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INCENTIVES AND IDEOLOGY

James Kwak*

“*If only the King knew!*, we cried a thousand times from the depths of our abyss.”

– Cahiers de doléances de Cahors, 1789¹

On November 4, 2008, Barack Obama won the United States presidential election, defeating John McCain by over seven percentage points in the popular vote.² That same day, his party gained larger majorities in the House of Representatives and the Senate than either party had held at the same time since the Carter administration.³ President Obama was elected in the midst of a severe financial crisis that wiped out half the value of U.S. stock markets and caused a net loss of almost nine million jobs.⁴ More than anything else, the public expected him to *do something about it*: protect the financial system, restore the economy to health, and reform financial markets so that such a disaster could not happen again.

Professor Adam Levitin’s Book Review⁵ surveys five books providing accounts of what happened next, as well as a sixth (*The Banker’s New Clothes*) that focuses on what should happen in the future. These books provide different perspectives on the failure of financial regulators to prevent the crisis and their many stumbles in responding to it. Behind the blow-by-blow narratives and specific policy suggestions,

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¹ Quoted in GRAHAM ROBB, *THE DISCOVERY OF FRANCE: A HISTORICAL GEOGRAPHY FROM THE REVOLUTION TO THE FIRST WORLD WAR* 81 (2007).

² FED. ELECTION COMM’N, *FEDERAL ELECTIONS 2008: ELECTION RESULTS FOR THE U.S. PRESIDENT, THE U.S. SENATE AND THE U.S. HOUSE OF REPRESENTATIVES* 5–6 (2009).

³ *Id.* at 3; *Party Divisions of the House of Representatives*, U.S. HOUSE OF REPRESENTATIVES, <http://history.house.gov/Institution/Party-Divisions/Party-Divisions/> (last visited May 13, 2014), *archived at* <http://perma.cc/X5LP-7TRT>; *Party Division in the Senate, 1789–Present*, UNITED STATES SENATE, http://www.senate.gov/pagelayout/history/one_item_and_tasers/partydiv.htm (last visited May 13, 2014), *archived at* <http://perma.cc/84DZ-9XCE>.

⁴ *Wilshire 5000 Full Cap Price Index*, ECONOMIC RESEARCH: FED. RESERVE BANK OF ST. LOUIS, <http://research.stlouisfed.org/fred2/series/WILL5000PRFC> (last visited May 13, 2014), *archived at* <http://perma.cc/JP7X-DWVZ>; *Employment, Hours, and Earnings from the Current Employment Statistics Survey (National)*, BUREAU OF LAB. STAT., <http://data.bls.gov/cgi-bin/dsrv?ce> (choose “Seasonally adjusted”; then choose “Total nonfarm”; then choose “All Employees, Thousands”; then choose “Total nonfarm”; then select “Retrieve data”).

⁵ Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay*, 127 HARV. L. REV. 1991 (2014) (reviewing six books on the financial crisis).

Levitin identifies a more fundamental question of regulatory structure and accountability in the modern administrative state. According to one story, which is popular in Washington, financial regulation is an apolitical, technocratic exercise, and it failed because the technocrats did not have the right tools. But in a second telling, which Levitin prefers, regulation is inescapably political, and it failed because regulators were captured by the very financial institutions they were charged with overseeing.

I agree with Levitin that “the real challenge for financial regulation is not in perfecting technical details . . . but in taming the politics of financial regulation.”⁶ How can this be done? Levitin discusses three possible approaches: increasing political accountability; modifying the “regulatory architecture” to reduce the possibility of capture; and mobilizing different interest groups to offset the dominant players.⁷ These are all valuable ways of correcting for the capture mechanisms that he identifies as particularly effective in the financial setting: charter shopping, shared incentives of regulator and regulated, sustained personal familiarity, and buying congressional representatives with campaign contributions.⁸ For example, as Levitin describes, the financial independence of the Consumer Financial Protection Bureau should prevent the kind of abject, fee-chasing behavior practiced by the late Office of Thrift Supervision (OTS).⁹

These types of “change[s] in governance structures for financial regulation”¹⁰ will make it possible for regulators to act in the interest of the public rather than that of the financial sector. This is a necessary condition for a safer financial system — but it may not be sufficient (and Levitin does not claim that it is).

In pre-Revolutionary France, common people would often say of their problems, “If only the King knew”¹¹ Whatever evils they suffered at the hand of their government must be due to the king’s ministers and officials, for the king himself could not be at fault. But the king knew exactly what was going on.

As Levitin shows, our financial regulators were and remain deeply enmeshed in a complex political environment. At the margin, they have the discretion to do favors for the industry or for specific institutions (such as the OTS backdating a capital infusion by IndyMac to

⁶ *Id.* at 2049.

⁷ *Id.* at 1993–94.

⁸ *Id.* at 2041–44.

⁹ *Id.* at 2055–56.

¹⁰ *Id.* at 2068.

¹¹ In French, “Si le Roi savait.” See, e.g., 1 JULES MICHELET, HISTOIRE DE LA RÉVOLUTION FRANÇAISE 78 (Paul Ollendorff 1889) (1847).

make it seem well capitalized when it actually wasn't¹²). But major regulatory decisions, such as turning a blind eye to derivatives or bailing out banks, are made by the political system as a whole.

For me, two quotations punctuate the story of the financial crisis. One is Deputy Treasury Secretary Larry Summers telling Brooksley Born in 1998, "I have thirteen bankers in my office, and they say if you go forward with this you will cause the worst financial crisis since World War II."¹³ (By "this," he was referring to Born's proposal to consider regulating over-the-counter derivatives.) The other is an unnamed Treasury official saying in 2010, "Brown-Kaufman would have broken up the six biggest banks in America. . . . If we'd been for it, it probably would have happened. But we weren't, so it didn't."¹⁴

One quotation shows a government official blocking regulation of the complex derivatives that later played a crucial role in both the inflation of the credit bubble and its spectacular collapse in 2008. In the other, a government official talks about blocking the most aggressive legislative attempt to reform the financial sector. Both are from the Treasury Department — which is directly accountable to the president. There are other examples: according to Representative Zoe Lofgren, Treasury Secretary Tim Geithner was "really dismissive" about mortgage "cramdown" (allowing bankruptcy judges to reduce the principal owed on mortgages), a campaign promise made by then-candidate Obama;¹⁵ the administration instead supported a housing program backed by the financial lobby that functioned as a back-door bank bailout.¹⁶

More generally, we can't blame everything on the bureaucrats. The financial non-regulation that made the 2008 crash possible was the explicit policy of multiple presidential administrations, and some of its most important elements sailed through Congress with bipartisan

¹² Edmund L. Andrews, *Irregularity Uncovered at IndyMac*, N.Y. TIMES, Dec. 23, 2008, <http://www.nytimes.com/2008/12/23/business/23thrif.html>, archived at <http://perma.cc/B7CC-FEWE>.

¹³ Quoted — based on the recollection of Born's lieutenant Michael Greenberger — in Manuel Roig-Franzia, *Brooksley Born, the Cassandra of the Derivatives Crisis*, WASH. POST (May 26, 2009), http://www.washingtonpost.com/wp-dyn/content/article/2009/05/25/AR2009052502108_pf.html, archived at <http://perma.cc/AE8L-LN4F>.

¹⁴ Quoted in John Heilemann, *Obama is from Mars, Wall Street is from Venus*, N.Y. MAG. (May 22, 2010), <http://nymag.com/news/politics/66188>, archived at <http://perma.cc/35WG-L8ZA>. The Brown-Kaufman Amendment to what became the Dodd-Frank Act would have placed strict size limits on financial institutions.

¹⁵ Paul Kiel & Olga Pierce, *Dems: Obama Broke Pledge to Force Banks to Help Homeowners*, PROPUBLICA (Feb. 4, 2011, 8:48 AM), <http://www.propublica.org/article/dems-obama-broke-pledge-to-force-banks-to-help-homeowners>, archived at <http://perma.cc/4PD9-4VG9>.

¹⁶ NEIL BAROFKY, BAILOUT: AN INSIDE ACCOUNT OF HOW WASHINGTON ABANDONED MAIN STREET WHILE RESCUING WALL STREET 156–57 (2012).

support.¹⁷ The choice to bail out large banks rather than homeowners was made by the Bush and Obama Administrations. And Congress passed the Dodd-Frank Act, which largely left in place the regulatory system that had failed so spectacularly, with the Administration lobbying heavily to weaken the most far-reaching reforms.¹⁸ In other words, President Obama knew exactly what was going on — just as President Clinton knew what was going on when he signed the Gramm-Leach-Bliley Act, allowing the consolidation of commercial and investment banking.

Levitin recognizes that elected politicians always have influence over financial regulation. “[I]n Washington,” he writes, “agency independence notwithstanding, one does not refuse the President.”¹⁹ He also highlights the problem of “legislative capture”: the ability of industry to use its financial clout to influence Congress and, indirectly, agencies that are overseen by Congress.²⁰ Whether it comes from the executive or the legislative branch, that influence will not necessarily be used in the public interest; in practice, both branches were united behind the policies that produced the financial crisis.

At the same time, regulators were not simply taking orders from their political masters. Deregulation and bank bailouts were as popular in the regulatory agencies as in the Treasury and the White House — and not only to curry favor with financial institutions or their congressional water-carriers. The Federal Reserve is as independent as independent agencies come, and for most of our story it was controlled by a man with his own base of popular support.²¹ Federal Reserve Chair Alan Greenspan maintained repeatedly that “private regulation generally is far better at constraining excessive risk-taking than is government regulation”²² and that “[r]isks in financial markets, including

¹⁷ For example, the Gramm-Leach-Bliley Act of 1999 was passed with final votes of 90–8 in the Senate and 362–57 in the House and was signed by a Democratic president. Gramm-Leach-Bliley Act, S. 900, 106th Cong. (1999) (enacted), *archived at* <http://perma.cc/SS9T-ECBR>.

¹⁸ Shahien Nasiripour & Ryan Grim, *Obama's Treasury Dept. Working to Defeat Derivatives Proposal 'Of Utmost Importance' to Reforming Wall Street*, HUFFINGTON POST (June 14, 2010, 2:30 PM), http://www.huffingtonpost.com/2010/06/14/obamas-treasury-dept-work_n_611205.html, *archived at* <http://perma.cc/SFM5-AP62>; Matt Taibbi, *Wall Street's Big Win*, ROLLING STONE (Aug. 4, 2010, 1:00 PM), <http://www.rollingstone.com/politics/news/wall-streets-big-win-20100804>, *archived at* <http://perma.cc/S7JB-6FYQ>.

¹⁹ Levitin, *supra* note 5, at 2020.

²⁰ *Id.* at 2044.

²¹ Between 1997 and 2006, Alan Greenspan's favorable/unfavorable ratings ranged from +13 to +44 points. Joseph Carroll, *Greenspan Gets High Marks from the Public*, GALLUP (Jan. 30, 2006), <http://www.gallup.com/poll/21160/greenspan-gets-high-marks-from-public.aspx>, *archived at* <http://perma.cc/KRY8-VGPK>.

²² Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks at the 2003 Conference on Bank Structure and Competition (May 8, 2003) (transcript archived at <http://perma.cc/8VG-2C7X>).

derivatives markets, are being regulated by private parties.”²³ Greenspan’s opposition to derivatives regulation, his refusal to enforce consumer protection laws, and his reliance on low interest rates during the housing boom all contributed to the financial crisis.

What Alan Greenspan, Larry Summers, and Tim Geithner have in common is not just that all supported policies that were friendly to the financial sector; they also shared an ideology: the belief that lightly regulated financial markets are good for the economy. The presidents who appointed them and stood behind them endorsed that belief. This ideology of finance was dogma from the 1990s until 2008 and has survived the financial crisis surprisingly intact, at least in inside-the-Beltway policymaking circles. It was reflected in the bipartisan campaign to increase homeownership by expanding subprime lending before the financial crisis, and it was reflected in the bipartisan campaign to water down provisions of the Dodd-Frank Act that might have put constraints on real estate lending.²⁴

Levitin is aware of the role of ideology; he lists ideological capture as one mechanism of regulatory capture (and the one most apparent at the Federal Reserve).²⁵ But the problem of ideological capture is not well addressed by structural reforms aimed at the governance of financial regulation. Increasing democratic accountability and increasing agency insulation are alternative ways of modifying the pressures on regulators and the incentives that they face; mobilizing different industry interest groups is one way of reducing the seeming dominance of the financial sector. These approaches can help level the playing field in the corridors of power, and they are urgently needed.

But the marketplace of beliefs is another field of combat, and one where money talks. Ideology does not fall ready-made from the sky. Its raw materials are ideas, good or bad, that are often genuinely developed by their proponents and adopted by their adherents. Those ideas are then manufactured into political weapons — through industry-sponsored research (such as the Institute of International Finance’s report claiming that new regulations would make the U.S. economy almost three percent smaller²⁶), public relations campaigns, and lobbying organizations. The financial sector, its industry organizations, and its sympathetic think tanks and super PACs together have an enor-

²³ Quoted in Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, <http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html?pagewanted=all>, archived at <http://perma.cc/8Z98-Z7RR>.

²⁴ Floyd Norris, *Mortgages Without Risk, at Least for the Banks*, N.Y. TIMES, Nov. 29, 2013, <http://www.nytimes.com/2013/11/29/business/mortgages-without-risk-at-least-for-the-banks.html?pagewanted=all>, archived at <http://perma.cc/J8LC-NSW9>.

²⁵ Levitin, *supra* note 5, at 2042, 2044–45.

²⁶ INST. OF INT’L FIN., *THE CUMULATIVE IMPACT ON THE GLOBAL ECONOMY OF CHANGES IN THE FINANCIAL REGULATORY FRAMEWORK 10* (2011).

mous amount of ideological muscle. Compared to them, consumer organizations are underfunded and undermanned, and advocates for financial stability are virtually nonexistent, apart from academics with limited audiences. Levitin himself is one of the people fighting the good fight, with his prolific publishing record and his repeated appearances before congressional committees, but he and his allies are vastly outnumbered.

The result is a world in which many politicians and regulators believe that financial innovation is inherently good, that more credit is always better, and that any constraints on financial markets will be paid for in jobs. I certainly agree with Levitin that, if we want financial regulation to serve the public interest, we need to “change the political environment for regulation,”²⁷ and he has outlined the key levers that are available to that end. The other battle, however, is to convince both politicians and regulators — and, ultimately, the public at large — that what’s good for Wall Street is *not* necessarily good for America.

²⁷ Levitin, *supra* note 5, at 2068.