

Political Fortunes: On Finance and its Regulation

Nolan McCarty
Princeton University

Keith T. Poole
University of Georgia

Thomas Romer
Princeton University

Howard Rosenthal
New York University

The financial crisis of 2008, as well as many earlier crises, had an important political dimension.¹ Government not only failed to intervene to restrain a bubble but government also directly abetted the expansion of the bubble. After the bubble popped, political considerations limited and delayed appropriate policy changes.

Both during and after bubbles, political outcomes reflect the same forces that operate even in normal times. Such forces include decision-making based on ideologies – free market conservatism, egalitarianism, and populism. Political decisions (and non-decisions) also reflect checks and balances across branches of the federal government, across layers of government in a federal system, and institutional checks, such as bicameralism and filibusters. Interests favoring current arrangements benefit from the status quo bias inherent in our political institutions. How these forces operate is greatly influenced by how ideology has contributed to the polarization between the two major political parties.

These forces are part of the normal flow of politics in our democracy. Politicians respond to the politically active, most notably campaign contributors and lobbyists. Policy is swayed by the self-interest of financial firms and, more broadly, creditors and debtors. So-called independent regulators, including the Federal Reserve, respond not only to their own ideology and expertise but also to elected officials with political power over them.

The crisis of 2008 followed the latest in a long history of real estate bubbles in the United States. Bubbles often spill over into other sectors, so that the pop in the asset bubbles frequently engenders a banking crisis.

The S&L debacle as foretaste

Before 2008, the most recent example of a real estate bubble's devastating effect on financial institutions was the savings and loan (S&L) crisis of the 1980s. This earlier crisis differed in important respects from the crisis of 2008. First, the political system was substantially less polarized than it is today. Second, the economic shock was much smaller. These two factors contributed to a less contentious eventual resolution of the crisis. Moreover, the crash in real estate prices at that time was much more geographically concentrated than in the 2000s, and the thrifts (as the firms in the S&L industry were called) were more Main Street than Wall Street. Nonetheless, the interaction between the financial and the political sectors strongly foreshadowed the events of 2008.²

Prior to the late 1970s, the S&Ls had a quite specialized niche. For the most part, they took in short-term deposits and offered long-term fixed-rate mortgages. Trouble might arise if the interest they had to pay to attract depositors rose above the rates on older mortgages. But

market conditions and government regulation of deposit interest rates helped to avoid the potential losses that might result from a mismatch between the short and the long. A serious mismatch did arise after the financial innovation of money market mutual funds in the 1970s, which drew deposits away from S&Ls and eroded their profitability.

The interest rate mismatch became critical as a consequence of the abrupt increase in interest rates initiated by the Volcker Fed and the ensuing severe recession of 1981-82. Real estate values collapsed, especially in the oil patch and the farm belt. By 1982 over two-thirds of the thrifts had become unprofitable. In the aggregate, the S&L industry had negative net worth by the regulatory capital standards of the time. The situation was well recognized by the industry's regulator, the Federal Home Loan Bank Board (FHLBB). The problem, however, was that the deposit insurer, the Federal Savings and Loan Insurance Corporation (FSLIC), had insufficient funds to shut down the insolvent S&Ls.

The political response to the severe economic shocks facing the thrifts was to relax regulatory standards and to expand the scope of assets that thrifts could hold. The key elements of the legislation affecting the S&Ls in the early 1980s were: deregulating interest rates; allowing for adjustable rate mortgages (ARMs); and permitting S&Ls to expand their loan products from home mortgages to commercial real estate, junk bonds, and other risky investments.³ Moreover, the FSLIC was not granted additional funding authority, which ensured a policy of regulatory forbearance against failing thrifts.

The profitability of some S&Ls temporarily improved. But the extra risk-taking encouraged by regulatory forbearance soon took its toll. By 1987, the magnitude of the industry's insolvency problem had increased dramatically. Yet political action enshrined continued regulatory forbearance by extending the use of lenient accounting rules and weakened capital standards. At the same time, legislation reaffirmed the "full faith and credit" backing of FSLIC-insured deposits, without providing the agency the additional financing authority to act aggressively against the owners of essentially bankrupt S&Ls.⁴ Equity holders and management in such insolvent firms bore virtually no downward risk. But, as long as they were allowed to operate, they would benefit from any success of risky gambles that restored profitability.⁵ These "zombie thrifts" continued to stay open, making increasingly risky bets as they gambled for resurrection.

Congress and the White House opted for forbearance for two related reasons. First, ending the S&L debacle required an unplanned and unbudgeted expenditure. The funds could come either from assessments on the industry or from general government taxes and borrowing. Sick thrifts had a strong interest in continued forbearance; the remaining healthy thrifts resisted the additional fees that they may have been assessed under a recapitalized FSLIC. The immediate beneficiaries of lax regulation were politically active. They pressed elected officials to support their case with the regulators and in framing legislation. There was no significant constituency in favor of confronting the full magnitude of the S&L problem when it was still relatively small, or to curtail – rather than extend – forbearance. Importantly for connecting the dots to the current crisis, these looser regulations remained in effect even after the S&L meltdown.

Second, incumbents of both parties were concerned that dealing with the crisis with a large recapitalization of FSLIC would look like a bailout and be unpopular with the voters in the November 1988 elections. Banking deregulation and regulatory forbearance had been supported by both parties. Even though the gravity of the S&L industry's situation was widely recognized by experts both inside and outside the Beltway, discussion of the crisis by the candidates was essentially absent from the presidential election campaign.

By early 1989, the need to shut down failed S&Ls and to recapitalize the deposit insurance fund could no longer be put off. There was relatively rapid legislative action, with the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA), which President Bush signed that August. FIRREA led to a bailout of depositors and disposal of the assets of failed thrifts by a new entity, the Resolution Trust Corporation (RTC). The FHLBB was folded up and a new regulator put in place. The new regulator, the Office of Thrift Supervision (OTS), represented a soft reform. By the 2000s, it was a regulatory venue of choice for mortgage institutions seeking to escape the stricter regulatory arm of the Fed. A concession to the industry in 1989, OTS in more recent years accommodated the likes of Washington Mutual, IndyMac, and AIG.⁶

In brief, unintended consequences of financial innovation and deregulation produced a crisis; interest group politics and populist abhorrence of bailouts prolonged it. The media coverage of the S&L crisis in full bloom focused on colorful stories of malfeasance and alleged political corruption (most notably Charles Keating of Lincoln Savings and Loan and his five senators, including future presidential nominee John McCain). But the true highlight tape should recognize that most of the S&L gambles were completely legal actions in the regulatory environment created by elected officials responding to interest group pressures and to electoral concerns with the mass public.

The politics of finance

The resolution of the S&L debacle did not include tightening the looser regulation of interest rates and other dimensions of the home mortgage industry. Not surprisingly, then, financial markets witnessed an explosive growth of financial innovation in a generally permissive regulatory environment. Before the 2008 meltdown, this financial innovation was generally seen as a positive force that delivered real benefits. The pace of innovation accelerated during a period of global economic growth and, in particular, the American economic ascendancy of the 1990s. Financial sector profitability rose and financial sector profits became a much larger share of total corporate profits. Financial sector wages increased much faster than wages in other sectors.⁷ Highly skilled individuals flocked to financial engineering.

While the financial sector often attributed this innovation and growth to the virtues of unbridled capitalism and free markets, the shadow of politics was never far behind. First, much of this innovation was designed to create instruments that would optimize profits around regulatory constraints. Notably, banks invented off-balance-sheet vehicles that created leverage without violating the Basel I capital requirements.⁸

Second, the importance the industry placed on maintaining a favorable political environment is underscored by a massive increase in political involvement. Between 1992 and

2008, political campaign contributions from the financial sector nearly tripled, even after adjusting for inflation. (Only the legal profession had a faster growth rate of contributions.) The current magnitude of giving is also remarkable. Four subsectors of finance (securities and investments, real estate, insurance, and miscellaneous finance) are now in the top ten of all industry contributions, and two of them (securities and investments; real estate) have dominated the growth in contributions.⁹

Although Republicans and Democrats have both been blessed with contributions from the financial sector, the implications for the Democratic Party have been especially significant. Over the past forty years, voting behavior and partisan identification in the US has become highly structured by income. The Republican Party has fared somewhat better among voters with middle income and higher, while the Democratic Party has received the majority of the votes from those with lower incomes.¹⁰ But even as the Democrats were depending more heavily on the votes of lower-income voters, the party came to rely more on the financial resources of wealthier supporters and interest groups. Consequently, the Democratic Party now has two distinct wings: the “money wing” and the “votes wing”. The financial services sector has become an increasingly important part of the money wing.

Like many corporate contributors, the financial sector tends to shift its campaign contributions based on which party controls Congress. From 1987 to 1994, a majority of the money went to the Democratic Party, which had majorities in both the House and the Senate. Following the 1994 elections, there was a big shift in contributions to the newly-empowered Republicans. Following the Democratic takeover of Congress in 2006, the money switched back to about where it was in the early 1990s.

But even during the period when it had relatively little power in Washington, the Democratic Party did well with the securities and real estate industries. From the party’s perspective, finance makes an almost ideal money wing (almost as good as Hollywood). Unlike many other industries with potential claims on political attention, financial sector firms do not pollute the environment (at least not directly) and do not have especially contentious labor relations. During normal times and even during economic booms, this makes for much less conflict with other Democratic constituencies like environmentalists and labor unions. Of course, an ideal alliance during good times is not necessarily one that can survive a bust.

The bubble and deregulation

In a Washington epitomized by Alan Greenspan’s nearly 19-year tenure as Fed chairman, regulatory constraints were viewed in a dim light. There was either bipartisan support for a hands-off policy or a lack of a winning coalition that would revamp regulation to address a new and highly complex environment. Indeed, a considerable amount of financial deregulation occurred through agency decisions and legislation during the Clinton administration. In 1998, Brooksley Born, Bill Clinton’s appointee as chair of the Commodity Futures Trading Commission (CFTC), had proposed regulating off-exchange trades in swaps and other derivatives. Her initiative was shot down by Greenspan, Treasury Secretary Robert Rubin, deputy secretary Larry Summers, and SEC chair Arthur Levitt. The Commodity Futures Modernization Act of 2000 (CFMA) – passed by an overwhelming 377-4 roll call vote in the

House and a voice vote in the Senate – codified the marginal role of the CFTC and facilitated active expansion of over-the-counter derivatives markets.

Previous executive and deregulatory measures of the financial sector culminated in the Financial Services Modernization Act of 1999, which also passed with large bipartisan majorities.¹¹ It repealed the Glass-Steagall Act of 1933 that had separated commercial banks, investment banks, and insurance companies; it also explicitly prohibited the SEC from regulating securities-based swap agreements. During the decades when these boundaries were being contested, commercial banks, investment banks, and insurance companies were frequently on different sides of disputes over financial regulation. The eventual erosion of legal and regulatory boundaries between segments of the financial sector also removed some of the political conflicts over economic turf within the sector. As deregulation took these issues off the table, previously separated parts of the sector now had more closely aligned interests.

The turn of the century was not without warning that deregulated financial markets posed dangers. The collapse of the hedge fund LTCM in 1998 revealed the potential for global contagion and systemic risk. A second warning shot was fired in 2001 with the failure of Enron, WorldCom, and other firms with accounting scandals. It became apparent that the specifics of deregulation were designed to benefit financial and corporate interests – such as the “Enron loophole” in the CFMA.¹² There was also evidence that deregulation’s fundamental premise – that accounting firms, Wall Street analysts, and rating agencies would provide unbiased and transparent information to investors – was false. Nonetheless, the spirit of deregulation continued relatively unabated. Much like FIRREA, the Sarbanes-Oxley Act (2002) did not address forms of accounting arbitrage, such as off-balance sheet vehicles that avoided capital requirements, employed by financial institutions as they marched toward the 2008 crisis. During the George W. Bush administration, the SEC essentially eliminated its capacity to inspect investment banks and weakened its enforcement.¹³ Ignoring the warning signals of the turn of the century was facilitated by continued economic growth. The crisis of 2008 arrived in an environment where most financial transactions were unregulated and regulated activities were largely unmonitored.

Housing politics: A marriage of ideologies

By 2000, the foundation had been laid for a housing market bubble that would reflect the alignment of two disparate ideologies, free market conservatism and redistributive egalitarianism. The foundation consisted of a crazy quilt of legislative, executive, and judicial decisions in the 1980s and 1990s that are overwhelming in their details. A brief recap would note that (1) a variety of financial institutions were permitted entry into various loan and insurance markets, (2) usury laws were stripped away, and (3) the ability of states to regulate financial products, like credit cards, offered by out-of-state firms, was largely eliminated while other features, such as loan-to-value limits, remained with the states. States could also compete in the chartering of banks. The result was the expansion of predatory lending practices, loans that would be quickly underwater if housing prices declined, and another round of “zombie” banking that encompassed institutions large – such as Washington Mutual – and small, including 39 Georgia banks eventually forced into receivership by the FDIC.¹⁴

A Republican twist to free market capitalism was a belief in the political advantages of the “ownership society”. In brief, homeowners were thought to be more likely to vote

Republican than renters.¹⁵ The post-1980 support for low- and moderate-income housing by Republicans represented a historical shift. In 1977, conservatives, supported by lenders, had mustered considerable backing for a Senate amendment that unsuccessfully sought to delete Title VIII, the Community Redevelopment Act, from the housing bill that passed that year. The later shift away from partisanship on housing policies came after the deregulation of the 80s and 90s created a profitable market in loans to low income families.¹⁶ By the administration of George H. W. Bush, there was bipartisan support for legislation such as the National Affordable Housing Act (1990), which included a variety of initiatives directly aimed at expanding home-ownership among low-income households, and the Federal Housing Enterprises Financial Safety and Soundness Act (1992), which set minimum percentage-of-business targets for Fannie Mae and Freddie Mac purchases of mortgages issued to low-income households.

On the Democratic side, redistributive egalitarianism sought to increase homeownership among the poor and minorities. Fannie Mae stated in its 2003 annual report: “So as long as there is a gap in minority and non-minority homeownership rates, Fannie Mae and Countrywide will continue to make sure all Americans have the chance to realize the dream of homeownership.” While it was not politically feasible to make owning a home an entitlement like food stamps and Medicare, political pressure and economic incentives encouraged lenders in the mortgage market to accomplish egalitarian goals. Going egalitarian through a market led by government-guaranteed enterprises Fannie Mae and Freddie Mac not only appealed to the Democratic base but also to highly compensated Democrats. The CEO of Fannie Mae from 1991 to 1998 was James Johnson, an executive assistant to Vice-President Mondale, member of the Kerry vice-presidential selection team, and cashiered member of the Obama vice-presidential selection team.¹⁷ From 1998 to 2004, Fannie Mae was headed by former Clinton director of OMB Franklin Raines.¹⁸ Raines presided over Fannie Mae during a major accounting scandal; his executive compensation has been extensively criticized.¹⁹

Spawned from this marriage of otherwise opposed ideologies, housing policy was one area largely devoid of partisan conflict in an era characterized by highly polarized politics.²⁰ The American Homeownership and Economic Opportunity Act of 2000 – directed at easing financing of mortgages, including reverse mortgages, and at increasing financial assistance for homeownership by the poor, elderly, and disabled – was passed by voice vote in the House and unanimous consent in the Senate. The American Dream Downpayment Act of 2003 was passed by unanimous consent in the Senate and without objection in the House.²¹ It was enthusiastically signed into law by President Bush as a measure that would build the “ownership society” by providing “\$200 million per year in down payment assistance to at least 40,000 low-income families.”²²

Both “American” acts relaxed standards for lenders. In contrast to these measures directed at expanding homeownership, during 2000-2006 only one of sixteen legislative bills aimed at curbing predatory lending and at enforcing other aspects of consumer protection passed the House; none passed the Senate; and, of course, none became law. Lobbying against these bills came disproportionately from riskier lenders who originated mortgages with high loan-to-income ratios, who used securitized instruments, and who had fast-growing mortgage loan portfolios.²³ As in the S&L fiasco, lenders in the weakest economic condition were most likely to lobby against regulatory constraints.²⁴

The pop, its aftermath, and polarized politics

The “What, me worry?” environment had been made possible by the agreement of free market capitalists and redistributive egalitarians on policy in the mortgage market. This coalition was blown apart by the unraveling of the housing bubble that preceded the financial crisis. Housing prices started to fall in 2006, sub-prime mortgage bonds plummeted in early 2007, and residential foreclosures accelerated. To deal with the foreclosure problem meant moving from the “win-win” scenario of the pumped-up housing market to hard choices involving helping borrowers through an on-budget bailout or forcing lenders to take a haircut via a moratorium, or an imposed reduction in either principal or interest.

Making these choices would take place in a far more polarized political environment than was present at the time FIRREA resolved the S&L crisis. Partisan “blame game” politics would prevail over any grand crisis coalition in the national interest. The first move in this game was The American Housing Rescue and Foreclosure Prevention Act (AHRFPA), signed into law by George W. Bush in July 2008, after he had threatened to veto an earlier bill passed by the House in May. The July vote on final passage in the House showed a sharp ideological split, with unanimous support from Democrats, support from more moderate Republicans, and opposition from conservative Republicans. Salient local issues can at times trump ideology, lobbying, and contributions from out-of-constituency interests. In the AHRFPA case, Republican House members also proved sensitive to the extent of foreclosures in their districts, especially foreclosures in Republican voting areas of the districts.²⁵ AHRFPA, however, left so much discretion to lenders that it did little to avoid foreclosures.

The bubble definitively popped with the failure of Lehman brothers on September 10, 2008. How the executive and regulatory branches handle a pop is conditioned by political circumstances. The S&L crisis did not endanger the entire economy; for electoral considerations, both the Reagan administration and the Democratic-controlled Congress chose to sweep the crisis under the rug in 1987-88. It is instructive to compare the 2008 crash with the stock market crash of October 1929 that occurred just seven months into the four-year term of Herbert Hoover. His administration, largely personified by Treasury Secretary Andrew Mellon, responded passively. In a European parliamentary system, Hoover would not have been expected to survive for four years. The American institution of four year terms may well have contributed to the severity of that crisis. (The Democrats did capture the House in the 1930 midterm elections.)

In contrast to the setting of the Depression, the crisis of 2008 occurred less than two months before an election and less than four months before the inauguration of the new president. Not only was the incumbent president a lame duck, his presidency was tarnished by Iraq and other events. Bush had very limited sway over Republicans in a Democratic-controlled Congress. In the current push for financial reform, President Obama is out front, with Treasury Secretary Geithner and especially Fed chair Bernanke in supporting roles. But in the pop, Treasury Secretary Paulson and Bernanke were front and center. In the absence of presidential leadership, Paulson and Bernanke were especially concerned that their actions be legitimated by Congress – or at least not overly attacked. The financial markets’ response to the initial failure of the Troubled Asset Relief Program bill (TARP, “the bank bailout”) showed that those markets

could be roiled by either the capitalist right, fixated on moral hazard, or by the progressive left, disturbed by the distributional implications of a bailout.

Opposition from both extremes of the liberal-conservative spectrum, reelection concerns, and a proposal from a Republican administration facing a Democratic Congress combined to blur ideological voting on the TARP bill in the fall of 2008. When the auto bailout bill was voted on in December, there was strong ideological polarization, a pattern that reached perfection when the stimulus bill was considered early in the Obama administration. In the House, there was perfect party separation, except for six, non-pivotal Democrats who were “allowed” to defect. In the Senate, there was perfect ideological separation; the administration made just enough concessions to buy the votes of the three least conservative Republicans, Specter, Snowe, and Collins. This pattern, likely to reappear on all aspects of financial reform, was again manifest when Edward Kennedy’s replacement, moderate Republican Scott Brown, demanded and obtained modifications to the conference report on the 2010 reform bill. The modifications were sought by such institutions as State Street Bank and Fidelity Investments, headquartered in Brown’s home state of Massachusetts.²⁶

Not only is polarization problematic in initial reform efforts, the gridlock it produces impedes the routine legislative maintenance required for a robust regulatory environment.²⁷ Any reform legislation that may be forthcoming will undoubtedly need such future fine tuning.

Regulatory (in)capacity

In an ideal setting, regulators would have the resources and expertise to closely monitor developments in the regulated sector and the incentive to promulgate and implement policies that are in the public’s interests. The conditions for such regulatory performance are hard to meet in any domain, but the problem of regulatory capacity is particularly acute in the case of financial regulation.

The most obvious difficulty stems from the complexity of modern finance. Armies of rocket scientists are employed to develop and implement increasingly complicated financial products and trading strategies. Many of the products are not well understood by Wall Street executives, much less outside regulators. This problem might be mitigated somewhat if the regulatory agencies could easily draw from the same talent pool as Wall Street. But the salary differentials make this difficult. The highest paid financial regulators (the president of the New York Fed and the chairman of the Fed) make a fraction of a middling trader’s annual bonus. Even where regulatory agencies can hire individuals with the background to understand the intricacies of modern finance, such individuals are usually on their way from or their way back to Wall Street. Such a revolving door undermines the autonomy of regulatory agencies from the industry they are supposed to regulate. Even if such regulators are not motivated by a future Wall Street payout, they may still be inclined to share Wall Street’s worldview.

The most direct implication of low regulatory capacity is that it will be hard to sustain a regulatory regime that depends too heavily on the delegation of discretionary power to regulators. This concern speaks directly to the debate about whether a council of super-regulators can monitor the financial sector for emerging systemic risks and react effectively with new capital requirements, leverage limits, or conversion of contingent bonds. Such a system requires

that regulators have very high levels of information and expertise as well as the incentive to act in ways that may be adverse to the financial services industry. The recognition of low capacity argues against sophisticated discretionary regulatory management of the industry and in favor of blunter approaches such as banning the most systematically dangerous products and practices or capping the size of financial institutions. Blunter, less complex, and less lengthy legislation would not only reduce opportunities for financial innovators to find loopholes but also focus the attention of regulators.

Beyond the technical problems that plague low capacity agencies, there is important political feedback. Low capacity makes it harder to hold agencies accountable to congressional and presidential oversight because it is harder to distinguish between bad policies and poor implementation. This may cause elected leaders to be reluctant to endow agencies they cannot control with substantial discretionary power.

Current reform proposals strive to mitigate these problems by strengthening the informational capabilities of regulators (such as the creation of the Office of Financial Research in Treasury) and by beefing up accountability mechanisms (especially those relating to the Federal Reserve, including presidential appointment of the head of the New York Fed and restriction of the Fed's emergency lending authority with increased oversight by the Government Accountability Office). But there are strong reasons to believe that these reforms by themselves will not significantly improve financial regulation. Better information and policy analysis can only go so far if agencies lack the resources to act effectively on that information and analysis. But the lack of expertise and information also reduces the value of increasing regulatory capacity. Why increase the ability of an agency to implement uninformed policies? Expertise and capacity are complements; this creates a bureaucratic "reform trap."²⁸

A reform trap also exists with respect to improving oversight and accountability. Investing in greater oversight of agency decisions is most valuable when the links between agency policy and outcomes are the most transparent, because it is then easier to detect policies of which the Congress does not approve. Since low capacity distorts the relationship between policies and outcomes, more oversight is not very helpful. Conversely, when oversight mechanisms are poor, raising capacity is not very valuable since the political overseers do not benefit from the increased transparency of the policy-outcome link. Reforms, therefore, might well consider restrictions on firm behavior that would serve to simplify rather than expand regulatory authority. For example, a relatively limited (and visible) menu of exchange-traded derivatives might be preferred to a giant (but semi-secret) smorgasbord of over-the-counter special orders. Similarly, bank supervision might benefit from the "Volcker rule", which, among other things, would prohibit banks from running private-equity and hedge funds.

Political fortunes

Although the current economic situation is much more complex than that of the S&L crisis, there are some similarities. There is conflict between large and small banks and between interests that were cashiered (Lehman, WaMu) and those that were rescued (Citicorp, BofA). Both crises were influenced by regulatory venue shopping. Existing regulators have fought to maintain their turf, without regard to competency. Both crises were influenced by "zombie seeking" of high returns without due regard to risk. The reluctance to deal with the S&L crisis

when the 1988 elections were on the horizon appears to be paralleled by a failure to address reform of Fannie and Freddie before the 2010 elections. More generally, the inadequacy of the S&L reforms gives pause as to the effectiveness of financial sector regulatory reform legislation that will come forth.

There are several difficulties in the political process and in a “regulatory-financial complex” that present severe hurdles to effective regulation of the financial sector. First, we should keep in mind an observation made by the political scientist E. E. Schattschneider: In normal times, policy reflects the balance of political clout among moneyed interests; but if an issue becomes broadly salient, as after an economic crisis, then all bets are off. Politicians care about being reelected, so if the “folks” get upset the politicians will cater to their wishes (or at least what the politicians perceive these to be). But once an issue sinks back below the surface the moneyed interests reassert themselves.²⁹ Whatever the contents of new regulatory reform legislation, many of the key decisions will be made by regulators months and years afterwards – when financial regulation is not nearly so salient – and therefore can be expected to be much more deferential to the industry than the spirit of the legislation.

Second, because political polarization appears to decline and rise with income inequality³⁰ and income inequality in turn partly reflects the strong increase in financial sector profits and income,³¹ future efforts at dealing with U.S. financial crises are likely to continue to occur in a highly polarized environment. Polarization inhibits timely and effective responses – both by causing legislative gridlock and by increasing the willingness of those out of power to block all change until they get back in, rather than compromise on centrist policies. Intensive lobbying from affected interests further reinforces ideological opposition.

Third, financial markets are now extremely complex, with myriad products. Regulatory incentives, staffs, and budgets are not aligned toward successful monitoring and enforcement.³² Consequently, even if financial products are limited and regulated, private parties will continue to innovate within the constraints of existing regulation. Technological change, as in data processing and mathematical models, will bring forth innovations. Regulators, in contrast, are unlikely to be proactive with respect to innovations.

Fourth, there is a taboo against rigorous enforcement. In his remarks at the Pittsburgh G20 meeting in 2009, President Obama spoke of the financial crisis as the result of the “reckless few”. After Enron and WorldCom, President Bush claimed “a few bad actors can tarnish our entire economic system.” And following the Panic of 1907, President Roosevelt comforted the public by declaring, “Dishonest dealing and speculative enterprise are merely the occasional incidents of our real prosperity.”³³ Once the immediate crisis has passed, there is little continued political payoff in either stating or acting on the premise that most of those in the financial sector will at best bend the rules as much as they can and push politicians to get rid of the rules when the rules are inconvenient.

Finally, not only have financial markets become more interconnected, so have the worlds of finance, politics, philanthropy, and academia. For example, the outside directors of AIG between 2005 and 2008 included Obama and Clinton diplomat Richard Holbrooke, Clinton Defense Secretary William Cohen, Reagan White House advisor and Harvard economist Martin Feldstein, Ford HUD secretary and Bush trade representative Carla Hills, Ford “energy czar”

Frank Zarb, American Museum of Natural History president Ellen Futter, and public television executive George Miles. Feldstein, Futter, Holbrooke, Miles, and Zarb served on the board for all or part of the years 2005-08. Over that period, their individual compensation as director ranged from \$792,000 to \$1,136,000.³⁴ Again, once the crisis is past, criticism of the financial sector from government, academia, and non-profits is likely to be muted. We appear to be stuck with the regulatory-financial complex.

¹ Poole thanks his colleagues at the University of Georgia for offering many helpful comments. Romer is grateful to the United States Studies Centre at the University of Sydney, where he was on sabbatical leave during the North American winter months of 2010, for its gracious hospitality. It was an excellent environment for stimulating conversations about the global financial crisis. Rosenthal thanks his colleagues at the California Institute of Technology in the spring quarter of 2010, especially Peter Bossaerts and Jean-Laurent Rosenthal, for discussion and comments, as well as participants in conferences at Columbia University and Università Cattolica del Sacro Cuore.

² Our summary of the politics of the S&L crisis is based on Thomas Romer and Barry R. Weingast, "Political Foundations of the Thrift Debacle," in Alberto Alesina and Geoffrey Carliner, eds. *Politics and Economics in the 1980s* (Chicago: University of Chicago Press, 1991).

³ The two principal pieces of legislation were the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Depository Institutions Act of 1982.

⁴ Competitive Equality Banking Act of 1987.

⁵ See David H. Pyle, "The U.S. Savings and Loan Crisis," in Robert A. Jarrow *et al.*, eds., *Handbooks in Operations Research and Management Science, Vol. 9: Finance* (Amsterdam: Elsevier, 1995).

⁶ The RTC is now generally thought to have done a good job, though it had some rocky years. In disposing of the assets of failed thrifts, the RTC faced conflicting political mandates (including social policy objectives such as minority contracting and affordable housing, as well as getting the highest value for the assets). See Lee Davison, "The Resolution Trust Corporation and Congress, 1989-1993. Part II: 1991-1993," *FDIC Banking Review*, 2006. Available online at <http://www.fdic.gov/bank/analytical/banking/2007apr/article1/index.html>

⁷ Thomas Philippon and Ariell Reshef, "Wages and Human Capital in the U.S. Financial Industry: 1909-2006," National Bureau of Economic Research Working Paper 14644 (2009).

⁸ See Markus K. Brunnermeier, “Deciphering the Liquidity and Credit Crunch 2007-08,” *Journal of Economic Perspectives*, Winter 2009.

⁹ Lawyers and law firms, considered as a separate industry, contributed \$126 million in 2008. Many of these contributors may also have had interests in financial sector regulation.

¹⁰ See Nolan McCarty, Keith T. Poole, and Howard Rosenthal, *Polarized America: The Dance of Ideology and Unequal Riches* (Cambridge, Mass.: MIT Press, 2006).

¹¹ The law is more commonly known as the Gramm-Leach-Bliley Act, after its three Republican co-sponsors.

¹² Certain energy derivatives contracts were exempt from regulation by the CFTC. One of these exemptions was for trades conducted over electronic trading platforms such as the one developed by Enron; hence the “Enron loophole”. See Mark Jickling, “The Enron Loophole,” Congressional Research Service Report RS22912, 2008.

¹³ Ross Levine, “An Autopsy of the U.S. Financial System,” National Bureau of Economic Research Working Paper, April 2010.

¹⁴ <http://www.fdic.gov/bank/individual/failed/banklist.html> (harvested April 16, 2010).

¹⁵ This belief extended to support for self-directed defined contribution pension plans and privatizing Social security.

¹⁶ See Edward M. Gramlich, *Subprime Mortgages: America’s Latest Boom and Bust* (Washington, D.C.: The Urban Institute Press, 2007), p. 5.

¹⁷ Johnson resigned his position on the selection committee after it was revealed that he received a loan on very favorable terms from Countrywide Financial Corporation, Fannie Mae's largest mortgage provider and a key player in the subprime lending crisis. See John M. Broder and Leslie Wayne, “Obama Aide Quits Under Fire for His Business Ties,” *New York Times*, June 12, 2008.

¹⁸ Clinton also named former Arizona Senator Dennis DeConcini to the Freddie Mac board, where he served from 1995 to 1999. DeConcini was one of the Keating Five and was formally criticized in 1991 by the Senate Ethics Committee for improperly interceding with the FHLBB on Charles Keating’s behalf.

¹⁹ See Lucian A. Bebchuk and Jesse M. Fried, “Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay and Camouflage,” *The Journal of Corporation Law*, 2005.

²⁰ See McCarty *et al.*, *op. cit.*

²¹ Some conservative groups, such as the Heritage Foundation, opposed the bill as “fiscally irresponsible.” See <http://www.heritage.org/Research/Reports/2003/12/American-Dream-Downpayment-Act-Fiscally-Irresponsible-and-Redundant-to-Existing-Homeownership-Programs> (harvested April 22, 2010).

²² See remarks of President George W. Bush, December 16, 2003, documented at <http://www.presidency.ucsb.edu/ws/index.php?pid=64935> (harvested April 22, 2010).

²³ See Deniz Igan, Prachi Mishra, and Thierry Tressel, “A Fistful of Dollars: Lobbying and the Financial Crisis,” International Monetary Fund Working Paper 09/287 (2009).

²⁴ The development of the subprime mortgage market can also be traced back to the deregulation of the early 1980s. Subprime mortgages were based on charging higher interest rates and offering ARMs to risky, often low-income and minority, borrowers. Allowing for the “freedom to choose” among a wider variety of mortgage products would make sense were borrowers informed. The unintended consequence was that these products would be offered in a world of naïve borrowers and predatory, fraudulent, and unsupervised mortgage originators. See Gramlich, *op. cit.*

²⁵ Conservative Republicans, ideologically opposed to government intervention, were less likely to be swayed by economic conditions in their district than were their more moderate colleagues. See Atif Mian, Amir Sufi, and Francesco Trebbi, “The Political Economy of the U.S. Mortgage Default Crisis,” *American Economic Review*, forthcoming.

²⁶ Robert Schmidt and Phil Mattingly, “Joining Forces on Financial Reform Loopholes,” *Bloomberg Businessweek*, July 8, 2010. http://www.businessweek.com/magazine/content/10_29/b4187030971399.htm (harvested July 9, 2010).

²⁷ For example, although Glass-Steagall is now often hailed as instrumental in maintaining financial stability through the 1980s, the regulatory regime it created needed to be patched and extended by other important pieces of legislation such as the Public Utility Holding Company Act of 1935, the Investment Act of 1940, and the 1956 Banking Act.

²⁸ John Huber and Nolan McCarty, “Bureaucratic Capacity, Delegation, and Political Reform,” *American Political Science Review*, 2004.

²⁹ Elmer Eric Schattschneider, *The Semisovereign People: A Realist's View of Democracy in America* (New York: Holt, Rinehart and Winston, 1960).

³⁰ McCarty *et al.*, *op. cit.*

³¹ Philippon and Resheff, *op. cit.*

³² In the context of investigating the 1000-point plunge of the Dow Industrial Average on May 6, 2010, SEC chairman Mary Schapiro stated that “the technology for collecting data and

surveilling our markets is ... as much as two decades behind the technology currently used by those we regulate.” “Warp-speed Trades Outpace SEC,” *Politico.com*, June 1, 2010.

³³ Obama: September 25, 2009 press conference, <http://www.whitehouse.gov/the-press-office/remarks-president-g20-closing-press-conference>; Bush: weekly radio address, June 29, 2002, <http://www.whitehouse.gov/news/releases/2002/06/20020629.html>; Roosevelt: October 24, 1907, in Elting E. Morison (ed.), *The Letters of Theodore Roosevelt, Vols. 1-8* (Cambridge, Mass.: Harvard University Press 1952), p. 839, cited in Robert F. Bruner and Sean D. Carr, *The Panic of 1907: Lessons Learned from the Market's Perfect Storm* (Hoboken: Wiley, 2007).

³⁴ From AIG'S DEF14A filings available at www.sec.gov. For 2006, 2007, and 2008 we used AIG's pricing of the value of stock grants and options. For 2005, we priced stock grants at the closing price on Dec. 30, 2005. We did not include a value for 2005 stock options. Much of the value of stock awards was erased in the financial crisis.