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Preface

By 2008 the global financial crisis threatened the world economy. As asset prices plummeted and investors lost confidence in major financial institutions, governments around the world rushed to shore up their financial systems. The US government took over the multi-trillion dollar mortgage finance giants, Fannie Mae and Freddie Mac, as they were going bankrupt. Governments in about two dozen industrial economies deemed it necessary to provide financial support to many of the world's largest financial institutions, including American International Group, Bank of America, Citigroup, Goldman Sachs, JP Morgan, Union Bank of Switzerland, Northern Rock, and Royal Bank of Scotland.

The global crisis is much more than a financial disaster: it is an economic and social calamity that has had devastating and lasting effects on the lives of millions of people around the world. The unemployment rate in the United States was about 4.5 percent in 2006 to 2007. It more than doubled to over 10 percent in 2010 and still remained about 9 percent in mid-2011. Workers in European countries also suffered, with unemployment rates rising from about 7.5 percent in 2007 to 10 percent in 2011. Alarmingly, youth unemployment rates reached 40 percent in some countries. Economic opportunities available to many individuals were constrained by crippled financial systems. Bank credit, which when employed effectively provides the means for entrepreneurs to grow existing businesses or start new ones, dried up in 2008. In Europe, net bank lending (new loans less the repayment of the principal on existing loans) declined to zero, while in the United States, it turned negative.

The fiscal burdens imposed on governments by the crisis will be felt for many decades. As governments nationalized the losses of failing financial institutions and economies slid into recessions, national debt soared to alarming levels. In the United States, federal debt held by the public nearly doubled, jumping from about 35 percent of gross domestic product in 2001 to almost 70 percent in 2011. The fiscal fallout has been similar in many other countries. In Spain, the national debt also doubled, rising from less than 40 percent in 2007 to about 80 percent of national output in 2011; the debt burden in Ireland has been even worse. All of this additional debt means that current and future citizens are going to pay more in taxes and receive less in social services during the coming decades.

The adverse consequences resulting from the global crisis are all too evident in various statistics. Investors often rush to invest in gold when they are worried about the future; the price of gold was about $400.00 an ounce in 2002 but rose to above $1,500 an ounce by mid-2011. The major rating agencies downgraded the sovereign debt of many major countries, and even downgraded US government debt in 2011. The cost of insuring the payment on the outstanding debt of several European countries, notably Greece, Ireland, Italy, Portugal, and Spain, and several US states, such as California, Illinois, Michigan, and New York jumped markedly after 2008, in some cases rising four- or fivefold.

The widespread financial collapse has severely undermined faith in the institutions that were created by governments to ensure the safety and soundness of financial systems. Whether through official supervision, sound regulatory rules, or effective markets, the major regulatory agencies were charged with creating an environment that would foster an efficient allocation of resources, promote economic growth, enable the pursuit of economic opportunities, and reduce the likelihood of a systemic crisis like the one that occurred and from which so many continue to suffer.

What went wrong? Did a combination of bad luck, a few policy mistakes, and some overly ambitious financiers lead to the collapse of the global financial system? Or did core institutional deficiencies in the system associated with selecting, implementing, and reforming financial policies help cause this and other crises? If the latter, have we corrected those weaknesses and, if not, are those defects setting the stage for the next, perhaps even larger, crisis?

This book is about the role played by the Guardians of Finance—the major financial regulatory institutions—in aiding and abetting the global financial crisis. During the ten to fifteen years during which this crisis was brewing, what were such "Guardians" as the Federal Reserve, Securities and Exchange Commission, and Federal Deposit Insurance Corporation in the United States doing? What about financial regulators in other countries? Did the Financial Services Authority in the United Kingdom, the Irish Financial Regulator, the Financial Supervisory Authority in Iceland, the Office of the Superintendent of Financial Institutions in Canada, and regulators in many other countries encourage or discourage the excessive risk-taking associated with the economic devastation through which millions of individuals are suffering? In the most recent crisis, and in earlier crises, governments have usually responded by adding more regulations and more regulators. Given that the severity of crises has been growing over time, isn't it time to reconsider the fundamentals—the core institutions associated with financial regulation?

In this book we evaluate the role of major financial regulators in leading us from crisis to crisis, analyze their behavior, and suggest ways of reforming the Guardians of Finance so that they work for society at large—and not just for a few financial elites.

Acknowledgments

Authors depend on discussions with, feedback from and advice given by many in the course of putting together a manuscript, and we are no exceptions. In addition to valuable suggestions from three anonymous referees, we received numerous comments, source materials, and/or suggestions on the manuscript from Maria Carkovic, John Chant, Chuck Friedman, Charles Goodhart, Stephen Grenville, Stephen Haber, Patrick Honohan, Philip Lane, Eric Lewin, Charles Littrel, Rick Mishkin, Lindsay Mollineaux, Dan Nolle, and Larry Promisel. We also benefited from excellent advice and editorial services at MIT Press from Jane Macdonald, Janice Pieroni, and Emily Taber, as well as Dina McNichols, Jim's former Milken Institute colleague.

Jim was fortunate roughly ten years ago, thanks to Jerry, to spend a semester visiting the World Bank, where he met Ross. This has led to a stimulating and productive collaboration examining various aspects of bank regulation. This book is the most recent product of our joint research. He has benefited from conversations with several of his colleagues at Auburn University, especially Dan Gropper and John Jahera, as well as his colleagues at the Milken Institute, including Glenn Yago, Tong Li, Triphon Phumiwasana, Wenling Lu, and Apanard Angkinand. He is also grateful to Dan Brumbaugh, who not only first introduced him to the problems of bank regulation but co-wrote numerous papers that have influenced his thinking about these problems. Helpful comments, even when taking issue with some of the conclusions, were provided at a seminar at the US Comptroller of the Currency a few months before the book was finalized.

Jerry began thinking about this book while supported by a Fulbright grant to visit at Trinity College, Dublin, during the unfolding of the Irish crisis in 2009; he thanks the Institute for International Integration Studies at Trinity, as well as the World Fellowship from Williams College and the Fulbright Program, for making that visit possible. He benefited from comments from the PhD seminar he taught on Financial Crises at Trinity, and from those he received at conferences at the Finlawmetrics Conference at Bocconi University; the VII Colloquium on "Financial Collapse: How Are the Biggest Nations and Organizations Managing the Crisis?" organized by the Associazione Luiss-Guido Carli and Fondazione Cesifin "Alberto Predieri" in collaboration with the editors of *The Journal of Financial Stability,* October 2, 2009, Ravenna; The World Bank; Queens University, Belfast; The Central Bank of Ireland; The Brookings Institution; and the University of Maryland.

Ross had the good fortune of presenting bits and pieces of this book at many seminars and conferences, including at the Bank for International Settlements, Brown University, Claremont–McKenna College, the Federal Reserve Banks of Boston and Chicago, Kansas City Federal Reserve's conference in Jackson Hole, Wyoming, the Fuqua School of Business, the Geneva Institute, George Washington University, the Hoover Institute, the International Monetary Fund, the London School of Economics, and the World Bank. Unsurprisingly, some regulatory individuals and others at these conferences had objections. And indeed we have revised and honed our views through these helpful interactions. Furthermore Ross deeply appreciates the numerous helpful conversations with his colleagues and students at Brown, including Oded Galor, Juan Carlos Gozzi, Peter Howitt, Eric Lewin, Glenn Loury, Lindsay Mollineaux, David Weil, and Yona Rubinstein, each of whom sometimes disagreed vehemently with various points but none of whom gave up on setting Ross right.

We are indebted to our families. Ross thanks Steve who kept forcing him to explain things better and Norman who urged him to put the big picture together in a book. His wife Maruja was an intellectual companion, talking about the big themes, the organization of chapters, the phrasing of sentences, the rewriting of sentences, the reorganization of chapters, and the reconsideration of big themes. The book would not be the same without the clarity or her insights. And Ben and Rebecca were enthusiastic supporters, patiently hearing more about financial regulation than teenagers should have to bear over dinner.

Jerry thanks his wife Jeanne for putting up with far too many nights and weekends of work on this manuscript, not to mention so many "thrilling" conversations given over to explanations of the regulation of finance on far too many occasions!

Jim dedicates this book to his daughter Rachel for always "pushing" him to write for a broader and less technical audience and to his brother Robert for providing motivation to write another book for him to read.

Despite all of this support, we take responsibility for the views expressed here. Any errors likely result from not listening sufficiently to one or more of the people who tried to help us.

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Introduction

. . . the recent financial crisis was not a natural disaster. It was a man-made economic assault. People did it. . . . And, it will happen again unless we change the rules.
—US Senator Carl Levin[1]

An Accident?

It was a terrible, terrible accident—something awful to watch unfold. This is the narrative told by many of the world's most influential policy makers and financiers to explain the financial crisis. It was a terrible accident precipitated by an unforeseeable confluence of events that conspired to bring down the global financial system. A global savings glut, integrated international capital markets, and poorly designed macroeconomic policies fueled large capital flows. In several major economies, those flows in turn triggered lower interest rates, weaker loan standards, a boom in toxic financial innovations, and an unsustainable explosion of credit.[2] The inevitable crisis was a "perfect storm," in which fate brought together all of these events in a way no one could anticipate.

The story is told and retold by a chorus of luminaries who include Treasury Secretary Timothy Geithner and his predecessors in the position, Henry Paulson and Robert Rubin. Ben Bernanke, Chairman of the Federal Reserve Board, and his predecessor, Alan Greenspan, are in the choir, as are numerous other current and former officials and observers from around the world. Greenspan has likened the financial crisis to a "classic euphoric bubble" and a "hundred years flood."[3] Those outside the United States—such as the late Brian Lenihan, the former Finance Minister of Ireland, and then French Finance Minister (now IMF Managing Director)

Christine Lagarde—were quick to concur, suggesting that their country's "accidents" were made worse by US policy choices. Building on the bubble image, others have painted a picture of financiers behaving like lemmings following each other off the risk-return cliff in the massive rush to market increasingly complex financial products. One of them, Charles O. Prince, the former CEO of Citigroup, is frequently cited for his remarks on the eve of the crisis: "When the music stops . . . things will be complicated," he said. "But as long as the music is playing, you've got to get up and dance. We're still dancing."[4] In this version of events, policy makers were confronted with floods, bubbles, and suicidal financiers, and there was not much they could do. The crisis happened *to* them.

When policy makers are not blaming unpredictable events and uncontainable forces, they frequently claim that they could have prevented the crisis, or at least dampened its severity, if only their agencies had been granted more and broader powers. Ben Bernanke, Henry Paulson, and Christopher Cox, the former head of the SEC, repeatedly argue that they had insufficient "tool kits" to combat increasing financial market fragility. These policy makers also argue that it was sometimes unclear who had supervisory authority over systemically important financial institutions.[5] This view also fits the "accident" narrative: with insufficient legal authority and insurmountable regulatory gaps, it was impossible for policymakers to prevent the crisis.[6] As argued by Treasury Secretary Geithner,

> If we could have done it any differently, we would have done it differently. Instead, we had no other choice. That is the basic lesson.[7]

This extraordinary statement—"we had no other choice"—is at best incomplete, and an unsympathetic reader might describe it as deceptive or at least self-serving. Granted, once the crisis exploded, the damage was inevitable. Once Bear Stearns, Lehman Brothers, American Insurance Group (AIG), the government-sponsored housing finance entities (Fannie Mae and Freddie Mac), and other major banks and investment banks had failed or been bailed out by authorities around the world, serious and widespread economic fallout was unavoidable. But this does not mean that policy makers couldn't have *prevented* such a devastating crisis; it does not imply that they could not have taken prudent actions in the decade or so before the crisis to lower the risk and severity of the "accident."

This accident view is not all wrong. Large international capital flows and macroeconomic policies did fuel speculative investments. Financial innovations and deceptive practices did facilitate excessive risk-taking, fraud, and the exploitation of uninformed investors. There were regulatory gaps. Real estate prices soared and then plummeted in many parts of the United States and around the world. Many troublesome developments taking place during the decade before the crisis were difficult to discern through the deluge of daily events.

But the accident explanation is woefully incomplete. In the decade or so before the crisis, policy makers watched closely as international capital flows lowered interest rates and narrowed credit spreads, and set off the East Asian crisis in 1997. They monitored the unprecedented boom in housing prices in the United States, Iceland, Ireland, the United Kingdom, Spain, and elsewhere. They documented the credit boom and surge of fraudulent mortgage lending practices in the United States, and the growing reliance on short-term financing by banks in many countries. They closely analyzed, reviewed, and debated the explosive use and abuse of derivatives, which are financial instruments whose prices depend on the value of other assets. They enacted policies that allowed and encouraged bankers to lower the capital supporting their assets and then engage in ever more risky activities.

Things just don't add up to the perfect storm view. Several European countries with a single financial regulator and little financial innovation suffered a financial crisis, suggesting that new financial instruments and regulatory gaps were not essential ingredients. Following expert reports, authorities in Iceland, Ireland, and the United Kingdom now reject the accident view and admit that systemic defects with regulatory systems helped cause the crises. Describing the events of 2007 to 2009 as an accident misses essential features of what transpired during the ten to fifteen years before the crisis.

By wrapping the accident narrative around themselves as insulation against blame for the current crisis, policy makers impede the development of reforms that might prevent the next crisis. The world is now dealing with wreckage from the colossal failure of financial regulation, where "regulation" refers to the full range financial policies, rules, enforcement procedures, and official supervisory practices associated with shaping financial market activities. Only by identifying the full range of factors giving rise to the crisis—including flaws with regulatory institutions themselves—can one develop comprehensive and meaningful reforms that enhance the functioning of financial markets and institutions to the betterment of societies.

This Book

The purpose of our book is to document major financial regulatory failures during the ten to fifteen years before the most recent crisis and propose reforms that would improve the financial regulatory system. It is not about the crisis period and who did what after it broke out; nor is it only about the United States. It is about how systemic weaknesses with the governance of financial regulation—the system associated with designing, implementing, assessing, and reforming financial policies—contributed to crises around the world and how to fix those defects.

We extract the more general and essential causes of the crisis by providing a longer run perspective and by looking beyond the US financial system. In analyzing the decade or so before the cascade of financial institution insolvencies and bailouts, and hence before policy makers shifted into "emergency response" mode, we examine a comparatively calm period during which the authorities had ample time to learn about the evolving impact of their policies and make adjustments to address emerging problems. By looking beyond the United States, we use a richer array of experiences to identify common deficiencies in the institutions associated with selecting, implementing, and evaluating financial policies. Although the US financial system is the epicenter of the global financial crisis and hence a focus, it has unique elements. For instance, while US regulators blame financial innovation and the alphabet soup of regulatory bodies operating in the United States, many crisis countries, some of which suffered much worse damage than the United States, did not have any of these characteristics. Did so many countries suffer their worst crisis since the Great Depression with no common elements? In this book, we identify the common elements underlying breakdowns in regulatory systems in countries around the globe.

The Guardians of Finance Did Not Work for Us

Rather than characterize the crisis as an accident, we show that financial regulators—the Guardians of Finance—repeatedly designed, implemented, and maintained policies that helped precipitate the global financial crisis. The Guardians embraced policies that permitted, and too frequently encouraged, the executives of private financial institutions to undertake socially harmful, though privately profitable, investments. We do not believe regulators intended to cause the crisis, or even that they acted with malice. But we do provide abundant evidence that they recklessly endangered the global economy.

Regulators ignored warning signs of increasing financial system fragility, signs that should have been quite clear in light of the 130+ financial crises around the world since 1980.[8] Regulators did little when leading commercial banks moved over half of their assets off balance sheets, when the largest financial institutions dramatically reduced owner-contributed equity capital through the purchase of opaque credit default swaps, when their own inspectors repeatedly identified problems in financial institutions, when banks grew their assets at unprecedented rates, and when they learned that their own policies were encouraging reckless behavior by financiers. We do not claim that any single policy maker put all the pieces together and predicted the depth and breadth of the crisis. Rather, we show that regulators working within the narrow confines of their own institutions systematically chose policies that increased the fragility of that component of the financial system for which they were responsible, and they maintained those policies even as they learned about the adverse consequences of their decisions.

The crisis was not simply the result of an uncontainable bubble, it was not only due to the incompetence and impotence of regulators, it was not just a mistake, and it does not primarily reflect regulatory gaps. There was a systemic failure of the system associated with selecting, implementing, assessing, and reforming financial regulations. The crisis did not just happen *to* policy makers. It happened because of them.

Although we recognize that a multitude of factors contributed to the crisis, we focus on one, crucial precipitating factor: the Guardians of Finance adopted policies that induced financiers to take excessive risk; they often knew their policies were destabilizing the financial system many years before the crisis; and the Guardians too often chose not to reform their destabilizing policies, even though they had the power and time to do so.

Why Do the Interests of the Guardians Deviate from Those of the Public?

Why didn't the Guardians work for us? To address this question, we first ask, what *incentivized* regulators to behave the way they did? We then document the failings in the governance of financial regulation that *allowed* regulators to behave in the ways that they did.

What motivated the Guardians to make the decisions they made? Perhaps there is no single answer. One line of reasoning argues that the Guardians of Finance were captured by a flawed ideology that led to a series of regulatory debacles. For example, Ayn Rand's "acolytes"—Alan Greenspan and Christopher Cox—made policy decisions based on a superficial understanding of free markets. By assuming that private financial institutions would operate prudently, *despite* incentives to do otherwise, these Guardians helped guide the world directly into a "perfect storm." Although we do not believe that one ideology fully accounts for the crisis, ideologies matter. We later document how defective ideologies helped destabilize financial systems.[9]

Many stress that corruption and the "revolving door" between financial institutions and regulatory agencies pervert financial regulation. For example, the prominent MIT economist Simon Johnson and former McKinsey consultant James Kwak note that as people move from private financial institutions to regulatory positions and back again, there is a question of whose interests these people are serving when they are regulators.[10] Robert Rubin was the co-head of Goldman Sachs, then Secretary of the Treasury, and then a senior official at Citigroup. Henry Paulson was CEO of Goldman Sachs and then Secretary of the Treasury. Gerald Corrigan was president of the New York Federal Reserve and is now a senior official at Goldman Sachs. William Dudley was a partner and managing director at Goldman Sachs and is now president of the New York Federal Reserve Bank. David Mullins was vice-chairman of the Board of Governors of the Federal Reserve System (subsequently in this book, "the Fed") and then resigned to become a partner in the infamous hedge fund Long Term Capital Management.[11] More generally, every single president of the New York Federal Reserve, except the first one, Benjamin Strong (who held that job after serving as president of Bankers Trust and then died in office) and Timothy Geithner (who went on to become Treasury Secretary, but whose career is not yet over), went on to work for a private financial institution after leaving public office. And, the co-founder and editor of *Institutional Risk Analytics*, Christopher Whalen documents how members of the New York Federal Reserve, including those in the Division of Supervision and Regulation, frequently move directly from