Foreword: Deregulation: A Major Cause of the Financial Crisis

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Introduction

I am delighted to introduce this Harvard Law and Policy Review Symposium on Regulation and Institutional Reform. The articles in this issue explore the importance of government regulation of business in protecting the health and welfare of the American people. *The Truth About Regulation in America* describes the critical need for safety regulations provided by several federal agencies devoted to protection of consumers, workers, and the environment. *The Big Squeeze: The Communications Crisis in America* focuses on increasing concentration in the communications industry, the resulting reduction in competition, and its implications for the public. *Business as Usual? Analyzing the Development of Environmental Standing Doctrine Since 1976* presents an empirical analysis of the application of standing rules in environmental cases, with some encouraging results for environmental advocacy groups. Finally, *Federal Funding and the Institutional Evolution of Federal Regulation of Biomedical Research* describes challenges in federal oversight of medical research in an era where funding and other aspects of the research are changing.

My recent service as a member of the Financial Crisis Inquiry Commission ("FCIC") brought home to me how important it is for us to reexamine the role of business regulation. We are now experiencing the tragic results of thirty years of deregulatory pressures in the financial sector. The FCIC quite rightly concluded that failures in financial regulation and supervision along with failures of corporate governance and risk management at major financial firms were prime causes of the financial crisis engulfing this country in 2007 and 2008.[1]

As the report recently issued by the FCIC documents, decades of deregulation and failure to regulate newly emerging financial markets, firms, and products led to a financial system that was extremely fragile and vulner-

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[1] Fin. Crisis Inquiry Comm'n, Financial Crisis Inquiry Report at xviii-xix (2011), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf [hereinafter FCIC Report]. The FCIC was created by section 5 of the Fraud Enforcement and Recovery Act of 2009 and was directed "to examine the causes, domestic and global, of the current financial and economic crisis in the United States." Pub. L. No. 111-21, § 5(a), 123 Stat. 1617, 1625 (2009). It issued the FCIC Report on January 27, 2011.

able to a full-blown crisis when the U.S. housing bubble collapsed. Federal Reserve Board ("Fed") Chairman Ben Bernanke told the FCIC,

> [P]rospective subprime losses were clearly not large enough on their own to account for the magnitude of the crisis. . . . Rather, the system's vulnerabilities, together with gaps in the government's crisis-response toolkit, were the principal explanations of why the crisis was so severe and had such devastating effects on the broader economy.[2]

The FCIC found that these vulnerabilities in our financial system were the direct result of a growing belief in the self-regulating nature of financial markets and the ability of financial firms to police themselves. Former Fed Chairman Alan Greenspan—a laissez-faire economist—championed these beliefs during his nineteen years in office. With support from large financial services firms, their trade associations, and like-minded economists, he was able to persuade a number of policy makers in several successive presidential administrations, members of Congress, and federal financial regulators to support deregulatory efforts on the false assumption that self-regulation would be sufficient to protect the financial system and our economy against excesses in the market. As he argued in 1997, "[I]t is critically important to recognize that no market is ever truly unregulated. The self-interest of market participants generates private market regulation. Thus, the real question is not whether a market should be regulated. Rather, the real question is whether government intervention strengthens or weakens private regulation."[3]

The FCIC found that the financial sector devoted enormous resources to its effort to convince federal policy makers of the need for deregulation. In the decade leading up to the financial crisis, the sector spent $2.7 billion on federal lobbying efforts, and individuals and political action committees ("PACs") related to the sector made more than $1 billion in federal election campaign contributions.[4] Fannie Mae and Freddie Mac, government-sponsored entities with a public mission to support the mortgage market, exemplify the political power financial services firms used to resist regulation. From 1999 to 2008, they spent $164 million on lobbying efforts, and their employees and PACs made $15 million in campaign contributions.[5] As stated by Armando Falcon, Jr., who headed their federal regulator, "[T]he Fannie and Freddie political machine resisted any meaningful regulation using highly improper tactics."[6]

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[2] FCIC REPORT, *supra* note 1, at 27; Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Written Statement before the FCIC 2 (Sept. 2, 2010).

[3] FCIC REPORT, *supra* note 1, at 53–54; Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Government Regulation and Derivative Contracts, Remarks at the Financial Markets Conference of the Federal Reserve Bank of Atlanta (Feb. 21, 1997) (transcript available at http://www.federalreserve.gov/boarddocs/speeches/1997/19970221.htm).

[4] FCIC REPORT, *supra* note 1, at 55.

[5] *Id.* at 41–42.

[6] *Id.* at 42; Armando Falcon, Jr., Written Testimony before the FCIC 5 (Apr. 9, 2010).

As a result of these pressures, significant regulatory gaps developed in the financial system including the lightly regulated shadow banking system that grew to rival the traditional banking system in size and importance and the enormous market in deregulated over-the-counter derivatives. A number of investment banks grew to be of systemic importance without adequate oversight. Institutional supervision of large bank holding companies, commercial banks, and thrifts was gradually weakened, allowing them to engage in riskier activities. Mortgage lending standards deteriorated, and securitization of mortgage-related assets burgeoned with little regulatory scrutiny. These developments created the conditions that caused the collapse of the housing bubble to turn into a major financial crisis. As Fed Chairman Ben Bernanke told the FCIC, "As a scholar of the Great Depression, I honestly believe that September and October of 2008 was the worst financial crisis in global history, including the Great Depression."[7]

As a member of the FCIC, I voted in favor of adopting and issuing its report, which is a comprehensive history of the financial crisis and its causes. The report is based on an extensive investigation, which included nineteen days of public hearings, interviews with more than 700 witnesses and review of millions of pages of documents. I commend the report to the reader. It fully supports the FCIC's conclusions about the devastating role that inadequate regulation played in causing the financial crisis and the resulting economic crisis we are still suffering today.

During the late 1990s, as chair of the U.S. Commodity Futures Trading Commission ("CFTC"), I participated in the debate described in Section III below about whether the over-the-counter derivatives market should be regulated. The CFTC was concerned that the rapidly growing and opaque market posed dangers to market participants and the financial system as a whole and asked whether a regulatory scheme similar to that imposed on futures and options markets would significantly reduce those dangers. Deregulatory forces prevailed in the debate, and during the FCIC's investigation it came as no surprise to me as evidence demonstrated that excesses in the deregulated over-the-counter derivatives market played a major role in the financial crisis.

Beyond that, however, the FCIC investigation revealed that financial deregulation was not limited to the derivatives market, but has been pervasive, extending to mortgage lending, securities regulation, and institutional supervision, among other areas. Described in more detail below are some of the deregulatory actions that the FCIC found contributed significantly to the financial crisis. Without comprehensive financial regulatory reform such as that contained in the Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") enacted last year,[8] we would remain vulnerable to the dangers of widespread regulatory inadequacy.

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[7] FCIC Report, *supra* note 1, at 354; Interview by the FCIC with Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., 24 (Nov. 17, 2009).

[8] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

I. The Federal Reserve Board's Refusal to Regulate Mortgage Lending Standards

The FCIC found that there was an explosion in risky mortgage lending accompanied by a significant deterioration in mortgage lending standards in the years leading up to the financial crisis, with many mortgage lenders ignoring borrowers' ability to repay their loans. Because lenders no longer held loans for the duration of the mortgages, but instead sold them to mortgage securitizers, they passed on the risks of the loans and had little incentive to maintain high lending standards.[9] In addition, lenders made many predatory loans designed to impose high interest payments or other terms increasing the yield on the loans.

The FCIC found that the Fed had the statutory authority to regulate the terms of mortgages issued by all lenders nationwide and to address predatory lending practices under the Home Ownership and Equity Protection Act of 1994.[10] The Fed was well aware of the widespread abuses in mortgage lending practices, having received reports from lenders, consumer advocates, and its own staff about the increase in risky mortgage lending and the falling underwriting standards.[11] Nonetheless, the Fed refused to take action effectively to regulate this irresponsible lending.

Sheila Bair, the current chairman of the Federal Deposit Insurance Corporation and an Assistant Secretary of the Treasury from 2001 to 2002, testified before the FCIC that such regulation would have made a difference:

> I think nipping this in the bud in 2000 and 2001 with some strong consumer rules applying across the board that just simply said you've got to document a customer's income to make sure they can repay the loan, you've got to make sure the income is sufficient to pay the loans when the interest rate resets, just simple rules like that . . . could have done a lot to stop this.[12]

Despite her efforts and those of Fed governor Edward Gramlich, the Fed refused to strengthen its regulations to stop the predatory lending. As explained by the Fed's General Counsel, Scott Alvarez, it failed to do so because of its deregulatory attitude: "The mind-set was there should be no regulation; the market should take care of policing, unless there already is an identified problem . . . . We were in the reactive mode because that's what the mind-set was of the '90s and the early 2000s."[13]

Stemming the volume of risky mortgages might well have prevented the housing bubble that triggered the financial crisis or at least mitigated its

[9] FCIC Report, *supra* note 1, at xvii, xxiii–xxiv.

[10] *Id.* at xvii; Pub. L. No. 103-325, §§ 151–158, 108 Stat. 2160, 2190 (1994).

[11] *See* FCIC Report, *supra* note 1, at 20, 93–96, 108–09.

[12] *Id.* at 79; *First Public Hearing of the Financial Crisis Inquiry Commission, Day Two*, 97 (2010) (statement of Sheila Bair, Chairman, Fed. Deposit Ins. Corp.).

[13] FCIC Report, *supra* note 1, at 96; Interview by the FCIC with Scott Alvarez, General Counsel, Bd. Of Governors of the Fed. Reserve Sys., 15 (Mar. 23, 2010).

effects. Current Fed Chairman Ben Bernanke told the FCIC that the failure to regulate the mortgage market during the housing boom "was the most severe failure of the Fed in this particular episode."[14] The FCIC found that this inaction was a "prime example" of regulatory failure to prevent the financial crisis.[15]

II. The Securities and Exchange Commission's Failure to Enforce Disclosure by Mortgage Securitizers

The FCIC found that many of these risky mortgages were securitized and sold to investors around the world. Indeed, between 2003 and 2007, $4 trillion of mortgage-backed securities and $700 billion of mortgage-related collateralized debt obligations ("CDOs") were issued.[16] This mortgage securitization fueled the demand for risky mortgages and contributed significantly to the housing bubble.[17]

The large financial institutions creating and selling these securities were transferring the risks of the underlying poor quality mortgages to their purchasers. Those investors were lulled into a false sense of security because of the high credit ratings of the securities and the availability of credit default swap protection from large institutions such as insurance giant American International Group ("AIG"). When the housing bubble burst, many of these securities were downgraded and lost much of their value.

The FCIC found that in a number of instances the securitizing firms sold the securities to investors without full and adequate disclosure of the quality of the loans.[18] "[F]irms securitizing mortgages failed to perform adequate due diligence on the mortgages they purchased and at times knowingly waived compliance with underwriting standards. Potential investors were not fully informed or were misled about the poor quality of the mortgages contained in some mortgage-related securities."[19]

The Securities and Exchange Commission ("SEC"), which had the responsibility to ensure that adequate disclosures were made to investors, conducted little or no review of the disclosures on mortgage-related securities because of reliance on "shelf registration" and exemptions from registration.[20] Shelf registration permitted securitizers to file an initial prospectus for mortgage-backed securities and then to file supplements for each subsequent issuance. Shelley Parratt, the SEC's deputy director of disclosure, admitted, "The elephant in the room is that we didn't review the prospectus

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[14] FCIC Report, *supra* note 1, at 3; Bernanke, *supra* note 7, at 74; *Hearing on "Too Big to Fail: Expectations and Impact of Extraordinary Government Intervention and The Role of Systemic Risk in the Financial Crisis" before the FCIC, Day Two*, 27 (2010).

[15] FCIC Report, *supra* note 1, at xvii.

[16] *Id.* at 129.

[17] *See id.* at xxiii-xxiv.

[18] *Id.* at xxii, 165–69.

[19] *Id.* at 187.

[20] *Id.* at 169–170, 187.

supplements."[21] Mortgage-related CDOs were generally exempt from all registration because they were not treated as public offerings. Not only did the SEC fail to review the disclosures to investors concerning these securities, but state regulators had been preempted from doing so.[22]

III. Deregulation of Over-the-Counter Derivatives

The FCIC concluded that over-the-counter ("OTC") derivatives contributed significantly to the financial crisis and that the market's deregulation by statute in 2000 "was a key turning point in the march toward the financial crisis."[23] This deregulation of an enormous financial market was knowingly undertaken at the urging of large financial services firms and their regulators despite widely available information about the dire risks it posed.

Until the early 1990s, most derivatives were required by statute[24] to be traded on exchanges and were overseen by the CFTC, which enforced a comprehensive regulatory regime. However, in 1993, under the chairmanship of laissez-faire economist Wendy Gramm, the CFTC exempted certain non-fungible derivatives traded by sophisticated parties from exchange trading and most other regulatory requirements.[25]

Soon thereafter, a number of scandals and large losses occurred involving these exempted OTC derivatives.[26] In response to these events, the U.S. General Accounting Office conducted an investigation and issued a report pointing out serious systemic risks posed by this market.[27] In addition, in 1998 while I was chair of the CFTC, it considered whether more regulation of the market was needed.[28]

The CFTC effort was immediately condemned by Alan Greenspan and other federal financial regulators, who proposed a Congressional moratorium on the CFTC's regulation of OTC derivatives. In testimony urging such a moratorium, Alan Greenspan said, "[A]side from safety and soundness regulation of derivatives dealers under the banking and securities laws, regulation of derivatives transactions that are privately negotiated by professionals is unnecessary."[29]

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[21] *Id.* at 169.

[22] *Id.* at 187.

[23] *Id.* at xxiv–xxv.

[24] Commodity Exchange Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (1974).

[25] FCIC Report, *supra* note 1, at 46.

[26] *Id.* at 46–47.

[27] *Id.* at 47; U.S. Gen. Accounting Office, Financial Derivatives: Actions Needed to Protect the Financial System, GGD-94-133 (1994).

[28] FCIC Report, *supra* note 1, at 47; Over-the-Counter Derivatives Concept Release, 63 Fed. Reg. 26,114 (May 12, 1998).

[29] FCIC Report, *supra* note 1, at 47; *Hearing on H.R. 4062, the "Financial Derivatives Supervisory Improvement Act of 1998" Before the H. Comm. on Banking and Fin. Servs.*, 105th Cong. (1998) (written testimony of Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys.).

Two months after this testimony, in September 1998, the systemic dangers of OTC derivatives were vividly demonstrated by the threatened default of Long Term Capital Management ("LTCM") on $1.25 trillion in notional amount of OTC derivatives that it had managed to acquire on less than $5 billion in capital. The Federal Reserve Bank of New York concluded that a failure by LTCM would endanger the financial system and masterminded a rescue by fourteen of LTCM's OTC derivatives counterparties.[30]

Despite this clear example of the dangers posed by the deregulated OTC derivatives market, Congress passed the CFTC moratorium a few weeks later in October 1998.[31] In December 2000, on the recommendation of federal financial regulators, Congress adopted the Commodity Futures Modernization Act, deregulating the OTC derivatives market by eliminating CFTC jurisdiction over it and preempting state laws on gaming and bucket shops.[32]

After this deregulation, the OTC derivatives market experienced explosive growth, expanding more than sevenfold in the seven and a half years leading up to June 2008, when it reached its peak at $672.6 trillion in notional amount.[33] The FCIC found that this enormous unregulated market was characterized by "uncontrolled leverage; lack of transparency, capital, and collateral requirements; speculation; interconnections among firms; and concentrations of risk."[34]

The FCIC concluded that OTC derivatives played several major roles in the financial crisis. Credit default swaps ("CDS") are OTC derivatives contracts in which one party agrees to pay the other party in case of a default on an obligation such as a mortgage-related security. In exchange, the other party makes a series of premium-like payments. Investors in mortgage-related securities purchased CDSs from large OTC derivatives dealers such as AIG in order to protect themselves from default on the securities. The FCIC found that the reassurance provided to investors by these CDSs fueled mortgage securitization and the housing bubble.[35]

In addition, CDSs were used to create synthetic CDOs, which were not actual mortgage assets at all but rather were merely bets on mortgage securities. These bets significantly amplified the losses from the collapse of the housing bubble, multiplying the amount riding on particular mortgage securities. Goldman Sachs alone created and sold more than $70 billion of such bets.[36]

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[30] FCIC Report, *supra* note 1, at 47–48.

[31] Omnibus Consolidated and Emergency Supplemental Appropriations Act, Pub. L. No. 105-277, § 760, 112 Stat. 2681-1, 2681-35 (1998)

[32] FCIC Report, *supra* note 1, at 48; Pub. L. No. 106-554, appx. E, 114 Stat. 2763, 2763A-35 (2000).

[33] FCIC Report, *supra* note 1, at 48.

[34] *Id.* at xxiv.

[35] *Id.*

[36] *Id.* at xxiv-xxv, 190–192.

AIG's near failure because of its issuance of $79 billion of CDSs on risky mortgage securities was one of the precipitating causes of the financial crisis. AIG had failed to set aside capital reserves or hedge its exposure on these OTC derivatives because it erroneously believed it would never have to pay out on them. When AIG was unable to meet its obligations to post collateral on these CDSs, the government had to rescue it, ultimately committing more than $180 billion because of concerns that AIG's collapse would trigger losses cascading through the financial system.[37]

In addition to the role of CDSs in the financial crisis, the FCIC concluded that "the existence of millions of derivatives contracts *of all types* between systemically important financial institutions—unseen and unknown in this unregulated market—added to uncertainty and escalated panic, helping to precipitate government assistance to those institutions."[38] Because OTC derivatives contracts created interconnections between firms through counterparty credit exposures, the failure of one large financial firm had the potential of spreading losses and failures throughout the financial system.

IV. Profound Failures of Institutional Supervision

The FCIC found that federal supervisors of bank holding companies and investment banks failed in their mission to preserve the safety and soundness of a number of systemically important financial institutions.[39] These institutions either failed or would have failed but for government assistance during the financial crisis.

A. Investment Banks

Perhaps the most egregious supervisory failure was the SEC's Consolidated Supervised Entity ("CSE") program, which was established in April 2004.[40] Under the program the country's five largest investment banks, Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns, voluntarily submitted themselves to prudential supervision by the SEC.

The SEC had previously regulated the investment banks' securities broker-dealer operations and in doing so focused primarily on investor protection. The CSE program was essentially the SEC's first foray into "safety and soundness" or prudential institutional supervision, and the FCIC found that it had neither the expertise nor the resources necessary to perform that role.[41]

[37] *Id.* at xxv, 352.
[38] *Id.* at xxv (emphasis added).
[39] *Id.* at xviii.
[40] *Id.* at 150–54.
[41] *Id.* at 151.

The primary incentive for participation in the CSE program was a 2002 directive of the European Union that consolidated supervision of financial holding companies and their subsidiaries was a prerequisite for them to continue to do business in Europe.[42] The large U.S. investment banks with worldwide operations suddenly needed to find a consolidated supervisor to oversee their operations. Rather than submit themselves to the rigor of consolidated supervision by the Federal Reserve System, which oversees bank holding companies, they requested that the SEC establish the CSE program, presumably on the assumption that the SEC would be a more lenient supervisor.[43]

Because the SEC had no statutory authority to impose supervision on investment banks, it developed a program that allowed the five investment banks to submit to supervision voluntarily. As an inducement for the investment banks to do so, the SEC decided to permit a supervised investment bank to use a different and less rigorous method of calculating its securities subsidiary's net capital based on value-at-risk models created by the firm. The SEC believed that this change would allow an estimated reduction of forty percent in the subsidiary's capital charges.[44] Concern about this capital rule change was expressed during the SEC meeting at which the CSE program was adopted. Commissioner Harvey Goldschmid said, "If anything goes wrong it's going to be an awfully big mess. Do we feel secure if these drops in capital and other things [occur] we really will have investor protection?"[45]

Within four and a half years of the SEC's adoption of the CSE program, all of the five investment banks supervised under the CSE program had disappeared in the financial crisis: Lehman Brothers was bankrupt, Bear Stearns and Merrill Lynch had been acquired under emergency circumstances by large bank holding companies, and Goldman Sachs and Morgan Stanley had saved themselves by converting to bank holding companies supervised by the Federal Reserve. In terminating the program, then Chairman of the SEC Christopher Cox concluded that it had been "fundamentally flawed from the beginning."[46]

The FCIC found that the CSE program had a number of weaknesses. The program's staff was so limited that, unlike banking supervisors, it was unable to place on-site examiners at the investment banks, and it failed to follow up on findings of deficiencies by requiring changes in operations.[47]

The supervised investment banks were brought to the brink of failure by high leverage, insufficient liquidity, large exposures to risky mortgage loans and mortgage-related securities, and an undue reliance on short-term

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[42] *Id.* at 150–51.
[43] *Id.* at 151, 154.
[44] *Id.* at 151–52.
[45] *Id.* at 152–53.
[46] *Id.* at 154; Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008) (on file with the Harvard Law School Library).
[47] FCIC Report, *supra* note 1, at 153.

borrowing in the commercial paper and repo markets.[48] For example, Bear Stearns had enormous leverage—thirty-eight to one. Despite that, former SEC Chairman Christopher Cox testified that he believed that Bear Stearns "had a capital cushion well above what is required" in March 2008 just before its collapse and emergency acquisition by J. P. Morgan.[49] Bear Stearns was also relying heavily on short-term borrowing. At the end of 2007, it was borrowing $70 billion in the overnight repo market with $11.8 billion in equity.[50]

The SEC had power under the CSE program to demand that the investment banks act more prudently, but it failed to do so. For example, the SEC Inspector General reported that the CSE program had failed to require Bear Stearns to reduce its high leverage and its large position in mortgage securities.[51] The FCIC was told that the SEC failed to do so because of an attitude on the part of senior staff in the CSE program that "the SEC's job was not to tell the banks how to run their companies but to protect their customers' assets."[52] If indeed that was the view, the SEC had abandoned its role as prudential institutional supervisor and reverted to its traditional role of merely protecting the investor. As stated by current SEC Chair Mary Schapiro, the CSE "was not successful in providing prudential supervision."[53]

B. Banking Supervisors

Federal banking supervision, though somewhat more effective than the SEC's CSE program, failed to rein in the risky activities of some of the country's largest bank holding companies, including Bank of America and Citigroup. As the FCIC concluded, "In case after case after case, regulators continued to rate the institutions they oversaw as safe and sound even in the face of mounting troubles, often downgrading them just before their collapse."[54]

For example, the Office of the Comptroller of the Currency ("OCC") and the Federal Reserve Bank of New York did not downgrade Citigroup to "less than satisfactory status" until April 2008, several months after it had announced in November 2007 that it had exposure to $55 billion of subprime mortgage-related holdings and would take an $8 to $11 billion loss on

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[48] *Id.* at 230, 291.

[49] *Id.* at 288; Christopher Cox, Former Chairman of the U.S. Sec. and Exchange Comm'n, Written Testimony Before the FCIC 6 (May 5, 2010).

[50] FCIC Report, *supra* note 1, at xix–xx.

[51] *Id.* at 283; SEC Office of Inspector Gen., SEC's Oversight of Bear Stearns and Related Entities: the Consolidated Supervised Entity Program, Rep. No. 446-A at ix–x (2008).

[52] FCIC Report, *supra* note 1, at 283.

[53] *Id.* at 154; *First Public Hearing of the Financial Crisis Inquiry Commission, Day Two*, 39 (2010) (statement of Mary Schapiro, Chairman, U.S. Sec. and Exchange Comm'n).

[54] FCIC Report, *supra* note 1, at xviii.

them.[55] The OCC had become aware of Citigroup's enormous exposure to subprime mortgages through liquidity puts and super-senior tranches of CDOs in 2005, but did not recognize the great risks it posed to the institution. The Federal Reserve Bank of New York seemed to be unaware of Citigroup's risk management and internal control problems.[56] Timothy Geithner, then President of the Federal Reserve Bank of New York and now Secretary of the Treasury, testified, "I do not think we did enough as an institution with the authority we had to help contain the risks that ultimately emerged in that institution."[57]

These failures in banking supervision were another result of the prevailing deregulatory mindset at the Fed and other banking supervisors. As Richard Spillenkothen, a former director of the Fed's Banking Supervision and Regulation Division, explained, "Supervisors understood that forceful and proactive supervision, especially early intervention before management weaknesses were reflected in poor financial performance, might be viewed as i) overly-intrusive, burdensome, and heavy-handed; ii) an undesirable constraint on credit availability; or iii) inconsistent with the Fed's public posture."[58]

This weakening of bank supervision was in part a result of a long-term increase in permissible activities for banks that banking supervisors had allowed as exceptions to the Glass-Steagall Act of 1933,[59] which restricted banks' participation in securities markets. As banks experienced growing competition from investment banks, they pressed their supervisors and Congress to allow them to enter into new activities. Banking supervisors issued rules permitting banks or their nonbank subsidiaries to engage in increasingly risky activities, including securities activities and over-the-counter derivatives trading.[60] By 1998, many of the restrictions of the Glass-Steagall Act had been effectively eroded, and Citicorp announced a planned merger with Travelers Insurance, which would have violated the Act. In response, Congress enacted the Gramm-Leach-Bliley Act of 1999, repealing most of the remaining constraints of Glass-Steagall.[61] In explaining the bank supervisors' support for this action, Eugene Ludwig, Comptroller of the Currency from 1993 to 1998, said they had an "historic vision, historic approach, that a lighter hand at regulation was the appropriate way to regulate."[62] The

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[55] *Id.* at 260, 302–04.

[56] *Id.* at 303.

[57] *Id.*; *Hearing on "The Shadow Banking System" before the FCIC, Day Two*, 210 (2010) (statement of Timothy F. Geithner, Secretary, U.S. Dep't of the Treasury).

[58] FCIC Report, *supra* note 1, at 54; Rich Spillenkothen, Notes on the Performance of Prudential Supervision in the Years Preceding the Financial Crisis by a Former Director of Banking Supervision and Regulation at the Federal Reserve Board (1991 to 2006), at 28, May 31, 2010, *available at* http://fcic.law.stanford.edu/documents/view/1237.

[59] Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933).

[60] FCIC Report, *supra* note 1, at 34–35.

[61] Financial Services Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999); FCIC Report, *supra* note 1, at 52–55.

[62] FCIC Report, *supra* note 1, at 171; Interview by the FCIC with Eugene Ludwig, Promontory Fin. Group (Sept. 2, 2010).

Gramm-Leach-Bliley Act left some banks as vulnerable to the collapse of the housing bubble as investment banks, and a number of large bank holding companies were brought to the brink of failure during the financial crisis.

The FCIC also found that the ability of banks to choose among banking supervisors "became a race to the weakest supervisor."[63] Alan Greenspan strongly supported this ability of a bank to choose among supervisors and touted it as a mechanism to diminish regulation:

> The current structure provides banks with a method . . . of shifting their regulator, an effective test that provides a limit on the arbitrary position or excessively rigid posture of any one regulator. The pressure of a potential loss of institutions has inhibited excessive regulation and acted as a countervailing force to the bias of a regulatory agency to overregulate.[64]

The FCIC found that Countrywide Financial Corporation chose the Office of Thrift Supervision ("OTS") to be its regulator in December 2006 in part because its "regulation of holding companies is not as intrusive as that of the Federal Reserve. . . . The OTS generally is considered a less sophisticated regulator than the Federal Reserve."[65] That weak supervision permitted Countrywide Financial to issue an enormous volume of risky loans that brought it to the brink of failure prior to its acquisition by Bank of America in 2008.

OTS had also undertaken to act as the consolidated supervisor of AIG and its subsidiaries, and the FCIC found that "it lacked the capability to supervise an institution the size and complexity of AIG."[66] Not only did OTS fail to recognize the risks inherent in AIG's issuance of mortgage-related CDSs that led to its near collapse, but OTS did not adequately understand the operations of this enormous enterprise. As John Reich, who had been the director of OTS, told the FCIC, "[A]n organization like OTS cannot supervise AIG, GE, Merrill Lynch, and entities that have worldwide offices. . . . [I]t's like a gnat on an elephant—there's no way."[67]

Conclusion

The causative role of deregulation and inadequate regulation in the financial crisis demonstrates the fallacies of reliance on self-regulation in a field central to the American economy and the welfare of the American people. Rebuilding a regulatory scheme designed for modern financial markets

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[63] FCIC Report, *supra* note 1, at xviii.

[64] *Id.* at 54; Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Statement before the Senate Committee on Banking, Housing and Urban Affairs (Mar. 2, 1994), *in* 80 Fed. Reserve Bull., May 1, 1994, at 382.

[65] FCIC Report, *supra* note 1, at 173–74; Briefing Paper, Countrywide Financial Corporation, Meeting With Office of Thrift Supervision (July 13, 2006) (on file with the Harvard Law School Library).

[66] FCIC Report, *supra* note 1, at 352.

[67] *Id.* at 351; Interview by the FCIC with John Reich (May 4, 2010).

is the challenge the country now faces. The enactment of financial regulatory reforms in the Dodd-Frank Act[68] is an important first step in doing so. However, it is imperative that those provisions should be fully implemented through new agency regulations and rigorously enforced. The long-time proponents of self-regulation have launched a campaign against implementation of a number of critically important provisions using the same old arguments of unnecessary regulatory burdens. Indeed, Alan Greenspan has publicly warned against implementation of some provisions of the Act.[69] That campaign must be resisted. If the country's policymakers have not learned from the financial crisis, we will all be doomed to repeat it.

[68] Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified at 12 U.S.C. §§ 5301–5641).

[69] Alan Greenspan, *Dodd-Frank Fails to Meet the Test of our Times*, FT.COM (March 29, 2011), http://www.ft.com/cms/s/0/14662fd8-5a28-11e0-86d3-00144feab49a.html#axzz1K10k5vOd (on file with the Harvard Law School library).