been central in preventing any effort to impose regulatory oversight on the market (see later sections for more; Whalen (2010, 20) similarly suggests that the agency "deliberately encourage[d] and tolerate[d] the growth of complex OTC instruments inside banks"). Of course, scholars of 'capture' would likely contend that such actions and statements were unsurprising given the concomitant rapid expansion of the OTC markets, particularly the exponential growth in lucrative credit derivatives trading. However, there is surprisingly porous evidence for the claim that, at least in the critical early period of swap market development, that "the intent and action of the industry regulated" was the primary force shifting policy (see next section; I discuss the possibility of 'cultural capture' – a concept advanced by Kwak 2013 amongst others – in the conclusion of this chapter). Moreover, Greenspan had been expressing such forceful public and private rhetoric in favor of these products and against regulation dating back to the earliest days of the emerging swap markets. Finally, it is clear that the decision to embrace private governance and prevent public regulation had its origins in the mission and distinctive competence of the FRB, and was closely related to its monetary policy objectives and agenda on bank capital regulation. As such, there is a strong case to suggest that the FRB's preferences on OTC derivatives regulation were independent.

First, it is important to note that the FRB, in contrast to both the CFTC, traditionally had little policy involvement in the development of derivatives regulation. Prior to the 1980s, the most notable contribution that the Board made to derivatives policy was an exemption it secured, along with the Treasury Department, for hybrid securities forwards in the 1974 CFTCA, one of the few products traded on the small OTC market at the time (specifically, the FRB and Treasury sought to protect bank involvement in the packing and trading of pooled hybrid contracts comprised of mortgages underwritten by the Government National Mortgage Association or GNMA. See Coffee 1995, 458). Second, when it did intervene in the internecine squabbles between the CFTC and the SEC over issues such as margins on exchange traded derivatives, its policy views generally were accepted by Congress, despite its lacks of expertise as a derivatives regulator (Coffee, 1995, 460). This owes largely to the fact, as Kane (1984, 19) observed, that "[i]n any skirmish over regulatory turf, the Fed is strategically positioned. As financial regulator and stabilizer of last resort, the Fed's span of

control far exceeds that of any other financial regulator”; by contrast, “the SEC and CFTC have narrower spans of control. In responding to actions taken by the Fed to defend what it views as its own span of control, these agencies’ narrower turfs and control frameworks put them at a distinct disadvantage.” Finally, as Karmel (2009, 19) puts it, the FRB “did not see it [as being in their] interest to resolve the controversies between the SEC and CFTC by creating a more powerful market regulator”; in particular, the FRB tended to oppose efforts by the more powerful of the two – the SEC – to merge the agencies or accrue additional authority onto itself (see Karmel 2009; Coffee 1995). In short, the FRB was a generally disinterested, though potentially powerful actor, in the area of derivatives policy regulation prior to the mid-1980s.

The emergence and growth of the swap markets in the mid-to-late 1980s quickly transformed the FRB into a far more active policy player. In contrast to the SEC and the CFTC, senior FRB officials were quick to note both the potential and risks of these new OTC products. It also became unambiguously clear – as evidenced by the Board’s attempt to prevent CFTC regulation in 1987 (see section), that the FRB would oppose any attempt that they perceived as ‘stifling’ ‘innovation’ in the sector, preferring instead to see industry self-regulation coupled with enhanced risk management practices at large banks. This view was most forcefully and consistently expressed by Alan Greenspan, who had become Chairman of the Board in August 1987. Greenspan’s preferences on the subject of OTC derivatives were quite clear and largely predate both the rapid growth of the industry that began in 1992 and accelerated in 1996. For example, in his first direct public comments on the issue of derivatives in 1988, given in testimony before the House Agriculture Committee, he noted that despite recent market volatility (which had been blamed on such trading) “equity derivatives... have become so large not because of slick sales campaigns but because they are providing economic value to their users” (Greenspan, 1988a, 4). He further argued that “[f]inancial derivatives, especially customized OTC derivatives, allow financial risks to be adjusted more precisely and at lower costs than is possible with other financial instruments” (Greenspan, 1988a, 2).

This advocacy for private sector solutions was extended in Greenspan’s testimony before the Senate Agriculture Committee in 1990, when he made clear that he felt the current broad definition of “commodity” was holding back the development of the swaps markets. Greenspan noted that “this restriction, when interpreted broadly, serves to discourage the development of new financial products that might be offered outside of the futures exchanges and tends to stifle the innovation process”; he continued by saying that the CEA provision should be modified “to include an exemption for transactions subject to other regulatory safeguards [and] sophisticated trader exemptions” (Greenspan, 1990, 8). When the exemptive language relating to swaps was included in the 1991 reauthorization of the CFTC (see below), Greenspan praised legislators for “reassur[ing] the markets that financial innovations and new products will not be curbed by ambiguities in the regulatory process” (Greenspan, 1991, 6). These early statements only became more forceful over time, as illustrated throughout this



chapter. Indeed the consistency and volume of his rhetoric on the subject is noteworthy; of the entire 238 available public speeches and testimony that Greenspan gave between 1987 and 1994, there were favorable references to the risk-attenuating benefits of OTC derivatives or discussion of the damaging effect of regulation in at least one-fifth of those public statements<sup>10</sup>. This leaves little doubt that Greenspan was an early believer in the important contributions of OTC products and a strong opponent of regulatory or legislative oversight of the emerging market.

Although few would disagree that Chairman Greenspan was the earliest and most “constant cheerleader for financial derivatives” (Karmel, 2009, 19), he was not the only senior Federal Reserve official that expressed strong support at an early stage in the development of the market. In 1992, FRB Governor Susan Phillips, who was the agency’s point person on these issues and a former Chairman of the CFTC, warned against an “overreaction to the risks that derivatives participation actually entails” and highlighted “the potential adverse effects of regulation on competition, efficiency, and innovation in the OTC derivative markets” (quoted in Cummins 1992b). Like Greenspan, Phillips praised a decision by the CFTC to exempt swaps from its authority earlier that year. Despite warnings to bankers about the need to manage the risk of their OTC derivatives operations more effectively, New York Federal Reserve Bank President Gerald Corrigan emphasized in a letter to the House Agriculture Committee that swaps should not be regulated as exchange traded derivatives were since it would effectively shut down the market, which existed in large part because such products were customizable to each party’s needs (Holland 1992b; this is particularly notable since Corrigan was widely perceived to be the most reluctant amongst the senior policy officials in the Federal Reserve. See Holland 1992a). While divisions undoubtedly existed at lower levels within the agency, all the public evidence<sup>11</sup> suggests that key FRB policymakers believed that OTC products were inherently beneficial and were consistently opposed to *any* form of regulation or legislative action<sup>12</sup>.

This belief in the benefits of OTC products was not, however, borne out of ignorance of the risks involved. In fact as early as 1985, the New York Federal Reserve Bank President, Gerald Corrigan, warned banking executives that unless swap instruments were carefully

---

<sup>10</sup>These statements are available online at the <http://fraser.stlouisfed.org/publication/?pid=452tid=82>. This figure understates the salience of the topic in Chairman Greenspan’s public rhetoric, since many speeches were relating to macroeconomic policy or were otherwise not germane to the subject of market regulation.

<sup>11</sup>FOMC meeting transcripts between 1987 and 1994 are marked by several references to derivatives, but none indicate the Committee members’ views on the issue of regulation or oversight.

<sup>12</sup>This does not mean that there was no division within the agency on the subject. As Whalen (2010, 30) notes, “the more conservative bank supervision personnel in the DSR [Division of Supervision and Regulation] in Washington [and] at the 12 regional Federal Reserve banks... often opposed ill-considered liberalization efforts such as OTC derivatives.” However, as Whalen notes, the Division of Banking Supervision and Regulation was widely perceived during this period to play little role in the formulation of FRB policy relating to capital or derivatives.

monitored they would not only not eliminate risks but instead exacerbate them (American Banker, 1985). In 1987, the FRB, in an effort to gain a better sense of the derivatives exposures of major banks, created a new metric for its supervisors known as a “credit equivalent amount” that was designed to estimate the potential risk exposure derived from off-balance sheet items such as swaps and in turn use that information to determine appropriate capital adequacy levels for the BHCs it regulated; notably, this preceded efforts by the other major banking regulators, who largely followed the FRB’s lead (Forde, 1987). In FOMC discussions between 1988 and 1991, regional presidents frequently brought up reports relating to OTC derivative exposure produced by their bank examiners (e.g. Fed 1990a, 20, Fed 1990b, 42). This close monitoring continued into the early 1990s. In 1993, the FRB issued instructions to field examiners on evaluating internal bank risk management systems relating to derivatives trading (Cummins and Garsson, 1993) and in early 1994 produced a detailed examination manual on the same subject. The FRB was also well aware of the systemic risks arising from the growth in swap trading, since it had encouraged the BIS and Basel Committees to produce an array of research reports and recommendations on the subject (e.g. see Cummins 1992a).

In early 1992, Corrigan cited the FRB’s research, excoriated banking executives for their failure to adequately monitor risks, telling them that they “all better take a very, very hard look at off-balance sheet activities” and the derivatives trading “must be understood by top management, as well as by traders and rocket scientists” (quoted in Hu 1993, 1462). Corrigan’s replacement at the New York Federal Reserve, William McDonough, similarly warned bankers that the Federal Reserve was concerned about “systemic risk of liquidity failure in the OTC derivatives market,” noting further that “our admonitions have a nagging quality because you have not specified a concrete approach to controlling and managing this risk” (quoted in Hansel 1994). In other words, at an early stage in the development of the OTC markets, Corrigan, McDonough and other Federal Reserve officials were significantly more aware of the risks involved in OTC trading than their counterparts at the other banking agencies as well as at the CFTC and the SEC. Even enthusiastic supporters such as Susan Philips underscored the need for enhanced internal risk management and greater monitoring by regulators (Cummins, 1993b), suggesting industry self-regulation was necessary in order “to allay the concerns that have been expressed by regulators and to ensure a favorable outcome to legislative deliberations regarding the OTC derivatives markets” (quoted in Cummins 1992b).

In fact no one appeared to be more aware of the potential risks and problems of internal bank oversight than Greenspan. Responding to criticism from a GAO Report on the Derivatives Industry (see later sections), Chairman Greenspan admitted that concentrations of credit exposures to derivatives dealers posted “systemic difficulties” and that even though “derivatives activities are not themselves a source of systemic risk, they may help speed the transmission of a shock from some other source to other markets and institutions” (Greenspan, 1994b, 4). In order to rectify this, he outlined a variety of risk management

principles, largely taken from a G-30 report on the subject (see below). He moreover noted that the FRB had been closely monitoring OTC derivatives trading by banks since the early 1980s and had expanded its monitoring efforts since 1992, when the industry began to expand rapidly (Greenspan, 1994b, 7). Greenspan also highlighted the FRB's international "leadership" on issues relating the treatment of derivatives in capital adequacy standards, efforts to "develop meaningful comprehensive measures of the size of the derivatives markets," and work on "netting"<sup>13</sup> and other payment and settlement issues (Greenspan, 1994b, 6-7). That same year, in a speech that focused on risk measurement in regulatory capital calculations, Greenspan further noted that "counterparty risks involved in dealing swaps and other derivatives are [becoming] a growing position of overall bank risk" and discussed in detail steps that banks could take to improve their IRB models to better monitor these risks (Greenspan, 1994a, 10). Again, like his colleagues, Greenspan believed himself to be acutely aware of the risks; however he and his colleagues clearly felt that the FRB had the necessary competency to monitor those risks effectively.

This leads to an important question of why the FRB took the position it did. While I address the alternative theories of interest group capture below and "cultural capture" in the conclusion to this chapter, a related and highly vigorous debate has emerged in recent years about the degree to which FRB policymaking reflected Chairman Greenspan's libertarian worldview (e.g. Cassidy 2009, Chapter 17), specifically with regard to OTC derivatives regulation. Without dismissing the influence that his *personal* views had, it is worth reiterating that other FRB officials similarly embraced this policy at an early stage in the process. It is also worth noting that while Chairman Greenspan's influence over senior appointments increased over time, in the early years of his tenure (1987-1995, prior to his renomination by President Clinton) his influence over the organization as a whole was more circumscribed than in later years (see Sheehan 2009, particularly chapters 9-11; see also Woodward 2001). Finally, the popular perception of Greenspan as "rock star" or a larger than life figure, a perception that doubtless boosted his internal and external policy influence, was a distinctly mid-to-late 1990s phenomenon (Cassidy, 2009). Finally, as will be discussed below, former Chairman Paul Volcker chaired a key group – the G-30 – that issued a landmark report in 1993 calling for industry self-regulation in the market. As a result there is reason to be skeptical of the idea that the FRB's position on OTC derivatives deregulation was solely shaped by Greenspan or that it would have differed radically under (plausible) alternative leadership.

What we can say is that the FRB position was, at least in some large part, influenced by its mission and distinct sense of competency. First, there was a very real connection to the FRB's overall risk-based approach to capital adequacy. The Basel I Accord had been based

---

<sup>13</sup>Netting occurs when "two parties who have entered into multiple derivative transactions with each other aggregate all such transactions in the even of bankruptcy, thereby reducing credit risk" (Hu, 1993, 1510). For more, see Cunningham and Rogers (1991).

on the FRB's belief in tailoring capital to risk, and accounting for "credit risks" resulting from nontraditional financial products had been included in the agreement (Hu, 1993, 1460). In a 1992 speech to Japanese bankers on the benefits of the Basel I RWA approach to bank capital, he linked the principles underpinning the Accord with the risk-attenuating qualities of OTC derivatives, arguing that "derivative and other off-balance sheet instruments... [allow] banks and their customers alike [to] manage and hedge various market risks more completely and more efficiently than they could in the absence of such instruments." Over the course of the 1990s, not only did OTC derivatives become increasingly central to measures of risk-weighted assets as part of the Basel capital rules, but the FRB encouraged banks to make *greater* use of these products as a way to attenuate risk (Scheerer 2000, 175-182; see later sections for a more in depth discussion). In short, risk-based capital and OTC derivative products, and later credit derivatives in particular, were widely seen by FRB officials as part of the same broader sophisticated approach to ensuring bank safety and soundness.

Moreover, FRB officials clearly felt the combination of enhanced supervisory measures and internal bank risk controls were sufficient to monitor risk at large banks. First, as Hu (1989) argues, the FRB believed that institutional regulation, such as the enhanced capital regulations as part of the Basel framework, would better control risk than direct regulation of OTC products themselves. Aside from its own internal changes mentioned above, the FRB had led BIS efforts to improve capital guidelines, settlement systems, and disclosure by banks (Kraus, 1994). Senior FRB officials had, as has been mentioned, pressured banks to improve their IRB models through public rhetoric, supervisory pressures, and promotion of best practice standards, such as those articulated in the G-30 report. In short then, it appears that officials at the FRB felt their efforts had been successful at containing risk and therefore opposed legislative solutions that, in the words of the then Vice President of the Federal Reserve Bank of New York, would "micromanage regulation" and "stifle innovation" (quoted in Tomasula 1994d). Finally, the promotion of OTC derivative products was at least consistent with the Federal Reserve's overall monetary policy agenda: because OTC derivative products reduced trading costs for banks and allowed banks to (in theory) hedge more effectively against risk, they also had the effect of freeing up capital for more efficient investments in the real economy (Stulz, 2004). The promotion of OTC products is particularly consistent with the pro-growth, low interest rate approach the Federal Reserve pursued after 1994. Whether this influenced the FRB's thinking is unclear, but it is at least plausible.

In sum, the FRB, though formally a peripheral actor, had shown the necessary political authority to intervene to protect its policy objectives in conflicts between the far smaller principal regulators, the SEC and CFTC. However, with the emergence of the swaps markets, it became a more active participant in these debates. Both Chairman Greenspan and other senior FRB officials were clearly opposed to regulation of the OTC markets from an early stage in their development, based not on a lack of knowledge of the risks involved or solely as a result of pressure from banking interests, but on a belief that this form of financial

innovation would – if properly managed – ultimately attenuate systemic and institutional risks in the banking system. As such, it seems clear that the Federal Reserve’s preferences on the issue were intensely held at an early stage, suggesting that they were to some large degree independent of other actors.

## 4.6 The SEC’s Cautious Strategy on OTC Derivatives

The SEC was a potentially powerful actor in the debate over OTC derivatives. However, as is explained here, its impact was mostly felt by its failure to embrace opportunities to assume a more significant and central role in the regulation of the market. To give some background first: the SEC and the CFTC are, despite seemingly similar mandates, nevertheless strikingly different agencies. As Russo (1983) observes, the SEC takes a far more interventionist approach to regulation relative to the CFTC, a fact that owes to differences in mission and expertise. Unlike the CFTC, which “oversees the hedging of risk” (Karmel, 2009, 12), “the cornerstone of SEC regulation is full disclosure to the public in securities offerings” (Markham, 2009-2010), which reflects its role as the protector of ordinary investors, and maintaining “fair, orderly, and efficient securities markets” (Sarra, 2009-2010, 639). The organization is dominated by securities lawyers (see Khademian 1992 for more) and as a result SEC is “rules-oriented,” with its distinctive competency being stringent legal enforcement (Markham 2009-2010, 557; see also Karmel 1982). Indeed, the SEC, particularly since the early 1960s, primarily built its reputation within the policymaking community on an image of itself as a vigorous prosecutor of securities fraud and insider trading practices (Markham, 2009-2010, 556). Internally, this commitment to strict rules-based enforcement was equally as strong; as a result, members of the agency proudly perceived it, in the words of its former Chairman Arthur Levitt, to be “the crown jewel of the financial regulatory infrastructure” (quoted in Fisch 2009, 785). The agency was also renowned for being fiercely protective of its jurisdiction over the securities markets, which in part explains its ongoing battles with the CFTC from its creation through the early 1990s (Markham, 2009-2010, 558). In short, the SEC during this period was perceived internally and externally to be a tough, highly competent, if narrowly focused, protector of the equity markets and ordinary investors (Langevoort 2009; this image would change in later years; see Chapter 5; see also Fisch 2009 for a discussion).

Given this mission, the SEC’s principal interest in the derivatives markets was unsurprisingly related to their influence on stock market pricing and stability. Specifically, since many derivatives were based on an underlying equity asset, sales and purchases of those products also impacted prices and patterns of trading in the stock markets. As a consequence, in the late 1970s and early 1980s the SEC waged a “vigorous campaign to wrest jurisdiction from the [CFTC] over futures contracts in at least some types of securities” (Johnson and Hazen, 1989, 250). While a temporary accord between the two agencies in 1982 diffused tensions for

a period (Romano, 1997, 354)<sup>14</sup>, the 1987 Stock Market Crash appeared to confirm for the SEC the deleterious effects that equity based derivatives such as stock market futures could have on the securities market. Its response was once again to request that Congress grant it jurisdictional authority over such equity based derivative products. This effort failed and the agency subsequently lost a key 1989 court case – *Merchantile Exchange v. SEC* – that challenged the legality of listing of stock futures on SEC regulated exchanges. Despite these defeats, regulating equity based derivative trades, whether exchange based or those traded on the OTC markets, remained a key policy concern of the SEC throughout the early 1990s.

It should be noted that this concern over the impact of equity based derivative trading was also later buttressed by another one: the increasing involvement of investment banks in OTC derivatives trading from the mid-1990s onwards. The SEC knew little of the structure of most of these trades, their extent, or the potential risks to the solvency of the broker/dealers in the event of a major credit event occurring (see Faerman et al. 2001; Fisch 2009). This problem was further exacerbated by the fact that most of the derivatives-trading operations were being conducted through special purpose vehicles or subsidiaries that were technically not subject to the agency’s oversight and therefore rules such as capital requirements (Markham, 2009-2010, 576). Since failure of any of these major dealers would be a devastating blow to the agency’s reputation and effective jurisdiction (as it was in 2008 when that very scenario occurred), it had every incentive to obtain both more information and exercise greater oversight over such derivatives activity. Although outside of the scope of this chapter (a detailed discussion can, however, be found in Chapter 5), this was also a background concern for the SEC during the 1994 legislative debate over regulation.

Therefore, the SEC had an interest in more stringent regulation of securities-based OTC products and greater disclosure by securities firms of their derivatives activities. In pursuing those objectives, however, the agency behaved in a characteristically cautious manner. Indeed, while protective of its own jurisdiction, the SEC had generally displayed a reticence for large-scale turf expansion into the derivatives field over the previous twenty years. Benson (1991, 1175) notes that the SEC turned down entreaties from the White House to assume regulation of the futures industry, though offers no explanation for that decision. Again, in 1978, the GAO, the Treasury Department, and the endorsed proposals that would have significantly expanded the SEC’s authority, though the SEC’s concern remained focused on securities-based futures (Markham 2009-2010, 569; ultimately no legislative change occurred). In fact, it was only after the 1987 Crash that the SEC began to advocate for a

---

<sup>14</sup>Both parties had incentives to reach an accord. There were threats of legal action from the futures exchanges weighing on the SEC and a desire by the CFTC to “preempt political pressure by the SEC that could obstruct its impending reauthorization.” As a result, they agreed to what became known as the “Shad-Johnson Accord” (named after the two agencies chairmen) in 1982; it allocated options on securities to the SEC, while the CFTC would retain authority over all other options and all futures, even those based on equity. The agreement was ratified by Congress in the 1983 CFTCA reauthorization.

merger between itself and the CFTC. Nevertheless, as Markham and Stephanz (1987-1988, 223) observes, that campaign was not particularly vigorous (notably it was opposed by two of the five SEC commissioners) and ultimately failed because of opposition from the FRB and the Agriculture Committee (see Benson 1991, 1191). As will be discussed below, the SEC would have become, under some legislative proposals discussed in 1994, the lead regulator of the OTC derivatives industry, but it demurred at the opportunity.

Why did the SEC display such caution, even ambivalence, about assuming a broader jurisdiction over the derivatives markets? In this case, one factor was the attitude of the FRB and other regulators; calling for new regulation may have isolated it and created a powerful enemy in the form of the FRB (this is discussed again in Chapter 5. See also Faerman et al. 2001, 381). Second, as was noted in Chapter 2, agencies are not pure turf-maximizers and will eschew expanded discretion when doing so could undermine their reputation for competence or dilute their core mission. In this case, there were cultural and legal challenges that would have made it difficult to take on additional jurisdiction. The SEC would have had to overcome “hands-off regulatory attitude” of CFTC staffers that would be transferred to the agency (Markham, 2009-2010, 592); it would have been required to administer an opaque speculative market dominated by institutional investors rather than a retail market based on transparent pricing (Karmel, 2009, 12); and it may have been forced to administer the unfamiliar principles-based CEA and CFTCA legal framework (see Carlucci 2008). However, the challenges would also have been capacity-related. As the 1978 GAO report notes, despite its call for expanding the SEC’s jurisdiction, “integrating all futures regulation into [*sic*] SEC could jeopardize [*sic*] SEC’s ability to carry out its responsibilities under the securities laws which contemplated separate, expert, and quick administration by a body not distracted by other demands” (GAO, 1978, 11).

These strains on the agency’s resources would have been far greater in the case of the much larger and opaque OTC markets. As Hu (1993, 1463), echoing comments of a senior Bank of England official, noted of the then developing market, “[i]t is difficult for regulators to understand the risks of more complex derivative transactions with certainty, much less the risks of more complex derivative transactions or a bank’s entire portfolio of derivative transactions.” This challenge was particularly acute for the SEC which had little experience either as a derivatives regulator or monitoring swap trading activities at an institutional level (unlike the FRB, since commercial banks were more active in trading swaps in the 1980s and early 1990s than securities firms). It also lacked the in-built international OTC derivatives research network that the FRB, for example, had access to through the BIS and the Basel Committee. Added to this, while the SEC possessed significantly greater budgetary and staff capacity than the CFTC, it still paled in comparison with the FRB. Finally, its staff was (and is) dominated by securities lawyers; as such, it did not have the expertise to effectively monitor complex bank risk models (see Seligman 2009). In short, a decision by the SEC to seek broader discretion over either the futures or OTC markets would likely have created cultural, legal, and capacity challenges that could well have damaged its reputation as a

competent enforcer of securities laws and protector of equity investors. As such, the SEC, while a potentially powerful actor in this debate, often appears conspicuously silent.

## 4.7 Industry Influence on the Early OTC Debate

As Carpenter and Moss (2013, 4) note “all too often, observers are quick to see capture as the explanation for almost any regulatory problem, making large-scale inferences about agencies and their cultures without a careful look at the evidence.” Moreover, they continue, “the fact that an industry is well served by regulation is deeply insufficient for a judgment of capture. Both *intent* and *action* on the part of the regulated industry are required” (emphasis added; Carpenter and Moss 2013, 16). There is little question that major banks and their trade associations – the ISDA, the ABA, and the ABHC (later the Bankers Roundtable) – all held a strikingly similar position to that of the FRB i.e. opposition to formal regulation of OTC markets (see Singher 1994; Scheerer 2000; McCaffrey 2012). Moreover these groups largely achieved their preferred regulatory and legislative outcomes. For some, such as Tett (2009, Chapter 2), who specifically focuses on the role played by the ISDA, this correlation between intent and outcome is sufficient to prove that the major dealers were shaping the regulatory and legislative responses in the early 1990s<sup>15</sup>. However we must also identify the mechanism through which such groups exercised influence before we can begin to evaluate capture claims. It is on this point that there is significant reason to be skeptical.

Today, one of the most influential trade associations on the issue of OTC derivatives is undoubtedly the ISDA (McCaffrey, 2012). The organization, founded in 1985 by eleven major dealers, played a crucial private governance role in the early stages of market development, helping to develop common codes and standards for dealers and end users (for detailed discussions, see McCaffrey 2012; Biggins and Scott 2011). Moreover, as Flanagan (2001, 246) notes, the ISDA “has coordinated industry opposition to CFTC and SEC regulation, acting both as an advocate for the industry and an instrument for its self-regulation” and has been involved in extensive lobbying of elected officials in the United States. By 2012, the organization had 845 members worldwide, a large staff, and offices in New York, London, Brussels, Hong Kong, Singapore, and Tokyo (McCaffrey, 2012, 14). Its membership primarily comprised of dealers of OTC contracts, such as major commercial and investment banks, though it also has “subscriber members” that include a wide variety of large corporations and governmental entities (ISDA, 2012). In short, the ISDA is today both a self-regulatory organization and a highly institutionalized international trade association.

---

<sup>15</sup>For example, on page 38, Tett discusses how the ISDA “Somewhat to their surprise” “prevailed two years later when the CFTC backed down” from their threat to regulate swaps. Yet there is no evidence provided for a lobbying campaign, and the two year gap between those decisions and their ‘surprise’ at the outcome suggest that other factors were likely more important in that specific episode.



However, in the late 1980s and early 1990s, the ISDA was an incipient standard setting body with virtually no full-time staff and little involvement in lobbying. As Flanagan (2001, 234) documents in his history of the organization, the ISDA “began as an informal swap documentation project” in 1984. Even when the organization was formed in 1985, the objective of the organization was limited to standardizing the unique form agreements that different dealers had been using since the swap market first emerged in 1982 (Forde, 1986b). The ISDA spent several years working to resolve these ‘language’ differences between traders, differences that had produced end-user confusion and costly negotiations between dealers. In other words, the ISDA “remained focused on standardizing terms and vocabulary” in its early years (Flanagan 2001, 243). Moreover, the young organization had to reconcile cultural clashes between commercial and investment banks who were not, at least in the United States, used to directly competing against one another. In particular, the organization had to balance ongoing demands from commercial banks (who were used to long-term lending relationships) for more stringent credit and default terms than those preferred by investment banks (Cunningham and Rogers, 1991). Finally, the organization had just a handful of permanent staff, with most of its work outsourced to legal firms.

The ISDA of the late 1980s and early 1990s was therefore far from the politically active trade association it is today. Indeed, as Flanagan (2001, 245-246) notes, it was not until the early 1990s that it began to become “involved in discussions with regulators on behalf of the OTC derivatives industry” and broaden its commitment to issues other than documentation. In fact, the board of the organization only “agreed to begin transforming the organization into a more “traditional,” staff-driven trade association” in 1993 (Flanagan, 2001, 246). Notably this was long after FRB senior officials had publicly and frequently expressed their opinion on the issue of OTC derivatives regulation and oversight. It was also after the CFTC decision to issue a broad swap exemption (see below). The ISDA and its members therefore may therefore had the intent to seek an exemption from regulatory oversight, but they certainly did not have the means to put that intent into action and there is virtually no evidence from reporting prior to 1994 that indicates the organization was heavily involved in lobbying legislators or regulators<sup>16</sup>.

What about the other major banking organizations? There is little evidence based on reports from that time period and their own publications, that either the ABA or the ABHC were actively involved in lobbying on this issue either, at least prior to a 1994 congressional debate over derivatives regulation (see Garsson and Rehm 1994 for more on those limited efforts). In large part, this was likely because their attention in 1987-1988, and again in 1991, was focused on broad deregulation bills that would have repealed the Glass-Steagall Act and were unrelated to the OTC derivatives issue. Such lack of activity could also have

---

<sup>16</sup>In 1994, the ISDA did issue a position paper in response to the GAO report on swaps and derivatives, a paper that led to the GAO to respond to the points it made (GAO, 1994b). This marked the ISDA’s first notable lobbying effort since their foundation.

resulted from a belief that regulation of the emerging market was unlikely given the position of the FRB, the language in the 1991 CFTC reauthorization, and the fact that Wendy Gramm, Chairperson of the CFTC from 1989-1993, was known to be sympathetic to broad deregulation. The bottom line, however, is that irrespective of the reasons, these organizations, which represented the major dealers in OTC products, were not nearly as important participants in the public debate as they later would become. This suggests that even if their *intent* was to ensure continued non-regulation of the market, there is little evidence of *action* since they did not appear to devote significant resources to ensuring that outcome, at least prior to the mid-1990s.

None of this should be taken to mean that industry interest groups and individual firms did not exert influence over the OTC debate, particularly in the late 1990s. However, there simply is a dearth of compelling evidence to suggest that industry groups were shaping the views of key regulators, particularly the FRB, at the early stages of public discussion over regulation. Indeed, accounts of key episodes in the debate that occurred prior to 1995, such as Tsingou (2003); Maxwell (2011), similarly do not emphasize the role of industry groups in shaping the critical legislative and regulatory decisions that were made during this period. As a result, we can be more confident in concluding that at least the FRB's preferences were to some significant extent independent of those of the major dealers. Beyond the issue of regulator preferences, it also casts doubt on the actual influence they exerted prior to the mid-1990s, an era which is the main focus of this chapter. Indeed, as will be seen in the discussion of key episodes, it was principally federal regulators, rather than industry interest groups, that exerted the key influence on the early debate and legislative outcomes.

### 4.8 Early Attempts to Regulate the OTC Markets and their Consequences

The first significant attempt to regulate the emerging swap markets occurred in 1987. That year, the CFTC launched an investigation into Chase Manhattan Bank's new commodity-based swap products, contracts that Chase's competitors and futures exchanges had claimed constituted illegal futures contracts (see Bair 1994, 699-700). As one observer put it "[t]he Chase product presents the clearest challenge to the commission's [CFTC's] jurisdiction that has come to light," largely because the products had some typical features of a futures contract and were based exchange-traded commodities such as oil and metals (Horowitz, 1987b). This investigation attracted the ire of the FRB and the OCC, which retaliated two months later by formally authorizing banks to engage in commodity swap trading (Rehm, 1987). Nevertheless, in December of 1987, the CFTC published an advance notice of proposed rule-making in which it planned to impose limitations on the trading of commodity based swaps. In addition the agency, which claimed it was concerned about "the proliferation of unregulated products that are not rated on commodity exchanges," sought to limit speculation and

abuse by traders by only permitting parties that made direct commercial use of the underlying commodity to participate as a buyer, seller, or financial intermediary (Horowitz, 1987a). The rule, if implemented, would therefore have effectively put an end to the trading of commodity-based derivatives by commercial banks.

However, the CFTC's authority was particularly contested during this period. The Stock Market Crash of 1987 led to widespread criticism of the role played by stock index futures, most of it emanating from the SEC and the NYSE. Indeed, a variety of studies conducted over the course of the next year concluded that the index futures prices were now effectively setting stock prices, and that speculation in the futures markets (where traders had lower margin requirements) had been a significant cause of the steep decline in equity prices (Karmel 1988, 103-104; Karmel 2009, 14). As a result, the SEC asked Congress to award it jurisdiction over stock indexes (Coffee, 1995, 462). Indeed, a presidential task force formed in the wake of the crisis and headed by (later Treasury Secretary) Nicolas Brady supported this recommendation, moreover hinting at the benefits from a possible merger of the two agencies; these recommendations were, however largely ignored by the Reagan administration. Appointed Treasury Secretary by President Bush, Brady and SEC Chairman Richard Breeden once again sought to gain control over equity based derivatives from the CFTC and, as aforementioned, both began a campaign to see full transfer of the CFTC's functions to the SEC. At one point, the *Wall Street Journal* predicted that the SEC was likely to at the very least win control over securities-based derivatives from the CFTC (Salwen, 1990).

This effort ultimately failed, in part because of divisions within the SEC about the wisdom of integrating futures oversight into the agency's existing mission and structures (Markham, 2009-2010, 572), but mostly thanks to the vigorous opposition of the FRB (Romano, 1997, 362-363). Although the Board was strongly opposed to the CFTC's proposed swaps rule, the prospect of empowering a new 'super regulator' in the mold of the SEC was simply unacceptable to it (Karmel, 2009, 15). Simply put, the CFTC was far less likely to pose a threat to the FRB's policy objectives in the area of derivatives since it lacked the political authority of the securities regulator. This was particularly true now that its authority had been publicly contested by both the SEC and the administration, a problem only compounded by a series of price manipulation scandals and another stock market break (Romano, 1997, 361). Indeed, in July 1989, following a "firestorm of criticism" it received from the FRB in particular (Bair, 1994, 700), the CFTC issued a policy statement that declared swap trading would be placed in 'safe harbor,' meaning that the CFTC would not pursue swap trading investigations or prosecutions under the CEA (Horowitz, 1989).

Despite this victory and the appointment of an avowed advocate for deregulation – Wendy Gramm – as CFTC Chairman, there were still concerns about the long-term status of the CFTC's safe harbor finding. As Stamas (1992) later noted, "that pronouncement has not provided the legal foundation for trading that dealers have sought." Indeed, the CFTC was taken to Court in a variety of court cases in which it was claimed that the OTC products were, in fact, futures and thus illegal, a fact that made traders and other regulators concerned

that the agency would be forced to reverse its safe harbor policy regarding swaps<sup>17</sup>. In any event, even with the safe harbor rule in place, traders and end-users frequently had to obtain advice from the Commission and petition for case-by-case exemptions before beginning to trade new types of instruments, since many of those instruments contained features of both swaps and other types of derivatives (Stamas, 1992).

As a result, a collection of lawmakers, the FRB, and the Treasury Department used the opportunity provided by the forthcoming CFTC reauthorization to push for an amendment to that would have forced the CFTC to permanently exempt swaps from its jurisdiction. That bill failed in the Senate in October 1990, thanks to opposition by the futures exchanges and their supporters on the agriculture committees. After over a year of negotiations, the Congress finally passed the Futures Trading Practices Act of 1992, which provided, if not formally mandated, the CFTC the authority to issue a broad exemption from the CEA to swap instruments (Markham, 2009-2010, 575). However, there was little question that the intent of the bill was, as expressed in its legislative history, for the CFTC to “use its exemptive powers” for swaps and hybrid instruments (Romano, 1997, 377). As if to reinforce that point, the bill also only reauthorized the CFTC for two years, a clear indication that the agency would be expected to issue a broad exemption ruling. Unsurprisingly, in January 1993, the CFTC exempted swap transactions from future regulations by a unanimous vote (Cummins, 1993c)<sup>18</sup>.

In addition, the bill made two major reforms. First, it granted the FRB control over margin requirements for securities based futures, a power that the SEC had sought as a way of limiting the potentially dangerous impact of speculative futures trading on the stock market. Second, the CFTC’s traditional allies – the futures exchanges – were effectively cleaved away from it. The law specifically permitted futures exchanges to trade on a OTC basis, a vital shift that would give them the opportunity to compete with commercial banks and securities firms for OTC business (Stamas, 1992). As a result, the law effectively sidelined the CFTC as a player in the OTC derivatives debate, granted the FRB an important source of leverage over the SEC and accomplished the Board’s principal policy objective: preventing regulation of the OTC sector. While other dynamics influenced these outcomes, the FRB’s role was certainly important: it was principally responsible for thwarting the initial CFTC attempt to regulate swaps in 1987; it blocked the SEC effort to accrue authority over securities-based futures – which could have led to further claims of jurisdiction over equity based OTC prod-

---

<sup>17</sup>The problem arose from the fact that while the CFTC had the power to exempt specific products, it could not formally exempt broad categories such as swaps.

<sup>18</sup>Nevertheless, legislators did not need to push the CFTC very hard since Chairman Gramm strongly supported the effort, arguing that “[t]he bill gives needed legal certainty for swaps and other new derivatives. It gives our regulators flexibility to respond promptly and appropriately to changes in the marketplace... That flexibility – leaving enterprises free to excel and to innovate is at the heart of good government. This bill will help America keep its status as the world leader in financial engineering” (quoted in Stamas 1992)

ucts – as well as proposals for a full scale merger between the two market regulators; and it played a vital role in pressuring Congress for the permanent exemption and for an expansion of its margin setting powers. Despite these victories, the FRB’s position on OTC regulation remained contested, a fact that shaped its subsequent strategic actions.

## 4.9 The Emergence of a Congressional ‘Threat,’ 1993-1995

### 4.9.1 Crises, the GAO Report, and Legislative Efforts

A series of significant derivatives losses ensured continuing congressional attention to the issue of derivatives between 1991 and 1994. Amongst them was Bankers Trust, which reported that a single interest rate swap with a counterparty that defaulted had led to losses of \$39 million in 1991 (Holland, 1991). Smaller but regionally significant institutions, such as Executive Life Insurance and the Bank of New England, had also failed as a result of defaults by counterparties on swaps deals. Later, Kiddy Peabody, a mid-sized securities firm owned by General Electric, reported a massive \$350 million in trading losses, thanks in that case to the use of fraudulent forward contracts (Times, 1994). The problem was, however, by no means confined to dealers; end-users were increasingly unable to understand the risks involved in the derivatives contracts banks structured (Cuccia, 1997). This problem was a result of the fact that banks were beginning to structure contracts that contained complex hybrids of multiple types of derivative; as one observer noted “I think you’re moving away from the commodity sort of interest rate or foreign exchange swaps... Now you’re getting into very innovative combinations of swaps and futures contracts. That’s where the real growth is” (quoted in Holland 1991).

The risks to end-users became far clearer in 1994. At the end of 1993, the Federal Reserve began to implement a series of modest increases in interest rates, an event that nevertheless precipitated high profile losses amongst users of interest rate swap derivatives (Figlewski, 1994). As Faerman et al. (2001, 372) notes, a large number of “landmark financial catastrophes” occurred during this period. One particularly high profile case involved Procter & Gamble; in April 1994, the firm reported that it incurred a \$157 million loss on two interest rate swap contracts sold to it by Bankers Trust (the firm had exchanged fixed rate debt payments for variable payments, which resulted in the losses). Procter & Gamble subsequently sued Bankers Trust, arguing that they failed to disclose the risks of the transaction (Cuccia, 1997, 208). Gibson Greetings, a mid-sized greeting card company, also took Bankers Trust to court for allegedly misleading them about the risks involved in a range of swap and other derivative transactions arranged by the bank that had resulted in losses of \$20.7 million for Gibson (see Hu 1995). This case was particularly significant, because it led to reignited disputes over jurisdiction (see below; see also Coffee 1995, 466-468). Finally, and perhaps most

notably, in December 1994 Orange County became the largest municipality in the United States to ever declare bankruptcy after it suffered a \$1.7 billion loss as a result of a highly leveraged derivatives strategy (see Halstead et al. 2004 for a history of this episode).

Between 1992 and 1994, senior members of the House and Senate Banking Committees and House Energy and Commerce Committee had expressed concerns about growing risks in the derivatives markets, but most action had been postponed until the completion of a GAO report that had been commissioned by Representative Ed Markey (the Chairman of the House Subcommittee on Telecommunications and Finance) in 1992 (Maxwell, 2011, 6)<sup>19</sup>. Nevertheless, in late October 1993, the House Banking Committee held the first of a series of hearings on the derivatives industry, hearings that suggested both the Committee's Chairman, Henry Gonzalez, and its Ranking Member, Jim Leach, wanted to see increased oversight of the OTC derivatives markets (Cummins, 1993d). Indeed Leach in particular was widely seen as "a leading advocate on Capitol Hill for tighter regulation of the derivatives markets" Cummins and Garsson (1993). By the end of the year, industry experts were already expressing concerns that legislation mandating the creation of new inter-agency panel to supervise the industry and bans on poorly capitalized banks from trading such products would be shortly introduced (Racine, 1993). This anticipation furthermore led to an across the board drop in the stock prices of banks heavily involved in OTC trading through the first half of 1994 (Tomasula, 1994c). Nevertheless, at this stage there was some doubt about the seriousness of the effort; as Karen Shaw, a prominent commentator on financial policy issues, suggested "[t]ake four more companies that lose meaningful amounts of money, add one bank and maybe a pension fund, and there will be a bill" (quoted in Garsson and Rehm 1994).

Sure enough, by mid-1994 some of the high profile end user losses discussed above came to public attention. Moreover, in May 1994, the GAO published its long awaited report entitled *Financial Derivatives – Actions Needed to Protect the Financial System*. The report largely highlighted systemic risks from OTC derivatives trading, though, in an implicit testament to the work done by the FRB and followed by the OCC, it expressed particular concern the lack of oversight and internal controls amongst securities and insurance dealers rather than commercial banks (Faerman et al., 2001, 374). The report stated that "[i]f one of these large OTC dealers failed, the failure could pose risks to other firms– including federally insured depository institutions – and the financial system as a whole" (GAO, 1994a, 11-12). As a result, the GAO made a series of recommendations that would have subjected the derivatives subsidiaries of broker-dealers to oversight by the SEC, created an inter-regulator commission that would set common disclosure, capital, and internal risk regulations for all traders, and grant the SEC to authority to mandate independent audit committees and other internal

---

<sup>19</sup>Ironically, it was Gerald Corrigan's comments to bankers in 1992 that led Markey to commission the GAO study. See Layne (1993).

controls amongst end-users of OTC products (GAO, 1994a, 14-16). Edward Yingling, the chief lobbyist for the ABA, expressed a concern that the report would add to the existing “prairie fire” amongst Members of Congress advocating for tougher regulation and “could lead people [i.e. lawmakers] to believe they have to act” (Garsson and Rehm, 1994). Indeed, the report led to a flurry of legislative proposals in the summer of 1994.

Earlier in 1994, Leach had proposed a bill that would have created a commission to oversee derivatives trading comprised of the major financial regulatory agencies (Rehm, 1994a). However, following the publication of the GAO report, Gonzalez and Leach agreed to co-sponsor legislation to implement many of its key recommendations. In contrast to the report, the bill nevertheless focused heavily on restrictions on derivatives activity at federally insured depository institutions, notably banning trading at such institutions unless the board of directors of the bank made certifications that they were familiar with the risks involved (the powers of the SEC largely mirrored those in the GAO report; see Garsson 1994a). Gonzalez characterized the effort in this way: “[r]ather than waiting for problems to occur, [the] legislation will enable the federal bank regulatory agencies to move aggressively to deal with risky practices” (Cummins, 1994c). Other bills based on the GAO report soon followed. Legislation introduced by Senators Byron Dorgan and Barbara Mikulski, as well as a separate bill introduced by Senate Banking Committee Chairman Donald Riegle, would have gone a step further and prohibited federally insured institutions from engaging in proprietary trading, an effort that Senator Dorgan argued was necessary to prevent “banks and other institutions with federal insurance from playing roulette in the derivatives market” (quoted in Tomasula 1994c). A final bill, introduced by Representative Markey, would have effectively granted the SEC significant authority over the market, forcing all unregistered derivative dealers to register with the agency (see Garsson 1994a, Culp and Mackay 1994; commercial banks would be exempt from this registration, however).

### 4.9.2 Regulators Respond

How did regulators and groups respond to these initiatives? Initially, the OCC had also been considering restrictions on the types of derivatives that banks would be able to use, particularly complex instruments, as well as a ban on proprietary derivatives trading (in contrast to trading designed solely for hedging purposes). The Comptroller, Eugene Ludwig, gave a major speech in April 1994 where he stated “[b]ecause of our increasing concern about the risks posed by exotic and complex derivative instruments, we are looking at whether they are appropriate for national banks” (quoted in Cummins 1994e). He highlighted a recent reviews that showed that there was insufficient understanding and oversight of the derivative instruments by senior managers, that complex instruments may be inherently more risky, and that proprietary trading may be exacerbating those risks (Rehm, 1994b). The comments by the head of the OCC were actually largely in line with the Gonzalez-Leach proposals, and were later cited by the House Banking Chairman in support of their bill (Tomasula, 1994c). By

July, however, the OCC had changed its position, noting dispassionately that “[t]he administration’s view at this point is not to encourage legislation.” This was despite widespread skepticism on Capitol Hill; for example, even traditional bank deregulation supporter, Representative Charles Schumer, argued that “if it is new and if it is risky” then banks should “do it without insured dollars” (quoted in Meredith 1994a). Whether the OCC’s changed position owed to pressure from the Treasury Department, the FRB, industry groups is unclear. Either way, its views were not perceived as having a major impact on the bill (Maxwell, 2011, 7).

The CFTC expressed mooted opposition to these pieces of legislation, though that position could have reflected the fact that its leadership was in transition at the time. As Romano (1997, 377) suggests, it may also have reflected the consequences of the 1992 reauthorization that permitted the futures exchanges to trade OTC products; indeed the Chairman of the Chicago Mercantile Exchange commented, in reference to the derivatives bills, that “harmful regulation will simply drive the business offshore” (quoted in Garsson and Rehm 1994). However, by the end of 1994, under its new Chairman, Mary Schapiro, the CFTC did raise the possibility of narrowing the OTC derivatives exemption, again highlighting how the agency’s preferences appeared to shift with changes in its leadership (Tomasula, 1994a). Unsurprisingly, the FRB was the most vocal opponent of these congressional efforts. The Board had already criticized the OCC for its earlier stance, with Governor John LaWare arguing that “[w]e don’t see banks getting in over their heads” and that “[w]e don’t have any evidence at this stage of the game that this derivatives activity has affected the safety and soundness of banks” (Cummins, 1994b). In response to the Gonzalez-Leach bill, Chairman Greenspan stated that derivatives legislation “could actually increase risks in the U.S. financial system by creating a regulatory regime that is itself ineffective and that diminishes the effectiveness of market discipline” (Committee on Energy & Commerce, 1994, 112). Moreover, he stated, as he had previously that derivatives were “far less risky than certain types of loans that are made” and, notably, referred constantly to the FRB’s efforts to improve internal bank controls, noting that “[w]hile banks suffered losses trading in some markets, their risk controls worked” (quoted in Cummins 1994f).

### **4.9.3 The Strategic Responses of the FRB: Rhetoric and the G-30**

Indeed, the FRB had been strategically working to reassure lawmakers that their efforts and the efforts made by industry actors had been sufficient to contain risk. They did so in two ways. First, they emphasized the importance of the improvements they had made to their supervisory guidelines in their discretionary actions and public rhetoric. In 1993, just prior to congressional hearings before the House Banking Committee, the FRB announced that it would be issuing new guidelines to its examiners and to the industry regarding risk management standards and in January 1994, it issued its ‘supervisory letter’ on the subject (Cummins and Garsson, 1993). The 15-page directive established standards for boards of



directors and senior executives, risk measurement guidelines, as well as internal audit procedures. Governor Susan Phillips portrayed the effort as part of an ongoing process of “beefing up of examinations” (quoted in Cummins and Garsson 1993). Phillips echoed these points in public speeches. In February, she noted that “[g]oing forward, we expect to place much more emphasis on evaluating banks’ assessments of worst-case scenarios and on testing the implications of underlying assumptions embedded in internal models” (quoted in Cummins 1994a). At an earlier hearing, she had also underscored that the FRB had “made the continuous updating and strengthening of policies and procedures for on-site examination of derivatives a top priority” (Committee on Banking and Urban Affairs, 1993, 7).

In addition to emphasizing the improvements it had made to its supervisory procedures, FRB officials also highlighted the fact that they were, in Philips words, providing “useful risk-management tools” to banks (quoted in Cummins and Garsson 1993). In a March 1994 speech, Chairman Greenspan noted that his agency had been engaged in an effort to educate banks about the need to engage in “rigorous analysis” and to pay “detailed attention to risk issues within the context of the full portfolios of financial institutions” (quoted in Cummins 1994d). Phillips also noted that the Board’s other “strategy is the encouragement of private sector initiatives to foster sound risk management of derivatives activities” (Committee on Banking and Urban Affairs, 1993, 7). She moreover emphasized that these education efforts, rather than rule making, should be the focus of regulators, suggesting that “[p]erhaps it is time to shift some of the focus on derivatives from instrument design to risk management, appropriate capital levels, and adequate communication of risk profiles... Through their use of supervisory initiatives and efforts to implement sound management techniques, the regulatory and financial communities [are] develop[ing] the necessary disclosures and ensur[ing] commonsense ethical standards are in place” (Committee on Banking and Urban Affairs, 1993, 52).

This emphasis on improved supervision and risk management education by the FRB was certainly noted by key committee members. Both Chairman Gonzalez and Ranking Member Leach expressed their approval for the FRB’s information gathering on bank credit exposures and their revised supervisory guidelines (Committee on Banking and Urban Affairs, 1993, 54). In another hearing, the Chairman of the House Energy and Commerce Subcommittee on Telecommunications and Finance, Representative Markey similarly suggested that the FRB was “acting quite responsibly” in highlighting the importance of internal risk management at banks (see Cummins 1994f). Whether the actions and rhetoric of the FRB had any effect on the outcome of the legislation is difficult to tell, but it is notable that the revised bills introduced by Gonzalez, Leach, and Markey largely focused on new regulatory arrangements for securities firms and/or insurance companies. These Members of Congress also commented favorably on other efforts that the FRB had been associated with: changes to the Basel capital standards to take account of derivative risks and the G-30 report that had been issued in late 1993. Representative Leach, who was a strong believer in the importance risk-based capital standards, suggested that the ongoing revisions to the Basel Accord

to take account of trading risk were a positive development (Committee on Banking and Urban Affairs, 1993, 48); he furthermore characterized the G-30 effort as a “very helpful constructive report” (Committee on Banking and Urban Affairs, 1993, 48). In a 1994 hearing, Representative Mike Oxley, further referred to the G-30 group as “a distinguished collection of the world’s financial executives and academicians” (Committee on Energy & Commerce, 1994, 3).

Indeed, the FRB consistently drew upon its transgovernmental connections to help bolster its case in favor of improved industry risk management and self regulation. As Chairman Greenspan frequently alluded to in his public statements (see above), the Board had proposed a sharing of supervisory data relating to swaps and initiated a research agenda designed to examine ways in which risk management systems at banks could be improved (Wood, 2005, 967-97). This research not only allowed it to refine its own supervisory guidelines, but also projected an image of the agency as at the cutting edge of knowledge about this still new and opaque industry. The FRB had also highlighted the ongoing modifications to the Basel capital adequacy framework to take account of trading risks (Tarullo, 2008, 62-64). These changes, which were broadly opposed by U.S. banks and their trade associations (see Gapper 1993), were proposed in 1993 and ultimately went into effect in 1995 (Fox 1995, Tarullo 2008, 64). In 1994, the Basel Committee also issued common supervisory guidelines, a document that – perhaps not unconfidently – mirrored the FRB’s own supervisory letter published earlier that year (Singher, 1994, 1464). In short, these changes helped to reinforce the perception that the FRB was addressing potential risks through a combination of increasingly sophisticated capital requirements and globally endorsed ‘best practice’ supervisory standards.

The FRB also spoke favorably about the G-30 report. The Group’s recommendations, which its authors emphasized was based on “the best standards we could find” in the industry (see Brickell testimony on behalf of the G-30 before Congress Committee on Banking and Urban Affairs 1993, 40), had indeed largely mirrored the FRB’s focus on internal risk management, industry self governance, and opposition to government regulation. While highlighting risks involved in derivatives trading (Darby, 1994), the report’s conclusions were unmistakable: as Brickell noted, the study “concludes that the risks of swaps are the same types of risks that banks manage every day in traditional business activities” and that the G-30 “saw no significant increase in systemic risk from derivatives.” Moreover, he stated that, in the view of the organization, “bank involvement has been so far a healthy development. And as the use of derivatives expands in the banking system and in the economy, and as these principles [contained within the G-30 Report] are more widely used, the U.S. banking system is likely to be come safer and sounder [and] more competitive” (Committee on Banking and Urban Affairs, 1993, 40). In addition, as Tsingou (2003, 10) notes, the Group also made clear, industry self governance and promotion of best practice guidelines was the best way to attenuate risk.

David Mullins, the Vice Chairman of the FRB characterized the effort as an “important

contribution to the evolving analysis of this market” (Journal, 1993). In written comments to Congress on the report, the FRB echoed this, stating that the recommendations would “contribute to a better understanding of found risk management and accounting practices” and, if adopted “should help to strengthen the management management and operating practices” of financial institutions (Committee on Banking and Urban Affairs, 1993, 121). Moreover, the agency noted that market participants “with encouragement from regulators, will work toward implementing the recommendations where appropriate” (quoted in Tsingou 2003, 16). Vice Chairman Mullins, in a separate statement, also highlighted the fact that the report would help improve regulatory oversight, noting that it had laid out specific steps that regulators could take in order to “build the expertise and standards to make sure that firms have sound risk management.” Finally, and perhaps most importantly, he underscored the fact that the report supported the FRB’s contention that there was no need for dramatic regulatory change (Hansell, 1993a).

The embrace of the G-30 by the FRB was hardly surprising. The organization, founded in 1979 as a way to bring “together high-level officials from the largest financial institutions, central banks, and international organizations” (Tsingou, 2003, 3), as well as leading academics (Hansell, 1993a), was headed by the former Chairman of the FRB, Paul Volcker, and its membership included Alan Greenspan, recently departed head of the New York Federal Reserve Bank, Gerald Corrigan, his successor, William McDonough, and the former Chief Operating Officer of the New York Federal Reserve Bank (Hansell, 1993b). The fact that 20 percent of this committee were either current or recently departed former senior Federal Reserve officials is remarkable fact given the impressive list of members (among them: Larry Summers, Jean Claude Trichet, later president of the European Central Bank, and Mervyn King, later Governor of the Bank of England. See Tsingou 2003, 23-25 for a complete list). Much like the Basel Committee, this was an organization – though in this case non-governmental – in which the influence of the Federal Reserve was nevertheless very strong, thanks both to its representation within the Group and to the fact that the body was dominated by likeminded former or current central bankers.

As with its embrace of the work of the Basel Committee, the FRB relied heavily on the G-30 to provide legitimacy to its own policy position. In turn the legitimacy of the G-30 had been fostered partly as a result of the sheer volume of expertise contained within the organization, but equally by the level of research and extensive practical guidance contained within the report. The trade media, while acknowledging the presence of industry representatives within the Group, generally highlighted the expertise of the report’s authors and its comprehensiveness (Tsingou, 2003, 12). Indeed *The Economist*, in a characterization typical of others, suggested that the report “answers some, if not the most important, of the criticism of derivatives” (Economist, 1993). The report was so influential that within a matter of months it had turned it into the “the primary consultative document for regulators, supervisors and practitioners” across the globe (Tsingou 2003, 10; see also Morris 1993). This rapid global adoption by practitioners and other regulators, as well as the study’s depth

“impressed” legislators and “eased pressures for public regulation of OTC derivatives at the time” (McCaffrey 2012, 16; see also Tett 2009, 34-36). In short, the FRB, as it did in the case of capital standards, had relied heavily on its transgovernmental and informal international relationships to build legitimacy for its preferred policy positions at home.

#### 4.9.4 The SEC’s Position on Derivatives Regulation

What about the preferences of the SEC in this debate? In the years leading up to these legislative efforts, SEC officials had consistently identified the OTC markets as a high priority and a concern for them, particularly as securities firms were becoming more involved in trading the products. For example, Arthur Levitt, in his confirmation hearings to become SEC Chairman, repeatedly identified improved derivatives oversight as one of the key objectives he hoped to achieve and vowed to work more closely with other regulators on the issue than the agency had done previously (Cummins, 1993a). In the 1993 hearing before the House Banking Committee, SEC Commissioner J. Carter Beese spent the bulk of his prepared statement and responses highlighting the agency’s concerns about OTC trading and its potential impact on the equity markets. Like other regulators, he stated that the agency was concerned with risk assessment and capital. The SEC was also concerned, according to Beese, with disclosure, specifically that the underlying assets in contracts be ‘marked-to-market’ prices in order to allow both parties to accurately evaluate the benefits and risks associated with such contracts (Committee on Banking and Urban Affairs 1993, 16-17). In a speech in early 1994, SEC Commissioner Richard Roberts similarly reported that the “SEC has broad concerns about derivatives’ effects on the stock market in the event of a crash,” particularly in the context of the growing exposure of securities firms to risks associated with this type of trading (quoted in (Meredith, 1994b)). Therefore there is evidence that the residual concerns about equity based derivatives in particular, as well as issues of disclosure and potential fraud, were still very much present within the SEC.

Yet despite these concerns and the fact that it would have ostensibly have gained the most under the legislative proposals discussed during the 1993-1994 debate, the agency remained clearly opposed to legislative action. Beese, in the 1993 hearing, stated that “[w]hile in no way minimizing the risks associated with derivative products... The SEC currently has the tools at its disposal to address the concerns raised by the growth of this market” and that “the optimal approach to the regulation of OTC derivatives is to maintain stable markets and to protect investors, while allowing market participants the freedom to meet customer needs with new and innovative financial products” (Committee on Banking and Urban Affairs, 1993, 17). Later, in hearings before the the House Subcommittee on Telecommunication and Finance, Levitt explicitly rejected the GAO proposal to grant it authority over all non-bank entities conducting OTC trading, saying that he was “satisfied at this point that the industry has acted responsibly” and, as a result he was “not prepared to call for a specific piece of legislation” (quoted in Cummins 1994f). From a purely turf maxi-

mization viewpoint, this seems strange. Stranger still was their refusal to endorse legislation introduced by Representative Edward Markey, as well as Senate legislation introduced by Senator Donald Riegle, would have greatly empowered the agency by granting it authority over the derivatives trading subsidiaries of *all* institutions (and, in Markey's bill, over dealer activities, in effect giving it full jurisdiction over the OTC derivatives markets. See Singher 1994, 1444-1449 and Garsson 1994a for more detailed explanations).

Why did the SEC fail to endorse these legislative efforts when it clearly had serious concerns about the lack of regulation and stood to gain tremendously in terms of jurisdiction? One reason may have been a concern that these specific pieces of legislation were unlikely to have made it through Congress in 1994 owing to timing issues and the opposition of the FRB; embracing the proposals would, in that instance, have isolated it among the other regulators. However, there was another concern: taking on this immense jurisdictional responsibility was a risky proposition. As Commissioner Roberts suggested "[r]ight now, our foremost project is to attempt to close the learning curve that exists between the industry and the regulators in the derivatives field... That is the only way the commission will be able to ascertain whether these instruments will perform as advertised under stressful market conditions" (Meredith, 1994b). Another comment, made later by a senior unnamed SEC official, put it more bluntly "[r]ather than asking for legislation, which we weren't sure we could get, we needed more information [about the derivatives activities of securities firms]"; moreover "[l]egislation may not be what we wanted, because it might be really bad (quoted in Faerman et al. 2001, 379). In short, the SEC in 1994 simply lacked the information and resources to effectively oversee this rapidly growing and opaque industry, and doing so in all likelihood would have damaged their core reputation as a competent overseer of the securities markets<sup>20</sup>. Hence they ultimately decided not to play a major role in this debate.

### 4.10 The End of the Debate Over Regulation

In September, the Gonzalez-Leach bill, entitled the Derivatives Safety and Soundness Supervision Act, was due to be voted on in the House Banking Subcommittee; the bill passed through the Subcommittee narrowly, but no further action was taken thereafter. The Chairman of the Subcommittee, Representative Stephen Neal, had requested banking regulators to submit recommendations to the subcommittee, the answer was once again unambiguous: none of the regulators would support the legislation, with the FRB in particular making clear that it would oppose *any* legislative action at that point in time (deSenerpont Domis,

---

<sup>20</sup>Note that in Chapter 5, I discuss how the SEC created the 'Derivatives Policy Group' (DPG) in part to obtain more information about the trading risks at securities firms' subsidiaries. This issue was part of a broader effort to bolster the image of the agency as a competent prudential supervisor, a topic that is discussed in the next chapter.

1994). None of the other bills sponsored by Representative Markey, Senators Dorgan and Mikulski, and Senator Riegle, had been marked up for a committee vote. Although it was widely agreed that the current Congress would not pass a comprehensive derivatives package, there was still a widespread belief that the measure would come before the next Congress, particularly given the strong support of both Gonzalez and Leach for the measure (as an illustration of this, see Leach 1994). Indeed, the head of the GAO confidently predicted that “the question is sure to be back in full force next spring” (American Banker, 1994).

However, no serious attempt was made to reintroduce the Gonzalez-Leach bill in the 104<sup>th</sup> Congress that began in 1995. This development was hardly surprising. Although, as one contemporary report noted, “banking issues are not considered partisan” (Garsson, 1994b), and despite the fact that the incoming House Committee Chair, Representative Leach, was supportive of more stringent oversight of banks’ derivatives trading, the Republican takeover of the House and Senate in 1994 did change the political dynamics in important ways. First, the Senate Banking Committee Chairman, Senator Alfonse D’Amato, was viewed with suspicion from the banking industry given his close alliance with the securities and insurance industries; nevertheless, he made clear at early stage that he favored an industry self-governance approach to OTC oversight (deSenerpont Domis, 1995). Other key committee and subcommittee chairs expressed similar sentiments or ambivalence about further legislation (Garsson and deSenerpont Domis, 1994). More generally, the GOP-led Congress decided to impose a *de facto* moratorium on new regulation for six months, a fact that was also reflective of the anti-regulation sentiment within the Republican Conference; as such, there was little chance of any new oversight legislation passing (Rehm, 1995). Contemporary narratives between 1995 and 1996 also indicate a significant increase in lobbying by the ISDA and other industry groups, which may have had an impact (see, for example, Allen 1995a). Finally, Congress turned its attention to the issue of Glass-Steagall repeal, which consumed most of the time of members of the key committees (Ryan and Thurston, 2012, 26-28).

The more salient question, however, is why the earlier legislative efforts did not succeed in the 1993-1994 period. One factor was the division in jurisdiction in the House between the Banking Committee on the one hand and the Energy and Commerce Committee on the other; the latter had oversight over the securities and insurance industries. This led to delays and competing proposals in bringing forward legislation (deSenerpont Domis, 1994; Tomasula, 1994b). Relatedly, timing played a key role: the legislation was introduced in the summer of an election year; had the influential GAO report been published earlier, or had the hearings been held at the beginning of 1993, the legislation may have been more likely to succeed. Yet even under these conditions, it is difficult to imagine the passage of legislation opposed by all or most of the banking, securities, and derivatives regulators. As this project itself demonstrates, Congress rarely – if ever – passes legislation that is not either suggested to it by regulators or supported by at least some of them.

This then leaves the role of the specific agencies. There is little question that in the absence of the sustained, strategic campaign by the FRB, designed to reassure lawmakers

that a combination of internal financial institution controls, industry self-regulation, risk-based capital standards, and heightened supervision played a role in this outcome, as did the G-30 report that it was closely associated with (McCaffrey 2012, 16, Tett 2009, 34-36). Not only do the facts of this episode lend support to this case, but at every point in the debate over financial derivatives, whether it was in the 1970s (with the hybrid forwards exemption), the 1980s, or later in the 1990s, Congress consistently displayed a pattern of deference to the agency's views; there is no reason to believe that this episode diverged from that pattern. What's more, by 1994, its potential competitors were in a weak position: the FRB had helped to effectively sideline the functional regulator – the CFTC – from the debate years earlier. The only other major potential obstacle, the SEC, realized that the odds were stacked against it in any legislative battle. Moreover, any grant of sweeping new authority over the OTC markets would drain its resources from its core mission of securities market oversight and enforcement. Added to its lack of expertise and knowledge about the swaps marketplace, this new mandate would most likely have led to policy failures and damaged the agency's authority. In short then, with its strategic actions and lack of inter-regulator competition, the FRB exercised a critical, perhaps determinative, influence over the outcome of what was, without question, the most serious attempt to regulate the industry prior to 2009.

### 4.11 Conclusion

As Levine (2012, 6), commenting on the Federal Reserve's preferences regarding OTC derivative regulation in the late 1990s and early 2000s, observes, the "Fed's decision to maintain its regulatory stance towards [derivatives] was neither a failure of information or a shortage of regulatory power." That statement, however, equally well sums up its role in the key debates over OTC derivatives regulation in the late 1980s and early 1990s. First, this chapter has demonstrated that the Federal Reserve had clear preferences about regulation based on a relatively sophisticated understanding of the risks and benefits of OTC products as early as the mid-to-late 1980s. Moreover, these preferences were not confined to the person of its Chairman, Alan Greenspan, but were shared by a broad range of senior officials. Second, the agency proved critical in preventing regulation during key early episodes, both in blocking regulatory initiatives but also by weakening potential competitors such as the CFTC and SEC at the same time. Third, it drew upon rhetorical and transgovernmental strategies to boost images of its legitimacy in the debate and competency on the subject of risk oversight. Finally, because of the over-time analysis adopted here, I have shown that functionalist, structural, and traditional capture accounts cannot explain the Federal Reserve's preferences nor sufficiently explain the outcomes of these key episodes. In short, the Federal Reserve displayed all the characteristics of an autonomous agency capable of strategic behavior.

At the same time, I demonstrate the difficult positions of two other regulators involved

in this debate – the CFTC and the SEC. It is hard to escape the characterization of the former as a “sleeping, small, not terribly significant agency” or, in the words of Representative Barney Frank, of it being “a toothless agency” (quoted in Protesse 2012). Its preferences are inconsistent and appear to oscillate according to the preferences of its political leadership. Moreover, despite several attempts to regulate the OTC market, its political authority was heavily and consistently contested, leading to the failure of those endeavors. As such, the CFTC, at least as it then existed<sup>21</sup>, clearly did not meet the threshold of an ‘autonomous’ agency and posed no real threat to the Federal Reserve’s policy push. The SEC appears to have been more likely to hold its own independent policy preferences. Its mission – to protect investors through disclosure and ensure a functioning stock market – helped to generate a unique set of policy preferences. Specifically, it wanted greater oversight over equity-based derivatives and to combat the lack of transparency in the opaque OTC market. It also had a reservoir of political capital built up through its reputation as an effective enforcement agency. Yet, it displayed a reluctance to advocate for additional discretion in this area, since doing so would have potentially isolated it politically and endangered its ability to perform its core securities functions.

To further illustrate just how critical these early developments were, and therefore why it was vital to focus on them, it is useful to briefly note a later – and much better documented – attempt by the CFTC to impose sweeping new regulations on the OTC industry in 1998 (a comprehensive account of the episode can be found in the *PBS* documentary *Frontline* 2009). In May of that year, the CFTC, now headed by lawyer Brooksley Born, issued a so-called ‘concept release’ – that is, a document inviting public comment – that stated that certain OTC derivative products had become sufficiently standardized and displayed other trading characteristics that rendered them indistinguishable from traditional futures contracts; as such, the agency *suggested* that they may, in fact, be commodities subject to the CEA’s mandatory exchange trading requirement (CFTC, 1998, 16,114). The agency pointed to “22 examples of significant losses in financial derivatives transactions; and noted a 1997 GAO report that suggested there had been 360 end-user losses that year (CFTC, 1998, 26). In effect the CFTC was casting a shadow over the utility and legality of the entire OTC industry. The document had already faced stiff internal opposition; at least one commissioner, Barbara Holum, opposed the measure arguing that it would damage the agency’s

---

<sup>21</sup>There is also evidence that in the wake of the 2008 financial crisis, the CFTC, which had, in effectively exploited the moment to aggressively expand its authority. Not only did it influence the content of legislation, but it subsequently “proposed tighter external controls on the swaps market and generated rules more quickly than had been expected” (McCaffrey, 2012, 27). The agency was praised for its effective implementation of tough rules by advocates of more stringent regulation (e.g. ?). The Financial Stability Board, an increasingly important association of global banking regulators, noted in June 2012 that the CFTC had made the most progress in establishing new central clearing rules for OTC derivatives products (Board, 2012, 10). In other words, the CFTC strategically exploited the opening left by the financial crisis to advance its authority, even against the vigorous opposition of industry groups such as the ISDA.



reputation and relationships with other regulators; at least two other senior officials, one of whom was sympathetic to Born's position, were reluctant to go ahead for similar strategic reasons (Roig-Franzia, 2009). However, this opposition would pale in comparison to what it faced next.

It would probably be an understatement to describe the reaction from Chairman Greenspan and backed by Treasury Secretary Robert Rubin, as a 'backlash.' Chairman Born was warned that she "didn't know what she was doing and she'd cause a financial crisis." Chairman Greenspan, joined by Secretary Rubin, and, notably SEC Chairman Levitt, issued a joint statement on June 5 1998 calling on Congress to prevent Ms. Born from acting until the President's Working Group on Financial Markets, of which they were all members, issued its own findings. Despite the near-collapse in August 1998 of a large hedge fund, Long Term Capital Management (LTCM), that was heavily leveraged against risky off-balance sheet derivatives (Karmel, 2009, 24)<sup>22</sup>, Congress obliged by (in that same month) passing a six-month statutory moratorium to prevent the CFTC from taking further action on the concept release (Greenberger, 2011, 7). Born left the agency shortly thereafter and with its new Chairman, William Ranier, in agreement, the President's Working Group unanimously proposed that Congress permanently exempt virtually all OTC trading from the provisions of the CEA and other statutes. Congress, in turn, passed the Commodity Futures Modernization Act (CFMA) in December 2000 that, with minor exceptions, essentially prevented direct regulation of OTC derivatives (see Eppel 2001-2002, 700). In short then, the CFTC-Born effort showed just how far the debate had come from 1987 and 1994; the issue of OTC derivatives regulation had long ceased to be a politically viable agenda.

Many would doubtless look at this particular episode and conclude that the debate was over, not because of the influence of the Federal Reserve or Treasury, but because of 'cultural' or 'cognitive' capture – a circumstance in which all, or most, of the members of the policymaking community have internalized the particularized preferences of private industry (Kwak, 2013). Indeed, at least in this instance, that argument appears plausible. Relatedly, there is simply no escaping the fact that policy decisions described in this chapter coincided within a broader ideological context in which politicians, regulators, economists, and market participants embraced the concept of freer, deregulated markets as a way to achieve economic growth (e.g. see Blyth 2002; Prasad 2006; Fourcade 2009). Do cultural or ideological accounts, both of which logically suggest near consensus, better explain the events discussed in this chapter? By going back to the origins of this debate as this chapter did, we can say the answer is likely "no."

First, in the late 1980s and 1990s, it would have been factually incorrect to state that there was broad agreement on the utility of OTC derivatives or whether they should be regulated.

---

<sup>22</sup>By August 1998, LTCM had a capital base of \$2.3 billion but derivatives contracts outstanding worth, in notional terms, \$1.4 trillion. In an unprecedented move, the FRB facilitated the provision of private sector assistance to LTCM because it posed a systemic threat to the capital markets. See Karmel (2009, 24).

Aside from prominent Members of Congress, the CFTC, the SEC, and even some members of the Federal Reserve voiced concerns during this era, even if they ultimately agreed with the policy of avoiding regulation or legislation. Likewise, in 1994, the Comptroller of the Currency, Eugene Ludwig, expressed serious concerns about banks' growing use of complex OTC derivatives, suggesting that they may have been using these instruments to place dangerous bets on the market. That same year, the FDIC said there was a "significant probability" that restrictions would be put in place (Cummins, 1994b). Again, none of these actors ultimately opposed the Federal Reserve's view on regulation in 1994, but that is quite different from suggesting that they all thought OTC derivatives were an innovation that should be unhindered by any form of regulation. Second, one of the most notable aspects about the 1998 episode is how the subject of OTC derivatives regulation itself had evolved to become 'taboo' and that Born had been so widely characterized as a "rogue regulator" (Roig-Franzia, 2009); these facts suggest that some form of cultural or ideological consensus may have emerged (see Johnson and Kwak 2010 for similar characterizations of this episode). Yet the very fact that a vigorous public debate had existed just four years earlier suggests again that cultural or ideological 'capture,' if it existed at a later point, had yet to take hold.

In sum, neither structural, traditional capture, cultural capture or, for that matter, political control approaches can adequately explain the outcomes of these early, critical episodes, giving us more confidence in concluding that the early preferences and actions of regulators, particularly the Federal Reserve, exercised a determinative influence over the outcome in this case: the effective absence of OTC derivatives regulation. The next chapter examines the development of consolidated supervision policy for investment banks and the closely linked issue of capital standards for securities firms. These topics are substantively connected to this chapter; a major component of the debate over supervision and capital concerned the growing involvement of major investment banks in the trading of OTC derivative products in the mid-1990s. However, the chapter focuses not an agency in the ascendent but rather one whose authority became progressively more contested over time: the SEC. Its strategic miscalculations and responses to growing challenges are at the heart of the discussion that follows.

# 5 | The Transition to a More Contested Authority: Supervision, Capital, and the SEC

## 5.1 Introduction

The Securities and Exchange Commission (SEC) was once proudly declared the “crown jewel” of the U.S. financial regulatory infrastructure. For decades, it had cultivated an image as the “investor’s champion,” a consistent proselytizer for disclosure, and as tough, competent enforcer of securities laws. In particular, its high profile prosecutions of securities fraud and insider trading cases garnered it tremendous political support and deference. Given its success, the SEC model of securities regulation came to be seen as global best practice, and its “disclosure-enforcement” framework was widely emulated by developed and developing nations alike. Yet by the early-to-mid 2000s, it was clear that the agency’s luster had faded. Rocked by trading and accounting scandals, market volatility, and years of budgetary and staff constraints that had failed to keep pace with a rapidly growing and increasingly complex trading environment, the agency’s once unshakeable authority as a securities regulator came under sustained threat. Although this growing contestation of the agency’s authority was visible across a range of policy areas, perhaps the most high-profile and consequential domain was in the area of consolidated holding company supervision and capital standards for securities firms. As this chapter documents, a combination of strategic errors by the SEC, shifts in the political and industry environment, and a growing focus on the salience of prudential regulation produced growing challenges to its role as the primary supervisor of major securities firms. As its authority became more contested, it responded by collaborating with industry in a manner that arguably permitted excessive risk taking by investment banks, decisions which have been widely seen as playing a role in the collapse of the independent investment banking industry in the United States during 2008 financial crisis.

In contrast to the preceding discussions, this chapter is therefore an examination of an agency in transition from a position of largely unchallenged authority to one of growing contestation. This gives us a valuable insight into the differences in strategic bureaucratic

behavior under conditions of both non-contestation and contestation. The early 1990s was an era of unusually high political deference to the agency and a point in time in which the investment banking industry neither wanted nor felt it was able to force the agency's hand on issues of consolidated supervision and capital standards. In short, this was an era in which the agency's authority was largely unchallenged. Motivated by its disclosure based mission, the SEC rejected the concept of prudential consolidated supervision of major securities firms as a mandate that was neither necessary nor desirable, asking Congress instead to give it greater authority to compel disclosure by firms in 1991. While opposed by the major firms, neither they nor their supporters in Congress mounted any significant opposition to the SEC's request, reflecting the agency's high-level of political authority at the time. In much the same way, the SEC vetoed a potential transgovernmental agreement on common capital standards since doing so would have required it to assume consolidated oversight responsibilities and sacrifice the market pricing principles on which its existing Net Capital Rule was based. With its authority at home largely unchallenged, the SEC had no compelling reason to bind itself to a common standard, a sharp contrast to the incentives that compelled the Federal Reserve Board (FRB) to seek a similar agreement amongst banking regulators in the 1980s (see Chapter 3).

By the mid-1990s, two developments began to change the landscape for the SEC on these issues. First, Congress applied pressure to the agency to increase their oversight of the fast growing derivatives subsidiaries of investment banks, some of which had been involved in high profile scandals during 1994. Indeed, at this time the agency itself began to realize the potential risks that fast-growing derivatives subsidiaries of major investment banks posed to the firm and, more importantly, to their regulated broker-dealer subsidiaries. Second, as the political debate turned to the issue of Glass-Steagall repeal, the topic of consolidated supervision of newly integrated financial conglomerates became a more prominent topic of conversation. In particular, the SEC, while reluctant to take on prudential supervision of major investment banks itself, was also concerned about the prospect of such authority being vested in the FRB, an outcome that would dramatically reduce its influence over the securities industry. As such it set out to build up its reputation for competent entity oversight, specifically on the issue of derivatives, forming a public-private sector collaborative effort known as the Derivatives Policy Group (DPG). This entity produced a best practice framework for risk and capital management at the firms, as well as creating a system of risk data sharing that would enable the SEC to more closely monitor OTC trading activities. While this effort appeared successful in temporarily boosting the image of the SEC as an effective prudential supervisor, it nevertheless proved fleeting.

By the early 2000s, buffeted by a variety of external events and budget shortfalls, the threats to the SEC's authority had become far more pronounced. Thanks to the Gramm-Leach-Bliley Act, it was now possible for investment banks to convert their status to that of a bank holding company, a decision which would put them under the direct supervision of the FRB. The probability of such conversions occurring dramatically increased when the Eu-

European Union mandated that all financial conglomerates have a home country consolidated supervisor. This fact, combined with their growing size and dominance in the securities industry, granted the major investment banks growing leverage over the SEC, which found itself with no choice but to negotiate with the firms and its British counterpart – the (Financial Services Authority (FSA)) – on a plan to create a system of voluntary consolidated supervision for major U.S. securities firms. This scheme, known as the Consolidated Supervised Entity (CSE), permitted major investment banks to dramatically increase their leverage ratios by relaxing the SEC’s existing capital standards. At the same time, the SEC, which lacked resources as well as the experience in prudential regulation of complex firms, proved incapable of providing effective oversight of the scheme. Ultimately, in 2008, one of the major firms collapsed, two were sold to commercial banks after becoming insolvent, while the other two converted to become bank holding companies (BHCs) in order to access the Federal Reserve’s emergency discount window. The SEC lost much of its discretionary authority and suffered perhaps the most damaging blow to its reputation in its history, leading to calls for its abolishment or merger with other regulators.

Before examining these episodes, the chapter profiles the SEC as a securities regulator, focusing on the history of political deference to the agency, its investor-centered and disclosure-focused mission, and its approach to policymaking, which curiously mixes vigorous enforcement efforts with a rule making style that emphasizes cooperation with the industry. I examine alternative structural explanations for the growing contestation of the SEC’s role and its strategic actions, specifically global and domestic competitiveness arguments, as well as trends toward industry consolidation. I also present a variety of reasons to be skeptical of capture based accounts. Following a detailed analysis of each of the episodes outlined above, I discuss some of the important takeaways from this chapter, including its vivid illustration of the fact that mission-oriented and reputation-sensitive agencies are not pure ‘turf maximizers.’ Moreover, the chapter highlights the negative feedback loop created by the agency’s decision not to seek consolidated authority in the early 1990s, which demonstrates that the path dependent power dynamics discussed in previous chapters can work in both directions.

## 5.2 A Profile of the SEC as a Securities Regulator

### A History of Prestige and Deference

When Arthur Levitt, the former Chairman of the SEC, characterized it as the “crown jewel of the financial regulatory infrastructure” in the early 1990s, few would have disagreed (quoted in Fisch 2009, 785). Indeed, as Coffee and Sale (2009, 709) have observed, a critical debate over the SEC’s continued role as the regulator would “have been unimaginable” since “[t]he U.S. system of securities regulation was implicitly assumed to be the template for the rest of the world to follow.” For over thirty years, the agency has both perceived itself as be-

ing, and built a strong image amongst the broader public as, a tough, enforcement-driven protector of *retail* investors – a veritable “investor’s champion” as Langevoort (2009, 1029) characterizes it. Its high profile prosecutions of securities fraud and insider trading cases (the latter a category of law it itself created) won it plaudits from lawmakers, investment funds, as well as grudging respect from securities firms, who viewed it as both fair and competent (Markham, 2009-2010, 556). This reputation won the agency remarkable political authority and deference from elected officials on matters of securities market policy. Khademian (1992, 17) notes that its high profile public prosecutions “made the agency enormously popular in Congress.” Moreover, the salience of the industry it regulated only increased this tendency to defer to the agency. In summarizing the findings of her detailed study of the agency, Khademian observes that Members of Congress were reluctant to intervene in securities policy without the SEC’s consent because it would have been “risky to mandate legislation or try to influence decisions by the SEC that could be blamed for reducing investor confidence,” especially since policy in this area is of a highly technical nature (Khademian, 1992, 12). Krause (1996, 1097) similarly notes that the SEC’s “autonomy” is, in part, a function of the fact that “[w]ith the possible exception of the Federal Reserve, few, if any, other agencies have more responsibility for regulating economic affairs that contain potential large scale ramifications for the United States macroeconomy.” Indeed, like Khademian, Krause’s empirical study demonstrates that political deference to the SEC on securities market issues was the norm, not the exception, in the post-war period until 1992<sup>1</sup>.

### A Disclosure Based Mission

A key component of the SEC’s identity is investor protection, a belief “taken to heart by virtually all SEC staffers” (Pritchard, 2004-2005, 1083). Embodying this spirit, SEC Chairman Arthur Levitt unambiguously stated “[i]nvestor protection is our legal mandate. Investor protection is our moral responsibility. Investor protection is my top personal priority” (Levitt, 1998). Indeed Langevoort (2006, 1624) goes so far as to suggest that the agency’s staff view their role as the “investor’s champion” as a “religion more than [a] science.” This commitment to investor protection – particularly the protection of less sophisticated retail investors – has contributed to a mission that is almost entirely based upon disclosure, or as Khademian (1992, 20) characterizes it, “disclosure-enforcement” (see also Markham 2009-2010). This focus on promoting the availability of timely and accurate information is intimately linked to its role as a protector of ordinary investors and its mandate to ensure “fair, orderly, and efficient markets” (Sarra, 2009-2010, 639). Notably, this disclosure based mission “is a much a product of the preferences of SEC personnel and decisions made by the agency as of the preferences of [political actors]” (Khademian, 1992, 20). Specifically, the agency’s

---

<sup>1</sup>Notably, both studies concluded in 1992. This chapter argues that by the mid-1990s, the agency’s authority had begun to decline.

predominantly legal staff have long adopted the attitude famously expressed by Justice Louis Brandeis that “sunlight is said to be the best of disinfectants.” The idea behind this belief, in short, is that “disclosures permit investors to make more-informed decisions in purchasing or selling stock... assist directors in performing their monitoring role under corporate law... and generally increase the efficiency of the market in using information” (Thompson 2009-2010, 571).

Traditionally, there has been overwhelming internal unity on this mission. Indeed, as Pritchard (2004-2005, 1083) notes “[f]ew observers would suggest there is a great deal of diversity of thought at the SEC” on the matter. This means, however, that the agency can often be “unconstrained by market forces” in its decision making (Langevoort, 2006, 1605). Specifically, it historically ignored prudential concerns. As Seligman (2009, 680) notes, “[b]ank regulation... has long been based on safety and solvency priorities... By contrast, securities regulation largely focuses on investor protection, so its addresses disclosure obligations, accounting standards, audit quality, broker-dealer and investment advisor regulation, the regulation of stock and option exchanges, and fraud enforcement.” Entity regulation and capital standards are, by definition, prudential activities – they are designed to prevent institutional failures and attenuate systemic risks. Thus it should be no surprise that the agency saw the oversight of capital requirements as a “subsidiary” function, with its main purpose being to protect investors rather than preventing institutional collapse or systemic problems; indeed, as Lichtenstein (1993, 139) notes, the agency’s net capital requirements were designed solely “to insure that when a firm failed, the firm had sufficient liquidity to return to customers their securities.” The traditionally secondary status of prudential regulation amongst the SEC staff is reflected in its approach to the issue of capital standards and consolidated supervision discussed in this chapter. As a result, the agency appears to have been slow to recognize the growing salience of prudential regulation as functional divisions in the financial industry disappeared and markets became infinitely more complex, a mistake that would prove costly to its authority by the 2000s. Similarly, the agency did not invest in the expertise nor have the experience of overseeing complex financial conglomerates, a fact which forced it to increasingly rely on those institutions to provide self-regulatory solutions.

### **Approach To Regulation**

There are two, seemingly conflicting, ways in which the SEC’s broad approach to regulation has been characterized. The first view is of the SEC as a stringent, inflexible regulator. Reflecting this sentiment Langevoort (2009, 1032) notes that “SEC regulation of the securities industry is often described as heavy-handed, overly intrusive and enforcement dominated.” This enforcement heavy, “rules-based” approach contrasts with the “principles-based” approach of the CFTC and the U.K. FSA, both of which focus more heavily on “[n]on legal sanctions and informal regulatory suasion” (Langevoort, 2009, 1032,1036). Although the SEC’s regulatory attitude has been critiqued for ignoring systemic risk and imposing heavy

competitive burdens on U.S. businesses (Jackson, 2007; Coffee, 2007; ?), the agency has traditionally shown an insensitivity to such prudential and competitiveness concerns, arguing that its job is to vigorously promote disclosure so that market participants – particularly retail investors – are in a position to make informed investment decisions. Indeed, in its enforcement actions, the SEC has demonstrated a willingness to impose significant financial penalties and pursue criminal charges against market participants in a manner that has little parallel amongst U.S. financial regulators or indeed relative to securities regulators in other developed countries (Coffee and Sale, 2009, 728-729). This rules-oriented and enforcement centered approach to regulation is a reflection of the biases of the SEC’s dominant cadre of securities lawyers; conversely the lack of emphasis on prudential or competitive concerns reflects the marginal role played by economists and economic analysis within the agency (Khademian 1992, 105), a feature that still persists to this day (see Holzer and Ackerman 2012).

On the other hand, when it comes to formulating rules – rather than enforcing existing regulations – the agency has traditionally adopted a more conciliatory approach. Scholars have noted “that the Commission has often preferred enforcement to rule making for strategic reasons” (Langevoort 2006, 1619; see Karmel 1982, Ford 2005). Part of this “strategy” relates to the fact that enforcement cases, with a few exceptions, are lower visibility events that produce precedents that are not always immediately clear, at least to those outside of the confines of the securities law profession (Langevoort, 2006, 1620). As a result, enforcement actions often serve as the agency making policy by stealth, avoiding the controversy that might arise from more formal rule making processes (Shapiro, 1984). Throughout its history the agency has also opted for a strategy of cooperation and collaboration with industry in making policy. It is notable, for example, that much of the day-to-day rule making that occurs in the securities industry is actually made by self-regulatory organization (SRO)s such as the National Association of Securities Dealers (now the Financial Industry Regulatory Authority or FINRA), the stock exchanges (such as the NYSE), and the Financial Accounting Standards Board (FASB) (Thompson 2009-2010, 575-577). By delegating day-to-day responsibility for rule making to these SROs, the agency can act as an above-the-fray mediator between the competing interests – principally investors versus broker-dealers – that make up the securities trading community (Khademian, 1992, 101-103). This is not to say the SEC has failed to initiate rule making action when necessary, simply that its approach has been one of keeping a “shotgun... behind the door”: it will only impose rules when the self-regulatory process fails to produce results (Khademian, 2002, 517).

However, this cooperative approach to policy making has also been borne out of necessity. Despite its prestige and accomplishments, the SEC has always been a relatively small agency with a wide range of oversight responsibilities. For example in 2000, the SEC had 3,235 full-time staff members, approximately 40 percent of whom were attorneys; 17 percent were either accountants or financial analysts, while 6 percent were examiners (GAO, 2002a, 4). This body of staff had to review 17,000 publicly traded companies that made



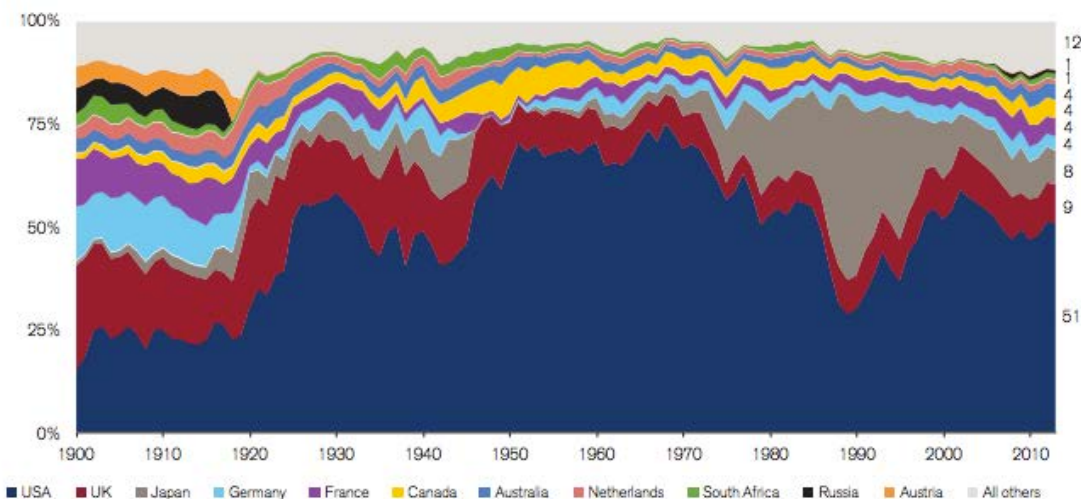
annual or quarterly filings with the SEC; ensure capital levels and professional standards were maintained at the approximately 700,000 registered brokerage firms; regulate the activities of 7,500 investment advisors and 34,000 investment company portfolios; and oversee the activities of the SROs under its jurisdiction (McConnell, 2002). In 2002, the agency assumed greater direct oversight of the auditing industry following the creation of the Public Company Accounting Oversight Board (PCAOB). There is little question that the agency has been subject to budgetary and size constraints throughout its existence, likely a function of its reliance upon the congressional appropriations process rather than self-funding mechanisms (Khademian, 2002). Indeed, as Khademian (1992, 116) notes, “[i]f the SEC had received larger budgets or more staff positions, it might not have enlisted the cooperation of the industry to such an extent.”

This style of policymaking is important to remember when evaluating the episodes discussed below. The SEC’s engagement in a collaborative effort with the private sector via the Derivatives Policy Group in the mid-1990s or its negotiations with the major investment banks to create the Consolidated Entity Program in the early 2000s was not entirely atypical of its past regulatory behavior. On the other hand, the agency has consistently engaged in collaboration for strategic reasons – a desire to avoid open contestation – and as a result of resource limitations. Therefore, its increasing turn to collaboration with the private sector and indeed its transgovernmental counterparts through the 1990s and 2000s should be seen as a sign that its authority was being subjected to growing challenges. As the threats to its authority as the primary regulator of securities firms increased, it needed the cooperation of the major securities firms in order to demonstrate its competency in entity regulation and thus help forestall the looming possibility that the FRB would be granted consolidated oversight over large conglomerates. By 2002-2004, the SEC – in an even weaker position – sought to collaborate with the private sector in order to prevent investment banks themselves converting to bank holding companies (BHCs), thus placing them under the jurisdiction of the FRB. Throughout, its turn to collaboration was also driven by a budget that had failed to be updated to reflect its growing responsibilities and staff who lacked the expertise to oversee complex entities, especially their derivatives subsidiaries.

### 5.3 Evaluating Structural Explanations for Growing Contestation

Between the late 1980s and mid-2000s, the SEC’s authority on the related issues of entity supervision and capital adequacy became increasingly contested. How do we explain this weakening of authority over time? Similarly, why did the agency refuse to engage in international cooperative efforts in the early 1990s, but later proved more willing to collaborate with industry and transgovernmental counterparts? Structural theories provide possible explanations for the pattern of increased contestation and shifts in strategic behavior witnessed in

Figure 5.1: National Equity Market Capitalization as a Percentage of Global Equity Market Capitalization: 1900-2012



Source: Credit Suisse (2013, 9). The figures on the right represent the share of equity market capitalization held by each country in 2012.

the episodes discussed below. Structural competitiveness theories, for example, would necessarily presuppose that the U.S. market was losing ground globally throughout the 1990s and 2000s. As a result, this would have increased domestic political pressure on the agency to enact pro-industry policies and incentivized it to engage in cooperation with both the private sector and transgovernmental entities. A similar logic would apply to domestic competition: if securities firms were losing significant market share to commercial banks, or not achieving comparable gains in new markets (such as OTC derivatives), then we might expect the securities industry to place pressure on the SEC to enact policies designed to protect or boost their domestic market share. Finally, the structural power of the industry would also presumably have grown if the industry was becoming more concentrated, increasing preference homogeneity and the clarity of messages sent to the SEC. As discussed briefly below, there is a dearth of evidence to support the global and domestic competitiveness arguments. Industry concentration levels were fairly static throughout the 1990s, suggesting that the structural influence of the industry likely does not explain policy outcomes during that period. However, concentration levels rise significantly in the early 2000s, which is consistent with other evidence presented in this chapter of suggesting growing industry influence over policy outcomes during this period.

### 5.3.1 Global Competitiveness

Were U.S. capital markets were losing their dominant global position during this era? In short, no. In fact the empirical evidence suggests that U.S. markets not only retained their global share of the securities and bond markets, but that they actually increased that share. As Gadinis (2008, 475) notes, until at least the early 2000s “U.S. dominance of the primary securities markets was strong. Foreign companies gravitated toward U.S. markets to take advantage of their deeper liquidity and lower cost of capital.” As study conducted by Pagano et al. (2002) shows that U.S. markets became increasingly attractive to foreign corporations seeking to raise capital from the mid-1980s to the late-1990s, particularly to European corporations. Indeed, between 1986 and 1997, the number of European corporations listed on U.S. based exchanges almost quadrupled, going from 52 to 206; during the same period, the number of U.S. corporations listing on European indices – the main competitors for such business – declined from 284 to 184. Over half of the capital raised as part of corporate equity and bond initial public offering (IPO)s – that is, new listings of stock or debt by a corporation – between 1999-2000 originated in U.S. markets (on Capital Markets Regulation, 2006, 30). Even in the early 2000s, the U.S. still attracted by far the most new listing by foreign corporations (Gadinis, 2008, 476). Indeed, as figure 5.1 vividly illustrates, over the course of the 1990s, U.S. capital markets grew significantly in strength, reestablishing a dominance temporarily threatened in the 1980s by the growth of the Japanese markets. Moreover, the U.S. maintained that dominance throughout the 2000s, accounting for close to or greater than 50 percent of global equity capitalization for the entire decade. This fact strongly suggests that international competitiveness concerns of the U.S. securities industry (or elected officials) were, in fact, fairly weak for the entire period examined in this study.

### 5.3.2 Domestic Competition

Had securities firms faced increasing domestic competition from commercial banks for their core business, or been unable to compete in new markets such as the OTC derivatives market, this may have increased pressure on the SEC to accede to the industry’s regulatory demands. However, there is surprisingly little evidence of such competitive pressures. An illustrative example is in the area of “underwriting.” Underwriting refers to the process through which a financial institution helps a corporation raise money via the issuance of *new* equity stock (often in the form of an initial public offering or IPO) or debt. The financial institution (usually a major investment bank) buys the securities or debt and then sells them to investors and the public at a markup; in addition, the underwriting institution charges large fees to corporations for providing analysis and advice on the offering. As a result, underwriting, in contrast to the lower margin business of brokering purchases of *existing* equity or debt for investors, traditionally provided one of the most lucrative sources of revenue for large investment banks (for a comprehensive overview of the underwriting business, see Ferris et al. 1992). In 1997, the FRB had dramatically relaxed underwriting and trading restrictions

Figure 5.2: Aggregate Market Share of Commercial Banks + Subsidiaries and Investment Banks, 1990-2002

Year	Total		Commercial Banks & Subsidiaries			Investment Banks		
	No. offers	Amount Offered (\$ millions)	No. offers	Amount Offered (\$ millions)	% of Total Amount	No. offers	Amount Offered (\$ millions)	% of Total Amount
<b>All Offerings</b>								
1990-92	1,891	117,167	549	25,382	21.7	1,342	91,785	78.3
1993-94	1,962	122,958	635	34,715	28.2	1,327	88,243	71.8
1995-96	2,470	181,747	946	55,483	30.5	1,524	126,264	69.5
1997-98	1,934	199,271	642	55,660	27.9	1,292	143,610	72.1
1999-00	1,846	355,502	586	83,421	23.5	1,260	272,081	76.5
2001-02	809	183,703	236	43,234	23.5	573	140,469	76.5
<b>Total</b>	<b>10,912</b>	<b>1,160,348</b>	<b>3,594</b>	<b>297,895</b>	<b>25.7</b>	<b>7,318</b>	<b>862,452</b>	<b>74.3</b>
<b>Initial Public Offerings</b>								
1990-92	872	42,827	251	9,000	21.0	621	33,828	79.0
1993-94	985	53,969	326	14,009	26.0	659	39,960	74.0
1995-96	1,284	76,719	481	23,840	31.1	803	52,879	68.9
1997-98	931	73,431	283	18,435	25.1	648	54,996	74.9
1999-00	983	143,777	307	25,992	18.1	676	117,784	81.9
2001-02	171	56,595	40	9,608	17.0	131	46,987	83.0
<b>Total</b>	<b>5,226</b>	<b>447,318</b>	<b>1,688</b>	<b>100,884</b>	<b>22.6</b>	<b>3,538</b>	<b>346,434</b>	<b>77.5</b>

Source: Chaplinsky and Erwin (2005, 45)

on so-called “Section 20” subsidiaries<sup>2</sup> of commercial banks, exacerbating the competitive pressures on securities firms that had been building since the FRB first authorized these types of subsidiaries in the late 1980s (Roten and Mullineaux 2002)<sup>3</sup>. Then, following the repeal of the Glass-Steagall Act in 1999, large commercial banks were able to enter into direct competition with securities firms (see Chaplinsky and Erwin 2005). Does the threat of commercial bank competition credibly explain growing contestation or indeed help us to understand the SEC’s largely pro-industry actions?

The answer is ‘probably not.’ As figure 5.2 shows, the overall market share of investment banks, whether measured in terms of total equity and debt underwriting offerings or in terms of IPOs, actually *increased* between 1997 and 2002. Indeed, as Chaplinsky and Erwin (2005, 32) note, the commercial bank share of offerings was almost entirely achieved through acquisitions rather than organic growth, further suggesting that the competitive pressures on investment houses were not particularly strong, at least in this area of their business activities (see Chaplinsky and Erwin 2005 and Ljungqvist et al. 2006 for an explanation of the failure of commercial banks to more effectively compete). Crotty (2007, 10), in much the same vein, observes that U.S. investment houses faced significantly less competition than their European counterparts, where fees for underwriting and assisting in mergers and acquisitions was far lower. This lack of competitive pressure held true across a range of traditional investment bank activities, including commissions earned from trading, client advice and research, and mutual fund management (Ljungqvist et al., 2006). While commercial banks were more active in the OTC derivatives markets – markets in which both they and major securities firms were earning a growing portion of their revenues (see below) – the fact that they were expanding exponentially enabled all institutions to increase their earnings from such activity and attenuated competitive tensions (e.g. see Edwards and Mishkin 1995). In short then, domestic competitive considerations appear to be an equally unlikely explanation for the SEC’s policy decisions.

---

<sup>2</sup>Section 20 refers to a provision of the Glass-Steagall Act that prohibited commercial banks from affiliating with a company “engaged principally” in the “issue, floatation, underwriting, public sale, or distribution” of “stocks, bonds, debentures, notes, or other securities.” It was the FRB’s re-interpretation of the “engaged principally” portion of Section 20 in 1988 that allowed banks to enter securities underwriting and trading, providing that the subsidiary derived no more than 5 percent of their gross revenues from such activity. In 1989, the Board raised that figure to 10 percent and in 1997 it raised it to 25 percent, as well as making other changes that reduced barriers between the subsidiaries and their commercial bank parent. See Bhargava and Fraser (1998, 449-451).

<sup>3</sup>However, these pressures were more pronounced in the debt underwriting markets than the equity underwriting markets. See Gande et al. (1999) for more.

Figure 5.3: Securities Industry Concentration Based on Total Revenue, 1980-2006

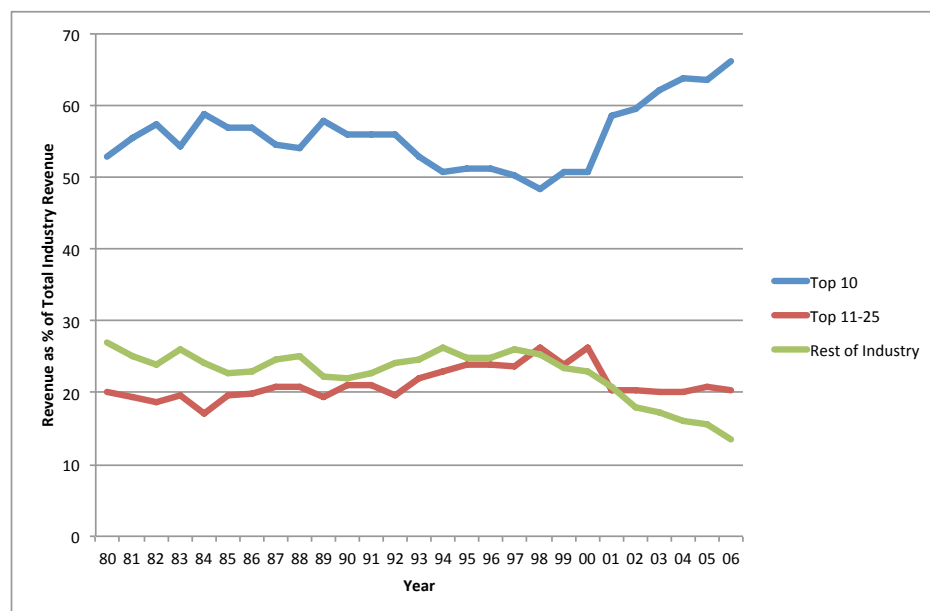


Chart is based on data from Securities Industry Association (2002, 40) and Financial Services Roundtable (2008, 130). Revenue concentrations are used in place of asset size as those figures are not commonly reported.

### 5.3.3 Industry Consolidation

As any industry consolidates it should, at least in theory, be able to speak with a clearer voice and send more powerful signals to policymakers regarding its preferences. Therefore a trend towards increased consolidation over time could potentially explain the patterns of increased contestation and offer an alternative explanation for the SEC's policy behavior, which indeed did generally favored the major investment banks. Figure 5.3, which uses revenue data (and is thus slightly more volatile than asset data) demonstrates that the securities industry was indeed relatively concentrated throughout the period examined in this chapter. Theoretically, this would imply that the large investment banks were capable of exercising a significant structural influence over the SEC. However, there are important qualifiers to that supposition in this case. For example, there is little evidence of industry concern with the consolidated supervision issue in earlier years (see below). The revenue data mask the fact that the industry also varies by function as much as it varies by size. As aforementioned, large investment banks traditionally engaged in underwriting initial offerings of stock or bonds and facilitating mergers and acquisitions in addition to broker-dealer activities. By contrast, small brokerage houses tend to be more specialized. Many focus solely on the core function of 'market making' – purchasing and selling financial instruments

on behalf of clients – in which case their revenue is primarily derived from commissions earned on those transactions. In turn, brokerage houses may focus on either institutional or retail clients. Some firms are dedicated solely to offering portfolio advice to their clients, while others, such as “merchant banks” essentially engage in providing private equity to firms and offering advice on strategy and management. Unsurprisingly, these firms have diverse policy interests on issues such as capital and supervision (see Goldberg et al. 1991). Of greater import, the agency has other audiences it must satisfy including the investment community and its preference for maximum disclosure. Thus concentration alone does not demonstrate structural influence, even though it is indicative of it. What is perhaps more revealing about figure 5.3 then are the trend lines it illustrates. Notably, the concentration of revenue in the top ten investment firms increases quite dramatically in the early 2000s. While this only presents a stylized illustration of the growing influence of the major investment banks relative to other segments of the industry, it does suggest that a fundamental shift occurred in the structure of the industry at that time. In turn, this *may* indeed have contributed to the patterns of contestation and SEC behavior witnessed in later periods, particularly with regard to the creation of the Consolidated Supervised Entity (CSE) program.

### 5.4 A Note on Preference Independence and Capture

There is little question that the relative political leverage of the securities industry, and specifically of major investment banks, increased over time. The explanations are not particularly complicated. In part, this was simply a function of the reduced diversity and growing consolidation in the industry noted in figure 5.4; that such concentration was occurring in a growing and economically important sector only served to further increase the influence of major securities firms. Their influence relative to the SEC also owed to the ongoing political debate over Glass-Steagall repeal, as well as the agency’s budget and staffing shortfalls. The growing strength of the industry was not the only reason the SEC’s authority became more contested, but it was certainly one of the factors contributing to that trend. The more relevant question then is not whether the influence of the major investment firms grew over time then, but the impact of that growing influence on the agency’s preferences, i.e. did that influence constitute “capture” during any of the periods discussed below? It is certainly true that the policies pursued by the SEC generally were beneficial for major securities firms. However, that alone does not demonstrate capture. Instead, four factors should be borne in mind. First, was there any evidence of clashes or disagreements on these issues, even if such disagreements were at a low-level? Second, were the SEC’s actions consistent with its mission, expertise, and experience? If not at all points in time, then when? Third, do existing empirical studies back up a capture claim? Finally, did the industry have a reason or an “intent” that caused them to influence the SEC on the issue of capital standards or consolidated supervision? If so, when did this intent emerge?

The first point is answered in later sections, but it is clear that at least in the early 1990s,

Figure 5.4: Percentage of Securities Industry Revenue Generated by Four Activity Categories, 1991-2006

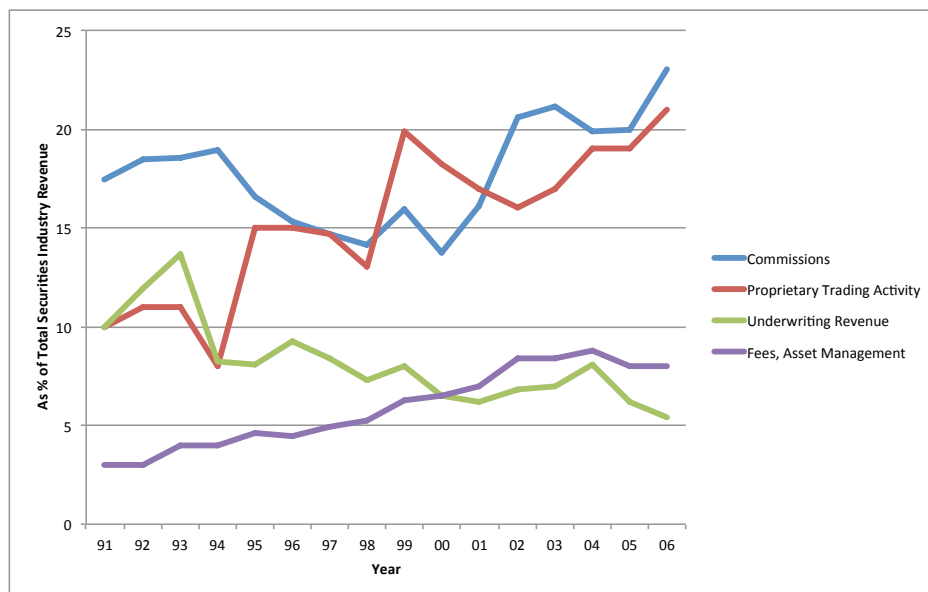


Chart based on data collected from Securities Industry Association (2002, 42) and the SIFMA Securities Industry Databank (available at <http://www.sifma.org/research/item.aspx?id=1688>). The remaining portions of securities firm have been more stable over time; see Securities Industry Association (2002) for a full breakdown

there were points of disagreement between the major investment banks and the agency, both on the topic of enhanced disclosure and on adoption of more relaxed capital rules, facts which cast doubt on capture at that stage. Second, there was a consistency between the SEC's policy decisions, its mission, and distinctive competency in earlier episodes. The policy choices it made in the early-to-mid 1990s clearly reflected its disclosure-based mission and the investment it had made in its long-standing Net Capital Rule. This consistency reflected the internal commitment to the agency's mission of disclosure and investor protection, as well as its organizational pride in its vigorous enforcement regime that as discussed previously. By contrast, in the 2000s its policy actions did not reflect that mission or experience – in fact, its embrace of the Basel II guidelines in many ways represented a rejection of its earlier strongly held views – a fact that adds more weight to a capture explanation during that period (however, in all periods its actions reflected the secondary status of prudential supervision in its core mission). This, taken together with the demoralization produced by budget cuts and high staff turnover, suggests there may be a plausible claim that the agency's preference independence weakened in later years (see final section of this chapter).

On the other hand, thanks to empirical scholarship that has focused on SEC decision-making and enforcement patterns, we know that there is death of evidence in support of the



capture claim. For example, as deHaan et al. (2012) demonstrate, the revolving door – one of the major hypothesized mechanisms of capture – had no significant impact in either direction on policy or enforcement behavior within the SEC between 1990 and 2007. This supports the findings of other SEC specific studies, such as Che (1995) and Salant (1995), both of which actually find a positive correlation between time SEC staff spent in industry and the stringency of the agency’s subsequent enforcement efforts. Indeed, most of the SEC’s senior officials have previously worked in the investment banking industry. In the majority of cases, those officials emerged as proponents of more stringent regulatory standards and tough enforcement actions on joining the agency – with Arthur Levitt, Chairman from 1993-2001, being a prime example of this (Khademian 2002, 520; Dwyer 1997). Beyond the revolving door issue, Pritchard (2004-2005, 1090) finds that investment banks have traditionally fared poorly in terms of SEC rule making and enforcement actions during downturns, again causing us to question claims of capture by large investment banks.

Finally, there is the question of industry intent. First, as section 5.5 and figure 5.5. below make clear, most major investment banks did not create unregulated derivatives subsidiaries until late 1993 to early 1994. Since these subsidiaries were key to the investment banks’ opposition to consolidated supervision (given that such a regime would have forced them to hold capital against their OTC derivatives positions), it seems unlikely that they would have had a reason to vigorously oppose the SEC prior to that point. To support this point, it is worth examining the shifting revenue patterns at securities firms between the early 1990s and the mid-2000s. As figure 5.4 clearly indicates, commissions (from trading and from advisory services) dramatically increases as a source of revenue, particularly in the late 1990s and early 2000s. Of greater salience to this discussion, the proportion of revenues generated through “proprietary trading” (trading that use the firm’s own capital the intention of making a profit) experienced a significant increase over time, beginning in 1994, the first full year in which the derivatives subsidiaries of three of the major investment banks began operations. While the firms’ OTC derivatives trading operations were both proprietary and market-making in nature, and while proprietary trading activity was not solely focused on derivatives, it was the key driver of its growth as a share of revenue in the later part of the 1990s (Davis, 2003, 82). In short, the industry simply lacked the incentives to invest in a campaign against consolidated supervision in the early 1990s. By contrast, they had a far greater stake in the issue early 2000s, since consolidated oversight would have forced firms to set aside capital against their derivatives positions, dramatically attenuating the lucrative nature of such trading activity. In short then, there seems little reason to presuppose a lack of preference independence and capture by industry, and most certainly not in earlier years.

## 5.5 A Lack of Contestation: Early Episodes Relating to Capital and Consolidated Supervision

### 5.5.1 Background

Under the terms of the 1934 Securities Exchange Act, a “broker-dealer” refers to any person or firms that trades securities for their own account or on behalf of others. In terms of entity supervision and capital requirements, broker-dealers have long been treated differently than banks for two reasons. First, as has been shown in previous chapters, banks have traditionally been treated as quasi-public utilities given their role as the holders of public deposits, in providing credit to consumers and businesses, and as payment intermediaries; as a result, the emphasis of banking regulation has been on risk-mitigation or institutional “safety and soundness” (Bhatia, 2011, 13). By contrast, securities firms are inherently involved in higher-risk activity that is more removed from the day-to-day functioning of the real economy; as such, and consistent with the SEC’s mission, the emphasis in securities regulation has been on investor protection and pricing transparency rather than the curtailment of risk. Second, there are practical differences in the risks each type of institution faces: while broker-dealers, much like commercial banks, face risks from defaults by counterparties, the risks in the case of banks traditionally have arisen from a credit default by a long-term debtor. By contrast, securities firms trading in highly liquid markets in which they can easily sell assets have to contend principally with short-term market risks – such as a decline in the value of its securities holdings – or general risks – such as changes in interest or exchange rates – rather than the long-term credit worthiness of their counterparties (Worth, 1992-1993, 138). As a result of these two factors, there has been no formal emphasis on “safety and soundness” supervision for securities firms while the only prudential regulatory tool that is applied to such firms – the SEC’s Net Capital Rule (NCR) – has largely ignored the risk profile of counterparties or the systemic linkages between firms.

The Net Capital Rule<sup>4</sup> has often been characterized as a “comprehensive” approach to capital adequacy calculation (Dimson and Marsh, 1995, 825). These rules required broker-dealers to hold capital equalling the value of a specified portion of the “long positions” held

---

<sup>4</sup>The rule was a provision contained in 15(b) of the Securities Exchange Act of 1934. It was significantly modified by the SEC in 1975. For more on the development and details of the Rule, see Jamroz (1991-1992).

by the firm in addition to a proportion of the value of its “short positions”<sup>5</sup>; specifically, the SEC required broker-dealers to retain capital in the amount of 15 percent of their long-holdings and hold capital against short holdings under specific circumstances (see Dimson and Marsh 1995, 829). The Net Capital Rule only took into account generalized market risks (or ‘position’ risk), rather than accounting for the risks inherent to the counterparty or type of security itself. By contrast, the British Securities and Investment Board (SIB), along with other European regulators, had begun to adopt a so-called “building block” approach that essentially separated out risks into two categories: general and specific, with the latter a rough approximation of the weighted risk-bucket approach used in Basel I (Worth, 1992-1993, 154). To ensure portfolio diversification (and thus avoid dangerous concentrations in certain categories of assets advantaged under the scheme), the SIB had permitted firms to hold lower capital levels provided that they maintained a diversified portfolio (see Dimson and Marsh 1996). The SEC, as discussed below, strongly opposed the building block approach, ostensibly on the basis that it would reduce overall capital levels.

The opposition of the agency to the building block approach doubtless was influenced by its long-standing commitment to, and experience overseeing, the Net Capital Rule framework. However, it was perhaps more fundamentally rooted in its reluctance to embrace “consolidated supervision” of the parent or holding companies that in many cases owned registered broker-dealers. As Lichtenstein (1993, 146) notes, until 1988 the SEC “was not in the least concerned with broker-dealer affiliation with either its parent companies or its non-broker-dealer sister companies or even its non-regulated securities subsidiaries” when determining capital requirements. This stemmed in large part from the fact that prudential supervision was neither a core function or key expertise of the SEC: the agency was, after all, a disclosure-focused, enforcement oriented organization, not an agency focused on safety and soundness concerns. As will be seen below, the SEC felt that taking on the complex prudential task of consolidated supervision could endanger its largely unchallenged image as a highly competent, if narrowly focused, prosecutorial agency by diverting resources from that task and heightening the risk of supervisory failures.

However there was another factor. In the late 1980s and early 1990s, the bulk of business conducted by securities holding firms was done through their broker-dealer units, obviating the need for oversight authority over the consolidated firm in the eyes of the SEC, even after the high-profile failure of Drexel-Burnham-Lambert (see below). It was only in the years

---

<sup>5</sup>“Long positions” refer to securities or other assets purchased with the expectation that they will rise in value over time. When a broker-dealer (or any investor) purchases a “short” or “short position,” they expect the value of the asset to decrease in value. In that instance, the short-seller sells “borrows” the underlying instrument from its owner, sells them and then repurchases them upon a decline in the traded price of the asset. The firm (or individual) then returns the assets to the original owner and retains the profits from the transaction minus the interest fees charged by the original owner. The practice of short-selling and particularly “naked short selling” is controversial; see, for example, Christian et al. (2006).

Figure 5.5: Major Derivatives Product Companies: Date of Creation and Parent Company

<b>Date Derivatives Policy Company Created</b>	<b>Parent Securities Firm &amp; Home Jurisdiction</b>
August 1990	Credit Suisse Group AG (Switzerland)
October 1990	General Re Inc. (USA)
November 1991	Merrill Lynch & Co. Inc. (USA)*
November 1993	Paribus (France)
November 1993	Westpac Banking Corporation (Australia)
December 1993	Goldman Sachs Group Inc. (USA)*
January 1994	Morgan Stanley & Co. Inc. (USA)*
January 1994	Lehman Brothers Holdings Inc. (USA)*
October 1994	Credit Lyonnais (France)

\* Indicates one of the four major U.S. investment banks. Chart adapted from Kroszner (1999, 611).

proceeding the episodes discussed in this next section – the international negotiations on a common capital standard and the passage of the Market Reform Act – that major securities firms began to refashion themselves into holding companies (although the major investment banks had long had this status) and, more important, began to create so-called special purpose vehicle (SPV)s that handled their increasingly lucrative and expansive derivative transactions business (Dale, 1996). The dates on which major securities firms began to create Derivatives Product Company (DPC)s is indicated below in figure 5.5. The first major investment bank to establish a DPC was Merrill Lynch at the end of 1991; the other three other major investment banks did not set up equivalent operations until the end of 1993/beginning of 1994. This delay helps to explain why securities firms were not particularly active traders of OTC derivatives relative to large commercial banks until the mid-1990s, a point made in the previous chapter.

### 5.5.2 Drexel-Burnham and the Market Reform Act

As an SPV, DPCs were legally distinct entities with their own asset and liability structures. As such, they were exempt from the SEC's Net Capital Rule, which was one of the principal benefits of creating such entities. The other main benefit, in theory, was that the bankruptcy of the parent would have no impact on the operations of the subsidiary and vice-versa. In reality, however, the parent company could easily siphon the capital held by its SPV or, as the Enron incident a decade later illustrated, use it to hide the parent company's debt.

This was vividly illustrated by the collapse of Drexel-Burnham-Lambert Group, a corporate bond specialist that helped to develop the market for so-called “junk bonds” – bonds issued by corporations with low credit ratings. Following the prosecution of the company’s chief executive on fraud charges and an a legal admission of complicity by the firm in late 1989, the company was unable to raise the necessary capital to stay afloat, leading it to file for bankruptcy in February 1990. The collapse of the Drexel Group in turn led to significant systemic effects for the junk bond industry, with the lowly rated bonds dramatically dropping in value and leading to the collapse of many of Drexel’s corporate clients (since they were now unable to raise funds to stay afloat). However, the most important element of the Drexel collapse from the perspective of the SEC concerned the relationship between the parent company and its eponymous registered broker-dealer subsidiary. Immediately prior to its collapse, the holding company had been transferring capital into its own accounts from its broker-dealer arm. Indeed, by the time the SEC and the NYSE became aware of the transfers and ordered them to stop, over half of the broker-dealer’s capital – \$400 million – had been transferred to the holding company. This incident unquestionably highlighted “a serious hole in the SEC’s supervisory authority”: it lacked any supervisory authority over the parent company of broker-dealers (Singer, 2007, 86). However, the SEC’s response was not to demand such consolidated authority in the form of firm-wide capital standards, but rather seek a more limited solution: requiring broker-dealer holding companies to provide information on their financial health. This reflected several factors: its disclosure-based mission and experience, aversion to prudential supervision, belief that the Drexel case had been resolved efficiently and effectively, and the relatively small handful of SPVs that had been set-up by securities firms at that time, thus appearing to obviate the need for a more aggressive firm-wide approach.

In 1989, the SEC for the first time acknowledged that broker-dealers faced risks from unregulated counterparties and holding companies. In a House hearing in late 1989, SEC Chairman Richard Breeden suggested that Commission lacked vital data on large trades and had been unable to monitor the financial stability of the largest broker-dealers in the days prior to the 1987 Stock Market Crash (Sands, 1989). Indeed, as he colorfully noted in a separate Senate Banking Committee hearing that year “[i]f there’s a fire-alarm fire raging, we think we ought to know about it” (quoted in Singer 2004, 86). Partly as a result, the agency proposed that Congress pass legislation – known as the Market Reform Act – which would grant the SEC the authority to collect information and data on trading operations from the broker-dealer holding company (the proposed legislation also included other expanded powers for the agency – see Robb 1990). Following the Drexel failure, Breeden sought to push Congress to pass the legislation, reaffirming “[t]he Commission must have regular information regarding a [broker-dealer’s] holding company and related corporate organizations if market participants, lenders and public customers are to maintain confidence in the integrity of [broker-dealers] and U.S. securities markets” (quoted in Vise 1990). At the same time, he later made clear that:

the historical evidence suggests consolidated supervision [used by bank regulators] does not succeed. [The new rules] do not prevent failures – that can't be done. But they give warning, they give added notice (quoted in Pressman 1992).

He further counseled that the liquidation of the Drexel broker-dealer subsidiary had occurred in an orderly fashion, noting that the “customers, counterparties, and others who dealt with the regulated broker-dealer subsidiary of this firm have been protected” and resisted the suggestion of some House and Senate Members that the agency assume a more wide ranging prudential function (Garsson, 1990). In short, the message from the SEC was that reform needed to occur, but that such reform should be focused on disclosure and not prudential supervision based on firm-wide capital standards, since the Net Capital Rule had worked as it was intended to do so in this case. That is, it protected Drexel's investors, even if the collapse of Drexel itself produced systemic risks. As Roberta Karmel – a former SEC Commissioner – phrased it, the SEC was making two points clear: first, that it was “not responsible... for the soundness of holding company financial structures”; second “[w]hile [it] may need to understand the nature and extent of systemic risk in the securities market, it does not need to regularly monitor those risks to fulfill its [mission]” (Karmel, 1992, 3). As is discussed later, this failure to seek consolidated supervisory authority would prove to be a consequential one for the agency.

Beyond the SEC's clear preference for a disclosure-only expansion of its jurisdiction, there are a few other notable takeaways from the debate over the Market Reform Act. First, there was the position of the Federal Reserve. Two senior Federal Reserve officials – Chairman Alan Greenspan and New York Bank President Gerald Corrigan – also lent their support to the bill, but their testimony suggested that they saw a broader role for consolidated entity supervision in order to stem systemic risk (Vise, 1990; Garsson, 1990). As Greenspan noted, once problems had begun at Drexel, they “quickly spilled over into other areas... As a consequence, the viability of a regulated entity was affected by developments in non regulated parts of the firm. This experience raises issues about the possible need for an overview of the entire company” (quoted in American Banker 1990). As noted in Chapter 4, the Federal Reserve had already declined the role of systemic market regulator and did not appear to be putting itself forward for that role now; at the same time, both Greenspan and Corrigan were clearly concerned about the absence of consolidated oversight. As the 1990s progressed, the FRB increasingly came to the view that it should hold that oversight authority and that the SEC was not adequately resourced to perform that role (see below). However, at this point, there was no discussion about the identity of a consolidated regulator; Greenspan simply recommended that “the Federal banking agencies, and the SEC should consult on the appropriate approach to collecting [consolidated firm] information” (quoted in American Banker 1990). Thus while the two agencies were engaged in jurisdictional and policy battles in other areas, on the issue of securities firm oversight, there appeared to be concern about the policy but little or no contestation of the SEC's authority, by the Federal Reserve.

Second, there was remarkably little opposition from major securities firms. Although Singer (2007, 86) notes that a handful of large securities firms were concerned that the law was just “one small step away from consolidated supervision,” there is a dearth of evidence from media reports or press releases (from organizations such as the Securities Industry Association) indicating outright opposition to the bill. While it is impossible to rule out pressure being placed upon the agency prior to its proposal, the fact is that the disclosure based approach was consistent with the agency’s mission, competence, and history. Thus, in short, there was only minimal group opposition, again suggesting that on this issue, the agency’s authority was largely unchallenged. Finally – and perhaps unsurprisingly given the lack of opposition from other sources – there was strong support for the agency from members of the committees of jurisdiction and the bill passed, with minimal amendment to the SEC’s original proposal (with the important exception of a proposal to partially fund the agency through registration fees; see Robb 1990). This is largely consistent with the image of the agency portrayed by scholars such as Khademian (1992); that is, an agency that enjoyed unusually high political deference on securities market issues, particularly when the policy also was focused on increasing disclosure. In short then, the domestic debate surrounding the Drexel failure and the Market Reform Act appears to indicate the largely uncontested nature of the SEC’s autonomy at this time. It is this lack of contestation that, I argue, also explains the second episode discussed in this chapter – the failure to agree upon common international capital standards for securities firms between 1991 and 1993.

### 5.5.3 The Failure of International Collaboration Efforts on Capital, 1989-1993

The Stock Market Crash of 1987 underscored the increasing correlation between major equity markets and the “potentially deleterious consequences of the collapse of a major securities firm” on other institutions with which it had counterparty arrangements (Singer, 2004, 547). It was also a key factor in spurring a transgovernmental organization known as the International Organization of Securities Commissions (IOSCO) to begin discussions about the formulation of common capital standards. In brief, the IOSCO had been founded in the mid-1980s out of a loose transgovernmental network known as the Inter-American Association of Securities Commissions and Similar Organizations (Zaring, 1998, 292). As Bach and Newman (2010, 510) note, when that group became a global body in 1984 it also took on a more expansive and formal role in “shar[ing] information, develop[ing] best practice standards, and build[ing] expertise through organized training programs and peer advising.” Indeed, the organization made significant progress in the 1980s and 1990s on harmonizing standards across a variety of areas, including derivatives trading, clearing and settlement, disclosure standards for foreign stock issuers, and in disseminating SEC ideas about insider trading regulations (Bach and Newman, 2010). Nevertheless, as the *Financial Times* commented, the IOSCO “always had the reputation of being a rather sleepy organization whose

annual get-togethers gave the opportunity for jamborees rather than jaw-boning” (quoted in Tobin 1991, 315). Writing later, Zaring (1998, 296) similarly noted that the “IOSCO has not achieved the regulatory success of the Basle Committee in implementing global standards for securities traders.” These unfavorable commentaries on the organization are largely the result of the IOSCO’s failed attempt to establish common capital standards for securities firms in the mode of the Basel Accord in the early 1990s. As outlined below, that failure was unambiguously the result of the decision by the organization’s dominant member – the SEC – to oppose common standards, despite concerns about systemic risks. Why raise the question: why did the SEC veto the attempt to establish common standards while the FRB had so enthusiastically embraced similar rules for banks just a few years earlier? The answer, in short, has much to do with differences in the degree to which their authority was contested.

Just weeks prior to the 1987 Stock Market Crash, the Technical Committee – the body’s central policy-making organ (Blackwell, 2002) – established a working group to examine the issue of capital adequacy for securities firms (Singer, 2007, 73). In 1989, the Committee approved the working group’s plan and released a concept paper that outlined the main principles of a common framework of regulating securities firms (Worth, 1992-1993, 153). The plan called for the creation of a minimum capital requirement based upon the size and nature of the firm’s activities, which in many ways drew parallels to the earlier work conducted by the Basel Committee. Beyond this, however, it appeared to endorse, in principle, the SEC’s comprehensive approach, suggesting that capital requirements should be calculated on position (i.e. market) risks (Dimson and Marsh, 1995, 831). The draft also envisioned requiring portfolio diversity, but made no mention of lowering existing capital standards as the SIB had done in the United Kingdom (see previous discussion). This appeared to be a rejection of the more flexible standards put forward by the SIB and other European regulators (Singer, 2004, 91). This initial report therefore appeared to represent a victory of the SEC and was received warmly by its incoming Chairman, Richard Breeden (Rehm, 1989). After all, the SEC – both prior to and during Breeden’s tenure – had expressed strong opposition to a building block approach, which it felt would enable securities firms to lower their overall capital requirement (Cope, 1991). In a letter Breeden wrote to his IOSCO colleagues, he made clear this opposition, noting “that the building block approach will not yield sufficient levels of capital to protect markets in the face of major disruptions” (quoted in Zaring 1998, 296).

At this point, the prospects for an accord similar to that reached by the Basel Committee appeared, on the surface, to be good, mostly thanks to the support of the SEC. It would be no exaggeration to say that the SEC was the dominant actor within the IOSCO, as others have noted (Zaring 1998, Trachtman 1991). For example, the critically important Technical Committee had been created at the behest of the SEC in 1987 and it was certainly its leading participant (Zaring 2005, 564). Throughout its history, the SEC has been the primary driver of virtually every single standard setting agreement that has been successfully reached by the IOSCO (Bach and Newman, 2010). It has furthermore shaped the content of its charter to re-



flect its investor-centered, disclosure based ethos (Zaring, 2005, 567-568); as then Chairman Arthur Levitt commented in 1994, just prior to the passage of an SEC sponsored charter amendment that effectively mirrored its own mission statement, “here at the IOSCO, we... strive to serve the individual investor. With each new issue, and with every new resolution we ought to be asking ourselves: how will this affect investors?” (Levitt, 1994). Of course such dominance should not be surprising, given the size and strength of U.S. capital markets, and the SEC’s strong international reputation at the time (Mahoney, 1990). This dominance within the IOSCO, combined with Breeden’s formal assumption of the Chairmanship of the Technical Committee in 1991 (Cope, 1991), all seemed to indicate that the agency would quickly achieve its objective: institutionalizing its comprehensive approach on a global basis.

However, this impression was misleading. The initial “report was merely a set of guidelines that set the agenda for further negotiations” (Singer, 2004, 548). Specifically, the working group had not agreed on the baseline for capital measurement, nor had it reached a position on the level of capital that would be required. In fact, although the report had ostensibly endorsed the comprehensive approach, it was surprisingly vague and also included references to settlement and credit risks, which were prominent features of the alternative building block approach. Above all, the initial report made little reference to the level at which capital standards were to be applied, though it made numerous references to the concept that capital calculations should be based on “a firm’s true position” (IOSCO, 1989). This was taken by other participants such as the SIB to mean that the SEC was open to the concept of consolidated supervision, which would represent an important leveling of the playing field for securities firms in smaller jurisdictions who were generally subject to supervision at the holding company level (Singer, 2007, 84). However, the SEC had no intention of compromising on its Net Capital Rule rule framework which it believed provided an “accurate and financially responsible safety margin against the risks to which broker dealers holding equity positions have been exposed, especially in times of market stress” and represented, in Chairman Breeden’s view, a “much tougher” set of standards than those used by banking regulators (Cope, 1991). Moreover, for reasons already discussed, it wanted to avoid taking on the responsibility for consolidated supervision and was simply not going to bind itself to an international accord that applied at the holding firm level, particularly after eschewing the opportunity to obtain that authority in the Market Reform Act. Thus, the vagueness of the 1989 report had created a misunderstanding, one that was quickly corrected when regulators settled down to the more detailed work of striking an accord.

In late 1990, it first became clear to the SEC that the SIB and other European nations were very reluctant to concede on the building block standard applied at the firm-wide level; as a result, it decided to slow down the process, delaying further serious discussion of a plan until 1992 (Waters, 1992). When negotiations restarted, the parties appeared to be converging on a capital equivalent of 4 percent of gross holding plus 8 percent of net holdings, a position that would have raised the SIB’s and other European countries standards significantly. However, in a July meeting of that year, the SIB introduced a proposal that

would permit securities firms to, theoretically, carry as little as 2 percent of the sum of its long and short-positions, on condition that its portfolio was adequately diversified and had been perfectly hedged (Peston and Corrigan, 1992). This was wholly unacceptable to the SEC. Chairman Breeden denounced the SIB's building block approach as "fatally flawed," and repeated earlier criticism that "[d]epending on how you engineer your portfolio, under the building block approach you could achieve a lower capital requirement" (quoted in Cope 1991). As Singer (2007, 87) reports, there was a widespread feeling amongst participants at the July meeting "that [Breeden] didn't want an agreement"; indeed, he demanded a further delay in the proceedings until October (Waters, 1992). At that meeting he made clear that the SEC did not "see any value to an agreement that ratifies the bottom of the barrel," pointedly asking "[h]ow does it serve our duty of protecting the public by cutting capital requirements?" (quoted in Peston and Corrigan 1992). This abrupt turn was capped by a statement from Breeden that made it very clear the SEC was not interested in further negotiations, suggesting that the IOSCO should act as "a clearing house of ideas" but not as a rule maker (quoted in Peston and Corrigan 1992). Without the SEC's support, the plan for a common accord quickly fell apart and the IOSCO formally abandoned the project in early 1993 (Singer, 2004, 93).

The contrast with the approach adopted by the FRB during the first Basel negotiations is notable. While the FRB certainly succeeded in implementing the broad outlines of its RWA proposal in the Basel Committee, it also made important concessions to the Japanese delegation in order to secure an agreement; moreover, it showed patience and persistence in order to secure a deal (see Chapter 3). The SEC, in comparison, gave the strong impression that it was only interested in an agreement that closely hewed to its own capital standards framework and appeared to put little effort into reaching an agreement in 1992, as evidenced by Chairman Breeden's strong denunciation of the SIB's position in the July 1992 meeting and its abrupt, *de facto* withdrawal from the negotiations in October. This reflected a pattern of SEC engagement with its international partners in which it had "responded to internationalization of the securities markets will calls for uniformity in securities regulation, a uniformity that is to be based on the American model" (Mahoney, 1990, 320). Even when it came to agreements that were far less costly for the agency, such as bilateral memorandums of understanding to provide technical assistance to other securities regulators, the SEC laid down a dizzying array of preconditions that effectively required the recipients of such assistance to adopt a U.S. style legal framework for governing the securities industry before an accord could be reached (see Raustiala 2002, 32, Choi and Guzman 1997). These requirements were equally onerous for securities regulators of more developed countries; as Trachtman (1991, 95) noted of SEC-Canadian relations, there is no "evidence [of] significant regulatory compromise on the part of the SEC... the principle of mutual recognition... is followed only to the extent that foreign rules satisfy the SEC's regulatory goals."

This reluctance to compromise obviously reflected the strength of U.S. securities markets relative to other jurisdictions (Singer, 2007, 93). However this alone cannot explain the

failure to reach an agreement: the U.S. banking sector was arguably in nearly as strong a global position, yet the FRB, in sharp contrast to the SEC, pushed relentlessly for a common accord. The answer then most likely rests on the differences in domestic authority between the two agencies: the SEC's role in this policy area appears to have been largely uncontested while the FRB's authority clearly was. The SEC simply had no incentive to forge significant compromises in order to reach an agreement with its international counterparts since in doing so it would actually suffer a net loss of authority (see Ryan 2012b for more on the related concept of "autonomy costs"). The centrality of domestic authority as an explanatory variable is further bolstered the SEC's later decision to cooperate with the SIB's successor in its establishment of the Consolidated Supervised Entity (CSE) program in the mid-2000s. At that point, its domestic authority was under significant threat, and an international agreement was one of the mechanisms it was forced to turn to in order to protect its authority over major investment banks.

## 5.6 The Turn to a More Contested Authority in the Mid-1990s

In the mid-1990s, two broad developments began to slowly shift the landscape of the debate and with it, the SEC's authority in this area. The first concerned the growing involvement of securities firms in OTC derivatives trading, activities which, as aforementioned, were conducted outside of the broker-dealer framework (via DPCs) and thus were not subject to the Net Capital Rule. The second arose from personnel changes on key congressional committees following the 1994 midterm elections, alongside the renewed efforts to repeal the Glass-Steagall prohibition on cross-activity and ownership between the commercial banking and securities trading industries. The first development forced the SEC to demonstrate greater competency in the area of entity supervision in order to curtail the perception of growing risks at securities firms. It also led to calls for consolidated supervision of securities firms, something the SEC remained eager to avoid. The second development also placed the issue of consolidated or "umbrella" supervision on the agenda. Specifically, it soon became clear that Congress, with the support of the FRB, was likely to name the Board as the primary supervisor of large consolidated financial holding companies as part of any repeal effort. This raised the concern for the SEC that large investment banks might either be required or incentivized to convert to this new form of company in order to compete with commercial banks in retail services and have access to the Federal Reserve's discount window. Such an eventuality would reduce the agency to the status of a frontline manager of the securities markets, while more consequential regulatory decisions would be made by the FRB. In order to avoid this outcome, the SEC responded strategically, stating its willingness (albeit reluctantly) to act as a consolidated supervisor if necessary and, more importantly, by creating a voluntary system of oversight through the Derivatives Policy Group (DPG), a

framework that was designed to demonstrate its competency and attenuate calls for entity oversight in the first place.

### 5.6.1 Derivatives, Glass-Steagall, and Consolidated Supervision

As discussed in Chapter 4, a series of high profile losses by end-users of derivatives products brought the issue of OTC derivatives oversight to the fore in Congress during 1994. Although the scandals which provoked the initial congressional debate involved commercial banks such as Bankers Trust (see Cuccia 1997, Hu 1995), the most high profile loss incurred during 1994 actually involved an OTC deal that had been arranged by Merrill Lynch's derivatives trading subsidiary (which was the most active DPC at the time). In December 1994, Orange County became the largest municipality to ever declare bankruptcy following a \$1.7 billion loss arising from complex derivatives strategy arranged by Merrill's DPC (Halstead et al., 2004). Although Merrill did not actually take out counterparty positions against Orange County, it did broker the deals and earn sizable commissions from doing so (Miller, 1996, 116). Orange County filed legal action against the investment firm, claiming that it provided incomplete and misleading advice to the County in breach of the SEC's suitability rules – rules designed to protect investors from poor or intentionally misleading investment advice regarding the sale or purchase of securities (for an overview, see Gibson 1997-1998). The high-profile suit attracted significant negative media attention and took several years to be resolved (Pollack and Wayne, 1998)<sup>6</sup>. Orange County was not the only case involving securities companies in 1994 and early 1995, with several smaller-scale losses on transactions that had been arranged by Morgan Stanley also garnering attention (see Gibson (1997-1998, 528)). The SEC had already been pressured by the House Energy and Commerce Committee to produce detailed guidelines on derivatives best practice at securities firms and recommend possible regulatory steps before the end of the year (Morrison, 1994a); the ongoing high profile losses added to the urgent need for the agency to demonstrate competency on the issue and learn more about the exposures at the consolidated firm level (Faerman et al., 2001, 374).

This need was heightened by the release of a series of letters written by an anonymous SEC staffer which portrayed an overly bureaucratic organization whose resources that were beginning to strain. In particular, the letters suggested that the agency would struggle to regulate the OTC derivatives markets if given that opportunity. While others inside and outside the agency noted that the letters contrasted with their image of an agency “bursting with pride” and “[t]he conventional wisdom that it's a happening agency,” their release attracted unwanted attention from members of Congress, placing further pressure on the

---

<sup>6</sup>Ultimately, Merrill agreed to a settlement with the County in the amount of \$400 million, though it denied improper behavior in arranging the derivatives transactions. Moreover, there were questions regarding the legal applicability of the suitability rules to derivatives transactions. See Gibson (1997-1998, 529).

agency to prove that it was capable of supervising such activities (see Lux 1994 for more on this episode). More importantly, the change in leadership in the House and Senate following the 1994 midterm elections increased pressures on the SEC. The agency's committee of jurisdiction – the House Energy and Commerce Committee – was no longer headed by Representative John Dingell, who had been widely viewed as a strong defender of the SEC (Wells, 1996). Beyond the general backing he had given to the agency, he had also deferred to it on the issue of consolidated supervision; as the Committee's counsel noted during debates in 1994, Dingell had been “unconvinced of the need for another over-arching regulator” to monitor large financial institutions, particularly in the context of their increasing involvement in derivatives trading, preferring instead the (SEC suggested option) of inter-regulator coordination (Hume 1994). Thus Dingell's departure robbed the agency of a vital ally in future discussions over consolidated supervision and capital standards. The fact that Representative Jim Leach, a well-known skeptic of derivatives trading, had assumed the Chairmanship of the House Banking Committee also appeared to ensure that there would be continued pressure applied to the agency on the derivatives issue (see Chapter 4).

Perhaps the most salient outcome of the Republican takeover of both Houses of Congress was the renewed focus on the previously moribund issue of Glass-Steagall repeal. Between 1995 and 1999, a series of bills were introduced by leading Members of Congress seeking to repeal the provision, efforts that were, in most cases, also supported by the Clinton administration (Hendrickson, 2001; Ryan and Thurston, 2012). The relevance of this effort to the discussion here lies in the fact that the repeal bills envisioned the creation of a new form of consolidated entity that could trade both securities products and engage in commercial banking (hereafter known as a Financial Holding Company (FHC), the term applied in the Gramm-Leach-Bliley Act of 1999), which in turn raised the obvious question of how such entities would be supervised (Greenlee, 2008, 15). In February 1995, Representative Leach introduced his first repeal bill, which, like the Clinton administration's proposal released earlier that year, would have created the new FHC category. However in contrast to the administration's proposal, which had been silent on the issue of oversight responsibility, Leach's bill designated the FRB as the new primary regulator for such entities (Garsson and deSenerpont Domis, 1995). Although the new category was technically only open to existing BHCs, the bill made it relatively easy for firms to become both BHCs and FHCs simultaneously (Greenlee, 2008, 21). Thus, while it did not mandate that investment banks convert themselves into the new status, it provided them with the option of doing so for the first time (White 2009-2010, 943; this ultimately did occur in 2008 – see below). Under such circumstances, the SEC would be reduced the role of a distinctly junior partner alongside the FRB, serving as a frontline manager of broker-dealers while the key strategic decisions relating to major securities firms were made by the Federal Reserve.

A key determinant of this debate was the position of the FRB. In the late 1980s, Chairman Greenspan had firmly rejected the opportunity to assume a systemic “super-regulator” role as part of proposed reforms following the 1987 Stock Market Crash (see Coffee 1995, Karmel

2009)<sup>7</sup>. Specifically, he had been concerned that such a role would create the impression that it would provide emergency assistance to securities firms in financial difficulty (Greenspan, 1988b). While Greenspan reiterated these concerns in a hearing to discuss Chairman Leach's bill in February 1995, he was far more favorable than he had in the later 1980s to the concept of his agency acting as a form of "super-regulator," even as he displayed an unwillingness to assume day-to-day oversight of securities affiliates. Specifically, in response to a question asking him whether he felt the FRB should be granted powers to directly regulate the securities industry under a Glass-Steagall repeal bill, Greenspan responded "[n]o, I don't think that we consider that necessary." However, he further noted that his views had evolved as he had become "increasingly aware of the importance of umbrella supervision for the purposes of maintaining a systemic control of a system." As a result, he endorsed the consolidated supervision provision, agreeing with the Leach that his agency was best positioned to take on this responsibility: "[w]hat we consider necessary basically is for us to have a general umbrella supervision over large international institutions and a sufficient spread across smaller institutions... to give us a sense of the way our system works" (Committee on Banking, 1995). Again, while Greenspan clearly did not want to take on day-to-day supervision of the securities industry, it was obvious that Federal Reserve's growing concerns about systemic stability and the increasing breakdown of distinctions between banks and securities companies had created a willingness to assume a role as primary overseer of the nation's largest financial institutions, which conceivably would include major investment banks.

Perhaps unsurprisingly, the SEC remained opposed to the principle of consolidated supervision throughout this period. For example, in late 1993, SEC Commissioner (and later Chairman from 2009-2012) Mary Schapiro commented that "I am not convinced that consolidated regulatory supervision of securities firms and their affiliates is necessary or appropriate at this time" and that the SEC's "strong capital and margin requirements [are] protecting customers as well as avoiding systemic problems" (Schapiro, 1993). SEC Chairman Levitt characterized Leach's bill as "step in the right direction" but expressed concern about bank regulators overseeing securities firms and applying what he called "weaker standards of protection for investors" (National Journal, 1995). Levitt again raised this issue in 1997, claiming that the FHC framework under FRB supervision would lead to weaker standards of protection (Morrison, 1997). In testimony in May of that year, Levitt – recognizing the likelihood that some form of consolidated supervision would be part of a financial reform package – made a competitiveness argument against FRB oversight, noting that the "holding company model of regulation has never been applied to securities holding companies" and arguing that

---

<sup>7</sup>The Report of the President Task Force on Market Mechanisms, also known as the Brady Report, noted that "the markets for stocks, stock index futures, and stock options – are in fact, one market" and that therefore "one agency must have the authority to coordinate a few but critical intermarket regulatory issues, monitor intermarket activities, and mediate intermarket concerns" (Presidential Task Force, 1988, 55.59); the Report further recommended that the FRB assume this role.

such an inflexible regulatory structure with its commensurate “layers of safety and soundness regulation” would damage the ability “to remain innovative and competitive” (Levitt, 1997, 16-17). With some obvious reticence, he then stated for the first time that

[i]f a lead regulator is necessary... the oversight of any holding company in which a securities firm is the largest affiliate should be allocated to the Commission, not to a bank regulator. The Commission has the experience and expertise to oversee companies conducting primarily a securities business, and would defer to the appropriate banking regulator with regard to regulation of any affiliated bank (Levitt, 1997, 17-18).

In order to protect its authority as the principal regulator of large securities firms, the SEC would clearly now have to display an ability to gather information, establish trading guidelines, and monitor risks at securities firms’ DPCs. Its targets were also clear: assuage the concerns of key Members of Congress such as Leach, reassure the major investment banks that might consider the BHC/FHC option should it become available, and demonstrate to the Federal Reserve that it was capable of effective consolidated oversight of securities firm activities.

### 5.6.2 The Derivatives Policy Group

In order to achieve these objectives, the SEC sought to recruit the industry in a collaborative effort known as the Derivatives Policy Group (DPG). The origins of the group can be traced to May 1993 when the SEC had issued a concept release on the issue of capital standards for securities-based derivatives; in recognition of the trend towards the establishment of DPCs, the document discussed possible ways in which the Net Capital Rule could be changed to make it easier for broker-dealers to conduct derivatives trades (Cummins, 1993e). At this point, the SEC reached out to the Securities Industry Association (SIA) to work on a set of guidelines that would subject the derivatives trading of broker-dealer DPCs to more stringent risk controls and monitoring, a process that led to the formation of a derivatives committee within the organization. However, under increasing pressure to produce guidelines or suggest legislation that would subject DPCs to greater oversight, and frustrated by the slow progress made by the SIA committee, Levitt contacted the heads of the five major securities firms – Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Salomon Brothers – as well as another significant dealer of derivatives products, CS First Boston, to ask for their commitment to form a new working group on derivatives policy (Faerman et al., 2001, 380). The DPG was consequently created in August 1994 with a mandate to improve internal risk management, increase the information flow on risk exposures that would be made available to the SEC, determine appropriate levels of capital that should be held against such transactions, and establish guidelines designed to protect end-users (Morrison,

1994b)<sup>8</sup>.

The incentives for the firms to participate in this process were fairly clear. As one participant (quoted by Faerman et al. 2001, 379) put it “[w]hat we needed to do was head off legislation... We had lived through the mid-1980s, when Congress adopted registration of government securities dealers, subjecting them to the same capital requirements. It was harmful to innovation.” Moreover, failing to take advantage of this “voluntary opportunity” would inevitably lead to tensions with the SEC; as another participant put it “the SEC always could have inspected the firms. [The firms] had to ask themselves, ‘Do I want to cross the SEC?’ No one wanted to be the odd man out. So there was good reason to say yes” (quote from Faerman et al. 2001, 380). For the SEC, the DPG represented an effort to bolster its credibility on the supervision and derivatives issue at a time when the threat of consolidated supervision under the FRB appeared to be a viable possibility. It also was a means to attenuate opposition within the securities industry and avoid the risk of asking Congress directly for supervisory oversight. As Faerman et al. (2001, 379), quoting an agency official, note the “threat of legislation was useful” in cajoling the parties to reach an agreement, though “actually *asking* for legislation was risky” (emphasis in original). Indeed, as Levitt himself remarked in congressional testimony “I have, since I’ve been at the Commission, studiously tried to avoid asking Congress for anything... With all due respect, I don’t know when we’re going to get it or what we’re going to wind up with” (Committee on Commerce, 1996, 138). Another principal staff person put it in the following way:

Rather than seek legislation, which we weren’t sure we could get, we needed more information... We had to have better capital/risk evaluation. We figured that we could get most of what we wanted if we worked with firms... If they didn’t produce something, we’d go to Congress. The chance of their getting something useful out was greater than us getting productive legislation (Faerman et al., 2001, 379)

In short, as these quotes from SEC officials confirm, the agency realized that they would either not be granted additional regulatory authority or they would be left with an impossible mandate that they would struggle to implement. Thus the DPG was likely a better vehicle for achieving its goals.

On March 9 1995, the DPG issued its report entitled a *Framework for Voluntary Oversight*, a document that contained a series of what Corrigan characterized as neither “recommendations or proposals” but as “commitments” by the participants. These commitments, perhaps unsurprisingly given the involvement of Corrigan, were clearly heavily influenced by the G-30 report that had been issued a year-and-a-half earlier, with an emphasis on best practice standards and industry self-regulation (Maxwell, 2011, 7). The participants agreed

---

<sup>8</sup>Note that in January 1999, the group was re-formed into a larger organization known as the “Counterparty Risk Management Policy Group.”



to provide increased disclosure to regulators in the form of quarterly confidential reports to the SEC and CFTC on credit risks related to OTC derivatives positions; create a “framework” to calculate capital needs based on risk models, with firms voluntarily agreeing to hold appropriate levels of capital to protect against those risks; make improvements to internal risk management controls at the holding company level to ensure that DPC operations were adequately monitored; and finally, implement end-user protections in sales practices (Wells 1995; the investor protections the agreement did not, however, go as far as the SEC had hoped. See Faerman et al. 2001, 382). Levitt praised the work of the Group at a press conference announcing the *Framework*: “we appreciate the extraordinary efforts of the DPG and know that the time it has committed to these efforts has been time well-spent” (quoted in Tran 1995). He also made clear that “[w]e have more than enough power to take action” should any of the firms to the agreement renege on their commitments (quoted in Bureau of National Affairs 1995, 395).

The SEC strategically sought to assuage potential critics of this voluntary accord through a number of actions. First, it was significant that Levitt had asked Gerald Corrigan, the former President of the New York Federal Reserve Bank (at that time, a partner at Goldman Sachs and member of the G-30) and the former Comptroller of the Currency, John Heimann, to co-chair the DPG. Both helped to legitimate the effort with the banking community and, critically, with the FRB, which welcomed the report (Faerman et al., 2001, 381). Second, the agency launched a campaign in support of the *Framework* focused heavily on persuading skeptical Members of Congress of the utility of the effort (Faerman et al. 2001, 382; see also Maxwell 2011, 6). One skeptic, Representative Leach, was won over quickly, praising Levitt and suggesting that “[t]his voluntary agreement reflects a proper mutual self-interest to protect the market and in doing so sets a standard for the United States which then becomes a standard for other countries as well” (quoted in Morrison 1995b). Representatives Dingell and Markey expressed deeper skepticism initially, outlining concerns about the voluntary nature of the agreement and particularly about the lack of stringent end-user protections in the agreement, which they described as “the most problematic and disappointing component of the framework” (quoted in Morrison 1995a). Markey was particularly critical, suggesting the accord was “no substitute for an effective system of regulations aimed at protecting investors from potential abuses” (quoted in Morrison 1995b). Levitt responded by reassuring the legislators that more work would be done and that the guidelines, particularly in the area of end-user protections, represented a “minimum standard.” Levitt also emphasized that his agency would continue to work with the group and its authorized SRO, the National Association of Securities Dealers, to implement these guidelines (Morrison, 1995a). In short, Levitt was portraying an image of his agency cognizant of the need to continually update and improve the standards outlined in the agreement, an effort that was designed to assuage skeptics such as Dingell and Markey.

This campaign continued through the course of 1995. Steven Wallman, an SEC Commissioner, suggested as early as August “that the agreement has been generally recognized as

having made a positive contribution,” citing evidence of improved information sharing with the agency and increased capital levels at some derivatives subsidiaries (quoted in Allen 1995b). Indeed, by the end of 1995, the agency’s Chief Counsel commented that “the effort, particularly by the DPG, has gone a long way to, if you will, moving the clock back away from the midnight of legislation,” making clear that the visible progress had been made as a result of the SEC’s collaborative efforts with the DPG, specifically in terms of improved information flows and a bolstering of risk management safeguards at the DPC subsidiaries (quoted in Heap 1995). Indeed, in hearings in early 1996, Representative Markey praised the SEC for its work on the progress it had made on the issue over the previous year, even as he still expressed concerns about investor protection portion of the *Framework* (Subcommittee on Telecommunications & Finance 1996; it should be noted that these concerns were publicly shared by SEC officials at this and other hearings). Faerman et al. (2001, 384) similarly document the effect of the SEC’s public campaign of support, noting that the DPG, while initially treated with skepticism by congressional critics and end users, came to enjoy broad support over the following two years. The DPG effort therefore appeared to have succeeded in its primary goal from the perspective of the SEC: projecting an image of it as a competent supervisor of securities firms. By recruiting the industry to work on the standards, it neutralized potential criticism that might have occurred had it sought legislation (an effort that would have likely been unsuccessful in 1995-1996). Moreover, by appointing Corrigan and Heimann to head this effort, Levitt and the SEC also helped to secure the support of the FRB. The short-term political “success” of the DPG project appears fairly clear: the question that the issue of consolidated supervision of securities firms became less prominent in the debate in the late 1990s. However, in the medium-to-long term this voluntary approach to regulation, which was embodied to an even greater degree in the CSE program discussed below, proved to be tremendously damaging to the agency’s authority.

## 5.7 The SEC’s Authority in Decline and The Consolidated Supervised Entity Program

### 5.7.1 Decline and Contestation

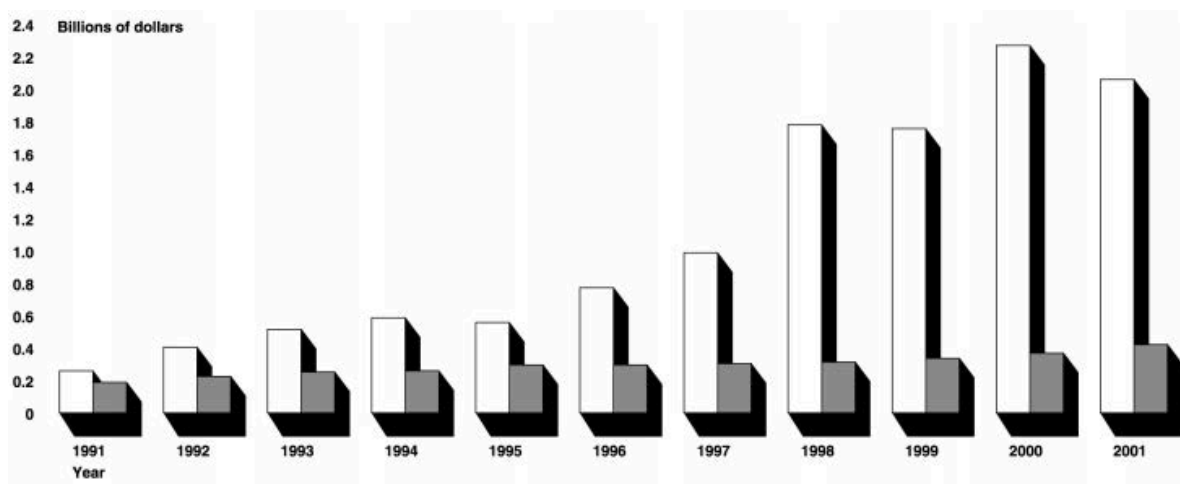
Despite the SEC’s efforts with the DPG, the issue of consolidated supervision over securities holding companies reemerged in the late 1990s. In part this was the logical outcome of the various Glass-Steagall repeal efforts that were being considered during 1998 and early 1999. However, the near-collapse of one of the largest U.S. hedge funds, Long-Term Capital Management (LTCM), in September 1998 and the Federal Reserve’s response had an important effect on the debate. LTCM was a hedge fund with equity positions totaling \$4.72 billion and derivative positions notionally valued at \$1.4 trillion (GAO, 1999, 38). Following massive losses on swap positions it had taken on Russian bonds and currency, losses which were

triggered by the broader crisis in developing markets that occurred that year, the New York Federal Reserve Bank facilitated a private sector recapitalization of the fund, assembling fourteen commercial banks to provide financing for the rescue (Westercamp, 2009, 211). While this effort attracted political criticism, particularly from Chairman Leach (Committee on Banking & Financial Services, 1999), it also “catalyzed the adoption of the Financial Modernization Act (Gramm-Leach-Bliley Act) of 1999, with general regulatory supervision conducted by the Fed” (Westercamp, 2009, 212). The reason is straightforward: although LTCM was a hedge fund, its near-collapse had vividly illustrated that in an increasingly inter-connected market there was a need for a regulator with the capability of conducting prudential entity regulation on a consolidated basis; in particular, the episode also revealed that need for such a regulator to possess a “macro-prudential” focus – that is an awareness of the systemic linkages between institutions (see Elliott 2011).

Given the breadth of its purview, capacity, and proven experience, there was no question after LTCM that such authority would be vested in the Federal Reserve. Indeed following the crisis, the legislative pace quickened and the Act was passed in early 1999. Under the Act, the FRB was granted “umbrella” supervisory powers over all FHCs, while functional regulators (such as the SEC) retained their prior discretionary authority to regulate firm activity, which for the SEC this meant continued supervisory authority over broker-dealers (Greenlee, 2008, 20). Much like Leach’s 1995 bill, it would now be possible for investment banks to convert to BHCs and/or FHCs. Now that consolidated supervision of large financial institutions had formally been vested in the FRB, and given the potentially attractive option of charter conversion was now available to securities holding companies, the SEC’s position was greatly weakened (Hemel 2011, 244). Congress had clearly rejected the option of vesting the SEC with similar authority over investment banks, which sent a signal that it lacked confidence in the agency’s capacity to perform that function. In fact there was now realistically no question of it obtaining that authority (Coffee and Sale, 2009, 738). Added to this, the major securities holding companies had obtained tremendous leverage now that the conversion option was available (although some are skeptical about that degree of leverage – see the conclusion). Combined with the growing consolidation in the industry and the increasing reliance of these firms on revenue generated from their unregulated DPCs, there was no little question that they had the intent and capacity to exert influence over the agency to an extent previously not possible.

Beyond the leverage it had lost in the battle over consolidated supervision, the SEC’s authority more generally was under threat in the early 2000s thanks in large part to revelations of “pervasive misconduct” amongst market participants (Coffee and Sale, 2009, 713). Amongst these revelations were misleading public disclosures that the agency failed to catch in the run-up to the 2000 dot-com crash, a high-profile investigation into the analyst conflicts of interests by then New York Attorney General Elliot Spitzer in 2003, the “market timing” scandal involving mutual funds and, most of all, the financial reporting scandals that led to the bankruptcy of Enron and WorldCom between 2001-2002 (Coffee and Sale, 2009,

Figure 5.6: SEC Fees Collected and Appropriated Funding, 1991-2001



Source: GAO (2002a, 8).

712-713). The Enron scandal in particular led to widespread criticism of the SEC for its failures in overseeing the auditing profession. Moreover, while the Sarbanes-Oxley Act passed in its wake actually expanded the agency’s discretionary authority, it ironically produced a backlash against the agency as businesses complained about the compliance costs associated with its implementation (see Jones 2009-2010, 620), furthering damaging the broader political authority of the agency. The SEC’s sterling reputation as an enforcement agency also began to attenuate, in part from the high profile scandals already mentioned, and in part owing to the decreasing frequency of regular inspections and reviews. A 2002 GAO report found, for example, that the percentage of corporate filings that received either a full or partial review by the agency dropped from 21 percent in 1990 to 8 percent in 2000 (GAO, 2002b, 22). This owed in large part to a mismatch between the agency’s responsibilities and the budgetary “starvation diet” it had been subjected to through over the previous decade (Perino, 2004, 854). This divergence is illustrated below in figure 5.6; even as the fees collected by the agency (which it was unable to retain) increased dramatically owing to the expansion of the capital markets, its appropriations from Congress remained relatively static in real terms (see GAO 2002b for more). In short then, even as the “securities markets became larger, more complex, increasingly global, and as financial engineers churned out increasingly more exotic instruments, the Commission’s resources lagged farther and farther behind its workload,” leading to increasing delays in rule making, oversight, and enforcement actions (Perino 2004, 853; see also Seligman2009).

There was also a knock-on effect on morale within the organization. The agency experienced increasingly high staff turnover rates, in large part because of its inability to pay competitive salaries relative not only to the private sector, but to other financial regulators

(GAO, 2002a, 4). As a result, between 1998 and 2000, the Commission lost one-third of its employees, with turnover amongst attorneys, accountants, and examiners running at 15 percent per year (twice the rate for equivalent positions outside of the agency – Perino 2004, 855). The average tenure for such employees declined from 3.4 years in 1992 to 2.5 years by 1999 (Khademian 2002, 522). Vacancies at the agency increased which, together with the less experienced staff working in oversight and enforcement roles, began to create a vicious cycle of poor performance, low appropriations from Congress, and high staff turnover. Indeed in its 2002 report on operations at the agency, the GAO consistently noted increasing job dissatisfaction and warned of declining morale within the agency (GAO, 2002a). The impact of these changes, particularly on policy-level decision making, is difficult to say with certainty. However the decline in internal morale, added to the fact that the agency’s mission appeared to be less relevant in guiding its decision-making in the 2000s, suggest that not only had the agency’s external authority weakened, but its internal commitment to its mission and pride in its distinctive competency were also weakening. In short then, by the early 2000s, the SEC’s autonomy had weakened. Moreover, its authority both on issues of consolidated supervision and capital standards, as well as in a more general sense, had become increasingly contested. It was in this context that the agency fought an increasingly uphill battle to protect its authority as the principal regulator of major securities firms.

### **5.7.2 Broker-Dealer-Lite and the Consolidated Supervised Entity Program**

The CSE was closely linked to an earlier program that had been introduced by the SEC called ubiquitously known as “broker-dealer-lite” scheme. When the “lite” program was announced in 1996, it was portrayed by the agency as a “trail vehicle” designed to gain “some experience with looking at at a different regulatory scheme” (Morrison, 1996). In short, the effort was an attempt to encourage securities holding companies to place their DPC operations within their broker-dealer subsidiaries and thus subject them to SEC oversight (Markham 2009-2010, 576; see chapter 3 for more on these models). The rules creating the program were finalized in early 1998 and it went into effect in the middle of the year (Koning, 1998). The scheme required participating firms to establish risk oversight procedures for their derivatives trading operations and make periodic reports to the SEC. However, it offered them a significant incentive to participate: they would be permitted to use VaR estimations based on proprietary IRB models to calculate capital levels relating to their derivative positions (this did not apply to securities trading operations), thereby employing a similar standard to the one that was adopted under the Basel II bank capital regime (Markham, 2009-2010, 576). While the rules did include a minimum net capital requirement (63 Fed. Reg., 1998), those levels were significantly lower than existed set by the Net Capital Rule for broker-dealers. The attraction for securities firms that dealt in derivatives involved the concept of “netting” discussed in Chapter 4; in short it is easier for dealers to reduce credit exposure to a single

counterparty when they can "net" all of their outstanding financial obligations across their securities, exchange-traded, and OTC derivatives operations (Koning, 1998). Unsurprisingly perhaps, the Securities Industry Association enthusiastically welcomed the move, arguing that "the new rules appropriately require that firms making use of these new rules must have a robust and well-documented system of risk-management controls" and there was a widespread expectation that the program would prove popular (quoted in Koning 1998).

Despite these incentives, none of the major investment banks participated in the broker-dealer-lite registration program prior to 2004 (Markham 2009-2010, 576). This lack of participation is not difficult to explain: DPCs were a major source of revenue for securities firms by the late 1990s and, at the time, not subject to *any* form of formal capital requirement or other regulation (the commitments made in the DPG process were, of course, voluntary in nature). As such, despite the incentives of a relaxed capital scheme and the netting benefits that a consolidated operation would provide, they were simply not sufficient to outweigh the costs for major derivatives dealers. Before turning to the CSE, it is worth noting a few points about the broker-dealer-lite scheme itself. First its creation was, in some ways, an implicit acknowledgement that the *Framework* agreed to by the DPG had not produced the results that the agency had hoped for. Second the principles on which this scheme was based – an emphasis on credit and institutional risks rather than the market risks that were traditionally used to calculate the Net Capital Rule – were precisely those that the SEC had fought so vigorously against during the 1992 IOSCO debate over common capital standards for securities firms. Third, a related aspect of the scheme also violated the SEC's traditional commitment to basing capital adequacy on market risks: the reliance of the VaR models. These models principally used the historical or purchase price of instruments, not market prices, in order to make capital calculations and failed to account for extreme market conditions (Taleb 2007; this detachment between market realities and capital levels proved dangerous for highly leveraged investment banks in 2007-2008 (Markham, 2009-2010, 578)). As such, the broker-dealer-lite scheme itself was a clear signal that the agency's commitment to its traditional mission, along with its authority in this area, were weakening. That signal of weakness was likely received by others, particularly the major investment banks.

In 2002, the European Union (E.U.) adopted a Financial Conglomerates Directive which mandated that all non-E.U. firms operating within the bloc be subject to "consolidated supervision" by their national regulator that was "equivalent" to the supervision that national and E.U. regulators imposed on their financial companies or else be subject to consolidated regulation by a Member State (see Vinuales 2006 for more on the Directive itself). A year later, the U.K. Financial Services Authority (FSA – the successor regulator to the SIB) released a "consultation paper" that similarly stated that unless home-country supervision could be established to its satisfaction, it "may well require the establishment of a European holding company and restriction of exposures between between the European sub-group and the worldwide group ('ring-fencing')" (FSA, 2003). For major U.S. financial firms – all of which had significant operations in the E.U. and much of which was concentrated in London,

the prospect of Member State supervision and/or ring fencing would have produced tremendous compliance costs and for many would have dramatically raised capital standards. This was not a particularly worrying problem for BHCs and FHCs; after the Gramm-Leach-Bliley Act there was little question that the FRB would be recognized as an “equivalent” consolidated regulator under the terms of the Directive and by the FSA. Indeed, as FRB Governor Susan Bies stated in 2004 testimony before the House Committee on Financial Services, the agency “fully expect[s] that U.S. banking organizations will be found to meet the supervision standard of the [D]irective” (quoted in Hemel 2011, 244). By contrast, U.S. investment banks, who had lobbied heavily against the Directive (Corporate Financing Week, 2002), were clearly facing a dilemma since they lacked an obvious consolidated supervisor.

Following appeals from the Securities Industry Association and the major investment firms, the SEC attempted to secure E.U. recognition of its broker-dealer oversight as “equivalent” but it quickly became apparent that such an effort would be unsuccessful (Corporate Financing Week, 2002). A brief attempt to seek legislation from Congress also appeared to go nowhere (Coffee and Sale, 2009, 738), which, in part, reflected the agency’s weakened political influence in the immediate aftermath of the Enron scandal. At this point there appeared to be a real prospect that investment banks would be forced to convert to the a BHC structure, an option that would have placed far tougher capital and regulatory burdens upon them and dramatically attenuated the SEC’s role as the lead regulator of securities firms. The alternative was to create a voluntary scheme that would be acceptable to an E.U. Member State and the investment banks. The SEC duly entered into negotiations with the U.K. FSA on equivalence recognition that would satisfy the terms of the Directive *and* its own proposed equivalence standard, while simultaneously opening discussions with the U.S. investment banks on the terms of a voluntary scheme. After a little under a year of these discussions and with increasing pressure being placed upon it by the Treasury Department as well as the major investment banks (Maxwell, 2011, 9), the SEC proposed a new voluntary program – the CSE – in October 2003 that it felt would satisfy all parties. The CSE program retained many of the core features of the dealer-broker-lite scheme, including the requirement for internal risk-management controls and reporting requirements, as well as the ability to use internal VaR models to calculate consolidated capital in line with the Basel II framework that applied to commercial banks (Vinuales, 2006, 38). The use of the Basel guidelines was supported by the investment banks but was also seen as an attempt to head-off a potential dispute with the FRB, which had expressed an eagerness to see the same set of rules applied to all large financial firms (Coffee and Sale, 2009, 739).

The scheme also contained what Coffee and Sale (2009, 738) characterize as “an added (and probably unnecessary) corollary”: participants could calculate their consolidated capital, which *included* their broker-dealer subsidiaries, based on a new “Alternative Net Capital” rule. Although complex, this provision was a significantly more relaxed version of the Net Capital Rule, or at least it was for large investment banks (Coffee and Sale, 2009, 738). This largely owed to the fact that the minimum 15-1 fixed-ratio of debt to to capital contained

within the existing rule was replaced with a numerical minimum requirement of \$500 million in net capital and \$1 billion in what was known as “tentative” net capital<sup>9</sup>; while that would have raised the capital levels for most broker-dealers, it would dramatically lower them for the major firms (Vinales, 2006, 39). Even more important, those firms no longer had an outer limit on the amount of leverage they could incur, since they were no longer bound by the Net Capital Rule (Coffee and Sale, 2009, 739). The program was formalized in 2004, and the FSA granted equivalence recognition to the CSE structure in 2005 (Vinales, 2006, 49). Owing to the terms of the program, the only plausible applicants for CSE coverage were the five major investment banks – Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers, and Bear Stearns – each of whom were admitted to CSE status between December 2004 and November 2005 (Vinales, 2006, 41).

The manner in which the CSE scheme was created demonstrate an obvious shift in strategy for the SEC as its authority became increasingly contested. In order to protect its role as the primary supervisor of the largest securities firms, it was forced to create a program that on its face contained a large element of industry self-regulation. At the same time, it also had to tailor the program to meet the needs of a transgovernmental counterpart – the FSA – in a manner that would have been unthinkable in the early 1990s. The content of the agreement also demonstrated its weakened status and at least calls into question the degree of internal preference independence. Like the broker-dealer-lite program that preceded it, the agency’s decision to ape the Basel II standards that had been so fiercely advocated for by the FRB showed a willingness to compromise its traditional commitment to market pricing principles. There is no clear evidence, as Coffee and Sale (2009, 740) note, that the agency was “captured” in the traditional sense when it proposed the program; the SEC Inspector General’s report on the program indicates that there was an internal belief that the program was emblematic of ‘best practice’ and that agency would be able to effectively manage its responsibilities when it was enacted (Office of Inspector General, 2008, 1-5). Similarly, as Chairman Mary Schapiro commented in 2009, there was a genuinely held view “that the inherently self-correcting nature of markets would prevent institutions from taking on excessive risk, including in the origination or trading of exotic financial instruments” (Schapiro 2010; this may imply “cultural capture” by the mid-2000s, which is not inconsistent with the narrative presented in previous chapters). Irrespective of the true preferences within the agency, the policy outcome certainly deviated from its traditional view and mission, which can only lead to the conclusion that its overall autonomy had weakened since the early 1990s.

What proceeded next again simply underscores this conclusion. When the program was created in 2004, it had just seven staff available to examine the parent companies of the five major investment banks; in fact, throughout its existence, there were no more than twenty-five examiners assigned to the program at any one time (Jones, 2009-2010, 619). In any event

---

<sup>9</sup>Firms also had to notify the agency when the tentative net capital figure fell below \$5 billion.



there were virtually no inspections of the CSE entities during the existence of the program, likely both a result of understaffing, resistance from the investment banks themselves, and a belief that the internal risk-models that banks were using were effectively managing risk (Markham, 2009-2010, 577). Even if there had been more staff made available to conduct inspections, the SEC simply lacked experience overseeing large, complex entities and its legal staff lacked the expertise to monitor the risk models on which capital calculations were being made (Coffee and Sale, 2009, 742). In a further sign that the agency's autonomy was weakening, the assumption of the Chairmanship by Christopher Cox in 2005 produced a dramatic reorientation in the agency's market regulation and enforcement divisions towards "passivity" (Jones, 2009-2010, 615). Indeed, as discussed in Chapter 4 (on the subject of the CFTC), when leadership can easily shift an agency's policy orientation in ways that contradict its historical mission and distinct competency, it suggests a weak internal commitment to those beliefs. As a result, it is difficult to disagree with Levine's conclusion that "[i]n easing the net capital rule, adopting a system of consolidated supervision, but failing to develop the capabilities to supervise large financial conglomerates, the SEC became willfully blind to excessive risk-taking" (Levine, 2012, 49).

Ultimately the SEC's half-hearted regulatory effort contributed to it losing its status as the primary regulator of the major investment banks. In March 2008, Bear Stearns, whose debt-to-capital leverage ratio at the time was 33-to-1 became insolvent and was sold to the commercial banking giant JP Morgan Chase. In September 2008, Lehman Brothers declared bankruptcy and Merrill Lynch was sold to Bank of America; both companies had leverage ratios of close to 40-to-1 (Pozen, 2010, 133). In order to avoid similar fates, both Goldman Sachs and Morgan Stanley needed access to emergency liquidity from the Federal Reserve; as a result, on September 21, both banks converted into BHCs (and FHCs simultaneously) in order to take advantage of the Federal Reserve's emergency discount window (New York Times, 2008). In short, within a few months, all five of the firms that had participated in the CSE program had ceased to exist as independent investment banks. Chairman Christopher Cox, upon the formal disbandment of the CSE program on September 26 2008, was forced to ruefully note that "the last six months have made it abundantly clear that voluntary regulation does not work" (quoted in SEC 2008). However, this realization was too late: the agency had lost its primary regulatory authority over the most important traders of securities and securities-based products, dramatically decreasing its influence as a regulator. Moreover, the criticism that followed threatened its very existence as an independent agency (see Fisch 2009, Coffee and Sale 2009, Markham 2009-2010, Jones 2009-2010).

## 5.8 Conclusion

Writing in late 2009, Jones (2009-2010, 609) commented that "[t]he Securities and Exchange Commission is currently under siege. Its once stellar reputation has been tarnished by a series of inauspicious events that unfolded during the meltdown of 2008" amongst them "the

failure of the Consolidated Supervised Entity Program” which has “led many to question the agency’s competence and relevance in an era of globalized financial markets” (see also Fisch 2009). Indeed, a 2008 Treasury Department proposal that would have abolished the agency completely was still being treated with surprising seriousness amongst commentators and lawmakers as they debated a financial reform bill (Coffee and Sale, 2009). While the SEC ultimately survived financial regulatory reform and has, by most accounts, rehabilitated some of its image in recent years, there is little question that it is perceived to be a shadow of its former self (see Eaglesham and Demos 2012). This diminished role is partly a reflection of the fact that functional regulators such as the SEC became less relevant when major firms began to be able to engage in a panoply of financial activities and as institutions became increasingly interconnected one another. Indeed, following the 2008 crisis, there has been an even stronger emphasis on the need for prudential or “macro-prudential” supervision (Elliott, 2011), an emphasis that will likely further empower the Federal Reserve and the Treasury Department relative to the SEC over time

However, the SEC also played a major role in its own decline. Perhaps most consequentially, its disclosure-enforcement mission blinded it to the growing salience of prudential supervision in the early 1990s, a point in time in which it likely would have been successful in seeking consolidated supervisory powers over securities holding companies. This underscores yet again the salience of early decisions or “critical junctures.” While chapters 3 and 4 in some ways represent ‘power begetting power’ in the manner similar to that outlined by Pierson (2013), this chapter represents something of the opposite. The missed opportunity to seek consolidated supervisory authority created a *negative* feedback dynamic: the SEC had no incentive to build the expertise necessary to conduct such supervision, nor could it truly compel the major investment banks to share information about their emerging derivatives activities. Moreover, had the SEC assumed such authority, it would have changed beliefs about the agency; the policy community would have increasingly seen it as more than just a front-line enforcement agency and more as a prudential supervisor. In turn, this may have given it greater leverage to lobby for increased appropriations or independent funding in the 1990s. In short then, the (admittedly understandable) strategic errors it committed in the early 1990s had a multitude of knock-on impacts that weakened its authority.

Its actions also had a ‘signaling’ effect (Pierson, 2013, 9). As time went on, its increasing willingness to relax its regulatory standards – first, to some extent, through the DPG, but more obviously in the broker-dealer-lite and CSE programs – sent signals that its influence was waning, which may have emboldened the major investment banks to push the agency further towards their policy preferences. For example, there is little reason to believe – as Coffee and Sale (2009, 738) similarly observe – that that the SEC needed to abandon the Net Capital Rule leverage ratio in creating the CSE scheme in order to incentivize investment banks to participate. In truth, the regulatory stringency of *any* SEC program would have been *significantly* lower than the alternative of FRB supervision under the Bank Holding Company Act. In part this would have owed to the clear legal discretionary authority the

FRB would have possessed, its greater resources and experience in entity supervision, and, frankly, the fact that the five investment banks would have had to compete with dozens of other major commercial banking conglomerates vying to influence FRB decision making. In other words, the implicit threat of conversion to a BHC/FHC charter was perhaps a somewhat hollow one, suggesting that earlier signals of weakness had a path dependent dynamic to them, a negative colliery of the “victory as a signal” hypothesis put forward by Pierson (2013, 9).

Beyond the path dependent dynamics apparent here, this chapter vividly illustrates how bureaucratic agencies respond to the shift from an environment in which their authority is largely unchallenged to one in which it becomes more contested. In the early 1990s, the SEC had few incentives to cooperate with its transgovernmental counterparts, since doing so would have produced a net cost to its authority. While international collaboration on capital standards yielded short-term policy benefits and accrued long-term domestic influence to the Federal Reserve, such an agreement – with the compromises contained within it – would be have been unnecessary had it already possessed the necessary authority to implement its preferred policy. As such, with no perceptible threats to it domestically, the SEC simply did not perceive the need to bind itself to an international capital regime that it felt was subpar to its own Net Capital Standards. By contrast, as its authority became increasingly contested, the SEC engaged in a series of collaborative, voluntary efforts with the private sector designed to boost its reputation for competence as an entity supervisor, specifically promoting the image of it as an effective overseer of the growing OTC derivatives trading operations of investment banks. Finally, the agency, with its authority under threat, was forced to negotiate with the U.K. FSA in the creation of the CSE program. In short, as has been illustrated in other chapters, agencies respond in distinct strategic ways to protect or advance their authority, but only when such authority is challenged.

Finally, the episodes above highlight a key point made in Chapter 2: bureaucratic organizations are not pure turf maximizers. While in hindsight it may have been a strategic mistake, the SEC decision not to seek additional prudential supervisory authority is understandable. Doing so would have diluted its at the time highly regarded reputation as a “disclosure-enforcement” agency and opened it up to new forms of criticism in the event that a securities firm collapsed. Perhaps even more important, it would have changed the internal dynamics of the agency itself. Prudential supervision would have required hiring supervisors and experts in financial institutional analysis, many of whom would likely have possessed an economics background. This would, in turn, have likely led conflicts between the dominant legal profession within the agency over the utility of its enforcement efforts and pursuit of disclosure, and led to an extended period of uncertainty in which staff could no longer clearly identify the agency’s mission. Indeed, Eisner (1991, 1993) observes precisely this type of dynamic play out at the Federal Trade Commission, another agency traditionally dominated by lawyers that was forced to incorporate economic analysis into its decision making over the course of the 1980s and 1990s. Therefore, the SEC’s actions here (and, as Chapter 4

## Chapter 5. The Transition to a More Contested Authority: Supervision, Capital, and the SEC

---

underscored, on OTC derivatives more generally), underscore that bureaucratic actors are cautious about taking on new mandates that stray too far from their existing mission and competencies.

## 6 | Conclusion

### 6.1 Summary

The revolution that occurred in the U.S. financial industry was facilitated, encouraged, and actively shaped by consequential public policy decisions made in the United States between the late 1970s and early 2000s. Contrary to popular perception, these policy decisions were not simply products of interest group ‘capture’ or responses to amorphous forces emanating from ‘globalization.’ Rather, as this project has demonstrated, some of the most critical policy issues were determined in large part by ‘autonomous’ bureaucracies, who took self-motivated actions over extended periods of time in an effort to advance their political and policy authority. It was, for example, the Federal Reserve Board (FRB) that pushed the United States to adopt formal capital requirements for banks, transforming them into *the* central prudential tool for financial regulators. Similarly, the FRB, based on its long-standing supervisory experience using risk-based capital standards, waged a campaign in the mid-1980s to have capital requirements reflect the risks banks faced. It overcame the concerted opposition of lawmakers, other regulators, and interest groups to achieve that goal, in part by leveraging its legitimacy as a monetary policymaker. It also turned to the Basel Committee on Banking Supervision, an organization in which it exercised significant influence, to help it promote its favored risk-based approach as international ‘best practice.’ By doing so, it established a precedent that future amendments to capital standards would be negotiated through the Committee, thus entrenching its own power over the long-term. This was vividly seen in the Basel II negotiations in the late 1990s, in which the FRB’s authority – both domestically and internationally – was far less contested than it had been in the mid-to-late 1980s

Similarly, the Federal Reserve played a critical role in the development of the over-the-counter (OTC) derivatives markets. When these markets were still in their nebulous stages in the mid-to-late 1980s, and at a time in which the political power of the industry was weak, it was the Federal Reserve that acted to prevent an effort by the Commodity Futures Trading Commission (CFTC) to regulate such instruments. It helped to ensure that its potential policy competitors – the CFTC and the Securities and Exchange Commission (SEC) – remained divided and, in the case of the CFTC, politically weakened. When the threat

of regulation appeared to be high in 1993-1994, the Federal Reserve effectively deployed rhetoric to remind Members of Congress of its work to improve risk management practices at banks and assure them of its ability to oversee this complex, opaque market. Likewise, it drew upon another international body in which it exercised considerable informal influence – the Group of Thirty (G-30) – to promote the benefits of industry self-governance and highlight the dangers of government intervention. These efforts were critical in preventing government regulation of the OTC derivatives industry; moreover, they helped to shift the debate, effectively marginalizing those with concerns about these markets, as the 1998 episode involving the CFTC’s concept release underscored. In short, the Federal Reserve, which had held strong preferences on the issue from an early point in the public debate, progressively enlarged its authority over the issue, though in this case that authority was directed towards preventing regulation rather than imposing new rules. Its actions, in turn, had immense consequences for the U.S. and global economies, as witnessed during the 2008 financial crisis.

In 2008, Lehman Brothers collapsed, an event that directly precipitated the most severe phase of the 2008 financial crisis; within days, the rest of the independent investment banking industry in the United States effectively disappeared. As a partial explanation of those events, many pointed to the decisions of another financial regulator – the SEC. Its policy preferences and actions in the early 1990s helped produce a cascade of events that indeed may well have contributed to these outcomes. In the early 1990s, its domestic political authority as an “enforcement-disclosure” agency was largely unchallenged. In this environment, and prior to the significant involvement of investment banks in OTC derivatives trading, it spurned the opportunity to assume consolidated oversight of major securities holding companies, a prudential activity that it felt would damage its sterling reputation for enforcing disclosure-based rules. Similarly, its domestic authority, together with the dominance of U.S. markets, produced little incentive for compromise with its international colleagues on a new global regime that would mandate capital requirements for securities firms, a fact that resulted in the ignominious failure of that effort. By the mid-1990s, however, the agency faced new challenges as investment banks became more heavily involved in OTC trading activities and as efforts to repeal the Glass-Steagall Act led to a growing discussion about the need for “consolidated supervision” of financial holding companies, most likely by the FRB. The agency sought out industry assistance to help boost images of its competency as a prudential supervisor through the Derivatives Policy Group (DPG), and created a voluntary supervision scheme known as the “broker-dealer-lite” program. By the early 2000s, with its authority as the primary supervisor of securities firms under sustained threat, it agreed to a program of voluntary consolidated supervision – the Consolidated Supervised Entity (CSE) initiative – that, arguably, permitted excessive risk-taking at the major investment houses and contributed to the events of 2008.

Each of these cases highlights that government bureaucracies with independent and consistent policy preferences, are capable of taking actions over a sustained period of time that

influence public policy outcomes. Put differently, each of these three cases demonstrate – at different points – that regulators in this policy space are “autonomous” political actors, rather than pawns of the industry which they regulate or compliant automatons faithfully carrying out the directions of their political masters. The cases also illustrate a series of strategic behaviors that financial regulators engage in order to protect or bolster their authority when it is threatened. In particular, they show the value of international collaboration as a mechanism for escaping the confines of domestic political constraint. Such agreements help to bolster the agency’s legitimacy with domestic audiences by creating the impression of a global consensus. The benefits of such collaboration are not only short-term, but long-term. Specifically, by empowering small, regulator-centered international bodies in which U.S. regulators typically enjoy outsized influence, and by projecting their preferred policy outcomes as global ‘best-practice,’ regulators can create path dependent dynamics that entrench their authority over time. In theory, regulators can achieve much the same type of outcome through cooperation with private sector actors, efforts which can help regulators boost their political authority, while also removing the issue to some degree from domestic political discussion. While these public-private collaborative efforts undoubtedly produced short-term benefits for regulators in the cases discussed here, whether they did so in the long-term is more questionable. Finally, this project has demonstrated that agencies whose authority is threatened make use of rhetoric and alter their discretionary behavior in order to boost perceptions of their legitimacy and reputations for competency, strategies that often prove to be highly effective.

## 6.2 Contributions and Take-Away Considerations

### 6.2.1 Building Upon the ‘Carpenterian’ Autonomy Framework

#### A Clarification of the Concept

Daniel Carpenter’s groundbreaking work on bureaucratic autonomy has heavily shaped this project. His 2001 book, *The Forging of Bureaucratic Autonomy*, was the first major effort to break away from the principal-agent framework that had dominated the political science discipline for two decades. Eschewing the principal-agent characteristics of agencies as either compliant automatons or occasionally misbehaving children, Carpenter instead examined bureaucratic organizations as political actors in their own right. He argued that agencies were capable of possessing distinct, self-guided preferences and had the capacity to impact not just narrow, technical regulatory outcomes, but broad policy agendas over sustained periods of time. Both *Forging* and Carpenter’s 2010 book, *Reputation and Power*, emphasize the salient role of “reputations” and “beliefs” as the key source of bureaucratic influence, which has also informed my own view. Despite these contributions to this project and to bureaucracy scholarship more generally, Carpenter’s work unfortunately lacks in clarity, leading to

conceptual and theoretical ambiguities that have made it difficult for scholars to apply his framework to other cases. One of the principal contributions of this project has therefore been to provide this clarity and to identify concrete, observable implications of autonomy.

To recall, the first component of his definition, which refers to preferences, states that agencies must be capable of taking “actions consistent with their own wishes” and moreover, that such actions occur in “sustained patterns” (Carpenter, 2001a, 14). The second part of his definition indicates that an agency is autonomous when “politicians and organized interests defer [to those bureaucratic actions] even though they would prefer that other actions (or no action at all) be taken” (Carpenter, 2001a, 4) and that “actions that will not be checked or reversed by elected authorities, organized interests, or courts” (Carpenter, 2001a, 14). In short then, Carpenter’s formulation of bureaucratic autonomy distinguishes between two largely independent concepts, even though he himself rarely makes this clear: preference independence, which he argues must be “sustained” over time, and influence or authority, which is implied by the deference of political officials. By clarifying the distinction between the two elements of autonomy, we are in a stronger position to think about observable implications of each, implications that are never actually outlined by Carpenter. For example, this project has emphasized that the validation of preference independence involves tracing their origins, noting the timing of public expressions of such preferences relative to other actors, their closeness of fit with the agency’s mission, and their consistency over time.

### **Establishing Preference Independence: A More Realistic Approach**

Beyond the clarification of terms, this project has also uncovered ways in which Carpenter’s theory itself and the extent of its applicability should be revisited. For example, Carpenter is right that autonomy, in *its strongest form*, exists when politicians and organized interests defer to bureaucracies even though they would “prefer that other actions (or no action at all) be taken” (Carpenter, 2001a, 4). This project has indeed uncovered instances of bureaucratic autonomy that fit this description. However, if this is a necessary hurdle to demonstrate autonomy, then it is an extraordinarily high one. Specifically, it fails to pick up on instances in which bureaucratic preferences are closely aligned with those of one or more actors in the policy subsystem, yet where the empirical evidence clearly suggests that those preferences were formed independently. For example, in Chapter 4 it is clear that the actions of the Federal Reserve were critical in preventing the enactment of rules or legislation that would have regulated the industry. However, the Federal Reserve and the derivatives industry – the International Swaps and Derivatives Association (ISDA) and the major bank dealers – were in relatively broad alignment on the issue of government regulation. Therefore, under Carpenter’s definition, the Federal Reserve was not not “autonomous” in this instance. Yet the empirical evidence suggests otherwise. The Federal Reserve possessed well-defined policy preferences from an early stage in the public debate (the mid-to-late 1980s onwards), preferences which were, notably, also sustained over time. Moreover, there was no obvious



mechanism through which group influence could have been exerted: the ISDA was poorly organized at the time, while the OTC industry was relatively small in the late 1980s. Despite all the signs pointing to the Federal Reserve's preference independence, adding the precondition of disagreement or opposition by other actors would prevent us from classifying this case as an instance of autonomy.

Moreover, Carpenter's definition of preference differentiation produces a logical inconsistency. When bureaucratic authority is largely uncontested, we should not expect to find evidence of strong, open disagreement amongst actors in the policy subsystem. For example, outright opposition to the SEC's Market Reform Act in 1990-1991 by the major investment banks would almost certainly have resulted in a loss for them given the agency's political support and authority at the time. Instead we find mild disagreement or no obvious expression of opposition from industry associations or the securities firms themselves. However, under a strict reading of Carpenter's definition, this would not represent autonomy, since there was an absence of "political differentiation" or indications that they would prefer "other actions" be taken. As discussed in Chapter 2, scholars do face an *empirical* dilemma in instances in which preference differentiation does not exist, since there is an observational equivalence with capture arguments. As I have demonstrated, however, this can be overcome through over-time analysis, particularly by focusing on earlier critical episodes that help us to identify the origins of actor preferences and therefore allow us to better distinguish between them. However – as Caughey et al. (2009) also note – Carpenter confusingly does not make clear whether his reference to preference differentiation is simply a methodological point or one that is central to his conceptualization of autonomy. In any event, this project takes the position that the problem is solely observational and can be overcome with the application of appropriate longitudinal methodology.

### **Autonomy is Possible in the Modern American State**

Finally, as I have alluded to elsewhere, this project runs directly counter to Carpenter's apparent view – expressed in the conclusion to *Forging* – that bureaucratic autonomy is a distinct characteristic of the pre-New Deal American state. Specifically, Carpenter states that "contemporary American politics has reduced the likelihood of bureaucratic autonomy founded on legitimacy." He continues by clearly implying that such autonomy is confined to the period that preceded the New Deal: "[f]rom the Civil War to the Great Depression, in pockets of the American state, *genuine* bureaucratic autonomy was forged on the anvil of agency reputations" (emphasis added; both quotes taken from Carpenter 2001b, 366). Carpenter is right to be skeptical for two reasons. First, his study is focused on agencies that were relatively young. Those organizations began with little or no autonomy and had to build it slowly over time through entrepreneurship, policy innovation, and through the construction of "program coalitions" of supporters. By contrast, most agencies today are well-established entities; indeed some, such as the Federal Reserve and the SEC, have strong

organizational cultures, clearly defined reputations, and long-standing coalitions of support. In that sense Carpenter is correct that the specific type of autonomy he describes is unlikely to be repeated in the modern political and institutional environment (the case of the Consumer Financial Protection Bureau maybe a rare exception to this – see ‘Directions for Future Research’ below).

Second, the pre-New Deal state was institutionally sparse. Had Carpenter examined banking and market regulation in the same time period, he would have noted that just one federal agency existed prior to 1913 – the Office of the Comptroller of the Currency (OCC). There was effectively no federal policy governing the securities or derivatives markets (Romano, 1997). Moreover, there were no nationally organized trade associations or consumer groups focused on banking or capital markets issues. There simply would have been far fewer ‘veto points’ or sources of contestation for a hypothetical agency in the mold of either the FRB or SEC in that environment. The contemporary American policymaking environment, by contrast, is institutionally dense and politically competitive. In the area of financial services policymaking alone there are nine federal regulators (and many more indirectly impact financial regulation), state regulators (particularly state attorneys general), as well as five congressional committees of jurisdiction and multiple subcommittees. Similarly, beyond government, there are literally hundreds of interested parties seeking to influence public policy outcomes – trade associations, representatives of individual corporations, investor groups, and, more recently, “public interest” organizations such as Americans for Financial Reform (on the latter points, see Woolley and Ziegler 2012). Carpenter is therefore right to be skeptical that bureaucratic autonomy can be “forged” amidst this forrest of deeply entrenched institutions and interest groups, each of which is vigorously competing for influence and intently monitoring the behavior of other actors.

However, this project has clearly demonstrated that under specified conditions autonomy is not only possible, but actually commonplace. First, it is simply an empirical fact that even established agencies can augment their authority, and thus autonomy, in specific policy areas over time. Second, when the policy under discussion is characterized by low electoral salience and visibility, high levels of technical complexity, together with economic centrality, the normal competitive political dynamics shift in important ways. There is simply little incentive, and indeed high barriers, to the acquisition of expertise by Members of Congress. While the first three conditions do not remove Congress from the political equation, it all-but-guarantees that broad policy making authority will be delegated to other entities, such as government bureaucracies or interest groups. It is the final condition – economic centrality – that increases the likelihood will witness patterns of deference to bureaucratic actors rather than capture by industry, since it raises the costs of making suboptimal policy or ‘outsourcing’ policymaking to particularized groups. Therefore, they are more likely to defer to bureaucratic actors perceived as both legitimate and competent on the policy issue at hand. When this is taken together with the heterogeneity of interests in the financial services industry, these factors help to explain why autonomy is actually quite commonplace in

the area of financial services regulation. While this logic may only hold true within certain policy domains, such as financial regulation or macroeconomic policymaking, it does indicate that autonomy is more than possible in the modern American polity.

It is also notable that one of the key strategies for enlarging autonomy highlighted here – transgovernmental collaboration – in many ways represent the lightly institutionalized frontier that Carpenter describes in *Forging*. The environment in which cooperation occurs is one in which rules are informal, where negotiations are typically secretive, and in which there exists little substantive equality (Zaring, 2005, 569-572). In this removed location, where they also happen to enjoy significant structural and status advantages, U.S. agencies are far freer to initiate and develop policy than they are within the confines of domestic institutions and politics. Moreover, as we have seen, regulators can in turn use these organizations help to build legitimacy for their policy preferences domestically by portraying their agreed standards as global ‘best practice’ (Zaring, 2005, 572), as well as by embedding expectations that future policy making will also be conducted at the transgovernmental level. As a result, international collaboration offers regulators an opportunity they lack in the politically crowded domestic setting: the ability to construct entirely new policy architectures that reflect their own unique preferences and in turn help to endow those preferences with credibility and legitimacy for domestic audiences. When these patterns are repeated over time, those transgovernmental institutions become embedded and widely accepted by domestic actors, as does the autonomy of the regulatory actor itself. In short then, transgovernmental collaboration acts as an ‘escape hatch’ from the constraints that exist in the modern American polity, again explaining why Carpenter’s skepticism regarding the possibility of autonomy is overstated.

### 6.2.2 The Salience of Path Dependence

One of the key insights of this project is that regulators pursue strategies designed to bolster and enlarge their authority not just in the short-term, but with a view to the long-term; in other words, they are capable of behaving in a strategic and not simply a tactical manner. This means that agencies adopt strategies designed to create ‘self-reinforcement’ or ‘positive feedback’ loops that lead to path dependence (Pierson, 2004). A prime example of this is international collaboration on capital standards via the Basel Committee; by successfully establishing a precedent that decision-making on capital issues occur via that body, it helped to dramatically alter the incentives and expectations for domestic actors in future debates. Indeed, when the debate about amending the capital framework reemerged in the mid-to-late 1990s, there was little domestic challenge to the widely accepted notion that changes would be made first and foremost using the Basel institutional framework. These path dependent dynamics are not simply about entrenching institutions and policies, but also about power relationships (Pierson, 2013). The Basel Accord sent a powerful signal to other actors that the international community endorsed the FRB’s approach to risk-based capital standards; it

shifted the arena permanently to one in which that agency was significantly more influential; and it marginalized those voices, such as the FDIC, who had opposed risk-based standards.

On the issue of OTC derivatives, the Federal Reserve took early, critical actions that weakened potential proponents of regulation. In the late 1980s and early 1990s, it ensured that the SEC did not accrue broader authority as a market regulator. It supported granting the futures exchanges – the main base of political support for the CFTC – the right to trade in the OTC products, a fact that attenuated the prospect of the CFTC proposing to regulate those markets in the future. It also saw fit to allow continued jurisdictional divisions between the two agencies to persist, preventing the emergence of any form of markets super-regulator that could pose a greater threat (see Karmel 2009 for more). It invoked the G-30 to promote the idea that industry self-governance was a global consensus and indicative of best practice, while using public rhetoric to castigate supporters of regulation for endangering financial innovation. All of these actions helped to marginalize potential opponents and dissenting views, creating a “spiral of silence” (see Pierson 2013, 10) where outright advocacy for regulation – such as that briefly adopted by the CFTC in 1998 – was not tolerated.

Conversely, in Chapter 5, I show that the SEC’s missed opportunity to seek consolidated supervisory jurisdiction during a period in which its authority was largely unchallenged created a *negative* feedback dynamic. It meant that the the SEC had no incentive to build the expertise necessary to conduct such supervision, nor was it in a position to compel the major investment banks to share information about their emerging derivatives activities. Without the experience of conducting prudential oversight, few could conceive of the agency as a possible consolidated supervisor. These dynamics ultimately contributed to its loss of authority as the primary regulator of major securities firms. Its actions over-time also had a path-dependent ‘signaling’ effect (Pierson, 2013, 9). As time went on, the SEC’s increasing willingness to relax its regulatory standards sent signals that its influence was waning, which may have emboldened the major investment banks to push the agency further towards their policy preferences; in short, this represents a negative colliery of the “victory as a signal” hypothesis put forward by Pierson (2013, 9).

Methodologically, the importance of path dependent dynamics also underscores the need for studies to focus primarily on earlier, rather than later policy episodes. Specifically, events or decisions that may have appeared of minor significance at the time often have an outsized impact on later developments by foreclosing certain options over others (Pierson, 2004). For example, the decision by the Federal Reserve to adopt a risk-based approach to calculating bank capital in the 1950s, a decision with little real-world impact over the proceeding two decades, powerfully shaped its preferences in critical later debates. In another instance, the fact that formal capital standards had been introduced prior to the FDIC’s proposal for risk-based deposit insurance reduced the likelihood of that proposal succeeding, simply because of the investments made in supervisory regimes focused on capital adequacy. The decision to permit futures exchanges to trade OTC derivatives in 1992 – a little noticed change – cleaved that group away from the CFTC in policy debates two years later. The opposition

of the SEC to international capital standards for securities firms in the early 1990s proved a missed opportunity, since it made it more difficult for it to later gain consolidated oversight authority over the derivatives-trading special-purpose vehicles of broker-dealers. By contrast, later episodes, while often attracting more attention, simply serve to highlight a power or institutional dynamic that has already long been in place. The 1998 debate over the CFTC's 'concept release,' which proposed regulating classes of OTC derivatives, underscored the by-then politically dominant position of the Federal Reserve, its allies, and their opposition to regulation. In sum then, this project has demonstrated that path dependent power dynamics are essential to understanding how and why bureaucratic autonomy emerges. This furthermore suggests that other bureaucracy scholars would do well to incorporate over-time, developmental analysis into their own research designs in order to fully capture such dynamics.

### 6.2.3 Assessing the Role of “Cultural Capture”

Kwak (2013, 9) defines “cultural capture” in the following way: it is “cultural” because it “operates through a set of shared but not explicitly stated understanding about the world” and “capture” “because it can produce the same outcome as traditional capture – regulatory actions that serve the ends of industry.” He hypothesizes that this form of “capture” is particularly prevalent in the financial policymaking community because of the shared ‘in-group’ identities between regulators and those working for financial institutions; deference produced by the perception of the industry’s superior financial status and quantitative sophistication; and the close relationships that exist in what is actually a relatively small community of regulators, politicians, industry executives, and lobbyists. Indeed the latter point, which he admits is closely connected to the “revolving door” arguments in traditional capture theory, has been well documented in both press accounts (see, for example, Weinberg 2013) and in scholarly articles (Solomon 1995; Underhill 1997). Take the Derivatives Policy Group (DPG) as an example: almost all of the participants in the Group had worked for both the public and private sectors; Gerald Corrigan, one of the two co-chairman, had been President of the Federal Reserve Bank of New York before becoming a partner at Goldman Sachs, while the other co-chair, John Heimann of Merrill Lynch, was previously the Comptroller of the Currency and had been acting chairman of the FDIC. More recently, Mary Schapiro, who was Chairman of the SEC from 2009-2012, left the agency to join Promontory Financial, a consulting firm that provides services to major financial corporations (Weinberg, 2013); prior to this, she had been head of the securities industry self-regulator, the Financial Industry Regulatory Authority (FINRA), Chairman of the CFTC, and an SEC Commissioner. In short, the revolving door is a fact of life in the financial industry.

Close relationships are also understandable for other reasons. Aside from the small size of the policy community, there is the fact that the industry is subject to unusually stringent regulatory oversight; as a result, regulators and regulatees are brought into frequent contact.

Likewise the proliferation of self-regulatory organizations (particularly in the capital markets – see Chapter 5) also serves to increase the quotidian interactions that occur between industry and government bureaucracies. Finally, growing market volatility since the early 1980s has increased such contract; as one participant in the Derivatives Policy Group (DPG) observed, “the incidence of financial disturbance [over the previous fifteen years] have been of sufficient frequency and magnitude that it leads to interaction” (quoted in Faerman et al. 2001, 378). The ‘status’ hypothesis has been informally made by many commentators, who argue that regulators were impressed by the level of sophistication in the financial sector and thus more likely to defer to the industry in making policy (see Kwak 2013, 20-21). Relatedly, it has been stated that the compensation provided to those working on Wall Street attracted the ‘best and the brightest,’ with regulators occupying a comparatively second-class status in which they aspired to the lifestyles of their private industry counterparts, thus aligning their policy views with their social superiors working in the industry (see, for example, Ho 2009). The ‘in-group’ identity concept suggests that a sharing of backgrounds and training leads to a shared identity and a desire to conform to the expectations of others in the group (see Akerlof and Kranton 2000). It is extraordinarily difficult then to escape the impression that both status and in-group identity dynamics were prominent, particularly in the late 1990s and 2000s.

Does this mean there was a form of “cultural capture” that pervaded the financial regulatory policy community? Maybe. Unfortunately it is difficult to render a definitive answer given extraordinary empirical hurdles that exist to doing so. As Kwak (2013, 10) admits “there are always multiple explanations for the beliefs” someone possesses and “in practice, non-rational influences will ease the adoption and strengthen the grip of beliefs that have plausible rational justifications.” Indeed, the empirical problems facing the cultural capture argument closely parallel those facing advocates of the ideational “third face of power” or “false consciousness.” Many, such as Polsby (1963) and Wolfinger (1971), argued that it was pointless to study dynamics that could not be directly observed. Yet as Pierson (2013, 4) observes, John Gaventa’s classic study of this phenomenon overcame these obstacles through careful explication of mechanisms and observable implications, as well as by adopting a temporal approach to his study that allowed him to uncover hidden dimensions of power (see Gaventa 1980). Therefore, it may be possible for proponents of a cultural capture perspective to identify the phenomenon empirically. However, scholarly work thus far has not come close to doing so.

In the absence of such studies, however, we can still make some preliminary conclusions. We do know, for example, that Kwak’s hypothesized mechanisms, particularly status differentials (e.g. see Hu 1993) and closeness of interaction (e.g. see Faerman et al. 2001), increased gradually between the 1980s and 2000s, suggesting the phenomenon – if it existed – was likely stronger in later years. Perhaps even more conclusively, this study has demonstrated that consensus on key issues, such as OTC derivatives regulation, was far greater from the mid-1990s onwards than it had been in the previous fifteen-to-twenty years. Since

cultural capture logically predicts a high degree of agreement between policymakers and the regulated industry, its absence is a fairly clear indication that that form of capture was not yet pervasive in the late 1980s and early 1990s. Moreover, even if there was widespread consensus on policy and that policy in turn benefited large segments of the industry, is it still “capture” if that policy was proposed by regulators *first*? Alternately, if industry interest groups initially *opposed* a policy that ultimately benefitted them and became a consensus position, can we appropriately refer to that as “cultural capture”? Indeed, on the issue of risk-based capital standards, the FRB initiated the policy and then faced opposition from significant portions of industry; ten years later, the concept of risk-based standards was widely accepted and seen as broadly a positive for large commercial banks. Frankly, in that case, it might be more accurate to state that the FRB engaged in a form of reverse cultural capture, succeeding in having its views accepted as ‘best practice’ and ‘cutting edge’ by politicians, other regulators, *and* the industry. In sum then, the cultural capture argument is intriguing but there is little hard evidence nor logical reason to believe it shaped the preferences of regulators, particularly in the earlier episodes discussed in the three chapters in this project

### 6.3 Does Autonomy Still Exist in Financial Policymaking? Evidence from the Dodd-Frank Debate

The conclusions this project reaches are largely, though not entirely, based on policy debates and developments that occurred in the 1980s and 1990s. However, we also know that the political climate has changed significantly over the past ten-to-fifteen years. Partisan polarization in Congress has increased dramatically and has spilled over into previously uncontroversial policy and procedural areas (see Lee 2009). This includes financial services policy, as evidenced by the heated partisan debates surrounding the Dodd-Frank Wall Street Reform Act (see below) and the highly contested nature of the newest agency created by the Act, the Consumer Financial Protection Bureau (CFPB), which continues to manifest itself in the refusal of the Republican Party in the Senate to confirm the agency’s director, Richard Cordroy (see Adler 2013). As Chapter 1 and several of the proceeding chapters document, industry consolidation has continued apace, with the 2008 financial crisis ironically proving a catalyst for the emergence of ever bigger financial conglomerates (on the latter point see, for example, Fisher 2013). At the same time, the interest group space has arguably become more competitive, with new – if poorly funded – public interest advocacy organizations playing a sustained role for the first time. Financial regulatory issues attract far greater attention than they once did, even if most issues are still largely invisible to ordinary voters, as evidenced by the ongoing, high-profile debate over breaking up large financial institutions (Rehm, 2013). In short then, these changes certainly suggest that the landscape in which financial regulatory policy is made has changed; more important, all of them appear likely

to attenuate the possibility of bureaucratic autonomy.

Does this mean that autonomy of financial regulators is a relic of the – admittedly relatively recent – past? One way to begin to answer that question is to train our attention towards “crucial” or “least likely” circumstances – that is, situations in which we would expect the political authority of regulators to be at its *lowest* (see Gerring 2008 for more on the “crucial case” method). Perhaps the best example of a “least likely” case is the debate surrounding the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (hereafter ‘Dodd-Frank’). The legislation attracted widespread media attention, as well as significant criticism and controversy (Carpenter, 2010a, 3). The scope and scale of many of the proposed changes attracted an unprecedented lobbying campaign from the financial services sector, particularly the major trade associations such as the Financial Services Roundtable (hereafter the ‘Roundtable’), the American Bankers Association (ABA), and the Securities Industry and Financial Markets Association (SIFMA) (e.g. see Evans 2011, Brush 2010, Indiviglio 2010). The raised salience and visibility of financial regulatory issues, the high level of activity by many competing interest groups, as well as the unusually partisan nature of much of the debate surrounding the bill do not seem to be particularly propitious circumstances to find evidence of bureaucratic authority. Yet, as the short vignettes below suggest, at least one agency – the Federal Deposit Insurance Corporation (FDIC) – did have a clear and meaningful influence on the debate, specifically in two areas: the creation of a resolution process for so-called systemically important financial institution (SIFI)s and in increasing the minimum capital levels for banks. Given that this is a “least likely” circumstance in which to find patterns of bureaucratic authority, we can have some degree of confidence that such patterns persist under more “normal” conditions in the contemporary political system.

### **The FDIC: A Brief Background**

The mission and policy preferences of the FDIC were previously discussed in Chapter 3. However, in short, the principal mission of the agency is to administer the BIF, a scheme paid for through premiums by banks that insures deposits up to \$250,000. As Khademian (1996, 116) observes, protecting the solvency of the BIF is widely regarded as being at the “core of its organizational character”. Indeed, this was reflected in statement soon-to-be Treasury Secretary Timothy Geithner about then-FDIC Chairman Shelia Bair in 2008, when he observed that she “was more worried about keeping the FDIC’s insurance program protected than she was about the entire financial system” (quoted in Schmidt 2008). Perhaps unsurprisingly then, the agency is widely perceived as “risk-averse” and “conservative” in its attitude towards regulation and less concerned with the bank competitiveness issues than either the Office of the Comptroller of the Currency (OCC) or the FRB (Khademian, 1996). Under Bair in particular, the FDIC had burnished this reputation for prudence and had also displayed a willingness to challenge the banking industry regarding excessive risk taking.



Bair, for example, was the first regulator to raise the alarm in early 2007 about the spike in subprime mortgage lending by non-bank lenders, most of which obtained a significant portion of their financing from FDIC-insured commercial banks, as well as the growing rate of defaults on those loans (see Bair 2007); see also Nocera 2011). This move notably garnered her and the agency significant credibility with lawmakers, particularly the key House and Senate Committee Chairs – Representative Barney Frank and Senator Chris Dodd (Schmidt, 2008).

The agency had also strategically positioned itself as a voice against government ‘bailouts’ in the wake of the 2008 crisis, both in its rhetoric and actions. For example, it vetoed a deal arranged by the Federal Reserve and the Treasury Department that would have provided government support to the company in order to purchase Wachovia, a bank with a large retail deposit base that could provide much needed liquidity to Citigroup (Schmidt, 2008; Lizza, 2009). In another case, Bair vociferously denounced the payment of bonuses to executives at American International Group (AIG), which had received a total of \$85 billion in emergency assistance from the government (Nagourney, 2009). Later in 2009, the FDIC took a high-profile, tough stance towards Citigroup, insisting that it replace senior management before it would provide additional financial support to the institution (Andrews and Story, 2009). In short, the combination of these actions boosted the FDIC’s legitimacy and credibility on a range of key issues, particularly those related to the broad topic of ending “too-big-too-fail.” Amongst those were the issues of how to “resolve” (wind-down or liquidate) SIFIs in order to avoid the need for ad-hoc government assistance and raising capital standards to prevent insolvency in the first place.

### **Placing SIFI Resolution on the Agenda**

In March 2008 the Federal Reserve made an unprecedented \$30 billion emergency loan to JP Morgan Chase to enable them to take-over the failing investment bank Bear Stearns (Sidel et al., 2008), clearly underscoring that there was an implicit government guarantee in place for so-called SIFIs or institutions that were simply “too big too fail” (Davenport, 2008). In June 2008, Bair became the first prominent regulator to call for “...a special receivership process for investment banks that is outside the bankruptcy process, just as it is for commercial banks and thrifts...” the goal of which was to both “minimize any public loss and impose losses first on shareholders and general creditors” (Bair, 2008b). Moreover, this scheme should not allow for “open bank assistance”; that is, failing firms would need to be broken-up and liquidated. Bair moreover argued that FDIC had the correct mix of expertise and experience in this area to administer this special resolution process (Davenport, 2008). Although FDIC officials discussed the plan in public statements, there was scant mention of the issue by other key policymakers (Nocera, 2011).

However the outcry created when biggest recipient of Temporary Asset Relief Program (TARP) funding, AIG, decided to award approximately \$165 million in annual bonuses to

executives in its financial products unit (Nagourney, 2009) presented the FDIC with opening to place the issue on the agenda. Following the AIG revelation, Bair testified before the Senate Banking Committee, making clear that “a legal mechanism for the orderly resolution similar to that which exists for FDIC insured banks” represented a way to bring “an end to too big to fail.” Shortly thereafter, Chairman Dodd endorsed the broad outlines of the FDIC’s resolution program, noting that the agency should administer such a program because of its “considerable experience in resolution matters” (all quotes from Kaper 2009). Bair, in a critical White House meeting on the subject of the AIG bonuses, had also persuaded the President that a FDIC-style resolution process – where the agency can break contracts, replace management, and alter remuneration structures – must be included in the soon-to-be published Treasury “rules of the road” discussion document on financial reform (Nocera, 2011). Indeed, once the Treasury document was published on March 26, it did include a SIFI resolution process closely modeled on that proposed by Bair. In short, it appears as though the agency not only placed the issue on the agenda, but strategically employed its legitimacy and credibility to ensure that it would be part of the broader financial reform package. In other words, it demonstrated that it had significant political authority.

### **Securing Authority Over the Orderly Liquidation Process**

The next question was how the new Orderly Liquidation Authority (OLA) be administered. Although the initial Treasury proposal – under pressure from the White House – had suggesting giving the FDIC wide discretion to run the resolution process, Treasury was wary of entrusting too much authority in the FDIC, as were the major financial trade associations. Treasury’s concerns stemmed from its previous clashes with the FDIC over the home mortgage modification scheme and Citigroup (see Ryan 2012a for a more detailed background). The ABA and the Roundtable were worried that the agency would be overly aggressive in winding down companies and removing their leadership the event of liquidation (Blackwell, 2010), as evidenced by the forceful approach it had taken with companies receiving FDIC support, particularly Citigroup (Andrews and Story, 2009; Adler, 2009). Both groups also questioned whether the agency had the right expertise and experience to manage the fund, a sentiment that found support amongst commentators such as Peter Wallison and David Skeel, who argued that the FDIC was “completely unequipped by experience to handle the failure of a giant nonbank financial institution,” having never resolved a bank with more than \$40 billion in assets.

Reflecting these concerns, Treasury published its *New Foundation* document in June 2009; under its terms, in the words of one commentator, the FDIC had “been downgraded from Treasury’s equal partner to a sidekick” (Lizza, 2009). Specifically, the *New Foundation* stated that “The authority to decide how to resolve a failing firm under the special resolution regime should... be vested in Treasury” (Treasury, 2009, 77). This included the authority to determine whether receivership or conservatorship was appropriate, in addition

to an extraordinary range of other discretionary powers, including decisions about whether to “make loans to the firm, purchas[e] assets from the firm, guarantee the liabilities of the firm, or mak[e] equity investments in the firm” (Treasury, 2009, 77). As such, the FDIC would merely be a contractor carrying Treasury’s plans for the resolution. The ABA, as well as the SIFMA, were both strongly supportive of this ‘contracting out’ model, since a program administered by the Treasury Department would be more likely to keep the company intact and at least some of the existing management in place (Kaper, 2010b). This effort by the Treasury Department posed a significant threat to the FDIC: not only would it have little real control over the program, but Treasury would be more likely to favor lenient resolution terms. As a result, the FDIC would be left in the invidious position of being forced to administer a program that would possibly damage its conservative, anti-bailout reputation.

In response, the FDIC emphasized its experience in handling resolutions and its widely praised management of other government assistance programs that had attracted far less controversy than TARP, such as the Temporary Liquidity Guarantee Program (TGLP) (Adler, 2012)<sup>1</sup>. In public statements on the subject, FDIC officials consistently emphasized their experience handling resolutions, highlighting on multiple occasions the need for ‘independence’ from other regulators, as well as noting the need for “flexibility in implementing the resolution” process (Krimminger, 2009). In her testimony before the House Financial Services Committee in late October 2009, Bair appeared to assuage any concerns about giving the agency full resolution authority, emphasizing that it would cooperate with other regulators before taking a company into receivership (Bair, 2009). By the time the interim House version of the bill was published on November 6, 2009, the Treasury’s *New Foundation* framework was nowhere to be found, and the FDIC had been granted wide discretion in administering the OLA; the Senate draft bill also granted the FDIC similar powers (Nazareth, 2009). Without drawing overly definitive conclusions from this vignette, it does suggest that the FDIC, by appealing to its reputation for competence on the issue of resolutions and management of the TGLP, likely prevailed in its dispute with the Treasury Department and the major financial trade associations. In other words, this appears to signal the presence of bureaucratic autonomy.

---

<sup>1</sup>This program provided insurance on debt issuances made by banks, BHCs and financial holding companies (FHCs), giving them vital access to low-cost funding from investors willing to buy debt backed by government guarantees. In return for participating in the program, the FDIC charged a non-refundable, variable assessment premium that would be paid into the BIF upon expiration of the program. See Bair (2008a); Oberg (2009).

### Ex Ante Resolution Fund

The agency did not win every battle in the OLA debate. The FDIC favored an *ex ante* fund, modeled on the BIF, that would be paid for by premiums imposed on large financial institutions on an ongoing basis. In the agency's view, an *ex ante* fund was preferable to the Treasury's proposal of an *ex post* collection of fees to fund an orderly liquidation since it a) made use of private funds, rather than taxpayer money that could be more easily portrayed as a public 'bailout,' b) concern that any *ex post* levy would be suspended, particularly if the collapse of a major financial institution coincided with a broader economic crisis, and c) since the Treasury Department could potentially attach conditions to the use of general funds (Hopkins and Kaper, 2009). The Treasury Department, and Secretary Geithner in particular, fought hard against the proposal, arguing that a standing fund would create "moral hazard" since it would be seen as a form of insurance for investors in large financial corporations (quoted in Paletta (2010)). Representatives of large financial institutions such as the ABA and the Roundtable vigorously opposed the FDIC, since the additional fees that would be charged to banks would add to the compliance costs arising from the overall financial reform bill (McConnell, 2009). However, initially, the FDIC looked likely to prevail on the *ex ante* fund issue. Following personal phone calls from Bair to Chairman Frank and other Democrats on the House Financial Services Committee (McConnell, 2009), the draft bill was amended in December 2009 to include an *ex ante* fund (Paletta, 2010). In the Senate, a similar proposal made by Senators Warner and Corker for an *ex ante* fund was added to drafts circulated by Dodd in January 2010 and his full draft bill in March 2010 (Block, 2010).

However, in mid-April 2010, Senate Republican Leader Mitch McConnell (R-KY) gave a speech claiming that the emerging bill "creates bailout funds, authorizes bailouts, allows for back-door bailouts from the FDIC... and even expands the scope of future bailouts" (Bolton, 2010). This speech, which was widely viewed as a strategic move to justify opposition to the broader bill (Paletta, 2010; Fisher, 2010), dramatically raised the salience of the fund. The reframing of the fund as a 'bailout' was fortuitous for Treasury, giving it renewed political leverage against the theretofore successful effort by the FDIC to push for pre-funding (Klein, 2010). The Treasury Department, as well as the White House placed calls to Senate Democrats asking them to drop the fund from the bill (Nocera, 2011). Although Senator Dodd made speeches on the Senate floor in which he evoked Ms. Bair's support in defense of the fund, the heightened political saliency of the issue, the lack of support from the Obama administration, and opposition from key GOP senators quickly ended any prospect that an *ex ante* fund would be included in the final bill (Kaper, 2010a; Brown and Shiner, 2010). The *ex ante* fund episode clearly illustrates the limits of bureaucratic autonomy when it is faced with increased political visibility. At the same time, despite the ultimate outcome, this case also vividly demonstrates the authority of the FDIC in this debate; there is no question that the provision was only included in the legislation after personal lobbying by Bair. In sum, even under extraordinarily unlikely conditions, there were clear signs that

the FDIC possessed significant political influence in this debate.

### **In Brief: The FDIC and Capital Standards**

Another example of the FDIC's political authority came in the form of the so-called "Collins amendment" on capital standards. In April 2010, Bair held a meeting with Senator Susan Collins – a key swing vote on the emerging financial reform bill – in which she argued in favor of a stringent definition of 'Tier 1' capital based almost exclusively on equity (a position the agency had long held – see Chapter 3) and b) that regulators should not be able to reduce minimum capital levels from their current raised levels – effectively creating a significantly higher floor for capital requirements than that mandated under the Basel II agreement (Tahyar 2010). Collins asked the FDIC to draft an amendment to the bill that would include these provisions (Davis, 2010). That amendment was introduced in mid-May and quickly adopted by unanimous consent in the Senate, largely because Collins' vote was considered critical to passage of a final bill (LaCapra, 2010). Most controversially, the amendment prevented the most popular type of subordinated debt, trust-preferred securities, from being counted as 'Tier 1' capital for regulatory purposes (Wack, 2011). As LaCapra (2010) notes, the FDIC had long opposed used trust-preferred securities as Tier 1 capital, reflecting its general emphasis on the importance of equity as a source of capital (see also Bair 2012, 262-265).

The measure was widely opposed. The FRB felt it would undermine the ongoing Basel III negotiations, as did the OCC; indeed, the Interim Comptroller of the Currency, John Walsh, criticized the amendment as "a move ways from international consistency since large internationally active U.S. banks will face a two-tiered set unlike comparable foreign banks" (Adler, 2011). The Treasury Department also opposed the measure; under TARP, it had purchased trust-preferred securities as part of its capital support for troubled banks. These instruments provided a relatively cheap source of capital for banks and many had held on to this government-funded capital throughout 2009 and 2010. As a result, if they were excluded from capital calculations, then many of those banks would become officially 'undercapitalized,' making it more difficult for them to raise additional funds (Davis, 2010). For the same reason, the ABA also expressed its unhappiness with the amendment (Borak, 2010). Moreover, the measure faced significant opposition in the House, where lawmakers were concerned it would negatively impact the economic recovery (Kaper and Borak, 2010). Nevertheless, the amendment was included in the final legislation largely intact. This episode again illustrates the FDIC's political authority during this period. Collins and other lawmakers viewed the agency as having legitimacy and credibility on this issue in the wake of the 2008 crisis, and showed remarkable deference to it by literally permitting it to write the legislative language that was inserted into the bill. Moreover, the fact that the legislative language remained largely intact in the final Dodd-Frank legislation despite the opposition of a range of powerful actors is noteworthy. While these vignettes are by no means conclusive, they

do suggest that the FDIC exercised significant authority under “least likely” conditions of high visibility paired with vigorous opposition from the Treasury Department and the major financial trade associations. As such, it is likely that bureaucratic autonomy is likely still commonplace under more ‘normal’ conditions in the financial regulatory policy space.

### 6.4 Directions for Future Research

Future research will likely first involve an examination of an expanded number of cases in order to determine if the patterns of bureaucratic autonomy observed here are present in other financial services policy domains. For example, regulators played a key role in dismantling inter-industry and inter-state barriers to ownership and activity in the 1980s and 1990s. My own work (Ryan, 2012b) has suggested that patterns of domestic authority contestation may explain the evolving relationship between the SEC and its international counterparts on the issue of financial reporting standards, a topic that still requires more extensive examination. Above all, future bureaucracy-oriented research efforts in this area should focus on the Consumer Financial Protection Bureau (CFPB). The Bureau, which has been endowed with significant formal powers, presents us with a unique opportunity to witness how a new agency strives to build autonomy. For example, does it follow the model described by Carpenter: policy innovation, entrepreneurship, and an attempt to build program coalitions? Will it employ some other mix of strategies? And how successful will those strategies be? While we cannot definitively answer all of those questions so close in time to the establishment of a new organization, there is little question that the CFPB will prove an invaluable contemporary testing ground for the theories discussed in this project.

It will also be worth exploring if the theories discussed in this project can be applied to areas beyond financial regulation. Potentially fruitful topics for future research may include macroeconomic policy making and trade agreements, but other scholars may find that a mix of low electoral salience and visibility, high complexity as well as high costs for suboptimal policymaking – even if those costs are not necessarily as economically obvious as the costs in these areas – are commonplace in other policy domains. These may include highly technical but consequential policies such as drug safety; indeed, while not explicitly examining these conditions, Carpenter (2010c) does imply the study of the Food and Drug Administration (FDA) possesses a significant degree of autonomy. Beyond an expansion to new cases and policy dimensions, future research would also do well to draw out two of the other key issues discussed in this chapter – power path dependence and cultural capture. Indeed, a future iteration of this project will likely seek to focus more systematically on the path dependent power dynamics in financial services policymaking over the past thirty years, looking beyond bureaucracies to a broader range of actors. The cultural capture argument will require detailed sociological and ethnographic oriented research. However, if such a project is carefully conducted it will shed far greater light on financial services policymaking and will make a much-needed contribution to the public discourse regarding the prevalence

of ‘capture.’

## 6.5 Final Thoughts

Over the past thirty-plus years, federal regulators played a critical role in reshaping the financial services industry in the United States and, by extension, the global marketplace for financial products. Whether in the creation of an entirely new framework of prudential rules in the form of risk-based capital standards, preventing regulation of the OTC derivatives markets, or refusing to administer consolidated oversight over investment banks, there is little question that the actions of regulators helped to create the financial system we have today. Agencies such as the Federal Reserve and, to a more limited degree, the SEC and the FDIC, did so by leveraging their legitimacy and reputation for competency to induce a remarkable degree of deference from elected officials. They acted strategically to advance their authority when it was contested, making careful use of public rhetoric, as well as entrenching their influence through collaborative arrangements with transgovernmental counterparts and with the private sector. Moreover, their motivations for such actions were to a large degree self-directed, based on their unique missions and experiences, rather than as responses to external pressure from politicians, interest groups, or markets. In short, these regulators exercised independent authority over policy outcomes in a way that rendered many of them “autonomous.”

Whether these autonomous bureaucracies have advanced the ‘public interest’ is, of course, an entirely different question. In some cases, such as the Consolidated Entity Program, the answer seems to be a fairly obvious ‘no.’ More often, however, the answer is less clear, with much ultimately depending on the balance between risk and growth one finds acceptable. Perhaps a better way to pose the question then is to contemplate the alternatives. Would the public interest have been better served if legislators, lacking expertise, susceptible to swings in public opinion in crises, and vulnerable to the influence of particularized interests, exerted more direct control over policy? Alternately, would wholesale delegation to highly expert, industry-run groups have adequately contained risks or protected small investors and consumers? While the idea of unelected bureaucrats exercising political influence over such a central component of the U.S. economy might offend normative democratic theorists, policy making by regulators probably achieves a better balance between the need for expertise and a commitment to protecting the general interest than any of the alternatives. As Winston Churchill famously remarked “democracy is the worst form of government, except for all those other forms that have been tried from time to time”; in this case, perhaps much the same can be said about bureaucratic autonomy and financial services policymaking.

# References

- 59, 362 63 Fed. Reg., “OTC Derivatives Dealers,” Technical Report November 3 1998.
- Abbott, Kenneth W. and Duncan Snidal**, *The Politics of Global Regulation*, Princeton, NJ: Princeton University Press, 2009.
- Aberbach, Joel D. and Bert A. Rockman**, *In the Web of Politics: Three Decades of the U.S. Federal Executive*, Washington DC: Brookings Institution Press, 2000.
- Adler, Joe**, “Can ‘Living Wills’ Help Resolve Big Institutions?,” *American Banker*, November 9 2009, 174 (202).
- , “After Crisis, Still Battling Over Basel II,” *American Banker*, June 15 2011.
- , “FDIC Debt Program Proves as Good as Tarp, Without the Baggage,” *American Banker*, April 26 2012.
- , “Second CFPB Fight May Be Just as Contentious as First,” *American Banker*, January 24 2013.
- Akerlof, George A. and Rachel E. Kranton**, “Economics and Identity,” *Quarterly Journal of Economics*, August 2000, pp. 715–753.
- Akhavein, Jalal, W. Scott Frame, and Lawrence J. White**, “The Diffusion of Financial Innovations: An Examination of the Adoption of Small Business Credit Scoring by Large Banking Organizations,” *The Journal of Business*, March 2005, 78 (2), 577–596.
- Albert, Andrew**, “Bush Group Urges Reallocation of Powers; Fed Wins Expanded State Supervisory,” *The American Banker*, February 1 1984.
- Allen, James C.**, “Derivatives Dealers’ Self-Policing Viewed by End User as Self-Serving,” *The American Banker*, June 26 1995.
- , “Regulators Stepping on Toes In Moves on Derivatives Risk,” *The American Banker*, August 25 1995.
- Alt, James E. and Alberto Alesina**, *A New Handbook of Political Sciences*, New York: Oxford University Press, 1996.
- Altfeld, Michael F. and Gary J. Miller**, “Sources of Bureaucratic Influence: Expertise and Agenda Control,” 1984.
- Andrews, Edmund L.**, “Greenspan Concedes Error on Regulation,” *The New York Times*, October 23 2008.



## REFERENCES

---

- **and Louise Story**, “Regulators Push for Change At Two Troubled Big Banks,” *The New York Times*, June 6 2009, *Section B*.
- Ansolabehere, Stephen, John M. de Figueiredo, and James M Jr. Snyder**, “Why is there so little money in US politics?,” *Journal of Economic Perspectives*, 2003, 17 (1), 105–130.
- Appolonio, Dorie, Bruce Cain, and Lee Drutman**, “Access and Lobbying: Looking Beyond the Corruption Paradigm,” *Hastings Constitutional Law Quarterly Symposium*, February 29 2008.
- Arnold, R. Douglas**, *The Logic of Congressional Action*, New Haven, CT: Yale University Press, 1990.
- Arrighi, Giovanni**, *The Long Twentieth Century*, London, UK: Verso, 1994.
- Arthur, Brian W.**, *Increasing Returns and Path Dependence in the Economy*, Ann Arbor, MI: University of Michigan Press, 1994.
- Association, The Securities Industry**, *Securities Industry Fact Book 2002*, New York: Securities Industry Association, 2002.
- Awrey, Dan**, “Complexity, Innovation and the Regulation of Modern Financial Markets,” *Working Paper*, 2011.
- Bach, David and Abraham L. Newman**, “Transgovernmental Networks and Domestic Policy Convergence: Evidence from Insider Trading Regulation,” *International Organization*, 2010, 64, 505–528.
- Bachrach, Peter and Morton S. Baratz**, “Two Faces of Power,” *The American Political Science Review*, 1962, 56 (4), pp. 947–952.
- Baer, Herbert**, “Private Prices, Public Insurance: The Pricing of Federal Deposit Insurance,” *Federal Reserve Bank of Chicago Economic Perspectives*, September/October 1985, pp. 41–75.
- Bair, Sheila**, “Statement on Turmoil in the U.S. Credit Markets: Examining Recent Regulatory Responses to the Committee on Banking, Housing and Urban Affairs, U.S. Senate,” October 23 2008.
- Bair, Shelia**, *The Handbook of Derivatives and Synthetics*, New York: Cambridge University Press, 1994.
- , “Fix Rates to Save Loans,” *The New York Times*, October 17 2007.
- , “Remarks by FDIC Chairman Sheila Bair to the Exchequer Club of Washington D.C.,” in “in” Federal Deposit Insurance Corporation 2008.
- , “Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on Systemic Regulation, Prudential Measures, Resolution Authority and Securitization before the Financial Services Committee; U.S. House of Representatives, 2128 Rayburn House Office Building, Washington DC,” October 29 2009.
- , *Bull By the Horns: Fighting to Save Main Street From Wall Street and Wall Street From Itself*, New York: Free Press, 2012.
- Banker, The American**, “RMA Opposes CofC’s Proposed Redefinition of Bank Capital,” *The American Banker*, October 17 1980.
- , “Remember Risks of Innovation, Corrigan Warns,” *The American Banker*, June 10 1985.

## REFERENCES

---

- , “Garn Bill Likely to Spark Fierce Debate,” *The American Banker*, June 30 1986.
- , “Fed’s Greenspan Responds to Wide-Ranging Questions,” *The American Banker*, April 26 1990.
- , “GAO Says Congress Will Weigh Crackdown in ’95,” *The American Banker*, October 3 1994.
- Banks, Erik**, *Exchange Traded Derivatives*, Chichester, UK: John Wiley & Sons, 2005.
- Barbara, & March James G. Levitt**, “Organizational Learning,” *Annual Review of Sociology*, 1988, *19*, 319–340.
- Bardos, Jeffrey**, “The Risk-Based Capital Agreement: A Further Step Towards Policy Convergence,” *Federal Reserve Bank of New York Quarterly Review*, Winter 1987-1988, *26*.
- Barke, Richard P. and William H. Riker**, “A Political Theory of Regulation with Some Observations on Railway Abandonments,” 1982, *39* (1), 73–106–.
- Bartlett, Robert P.**, “Inefficiencies in the Information Thicket: A Case Study of Derivatives Disclosures During the Financial Crisis,” *Journal of Corporate Law*, 2010, *36*, 1.
- Battey, Phil**, “Fed Approves Definition of Capital; But FDIC Remains at Odds with the Other Regulators,” *The American Banker*, December 3 1981.
- Baumgartner, Frank and Bryan Jones**, *Agendas and Instabilities in American Politics*, Chicago: University of Chicago Press, 1993.
- Bawn, Kathleen**, “Political Control Versus Expertise: Congressional Choices about Administrative Procedures,” *American Political Science Review*, 1995, *89*, 62–73.
- , “Choosing Strategies to Control the Bureaucracy: Statutory Constraints, Oversight, and the Committee System,” *Journal of Law, Economics, and Organization*, 1997, *131* (1), 101–126.
- Becker, Gary S.**, “A Theory of Competition Among Pressure Groups for Political Influence,” *Quarterly Journal of Economics*, 1983, *98*, 371–400.
- Bendor, Jonathan and Adam Meirowitz**, “Spatial Models of Delegation,” *American Political Science Review*, 2004, *98* (2), 293–310.
- , **Serge Taylor, and Gaalen Roland Van**, “Politicians, Bureaucrats, and Asymmetric Information,” 1987, *31* (4), 796–828–.
- Benson, John D.**, “Ending the Turf Wars: Support for a CFTC/SEC Consolidation,” *Villanova Law Review*, 1991, *36*, 1175–1219.
- Bentley, Arthur F.**, *The Process of Government: A Study of Social Pressures*, Chicago, IL: University of Chicago Press, 1908.
- Berger, Allen N.**, “The Economic Effects of Technological Progress: Evidence from the Banking Industry,” *Journal of Money, Credit and Banking*, 2003, *35* (2-4), 123–194.

## REFERENCES

---

- , **Anil K. Kashyap, Joseph M. Scalise, Mark Gertler, and Benjamin M. Friedman**, “The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It’s Been,” 1995, *1995* (2), 55–218–.
- Berger, Suzanne**, “Globalization and Politics,” *Annual Review of Political Science*, 2000, 3, 43–62.
- Berman, Sheri**, *The Social Democratic Moment: Ideas and Politics in the Making of Interwar Europe*, Cambridge, MA: Harvard University Press., 1998.
- Bernstein, Marver H.**, *Regulating Business by Independent Commission*, Princeton, NJ: Princeton University Press, 1955.
- Bernstein, Peter L.**, *Capital Ideas: The Improbable Origins of Modern Wall Street*, New York: John Wiley & Sons, 2005.
- Berry, John M.**, “Divided on Derivatives; Greenspan, Buffet at Odds on Risks of the Financial Instruments,” *The Washington Post*, March 6 2003, p. E01.
- Bhargava, Rahul and Donald R Fraser**, “On the wealth and risk effects of commercial bank expansion into securities underwriting: An analysis of Section 20 subsidiaries,” *Journal of Banking & Finance*, 1998, 22 (4), 447–465.
- Bhatia, Ashok V.**, “Consolidated Regulation and Supervision in the United States,” *IMF Working Paper*, 2011, (11/23).
- Biggins, John and Colin Scott**, “Extending and Contracting Jurisdictions in a Transnational Private Regulatory Regime: Efficiency, Legitimacy, ISDA and the OTC Derivatives Markets,” *UCD Working Papers in Law, Criminology, and Socio-Legal Studies*, 2011, (51).
- BIS**, *Semiannual OTC derivatives statistics at end-June 2012*, Basel, Switzerland: Bank for International Settlements, 2012.
- Blackwell, Richard**, “OSC Head to Lead International Group,” *Toronto Globe and Mail*, March 23 2002, B3.
- Blackwell, Rob**, “Roots of the ABA-ICBA Clash Over Reg Reform,” *American Banker*, December 21 2010, 175 (195), 1.
- Block, Donna**, “Dodd offers new reform plan,” *The Deal*, March 15 2010.
- Blyth, Mark**, *Great transformations : economic ideas and institutional change in the twentieth century*, New York: Cambridge University Press, 2002.
- Board, Financial Stability**, *OTC Derivatives Market Reforms: Third Progress Report on Implementation*, Basel, Switzerland: Bank for International Settlements, June 15 2012.
- Boin, R. Arjen and Tom Christensen**, “The Development of Public Institutions: Reconsidering the Role of Leadership,” *Administration & Society*, 2008, 40 (3), 271–297.
- Bolton, Alexander**, “McConnell lacks support to block Wall Street reform bill,” April 15 2010.
- Borak, Donna**, “ABA: Capital Measures Pose High Risks,” *American Banker*, June 17 2010, 175 (93), 16.

## REFERENCES

---

- , “Fix to International Bank Regulation Posed as ‘Protectionism’ Fears Grow,” *American Banker*, February 19 2013.
- Braithwaite, John and Peter Drahos**, *Global Business Regulation*, Cambridge: Cambridge University Press, 2000.
- Brown, Carrie Budoff and Meredith Shiner**, “Dodd and Shelby strike Wall St. Deal,” *Politico*, May 5 2010.
- Brush, Silla**, “Voters support financial reform, but details mixed,” *The Hill*, April 4 2010.
- Bryner, G. C. (1987)**., *Discretion: Law and Policy in Federal Regulatory Agencies*, New York: Pergamon, 1987.
- Buser, Stephen A., Andrew H. Chen, and Edward J. Kane**, “Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital,” *The Journal of Finance*, March 1981, 35 (1), 51–60.
- Buthe, Tim**, “The Dynamics of Principals and Agents: Institutional Persistence and Change in U.S. Financial Regulation, 1934-2003,” *Working Paper*, March 2010.
- and **Walter Mattli**, *The New Global Rulers: The Privatization of Regulation in the World Economy*, Princeton, NJ: Princeton University Press, 2011.
- Calvert, Randall L., Mathew D. McCubbins, and Barry R. Weingast**, “A Theory of Political Control and Agency Discretion,” *American Journal of Political Science*, 1989, 33 (3), pp. 588–611.
- Carlucci, Richard**, “Harmonizing U.S. Securities and Futures Regulation,” *Brooklyn Journal of Corporate, Financial, and Commercial Law*, 2008, 2, 461–483.
- Carpenter, Daniel and David Moss**, *Preventing Regulatory Capture: Special Interest Influence and How to Limit It*, New York: Cambridge University Press, 2013.
- Carpenter, Daniel P.**, *The Forging of Bureaucratic Autonomy: Reputations, Networks, and Policy Innovation in Executive Agencies, 1862-1928*, Princeton, NJ: Princeton University Press, 2001.
- , “State Building through Reputation Building: Coalitions of Esteem and Program Innovation in the National Postal System, 1883-1913,” 2001, 14 (02), 121–155–.
- , “Groups, the Media, Agency Waiting Costs, and FDA Drug Approval,” *American Journal of Political Science*, 2002, 46 (2), 490–505.
- , *The Evolution of National Bureaucracy in the United States*, New York: Oxford University Press, 2005.
- , “The Contest of Lobbies and Disciplines: Financial Politics and Regulatory Reform in the Obama Administration,” in “in” Working Group on Obama’s Agenda and the Dynamics of U.S. Politics Russell Sage Foundation Russell Sage Foundation October 2010.
- , “Institutional Strangulation: Bureaucratic Politics and Financial Reform in the Obama Administration,” 2010, 8 (03), 825–846–.
- , *Reputation and power : organizational image and pharmaceutical regulation at the FDA*, Princeton: Princeton University Press, 2010.

## REFERENCES

---

- **and George A. Krause**, “Reputation and Public Administration,” *Public Administration Review*, 2012, 72 (1), 26–32.
- **and Michael M. Ting**, “Regulatory Errors with Endogenous Agendas,” 2007, 51 (4), 835–852–.
- Carrington, Tim**, “Volcker Apparently Blocks Effort to Cut Fed Authority Over Banks,” *The Wall Street Journal*, January 26 1984.
- Carron, Andrew S.**, “Banking on Change: The Reorganization of Financial Regulation,” *The Brookings Review*, 1984, 2 (3), 12–21.
- Carson, Teresa**, “CofC May Trim Definition of Capital, Lift Loan Limits,” *The American Banker*, July 24 1980, p. 1.
- Cassidy, John**, *How Markets Fail: The Logic of Economic Calamities*, New York: Farrar, Straus and Giroux, 2009.
- Caughey, Devin, Sara Chatfield, and Adam Cohon**, “Defining, Mapping, and Measuring Bureaucratic Autonomy,” April 2009. Paper presented at 2009 Midwest Political Science Association Conference.
- Cerny, Philip G.**, “The dynamics of financial globalization: Technology, market structure, and policy response,” *Policy Sciences*, 1994, 27, 319–342. 10.1007/BF01000063.
- CFTC**, “Policy Statement Concerning Over-the-Counter Derivatives,” *Federal Register*, May 12 1998, 63 (91).
- Chakravorti, Bob**, “The Current and Historical Organization of Finance, Presentation at the Brookings Institution,” December 4 2012.
- Chan, Yuk-Shee, Stuart I. Greenbaum, and Anjan V. Thakor**, “Is Fairly Priced Deposit Insurance Possible?,” *The Journal of Finance*, March 1992, 47 (1), 227–245.
- Chander, Anupam and Randall Costa**, “Clearing Credit Default Swaps: A Case Study in Global Legal Convergence,” *Chicago Journal of International Law*, 2010, 10 (639).
- Chaplinsky, Susan and Gayle R. Erwin**, “Great Expectations: Banks as Equity Underwriters,” *Working Paper*, 2005.
- Che, Yeon-Koo**, “Revolving Doors and the Optimal Tolerance for Agency Collusion,” *The Rand Journal of Economics*, 1995, pp. 378–397.
- Chell, Gretchen**, “Garn Hits Idea of Continued Fed Regulation,” *The American Banker*, February 7 1984.
- Choi, Stephen J. and Andrew T. Guzman**, “National Laws, International Money: Regulation in a Global Capital Market,” *Fordham Law Review*, 1997, 65, 1855–1908.
- Christian, James W, Robert Shapiro, and John-Paul Whalen**, “Naked short selling: How exposed are investors,” *Housing Law Review*, 2006, 43, 1033.
- Christman, John**, *The Stanford Encyclopedia of Philosophy*, winter 2008 ed. 2008.

## REFERENCES

---

- Coffee, John C.**, "Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation," *Business Law Review*, 1995, 50, 447–484.
- , "Law and the Market: The Impact of Enforcement," *University of Pennsylvania Law Review*, 2007, p. 229.
- **and Hillary A. Sale**, "Redesigning the SEC: Does Treasury Have a Better Idea?," *Virginia Law Review*, 2009, 95 (4), 707–783.
- Cohen, Jeffrey E.**, "The Dynamics of the "Revolving Door" on the FCC," *American Journal of Political Science*, 1986, 30, 689–708.
- Cole, Rebel A. and Jeffrey W. Gunther**, "A CAMEL Rating's Shelf Life," *Federal Reserve Bank of Dallas Financial Industry Studies*, December 1995.
- Conte, Christopher**, "U.S. Weighs Added Premium for Insuring Savings Banks That it Fears Might Fail," *The Wall Street Journal*, November 3 1982, p. 2.
- Cope, Debra**, "Capital: Global Meeting Soon on Securities Ratios," *The American Banker*, October 1 1991.
- Cornett, Marcia Millon, Hamid Mehran, and Hassan Tehranian**, "The Impact of Risk-Based Premiums on FDIC-Insured Institutions," *Journal of Financial Services Research*, 1998, 13 (2), 153–169.
- Cox, Christopher**, "Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions Before the Committee on Banking, Housing, and Urban Affairs, United States Senate," September 23 2008.
- Crotty, James**, "If Financial Market Competition is so Intense, Why are Financial Firm Profits so High? Reflections on the Current 'Golden Age' of Finance," *Political Economy Research Institute Working Paper*, April 2007, (134).
- Cuccia, Christine**, "Informational Assymetry and OTC Transactions: Understanding the Need to Regulate Derivatives," *Delaware Journal of Corporate Law*, 1997, 22, 197–221.
- Culp, Christopher L.**, "Regulatory Uncertainty and the Economics of Derivatives Regulation," *The Financier*, December 1995, 2 (5).
- , *Restructuring Regulation and Financial Institutions*, Santa Monica, CA: Milken Institute Press, 2000.
- **and Robert J. Mackay**, "Regulating Derivatives: The Current System and Proposed Changes," *CATO Regulation*, 1994.
- Cummins, Claudia**, "BIS Sees New Risks in Derivatives; Central-Bank Group Urges Closer Global Monitoring," *The American Banker*, November 2 1992.
- , "Phillips Fears 'Overreaction' on Swaps," *The American Banker*, December 4 1992.
- , "Clinton's Nominee for SEC Vows Cooperation with Other Agencies," *The American Banker*, July 14 1993.
- , "Fed Taking Closer Look at Risk in Swaps Market," *The American Banker*, March 4 1993.

## REFERENCES

---

- , “Futures Commission Exempts Swaps,” *The American Banker*, January 15 1993.
- , “Lawmaker Calls for Reuglators to Tighten Control of Derivatives,” *The American Banker*, November 23 1993.
- , “SEC Reviewing Its Rules on Capital for Swap Trades,” *The American Banker*, May 10 1993.
- , “Fed Governor Says Regulators Eyeing Risk Measures for Swaps,” *The American Banker*, February 25 1994.
- , “Fed Sees No Sign of Threat in Banks’ Derivatives Use,” *The American Banker*, April 26 1994.
- , “Gonzalez Seeks More Oversight of Swaps,” *The American Banker*, April 13 1994.
- , “Greenspan Calls for Derivatives Data to Develop Policies to Reduce Risk,” *The American Banker*, March 11 1994.
- , “OCC Eyes Lid on Use of Swaps By Banks,” *The American Banker*, April 21 1994.
- , “Regulators to Congress: Hold Off on Swaps Bill,” *The American Banker*, May 26 1994.
- **and Robert Garsson**, “Fed to Give Examiners Guidelines on Swaps,” *The American Banker*, 1993.
- Cunningham, Daniel P. and William P. Rogers**, “Netting is the Law,” *Advanced Swaps and Derivative Financial Products*, 1991, (746), 177.
- D., Noll Roger G. McCubbins Mathew and Barry R. Weingast**, “Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies,” *Virginia Law Review*, 1989, 75, 431–482.
- Dahl, Robert A.**, “The concept of power,” *Behavioral Science*, 1957, 2 (3), 201–215.
- Dale, Richard**, *The Regulation of International Banking*, Cambridge, UK: Woodhead-Faulkner, 1984.
- , *Risk and Regulation in Global Securities Markets*, New York: Wiley, 1996.
- Darby, Michael R.**, “Over-the-Counter Derivatives and Systemic Risk to the Global Financial System,” *NBER Working Paper Series*, July 1994, (4801), 1–33.
- Davenport, Todd**, “Bair on I-Banks: Set Up a Receivership Program,” *American Banker*, June 19 2008, 173 (118), 118.
- Davis, Paul**, “Ramifications of Reform: TARP Takers Face Tier 1 Exclusions,” *American Banker*, June 10 2010.
- Davis, Steven I.**, *Investment Banking: Addressing the Management Issues*, New York: Palgrave, 2003.
- de Mesquita, Bueno B.**, *Counterfactual Thought Experiments in World Politics*, Princeton, NJ: Princeton University Press, 1996.
- deHaan, Ed, Kevin Koh, Simi Kedia, and Shivaram Rajgopal**, “Does the Revolving Door Affect the SEC’s Enforcement Outcomes?,” *Working Paper*, October 2012.

## REFERENCES

---

- Demirguc-Kunt, Asli and Edward J. Kane**, “Deposit Insurance Around the Globe: Where Does It Work?,” *The Journal of Economic Perspectives*, 2002, 16 (2), 175–195.
- **and Harry Huizinga**, “Determinants of Commercial Bank Interest Margins and Profitability: Some International Evidence,” *World Bank Economic Review*, 1999, 13.
- , **Baybars Karacaovali, and Luc Laeven**, “Deposit Insurance Around the World: A Comprehensive Database,” *World Bank Policy Research Working Paper*, 2005, (3628), 1–79.
- Demsetz, Rebecca and Philip Strahan**, “Historical Patterns and Recent Changes in the Relationship Between Bank Holding Company Size and Risk,” *Federal Reserve Bank of New York Economic Policy Review*, July 1995, 1 (2).
- Derthick, Martha and Paul J. Quirk**, *The Politics of Deregulation*, Washington DC: The Brookings Institution, 1985.
- deSenerpont Domis, Olaf**, “Bankers Lobby Hard Against Bills to Curb Derivatives Activity,” *The American Banker*, September 13 1994.
- , “Curbing Derivatives Would Curb Credit, Panel Told,” *The American Banker*, January 9 1995.
- deSwaan, Tom**, “Capital Regulation: The Road Ahead,” *FRBNY Economic Policy Review*, 1998, 4 (3), 231–235.
- Dimson, Elroy and Paul Marsh**, “Capital Requirements for Securities Firms,” *The Journal of Finance*, July 1995, 1 (3), 821–851.
- **and —** , “Stress Tests of Capital Requirements,” *Working Paper. Wharton Financial Institutions Center*, 1996, (95-50).
- Drezner, Daniel W.**, *All Politics is Global*, Princeton, NJ: Princeton University Press, 2007.
- Drutman, Lee**, “The Complexities of Lobbying: Toward a Deeper Understanding of the Profession,” *PS: Political Science*, October 2010, pp. 834–837.
- D’Souza, Frank, Nan S. Ellis, and Lisa M. Fairchild**, “Illuminating the Need for Regulation in Dark Markets: Proposed Regulation of the OTC Derivatives Market,” *University of Pennsylvania Journal of Business Law*, 2009-2010, 12, 473–517.
- Duffie, Darrell**, “Derivatives and Mass Financial Destruction,” *Wall Street Journal*, October 22 2008, p. A17.
- Duffy, John J.**, “Capital Rules Will Fortify Banks,” *American Banker*, January 20 1987.
- Dwyer, Paula**, “Arthur Levitt’s Hardball at the SEC: The SEC Chairman is Stepping on Toes. Is That Really Such a Bad Thing?,” *Business Week*, September 29 1997.
- Eaglesham, Jean and Telis Demos**, “SEC Chief Delayed Rule Over Legacy Concerns,” *The Wall Street Journal*, December 2 2012.
- Easton, Nina**, “Briefing: Bacon, Eggs, and Banking Talk,” *The American Banker*, February 24 1986.



## REFERENCES

---

- , “FDIC Study Says Risk-Based Plan Could Reduce Capital Overall,” *The American Banker*, April 21 1986.
- , “Justice Department Urges Fed to Amend Risk-Based Proposal,” *American Banker*, May 29 1986.
- Economides, Nicholas, R. Glenn Hubbard, and Darius Palia**, “The Political Economy of Branching Restrictions and Deposit Insurance: A Model of Monopolistic Competition among Small and Large Banks,” 1996, *39* (2), 667–704.
- Economist**, “Bump in the Night,” *The Economist*, July 24 1993.
- Edwards, Franklin R.**, *Changing Capital Markets: Implications for Monetary Policy*, Kansas City, MO: Federal Reserve Bank of Kansas City, 1993.
- , *The New Finance: Regulation and Financial Stability*, Washington, DC: American Enterprise Institute for Public Policy Research, 1996.
- Edwards, Franklin R and Frederic S Mishkin**, “The Decline of Traditional Banking: Implications for Financial Stability and Regulatory Policy,” Technical Report, National Bureau of Economic Research 1995.
- Ehlen, James G.**, “A Review of Bank Capital and Its Adequacy,” *Federal Reserve Bank of Atlanta Economic Review*, 1983, *68* (11).
- Eisenstadt, S. N.**, “Bureaucracy and Bureaucratization,” in S. N. Eisenstadt, ed., *Essays on comparative institutions*, New York, J. Wiley, 1965, pp. xiii, 376 p.
- Eisner, Marc Allen**, *Antitrust and the Triumph of Economics: Institutions, Expertise & Policy Change*, Chapel Hill, NC: University of North Carolina Press, 1991.
- , “Bureaucratic Professionalization and the Limits of the Political Control Thesis: The Case of the Federal Trade Commission,” *Governance*, 1993, *6* (2), 127–153.
- Elliott, Douglas**, “Choosing Among Macroprudential Tools,” Technical Report, The Brookings Institution June 7 2011.
- Elliott, Douglas J.**, “Basel III, the Banks, and the Economy,” *The Brookings Institution Research Papers*, July 2010.
- , “A Primer on Bank Capital,” *Brookings Institution Research Paper*, January 28 2010.
- Ely, Bert**, “Yes - Private Sector Depositor Protection is a Viable Alternative to Federal Deposit Insurance,” *Proceedings from a Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago, May 1985, pp. 335–353.
- Eppel, Desmond**, “Risky Business: Responding to OTC Derivative Crises,” *The American Banker*, 2001-2002, *40*, 677–703.
- Epstein, David and Sharyn O’Halloran**, “Administrative Procedures, Information, and Agency Discretion: Slack vs. Flexibility,” *American Journal of Political Science*, 1994, *38* (3), 697–722.
- and —, *Delegating Powers*, New York: Cambridge University Press, 1999.

## REFERENCES

---

- Epstein, Gerald**, “Financialization, Rentier Interests, and Central Bank Policy,” *Working Paper*, December 2001.
- Epstein, Julian**, “The Other Side of Harmony: Can Trade and Competition Laws Work Together in the International Marketplace?,” *American University International Law Review*, 2002, 17.
- Esty, Benjamin C.**, “The Impact of Contingent Liability on Commercial Bank Risk Taking,” *Journal of Financial Economics*, 1998, 47 (2), 189–218.
- Evanoff, Douglas and Larry Wall**, “Subordinated Debt and Bank Capital Reform,” *Economic Perspectives: Federal Reserve Bank of Chicago*, 2000, pp. 40–53.
- Evans, Christian**, “The Dodd-Frank Wall Street Reform and Consumer Protection Act: A Missed Opportunity to Rein in Too-Big-to-Fail Banks,” *Duquesne Business Law Journal*, 2011, 13, 43.
- Evans, Peter**, *Embedded Autonomy: States and Industrial Transformation*, Princeton, NJ: Princeton University Press, 1995.
- Faerman, Sue R., David P. McCaffrey, and David M. van Slyke**, “Understanding Interorganizational Cooperation: Public-Private Collaboration in Regulating Financial Market Innovation,” *Organization Science*, 2001, 12 (3), pp. 372–388.
- FDIC**, “Risk Related Program,” *FDIC Discussion Paper*, September 20 1985.
- , *An Examination of the Banking Crises of the 1980s and Early 1990s*, Washington DC: Federal Deposit Insurance Corporation, 1997.
- Fearon, James D.**, “Counterfactuals and Hypothesis Testing in Political Science,” *World Politics*, 1991, 43 (2), 169–195.
- Federal Open Markets Committee, Board of Governors of the Federal Reserve System, FOMC January 30-31 Meeting** January 1984.
- , *FOMC July 16-17 Meeting* July 1984.
- , *FOMC August 21 Meeting* August 1990.
- , *FOMC December 18 Meeting* December 1990.
- Feldman, Martha**, *Order without Design: Information Production and Policymaking*, Stanford, CA: Stanford University Press, 1989.
- Ferris, Stephen P, Janine S Hiller, Karen C Denning, and Glenn Wolfe**, “Encouragement of Innovation through Regulation of Equality of Access to the Capital Market, The,” *DePaul Business Law Journal*, 1992, 5, 237.
- Figlewski, Stephen**, “How to Lose Money in Derivatives,” *The Journal of Derivatives*, Winter 1994, 2 (2).
- Fiorina, Morris P.**, “Congressional Control of the Bureaucracy: A Mismatch of Incentives and Capabilities,” in Lawrence Dodd and Bruce Oppenheimer, eds., *Congress Reconsidered*, Washington, DC: Congressional Quarterly Press, 1981, pp. 332–348–.

## REFERENCES

---

- , *Congress: Keystone of the Washington establishment*, 2 ed., New Haven, CT: Yale, 1989.
- Fisch, Jill E.**, “Top Cop or Regulatory Flop? The SEC at 75,” *Virginia Law Review*, 2009, 95 (4), 785–823.
- Fisher, Max**, “GOP Searches for Strategy on Financial Reform,” April 21 2010.
- Fisher, Richard W.**, ““Ending Too Big to Fail: A Proposal for Reform Before It’s Too Late (With Reference to Patrick Henry, Complexity and Reality),” Speech by Richard W. Fisher, President of the Federal Reserve Bank of Dallas,” Technical Report, Federal Reserve Bank of Dallas January 16 2013.
- Flanagan, Sean M.**, “The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association,” *Harvard Negotiation Law Review*, 2001, 6, 211–264.
- Fligstein, Neil**, *The Transformation of Corporate Control*, Cambridge, MA: Harvard University Press, 1990.
- , *The Architecture of Markets: An Economic Sociology of Twenty-First-Century Capitalist Societies*, Princeton, NJ: Princeton University Press, 2001.
- Fombrun, Charles J.**, *Reputation: Realizing Value from the Corporate Image*, Harvard Business School Press, 1996.
- Ford, Christie L.**, “Toward a New Model for Securities Law Enforcement,” *Administrative Law Review* 2005, 2005, 57, 757.
- Forde, John P.**, “Regulators Unite Behind Risk-Based Capital at Forum,” *The American Banker*, September 19 1985.
- , “Bankers Cautious on Fed Capital Guidelines; Money Center Banks, Likely to Be Most Affected, Raise Questions as to Timing and Method,” *The American Banker*, February 3 1986.
- , “Rate Swap Dealers Form Trade Group as Industry Boom Continues,” *The American Banker*, March 8 1986.
- , “Off-Balance Sheet Items are Piling Up; Total Commitments Exceed 1 Trillion at Top Five Banks,” *The American Banker*, May 11 1987.
- Fourcade, Marian**, *Economists and Societies: Discipline and Profession in the United States, Britain & France, 1890s to 1990s*, Princeton, NJ: Princeton University Press, 2009.
- Fox, Justin**, “Banks Say Trading Set-Asides Tilt Field in Nonbanks,” *American Banker*, September 22 1995.
- Frame, W. Scott and Lawrence J. White**, “Empirical Studies of Financial Innovation: Lots of Talk, Little Action?,” *Journal of Economic Literature*, March 2004, 52, 116–144.
- Fraust, Bart**, “Seidman Opposes Volcker on Risk Plan,” *American Banker*, November 21 1985, p. 1.
- Friedman, Barry**, “Federalism’s Future in the Global Village,” *Vanderbilt Law Review*, 1994, pp. 1441–1484.
- Fromson, Brett D.**, “Hooked on Derivatives; Wall Street’s Snapping Up Profits on the Contracts, but Clients Feel the Bite,” *The Washington Post*, March 12 1995.

## REFERENCES

---

- Frontline, PBS**, “The Warning,” *PBS Frontline Documentary Series Transcript*, October 20 2009.
- FSA**, “Consultation Paper 204,” Technical Report, U.K. Financial Services Authority 2003.
- G-30**, *Derivatives: Practices and Principles*, Washington, DC: Group of Thirty, 1993.
- Gadinis, Stavros**, “The Politics of Competition in International Financial Regulation,” *Harvard International Law Journal*, 2008, 49 (2), 447–507.
- Gailmard, Sean**, “Expertise, Subversion, and Bureaucratic Discretion,” *Journal of Law, Economics, and Organization*, 2002, 18 (2), 536–555.
- **and John W. Patty**, “Slackers and Zealots: Civil Service, Policy Discretion, and Bureaucratic Expertise,” *American Journal of Political Science*, 2007, 51 (4), 873–889.
- **and —**, “Learning While Governing: Information, Accountability, and Executive Branch Institutions,” January 2012.
- Gande, Amar, Manju Puri, and Anthony Saunders**, “Bank entry, competition, and the market for corporate securities underwriting,” *Journal of Financial Economics*, 1999, 54 (2), 165–195.
- GAO**, *Regulation of the Commodity Futures Markets: What Needs to Be Done*, Washington, DC: Government Accountability Office, May 17 1978.
- , *Financial Derivatives: Actions Needed to Protect the Financial System*, Washington, DC: Government Accountability Office, May 19 1994.
- , *Response to the International Swaps and Derivatives Association Position Paper*, Washington, DC: Government Accountability Office, 1994.
- , *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systematic Risk*, Washington, DC: Government Accountability Office, October 1999.
- , *SEC Operations: Implications of Alternative Funding Structures*, Washington, DC: Government Accountability Office, July 2002.
- , *SEC Operations: Increased Workload Creates Challenges*, Washington, DC: Government Accountability Office, March 2002.
- Gapper, John**, “Banks Criticise New Basle Committee Plan,” *Financial Times*, December 13 1993.
- Garcia, Gillian**, “Deposit Insurance: Actual and Best Practices,” *IMF Working Paper*, 1999, 99 (54).
- Garsson, Robert**, “Financial Reform Unscathed by Drexel Failure, SEC Says,” *The American Banker*, March 5 1990.
- , “Key House Member Will Draft Bill To Control Risks from Derivatives,” *The American Banker*, May 20 1994.
- , “Lots at Stake for Industry in Congressional Contests,” *The American Banker*, November 2 1994.

## REFERENCES

---

- **and Barbara Rehm**, “Bankers Fear GAO Report May Spur Swaps Crackdown,” *The American Banker*, May 14 1994.
- **and Bartlett Naylor**, “Garn Bill Nears Reckoning Day,” *The American Banker*, July 21 1986.
- **and Olaf deSenerpont Domis**, “GOP Win Looks Good for Banks; Major Shifts in Store for Key Congressional Committees,” *The American Banker*, November 10 1994.
- **and —**, “Leach Attacks Clinton Plan for Underwriting As Too Risky,” *The American Banker*, March 1 1995.
- Garver, Rob**, “Top Ratings Agencies Unanimous in Basel Opposition,” *American Banker*, April 4 2000.
- , “Basel Battle Begins for OCC, Fed, Congress,” *The American Banker*, February 28 2003.
- , “Basel Prompts FDIC to Query Fed, OCC,” *The American Banker*, June 17 2003.
- Gaventa, John**, *Power and Powerlessness: Quiescence and Rebellion in an Appalachian Valley*, Chicago, IL: University of Illinois Press, 1980.
- Gerring, John**, “What is a Case Study and What is it Good For?,” *American Political Science Review*, 2004, 98 (2), 341–354.
- , *The Oxford Handbook of Political Methodology*, New York: Oxford University Press, 2008.
- Getter, Darryl E.**, “U.S. Implementation of the Basel Capital Regulatory Framework,” *Congressional Research Service Report for Congress*, November 14 2012.
- Gibson, Michael S.**, “Credit Derivatives and Risk Management,” *Finance and Economics Discussion Series Division of Research and Statistics and Monetary Affairs, Federal Reserve Board*, 2007.
- Gibson, Willa E.**, “Investors, Look Before You Leap: The Suitability Doctrine is Not Suitable for OTC Derivatives Dealers,” *Loyola University of Chicago Law Journal*, 1997-1998, 29, 527–582.
- Gioia, Dennis A., Majken Schultz, and Kevin G. Corley**, “Organizational Identity, Image, and Adaptive Instability,” *The Academy of Management Review*, 2000, 25 (1), pp. 63–81.
- Goldberg, Lawrence G, Gerald A Hanweck, Michael Keenan, and Allan Young**, “Economies of Scale and Scope in the Securities Industry,” *Journal of Banking and Finance*, 1991, 15 (1), 91–107.
- Golden, Marissa Martino**, *What Motivates Bureaucrats? Politics and Administration During the Reagan Years*, New York: Columbia University Press, 2000.
- Goodin, Robert E.**, *Political Theory and Public Policy*, Chicago: University of Chicago Press, 1982.
- Goodman, Peter S.**, “Taking Hard New Look at a Greenspan Legacy,” *The New York Times*, October 8 2008.
- Goodsell, Charles T.**, “The Grace Commission: Seeking Efficiency for the Whole People?,” *Public Administration Review*, 1984, 44 (3).

## REFERENCES

---

- Gormley, William T. Jr.**, “A Test of the Revolving Door Hypothesis at the FCC,” *American Journal of Political Science*, 1979, 23 (4), pp. 665–683.
- , *Taming the Bureaucracy*, Princeton, NJ: Princ, 1989.
- Gorton, Gary**, “The Panic of 2007,” *Paper presented at the Federal Reserve Bank of Kansas City, Jackson Hole Conference*, August 2008, pp. 20–34.
- Graham, George**, “Bankers’ Weight Loss,” *Financial Times*, April 4 1997.
- , “Fresh Drive to Reform Bank Capital Rules,” *Financial Times*, May 14 1999.
- Gramm, Wendy L.**, “Soothing Words About Derivatives; Futures Regulator Says Risks Have Been Exaggerated,” *The American Banker*, September 21 1992.
- Greenberger, Michael**, *The Political Handbook of Financial Crises*, New York: Oxford University Press, 2011.
- Greenlee, Mark B.**, “Historical Review of “Umbrella Supervision” by the Board of Governors of the Federal Reserve System,” Technical Report 08-07, Federal Reserve Bank of Cleveland Working Paper October 2008.
- Greenspan, Alan**, “Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Agriculture, US House of Representatives,” June 14 1988.
- , “Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve Board, before the Senate Committee on Banking, Housing and Urban Affairs,” 1988.
- , “Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Agriculture, Nutrition, and Forestry, US Senate,” May 8 1990.
- , “Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Agriculture, Nutrition, and Forestry, US Senate,” February 7 1991.
- , “Remarks before the Garn Institute of Finance, University of Utah, Salt Lake City, UT,” 1994.
- , “Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Telecommunications and Finance, US House of Representatives,” 1994.
- , “What Should Regulators Do?,” *Journal of Lending and Credit Risk Management*, 1996, 78 (14), 1996.
- , “The Evolution of Bank Supervision: Remarks to the American Bankers Association, Phoenix, AZ,” October 11 1999.
- , “Remarks Before the Futures Industry Association,” March 19 1999.
- Grim, Ryan**, “Moneyed Interests Lining Up For Battle Over Accounting Standards,” *Huffington Post*, March 18 2009.
- Groenleer, Martijn**, “The Autonomy of European Union Agencies: A Comparative Study of Institutional Development,” Master’s thesis, University of Leiden 2009.

## REFERENCES

---

- Grubel, Herbert**, "A Proposal for an International Deposit Insurance Corporation," *Princeton Essays in International Finance*, July 1979, (133).
- Hacker, Jacob S. and Paul Pierson**, "Business Power and Social Policy: Employers and the Formation of the American Welfare State," *Politics and Society*, 2002, 30, 277–324.
- and —, "Winner-Take-All Politics: Public Policy, Political Organization, and the Precipitous Rise of Top Incomes in the United States," *Politics & Society*, 2010, 38 (2), 152–204.
- Hacker, Jacob S and Paul Pierson**, *Winner-Take-All Politics: How Washington Made the Rich Richer - and Turned Its Back on the Middle Class*, New York: Simon & Schuster, 2011.
- Hall, Peter A.**, "Policy Paradigms, Social Learning, and the State," *Comparative Politics*, 1993, 25 (3), 275–296.
- Halstead, John M., Shantaram Hegde, and Linda Schmid Klein**, "Orange Country Bankruptcy: Financial Contagion in the Municipal Bond and Bank Equity Markets," *The Financial Review*, 2004, 39, 293–315.
- Hammond, Thomas H. and Jack H. Knott**, "Who Controls the Bureaucracy?: Presidential Power, Congressional Dominance, Legal Constraints, and Bureaucratic Autonomy in a Model of Multi-Institutional Policy-Making," *Journal of Law, Economics & Organization*, 1996, 12 (1), 119–166.
- Hansel, Saul**, "Regulators Mute Their Fears Over Derivatives," *The New York Times*, February 28 1994.
- Hansell, Saul**, "Market Place; Group Approves Use of Derivatives," *The New York Times*, July 22 1993.
- , "New York Fed's President Resigning," *The New York Times*, January 6 1993.
- Harrington, Shannon D.**, "DTCC May Raise Credit-Default Swap Disclosure Amid Criticism," *Bloomberg*, October 31 2008.
- Harris, Clay**, "Calls to Revise Banks' Capital Adequacy Rules," *Financial Times*, September 22 1998.
- Hawke, John D.**, "Remarks of the Comptroller of the Currency to the International Monetary Conference, Philadelphia, PA," June 8 1999.
- Heap, Peter**, "Regulation: Industry's Regulatory Push Has Killed Momentum for Legislation, SEC's McGuire Says," *The Bond Buyer*, December 19 1995.
- Heclo, Hugh**, "OMB and the Presidency - The Problem of Neutral Competence," *The Public Interest*, 1975, 38, 80–99.
- Heggstad, Arnold A. and Frank B. King**, "Regulation of Bank Capital: An Evaluation," *Federal Reserve Bank of Atlanta Economic Review*, 1982, 67 (3).
- Helleiner, Eric**, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s*, Ithaca, NY: Cornell University Press, 1994.
- and **Stefano Pagliari**, "The End of An Era in International Financial Regulation? A Postcrisis Research Agenda," *International Organization*, 2011, 65, 169–200.

## REFERENCES

---

- Heller, Michele**, “Shelby Plans Hearing on Overhauling Regulators; Says Regulatory Relief Drive Raises Questions About the System,” *American Banker*, March 25 2003.
- Hemel, Daniel Jacob**, “Regulatory Consolidation and Cross-Border Coordination: Challenging the Conventional Wisdom,” *Yale Journal on Regulation*, 2011, 28 (1), 213–251.
- Hempel, George H.**, *Bank Capital*, Boston, MA: Bankers Publishing Company, 1976.
- Hendrickson, Jill M.**, “The Long and Bumpy Road to Glass-Steagall Reform: A Historical and Evolutionary Analysis of Banking Legislation,” 2001, 60 (4), 849–879–.
- Herring, Richard J.**, “The Rocky Road to Implementation of Basel II in the United States,” *Atlantic Economic Journal*, 2007, 35, 411–429.
- Hershey, Robert. D. Jr.**, “Economic Scene: Rating Banks for Insurance,” *New York Times*, September 25 1985, p. D2.
- Hill, Jeffrey and Kenneth Williams**, “The decline of private bills: Resource allocation, credit claiming, and the decision to delegate,” *American Journal of Political Science*, 1993, 37 (4), 1008–1031.
- Hirschhorn, Eric**, “Developing a Proposal for Risk-Related Deposit Insurance,” *Banking and Economic Review*, 1986, 4, 3–10.
- Ho, Karen**, *Liquidated: An Ethnography of Wall Street*, Durham, NC: Duke University Press, 2009.
- Holland, Kelley**, “Swap Market Unnerved by Credit Risks,” *The American Banker*, December 9 1991.
- , “Corrigan Cultivates Role as Defender of the Fed,” *The American Banker*, 1992.
- , “Corrigan Sides with Bankers on Regulation of Swaps,” *The American Banker*, June 5 1992.
- Holzer, Jessica and Andrew Ackerman**, “SEC Addressing Gaps in Analysis,” *The Wall Street Journal*, April 16 2012.
- Hopkins, Cheyenne and Stacy Kaper**, “Unresolved Issues Haunt Systemic Bill; Lawmakers to spar over Fed power and fund for resolutions,” *America*, November 4 2009, 1 (174).
- Horowitz, Jed**, “Chase Swap Run Afoul of Regulators,” *The American Banker*, December 17 1987.
- , “Swap Product from Chase Draws Scrutiny,” *The American Banker*, April 23 1987.
- , “Bankers and Brokers Gear Up for Action in Fledgling Market for Commodity Swaps,” *The American Banker*, July 20 1989.
- Hu, Henry T. C.**, “The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm,” *University of Pennsylvania Law Review*, December 1989, 138 (2), 333–435.
- , “Sellers Remorse and OTC Derivatives,” *International Finance Law Review*, 1995, 14, 43–45.
- Hu, Henry T.C.**, “Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism,” *Yale Law Journal*, April 1993, 102 (6), 1457–1513.



## REFERENCES

---

- Huber, John and Nolan McCarty**, “Bureaucratic Capacity, Delegation, and Political Reform,” *American Political Science Review*, 2004, 98 (3), 481–494.
- Huber, John D. and Charles R. Shipan**, *Deliberate Discretion?*, New York: Cambridge University Press, 2002.
- Hughes, Joseph P, William W Lang, Loretta J Mester, and Choon-Geol Moon**, “The Dollars and Sense of Bank Consolidation,” *Journal of Banking and Finance*, 1999, 23 (2), 291–324.
- Hume, Lynn S.**, “Derivatives Market Warned Against Actions That Could Lead to Bill,” *The Bond Buyer*, April 4 1994.
- Hyneman, Charles S.**, *Bureaucracy in a democracy*, New York,: Harper, 1950.
- Indiviglio, Daniel**, “5 Ways Lobbyists Influenced the Dodd-Frank Bill,” *The Atlantic*, July 5 2010.
- IOSCO**, “Capital Adequacy Standards for Securities Firms. Report of the Technical Committee,” 1989.
- Isaac, William M.**, “Letter and Discussion Paper to FDIC Insured Banks,” September 23 1985.
- ISDA**, *Join ISDA*, Washington, DC: International Swaps and Derivatives Association, 2012.
- Jackson, Howell E.**, “Variations in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications,” *Yale Journal on Regulation*, 2007, p. 253.
- Jackson, Meredith S.**, “Leap of Faith: Asset-Based Lending to Asset-Backed Securitization - A Case Study,” *Stanford Journal of Law and Business Finance*, 1995-1996, 2, 193–210.
- Jackson, Patricia, Pamela Nickell, and William Perraudin**, “Credit Risk Modelling,” *Financial Stability Review (Bank of England)*, 1999, 6, 94–121.
- Jacobs, Alan M.**, “How Do Ideas Matter? Mental Models and Attention in German Pension Politics,” *Comparative Political Studies*, 2009, 42 (2), 2552–279.
- Jamroz, Michael P.**, “The Net Capital Rule,” *Business Law*, 1991-1992, 47, 863–912.
- Johnson, Philip M. and Thomas L. Hazen**, *Commodities Regulation*, Vol. 1, New York: Little, Brown, 1989.
- Johnson, Robert B.**, *The Economics of the Euro-Market: History, Theory, and Policy*, New York: St. Martin’s Press, 1983.
- Johnson, Simon and James Kwak**, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*, New York: Pantheon Books, 2010.
- Jones, David**, “Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues,” *Journal of Banking and Finance*, 2000, 24 (1-2), 35–58.
- Jones, Kenneth D. and Tim Critchfield**, “Consolidation in the U.S. Banking Industry: Is the “Long Strange Trip” About to End?,” *FDIC Working Paper*, 2005.

## REFERENCES

---

- Jones, Renee M.**, “Will the SEC Survive Financial Regulatory Reform?,” *University of Pittsburgh Law Review*, 2009-2010, 71, 609–624.
- Journal, The National**, “Levitt Supportive Of Leach Bank Bill, But Lists Concerns,” *The National Journal*, March 16 1995.
- Journal, Wall Street**, “Regulation Urged on Derivatives; Bankers Seeking Global Self-Policing,” *Wall Street Journal*, July 23 1993.
- Kane, Edward J.**, “Regulatory Structure in Futures Markets: Jurisdictional Competition Among the SEC, the CFTC, and Other Agencies,” 1984, *No. 1331*, –.
- , “Changing incentives facing financial-services regulators,” 1989, 2 (3), 265–274–.
- , “De Jure Interstate Banking: Why Only Now?,” *Journal of Money, Credit and Banking*, 1996, 28 (2), 141–161.
- , “How Offshore Financial Competition Disciplines Exit Resistance by Incentive-Conflicted Bank Regulators,” 1999, *No. 7156*, –.
- Kaper, Stacy**, “Key Endorsement for FDIC for Systemic Resolutions,” *American Banker*, March 25 2009.
- , “Dodd Recounts Battles Over Reg Reform; The Senate Banking chairman rejects criticisms, discusses legacy of new law,” *American Banker*, August 24 2010, 175 (130), 1–7.
- , “Resolution Deal is Near, But How Effective Will It Be?,” *American Banker*, March 22 2010.
- **and Donna Borak**, “Lawmakers Give Ground on Capital Measure,” *American Banker*, June 18 2010.
- Kapstein, Ethan B.**, “Resolving the Regulator’s Dilemma: International Coordination of Banking Regulations,” *International Organization*, 1989, 43 (2), 323–347.
- , “Between Power and Purpose: Central Bankers and the Politics of Regulatory Convergence,” *International Organization*, 1992, 46 (1), 265–287.
- , *Governing the Global Economy: International Finance and the State*, Cambridge, MA: Harvard University Press, 1994.
- Karmel, Roberta S.**, *Regulation by Prosecution: The Securities and Exchange Commission versus Corporate America*, New York: Simon and Schuster, 1982.
- Karmel, Roberta S.**, “The Rashomon Effect in the After-the-Crash Studies,” *Review of Securities and Commodities*, 1988, 21.
- , “Risk Assessment Reporting for Large Traders,” *New York Law Journal*, April 16 1992.
- , “The Future of the Securities and Exchange Commission as a Market Regulator,” Technical Report 152, Brooklyn Law School, Legal Studies Paper 2009.
- Karol, Bernard J.**, “An Overview of Derivatives as Risk Management Tools,” *Stanford Journal of Law and Business Finance*, 1995, 1, 195.

## REFERENCES

---

- Kaufman, Herbert**, "Emerging Conflicts in the Doctrines of Public Administration," 1956, *50* (4), 1057–1073–.
- , *The Forest Ranger: A Study in Administrative Behavior*, Washington DC: Resources for the Future, 1960.
- , "Ruminations on the Study of American Public Bureaucracies," *The American Review of Public Administration*, 2008, *38* (3), 256–263.
- Kelman, Steven**, *Making public policy*, New York: Basic Books, 1987.
- Keohane, Robert O.**, *After Hegemony: Cooperation and Discord in the World Political Economy*, Princeton, NJ: Princeton University Press, 1984.
- Khademian, Anne M.**, *The SEC and capital market regulation : the politics of expertise*, Pittsburgh: University of Pittsburgh Press, 1992.
- , "When Missions Matter: Professional Priorities and the "Stepchild" of Supervisory Programs," 1995, *8* (1), 26–57–.
- , *Checking on Banks: Autonomy and Accountability in Three Federal Agencies*, Washington DC: Brookings Institution Press, 1996.
- , "The Securities and Exchange Commission: A Small Regulatory Agency with a Gargantuan Challenge," 2002, *62* (5), 515–526–.
- Kiewiet, D. Roderick and Mathew D. McCubbins**, *The Logic of Delegation*, Chicago: University of Chicago Press, 1991.
- Kim, Jongho**, "From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events," *Fordman Journal Corporate and Finance Law*, 2008, *13*.
- Klein, Ezra**, "Explaining FinReg: Resolution authority," *The Washington Post*, April 20 2010.
- Kling, Arnold**, "Not What They Had In Mind: A History of Policies that Produced the Financial Crisis of 2008," *Mercatus Center Report*, September 2009, pp. 1–46.
- Kolb, Robert W.**, *Understanding Options*, Vol. 2, New York: Wiley Marketplace Book Series, 1995.
- Koning, Rachel**, "'Lite' Regimen for OTC Broker-Dealers is Ready to Go," *The Bond Buyer*, October 26 1998.
- Kramer, Kai**, "Aren't We Still in the "Garden of the Forking Paths"? A Comment on Consolidation of the SEC and CFTC," *Houston Business and Tax Law Journal*, 2004, *4*, 410–446.
- Kraus, James R.**, "Bankers See Derivatives as Risky, but Manageable Safeguards, Not Regulation, Said to Be Key," *The American Banker*, July 29 1994.
- Krause, George A.**, "The Institutional Dynamics of Policy Administration: Bureaucratic Influence over Securities Regulation," 1996, *40* (4), 1083–1121–.
- , "Policy Preference Formation and Subsystem Behaviour: The Case of Commercial Bank Regulation," 1997, *27* (4), 525–550–.

## REFERENCES

---

- , “Annual Herbert Simon Lecture, Midwest Political Science Association Conference, Chicago IL,” April 13 2012.
- **and J. Kevin Corder**, “Explaining Bureaucratic Optimism: Theory and Evidence from U.S. Executive Agency Macroeconomic Forecasts,” *American Political Science Review*, 2007, 101 (1), 129–142.
- **and James W. Douglas**, “Institutional Design versus Reputational Effects on Bureaucratic Performance: Evidence from U.S. Government Macroeconomic and Fiscal Projections,” *Journal of Pub*, 2005, 15, 281–306.
- Krimminger, Michael**, “Statement of Michael Krimminger, Special Advisor for Policy, Federal Deposit Insurance Corporation on Too Big to Fail: The Role of Bankruptcy and Antitrust Law in Financial Regulation Reform before the Committee on the Judiciary; Subcommittee on Commercial and Administrative Law; U.S. House of Representatives, 2141 Rayburn House Office Building, Washington DC,” October 22 2009.
- Krippner, Greta R.**, “The Financialization of the American Economy,” *Socio-Economic Review*, 2005, 3 (2), 173–208.
- Krippner, Greta R.**, *Capitalizing on Crisis: The Political Origins of the Rise of Finance*, Cambridge, MA: Harvard University Press, 2011.
- Kroszner, Randall S.**, “Can the Financial Markets Privately Regulate Risk?: The Development of Derivatives Clearinghouses and Recent over-the-Counter Innovations,” *Journal of Money, Credit and Banking*, August 1999, 31 (3), 596–618.
- Kwak, James**, *Preventing Regulatory Capture: Special Interest Influence and How to Limit It*, New York: Cambridge University Press, 2013.
- LaCapra, Lauren T.**, “Bank Capital Standards: Who’s On First?,” *The Street*, June 4 2010.
- Langevoort, Donald C.**, “The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty,” *Washington University Law Review*, 2006, 84, 1591–1626.
- , “The SEC, Retail Investors, and the Institutionalization of the Securities Markets,” *Virginia Law Review*, 2009, 95 (4), pp. 1025–1083.
- Langley, Monica**, “Altered Bank-Insurance System Proposed; Aim is to Promote Conservative Practices,” *Wall Street Journal*, December 14 1984, p. 1.
- , “Mixed Signals: Rival Bank Regulators Agree Only to Disagree On Most Major Issues - Fed, Comptroller and FDIC Have Bankers Uncertain How to Conduct Business - Volcker vs. Conover vs. Isaac,” *Wall Street Journal*, January 23 1985.
- **and Laurie McGinley**, “Higher Capital To Cover Risks Urged for Banks - Fed Chairman Volcker Says Added Reserves Needed for Some Investments,” *The Wall Street Journal*, July 19 1985.
- Layne, Richard**, “Bank Derivatives: Were Warnings False Alarms?,” *The American Banker*, May 19 1993.
- Leach, Jim**, “Verbatim: Leach Explains His Derivatives Control Bill,” *The American Banker*, October 6 1994.
- Lee, Francis E.**, *Beyond Ideology: Politics, Principles, and Partisanship in the U.S. Senate*, Chicago, IL: University of Chicago Press, 2009.

## REFERENCES

---

- Lester, John**, “Four Views of the US Financial System, Presentation at Brookings Institution,” December 4 2012.
- Levine, Ross**, “The Governance of Financial Regulation: Reform Lessons from the Recent Crisis,” *International Review of Finance*, 2012, 12 (1), 39–56.
- Levitt, Arthur**, “Putting the Investor First, Remarks by the Chairman of the Securities and Exchanges Commission to the IOSCO,” October 19 1994.
- , “Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission Concerning Financial Modernization Before the Committee on Banking and Financial Services, U.S. House of Representatives,” May 22 1997.
- , “A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading. Remarks at the SEC Speaks Conference,” February 27 1998.
- Lichtenstein, Cynthia C.**, “International Standards for Consolidated Supervision of Financial Conglomerates: Controlling Systemic Risk,” *Brooklyn Journal of International Law*, 1993, 19 (1), 137–157.
- Lindblom, Charles E.**, *Politics and Markets: The World’s Political-Economic Systems*, New York: Basic Books, 1977.
- Lipman, Brice**, “Diminishing Returns: Crisis Politics and Financial Reform Legislation,” *Xavier Journal of Politics*, 2011, II (1), 1–19.
- Litzenberger, Robert H.**, “Swaps: Plain and Fanciful,” *Journal of Finance*, 1992, 47, 831.
- Lizza, Ryan**, “The Contrarian: Sheila Bair and the White House financial debate,” *The New Yorker*, July 6 2009.
- Ljungqvist, Alexander, Felicia Marston, and William J. Wilhelm**, “Competing for Securities Underwriting Mandates: Banking Relationships and Analyst Recommendations,” *The Journal of Finance*, 2006, 61 (1), 301–340.
- Llewellyn, David T.**, “The Strategic Dilemma of World Banking: Competitive Implications of the Basle Capital Conference Provisions,” *Retail Banker’s Management Review*, 1989, Spring/Summer.
- Lowi, Theodore J.**, *The End of Liberalism: The Second Republic of the United States*, New York: W.W. Norton, 1969.
- Ludwig, Eugene A.**, “Comptroller of the Currency, Speech to the Federal Financial Institutions Examination Council Conference on Regulatory Capital,” December 12 1997.
- Lukes, Stephen**, *Power: A radical view*, London: Palgrave, 1974.
- Lux, Hal**, “The SEC Takes A Hard Look at Itself,” *Investment Dealers’ Digest*, May 16 1994.
- MacDonald, Jason A.**, “Limitation Riders and Congressional Influence over Bureaucratic Policy Decisions,” *American Political Science Review*, 2010, 104 (4), 766–782.
- **and William W. Franko**, “Bureaucratic Capacity and Bureaucratic Discretion: Does Congress Tie Policy Authority to Performance?,” *American Politics Research*, 2007, 35 (6), 790–807.

## REFERENCES

---

- MacKenzie, Donald A.**, *An engine, not a camera: How financial models shape markets*, Cambridge, MA: MIT Press, 2006.
- Macro, Monitor Global**, “America’s FIRE Economy,” *Global Macro Monitor Blog*, February 3 2011.
- Madhavan, Ananth**, “Market microstructure: A survey,” *Journal of Financial Markets*, 2000, 3 (3), 205 – 258.
- Mahoney, Paul G.**, “Securities Regulation by Enforcement: An International Perspective,” *Yale Journal on Regulation*, 1990, 7, 305–320.
- Maisel, Sherman**, *Risk and Capital Adequacy Requirements and Bank Holding Companies*, Ann Arbor, MI: University of Michigan Press, 1981.
- Markham, Jerry and Rita McCloy Stephanz**, “The Stock Market Crash of 1987 -The United States Looks at New Recommendations,” *Georgetown Law Journal*, 1987-1988, 76, 1993–2045.
- Markham, Jerry W.**, *The History of Commodity Futures Trading and Its Regulation*, New York: Praeger, 1986.
- , “Merging the SEC and CFTC - A Clash of Cultures,” *University of Cincinnati Law Review*, 2009-2010, 78, 537–611.
- Maxwell, Sylvia**, “Lessons from the History of Over-the-Counter Derivatives Regulation,” *Working Paper*, 2011.
- Mayhew, David**, *Congress: The Electoral Connection*, New Haven, CT: Yale University Press, 1973.
- , *Congress: The Electoral Connection*, New Haven, CT: Yale University Press, 1974.
- McCaffrey, David**, “Private and Public Regulation in the Over-the-Counter Derivatives Market 1984-2012,” *Working Paper*, October 15 2012.
- McConnell, Bill**, “Frank now seeks pre-failure assessments,” *The Deal*, October 30 2009.
- McConnell, James M.**, ““Critical Resource and Staffing Issues Facing the SEC,” Testimony before the Subcommittee on Oversight of Government Management Restructuring and the District of Columbia of the Senate Committee on Governmental Affairs,” April 23 2002.
- McCubbins, Mathew D. and Thomas Schwartz**, “Congressional Oversight Overlooked: Police Patrols versus Fire Alarms,” 1984, 28 (1), 165–179–.
- , **Roger G. Noll, and Barry R. Weingast**, “Administrative Procedures as Instruments of Political Control,” *Journal of Law, Economics, and Organization*, 1987, 3, 243–277.
- McDonough, William**, “Update on the Major Initiative to Revise the 1998 Capital Accord, Remarks to the 4th Annual Supervision Conference of the British Bankers Association,” June 19 2000.
- McLean, Bethany and Joe Nocera**, *All the Devils Are Here: The Hidden History of the Financial Crisis*, New York: Portfolio/Penguin, 2010.
- Meier, Kenneth J.**, *Regulation: Politics, Bureaucracy and Economics*, New York: St. Martin’s Press, 1985.

## REFERENCES

---

- **and John Bohte**, *Politics and the bureaucracy: Policymaking in the fourth branch of government*, 5th ed., Belmont, CA: Thomson Wadsworth, 2007.
- Meredith, Robyn**, “Regulators Oppose Derivatives Bill, Saying Oversight is Already Adequate,” *The American Banker*, July 13 1994.
- , “An SEC Commissioner Wants to Put Securities Oversight Under One Roof,” *The American Banker*, January 4 1994.
- Meyer, Laurence**, *Increasing Global Financial Integrity: The Roles of Market Discipline, Regulation and Supervision Remarks at the 16th Annual Monetary Conference, Money in the New Millennium: The Global Financial Architecture*, Washington DC: Cato Institute, October 22 1998.
- Miller, Merton H.**, “Financial Innovation: The Last Twenty Years and the Next,” *Journal of Financial and Quantitative Analysis*, 1986, 21 (4), 459–471.
- , “The social costs of some recent derivatives disasters,” *Pacific-Basin Finance Journal*, 1996, 4 (2), 113–127.
- Moe, Terry M.**, “An Assessment of the Positive Theory of ‘Congressional Dominance’,” *Legislative Studies Quarterly*, 1987, 12, 475–520.
- , “Political Control and the Power of the Agent,” *Journal of Law, Economics, and Organization*, 2006, 22 (1).
- , *Handbook of Organizational Economics*, Princeton, NJ: Princeton University Press, 2012.
- Mohr, Lawrence B.**, *Explaining Organizational Behavior*, San Francisco: Jossey-Bass, 1982.
- Montgomerie, Johnna**, “The Pursuit of (Past) Happiness? Middle-Class Indebtedness and American Financialisation,” *New Political Economy*, 2009, 14 (1), 1–24.
- Morgan, Stephen L. and Christopher Winship**, *Counterfactuals and Causal Inference*, New York: Cambridge University Press, 2007.
- Morris, Bailey**, “In Washington: Jumping Blind into the Futures; Few Understand Financial Derivatives,” *The Independent*, October 10 1993.
- Morrison, Joanne**, “Levitt Says Further Talks Needed on Derivatives Rules,” *The Bond Buyer*, December 16 1994.
- , “Levitt Says Further Talks Needed on Derivatives Rules,” *The Bond Buyer*, December 16 1994.
- , “Dingell and Markey Ask the SEC To Look Over Firms’ OTC Guidelines,” *The Bond Buyer*, March 16 1995.
- , “Leach Applauds, Markey Criticizes Firms’ Proposed OTC Guidelines,” *The Bond Buyer*, March 10 1995.
- , “SEC Mulls Brewing ‘Lite’ Style Rules for Derivatives Firms; SEC Looking at Creating a New ‘Lite’ Class of Broker-Dealers,” *The Bond Buyer*, October 15 1996.
- , “Levitt Says Bill Would Leave Banks’ Securities Under-Regulated,” *The Bond Buyer*, February 14 1997.

## REFERENCES

---

- Moulton, Janice M.**, “Nonbank Banks: Catalyst for Interstate Banking,” *Business Review: Federal Reserve Bank of Philadelphia*, 1985, November-December, 1–17.
- Moynihan, Donald P. and Sanjay K. Pandey**, “The Role of Organizations in Fostering Public Service Motivation,” *Public Administration Review*, 2007, 67 (1), 40–53.
- Munck, Geraldo L.**, *Rethinking Social Inquiry: Diverse Tools, Shared Standards*, Lanham, MD: Rowman Littlefield, 2004.
- Nagarajan, Sabitha and C. William Sealey**, “Can Delegating Bank Regulation to Market Forces Really Work?,” *Mimeo, New York University*, 1997.
- Nagourney, Adam**, “Bracing for a Backlash Over Wall Street Bailouts,” *The New York Times*, March 15 2009.
- Nash, Nathaniel C.**, “U.S. Regulators Want Banks to Cover Risky Loans Better,” *The American Banker*, January 16 1986.
- Naylor, Bart**, “Industry Cool to FDIC Insurance Plan; Plan for Risk-Based Premiums Leaves Some with Doubts About Effectiveness,” *The American Banker*, September 23 1985.
- Naylor, Bartlett**, “Volcker to Propose Risk-Based Capital Rule; Several Approaches Being Considered; Fed Chairman Also Endorses Requirement,” *The American Banker*, September 12 1985.
- , “Independent Bankers Plan to Reverse Stand and Oppose Risk-Based Premiums,” *The American Banker*, March 11 1986.
- Nazareth, Annette L.**, “The House and Senate Debate Resolution Authority,” *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, November 19 2009.
- Neri, Massimiliano**, “The Unintended Consequences of the Basel III Liquidity Risk Regulation,” *Working Paper*, July 2012.
- Noble, Kenneth B.**, “Deadlock Over Bank Regulation,” *The New York Times*, December 12 1983, p. D.1.
- , “Banking Regulatory Accord Set,” *The New York Times*, February 1 1984, p. D.1.
- , “New Costs to Banks is Backed,” *The New York Times*, September 6 1984, p. D.1.
- Nocera, Joe**, “Shelia Bair’s Bank Shot,” *The New York Times*, July 9 2011.
- Noelle-Neumann, Elisabeth**, “The Spiral of Silence a Theory of Public Opinion,” *Journal of Communication*, 1974, 24 (2), 43–51.
- Nolke, Andreas**, *Global Finance in Crisis: The Politics of International Regulatory Change*, New York: Routledge, 2010.
- Nordlinger, Eric**, *On the Autonomy of the Democratic State*, Cambridge, MA: Harvard University Press, 1981.
- North, Douglass C.**, *Institutions, Institutional Change, and Economic Performance*, Cambridge: Cambridge University Press, 1990.



## REFERENCES

---

- Norton, Joseph J.**, “Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?,” *Ohio State Law Journal*, 1988-1989, 49, 1299–1363.
- , *Devising International Bank Supervisory Standards*, Dordrecht, Netherlands: Martinus Nijhoff, 1995.
- Nuxoll, Daniel A.**, “Internal Risk-Management Models as a Basis for Capital Requirements,” *FDIC Banking Review*, 1999, 12.
- Oberg, Eric**, “Critics Off the Mark on TLGP,” April 27 2009.
- OCC**, *OCC’s Quarterly Report on Bank Trading and Derivatives Activities*, Washington, DC: Office of the Comptroller of the Currency, Second Quarter 2012.
- Odegard, Peter H.**, *Pressure Politics: The Story of the Anti-Saloon League*, New York: Oklahoma University Press, 1928.
- of Inspector General, U.S. SEC Office**, “SEC’s Oversight of Bear Stearns and Related Entities,” Technical Report 446-B, Office of Inspector General, U.S. Securities and Exchange Commission September 25 2008.
- of National Affairs, The Bureau**, “Firms Adopt Derivative Controls, Including Disclosures About Risks,” *Securities Regulation and Law Report*, March 17 1995, 27, 440.
- of Representatives Committee on Banking & Financial Services, U.S. House**, “Hearings on the President’s Working Group Study on Hedge Funds,” 1999.
- of Representatives Committee on Banking, U.S. House**, “Hearing of the House Banking and Financial Services Committee on the Financial Services Competitiveness Act of 1995,” February 28 1995.
- of Representatives Committee on Energy & Commerce, U.S. House**, “Hearing: Derivative Financial Markets - Part 1,” May 10 1994.
- of Treasury, US Department**, *Financial Regulatory Reform: A New Foundation*, Washington DC: US Department of Treasury, 2009.
- Olson, Mancur**, *The Logic of Collective Action: Public Goods and the Theory of Groups*, 2 ed., Cambridge, MA: Harvard University Press, 1965.
- on Banking, Finance Committee and U.S. House of Representatives Urban Affairs**, “Hearing: Safety and Soundness Issues Related to Bank Derivative Activities - Part 1,” October 28 1993.
- on Banking Supervision Basel Committee**, *Committee on Banking Regulations and Supervisory Practices, Report on International Developments in Banking Supervision*, Basel, Switzerland: Bank for International Settlements, 1981.
- , *Committee on Banking Regulations and Supervisory Practices, Report on International Developments in Banking Supervision*, Basel, Switzerland: Bank for International Settlements, 1982.
- , *Proposals for International Convergence of Capital Measurement and Capital Standards*, Basel, Switzerland: Bank for International Settlements, 1987.
- , *Amendment to the Capital Accord to Incorporate Market Risks*, Basel, Switzerland: Bank for International Settlements, 1996.

## REFERENCES

---

- , *A New Capital Adequacy Framework: Consultative Paper*, Basel, Switzerland: Bank for International Settlements, 1999.
- , *Overview of the New Basel Capital Accord: Consultative Document*, Basel, Switzerland: Bank for International Settlements, 2001.
- , *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, Basel-Committee2004: Bank for International Settlements, 2004.
- on Capital Markets Regulation, Commission**, “Interim Report of the Committee on Capital Markets Regulation,” 2006.
- on Commerce, The Committee**, “Hearing on the Capital Markets Deregulation and Liberalization Act of 1995,” Technical Report, U.S. House of Representatives 1996.
- on Market Mechanisms Presidential Task Force**, *Report of the Presidential Task Force on Market Mechanisms*, Washington, DC: United States Department of the Treasury, 1988.
- on Telecommunications & Finance, The Subcommittee**, “Hearing of the Telecommunications and Finance Subcommittee on the Subject of SEC Reauthorizations, Hearing, and Markup,” Technical Report, Commerce Committee, U.S. House of Representatives February 28 1996.
- Orgler, Yair E. and Benjamin Wolkowitz**, *Bank Capital*, New York: Van Nostrand Reinhold Company, 1976.
- Orhangazi, Ozgur**, *Financialization and the U.S. Economy*, Northampton, MA: Edward Elgar Publishing, 2008.
- Paarlberg, Laurie E. and James L. Perry**, “Values Management,” *The American Review of Public Administration*, 2007, 37 (4), 387–408.
- Pagano, Marco, Alisa Roell, and Josef Zechner**, “The Geography of Equity Listing: Why Do Companies List Abroad?,” *Journal of Finance*, 2002, 57, 2651–2694.
- Pagliari, Stefano**, *Public Salience and International Financial Regulation: Explaining the International Regulation of OTC Derivatives, Rating Agencies, and Hedge Funds. Ph.D. Thesis*, Waterloo, Ontario, Canada: University of Waterloo, 2013.
- Paletta, Damian**, “For the 50 billion fund, a tortured history,” *The Wall Street Journal*, 2010.
- Palley, Thomas I.**, “Financialization: What It Is and Why It Matters,” *The Levy Economics Institute Working Paper*, December 2007, (525).
- Palsey, Robert S.**, “Consolidation of the Federal Banking Regulatory Agencies,” *Annual Review of Banking Law*, 1990, 9, 255–312.
- Partnoy, Frank and David A. Skeel**, “The Promise and Perils of Credit Derivatives,” *University of Cincinnati Law Review*, 2006-2007, 75, 1019–1052.
- Pasley, Robert S.**, “Consolidation of the Federal Banking Regulatory Agencies,” *Annual Review of Banking Law*, 1990, 9, 255–309.

## REFERENCES

---

- Peltzman, Sam**, "Toward a More General Theory of Regulation," *Journal of Law and Economics*, 1976, 19, 211–240.
- Perino, Michael A.**, "SEC Enforcement of Attorney up-the-Ladder Reporting Rules: An Analysis of Institutional Constraints, Norms and Biases," *Villanova Law Review*, 2004, 49 (4), 851–866.
- Perry, James L.**, "Antecedents of Public Service Motivation," *Journal of Public Administration Research and Theory*, 1997, 7 (2), 181–197.
- Peston, Robert and Tracy Corrigan**, "Hopes Dwindle for New Agreement on Capital Requirements – IOSCO Conference," *The Financial Times*, October 28 1992.
- Philippon, Thomas**, "Has the US Finance Industry Become less Efficient? On the Theory and Measurement of Financial Intermediation," Technical Report, National Bureau of Economic Research 2012.
- and **Ariell Reshef**, "Wages and Human Capital in the U.S. Financial Industry: 1909-2006," *The Quarterly Journal of Economics*, October 2012.
- Pierson, Paul**, *Politics in Time*, Princeton, NJ: Princeton University Press, 2004.
- , "Power and Path Dependence," Technical Report, UC Berkeley March 1 2013.
- Pollack, Andrew and Leslie Wayne**, "Ending Suit, Merrill Lynch to Pay California County 400Million," *TheNewYorkTimes*, June31998.
- Polsby, Nelson**, *Community Power and Political Theory*, New Haven, CT: Yale University Press, 1963.
- Poser, Norman S.**, "Stock Exchanges of the United States and Europe: Automation, Globalization, and Consolidation," *University of Pennsylvania Journal of International Economic Law*, 2001, 22, 497–540.
- Posner, Elliot**, "Sequence as explanation: The international politics of accounting standards," *Review of International Political Economy*, 2010, 17 (4), 634–664.
- Pozen, Robert**, *Too Big to Save? How to Fix the U.S. Financial System*, Hoboken, NJ: John Wiley & Sons, 2010.
- Prabhakar, Rahul**, "Varieties of Regulation: Domestic Preferences and Global Outcomes in Finance," *Presentation at the Annual Society for the Advancement of Socio-Economics, Massachusetts Institute of Technology*, June 29 2012, pp. 1–26.
- Prasad, Monica**, *The politics of free markets: The rise of neoliberal economic policies in Britain, France, Germany, and the United States*, Chicago, IL: University of Chicago Press, 2006.
- Pressman, Aaron**, "SEC Adopts New Reporting Regulations for Brokerages; Seeks Earlier Warning on Troubled Firms," *Investment Dealers' Digest*, July 20 1992.
- Presthus, Robert V.**, "Authority in Organizations," *Public Administration Review*, 1960, 20 (2), 86–91.
- Pritchard, Adam C.**, "The SEC at 70: Time for Retirement?," *Notre Dame Law Review*, 2004-2005, 80 (3), 1073–1102.

## REFERENCES

---

- Protest, Ben**, “As Regulator Scores Record Fine, Support Emerges for Bigger Budget,” *New York Times*, June 28 2012.
- Putnam, Robert D.**, “Diplomacy and Domestic Politics: The Logic of Two-Level Games,” *International Organization*, 1988, 42 (3), 427–460.
- Quick, Perry D.**, “Reform Federal Deposit Insurance [Op-Ed],” *The New York Times*, June 30 1984.
- Quirk, Paul J.**, *Industry Influence in Federal Regulatory Agencies*, Princeton, NJ: Princeton University Press, 1981.
- Racine, John**, “Congressional Overkill Could Sap the Benefits of Swaps, Experts Say,” *The American Banker*, December 3 1993.
- Raustiala, Kal**, “The Architecture of Networks and the Future of International Law,” *Virginia Journal of International Law*, 2002, 43, 1–91.
- Rehm, Barbara**, “Fed Will Allow Citicorp Trading Unit to Enter the Commodity Swap Field,” *The American Banker*, October 1 1987.
- , “Rep. Leach to Introduce Legislation Creating Swaps Policy Commission,” *The American Banker*, January 26 1994.
- , “Trio of Heavyweights Sees No Swaps Crisis,” *The American Banker*, May 11 1994.
- , “Moratorium on Regulation May Hit Banks; Exemptions Sought for Key Proposals,” *The American Banker*, January 13 1995.
- , “Greenspan Tells Regulators to Stop Playing Politics with Capital Rules,” *The American Banker*, May 7 1999.
- , “Regulators Support Bigger Role for Market in Curbing Banks,” *American Banker*, October 7 1999.
- Rehm, Barbara A.**, “Breedon May Try to Extend Reach of SEC to Banking,” *The American Banker*, August 15 1989.
- , “How Big Banks Can Cure Break-'Em-Up Fever,” *American Banker*, March 20 2013.
- Reinicke, Wolfgang H.**, *Banking, Politics, and Global Finance: American Commercial Banks and Regulatory Change, 1980-1990*, Brookfield, VT: Edward Elgar, 1995.
- , *Global Public Policy: Governing Without Government?*, Washington, DC: Brookings Institution Press, 1998.
- Release, Joint News**, “Comptroller of the Currency and Federal Reserve Board,” *Federal Banking Law Report*, December 17 1981, 5554A, 3406.
- Report, 1985 Federal Reserve’s Second Monetary Policy**, “Hearing before the Committee on Banking, Housing, and Urban Affairs, United States Senate,” in “in” 1985.
- Reuters, Thompson**, “Analysis: Economy struggles to wag its financial tail,” *Reuters*, July 28 2010.

## REFERENCES

---

- Ringquist, Evan, Jeff Worsham, and Marc Allen Eisner**, “Salience, Complexity, and the Legislative Direction of Regulatory Bureaucracies,” *Journal of Public Administration Research and Theory*, 2003, 13 (2), 141–164.
- Riper, Robert Van**, *Setting Standards for Financial Reporting: FASB and the Struggle for Control of a Critical Process*, Westport, CT: Quarum Books, 1994.
- Ripley, Randall B. and Grace A. Franklin**, *Policy Implementation and the Bureaucracy*, Pacific Grove, CA: Brooks/Cole Publishing, 1986.
- Robb, Gregory A.**, “SEC Bill is Passed by House,” *The New York Times*, October 2 1990.
- Roberts, Patrick S.**, “FEMA and the Prospects for Reputation-Based Autonomy,” *Studies in American Political Development*, 2006, 20 (1), 57–87.
- Robertson, Ross M.**, *The Comptroller and Bank Supervision: A Historical Appraisal*, Washington DC: Office of the Comptroller of the Currency, 1968.
- Roig-Franzia, Manuel**, “Brooksley Born, the Cassandra of the Derivatives Crisis,” *The Washington Post*, May 26 2009.
- Romano, Roberta**, “The Political Dynamics of Derivative Securities Regulation,” 1997, 1913, 279–406.
- Rosenbluth, Frances and Ross Schaap**, “The Domestic Politics of Banking Regulation,” *International Organization*, 2003, 57 (02), 307–336.
- Rosenstein, Jay**, “Comptroller’s New Definition of Capital Is Viewed By Banks As Too Restrictive,” *The American Banker*, September 28 1980.
- , “Reagan Panel Urges Transfer of Fed’s Duties,” *The American Banker*, May 19 1983.
- , “Volcker Defends Regulatory Role for Fed, Calls Demands to Limit Power ‘Unacceptable,’” *The American Banker*, October 11 1983.
- , “Isaac Says Fed Should Shed Regulator Role; Contends Involvement Level in Bush Proposal is ‘Unwise,’” *The American Banker*, March 27 1985.
- , “Regulatory Reforms Need More Stress, House Leader Says,” *The American Banker*, March 28 1985.
- Roten, Ivan C. and Donald J. Mullineaux**, “Debt Underwriting By Commercial Bank-Affiliated Firms and Investment Banks: More Evidence,” *Journal of Banking and Finance*, 2002, 26, 689–718.
- Roubini, Nouriel and Stephen Mihm**, *Crisis Economics: A Crash Course in the Future of Finance*, New York: Penguin Press, 2010.
- Roundtable, The Financial Services**, *Financial Services Fact Book 2008*, Washington, DC: Financial Services Roundtable, 2008.
- Rourke, Francis E.**, *Bureaucracy, politics, and public policy*, 3d ed., Boston, MA: Litt, 1984.
- , “Responsiveness and Neutral Competence in American Bureaucracy,” *Public Administration Review*, 1992, 52, 539–546.

## REFERENCES

---

- Russo, Thomas A.**, *The SEC and CFTC in the Post Accord Era: Continued Autonomy or a Shotgun Marriage*, Cadwalader, Wickersham, and Taft, 1983.
- Ryan, Peter J.**, "Autonomy in a "Least Likely" Case: Evidence for Bureaucratic Influence in the Financial Reform Debate, 2008-2010," *Presentation at the Annual Midwest Political Science Association Conference*, April 15 2012.
- , "Power Through Cooperation: How U.S. Financial Regulators Expand their Domestic Autonomy Through International Standard Setting," *Presentation at the Society for Advancement of Socio-Economics Annual Conference, Cambridge MA*, June 2012.
- **and Chloe Thurston**, "Parties or Groups? Explaining the Democratic Party's Evolving Position on Banking Regulation, 1970-1999," *Paper presented at Annual Meeting of the American Political Science Association, August 2012*, 2012.
- Salant, David J.**, "Behind the Revolving Door: A New View of Public Utility Regulations," *The Rand Journal of Economics*, 1995, pp. 362–377.
- Saloner, Garth and Andrea Shepard**, "Adoption of technologies with network effects: an empirical examination of the adoption of automated teller machines," *The RAND Journal of Economics*, 1995, pp. 479–501.
- Salwen, Keith**, "SEC Seems Likely to Win Turf War with the CFTC," *Wall Street Journal*, February 16 1990, p. C1.
- Sanati, Cyrus**, "S.E.C. Answers Critics of Fair-Value Accounting," *New York Times*, January 5 2009.
- Sands, David R.**, "SEC Chairman Confident the System is Working Well," *The Washington Times*, October 26 1989.
- Santos, Joao A. C.**, "Bank Capital Regulation in Contemporary Banking Theory: A Review of the Literature," *Financial Markets, Institutions, and Instruments*, 2001, 10 (2), 41–84.
- Sarra, Janis**, "Financial Market Destablization and the Role of Credit Default Swaps: An International Perspective on the SEC's Role Going Forward," *University of Cincinnati Law Review*, 2009-2010, 78, 629–655.
- Sassen, Saskia**, *The Global City: New York, London, Tokyo*, Princeton, NJ: Princeton University Press, 2001.
- Schapiro, Mary**, "Testimony Concerning the Lehman Brothers Examiner's Report Before the House Financial Services Committees," Technical Report, Securities and Exchange Commission April 20 2010.
- Schapiro, Mary L.**, "Remarks of Commissioner Mary L. Shapiro, U.S. Securities and Exchange Commission on "The Derivatives Revolution and the World Financial System"," Technical Report, Eight Annual Symposium for the Foundation for Research in International Banking and Finance, Lugano, Switzerland October 14 1993.
- Schattschneider, Elmer E.**, *Politics, Pressures and the Tariff: A Study of Free Private Enterprise in Pressure Politics, as Shown in the 1929-30 Revision of the Tariff*, New York: Prentice Hall, 1935.
- Scheerer, Andre**, "Credit Derivatives: An Overview of Regulatory Initiatives in the United States and Europe," *Fordham Journal of Corporate and Financial Law*, 2000, 5, 149–203.

## REFERENCES

---

- Schein, Edgar H.**, *Organizational Culture and Leadership*, 3 ed., San Francisco: Jossey- Bass, 2004.
- Schmidt, Robert**, “Geithner Seeks to Push FDIC’s Bair Out After Clashes,” *Bloomberg*, 2008.
- Schwarcz, Steven**, “Rethinking the Disclosure Paradigm in a World of Complexity,” *University of Illinois Law Review*, 2004.
- , “Regulating Complexity in Financial Markets,” *Washington Law Review*, 2009, 87, 211.
- Seabrooke, Leonard and Ellen Tsingou**, “Revolving Doors and Linked Ecologies in the World Economy: Policy Locations and the Practice of International Financial Reform,” *CSGR Working Paper*, 2009, 260 (09).
- Seawright, Jason and John Gerring**, “Case Selection Techniques in Case Study Research: A Menu of Qualitative and Quantitative Options,” *Political Research Quarterly*, 2008, 61 (2), 294–308.
- SEC**, “Prese Release: Securities and Exchange Commission Chairman Cox Announces End of Consolidated Supervised Entities Program,” September 26 2008, (230).
- Seiberg, Jaret**, “Greenspan Hints at Revision in Capital Rules on Credit Risk,” *American Banker*, May 3 1996.
- , “N.Y. Fed Chief Urges Review of ’88 Global Capital Rules,” *The American Banker*, September 23 1998.
- Seidman, William**, *Financial Deregulation*, Cambridge: Woodhead-Faulkner, 1986.
- Seligman, Joel**, “The SEC in a Time of Discontinuity,” *Virginia Law Review*, 2009, 95, 667–684.
- Sellon, Gordon H. and Stuart E. Weiner**, “Monetary Policy Without Reserve Requirements: Analytical Issues,” *Federal Reserve Bank of Kansas City Economic Review*, 1996, 4th Q.
- Selznick, Philip**, *Leadership in Administration: A Sociological Interpretation*, Berkeley, CA: University of California Press, 1957.
- Shapiro, Susan**, *Wayward Capitalists: Targets of the Securities and Exchange Commission*, New Haven, CT: Yale University Press, 1984.
- Sheehan, Frederick**, *Panderer to Power: The Untold Sotry of How Alan Greenspan Enriched Wall Street and Left a Legacy of Recession*, New York: McGraw-Hill, 2009.
- Shiller, Robert J.**, “Causes of Changing Financial Market Volatility,” *Federal Reserve Bank of Kansas, Financial Market Volatility*, 1988.
- Sidel, Robin, Dennis K Berman, and Kate Kelly**, “JP Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis,” *Wall Street Journal*, 2008, p. A1.
- Simmons, Beth A.**, “The International Politics of Harmonization: The Case of Capital Market Regulation,” *International Organization*, 2001, 55 (3), 589–620.
- Simon, Herbert A.**, *Models of Bounded Rationality*, Cambridge, MA: MIT Press, 1982.
- Singer, David A.**, “Capital Rules: The Domestic Politics of International Regulatory Harmonization,” *International Organization*, 2004, 58, 531–565.

## REFERENCES

---

- , *Regulating Capital: Setting Standards for the International Financial System*, Ithaca, NY: Cornell University Press, 2007.
- Singher, Thomas C.**, “Regulating Derivatives: Does Transnational Regulatory Cooperation Offer a Viable Alternative to Congressional Action?,” *Fordham International Law Journal*, 1994, 18 (4).
- Sirri, Erik**, “Testimony Regarding Credit Default Swaps, Committee on Agriculture, U.S. House of Representatives,” October 15 2008.
- Skocpol, Theda**, *Bringing the State Back In: Strategies of Analysis in Current Research*, New York: Cambridge University Press, 1985.
- Smith, Ellen W.**, “New Control on Global Debt: The International Lending Supervision Act of 1983,” *Cornell Int’l LJ*, 1984, 17, 425–443.
- Solomon, Steven**, *The confidence game: how unelected central bankers are governing the changed global economy*, New York: Simon & Schuster, 1995.
- Somers, Margaret**, *The Historic Turn in the Social Sciences*, Ann Arbor, MI: University of Michigan Press, 1996.
- Sorkin, Andrew Ross**, “Revolving Door at S.E.C. Is Hurdle to Crisis Cleanup,” *The New York Times*, August 1 2011.
- Spero, Joan E.**, *The Failure of Franklin National Bank: Challenge to the International Banking System*, New York: Columbia University Press, 1980.
- Stamas, Vicky**, “Commodities Rule Could Energize Trading in Swaps,” *The American Banker*, October 19 1992.
- Stigler, George J.**, “The theory of economic regulation,” *Bell Journal of Economics and Management Science*, 1971, 2, 3–21.
- Stiglitz, Joseph**, *Freefall: America, Free Markets, and the Sinking of the World Economy*, New York: W.W. Norton, 2010.
- Stratmann, Thomas**, “Can Special Interests Buy Congressional Votes? Evidence from Financial Services Legislation,” *Journal of Law and Economics*, 2002, 45 (1), 345–373.
- Streeter, Bill**, “Bankers Continue to Press Fed Over Its Payments Role,” *ABA Banking Journal*, July 1983.
- Stulz, Rene M.**, “Should We Fear Derivatives?,” *Journal of Economic Perspectives*, 2004, 18 (3), 173–192.
- , “Credit Default Swaps and the Credit Crisis,” *National Bureau of Economic Research Working Paper*, 2009, (15384).
- Suarez, Sandra and Robin Kolodny**, “Paving the Road to ÓToo Big to FailÓ: Business Interests and the Politics of Financial Deregulation in the United States,” *Politics & Society*, 2011, 39 (1), 74–102.
- Suisse, Research Institute Credit**, *Credit Suisse Global Investent Returns Yearbook*, Credit Suisse Global, 2013.



## REFERENCES

---

- Swary, Itzhak**, “Stock Market Reaction to Regulatory Action in the Continental Illinois Crisis,” *The Journal of Business*, 1986, 59 (3), 451–473.
- Tahyar, Margaret E.**, “Collins Amendment Sets Minimum Capital Requirements,” July 8 2010.
- Taleb, Nassim N.**, *The Black Swan: The Impact of the Highly Improbable*, New York: Random House, 2007.
- Tarullo, Daniel K.**, *Banking on Basel: The Future of International Financial Regulation*, Washington DC: Peter G. Peterson Institute for International Economics, 2008.
- Tetlock, Philip and Aaron Belkin**, *Counterfactual Thought Experiments in World Politics*, Princeton, NJ: Princeton University Press, 1996.
- Tett, Gillian**, *Fool’s Gold: How the Bold Dream of a Small Tribe at J.P. Morgan was Corrupted by Wall Street Greed and Unleashed a Catastrophe*, New York: Free Press, 2009.
- Thelen, Kathleen**, “Historical Institutionalism in Comparative Politics,” *Annual Review of Political Science*, 1999, 2, 369–404.
- Thompson, Robert B.**, “The SEC After the Financial Meltdown: Social Control Over Finance?,” *Pittsburgh Law Review*, 2009-2010, 71, 567–583.
- Times, Los Angeles**, “Tremors in Glass Towers : With executives jittery, it may be time to regulate ‘derivatives’ trading,” *Los Angeles Times*, May 1 1994.
- Times, The New York**, “As Goldman and Morgan Shift, a Wall St. Era Ends,” *The New York Times*, September 21 2008.
- Tobin, Glenn P.**, “Global Money Rules: The Political Economy of International Regulatory Cooperation,” Ph.D. Dissertation,” Technical Report, John F. Kennedy School of Government, Harvard University 1991.
- Tomasula, Dean**, “Commodity Regulator Weighs End To OTC Derivatives Dealers’ Exemption,” *The American Banker*, October 26 1994.
- , “Congress Expected to Take Heat Off the Swaps Market,” *The American Banker*, October 14 1994.
- , “Derivatives: Bill on Swaps Oversight Making Investors Nervous,” *The American Banker*, June 24 1994.
- , “Derivatives: Treasury and Fed Officials See No Pressing Need for Swaps Law,” *The American Banker*, July 29 1994.
- Trachtman, Joel P.**, “Recent Initiatives in International Financial Regulation and Goals of Competiveness, Effectiveness, Consistency, and Cooperation,” *Northwestern Journal of International Law and Business*, 1991, pp. 241–316.
- Tran, Mark**, “Derivatives Rumours Hit J.P. Morgan,” *The Guardian*, March 10 1995.
- Treacy, William F. and Mark S. Carey**, “Credit Risk Rating at Large US Banks,” *Federal Reserve Bulletin*, November 1998, pp. 898–921.
- Trigaux, Robert**, “Volcker Vows to Fight Hard Against Bills that Would Restrict Fed Powers; Stern Speech at Closed-Door Meeting of Banking Groups,” *The American Banker*, January 13 1984.

## REFERENCES

---

- , “Briefing: Banking Stays Off Front Burners,” *The American Banker*, June 16 1986.
- , “Comptroller Unveils Risk Plan; Unlike Fed Proposal, Capital at Low-Risk Banks Could Fall Under 61986.
- Tsingou, Eleni**, “Transnational policy communities and financial governance: the role of private actors in derivatives regulation,” *CSGR Working Paper*, 2003, 111 (03).
- Tufano, Peter**, *Handbook of the Economics of Finance*, Amsterdam, the Netherlands: Elsevier B.V., 2003.
- Underhill, Geoffrey RD**, *The New World Order in International Dinance*, London, UK: Macmillan, 1997.
- Underhill, Geoffrey R.D.**, “Theory and the market after the crisis: The endogeneity of financial governance,” *CEPR Discussion Paper*, December 2010, (8164).
- Verhoest, Koen, B. Guy Peters, and & Verschuere Bram Bouckaert Geert**, “The Study of Organizational Autonomy: A Conceptual Review,” *Public Administration and Development*, 2004, 24, 101–118.
- Veron, Nicolas**, “Financial System Structures Seen from Outside the U.S., Presentation at Brookings Institution,” December 4 2012.
- , **Matthieu Autret, and Alfred Glichon**, *Smoke & Mirrors, Inc: Accounting for Capitalism*, Ithaca, NY: Cornell University Press, 2006.
- Vinuales, Jorge E.**, “The International Regulation of Financial Conglomerates: A Case Study of Equivalence as an Approach to Financial Integration,” *California Western International Law Journal*, 2006, 37 (1), 1–61.
- Vise, David A.**, “SEC Chief Says Drexel’s Fall Shows Need for Regulation,” *The Washington Post*, March 3 1990, p. C1.
- Vogel, David**, *Trading Up: Consumer and Environmental Regulation in a Global Economy*, Cambridge, MA: Harvard University Press, 1995.
- Vogel, Steven K.**, *Freer markets, more rules: regulatory reform in advanced industrial countries*, New York: Cornell University Press, 1996.
- Volcker, Paul A.**, “Statement of Paul A. Volcker, Chairman Board of Governors of the Federal Reserve System before the Committee on Banking, Housing, and Urban Affairs, United States Senate,” September 11 1985.
- Volcker, Paul A. 70 (1984): 547.**, “Federal Reserve Position on Restructuring of Financial Regulation Responsibilities,” *Federal Reserve Bulletin*, 1984, 70, 547–557.
- Volden, Craig**, “A Formal Model of the Politics of Delegation in a Separation of Powers System,” *American Journal of Political Science*, 2002, 46, 111–133.
- Wack, Kevin**, “Dodd-Frank: What Has Worked in Year One,” *American Banker*, July 18 2011.
- Wall, Larry D.**, “A Plan for Reducing Future Deposit Insurance Losses: Putable Subordinated Debt,” *Federal Reserve Bank of Atlanta Economic Review*, 1989, 74, 2–17.
- **and David R. Peterson**, “The Effect of Continental Illinois’ Failure on the Financial Performance of Other Banks,” *Journal of Monetary Economics*, 1990, 26, 77–99.

## REFERENCES

---

- Waters, Richard**, "International Draft Rules on Capital Delayed," *The Financial Times*, August 12 1992.
- Week, The Corporate Financing**, "SIA Lobbies Against EU Oversight Proposal On Conglomerates," *Corporate Financing Week*, January 27 2002.
- Weinberg, Neil**, "Schapiro's Promontory Move Latest Sign of Too Much Coziness," *American Banker*, April 2 2013.
- Weingast, Barry R.**, "Regulation, Reregulation, and Deregulation: The Political Foundations of Agency Clientele Relationships," 1981, *44* (1), 147-177-.
- , "The Congressional-Bureaucratic System: A Principal Agent Perspective (with applications to the SEC)," 1984, *44* (1), 147-191-.
- **and Mark J. Moran**, "Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission," 1983, *91* (5), 765-800-.
- Wells, Rob**, "Major Derivatives Report Calls For Stricter Controls and Risk Measurements," *The Associated Press*, March 9 1995.
- , "SEC Fears Small Business Relief Bill Will Harm Broker Enforcement," *The Associated Press*, March 29 1996.
- Westercamp, Kara M.**, "A Crack in the Facade and the Whole Building Came Tumbling Down: A Critical Examination of the Central Banks' Response to the Subprime Mortgage Loan Crisis and Global Financial Market Turmoil," *Transnational Law and Contemporary Problems*, 2009, *18*, 197-243.
- Whalen, R. Christopher**, "The Subprime Crisis - Cause, Effect and Consequences," *Journal of Affordable Housing and Community Development Law*, Spring 2008, *17* (3), 219-236.
- , "I am Superman: The Federal Reserve Board and the Neverending Crisis," *Networks Financial Institute Policy Brief*, 2010, *PB-03*.
- White, Lawrence J.**, *Performance of Financial Institutions: Efficiency, Innovation, Regulation*, New York: Cambridge University Press,
- White, Lawrence J.**, "The Gramm-Leach-Bliley Act of 1999: A Bridge Too Far? Or Not Far Enough?," *Suffolk University Law Review*, 2009-2010, *43*, 937-956.
- Whittington, Keith E. and Daniel Carpenter**, "Executive Power in American Institutional Development," *Perspectives in Politics*, 2003, *1*, 495-513.
- Wilmarth, Arthur**, "The Transformation of the US Financial Services Industry, 1975-2000," *University of Illinois Law Review*, 2002, *2*, 215-476.
- Wilson, James Q.**, *The Politics of Regulation*, New York: Basic Books, 1980.
- , *Bureaucracy: What Government Agencies Do and Why They Do It*, New York: Basic Books, 1989.
- Wilson, Woodrow**, "The Study of Administration," *Political Science Quarterly*, 1887, *2* (2), 197-222.

## REFERENCES

---

- Wolf, Martin**, “The Challenge of Halting the Financial Doomsday Machine,” *The Financial Times*, April 20 2010.
- Wolfe, Simon**, “Structural Effects of Asset-Backed Securitization,” *The European Journal of Finance*, 2000, 6 (4), 353–369.
- Wolfinger, Raymond E.**, “Nondecisions and the Study of Local Politics,” *American Political Science Review*, 1971, 65, 1063–1080.
- Woll, Cornelia**, “Learning to Act on World Trade: Preference Formation of Large Firms in the United States and the European Union,” *MPIfG Discussion Paper*, 2005, 05/01.
- Wood, Duncan**, *From Bretton Woods to Basle: Authority-Market Relations in the International Banking System*, Ph.D. Dissertation, Kingston, Ontario: Queen’s University, 1996.
- , *Governing Global Banking: The Basel Committee and the Politics of Financial Globalization*, Burlington, VT: Ashgate, 2005.
- Woodward, Bob**, *Maestro: Greenspan’s Fed and the American Boom*, New York: Simon and Schuster, 2001.
- Woolley, John T. and J. Nicholas Ziegler**, *Crisis and Control: Institutional Change in Financial Market Regulation*, Frankfurt, Germany: Campus,
- Worth, Nancy**, “Harmonizing Capital Adequacy Rules for International Banks and Securities Firms,” *North Carolina International Law and Commercial Regulation*, 1992-1993, 18, 133–171.
- Wright, John R.**, “Contributions, Lobbying, and Committee Voting in the U.S. House of Representatives,” *The American Political Science Review*, 1990, 84 (2), pp. 417–438.
- Yang, Catherine**, “Numbers Game,” *Forbes*, March 10 1986, p. 102.
- Zaring, David T.**, “International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations,” *Texas International Law Journal*, 1998, 33, 281–330.
- , “Informal Procedure, Hard and Soft, in International Administration,” *Chicago Journal of International Law*, 2005, 5 (2), 547–603.