THE POLITICS OF THE POST-2009 FINANCIAL SECTOR

REGULATORY REFORMS IN THE UNITED STATES

by

Brent A. Sutton

B.A., The University of British Columbia, 1985
M.A., The University of Western Ontario, 1986
M.A., Carleton University, 1993

A THESIS SUBMITTED IN PARTIAL FULFILLMENT OF
THE REQUIREMENTS FOR THE DEGREE OF

DOCTOR OF PHILOSOPHY

in
THE FACULTY OF GRADUATE AND POSTDOCTORAL STUDIES
(POLITICAL SCIENCE)

THE UNIVERSITY OF BRITISH COLUMBIA

(Vancouver)

September 2019

© Brent A. Sutton, 2019
The following individuals certify that they have read, and recommend to the Faculty of Graduate and Postdoctoral Studies for acceptance, the dissertation entitled:

The Politics of Post-2009 Financial Sector Regulatory Reforms in the United States

submitted by Brent A. Sutton in partial fulfillment of the requirements for

the degree of Doctor of Philosophy

in Political Science

Examiner Committee:

Yves Tiberghien
Supervisor

Paul Quirk
Supervisory Committee Member

Alan Jacobs
Supervisory Committee Member

Allan Tupper
University Examiner

Cristie Ford
University Examiner
Abstract

This dissertation is composed of three papers analyzing the post-2009 financial sector regulatory reforms in the United States. All three papers use process tracing to perform qualitative analysis. Evidence for my analysis in part comes from contemporaneous media reports, congressional hearings, and speeches and memoirs of key participants. In addition, about 50 interviews were conducted in Fall 2018, mostly in Washington, D.C. The first paper asks why the reforms brought about only incremental rather than transformational change given the obvious failures of the pre-crisis structure and an angry public demanding change. I argue that the need to restore the confidence of institutional investors in bank securities limited the types of policies that policymakers were willing to consider. The next two papers focus on particular regulations that were stronger than expected given strong bank opposition: capital adequacy rules for U.S. globally systemically important banks (G-SIBs) and the Volcker Rule. The second paper argues that the U.S. policymakers adopted capital adequacy rules for large banks exceeding international standards because they believed they were necessary to make banks safer but, also, that they would not undermine their international competitiveness. This paper counters the claim that the globalization of financial markets prevents countries from adopting regulations that exceed international standards. My third paper examines the Volcker Rule, a signature part of the Dodd-Frank Act that prohibits banks from engaging in proprietary trading and severely restricts investments in hedge and private equity funds. I argue the Volcker Rule was adopted because proponents were able to exploit veto points in the policymaking process. The result is different from most of the existing literature on veto points, which show how they tend to inhibit policy change. The final two papers find that factors widely believed to limit policy change may
do so only under certain conditions. Specifically, concerns about international competitiveness and the ability of policy opponents to use veto points to block policy change do not always prevent regulatory change from occurring.
Lay Summary

This dissertation is composed of three papers analyzing the post-2009 financial reforms in the U.S. The first paper asks why the reforms achieved only incremental change given the immense failure of pre-crisis regulations and a public demanding change. I argue that the need to restore the confidence of institutional investors in bank securities limited the types of policies that policymakers were willing to consider. The next two papers focus on particular regulations that were tougher than expected. The second paper argues that the U.S. policymakers adopted capital adequacy rules for large banks exceeding Basel III because they believed they were necessary to make banks safer but, also, that doing so would not undermine their international competitiveness. The third paper argues that the Volcker Rule was adopted because pro-reformers were able to exploit veto points in the policymaking process under conditions of high issue salience and a public demanding change.
Preface

This dissertation is composed of three research papers. All three are based on my research alone. I undertook the literature review, formulated the research questions, and collected and analyzed the data. Research for this dissertation includes interviews with senior policymakers involved with and knowledgeable experts of the policymaking process that led to the Dodd-Frank Act of 2010 and related regulations. Between September and December 2018, interviews were conducted with about 50 current and former regulators, congressional members, aides and staff, industry executives and representatives of civil society organizations, mostly in Washington, D.C. Details are found in the appendix. This research was approved by UBC’s Behavioral Research Ethics Board (Application #H18-01645).
Table of Contents

Abstract........................................................................................................................................ iii
Lay Summary.................................................................................................................................... v
Preface............................................................................................................................................... vi
Table of Contents ............................................................................................................................. vii
List of Tables ..................................................................................................................................... x
List of Figures ..................................................................................................................................... xi
List of Abbreviations ....................................................................................................................... xii
Acknowledgements ......................................................................................................................... xiii
Dedication .......................................................................................................................................... xv
Chapter 1: Introduction .................................................................................................................... 1
Chapter 2: Condemned to Incrementalism? Institutional Investors and the Post-2009
Financial Sector Reforms in the United States ................................................................................. 12
  2.1 The 2007-09 Financial Crisis and the Importance of Institutional Investors .................. 17
  2.2 The Regulatory Response ...................................................................................................... 20
  2.3 Argument ............................................................................................................................... 26
  2.4 Methodology ........................................................................................................................ 32
  2.5 Evidence ............................................................................................................................... 35

  2.5.1 Political leaders see restoring the confidence of institutional investors as
necessary to stabilize the banking sector and resolve the economic crisis. ......................... 35
  2.5.2 Political leaders consider the views of institutional investors when selecting
public officials to lead the regulatory reform process .......................................................... 40
2.5.3 Institutional investors react positively to the selection of centrist officials to lead the policy reform process ................................................................. 44

2.5.4 Policymakers prioritize regulatory proposals that boost the confidence of institutional investors in banks ............................................................... 48

2.5.5 Policymakers avoid transformational policy proposals that could weaken investor confidence while the health of the banks is in doubt ........................................... 51

2.5.6 Policymakers may support policies strongly opposed by banks if they are not expected to have a material effect on the attractiveness of bank securities to investors ..... 54

2.5.7 Policymakers may propose policies unfriendly to investors only after investor confidence has been restored ......................................................... 57

2.6 Conclusion ........................................................................................................... 66


3.1 International Competitiveness as a Regulatory Concern ..................................... 76

3.2 U.S. Concerns with International Competitiveness ........................................... 80

3.3 Why Would States Adopt Gold-plated Regulations? ......................................... 84

3.3.1 Policymaking in the financial sector .................................................................................. 85

3.3.2 Three explanations for gold-plated bank regulations ........................................ 88

3.4 Methodology ........................................................................................................... 92

3.5 U.S. G-SIB Capital Rules ....................................................................................... 94

3.6 Analysis .................................................................................................................. 97

3.6.1 Expert third-party assessments ....................................................................................... 98

3.6.2 Actions by legislators ............................................................................................... 100
List of Tables

3.1 Observable Implications of Three Possible Explanations ........................................ 93
3.2 Comparison of International Standards and U.S. Capital Rules for G-SIBs ........... 97
3.3 Share of Selected Markets in Europe, Middle East and Africa (EMEA) .............. 117
4.1 Expected Policy Outcomes ....................................................................................... 144
5.1 Constraints on Business Power ................................................................................ 188
5.2 U.S. Financial Re-regulation Initiatives Post-2009 (as of 2016) .......................... 189
List of Figures

2.1 St. Louis Fed Financial Stress Index

2.2 Capital Raised Each Year by U.S. Banks ($billions)
**List of Abbreviations**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
</tr>
<tr>
<td>CCMC</td>
<td>Center for Capital Markets Competitiveness</td>
</tr>
<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>CFPB</td>
<td>Consumer Financial Protection Bureau</td>
</tr>
<tr>
<td>CFTC</td>
<td>Commodity Futures Trading Commission</td>
</tr>
<tr>
<td>EMEA</td>
<td>Europe, Middle East and Africa</td>
</tr>
<tr>
<td>FCRF</td>
<td>Financial Crisis Responsibility Fee</td>
</tr>
<tr>
<td>FDIC</td>
<td>Federal Deposit Insurance Corporation</td>
</tr>
<tr>
<td>Fed</td>
<td>Federal Reserve System</td>
</tr>
<tr>
<td>FICC</td>
<td>Fixed Income, Currencies and Commodities</td>
</tr>
<tr>
<td>FSB</td>
<td>Financial Stability Board</td>
</tr>
<tr>
<td>FSOC</td>
<td>Financial Stability Oversight Council</td>
</tr>
<tr>
<td>G-SIB</td>
<td>Global Systemically Important Bank</td>
</tr>
<tr>
<td>HFSC</td>
<td>House Financial Services Committee</td>
</tr>
<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
</tr>
<tr>
<td>OCC</td>
<td>Office of the Comptroller of the Currency</td>
</tr>
<tr>
<td>RCAP</td>
<td>Regulatory Consistency Assessment Program</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SIFMA</td>
<td>Securities Industry and Financial Markets Association</td>
</tr>
<tr>
<td>SLR</td>
<td>Supplementary Leverage Ratio</td>
</tr>
<tr>
<td>TARP</td>
<td>Troubled Asset Relief Program</td>
</tr>
<tr>
<td>TLAC</td>
<td>Total Loss Absorbing Capital</td>
</tr>
<tr>
<td>TRuPS</td>
<td>Trust Preferred Securities</td>
</tr>
</tbody>
</table>
Acknowledgements

My research was motivated by personal experience. At 5:00 am on the morning of September 15, 2008, I entered my firm’s trading floor to uncharacteristic silence. A few hours earlier, Lehman Brothers had filed for bankruptcy and markets were in freefall. Without taking away from the much more horrific events of seven years earlier, this was my “9/11” moment. At the depth of the crisis, there was a very real fear that the financial system would collapse, ushering in an economic depression on par with the Great Depression. The financial system—its providers, customers and regulators—had failed us. Far-reaching regulatory changes to reshape financial institutions and markets seemed inevitable.

They weren’t. While a host of new regulations were introduced to re-regulate financial institutions and markets—changes that have made the system safer—the structure of the industry was left largely untouched. The financial sector continues to be dominated by mega-banks, complex financial products and transactions remain important drivers of industry profits, and large swaths of the financial sector are only lightly regulated. Yes, the financial system is safer, but is it safe enough? Why didn’t we get more regulation? Are policymakers really captured by industry? These were the questions that first motivated my research. But while the post-2009 regulatory reforms did not bring about transformational change to the industry, there are several instances of individual regulatory change that are meaningful. Further, they were adopted over the vigorous opposition of the largest banks. This suggests that the preferences of the largest banks do not always determine policy outcomes. There is more going on than just regulatory
capture. This motivated my second line of inquiry: What factors led to the adoption of regulations that were opposed by the large banks?

I have many people to thank, who over the years provided support and encouragement. First, there is my committee. At the suggestion of Mark Zacher, my friend, mentor and colleague, I was put in touch with Yves Tiberghien, who took an immediate interest in my work and demonstrated great patience and provided valuable guidance as its focus evolved. Paul Quirk also took an early interest and provided excellent advice and prompt feedback as my thesis progressed. His book (with Martha Derthick), *The Politics of Deregulation*, published almost 35 years ago, is still essential reading for anyone interested in regulation. Alan Jacobs’ penetrating questions, especially about causal mechanisms and evidence, made all three papers better.

I must also thank my classmates. Being a generation older, I was pleased that they nevertheless accepted me as one of their own. I’d especially like to thank Dominik Stecula, Camille Desmares and Itai Bavli, with whom I shared many dinners and laughs. My experience at UBC was also enhanced by fellow classmates, including Eric Merkley, Alex Held, Salta Zhumatouas, Jennifer Allan, Charles Roger and Alison James.

Finally, I would like to thank my wife and daughter. Lesley provided great support throughout the process, including reading many, many drafts of my work. Her encouragement never wavered. Our daughter, Nikki, never complained that my work was taking up too much family time and it even may have influenced her decision to study political science at university. Thank you both for being there.
Dedication

For Lesley and Nikki
Chapter 1: Introduction

Two competing narratives followed in the immediate wake of the 2007-09 financial crisis about the likelihood of U.S. policymakers enacting far-reaching changes to the regulations governing the financial sector, one optimistic and one pessimistic. Optimists argued that the economic crisis would lead to transformational changes to the governance, industry structure and conduct of the financial sector as policymakers acknowledged the inadequacies of the prevailing “light-touch” regulatory approach and responded to the demands of a now aware and engaged public who “never again” wanted to bare the financial and social costs of bank failures. Pessimists cautioned that significant regulatory change was unlikely, with the status quo expected to be largely maintained. In their view, policymakers were “captured” by the banking industry who at best would accept only symbolic measures that would seek to pacify the public’s demand for action without bringing about meaningful regulatory change.

Ten years later we know that both predictions are partly correct. Pessimists were right that the goals and principles guiding financial sector regulation and the prevailing industry structure would not change. The largest banks were not broken up, utility-type regulation was not imposed, barriers between different segments of the industry were not erected, few high-risk activities were banned, and there was no consideration of moving to a “narrow banking” system, which would limit the ability of private banks to create credit. Further, efforts to impose special taxes on banks or to curb their incentive compensation practices did not come to pass, even though both measures were popular with the public. Expectations that the financial crisis would prompt transformational change of the U.S. financial sector were misplaced.
However, optimists were partly right as well. Over strong opposition from the largest banks, U.S policymakers doubled the amount of capital big banks are required to hold, imposed significant regulation on previously unregulated over-the-counter derivative markets, created a powerful new regulatory agency to oversee consumer protection (the Consumer Financial Protection Bureau), prohibited banks from engaging in proprietary trading and placed tight limits on their ability to invest in hedge and private equity funds (the Volcker Rule), and applied tough new requirements on residential mortgage lending. U.S. policymakers also expanded the resolution regime to cover non-banks (the Orderly Liquidation Authority) and laid the foundations for macroprudential regulation with the creation of the Financial Stability Oversight Council. Each of these measures, plus others, are meaningful changes in their own right, although their entirety amounts to incremental rather than transformational change because they merely strengthen existing approaches to the regulation of financial institutions and markets rather than altering their structure and purpose.

My thesis addresses two questions related to these competing narratives. First, why did the 2007-09 financial crisis fail to bring about transformational change? Put differently, why didn’t we get more regulation? Second, how were policymakers able to overcome opposition from the large banks to bring about significant regulatory change in some areas? In other words, why didn’t the banks get everything they wanted? The first question in effect examines the “average” or “overall” degree of regulatory change in a country, whereas the second question focuses on particular regulations. Focusing on two levels of analysis—the overarching regulatory regime and individual regulations—is useful because regulatory reforms are often pursued in a
“piecemeal” manner due to the fragmented structure of policymaking in the financial sector.

Major parts of the regulatory reforms adopted in the United States after the financial crisis were crafted independently of other parts during the legislative and rule-writing phases of the policymaking process.

My dissertation focuses on U.S. regulatory reforms following the 2007-09 financial crisis, which includes the legislative process that led to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the rule-writing process that followed to implement the Dodd-Frank Act. My questions are addressed in three papers. Evidence for my analysis comes in part from media reports, speeches, memoirs of key participants, congressional hearings, comment letters, and regulatory filings. In addition, about 50 interviews were conducted with current and former government officials, industry executives and other knowledgeable observers between September and December 2018, mostly in Washington D.C. (The appendix provides details of the interviews.)

All three papers rely on process tracing for their analysis, which is “the analysis of evidence on processes, sequences and conjunctions of events within a case for the purpose of developing or testing hypotheses about causal mechanisms that might causally explain the case”. At its core, process tracing involves four steps: (i) identifying plausible explanations for the outcome under examination; (ii) unpacking the argument’s logic into its component parts; (iii) developing

observable implications of the explanation; and (iv) collecting evidence to support or refute the explanation’s observable implications. Process tracing is a particularly useful method of inquiry for small-N case studies because it relies on the occurrence (or not) of causal process implications rather than correlational evidence for casual inference.

My first dissertation paper (Chapter 2) asks why the 2007-09 financial crisis did not bring about the far-reaching changes to financial sector regulation called for by many politicians, regulators and policy analysts. Instead of transformative reforms that would have restructured the financial sector, the regulatory changes adopted by national governments and international standard-setting bodies produced only incremental change that strengthened existing regulations and added new regulations but did not fundamentally alter industry practices. The lack of transformative change has been linked to the policy preferences of policymakers, who continued to see large, complex financial institutions as central to the economy. This limited the range of regulatory reforms policymakers were willing to consider and provided opportunities for the financial sector to influence policy proposals. This explanation does not, however, tell us why policymakers continued to see the prevailing industry structure as beneficial in the face of strong evidence to the contrary and intense public anger at large banks. Looking at the U.S. experience between 2008 and 2010, I argue that policymakers held on to their preference to maintain the status quo because they believed it was necessary to stabilize the financial sector. Banks rely heavily on institutional investors to fund their activities. Transformative policy proposals

threatening the dominant position of the largest banks would create uncertainty about the future value of bank securities, which would discourage institutional investors from holding them at a time when their support is needed. This feedback link between policies and markets—where proposed regulations affect current market conditions—led President Obama to appoint a policy centrist to Treasury secretary, who was well regarded by Wall Street for his experience dealing with financial crises and his pragmatic approach to regulatory reform. A desire to restore investor confidence in the banking sector also tempered the types of regulatory reforms the Obama administration and Congressional committee leaders were willing to put forward while the health of the banking sector was in doubt. Proposals to regulate banks that were less friendly to institutional investors were considered only after the financial sector had stabilized.

The next two papers (Chapter 3 and 4) focus on the implementation of two stronger-than-expected regulations that were opposed by the biggest banks: additional capital requirements for very large banks and the Volcker Rule. These papers find that factors widely believed to limit policy change may do so only under certain conditions. Specifically, concerns about international competitiveness and the ability of policy opponents to use veto points to block policy change do not always prevent regulatory change from occurring.

My second dissertation paper (Chapter 3) examines minimum capital requirements for very large U.S. banks, what are referred to as globally systemic important banks (G-SIBs). The globalization of financial markets has made it more difficult for national authorities to adopt tough prudential regulations without placing local firms and markets at a competitive disadvantage relative to foreign rivals. International standards like Basel III have been
established to help policymakers balance these conflicting objectives by encouraging all states to enact similar regulatory measures. Nevertheless, on occasion, states have adopted gold-plated rules, which are local rules that exceed international standards. This is surprising because such rules are vigorously opposed by affected firms, and legislators are reluctant to undermine the competitiveness of their domestic financial sector because of its importance to the national economy. In the mid-2010s, the U.S. imposed on its largest banks capital adequacy requirements that exceeded Basel III. I examine three possible explanations for more stringent U.S. rules: (i) the “sham regulation” thesis argues that U.S. regulations may appear tougher than international standards but in practice are not; (ii) the “no impact” thesis argues that U.S. regulations are stronger but they are not expected to affect the competitiveness of U.S. banks despite the added cost; and (iii) the “justified impact” thesis argues U.S. regulations are stronger, and may undermine the competitiveness of U.S. banks, but the tougher rules are necessary to maintain financial stability. I use process tracing to examine four key (but different) observable implications of each explanation and then assess the degree to which they are consistent with the U.S. experience. I find support for the “no impact” thesis, an outcome made more likely by the particular political and financial conditions present when the capital rules were adopted.

My third dissertation paper (Chapter 4) explains how the Volcker Rule came to pass. The Volcker Rule is a highly technical regulation strongly opposed by the big banks prohibiting proprietary trading and severely restricting investments in hedge and private equity funds. Pepper Culpepper argues that political processes shaping economic policies in advanced
democracies differ under conditions of low and high issue salience. My paper explores this contention by examining the role of veto points under conditions of high issue salience and a public demanding policy change. Veto points are places along the policymaking process where a policy proposal can be defeated. Most of the literature argues that veto points tend to preserve the status quo by providing opportunities for opponents to defeat policy changes. I argue that while this tends to be the case when issue salience is low, pro-reformers may be able use veto points to bring about policy change when issue salience is high and the public wants an end to the status quo. During such periods, politicians need to respond to the public’s desire for change if they want to avoid criticism that could affect their electoral prospects. This creates opportunities for pro-reformers to use veto points to get what they want if they are able to block policies they find inadequate. To support my argument, I show that the Volcker Rule, a signature piece of the post-2009 financial sector regulatory reforms in the United States, owes its existence and strength to the ability of pro-reformers to use their veto power at key points in the policymaking process. In January 2010, President Obama put the Volcker Rule on the reform agenda by stating that it was essential to the administration’s efforts to rein in reckless bank behavior, a position he repeated often in the period leading up to passage of the Dodd-Frank Act in July 2010. Others performed similar roles at later veto points in the policymaking process. Senators Merkley and Levin ensured tough legislative wording in the Dodd-Frank Act and Commissioners Gensler, Chilton and Stein held out for strong measures in the final rule, which was adopted in December 2013. These efforts were aided by timely civil changes filed by the Securities and Exchange Commission (SEC) against Goldman Sachs and large trading losses at

JPMorgan Chase, two events widely covered by the media and used by pro-reformers to illustrate the need for the Volcker Rule. Paul Volcker, former Chair of the Federal Reserve, played a crucial role by formulating the initial policy, advocating for its inclusion in the Dodd-Frank Act, and by threatening to withhold public support for anything less than a meaningful rule. Adoption of the Volcker Rule was surprising because many of the conditions often associated with policy change were absent: financial experts were divided on the need for the Volcker Rule, Treasury and most regulators were opposed, the large banks lobbied heavily against it, and the rule is highly technical and not easily explained.

The chief contribution of my dissertation is to the literature on business power and policy change. My findings support both pessimistic and optimistic views about the ability of business to limit reforms they oppose. On the pessimist side, my first dissertation paper (Chapter 3) identifies an additional mechanism through which structural power limits policy change, at least in the financial sector. Because of the large amount of funding institutional investors provide banks—funding essential to their activities—policymakers prioritize policy proposals that are aligned with the perceived preferences of institutional investors. This limits the kinds of policy reforms that policymakers consider, with policies popular with the public often ignored. At the same time, my findings also support the optimists by identifying factors that limit the amount of power banks exercise in the policymaking process. In my second two dissertation papers (Chapter 3 and 4), I find that concerns about international competitiveness and the presence of multiple veto points do not necessarily reduce the likelihood of regulatory changes opposed by large banks. If policymakers believe that tougher local rules will not adversely affect their banks’ global activities, then putting in place local regulations exceeding international standards
is possible. Likewise, high issue salience and a public opposed to the status quo can create opportunities for pro-reformers to use veto points to bring about tougher regulation. Both findings cast a more optimistic light on the ability of policymakers to enact policies opposed by business. Given that most of the business power literature examining financial regulation has focused on how the financial sector is able to block policies they oppose, my findings contribute to a line of inquiry deserving more attention.4

My dissertation has three important limitations. First, I do not offer a single, unified theory of regulatory outcomes in the financial sector. While it is fair to conclude that high issue salience, which tends to occur after financial crises, prompts policymakers to review the adequacy of existing regulation, it is neither a necessary nor sufficient condition for tougher regulation to emerge. Strong regulation has been adopted in periods of low issue salience and proposals for tougher regulation have not been adopted in periods of high issue salience. My findings add to the list of factors that have been shown to facilitate the adoption of policies opposed by the banking sector, such as divided opposition, social mobilization, majoritarian decision-making processes, and ideological predisposition to strong regulation.

Second, and related to the first, I make no attempt to offer a coherent theory linking the arguments in the three papers. This is in part because they focus on different time periods. The

first paper focuses on the adoption of regulations in the immediate aftermath of the financial crisis, when the primary goal of policymakers was to stabilize the financial sector. This is what allowed concerns about the confidence of institutional investors to limit policy change. This concern was absent in the second two papers, which examined the adoption of regulations after financial markets had stabilized. The lack of a coherent theory linking the three papers is also because they focus on different levels of analysis. The first paper is concerned with the overall character of the post-2009 financial reforms whereas the second two papers examine particular regulations. Explanations of individual outcomes require greater attention to factors that may not extend to other areas.

Third, my dissertation is a study of what is; it is not a study of what ought to be. I make no attempt to evaluate the overall effectiveness of the financial sector reforms adopted in the United States after the 2007-09 financial crisis, nor do I pass judgement on whether particular regulatory outcomes are good or bad. My findings are limited to assessing the amount of change the reforms brought about and analyzing the factors leading to these results. That said, I have no doubt that the U.S. banking sector is safer today than prior to the financial crisis but I also accept that legitimate debate remains about whether the Dodd-Frank Act and attendant regulations have made it safe enough. This judgment goes to the heart of the dilemma facing policymakers: how to balance the competing goals of a stable and competitive financial sector. Policymakers can always make the financial sector safer, but at what cost? Beyond a certain amount of regulation, there is no easy way to determine if the marginal societal benefits of additional prudential measures exceed their marginal societal costs. In my view, there will always be room for debate
and, as a result, a pattern of regulatory tightening followed by a period regulatory easing will remain an immutable feature of financial sector regulatory policy.

The 2007-09 financial crisis prompted the most severe economic downturn in the United States since the Great Depression. The U.S. economy shrank by close to 5 percent and shed almost 10 million jobs. The unemployment rate reached 10 percent and stayed above 8 percent for more than 3 years. Median household wealth declined by almost 40 percent due to the collapse of housing prices and the stock market.\(^5\) The value of all U.S. stocks dropped $14 trillion between September 2007 and March 2009.\(^6\) By the end of 2009, more than 2 million American homeowners were in foreclosure and another 7 million were at serious risk of foreclosure.\(^7\) U.S taxpayers supported the financial sector with hundreds of billions of dollars in direct aid and trillions of dollars of additional support in the form of government guarantees and liquidity programs provided by the Federal Reserve.

Politicians of all stripes promised to impose a tough new regulatory regime that would transform the financial sector so that large banks would never again threaten the economy.\(^8\) The possibility of transformational change also found support in leading theories of policy change.\(^9\) Financial reform became a high salience issue, policy debates extended beyond the policy


\(^{8}\) Republicans initially supported tougher financial sector regulation, at least rhetorically, but only three moderate Republicans ultimately voted for the Dodd-Frank Act. Beginning in 2011, after Republicans gained control of the House, the House Financial Services Committee began efforts to repeal significant parts of the Dodd-Frank Act.

monopoly that had traditionally dealt with financial regulation, the public was angry at the banks and demanded a clamp down on their activities, advocates of “light-touch” regulation had been discredited, and policymakers acquired a new understanding of financial sector risks and of measures necessary to contain them. This suggested that the conditions necessary for a “paradigm shift”, a “third-order change” or a “punctuated” policy shift were in place to deliver transformational change to the financial sector.

This did not happen. Instead, the reforms put in place after the financial crisis brought about only incremental change—that is, they strengthened supervisory capabilities, toughened existing regulations and addressed regulatory gaps but they did not fundamentally alter the industry structure or change the underlying principles guiding financial sector regulation. Regulatory reforms did not, for instance, break-up the largest banks, re-impose the utility-type regulation in place between the 1930s and 1970s, nationalize the sector, or seek to control the credit creation

process by adopting a “narrow banking” structure. Scholars have argued that policymakers did not push for far-reaching policy changes because they remained committed to keeping large, complex financial institutions at the center of the financial system. This policy preference kept some radical policy proposals off the table and created opportunities for the large banks to use their considerable lobbying capabilities to water-down other ambitious regulatory proposals by exploiting institutional constraints on policy change. The desire of policymakers to preserve the central role of large banks limited the kinds of regulatory reforms that legislators and regulators were willing to consider and gave the large banks a significant voice in shaping the policy changes that were ultimately enacted.

This explanation provides valuable insights into the post-2009 financial sector regulatory reform process, but ignores a crucial analytically prior question: Why do policymakers maintain the view that large, complex financial institutions are central to the economy in the face of strong evidence that this structure failed and intense public anger at the large banks? One view is that policymakers are “captured” by industry, which results in policy preferences aligned with those of the major banks. However, I argue that an additional factor is at work as well. Looking at the U.S. experience between 2008 and 2010, I argue that policymakers held on to their preference to retain the existing industry structure because it was necessary to end the immediate crisis. Transformative policy proposals create uncertainty about the future profitability of the

---

11 The first three proposals were actively promoted by progressive Democrats after the crisis but gained little traction with the principal policymakers. Calls for “narrow banking” go back to the 1930s (then called the “Chicago Plan”) but serious consideration of these proposals has seldom taken place beyond academia.
12 Johnson and Kwak 2010, and Bell and Hindamoore 2015.
13 Ibid.
banking industry, which discourages institutional investors from investing in the sector. But without their support, the financial crisis would linger because a large portion of the funds supporting the activities of the largest banks come from institutional investors. This feedback link between policies and markets—where proposed regulatory changes affect current market conditions—led President Obama to appoint a policy centrist to Treasury secretary, who was well regarded by Wall Street for his experience dealing with financial crises and his pragmatic approach to regulatory reform. A desire to restore investor confidence in the banking sector also tempered the types of regulatory reforms the Obama administration and Congressional committee leaders were willing to consider while the health of the banking sector was in doubt.

The chief contribution of this paper is to identify an additional channel through which the financial sector’s structural power influences policy outcomes. Existing structural arguments focus on the possibility of banks altering their activities in ways that would preserve their profitability but run counter to the preferences of policymakers, such as relocating major business lines to less-regulated jurisdictions. The possibility of banks countering policy changes in ways that harm the economy discourages policymakers from pursuing those policies. My argument focuses on the structural power of institutional investors to curtail investment in the banking sector at a time when their support is crucial to ending the financial crisis. This insight contributes to the literature on business power, which seeks to identify the instrumental and structural resources available to business to influence policy choices in advanced industrialized
democracies, as well as the conditions that accentuate or diminish their influence. In an era of growing inequality, with elites capturing an ever larger share of global wealth and political power, this research program helps us to understand when policymakers are able to resist business pressure and when they are not.

It is surprising that the interests and actions of institutional investors have not received greater attention from scholars seeking to understand the character of the post-2009 regulatory reforms. After all, troubled banks failed when institutional investors stopped lending to them, and it was the confidence of institutional investors that policymakers sought to restore in their efforts to prevent another Great Depression. Institutional investors hold two-thirds of all outstanding U.S. stocks and at least 80 percent of all outstanding U.S. corporate bonds. They also hold between 70 and 85 percent of the outstanding stock issued by each of the five largest U.S. banks. At the depth of the crisis when President Obama and other senior policymakers spoke about the need to restore the market’s confidence in the banks, it was institutional investors to whom their efforts were directed since they own most of the equity and debt issued by banks.

---

16 This figure is based on data from the Federal Reserve as compiled by Global Macro Monitor, “Major Holders of U.S. Corporate Bond Market,” June 12, 2018.
17 Figures on institutional ownership of banks stocks is from NASDAQ based on 2018 regulatory filings.
and it is their confidence that had to be restored if banks were to raise sufficient debt and equity capital to regain a sound footing.

This chapter is divided into six sections. The first section briefly reviews the major phases of the 2007-09 financial crisis and identifies the immediate causes of it. The second section looks at the regulatory response to the financial crisis and explanations of the failure by policymakers to bring about transformational reforms. The third section develops my argument that policymakers’ need to pursue policies that do not undermine the willingness of institutional investors to invest in banks while their health is in doubt, which limits the types of regulatory reforms policymakers are willing to consider. The fourth section describes my methodology. The fifth section uses process tracing to assess evidence for my explanation against seven observable implications of my theory. Finally, the sixth section offers concluding observations and identifies future avenues of research.

2.1 The 2007-09 Financial Crisis and the Importance of Institutional Investors

The financial crisis unfolded in five phases. First, the origins of the crisis reach back to the late 1990s, when financial markets were de-regulated and financial innovation was embraced as a means to improve the allocative efficiency of capital markets and, ironically, to better manage risk. Second, the market excesses phase of the crisis (2002-2006) saw financial institutions take advantage of easy credit conditions and lax regulatory oversight to boost profits by using more leverage and engaging in riskier lending and investment activities. This coincided with greater reliance on short-term borrowing from wholesale markets to finance lending and investment
activities, more exposure to lower-quality assets (e.g., subprime mortgages) via increasingly complex financial instruments (e.g., collateralized debt obligations), and greater use of derivatives to manage and gain exposure to credit risks (e.g., credit default swaps). Third, warning signs appeared in 2007 as house prices began to fall, mortgage default rates started to climb, and markets for structured investments became less liquid. This was soon followed by troubles at moderately large banks, such as Bear Sterns in the United States, Northern Rock in the U.K. and IKB in Germany, though difficulties at these institutions were contained.

Fourth, the peak-crisis period began in September 2008 when the U.S. government placed the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) into conservatorship, and reached full panic a week later when Lehman Brothers filed for bankruptcy, AIG collapsed and the Primary Reserve Fund was unable to maintain a fixed price for its units. The peak-crisis period ended in the United States when financial markets stabilized in late-2009. Finally, the policy response phase began in 2008 and continued through 2016, when most of the new regulations required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 had been written and the Federal Reserve announced that it would begin to normalize its balance sheet after three rounds of quantitative easing. The focus of this period was initially on promoting economic recovery by restoring confidence in the banking system, fiscal stimulus and monetary expansion, and later on reducing the likelihood of future banking crises by tightening the regulation of financial institutions and markets. However, 2016 marked “peak regulation” as the Trump administration began efforts to roll-back parts of the Dodd-Frank Act.
The underlying causes of the financial crisis are many and remain subject to ongoing research and disagreements about the relative importance of each factor. However, the immediate cause of the crisis is not in dispute: institutional investors withdrew short-term funding from banks experiencing (or thought to be experiencing) large losses on their holdings of debt securities tied to sub-prime mortgages. In the United States, about half of all bank funding is provided by institutional investors via wholesale markets, which is a much less stable source funding than retail deposits. Investment banks, such as Goldman Sachs and Morgan Stanley are especially reliant on short-term wholesale markets, which include interbank deposits, repurchase agreements, commercial paper and asset-backed commercial paper. As institutional investors began to appreciate the magnitude of the problem with the sub-prime mortgage market, as well as the large amount held by U.S. banks, they reduced their funding and the term to maturity of that funding. By early September 2008, U.S. investment banks were dependent on billions of dollars of funding being provided on an overnight basis and its withdrawal caused Lehman Brothers to fail.

When institutional investors do not “rollover” their investments as they mature, banks must either find other sources of funding or sell assets. The U.S. Federal Reserve partially offset the


19 International Monetary Fund, Global Financial Stability Report, October 2013, Figure 3.1, p. 107. European banks are even more reliant on wholesale markets than American banks.

20 Short-term is defined as any security with a maturity of less than one year.
withdrawal of funds by institutional investors through various lending programs but the loans extended to banks by the Fed had to be secured with high-quality assets, which were in short supply. Therefore, banks were forced to sell assets to repay their short-term funding obligations at a time when there were few buyers. This caused asset prices to fall, especially for complex, hard-to-value securities, such collateralized debt obligations, which sparked a further exodus of investors from bank securities. This was reflected in large drops in the price of bank stocks and sudden spikes in a variety of credit spreads related to bank debt. Even seemingly healthy banks were affected. Banks are highly interconnected—they are among the largest providers of short-term financing to other banks—and their balance sheets are opaque. This meant that institutional investors were uncertain if a bank had direct exposure to sub-prime assets or indirect exposure via loans and derivative contracts with other banks holding large amounts of sub-prime assets. Thus, uncertainty regarding the value of securities tied to sub-prime mortgages and uncertainty about how much exposure banks had to these assets led institutional investors to pull funding from the banking sector. This constituted a “run” on the banks by institutional investors, much like what U.S. banks experienced in the 1930s, although at that time the exodus came from retail depositors.

2.2 The Regulatory Response

Significant re-regulation of the financial sector took place in most advanced industrialized democracies soon after the peak-crisis period ended. In Europe and America, the core reforms were designed to (i) lessen the likelihood of firms failing by imposing tougher prudential regulations and implementing better supervision and enforcement, (ii) lessen the impact of
failures on the economy through improved resolution mechanisms and enhanced consumer compensation schemes; and (iii) strengthen consumer and investor protections with stricter laws and enforcement capabilities. Tentative steps have also been taken to rely more on macro-prudential measures to control systemic risks in the financial sector by countering the procyclical bias of some prudential measures. The toughest regulations were applied to the very largest financial institutions because of their systemic importance to the global financial system. National reforms were driven primarily by domestic political considerations, particularly in the United States, which was one of the first countries to pass major legislation to re-regulate the financial sector.

In the United States, the reform process took place in two distinct phases: the legislative phase and the rule-writing phase. The legislative phase began in early 2009 and concluded in July 2010 with the passage of the Dodd-Frank Act. A notable feature of the Dodd-Frank Act is its heavy reliance on rule-making by regulatory agencies. Dodd-Frank has been described as a “skeletal structure with few affirmative commands and is heavily dependent on administrative implementation”. In most areas, the Dodd-Frank Act specifies where a rule is to be written, who is responsible for writing the rule, what factors are to be considered in developing the rule, and when the final rule is to be adopted, but leaves the content of the rule to the discretion of prescribed regulatory agencies. By one count, the Dodd-Frank Act specified 398 rules to be written. As of July 2016, 274 final rules had been issued, 36 had been proposed and 80 had

21 Coffee 2012, p. 1065.
22 Davis Polk, Dodd-Frank Progress Report, September 2013.
not been issued.\footnote{Davis Polk, \textit{Dodd-Frank Progress Report}, July 2016.} The inauguration of President Donald Trump in January 2017 ended efforts to tighten financial sector regulation in the United States.

Regulatory reforms in the United States (and elsewhere) fell short of being transformational based on related four indicators: (i) policy goals were unchanged; (ii) enacted reforms fell short of what policymakers initially called for; (iii) enacted reforms did not address the root causes of the crisis; and (iv) enacted reforms did not bring about structural change to the industry. Turning to the first indicator, new policy goals that would have redefined the role of the financial sector or the function of banks in the economy were not adopted.\footnote{Eleni Tsingou, “Transnational Veto Players and the Practice of Financial Reform,” \textit{British Journal of Politics and International Relations} 17(2) (2015), p. 325.} This is similar to Peter Hall’s concept of a “third-order change”.\footnote{1993.} The reforms did not break-up the largest banks or materially limit the scope of their activities. The reforms did not impose a utility-type regulatory regime by requiring banks to hold dramatically higher capital levels to achieve near-certain reliability nor did it require banks to seek prior regulatory approval on prices or before offering (or discontinuing) financial products and services. The reforms did not place the industry under public ownership and control. And the reforms did not end the fractional reserve banking system, which would have left credit creation largely in the hands of government. The reforms did not even impose meaningful macroprudential constraints on the banks to limit credit creation during periods of excessive growth. Any one of these proposed reforms would have constituted a transformational change.
A second indicator of the incremental character of the post-2009 financial sector reforms is that the final regulatory reforms fell short of the proposals initially put forth by legislators. At the peak of the crisis, politicians called for regulatory changes that would ensure banks would “never again” threaten the health of the economy and offered specific proposals about how this would be achieved. Frequently the final reforms did not go as far as their early proponents sought due to the inclusion of extensive exemptions severely limiting their impact—exemptions necessary to secure congressional approval. This definition of incremental change focuses on the gap between what was proposed and what was adopted.

A third indicator of the incremental character of the regulatory reforms is that they failed to address the root causes of the financial crisis. This definition is linked to the expected effectiveness of the new regulations, asserting that if the possibility of a future financial crisis has been reduced by only a modest amount, then incremental change has taken place. Many expert evaluations of the Dodd-Frank Act are that it did not go far enough, or target the right areas, to meaningfully reduce the likelihood a future crisis. Even a study by the Federal Reserve Bank of Minneapolis found that the regulatory changes adopted under the Dodd-Frank Act have reduced the 100-year chance of a 2008-type financial crisis by only 20 percent. Lastly, the post-2009 financial reforms did not prompt structural changes to the industry.

29 The Minneapolis Plan to End Too Big to Fail, November 16, 2016, p. 1.
30 Johnson and Kwak 2010, Moschella and Tsingou 2013.
Structure here refers to prevailing industry characteristics and practices, such as the size of the industry (or individual banks) as a share of gross domestic product, the funding mechanisms used to finance bank activities, or the continued use of complex financial instruments. None of these have materially changed in the United States.

A rich body of literature has emerged to explain the incremental character of the post-2009 financial sector reforms in the United States and elsewhere.\textsuperscript{31} Johnson and Kwak\textsuperscript{32} and Bell and Hindamoor\textsuperscript{33} argue that the financial sector shapes the policy preferences of policymakers through “cultural capture” and this has limited regulatory change. Policymakers adopt industry views by defining their identity as being part of the financial sector community, deferring to the expertise of high-status industry leaders about what are appropriate policies, and seeking acceptance from and conflict-free interactions within their social networks.\textsuperscript{34} The highest status industry officials are often those heading the largest banks and, thus, it is not surprising that policymakers continued to see large, complex financial institutions as essential to the economy even after the risks associated with that structure became apparent. When policymakers hold the same policy preferences as the industry they regulate, this gives industry representatives privileged access to policymakers, who need industry’s technical knowledge to develop regulatory proposals and to assess the impact of regulatory proposals on industry activities and profitability. It also makes the merits of changes sought by industry self-evident to

\begin{footnotesize}
\textsuperscript{31} See footnote 6.
\textsuperscript{32} 2010.
\textsuperscript{33} 2015.
\end{footnotesize}
policymakers, who are reluctant to challenge their views. As Tim Clark, a former bank supervisor at the Federal Reserve acknowledged, prior to the financial crisis “there was a very strong belief that if the banks thought they were adequately capitalized, they were adequately capitalized. [...] There was a strong belief that we should not push too hard against these people who were smarter than us.”

Others point to interest-group and institutional factors to explain the failure to put in place transformational regulatory reforms. Connaughton argues that the need of U.S. legislators to constantly raise funds for their re-election campaigns make them responsive to the financial sector, which is one of the largest contributors to politicians. Johnson and Kwak and Wilmarth make this point as well. Moschella and Tsingou, Carpenter and Kus identify institutional friction, notably veto points, as strengthening the ability of the financial sector to block or water down regulatory proposals they oppose. Those prioritizing ideational factors see these other explanations as complementary: shared policy preferences among policymakers and industry enables the banking sector to utilize their lobbying resources and to exploit institutional veto points to limit financial sector regulatory reforms.

36 2012.
37 2010.
38 2013.
39 2013.
40 2010.
41 2016.
A weakness of this literature is that it largely ignores an important analytically prior question: Why did policymakers prefer the status quo—to keeping large, complex financial institutions at the center of the financial system in the face of strong evidence that the existing structure had failed and intense public anger at the banks? The current literature offers convincing explanations of the embrace of “light touch” regulation prior to the 2007-09 financial crisis but these arguments are less compelling afterwards when it became clear that prevailing regulatory policies had failed, alternative policies were being widely debated, and an angry public was demanding meaningful regulatory reforms. These are the types of conditions that are typically associated with transformational change. Why is it that the policy preferences of legislators and regulators withstood these pressures?

2.3 Argument

I argue that another mechanism is at work during financial crises that limits the ability of policymakers to embrace transformational change to financial regulations: the need for tacit approval from institutional investors, which are entities with large portfolios of debt and equity securities. Institutional investors comprise a wide-range of organizations, including asset managers, pension plans, foundations, family business offices and sovereign wealth funds. Institutional investors do not often participate directly in efforts to reform financial regulations, except when proposals directly target their business activities. Large institutional investors and

---

42 Asset managers invest money on behalf of individuals, usually through mutual funds and exchange traded funds, and for institutional investors, such as pension funds, through both co-mingled funds and bespoke portfolios.
43 For instance, large asset managers took a strong interest in efforts to designate the largest of them as systemically important financial institutions, and in regulatory changes to money market mutual funds.
their trade associations\textsuperscript{44} are seldom witnesses at Congressional hearings on changes to U.S. financial sector legislation and few offer comments on proposed regulations that do not directly affect them.\textsuperscript{45} Instead, their influence on policymakers overseeing financial reforms is largely exerted through their investment decisions. Banks and insurance companies are also important institutional investors. They too exert influence through their investment decisions, but since almost all financial reforms affect their activities, they are also active participants in the regulatory reform process.

Resolution of a financial crisis cannot take place without restoring the confidence of institutional investors in the future profitability of the banking sector because a sizeable portion of their funding comes from institutional wholesale markets. Transformational policy proposals erode investor confidence. Institutional investors see them as raising compliance costs and creating uncertainty about their impact on the scale and scope of bank activities, which affects the valuation institutional investors place on bank securities. This limits their willingness to invest, and as long as they stay on the sidelines, the financial sector will lack the funds needed to recover. Thus, policymakers must be attentive to the views of institutional investors as they craft their policy responses to financial crises because proposed regulatory changes affect the attractiveness of bank securities to investors. This feedback link between policies and markets limits the range of policies that policymakers will consider.

\textsuperscript{44} These include the Managed Funds Association (hedge funds), Investment Companies Institute (asset managers) and the Council of Institutional Investors (pension plans and foundations).

\textsuperscript{45} For example, the proposed rules for a capital surcharge and enhanced supplementary leverage ratio on the largest banks did not receive comments from any institutional investors (other than banks and insurance companies). See https://www.federalreserve.gov/apps/foia/ViewComments.aspx?doc_id=R-1505&doc_ver=1 and https://www.federalreserve.gov/apps/foia/ViewAllComments.aspx?doc_id=R-1460&doc_ver=1.
To develop this explanation, I first briefly describe the economic function and operation of banks, plus the causes of financial crises. I then argue that policymakers need to restore investor confidence in the banking sector to return the economy to a sound footing. Finally, I argue that the need to restore investor confidence in the banking sector influences the selection of key policymakers to lead the regulatory reform process and the types of policies that regulators and legislators are prepared to consider.

Banks operate as financial intermediaries in an economy. A core function is maturity transformation—converting short-term liquid savings (e.g., deposits) into long-term illiquid investments (e.g., loans). Banks obtain short-term savings from depositors (individuals) and wholesale markets (institutional investors). As noted, the largest institutional investors of a bank’s securities are asset managers, pension funds, insurance companies and, indeed, other banks. They provide short- and long-term funding to banks through interbank deposits and repurchase agreements, and by purchasing commercial paper, asset-backed securities, bonds and common and preferred equity.

In the United States, about half of all bank funding comes from institutional investors. This figure, however, masks considerable variation within the industry. Commercial banks with large retail branch networks, such as JPMorgan Chase and Wells Fargo, secure only about 20-30 percent of their funding from institutional investors, whereas investment banks, such as Goldman Sacks and Morgan Stanley, obtain more than 90 percent of their funding from wholesale
Banks use these funds to provide loans and to invest in marketable fixed income securities issued by governments, corporations and structured investment vehicles. Loans are illiquid assets, meaning that they cannot be sold quickly without lowering their value. So too are some marketable securities, such as complex structured financial instruments like collateralized-debt obligations.

Financial crises are caused by the rapid withdrawal of funds from banking institutions in response to significant declines in the current value of their assets or heightened uncertainty about the future value of those assets. While banks maintain equity capital to absorb losses, this cushion is small, accounting for about five percent of total assets for the largest banks, but often much less than that. Given the small equity cushion, and the sizeable portion of bank assets that are illiquid, depositors and institutional investors have an incentive to pull their funds when the viability of a bank is in doubt. When depositors and investors withdraw their funds en masse, this creates a bank run. And when this happens at the same time for many banks, financial crises ensue. Deposit insurance—protection programs usually backed by governments guaranteeing the repayment of deposits to specified amounts—reduces the incentive for depositors to withdraw their funds during crises periods. Similar guarantees are not officially available to institutional investors. However, investors holding debt securities issued by large banks may believe these are covered by implicit government guarantees for banks thought to be

\[\text{\textsuperscript{46}}\text{ IMF, \textit{Global Financial Stability Report}, October 2010, Figure 2.10 and Figure 2.11, and IMF, \textit{Global Financial Stability Report}, October 2013, Figure 3.1, Figure 3.3 and Figure 3.4.}\]

\[\text{\textsuperscript{47}}\text{ This refers to Tier 1 capital as a percent of total assets. See Michael Brei and Leonardo Gambacorta, “The Leverage Ratio over the Cycle,” BIS Working Papers No. 471, November 2014, Figure 2, p. 30. See also FDIC, \textit{Global Capital Index: Capitalization Ratios for Globally Systemically Important Banks} (various years).}\]
“too-big-to-fail”. Central bank liquidity programs also lessen repayment risks to investors holding debt securities issued by banks.

Financial crises lead to economic recessions, higher unemployment, larger budget deficits and greater public debt. These adverse economic effects occur because banks reduce the supply of credit to consumers and companies, which slows economic growth, and because governments bear large costs when taxpayer funds are used to prop up ailing financial institutions. The latter costs arise from government-sponsored guarantees, asset purchases, equity injections, and wind-ups. Governments intervene to restore confidence in the financial sector, which is a precondition to return the economy to a sound footing. While government aid to the financial sector is deeply unpopular with the public, high unemployment, reduced credit availability, and declining values of homes and retirement savings are even more unpopular. This is why policymakers are willing to use public funds to bailout banks despite its unpopularity with the public.

Putting the banking sector back on a stable footing requires the support of institutional investors to fund bank activities. This includes purchasing equity to replenish the capital base of banks depleted by losses on their assets and buying debt to fund lending. Investors will only invest if they believe that the value of these securities will increase over time, which depends on expectations of future bank profitability. Investors are attracted to companies with high and

---

49 One exception is if governments are willing and able to nationalize the banking sector and to maintain public ownership indefinitely.
growing profits and stable earnings. These attributes provide equity investors with greater return potential and debt investors with a higher margin of safety that their capital will be returned when due.

The regulatory regime governing the banking sector is an important factor affecting investors’ risk-adjusted expectations about future industry profitability. Bank regulations are normally tightened following financial crises, which are expected to erode the future profitability of the banking sector due to higher compliance costs and constraints on banking activities. Institutional investors expect and support some regulatory change—financial crises harm them as well—but worry that substantial reform may lower industry profitability without a comparable decline in industry risks. As important, substantive reform proposals also create uncertainty about what future profitability might be. This is because policy proposals, when first announced, seldom contain sufficient detail to evaluate them fully and because the proposals themselves may change as they proceed through the legislative and rule-writing phases of the policy process. High and uncertain future regulatory costs dampen current investor interest in bank securities. The implication for policymakers is that if they need the support of institutional investors to stabilize the banking sector, and transformational reforms make banks less attractive to institutional investors, then policymakers will temper the reforms they will consider.

The public officials selected to lead the regulatory reform process also impacts the degree of uncertainty faced by institutional investors. Regulatory reform efforts led by officials who are members of the mainstream finance community will create less uncertainty among institutional investors than those who come from outside this group. This is because members of the
mainstream financial community are less likely to propose radical policies and are more likely to be receptive to industry points of views concerning the cost of regulatory changes. The implication of this for elected officials is that choosing well-regarded members of the mainstream financial community to lead the reform process will reduce uncertainty among institutional investors about the potential future cost of future regulatory changes, which in turn will help to restore confidence to the banking sector sooner.

Once the financial sector has stabilized, policymakers have greater latitude to consider more transformative policy proposals. However, with the stabilization of financial markets comes less urgency to impose meaningful regulatory changes. Stabilization reduces issue salience, undermines arguments about the need for radical change, and opens opportunities for the financial sector to use its instrumental power to exert greater influence on the policy process. Stabilization makes it harder for advocates of major change to move their proposals forward without accepting significant limits on them. By the time markets have stabilized, major elements of the reform package are typically in place and those overseeing the process are reluctant to accept significant new measures out of fear that doing so could cause tentative agreements to unwind.

2.4 Methodology

I use process tracing to evaluate my theory. Process tracing is “the analysis of evidence on processes, sequences and conjunctions of events within a case for the purpose of developing or
testing hypotheses about causal mechanisms that might causally explain the case”. At its core, process tracing involves four steps: (i) identifying plausible explanations for the outcome under examination; (ii) unpacking the argument’s logic into its component parts; (iii) developing observable implications of the explanation; and (iv) collecting evidence to support or refute the explanation’s observable implications. Process tracing is a particularly useful method of inquiry for small-N case studies because it relies on the occurrence (or not) of causal process implications rather than correlational evidence for casual inference.

My theory of regulatory reform following financial crises generates seven observable implications.

1. Political leaders see restoring the confidence of institutional investors as necessary to stabilize the banking sector and to resolve the economic crisis.
2. Political leaders consider the views of institutional investors when selecting public officials to lead the regulatory reform process.
3. Institutional investors react positively to the selection of centrist officials to lead the policy reform process.
4. Policymakers prioritize regulatory proposals that boost the confidence of institutional investors in the banks.
5. Policymakers avoid transformational policy proposals that could weaken investor confidence while the health of the banks is in doubt.
6. Policymakers may support policies strongly opposed by banks if they are not expected to have an effect on the confidence of institutional investors.
7. Policymakers may propose policies unfriendly to bank profitability only after investor confidence has been restored.

---

50 Bennett and Checkel 2015, p. 7.
A methodological limitation of the first five observable implications is that they do not discriminate between my argument about the importance of restoring the confidence of institutional investors to incremental regulatory change and an alternative explanation that policymakers were merely beholden to the interests of the biggest banks. This overlap is not surprising since the policy preferences of institutional investors and large banks are similar: both want the industry to be profitable. Observable implications 6 and 7 address this methodological weakness by generating different predictions for the two explanations. If policymakers were captured by the large banks, then they would not adopt any policies strongly opposed by the banks (observable implication 6). As we will see, the Consumer Financial Protection Bureau became a signature piece of the Dodd-Frank Act, despite vigorous opposition by the large banks. In contrast, institutional investors did not see the CFPB as having a material impact on the profitability of the industry. My explanation also predicts that once the confidence of institutional investors has been restored, policymakers may consider policies that are unfriendly to both banks and institutional investors (observable implication 7). Again, as we will see, President Obama proposed two polices that would harm bank profitability – the Financial Crisis Responsibility Fee and the Volcker Rule – but he did so only after the confidence of institutional investors in the banks had been restored. This last observable implication has a critical temporal component; namely, that policies undermining investor confidence in the banks are unlikely to be considered until after financial crises has passed.

The next section examines the regulatory reform process in the United States between 2008 and 2010, with particular focus on the period between November 2008 and January 2010. The
analysis is organized around the seven observable implications. Complicating the analysis is that financial sector reform was one of several policies pursued by the Obama administration to address the economic crisis; others were emergency measures to support troubled financial institutions, fiscal stimulus and monetary expansion. These other policy initiatives also affected the willingness of institutional investors to invest in bank securities and are discussed where appropriate. Evidence for my analysis comes in part from contemporaneous media reports, speeches, and memoirs of key participants. In addition, about 50 interviews with current and former regulators, congressional members, aides and staff, industry executives and representatives of civil society organizations were conducted between September and December 2018, mostly in Washington DC. The appendix provides details on the interviews.

2.5 Evidence

2.5.1 Political leaders see restoring the confidence of institutional investors as necessary to stabilize the banking sector and resolve the economic crisis.

President Obama’s priority on winning the November 2008 election was to formulate an economic plan to address the financial crisis. Economic conditions were deteriorating rapidly, with the U.S. economy having shed over a million jobs in the first 10 months of 2008 and the

51 These included the Troubled Asset Relief Program (TARP), which was established by the Emergency Stabilization Act of 2008, and various liquidity and guarantee programs put in place by the Federal Reserve and the Treasury Department in 2008 and 2009. Most of these programs, including TARP, were initiated by President Bush, but had the support of President-elect Obama and were designed in part by Timothy Geithner and Ben Bernanke, who continued on as leading economic officials in the Obama administration.


53 This includes cuts to the federal funds rate and quantitative easing programs. Because the Federal Reserve acts independently of the executive and congress, these policies were not initiated by the Obama administration but had their support.
unemployment rate having risen to almost seven percent. Obama’s economic advisors informed him that this was only the start of what was expected to be a deep and protracted recession. Obama opened many speeches after the election acknowledging the severity of the economic crisis and the necessity of considerable government action to avoid repeating the experience of the 1930s.

Obama publicly supported the extraordinary efforts taken by the Bush administration to deal with the economic fallout of Lehman Brother’s collapse. As the seriousness of the situation took hold, Obama said he “[…] fully support[s] the effort of Secretary Paulson and Federal Reserve Chairman Bernanke […]” to stem the crisis and to work with Congress to provide Treasury and the Fed with the authority they need to stabilize markets and maintain credit flows. This included supporting the Emergency Stabilization Act of 2008, which established the $700 billion Troubled Asset Relief Program (TARP) in October 2008. Obama also began advocating for a large fiscal stimulus plan to limit employment losses. As financial conditions worsened even after TARP was adopted, Obama remarked, “We should […] be prepared to extend broader guarantees if it becomes necessary to stabilize the financial sector.” Likewise, in February

2009, as stock markets reached new lows, Obama said that his “[...] administration will do
whatever it takes to restore our financial system. Our recovery depends on it.”\textsuperscript{59} Obama
understood that the economy could only recover if the financial sector stabilized.

Stabilizing financial markets required restoring the confidence of institutional investors in the
banks. Why? First, as previously noted, institutional investors are the dominant participants in
financial markets—in effect, they are the market—and they own most of the equity and debt
securities issued by the large banks. Second, institutional investors had serious doubts about the
quality of bank balance sheets and were reluctant to hold bank securities without knowing how
exposed individual banks were to “toxic securities,” either directly or via exposures to other
financial institutions with known problem assets. Debt investors in particular wanted greater
transparency about the health of bank assets and the adequacy of their capital, or government
guarantees to protect their fixed income investments from losses. Obama indicated his
awareness of this situation when he said, “We are going to have to work with the banks in an
effective way to clean up their balance sheets so that some trust is restored within the
marketplace, because right now part of the problem is that nobody really knows what’s on the
banks’ books”.\textsuperscript{60}

Recognizing this situation, Obama said that “[...] given the sensitivities of the market, I’ve got to
pay some attention to market psychology because part of what we have right now is such a loss

\textsuperscript{59} Executive Compensation Speech, February 4, 2009. Online by Gerhard Peters and John T. Woolley, The
American President Project.
\textsuperscript{60} The President’s News Conference, February 9, 2009. Online by Gerhard Peters and John T. Woolley, The
American President Project.
of trust. [...] I will be communicating with key market participants on a regular basis [...] to explain to them what exactly our plans are and to solicit from them good ideas.”61 A month later he also said, “[…] ultimately, the government cannot substitute for all the private capital that has been withdrawn from the system. We’ve got to restore confidence so that private capital goes back in.”62 Both comments highlight the importance Obama attached to restoring investor confidence to stabilize the financial sector.

Obama knew that his efforts to prop up ailing banks would be deeply unpopular with voters. His political advisors63 told him so, as did his economic advisors. During the transition period, Geithner told Obama that further “repugnant” measures would be necessary to get the financial system and the economy back on a sound footing.64 As Geithner remarked after the worst of the crisis was over, “We saved the economy, but we kind of lost the public doing it.”65 Geithner also sensed that Obama “[…] was deeply aware of and pained by the basic sense of injustice, the sense of, the immorality of what the bailouts meant. […] But he also felt […] you had to try to keep your eye on the fundamental moral obligation about what set of policies were going to produce the fairest outcomes in terms of getting people back to work […].”66 To counter the expected (and in his view justified) public outrage at continued efforts to aid the banks, Obama peppered his speeches on the economy with criticisms of bank executives. He frequently called

63 Axelrod 2015, p. 357.
65 Ibid.
66 Timothy Geithner, Interview with Michael Kirk, Frontline, June 6, 2016.
them “greedy,” “reckless” and “irresponsible,” and sought to enact measures that would prevent senior bank managers from personally benefitting from public efforts to stabilize the financial sector.\textsuperscript{67} When rumors circulated that the heads of some banks would not participate in TARP if their compensation was capped, Obama remarked, “I cannot imagine a position more selfish and greedy at a time of national crisis.”\textsuperscript{68}

Obama’s support of the extraordinary measures taken to stabilize the financial sector was also conditional on initiatives to help “Main Street”. Obama wanted relief for homeowners to be a central part of TARP.\textsuperscript{69} He also called for the deposit insurance caps to be raised to $250,000 (from $100,000)\textsuperscript{70} and for TARP funds to support consumer credit markets (e.g., credit cards, auto loans and student debt) and small businesses.\textsuperscript{71} In all of Obama’s speeches, support for the financial sector was justified on the basis of benefits to consumers, homeowners and small businesses. As Obama remarked in his first joint address to Congress about the extraordinary measures the government had taken to stabilize the financial sector, “It’s not about helping banks, it’s about helping people.”\textsuperscript{72} Efforts to prop up the financial sector were seen as a necessary evil to help average Americans—workers, homeowners, small business owners—get back on their feet.


\textsuperscript{71} Remarks in Toledo, Ohio, October 13, 2008. Online by Gerhard Peters and John T. Woolley, The American President Project.

\textsuperscript{72} February 24, 2009. Online by Gerhard Peters and John T. Woolley, The American President Project.
2.5.2 Political leaders consider the views of institutional investors when selecting public officials to lead the regulatory reform process

Obama’s first major administrative appointments were to his “economic cabinet”, which were announced on November 24, 2008. They followed several weeks of significant declines in the stock market and worsening economic news. The most important cabinet selection was Timothy Geithner to Treasury secretary. The Treasury secretary is the chief economic advisor to the President, leads government efforts to combat economic crises, and is the administration’s chief spokesperson on economic matters. However, despite these broad responsibilities, Geithner acknowledged that he was selected for his financial expertise and experience dealing with financial crises and not for his (limited) knowledge of broader spending and taxation matters.73 A former administration official echoed this view, saying that he believed Geithner’s “closeness to [financial] markets from his position at the NY Fed was a selling point” in his selection.74 Another added, “Tim Geithner was the only choice for Treasury secretary. The priority for Obama was to select someone who would be calming to the markets.”75 Other key economic appointments announced that day were Lawrence Summers to Director of the National Economic Council, Christina Romer to chair of the Council of Economic Advisors and Melody Barnes to Director of the Domestic Policy Council. Obama’s decision to name his economic team ahead of other senior cabinet appointments, and his selection of Geithner and Summers in particular, were

73 2014, p. 251.
74 Interview 32, former administration official, November 6, 2018.
75 Interview 47, former administration official, December 6, 2018.
designed to calm financial markets.\textsuperscript{76} The announcements also coincided with a major
government rescue package for Citigroup, one of the largest banks in the United States.\textsuperscript{77}

When Obama announced his economic cabinet choices, he opened his remarks by noting that the
country was “facing a crisis of historic proportions” and “financial markets are under duress.”\textsuperscript{78}
For both Geithner and Summers, Obama pointed to their extensive experience shaping financial
sector policy and dealing with domestic and international financial crises. Paul Volcker made
similar points in supporting testimony to the Senate Finance Committee at Geithner’s
confirmation hearing.\textsuperscript{79} The message sent by these appointments to institutional investors was
that the government’s economic levers would be in trusted and experienced hands that were
unlikely to seriously challenge current policies, particularly the extraordinary measures the Bush
administration had put in place since Geithner helped design them. In fact, Obama made this
explicit by saying that all public commitments made by the Bush administration would be
honored.\textsuperscript{80}

Summers was the other candidate most seriously considered for Treasury secretary.\textsuperscript{81} He would
have been equally acceptable to institutional investors but failed to get the position. Obama’s

\textsuperscript{76} Interview 49, former administration official, December 11, 2018.
\textsuperscript{77} On November 23, 2008, the Treasury Department, Fed and the Federal Deposit Insurance Corporation (FDIC)
announced that they would guarantee a portfolio of $306 billion of real estate assets held by Citigroup. They also
announced that Treasury would invest another $20 billion in Citigroup preferred stock. Bank stocks jumped sharply
the next day, with the price of Citigroup shares up over 50 percent and the price of most of the other large banks up
more than 20 percent.
\textsuperscript{78} Announces Nominations of Key Economic Advisors, November 24, 2008.
\textsuperscript{80} Announces Nominations of Key Economic Advisors, November 24, 2008. Online by Gerhard Peters and John T.
Woolley, The American President Project.
\textsuperscript{81} Axelrod 2015, p. 331-32.
close advisors felt Summers would be hard to confirm because of his recent employment at a
large hedge fund and his troubled tenure as President of Harvard.\textsuperscript{82} Paul Volcker was also
reported to have been considered for the position, though not seriously.\textsuperscript{83} Despite his extensive
experience, Volcker would have been less warmly received by institutional investors since in
recent years he had become critical of banking practices and inadequate regulation.\textsuperscript{84} No
consideration was given to candidates who would have appealed to progressive Democrats, such
as Joseph Stiglitz, Paul Krugman or Simon Johnson.\textsuperscript{85} Even when Geithner’s nomination was
jeopardized by revelations that he had not fully met his tax obligations while working at the
International Monetary Fund in the early 2000s, Obama did not waiver in his support.

An alternative explanation for Geithner’s appointment as Treasury secretary is that Obama relied
heavily on the recommendation of advisors closely tied to the financial sector who were looking
to preserve the industry’s privileged position in the policymaking process.\textsuperscript{86} Michael Froman, a
long-time Obama friend\textsuperscript{87} and senior executive at Citigroup, led Obama’s transition team to
select top-level economic appointments in the new administration. His three recommendations

\begin{itemize}
  \item Ibid., Paul Volcker, \textit{Keeping at It} (New York: Public Affairs, 2018). Shelia Bear, then chair of the FDIC, was
reported to have been considered as well. Despite being a Republican, she was known to favor tougher financial
  \item Volcker has long been opposed to financial deregulation. His reluctance to push deregulation was one factor
behind his ousting as Fed chairman by the Regan administration. Louis Uchitelle, “Volcker Pushes for Reform,
  \item Interview 32, former administration official, November 6, 2018, Interview 47, former administration official,
December 6, 2018.
  \item Matt Taibbi, “Obama’s Big Sellout: The President Has Packed his Economic Team with Wall Street Insiders,”
  \item Obama and Froman were classmates at Harvard.
\end{itemize}
for Treasury secretary—Robert Rubin, Lawrence Summers and Timothy Geithner—had all pushed financial sector de-regulation during the Clinton administration, and could be counted on by Wall Street to maintain the extraordinary measures supporting the financial sector and to resist calls for radical regulatory reforms. Further, Geithner, as President of the New York Federal Reserve Bank, was negotiating the terms of a significant bailout for Citigroup at the same time Froman was recommending him for Treasury secretary. Thus, this alternative explanation sees Geithner’s selection as the product of the banks’ influence on the appointment process rather than as a consequence of Obama’s deep concern about the impact of his announced economic team on the views of institutional investors.

While this alternative explanation is persuasive, the analytically prior question is why did Obama rely on advisors with close ties to the financial sector to select his economic team, instead of other advisors with more progressive views, such as Jared Berstein, Austan Goolsbee, Karen Kornbluch or even Paul Volcker, who were all part of the Obama campaign team? Obama has not spoken on this topic nor was he available for an interview. However, Obama’s extant concern about deteriorating financial conditions and his desire to calm financial markets is consistent with the view that he saw the appointment of Geithner as a means to achieve this goal. Apart from Volcker, his advisors with progressive views lacked close ties to Wall Street and deep knowledge of financial markets. They did not have the experience and contacts to provide

88 Froman’s recommendations were revealed by Wikileaks in 2016. See David Dayen, “The Most Important Wikileaks Revelation Isn’t About Hillary Clinton,” New Republic, October 14, 2016.
Obama with a comprehensive assessment about how the markets would react to his economic appointments.

2.5.3 Institutional investors react positively to the selection of centrist officials to lead the policy reform process

Geithner’s selection as Treasury secretary was reported by NBC at 3:00 pm on Friday, November 21, three days before the official announcement. This prompted a sudden rise in equity markets in the final hour of trading, which had been flat to that point in the day. The S&P 500 Index, a broad measure of the U.S. stock market, ended the day up 6.3 percent. Bank stocks, which had lost considerable ground during the day on concerns about the health of Citigroup, staged strong recoveries after Geithner’s selection had been reported.

Obama’s choice of Geithner as Treasury secretary garnered positive reactions in the financial press. The Economist called it a “[…] reassuring choice […],” the Financial Times noted that Geithner “[…] plausibly represents change while offering a high degree of continuity […],” and the Wall Street Journal wrote it indicated that “[…] addressing the immediate panic in the credit markets and its impact on the real economy is priority No. 1 for the new President.” Favorable assessments also came from senior financial executives, financial economists and

---

89 While impressive, daily market changes in excess of 5 percent were not uncommon in late 2008 and early 2009, a period of unprecedented volatility.
90 Banks stocks jumped even more on November 24, 2008 when Geithner’s selection was officially announced. However, markets were more likely reacting to a government rescue package for Citigroup, which was announced the day before.
91 “Meet Mr Geithner,” Economist, November 24, 2008.
former regulators. In their view, personnel choices are policy and they approved of the policy direction implied by Geithner’s appointment. As one former regulator commented, he was seen as “pro-business” who would “preserve the status quo for Wall Street.” An industry association executive added,

Geithner really was the only choice for Treasury secretary. Obama’s top priority was to calm the markets and Geithner was a known commodity. He was not a zealot that would push to break-up the banks. He had intimate knowledge of the efforts to prop up the banking system. [There was] a need to calm the market during a crazy period.

Investors responded positively to Geithner’s selection because it reduced uncertainty regarding Obama’s commitment to maintaining the emergency measures the government had put in place to support the banking sector and to the direction of financial sector reforms. As President of the New York Federal Reserve Bank, Geithner had worked closely with Treasury secretary Henry Paulson and Federal Reserve chairman Ben Bernanke to craft the Bush administration’s response to the financial crises, and his selection as Treasury secretary signaled to institutional investors that these policies would be continued. This perception was validated two days later when Geithner announced a large government rescue package for Citigroup, which was highly favorable to debt and equity investors. Geithner was also seen as a centrist on regulatory matters, and with him and Summers leading the administration’s efforts to reform financial sector regulation, institutional investors could take comfort that the new administration would


Interview 20, former regulator, October 24, 2018.

Interview 45, industry official, December 6, 2018.

likely focus on strengthening oversight and prudential regulations rather than seeking structural changes or imposing punitive measures on the banking industry. Geithner had close contacts with the financial sector in his role as President of the New York Federal Reserve Bank, especially at the largest banks, which meant that his views on bank regulation were known and industry executives could be confident that their voices would be heard.98

Prior to the announcement of Geithner’s selection as Treasury secretary, banks and institutional investors alike had good reason to be concerned about the direction of regulatory reforms. Obama had been highly critical of Wall Street and his advisors included several people from the progressive wing of the Democratic party. There were calls by progressive groups for his administration to take a hard line on the large banks, who were deeply unpopular with the public. That said, while Obama was clearly sympathetic to these views, his public comments on financial sector reforms lacked specifics. His first major statement on the topic was contained in a speech at Cooper Union in New York City in March 2008.99 His remarks followed closely after the collapse of Bear Sterns and proposals by Henry Paulson, then Treasury secretary, to reform the financial sector.100 Obama called for a “21st century regulatory framework” based on six key principles: (i) closer government oversight and supervision of financial institutions that are able to access Fed liquidity programs; (ii) stronger national and international capital adequacy and liquidity rules; (iii) consolidating regulatory agencies; (iv) regulating institutions

100 U.S. Treasury, Blueprint for a Modernized Regulatory Structure, March 2008.
by what they do rather than by how they are chartered; (v) cracking down on trading activity that
crosses the line into market manipulation; and (vi) establishing a financial market oversight
commission to identify systemic risks. He also stated that executive compensation schemes
needed to be realigned to better serve the interests of shareholders and to lessen risk-taking.

After the failure of Lehman Brothers, Obama made it clear that, in his view, inadequate
regulation and supervision, plus greed and reckless behavior, caused the financial crisis.101 In
campaign speeches and media interviews leading up to the November 2008 election, Obama
repeatedly criticized the economic philosophy underlying past efforts to revise outdated
regulations governing the financial sector and the influence Wall Street’s lobbyists had on the
policymaking process. He said that both practices would end with an Obama administration:
“It’s time to get serious about regulatory oversights, and that’s what I will do as President”.102
Given rhetoric like this, it is no surprise that banks and institutional investors responded
positively to the selection of an ideological centrist and policy pragmatist to Treasury secretary.
As a top lawyer for the banking industry put it, “I think Wall Street viewed Geithner, Bernanke,
Summers as a commitment by the incoming administration to balance a centralist view, not
leaning way to the left.”103

101 See, for instance, his campaign remarks in Golden, Colorado on September 16, 2008. Online by Gerhard Peters
and John T. Woolley, The American President Project.
American President Project.
103 Rodgin Cohen in an interview with FRONTLINE, April 24, 2012.
2.5.4 *Policymakers prioritize regulatory proposals that boost the confidence of institutional investors in banks*

The health of the U.S. financial sector began to show signs of improvement in Spring 2009. The price of bank stocks bottomed in March 2009 and then climbed steadily thereafter. Credit spreads on bank debt securities also began to narrow, another sign of growing confidence in the sector. The recovery reflected improved profitability and, after the release of the results of the government’s “stress tests”, reduced uncertainty regarding the health of bank balance sheets. Obama first acknowledged the improvement in July 2009 when he said, “one of the success stories of the past 6 months is that we really have seen a stabilization in the financial system. It’s not where it needs to be, but people are no longer talking about the financial system falling off a cliff. We’ve stepped away from the brink.” Obama’s confidence that the financial sector had stabilized grew over the next several months and, in the State of the Union speech in January 2010, he acknowledged that “markets have now stabilized,” by which he meant reduced volatility in stock and bond prices, particularly for bank securities. Thus, the key window to examine the link between proposals to reform financial sector regulatory and concerns about financial stability runs from November 2008 (Geithner’s selection as Treasury secretary) to Fall 2009 (when Obama began to offer unconditional statements on the stability of the financial sector).

---

104 A credit spread is the additional yield on a bank bond relative to a comparable government bond. It measures the market’s view on the likelihood of an issuer defaulting in the future and investors overall willingness to embrace risk. Spreads narrow when the market is more confident in the future viability of a bank.

The immediate priority for the administration after Geithner’s confirmation by the Senate was to restore investor confidence in the banks.\textsuperscript{106} While TARP funds dealt with the immediate crisis, institutional investors still had major concerns regarding the going-concern viability of the banks. There were calls from both the political left and right that nationalization of troubled banks was the best option. Progressive economists, such as Simon Johnson, Paul Krugman and Joseph Stiglitz were among those who favored nationalization, in part as a means to allow the government to restructure the industry by replacing management and reducing the size of the largest banks.\textsuperscript{107} On the right, Alan Greenspan said, “It may be necessary to temporarily nationalise some of the banks in order to facilitate a swift and orderly restructuring.”\textsuperscript{108} Nationalization was debated within the administration in March 2009.\textsuperscript{109} Geithner felt such drastic steps were unnecessary, favoring instead “stress tests,” which would provide investors with greater transparency of bank balance sheets. Geithner also rejected calls by some within the administration to fire the CEOs of banks requiring public funds because, in his view, this would alarm investors, making it more difficult for other banks to raise capital. Summers initially challenged the expected effectiveness of stress tests but ultimately supported Geithner. In a memo to Obama opposing the nationalization, Summers argued that the U.S. government had no authority to takeover large bank-holding companies, nationalization could disrupt rather than calm financial markets, taxpayers may not fully recover the funds they invest in troubled banks,

\textsuperscript{106} Geithner 2014.
\textsuperscript{109} Interview 32, former administration official, November 6, 2018 and Interview 47, former administration official, December 6, 2018.
and nationalization should always be the last option. In addition, the administration wanted to avoid having to request additional funds from Congress for the deeply unpopular banks. \(^{110}\)

Instead of nationalization, Geithner announced in February 2009 that the largest 19 banks would be subject to periodic “stress tests,” which would assess how they would fare if economic conditions worsened. This process would identify how much additional capital banks would need to raise to shore up their balance sheets. On the basis of the stress tests, banks would be required to raise the additional capital from private investors but, if unable to do so, capital would be provided by Treasury through a newly created Financial Stability Trust. Banks accessing these funds would be subject to additional government oversight and restrictions on their activities. The stress tests were designed to restore investor confidence by providing transparency on the health of bank balance sheets. The stress tests were part of a broader Financial Stability Plan, which also included a Public-Private Investment Trust to purchase toxic assets, a Consumer and Business Lending Initiative to free up credit markets, and a housing program to help families stay in their homes.\(^{111}\) While Geithner’s announcement of the stress tests was widely criticized at the time for being inadequate and vague,\(^{112}\) in hindsight it marked an important step to restore confidence to the financial sector.\(^{113}\) Requirements for annual stress

\(^{111}\) Remarks by Treasury Secretary Timothy Geithner Introducing the Financial Stability Plan, Tuesday, February 10, 2009.
\(^{113}\) Green 2010. Geithner agreed on their importance to ending the financial crisis, titling his 2014 autobiography Stress Test.
tests of “systematic important financial institutions” became a central element of the post-2009 financial sector reforms.

The administration’s next major regulatory reform announcement came in March 2009 with a call for a new resolution regime. This would give federal regulators the authority to take control of troubled bank-holding companies and non-bank financial institutions to restructure them on an administrative basis outside the bankruptcy process, a power the FDIC already had over insured banks. This administrative option is desirable because the high-leverage and short-term liability structure of banks effectively prevents an ailing bank from continuing to operate once in bankruptcy proceedings. The extension of orderly liquidation authority to bank-holding companies and non-bank financial institutions greatly expands federal powers over the financial sector but this measure was nevertheless supported by institutional investors because it provides the government an additional tool to deal with troubled financial institutions. This is another example of the early priority the Obama administration gave to regulatory measures designed to boost the confidence of institutional investors in the financial sector.

2.5.5 **Policymakers avoid transformational policy proposals that could weaken investor confidence while the health of the banks is in doubt**

The Obama administration laid out its full regulatory reform priorities in June 2009, with the release of *Financial Reform: A New Foundation*. The document mostly proposed to tighten

---


115 U.S. Treasury Department 2009.
existing regulations and to close regulatory gaps. The most significant changes sought by the administration were to: (i) establish a new systemic risk monitoring and regulatory agency;\(^ {116}\) (ii) impose more stringent supervision of large financial institutions;\(^ {117}\) (iii) raise capital and prudential standards on large financial institutions;\(^ {118}\) (iv) impose comprehensive regulations on derivatives markets;\(^ {119}\) (v) create a new consumer financial protection agency;\(^ {120}\) and put in place a new resolution regime for bank holding companies and non-bank financial institutions.\(^ {121}\)

The administration’s proposed reforms did not include measures to radically transform the financial sector. Treasury’s proposals did not call for the largest banks to be broken up, nor did they seek to reinstate the separation between commercial and investment banking that had previously existed under the Glass-Steagall Act of 1933, two measures that had considerable support among progressive Democrats. The proposals did call for higher capital adequacy requirements but stated that these would be developed in conjunction with the Basel Committee on Banking Supervision to ensure that banks were not able to take advantage of more permissive jurisdictions to skirt U.S. requirements.\(^ {122}\) This position all but guaranteed incremental change since France, Germany and Japan opposed substantial increases to capital adequacy requirements.\(^ {123}\) The most controversial proposal was for a new consumer financial protection agency and, while this was fiercely opposed by the banks, it did not constitute a structural change

\(^{116}\) This became the Financial Stability Oversight Council (FSOC) in the Dodd-Frank Act.

\(^{117}\) This became Section 165 of the Dodd-Frank Act.

\(^{118}\) This was included in Section 165 of the Dodd-Frank Act.

\(^{119}\) This became Title VII of the Dodd-Frank Act.

\(^{120}\) This became the Consumer Financial Protection Bureau (CFPB) in the Dodd-Frank Act.

\(^{121}\) This became the Orderly Liquidation Authority (OLA) in the Dodd-Frank Act.

\(^{122}\) U.S. Treasury June 2009, p. 80.

in the industry. As Ben Bernanke later described Treasury’s proposal, “It did not try to remake
the financial system or financial regulation from scratch but built instead on existing institutions
and arrangements.”

Working closely with the administration, the House Financial Services Committee (HFSC)
drafted a dozen bills closely aligned with the administration’s proposals. Chairman Barney
Frank, a long-serving Democrat from Massachusetts, drove the process. These bills were
eventually consolidated into the Wall Street Reform and Consumer Protection Act, which was
passed by the House in December 2009 largely on party lines. Progressive Democrats pushed
two amendments that would have limited the size and activities of the banks but only weak forms
of each survived. The Kanjorski amendment granted the Fed (with approval of the proposed
Financial Stability Oversight Council) the authority to break-up banks if they posed a “grave
threat” to the financial stability of the United States. Likewise, the Perlmutter-Miller
amendment granted the Fed authority to restrict the proprietary trading of banks if they
threatened the health of that institution or the stability of the U.S. financial system. Both are
weak measures because there is no requirement for large banks to be broken up or for their
investment banking operations to be curtailed, only that the Fed has the authority to seek these
changes under exceptional circumstances. Strong versions of both amendments were fiercely
opposed by Geithner, as well as conservative Democrats, and the final wording reflected their

125 This became Section 121 of the Dodd-Frank Act.
views. However, as we shall see, stronger limits on proprietary trading were later adopted in 2010, after the financial sector had stabilized.

In sum, proposed regulatory reforms by the administration did not seek to radically transform the financial sector while its stability was in doubt. Indeed, early reforms were aimed specifically at restoring confidence in the financial sector. This included the stress tests and expanded resolution authority. While progressive Democrats pushed two proposals that potentially could have led to significant changes to the structure of the financial sector, they were opposed by the administration and conservative Democrats, and survived only in a weak form.

2.5.6  **Policymakers may support policies strongly opposed by banks if they are not expected to have a material effect on the attractiveness of bank securities to investors**

The most contentious item in the administration’s June 2009 regulatory proposals and in the House’s December 2009 financial reform bill was to centralize consumer protection regulation and enforcement in a newly created agency, the Consumer Financial Protection Bureau (CFPB). The brainchild of Elizabeth Warren, then a professor at Harvard University, the CFPB would dramatically alter the way consumers would be protected by: (i) placing

---

126 Interview 10, former congressional member, September 27, 2018, Interview 11, former administration official, September 27, 2018, Interview 14, former congressional staff, October 1, 2018, Interview 48, former congressional member, December 10, 2018 and Interview, knowledgeable expert, 50, December 17, 2018.

127 The original name was the Consumer Financial Protection Agency but the name was later changed to the Bureau when it decided to locate the new entity within the Federal Reserve.

responsibility in a single agency with a sole focus on consumer financial protection; (ii) granting
the agency considerable autonomy from legislators and other regulatory agencies; and (iii)
expanding regulatory authority over the types of financial services and the range of providers.
The agency was proposed to address, inter alia, rampant abuses in mortgage underwriting, which
contributed to the 2007-09 financial crisis.

Fierce and unified opposition to the proposed new agency quickly emerged from the banking
sector, as well as from non-financial businesses, such as real estate agents and auto dealers, who
feared that they too would be subject to the new regulatory regime. Less than a month after the
agency was proposed, several financial sector trade associations began to plan and to set aside
funds to launch coordinated attacks on the proposed agency.129 In September 2009, the U.S.
Chamber of Commerce started an aggressive public campaign to kill the CFPB and behind the
scenes bank lobbyists put intense pressure on Democratic members of the House Financial
Services Committee to weaken the proposal.130 Significant grassroot efforts by opponents in the
period leading up to the House bill in December 2009 were successful in exempting non-
financial businesses from the CFPB’s reach, and community banks cut a deal with Barney Frank
to reduce the compliance burden on them in exchange for not opposing the agency.131 In
contrast, the large banks, despite their concerted efforts, secured few changes of benefit to them.
Kastner points to strong social mobilization led by a determined and capable political

130 Brody Mullins, “Chamber Ad Campaign Targets Consumer Agency, Wall Street Journal, September 8, 2009 and
Jared Allen, “Pelosi Backs Financial Protection Agency Over Objections from Some Blue Dogs,” The Hill, October
10, 2009.
entrepreneur as the key reason the CFPB overcame vigorous and sustained lobbying against it.\textsuperscript{132}

Others added that the deal struck between Barney Frank and the head of the Independent Community Bankers of America, in which the community bankers agreed to not oppose the CFPB in exchange for being exempted from the CFPB’s examination authority, was also a decisive factor.\textsuperscript{133}

My argument, however, suggests an additional factor contributed to creation of the CFPB; namely, that institutional investors had few concerns with the new consumer agency. Event studies, which assess the market’s reaction to key events, such as the Treasury’s June 2009 proposal and the House’s December 2009 bill, which both contained provisions for the CFPB, did not trigger meaningful abnormal negative returns for affected companies.\textsuperscript{134} Institutional investors viewed consumer protection regulation as less important in valuing bank securities than regulations dealing with capital adequacy rules and business powers. An independent political consultant advising asset managers on their investment strategies noted that the CFPB attracted little client interest in 2009 and 2010. It was only after the CFPB started issuing regulations in 2013 that investors began to take notice.\textsuperscript{135} A former regulator who worked at an asset


\textsuperscript{133} Interview 25, former industry official, October 23, 2018 and Interview 38, industry official, November 8, 2018. See also Kaiser 2013.

\textsuperscript{134} George Truk and Philip Swicegood, “Assessing the Market’s Reaction to the Dodd-Frank Act, \textit{Journal of Business and Economics Research}, 10(10) October 2012, pp. 569-577. Event studies provide only weak evidence of the market’s reaction to a single proposal, such as the CFPB, since other proposals were often announced at the same time and these studies cannot isolate the effects of each. In addition, when the CFPB was announced in June 2009, it was not a surprise. There had been much prior discussion of its possible inclusion and market participants had presumably taken this into account.

\textsuperscript{135} Interview 33, knowledgeable expert, November 6, 2018.
management firm in 2010 agreed that the CFPB did not factor into their investment decisions on the large banks.\textsuperscript{136}

The administration’s decision to propose the CFPB before financial markets had stabilized is consistent with my argument that concerns about how institutional investors would react to regulatory proposals helps to explain the pattern of post-2009 financial sector reforms. While the banks lobbied aggressively against the CFPB, arguing that the new agency was unnecessary and its regulations would limit consumer choice, institutional investors did not give the issue much consideration. The CFPB was not seen as an important driver of bank stock prices or bond yields. The importance of this finding is that it goes against a key prediction of the bank power theory: that only regulatory changes supported by the banks (or at least not vigorously opposed by them) would be part of the final policy reforms.

\textbf{2.5.7 Policymakers may propose policies unfriendly to investors only after investor confidence has been restored}

A central proposition of my argument is that policymakers will be attentive to the potential impact of regulatory proposals on the attractiveness of bank securities to institutional investors while the financial health of the banks is in doubt. However, once investor confidence has returned—as evidenced by more stable financial markets, tighter credit spreads on bank bonds, higher prices on bank stocks, and banks raising large amounts of capital from investors—this concern will no longer constrain the types of regulatory policies policymakers will consider.

\textsuperscript{136} Interview 43, former regulator, November 20, 2018.
This does not mean that policies unfriendly to institutional investors will necessarily be adopted, only that such proposals may receive serious consideration after investor confidence in banks has been restored. This section first shows that markets had stabilized by late 2009. It then identifies several proposals unfriendly to investors were put forward in 2010, notably the Financial Crisis Responsibility Fee (FCRF) and the Volcker Rule. These two populist measures were proposed by President Obama to appeal to voters who felt that the administration was not being sufficiently tough on the large banks.

Figure 2.1 and 2.2 show the extent to which the financial sector had recovered by January 2010. Figure 2.1 provides a broad measure of financial market stress based on 18 weekly data series of market conditions. The average market stress value between 1993 and 2018 is set to be zero. The maximum point of stress was in October 2008, which followed the failure of several financial institutions and the initial rejection of the TARP by the House of Representatives. Market stress declined steadily in 2009 and by January 2010 had returned to pre-crisis levels of stress. Improved confidence in the banks was also reflected in their stock prices, which more than doubled between February 23 (market low for banks) and December 31, 2009.\(^\text{137}\) Figure 2.2 shows U.S. banks raised large amounts of new capital from investors during this period; in fact, over 80 percent of the capital U.S. banks raised to replenish losses caused by the financial crisis and to meet new regulatory requirements was done in 2008 and 2009. Thus, it was only after the

\(^{137}\) Based on the performance of the KBW Bank Index, which is composed of the 24 largest publicly traded bank stocks.
banks had raised significant capital from institutional investors that proposals unfriendly to institutional investors were proposed.

Figure 2.1: St. Louis Fed Financial Stress Index

Source: Federal Reserve Bank of St. Louis.

Figure 2.2: Capital Raised Each Year by U.S. Banks ($billions)

Obama’s policy stance towards financial sector reforms hardened in January 2010 when he proposed a new tax on large banks (the FCRF) and prohibitions on banks engaging in proprietary trading and investing in hedge and private equity funds (the Volcker Rule). Progressive Democrats soon pushed additional measures that would also result in far-reaching changes to large banks, including breaking up the largest banks (the Brown-Kaufman amendment), an outright ban on the use of derivatives by deposit-taking institutions (the Lincoln amendment) and regulations governing incentive compensation schemes for senior bank executives and material risk-takers. These proposals coincided with tougher language directed at the banks. Obama not only continued to call them out on their reckless behavior and outsized executive compensation, but also for their concerted lobbying efforts to weaken regulatory reform, which he found particularly galling since they were only in a position to engage in such lobbying as a result of government aid to save the industry. In a widely reported remark in December 2009, Obama said, “I did not run for office to help out a bunch of fat cat bankers on Wall Street.”

This more populist stance reflected a greater voice for Obama’s political advisors in shaping the administration’s economic policy priorities. By this point it was apparent that the healthcare reforms were likely to harm the Democrats’ electoral chances in the 2010 mid-term elections, a view reinforced by Republican Scott Brown’s unexpected win of Democrat Edward Kennedy’s

______________________________

138 At this time, Obama also called for measures to prevent further consolidation in the financial sector. Since 1994, banks have not been permitted to hold more than 10 percent of nationwide deposits. Banks above the limit are permitted to grow organically but not through acquisitions. The administration proposed a similar 10 percent cap for bank liabilities, which was included in the Dodd-Frank Act. Both measures have had little impact to date, with the U.S. banking sector more concentrated in 2015 than in 2007. https://fred.stlouisfed.org/series/DDOI06USA156NWDB


140 This was broadcast by 60 Minutes. See Axelrod 2015, p. 366.
vacated Senate seat in January 2010. However, these populist proposals had been circulating among progressive Democrats for months but had been fiercely resisted by Treasury, in part because they would not help the banks to recover. It was only after financial markets had stabilized, and banks were in better shape after having raised large amounts of new capital from investors, that Obama pushed these investor-unfriendly initiatives.

Despite financial markets having stabilized, only the Volcker Rule garnered enough support among policymakers to be implemented. The Financial Crisis Responsibility Fee and the Brown-Kaufman amendment to break-up the largest banks were not included in the Dodd-Frank Act. A weak version of the Lincoln amendment to ban deposit-taking institutions from using derivatives was included in the Dodd-Frank Act but this provision was later eliminated by Congress in December 2014. Section 956 of the Dodd-Frank Act required regulators to draft rules governing incentive compensation schemes at large banks. These rules were not finalized before Obama left office and effectively died through inaction by the Trump administration. The only significant proposal adopted after financial markets stabilized was the Volcker Rule, which prohibits proprietary trading and severely limits investments in hedge and private equity funds. Space does not permit a detailed analysis of all these policy outcomes so in the remainder of this section I will briefly discuss one policy proposal that failed (the FCRF) and the one that succeeded (the Volcker Rule).

On January 14, 2010, President Obama called for a Financial Crisis Responsibility Fee to pay for the then $117 billion projected cost of TARP. He had voiced his support for such a fee during
the election campaign\textsuperscript{141} but the proposed fee was nevertheless a surprise since Obama had not pursued the matter for over a year. A fee of 0.15 percent of liabilities would be applied each year for 10 years on banks with assets exceeding $50 billion.\textsuperscript{142} Bank analysts estimated that JPMorgan Chase and Citigroup, the two largest U.S. banks at the time, would each pay about $2.5 billion per year.\textsuperscript{143} This would amount to about 14 percent of reported profits for JPMorgan Chase and about 23 percent for Citigroup on 2010-11.\textsuperscript{144} Treasury first began to consider a bank tax in August 2009 in response to provisions contained in the legislation authorizing TARP and as a means to stem public anger at the bank bailouts.\textsuperscript{145} Several options were considered, including a financial transactions tax, and in December 2009 Geithner recommended to Obama that the bank fee be included in the upcoming budget. Ultimately, the Financial Crisis Responsibility Fee, as well as a variety of other proposed taxes on the financial sector, were not included in the Dodd-Frank Act. This was because neither Dodd nor Frank wanted it in the regulatory reform legislation. They were opposed because it would muddy messaging around the financial reforms, which was about strengthening regulations to prevent future crisis and not about arbitrarily punishing the banks. In addition, they did not want to complicate the legislative process by having to secure the approval of additional congressional committees, which would have been necessary since the HFSC and the SBC do not have jurisdiction over tax matters. Finally, Republican Senator Scott Brown’s vote was necessary to pass the Act and he like all

\textsuperscript{144} Based on company annual reports, JP Morgan earned $17.4 billion in 2010 and $19.0 in 2011. The comparable figures for Citigroup were $10.6 billion in 2010 and $11.1 in 2011.
Republicans, and even some moderate Democrats, opposed any new taxes. The inability to put in place the FCRF shows that even after investor confidence in the banks has been restored, other factors also limit post-crisis reforms.

The Volker Rule was announced a week after the tax proposal and two days after Brown’s win in Massachusetts, which had left the Democrats one vote short of a filibuster-proof majority in the Senate. While the Volcker Rule did not attempt to fully reinstate the Glass-Steagall Act’s separation of commercial and investment banking and thus falls short of structural reform, it would nevertheless place an outright ban on a highly profitable activity and severely constrain others. Bank analysts estimated that the Volcker Rule could reduce revenues by up to 15 percent for banks with large trading books, such as Goldman Sachs. The loss of this income would dampen investor interest in bank securities unless accompanied by a commensurate decline in the riskiness of these institutions. As important to institutional investors was a fear that Volker Rule would reduce liquidity in key markets where the banks were major participants. This would cause asset prices to be more volatile and would make it more difficult for institutional investors to execute large trades. Calls for the Volcker Rule had been circulating among policymakers since early 2009 but were strongly opposed by both Geithner and Summers, and it was not included in the administration’s June 2009 reform proposals nor in the subsequent

146 Interview 2, former congressional staff, September 13, 2018, Interview 3, former administration official, September 17, 2018, Interview 9, former congressional staff, September 26, 2018, Interview 17, former congressional aide, October 4, 2018, Interview 21, former regulator, October 15, 2018, Interview 23, civil society representative, October 18, 2018, Interview 32, former administration official, November 6, 2018, Interview 38, industry official, November 8, 2018, Interview 42, former congressional member, November 19, 2018, Interview 48, former congressional member, December 10, 2018.
148 Their view was that neither proprietary trading nor holdings of hedge and private equity funds contributed to the financial crisis and thus these prohibitions were not justified.
House bill passed in December. At the urging of Vice President Joseph Biden, Obama met with Volcker, Geithner and Summers on October 28, 2009 and instructed Geithner to draft the rule. Volcker met again with Geithner and Summers on December 23 and 24, 2009, with Geithner agreeing to support the proposal.\textsuperscript{149} Obama publicly called for the Volcker Rule to be part of the financial reforms on January 21, 2010. Through the efforts of Senators Jeff Merkley (D-OR) and Carl Levin (D-MI), aided by Paul Volcker and timely charges against Goldman Sachs highlighting the importance of the prohibitions, the Volcker Rule became a central element of the Dodd-Frank Act. The regulatory agencies followed with a tough set of rules in December 2014. I argue in Chapter 4 that the success of the Volcker Rule, despite significant opposition from the large banks and the U.S. Treasury, was due to the ability of progressive policymakers to exploit veto points in the policymaking process.

As noted, the possibility of a bank tax and restrictions on proprietary trading had been circulating in Washington D.C. for at least a year before they were formally proposed by the president. Obama first raised the possibility of a “financial stability fee” in September 2008 in response to the AIG bailout.\textsuperscript{150} However, as the crisis deepened there were no further mentions of it by Obama and by mid-October his speeches had shifted to more general statements about the need to support the banks “in a way that protects taxpayers”.\textsuperscript{151} In the early 2009, public outrage over bonus payments to executives at firms receiving TARP funds led to calls by Obama and

\textsuperscript{151} Remarks in Toledo, Ohio, October 13, 2008. Online by Gerhard Peters and John T. Woolley, The American President Project.
Congressional leaders to impose special taxes on the recipients of bonuses, but no taxes on the banks themselves. The administration’s priority at this time was on measures, such as the stress tests, that would help banks raise new capital, and by reducing net income a special bank tax would make bank securities less attractive to investors and reduce the ability of banks to replenish their capital through retained earnings. It was not until August 2009, in the lead-up to the G20 Leaders’ Summit in Pittsburgh, that bank taxes were put on the agenda. There was strong support for bank taxes in Europe and the Leader’s Statement called for the IMF to prepare a report on how the financial sector could repay the support provided by governments.\(^{152}\) In November 2009, Gordon Brown, Prime Minister of Britain, called for a financial transaction tax, a proposal that Geithner said the administration would not support.\(^{153}\) Only after investor confidence in the banks had been restored and there was a political need for more progressive policy proposals did Obama call for the Financial Crisis Responsibility Fee.

The Volcker Rule followed a similar dynamic, though it was included in the final reforms. First proposed in January 2009, and discussed by the Senate Banking Committee a few weeks later,\(^{154}\) it was not formally proposed by Obama until a year later once financial markets had stabilized. Enactment of the Volcker Rule is another example of a policy that contradicts the bank power thesis, since it was vigorously opposed by the large banks. And while the Volcker Rule was expected to lessen bank profitability, and thus went against the interests of institutional investors,

the timing of the proposal supports my argument. The Volcker Rule was only given serious consideration after the confidence of institutional investors had been restored.

2.6 Conclusion

The 2007-09 financial crisis ushered in a period of financial sector re-regulation at the national and international level. The regulatory reforms did not, however, transform the financial sector. Instead, incremental changes were adopted that strengthened existing regulations and imposed new regulations on previously unregulated areas. Regulatory oversight was also improved. I argue that a factor limiting the extent of regulatory change was the need of policymakers to ensure that bank securities would be attractive to institutional investors, whose support was necessary to stabilize the financial sector. Banks rely on institutional investors for a large portion of their funding. Institutional investors withdrew their funding when they became uncertain as to the value of assets linked to sub-prime mortgages and the amount of exposure banks had to them. To stabilize the financial sector, President Obama appointed policy centrists to lead the regulatory reform process and policymakers initially focused on measures to restore the confidence of institutional investors in the banking sector so that they would again purchase their debt and equity securities. As long as the financial sector remained in crisis, policymakers exercised restraint in the types of regulatory reforms they proposed. Transformational regulatory reforms create uncertainty as to the future value of bank securities, which discourages institutional investors from investing in the sector. This feedback mechanism between proposed regulatory reforms and investor confidence limited the types of regulatory proposals that policymakers pursued.
The feedback mechanism between proposed regulatory reforms and institutional investors presents a “Catch-22” situation for policy entrepreneurs seeking to transform financial sector regulation. The opportunity for change is greatest at the peak of a crisis, when issue salience is highest, public anger is strongest, policy monopolies have cracked, and policymakers are openly questioning the regulatory status quo. At the same time, the types of proposals that policymakers are willing to consider is limited by the need to restore the confidence of institutional investors in bank securities, and investors see transformative proposals as creating high levels of uncertainty about the future value of bank securities. It is only after the financial sector has stabilized that policymakers are willing to consider more radical proposals but by this time the “winning conditions” for far-reaching regulatory change have subsided: issue salience has declined, public anger has receded, policy monopolies have begun to re-assert themselves, and a return to normalcy in financial markets suggests to policymakers that their prior policy preferences do not need to be revised.

My focus on the behavior of institutional investors complements the literature on how structural power by businesses shape economic policies. Structural power arises from the position private firms or industries occupy in democratic capitalist economies. Structural power does not involve explicit threats to thwart policies business does not like; rather it works by making policymakers reluctant to consider policies opposed by business in the belief that they will respond in ways that harm the interests of policymakers. In effect, structural power leads to self-restraint on the types of policies policymakers consider. Structural power operates through three mechanisms:
(i) worries about the amount and location of private investment in the real economy;\textsuperscript{155} (ii) reliance on business for data, expertise and training to support policymaking in complex policy domains;\textsuperscript{156} and (iii) ideational and cultural capture of policymakers.\textsuperscript{157} My findings show that structural power emanates not only from banks and non-financial companies but also from the institutional investors that fund the activities of these companies. Thus structural analysis needs to unpack the business sector into three entities: real economy firms (e.g., auto manufacturers, resource extraction companies), financial intermediaries (e.g., banks) and institutional investors (e.g., pension funds).

My argument provides only a partial explanation for the reforms that were ultimately included in the Dodd-Frank Act, which passed six months after markets had stabilized. I explain why transformative policy proposals were left out of the Act, but I do not explore why the Act contains strong regulations in some areas (e.g., CFPB, the Volcker Rule, G-SIB capital rules) and weak regulations in others (e.g., incentive compensation, hedge funds, credit rating agencies). What accounts for variation in the strength of different regulations? The theory presented here suggests that institutional investors differentiate among regulatory proposals, with

\begin{flushleft}
\end{flushleft}
areas of significant regulatory change more likely to be associated with activities that do not affect the willingness of institutional investors to invest in the financial sector. However, this hypothesis at best can only be a partial explanation since other factors, such as regulatory capture, business lobbying, issue salience, veto points and players, and political entrepreneurship, have been shown to explain regulatory outcomes. Exploring the interplay of these factors with the actions of institutional investors could yield additional insights into the character of post-crisis financial sector reforms.

The findings of this study point to other areas of useful research. First, why did financial sector regulations undergo transformational change during the Great Depression but not during the Great Recession? One possible explanation is that the structure of the banking sector differed. In particular, wholesale funding by institutional investors was not a significant part of bank funding, and deposit insurance was not in place in the 1930s. Thus, the feedback mechanism between financial stability, policy reforms and institutional investors was absent. Another possibility is that the 2007-09 crisis lacked the depth or duration to bring about transformative change. If true, this would suggest that not all economic crises are equal and that the possibility of policy change following a crisis is conditional on additional factors. A third possibility is that financial sector policy reforms in the 1930s were not the result of a change in the policy preferences of policymakers. Public choice scholars have argued that a key driving force behind the 1930s regulatory reforms lies in interest-group politics within the financial sector, where one

group was able to use regulatory changes to improve its competitive position relative to other groups. In effect, these groups were able to exploit poor economic conditions to push for regulations favorable to their interests.

Second, to what degree does the feedback mechanism between future regulatory reforms and mitigation of the current crisis exist in other policy areas? It is possible that the feedback mechanism I identified may only constrain policy reform in the financial sector. When a crude oil tanker spills large amounts of oil into the ocean, policymakers typically respond by proposing tough new measures to make such events less likely in the future. However, expected regulatory changes to lessen the possibility or severity of future oil spills have no impact on the resolution of the current crisis. Likewise, when an airplane crashes, an over-the-counter drug is tampered with, safety concerns with automobiles are revealed, or a chemical plant explodes, expected future regulatory changes are independent of efforts to deal with the current crisis. Financial crises are different. As I have argued here, uncertainty about the future cost of regulatory reforms reduce the willingness institutional investors to fund banks. And without their support, the current crisis cannot be resolved.


Policymakers overseeing the financial sector have two primary objectives. One is to ensure a stable financial sector, which is the absence of the simultaneous failure of large numbers of banks and other financial institutions.\textsuperscript{160} This requires prudential regulation to reduce the likelihood of firms failing, supervision to monitor and enforce compliance, and resolution mechanisms and protection schemes to lessen the impact of bank failures on the economy should they occur. A second policy objective is to promote the competitiveness of the financial sector, which supports the “real” economy by providing efficient and comprehensive financial services to individuals, businesses and governments. Competitiveness is also important because the financial sector is a large employer whose activities account for about five to seven percent of economic activity in most advanced industrialized economies\textsuperscript{161} and is a significant source of net service export earnings for countries such as the United States (U.S.), the United Kingdom, Singapore and Switzerland. Measures to promote stability and competitiveness are often in conflict. Prudential regulation adds to the cost of providing financial services, which makes firms subject to those regulations less competitive. For policymakers, this means they must strike a balance between stability and competitiveness.\textsuperscript{162}

\textsuperscript{160} To political scientists, “stability” can also mean a lack of structural change in the industry, i.e., maintaining the industry’s existing governance structure and industrial order. This is not how financial policymakers use the term.


\textsuperscript{162} The relationship between regulation and competitiveness is not linear. Some regulation is essential but too much is burdensome. Regulation and government oversight boost confidence in financial institutions, which supports the business of banking. However, at some point, on which there are considerable empirical and ideological differences about its location, the marginal cost of a regulation exceeds its marginal benefit. A particular challenge in making this calculation is assigning values to the degree to which a regulation lessens the likelihood of a financial crisis and to the expected cost of a financial crisis.
The globalization of financial markets has made it more difficult for national regulators to put in place tough prudential regulations without disadvantaging their local financial firms in domestic and foreign markets.\textsuperscript{163} To address this challenge, states have supported the development of international standards governing the financial sector, which are voluntary agreements among national regulatory agencies to put in place minimum regulatory requirements. The most well-known of these are the Basel agreements on bank capital adequacy but over the past decade the Financial Stability Board (FSB) and standard setting bodies such as the Basel Committee on Bank Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) have agreed to numerous others. While officially these are minimum standards, in practice they are often maximums because states worry that exceeding them would disadvantage their local financial institutions and markets. The financial sector is highly mobile and consumers (particularly large corporations) are price-sensitive so higher costs arising from more stringent regulations may cause financial institutions and markets to migrate to lower-cost jurisdictions. In addition, the financial sector has considerable resources at its disposal to fight regulation it opposes and has enjoyed remarkable success at getting what it wants.\textsuperscript{164} This suggests that states will be reluctant to adopt regulations that exceed international standards.


\textsuperscript{164} Johnson and Kwak 2010, Bell and Hindmoor 2015.
For the most part, this has been the case. However, there are examples of states adopting bank regulations exceeding international standards and putting in place costly regulations where international standards do not exist or that go beyond practices common in other countries. For example, the United States has subjected its largest banks to capital adequacy requirements that exceed those set out by Basel III. Further, the U.S. has placed restrictions on proprietary trading and investments in hedge and private equity funds (the Volcker Rule) that banks in other countries do not face and for which there is no international standard. Likewise, the United Kingdom requires banks to conduct their local activities through separately capitalized subsidiaries with more limited business powers (“ring-fencing”) and Switzerland and Sweden have imposed capital rules that also exceed Basel III requirements. The “gold-plating” of regulation, as this practice is known, is surprising because of the widespread belief that it makes local financial institutions and markets less competitive and because it is fiercely resisted by the financial sector. As noted, efforts to level the playing field through the Basel agreements were motivated by these concerns. Gold-plating also challenges the notion that states must engage in competitive deregulation (also known as the “race to the bottom”) to retain domestic capital and to attract foreign capital.

Why would states adopt regulations exceeding international standards? How are policymakers able to resist pressure from the powerful financial sector to avoid putting in place regulations threatening their competitiveness? At a time when the public is demanding greater economic and environmental protections, these are important questions as they offer insights into how regulators can escape the constraints that globalization places on them.
This paper examines the case of capital adequacy rules applied to U.S. global systemically important banks (G-SIBs). A G-SIB is a very large bank whose failure would threaten the stability of the financial system. They are designated by the FSB based on 12 indicators of size, interconnectedness, substitutability, complexity and cross-border activity, and by definition are the largest and most internationally active banks. U.S. G-SIBs are subject to higher capital surcharges, a higher supplementary leverage ratio (SLR) and tougher rules on total loss absorbing capital (TLAC) than the international standards contained in Basel III. The U.S. also applies “stress tests” to large U.S. banks, which can further add to the amount of additional equity capital U.S. banks must hold above Basel III. This raises bank funding costs because equity is a more expensive source of capital than bonds or deposits. The higher cost is because equity investors expect a higher rate of return to compensate for the greater risk they bear.\textsuperscript{165}

The higher funding cost, in turn, is passed on to customers in the form of higher lending rates and fees. Higher bank funding costs may also drive banks to exit certain business lines. Either way, banks facing higher funding costs than their competitors are disadvantaged in the marketplace, all other things being equal. This is why U.S. banks have and continue to vigorously oppose tougher capital rules.

I find that the U.S. adopted gold-plated regulations for U.S. G-SIBs because regulators believed that: (i) tougher rules were needed to achieve a stable financial sector and (ii) the competitive

\textsuperscript{165} Under ideal conditions, the Modigliani-Miller Theorem says that the capital structure of a bank should not affect its funding costs. Higher equity costs should be offset by lower debt costs. However, in the real world, equity is more expensive because: (i) debt receives favorable tax treatment; (ii) equity has higher issuance costs; (iii) deposit insurance premiums are only partially related to risk; and (iv) investors do not fully adjust their return requirements. See Douglas Elliott, “Costly Bank Capital and Its Implications,” Oliver Wyman, June 20, 2016.
position of U.S. banks would not be adversely impacted by the adoption of gold-plated rules, despite the added cost. This finding is supported by the use of process tracing, which examines the observable implications of three possible explanations and found the available evidence is most consistent with what I term the “no impact” thesis. The particular political and financial conditions at the time when the gold-plated rules were adopted likely contributed to this outcome. In the mid-2010s, U.S. policymakers were less constrained by competitiveness concerns because U.S. banks were in better financial shape than many of their chief foreign rivals and because the largest U.S. banks remained deeply unpopular with the public. I also argue that U.S. rules cannot be explained by their chief competitors facing similar requirements, that higher capital rules actually improved the competitive position of U.S. banks, or the presence of a “grand bargain” where U.S. banks accepted tougher capital rules in exchange for less onerous regulatory requirements elsewhere.

While this study focuses on a single case—U.S. capital adequacy rules for very large banks—it offers lessons to governments seeking to establish national rules exceeding international standards or norms in other highly globalized industries, such as pharmaceuticals, automobiles and telecommunications equipment manufacturing. These industries are all highly mobile and enjoy considerable influence with policymakers. Further, capital adequacy requirements raise production costs across a broad range of individual banking productions, much like environmental regulations, labor standards and taxation. However, a unique feature of this case is the extreme unpopularity of very large banks following the 2007-09 financial crisis. As I will argue, this gave regulators greater latitude to push for tougher requirements than may have been otherwise possible.
This chapter is divided into eight sections. The first defines competitiveness and explains why policymakers worry about it. The second section discusses the emergence of competitiveness as a policy concern of financial sector policymakers in the United States. The third section lays out a framework to analyze financial sector policymaking and then offers three possible explanations of why states adopt regulations that go beyond international standards: the “sham regulation” thesis, the “no impact” thesis, and the “justified impact” thesis. This section also identifies key observable implications of each explanation. The fourth section discusses my methodology. The fifth section describes the U.S. G-SIB capital rule regime, with a particular focus on the G-SIB capital surcharge. The sixth section assesses the degree to which each of the three explanations is consistent with the process that led to the tougher U.S. regulations. The seventh section discusses my findings and considers other factors that may have influenced the adoption of gold-plated G-SIB capital rules. The final section offers concluding observations and identifies future avenues of research.

3.1 International Competitiveness as a Regulatory Concern

Competitiveness is the ability of a company to produce goods or services of comparable quality at lower cost or of higher quality at comparable cost than other firms. Other firms include local firms in the same sector, foreign firms in the same sector, or domestic and foreign firms in competing sectors providing substitutes. For individual companies, competitiveness is determined by firm-specific and external factors. Firm-specific factors include management effectiveness, control of intellectual property, exploitable barriers to entry, and access to low-
cost inputs, such as capital, labor and materials. External factors cover such areas as regulation and taxation. The competitiveness of a firm is assessed by internal measures (e.g., relative unit costs of production) or external measures (e.g., market share growth). Uncompetitive firms tend to decline in size, perhaps even going out of business, or may shift their operations to jurisdictions where costs are lower. Policymakers want to promote the competitiveness of local firms because of their contribution to employment and economic activity.

International competitiveness is concerned with the ability of local firms to compete with foreign firms in domestic and foreign markets. Local firms may be unable to compete in foreign markets if they operate with higher costs or if they face restrictions on their ability to operate in those markets. Local firms may also face competitiveness challenges in their own market if foreign firms have lower costs and full market access. As globalization accelerated in the 1980s and 1990s, the impact of national policies and regulations on the international competitiveness of local firms gained importance with policymakers. The rise of Japanese multinationals and the 1990 publication of Michael Porter’s “The Competitive Advantage of Nations” tapped into a growing fear among Americans that the U.S. was losing its global competitiveness.166 Policymakers now judge policies in part by their impact on the international competitiveness of the country or particular sectors, and firms (and their trade associations) point to competitiveness issues in their lobbying efforts to support or oppose particular regulations and policies.

Banking is a highly regulated activity. Regulation sets out who can establish, work for or own banks, what types of products and services banks can offer, where products and services can be sold, how they are to be produced, what features they must include and disclosure they must provide, and even in some instances what prices can be charged. Regulation adds to bank operating costs by giving rise to the need to employ large compliance teams, collect and file enormous quantities of data, and use inefficient institutional structures to produce and deliver banking products and services. Regulation also reduces economies of scale and scope by limiting business powers and may raise overall funding costs by requiring more capital, and more expensive forms of capital, to be used. Finally, banks pay fees to fund the regulatory agencies that oversee them and for deposit insurance schemes.\textsuperscript{167} The cost to industry is justified by the social benefits regulation provides, such as financial sector stability and consumer protection. Regulation can also boost confidence in the financial sector (e.g., deposit insurance) and promote market efficiency (e.g., disclosure rules). However, the size of the costs and benefits, and who bears them, lie at the heart of policy debates on bank regulation.

International competitiveness issues arise when banks from different jurisdictions competing in the same markets face uneven regulatory burdens. If banks from two countries compete in the same market, and one bank is subject to more costly regulation than the other, then the former will be disadvantaged because its more onerous regulatory burden will result in higher prices for its products and services. This concern prompted negotiation of Basel I in 1988, the first

international standard on minimum capital adequacy ratios for banks. For domestic political reasons, the United States was committed at the time to raising capital adequacy requirements at home, which would raise operating costs for U.S. banks in both domestic and foreign markets thereby making them less competitive. During this period, U.S. banks were losing market share to foreign (notably Japanese) banks and U.S. policymakers saw the establishment of an international standard as a way to level the playing field at a higher level. States seek to develop international standards when domestic regulations harm the international competitiveness of local banks and other financial institutions by raising their costs, and are especially likely to pursue them if these changes coincide with a sudden loss in the market share by local financial firms in domestic or foreign markets.

Not all domestic regulations give rise to international competitiveness concerns. Regulations affecting only the domestic activities of internationally active banks, and applying equally to foreign banks operating in the local market, do not tend to raise international competitiveness concerns. This is because the cost of compliance is limited to products and services offered in the local market and apply equally to all providers, domestic and foreign. Consumer protection laws, professional licensing rules, and disclosure requirements (excluding accounting standards)

---

169 Simmons 2001. Concern about competitiveness alone is not the sole reason states seek international standards. A closely related one is to prevent regulatory arbitrage. Regulators fear that local firms will relocate banking activities to other jurisdictions in order to circumvent the cost of complying with domestic regulations, which would negate their effect. A third objective is to lessen the likelihood of financial crises in other countries. Global banks and financial markets are highly interconnected, which can lead to financial turbulence in one country quickly spreading to others. International standards are intended to promote global financial stability by raising the minimum regulatory requirements in countries home to the largest financial institutions and markets.
tend to fall into this area. In contrast, domestic regulations that impose additional costs on the production of goods and services offered world-wide by local firms raise international competitiveness issues. Examples include minimum capital adequacy requirements, limits on incentive compensation schemes, accounting standards, and derivatives rules. The divide between regulations that affect only domestic activities and those that affect global activities is not always clear cut and financial institutions tend to raise competitiveness concerns even when the link is tenuous.

3.2 U.S. Concerns with International Competitiveness

Policymakers began to consider the impact of regulation on the competitiveness of U.S. banks in the 1980s. Before then, federal and state regulation erected significant barriers between different types of financial institutions, limiting banks to offering a narrow set of products and services. The most well-known constraint was the prohibition on commercial banks offering investment banking services, the result of the Glass-Steagall Act of 1933. Banks also faced ceilings on deposit rates and restrictions on their ability to operate across state lines. Further, cross-border capital flows were constrained by the widespread use of capital controls. Policymakers claimed that these tough prudential measures were put in place solely to promote a stable financial sector—a premise later challenged by public choice scholars\textsuperscript{171}—and none of the major laws

\textsuperscript{171} Several scholars working in the public choice field have argued that some regulations are better explained by rent-seeking behavior because the rules advantage some segments of the financial sector at the expense of others. See, for instance, Abrams and Settle 1991, Calomiris and Haber 2013, Nicolas R. Economides, R. Glenn Hubbard and Darius Pailia, “The Political Economy of Branching Restrictions and Deposit Insurance,” Journal of Law and Economics XXXIX (October 1996), pp. 667-704; Macey 1984 and Shughart, 1988.
setting out this regime were driven by competitiveness or market efficiency concerns. The legacy of this regulatory structure was a highly fragmented financial system with a large number of financial institutions and few of any significant size.

Financial markets underwent far-reaching changes in the 1970s and 1980s, which led to a greater focus by policymakers on the competitiveness of U.S. banks, at first on growing competition from local non-bank financial institutions and later from foreign banks. Financial innovation, made possible by advances in technology, telecommunications and finance theory, permitted non-banks to circumvent existing regulations to grab a growing share of banks’ traditional markets. For instance, finance companies, often owned by industrial conglomerates like General Electric and General Motors, became significant providers of commercial loans, and newly created money market funds allowed securities dealers to compete with commercial banks for deposits and loans. Later, there was also growing competition from foreign banks in both domestic and overseas markets as barriers to capital flows and restrictions on the right of establishment were eased. By the early 1990s, much was made in U.S. policy circles of the absence of any U.S. banks on the list of the largest 25 banks by assets in the world, whereas 20 years earlier there were eight. Faced with competitive threats from domestic and foreign sources, U.S. commercial banks applied considerable pressure on policymakers to address their competitiveness concerns.

Ideational shifts, and in particular the embrace of neoliberalism, also elevated competitiveness issues with policymakers, making them more receptive to the demands of the major commercial banks to ease their regulatory burden. This shift was supported by studies showing that economic regulation often benefited incumbents at the expense of consumers and potential competitors,\textsuperscript{173} and the belief that regulation stifled financial innovation, which made the sector and the country less competitive.\textsuperscript{174} After the election of Ronald Reagan in 1980, policymakers added market efficiency, competition and international competitiveness as important considerations when evaluating the effects of existing regulations and when designing new regulations. In a major review of the regulation of the U.S. financial sector in 1984, the final report stated that the “[…] health and vitality [of the U.S. financial sector] have a direct impact on the international competitiveness of American products […]” and that policymakers need to strike the best possible balance between “[…] safety and soundness, consumer protection, and competition and efficiency”.\textsuperscript{175} Likewise, a 1991 U.S. Treasury Report asserted that a “[…] sound internationally competitive banking system is critical to the Nation’s economic vitality and the financial well-being of our citizens”.\textsuperscript{176} Perhaps the most ardent call for a re-assessment of U.S. financial sector regulation came in a 1997 U.S. Treasury Report:

[…] the time has arrived for federal policy to embrace competition in financial services wholeheartedly and open-mindedly. It is no longer necessary or desirable to view competition as the enemy of marketplace stability. […] [P]olicies that try to make the financial system safer by tying the hands of institutions will inevitably put a damper on innovation, at considerable cost to the economy as a whole and potentially to America’s world leadership in financial services.\textsuperscript{177}

\textsuperscript{177} U.S. Treasury 1997, p. 4-5.
These reports supported deregulation of the U.S. financial sector, which led to the elimination of restrictions on branch banking in 1994,\textsuperscript{178} repeal of Section 20 and 32 of the Glass-Steagall Act (which removed barriers between commercial and investment banking) in 1999,\textsuperscript{179} and permanently exempting over-the-counter derivatives from regulatory oversight in 2000.\textsuperscript{180} Notably, a stated goal of the Commodity Futures Modernization Act of 2000, which dealt with derivatives, was to “[…] enhance the competitive position of United States financial institutions and financial markets”.\textsuperscript{181} Likewise, in testimony to the Senate Banking Committee\textsuperscript{182} in support of repealing the Glass-Steagall Act, Alan Greenspan, then Chairman of the Federal Reserve, said:

> […] our financial institutions have been required to take elaborate steps to develop and deliver new financial products and services in a manner that is consistent with our outdated laws. The costs of these efforts are becoming increasingly burdensome and serve no useful public purpose. Unless soon repealed, the archaic statutory barriers to efficiency could undermine the competitiveness of our financial institutions, their ability to innovate and to provide the best and broadest possible services to U.S. consumers, and ultimately, the global dominance of American finance.\textsuperscript{183}

The 2007-09 financial crisis did not end policymakers’ concern for international competitiveness. While the Dodd-Frank Act of 2010 ushered in a period of re-regulation, the Act acknowledges in several places the importance of maintaining the international competitiveness of U.S. financial institutions and markets. For instance, one of the duties of the newly created Financial Stability Oversight Council is to make recommendations to “enhance the

\textsuperscript{178} Riegle-Neal Interstate Banking and Branch Efficiency Act of 1994.
\textsuperscript{179} Gramm-Leach-Bliley Act of 1999. Also known as the Financial Services Modernization Act of 1999.
\textsuperscript{180} Commodity Futures Modernization Act of 2000.
\textsuperscript{181} Section 2(8).
\textsuperscript{182} Formally known as the Committee on Banking, Housing and Urban Affairs.
integrity, efficiency, competitiveness and stability of the U.S. financial markets.”

The Dodd-Frank Act also mandated that several studies be prepared to aid regulatory agencies in the development of new rules, and that the efficiency and competitiveness of U.S. financial institutions and markets be explicitly considered in many of them.

### 3.3 Why Would States Adopt Gold-plated Regulations?

For the past 30 years, U.S. policymakers have paid close attention to the effect of national regulations on the competitiveness of U.S. financial institutions. The financial sector frequently raises competitiveness issues in their efforts to limit regulation and policymakers are sensitive to their concerns. Why, then, did the U.S. adopt gold-plated regulations? This section first sets out a framework to analyze policymaking in the financial sector, with particular emphasis on policymakers’ reluctance to put local financial institutions at a competitive disadvantage. This framework draws heavily on Singer. I then offer three possible explanations for this occurrence: (i) the gold-plated regulations are not in fact stronger than the international standard (“sham regulation” thesis); (ii) the gold-plated regulations do not adversely affect the competitiveness of local banks despite the added costs (“no impact” thesis); and (iii) the gold-plated regulations may affect the international competitiveness of local banks but are justified by the need to promote financial stability (“justified impact” thesis).

---

184 Section 112(D) and (M).

185 For example, Section 622, requires the Financial Stability Oversight Council to prepare a report on the impact of concentration limits for large financial institutions on, among other factors, “[…] the efficiency and competitiveness of U.S. financial firms and financial markets.”

186 2007.
3.3.1 Policymaking in the financial sector

Financial sector regulatory policies are the product of interaction among three primary actors: legislators, regulators and the financial sector. Other actors, such as civil society organizations and non-financial business groups, may play important roles at times and in some policy domains but their involvement is sporadic. Singer offers a useful analytical framework to understand how the three primary actors interact to generate regulatory outcomes in advanced industrialized democracies and this section builds on his efforts. He starts with a principal-agent framework, where legislators delegate authority to regulators for day-to-day rulemaking because politicians do not have the expertise, time or responsiveness to market conditions to oversee financial firms and markets. Legislators, even those within the same party, may be unable to reach agreement on appropriate policies, leaving difficult decisions to regulators. Delegation also enables legislators to deflect blame should problems arise in the financial sector. Financial sector regulatory policy is an issue the public seldom follows or cares about, except during and immediately following financial crises. When issue salience is low, legislators gain little by taking positions. Consequently, regulators enjoy considerable “policy space” and thus their beliefs, interests and actions are important to understanding regulatory outcomes.

The financial sector wants the regulatory burden to be as low as possible. Their goal is to maximize profits and regulation reduces their profit-earning potential, beyond that supporting the

\(^{187}\) Singer 2007.
functioning of markets and confidence in firms. Financial firms are also concerned about their relative compliance burden, as this affects their competitiveness vis-à-vis domestic and foreign firms. Because of their size and importance to the economy, financial institutions possess considerable structural power, which influences the policy choices of legislators and regulators. Large financial institutions and their trade associations also actively lobby policymakers to support policies they like and to oppose policies they don’t. However, regulations do not always affect all segments of the financial sector equally, which can divide the industry position on particular regulatory proposals.

Regulators seek operational autonomy. Their actions reflect a desire to keep the financial sector out of the public eye, which minimizes the likelihood that legislators will intervene in regulators’ affairs. Regulations promoting financial stability are one means to achieve this objective, which generally (but not always\textsuperscript{188}) result in a higher compliance burden. Regulators also have discretion over the extent of their enforcement of existing rules, the issuance of administrative guidance dealing with the application of agency rules, and the ability to publicly “name and shame” institutions violating regulations or agency guidance.

A key insight of Singer is that legislators are likely to become directly involved in regulatory policymaking in two situations.\textsuperscript{189} First, financial crises raise the salience of the financial sector with the public, particularly if associated with adverse economic conditions or taxpayer-funded

\textsuperscript{188} Starting in the late 1980s and up to 2007, regulators embraced the efficient market hypothesis that market excesses were self-correcting, prudential regulation should be limited and market mechanisms should be promoted. This view supported efforts to deregulate the financial sector.

\textsuperscript{189} 2007.
bailouts. Legislators respond to public anger by holding hearings into the causes of and the regulatory response to financial crises, and by proposing new legislation to strengthen the regulatory regime. Legislators do so because they believe financial sector regulation will be an election issue and that doing nothing would harm their re-election prospects. Second, when the financial sector is stable and issue salience is low, legislators may also become involved in the regulatory process if financial institutions are unhappy with rules proposed by regulators. Financial institutions make their concerns known to legislators, who in turn pressure regulators to reduce the regulatory burden by convening congressional hearings on regulatory matters, writing letters to regulatory agencies asking them to explain their actions or inaction on particular issues, expressing support or opposition in the media to regulatory proposals, reducing (or limiting increases) to agency budgets, and passing new legislation to overturn the decisions of regulatory agencies. The president can also replace agency heads with persons who are supportive of the administration’s priorities. Pressure is applied to legislators by the financial sector when regulations raise compliance costs, particularly if a rule places local firms at a competitive disadvantage relative to foreign and domestic competitors.

Regulators must therefore balance two competing considerations to maintain their operational autonomy from legislators. On the one hand, tough prudential regulation reduces the risk of financial crises, which keeps issue salience low and thus lowers the likelihood that legislators will intervene in the activities of regulators. On the other hand, adopting costly prudential

\[\text{This allows congressional members to ask pointed questions of regulators, to make statements in opposition to costly regulations, and to enable opponents to air their concerns about particular regulations.}\]
regulation will prompt financial institutions to appeal to legislators to overturn regulatory decisions. Thus, regulators face a trade-off between promoting financial stability and maintaining a competitive financial sector.

Regulators are unlikely to adopt rules that exceed international standards. Financial globalization has made local firms more vulnerable to competitors from other countries, and financial institutions inform legislators when rules exceeding global standards disadvantage them. Legislators are especially receptive to industry criticisms of gold-plated regulations because the added cost to financial firms is easily explained and because the more stringent rules demand a clear rationale that is not always readily available from regulators. The incremental benefit of tougher rules can almost never be precisely quantified, which leaves regulators open to criticisms that more onerous rules are not necessary, especially if regulators in other advanced industrialized countries see them as unwarranted.

3.3.2 *Three explanations for gold-plated bank regulations*

The central question addressed by my paper is: Why do states adopt regulations exceeding international standards? This section considers three possible explanations.\(^{191}\) First, the regulation is a sham: the headline regulation may appear to exceed international standards but in

---

\(^{191}\) Andrew Walter posits a broader range of possibilities: (i) countries want to enhance their reputation as a safe jurisdiction; (ii) local banks benefit from the signaling effect; (iii) other factors may compensate for the loss of competitiveness; (iv) opposition is fragmented; (v) strong anti-bank sentiment; (vi) low state fiscal capacity undermines the credibility of government guarantees; and (vii) policymakers have sufficient autonomy to resist financial sector lobbying. Andrew Walter, “The Political Economy of Post-Crisis Regulatory Response: Why Does ‘Over-Compliance’ Vary?” March 2, 2014 (unpublished paper), pp. 12-18.
practice it does not, either because the regulation contains definitions and exemptions that limit its effectiveness or because regulators do not fully enforce them. Regulatory forbearance may be a deliberate policy to aid local banks or the result of insufficient expertise and resources. Policymakers adopt sham regulation to address calls by the public for tougher regulation of the banks without increasing their actual regulatory compliance burden. Sham regulations are most likely to occur when: (i) private actor compliance costs are relatively high; (ii) the cost to policymakers of not addressing public concerns about the financial sector are perceived to be high; and (iii) it is difficult or costly for the public to judge the quality of the regulatory requirements and compliance. Condition (ii) tends to follow financial crises, when public demands for tougher regulation of the financial sector are highest.

If the “sham regulation” thesis is correct, then we should observe expert third parties, such as international organizations, academics, financial analysts and civil society organizations expressing doubt about the stringency of the regulation. We should also expect that legislators will not hold hearings into the competitive implications of the sham regulation nor will they push for legislation to weaken it because the banks are willing to go along with the illusion of


193 These conditions draw on insights from Andrew Walter, who examined the practice of East Asian countries implementing less stringent regulation of their financial sectors than required by international standards. Andrew Walter, *Governing Finance: East Asia’s Adoption of International Standards* (Ithaca: Cornell University Press, 2008).
regulatory stringency. Finally, we should expect regulators in their public statements and private comments to counter any criticism that the regulations are not as strong as they appear, and for banks to claim that current regulations are appropriate given their risk profiles and market conditions. Banks benefit from the “sham regulations” and thus want them to be seen as legitimate.

The second explanation is that the gold-plated regulation does in fact exceed international standards but does not undermine the international competitiveness of local banks despite the added cost. Bank competitiveness is affected by a number of factors—the regulatory burden is just one—and the impact of the excess component of a single tougher regulation (i.e., the difference between the domestic regulation and the international standard) may not be meaningful. There are a number of observable implications of the “no impact” thesis. One is that there should be a consensus among third-party experts that local regulations do, in fact, exceed the international standard. Another is that any hearings held by legislators into the regulation will focus on issues unrelated to international competitiveness. This is because legislative hearings are often motivated by industry lobbying, which in the case of the “no impact” thesis does not centre on competitiveness issues. This is why we also expect legislators will not attempt to reverse the regulation through legislation. In their criticism of the regulation, banks may raise international competitiveness concerns, but these will be minor relative to other objections, and will be much less forceful than under the “justified impact” thesis. Banks will

\[194\] This is because industry criticism of the regulation will tend to focus more on technical matters related to definitions, application and enforcement.
also have difficulty providing detailed analysis to support claims that their competitiveness has been hurt. There should also be public statements and private comments from regulators that, while aware the regulation exceeds international standards, they do not believe local banks are disadvantaged. The type of statements expected from regulators will differ from the “sham regulation” case, where the focus will be on defending the effectiveness of the regulation rather than on its limited impact on competitiveness.

The third explanation is that the regulation exceeds international standards and has a material impact on the competitiveness of local banks. Regulators are aware that local banks will be disadvantaged but believe the tougher regulation is necessary to promote a stable financial sector. Regulators take this view because they attach greater importance to financial stability than their foreign counterparts or because they have learned that regulations need to be tougher to achieve a given level of stability. Regardless, they accept that a higher regulatory burden is necessary, and issues of competitiveness are given less weight in the rule-making process. The “justified impact” thesis generates a different set of observable implications from the other two. Unlike the “sham regulation” thesis, third-party experts should confirm that the regulation exceeds international standards. Unlike the “no impact” thesis, legislators will hold hearings focusing on the competitiveness impact of the regulations and will propose legislation to ease the regulatory burden. Regulators in public and private will acknowledge the adverse competitiveness impact of the regulation but will justify the added cost to banks as necessary for a stable financial system. Banks will make competitiveness concerns a central argument in their efforts to lessen the regulatory burden and will provide detailed analysis to support their claims.
Table 3.1 summarizes the observable implications of the three possible explanations.\textsuperscript{195}

Table 3.1: Observable Implications of Three Possible Explanations

<table>
<thead>
<tr>
<th></th>
<th>“Sham regulation” thesis</th>
<th>“No impact” thesis</th>
<th>“Justified impact” thesis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opinions of third-party experts</td>
<td>Rules are not tougher</td>
<td>Rules are tougher</td>
<td>Rules are tougher</td>
</tr>
<tr>
<td>Actions by legislators</td>
<td>No hearings or attempts to change rules through legislation</td>
<td>Hearings possible but focus is not on competitiveness. No attempts to change rules through legislation</td>
<td>Hearings probable with a focus on competitiveness. Legislative attempts to weaken regulation likely</td>
</tr>
<tr>
<td>Public statements and private comments by regulators</td>
<td>Denial that regulations are weak</td>
<td>Competitiveness not affected</td>
<td>Competitiveness affected but justified</td>
</tr>
<tr>
<td>Comments by banks</td>
<td>Regulations are appropriate</td>
<td>Competitiveness used as ancillary argument in criticism of regulation. Claims not supported by detailed analysis</td>
<td>Competitiveness used as a central argument in criticism of regulation. Claims supported by detailed analysis</td>
</tr>
</tbody>
</table>

3.4 Methodology

The three alternative theories are evaluated using process tracing, which requires developing observable implications for each explanation and collecting within-case evidence to support or refute them.\textsuperscript{196} Particular attention is paid to analyzing observable implications that are unique to one explanation. For instance, expert third-parties acknowledging that local regulations are tougher than international standards provide strong evidence against the “sham regulation” thesis. Likewise, sustained and forceful criticism of the erosion of their competitiveness position

\textsuperscript{195} To help differentiate between the “no impact” and “justified impact” explanations, quantitative estimates of the degree to which tougher regulation affect the international competitiveness of local firms would be helpful. Such estimates are enormously difficult to calculate and are not available.

\textsuperscript{196} Bennett and Checkel 2015.
by the banks is a key differentiator between the “no impact” and “justified impact” thesis. Evidence for my analysis comes from media reports, speeches, congressional hearings, comment letters and regulatory filings. In addition, about 50 interviews with current and former government officials, industry executives and other knowledgeable observers were conducted between September and December 2018, mostly in Washington, D.C. (The appendix provides details of the interviews.)

A potential weakness of relying on interviews with and speeches by government officials directly involved in setting U.S. capital adequacy rules, as well as written justifications for the rules contained in regulatory filings, is that these officials have an incentive to overplay the importance of the rules in promoting financial stability and to underplay potential costs, including erosion of the international competitiveness by U.S. banks. The latter is of particular concern to the findings of this study. To address this issue, the observable implications include statements and actions by legislators and industry executives, who if anything have incentives running in the opposite direction. The large banks in particular are highly motivated to clearly demonstrate the potential harm caused by the U.S.’s more stringent capital adequacy rules.

---

197 These officials would deny that this happens.
198 For legislators, this is especially the case in periods of low issue salience. The U.S. G-SIB capital adequacy rules were adopted in 2014 and 2015, which is well after the financial crisis had ended.
3.5 U.S. G-SIB Capital Rules

Capital provides banks with a cushion against losses, acting as the last line of defense against insolvency. Capital is a source of funds for banks (i.e., it sits on the liability side of the balance sheet) and, in its narrowest form, is composed of common shareholder equity and retained earnings. These are considered permanent capital in that common equity and retained earnings are subordinate to all other claims on a bank and there is no obligation to return these funds to shareholders. It is also the type of capital that investors and counterparties have the greatest confidence in when assessing the creditworthiness of a bank. The protective capacity of capital depends on the amount of capital a bank holds relative to total assets and the riskiness of those assets. Loans to governments in developed economies, for example, are less likely to suffer losses than loans to highly-leveraged corporations or overextended consumers. As a result, capital regulations are sometimes expressed as a ratio of capital to risk-weighted assets, which requires more capital to be held against higher-risk assets. Thus, the key components of capital regulation are: (i) the definition of capital; (ii) the prescribed minimum ratio of capital to bank assets; and (iii) the risk-weight applied to different types of assets.

Capital adequacy regulations are set by national governments. However, since 1988 minimum international standards on bank capital and liquidity have been agreed to by the Basel Committee on Banking Supervision (BCBS), an international body composed of national regulators.

---

199 This refers to Common Equity Tier 1 (CET 1). Broader measures of capital are also used for regulatory purposes. They permit additional sources of funds, such as some types of preferred shares and debt that converts to equity under specified conditions, to be classified as capital.
operating under the authority of the Bank for International Settlements (BIS). These agreements are known as Basel I (1988), Basel II (2004) and Basel III (2010-2017). They are “soft law” because the international standards are implemented by national regulatory authorities on a voluntary basis. They are not treaties and the BCSC has no authority to penalize non-compliance by national authorities beyond “naming and shaming” countries who do not meet the standards. The United States has pushed for international standards for banks in areas and at levels to match domestic regulation.

Banks in the United States are subject to four types of regulations affecting the amount and quality of capital they must hold. First, risk-based capital ratios establish minimum amounts of capital that banks must have as a ratio of risk-weighted assets. The quality of capital is determined by the definition of capital. Second, leverage ratios set the minimum amount of capital relative to total assets. This alternative ratio makes no allowance for the risk profile of bank assets and, in effect, places a limit on the degree to which banks can reduce required capital by altering their asset profile or internal risk models. Third, large banks are required to hold a minimum amount of total loss absorbing capital (TLAC), which is unsecured, subordinated long-term debt that can be written down in the event of a bank failure. Fourth, stress tests

\[\text{...}\]

\[200\] Basel I established the first international capital adequacy standard. Basel II altered the rule by, most importantly, allowing large banks to use internal risk models to weight the riskiness of different types of assets. Basel III raised existing capital adequacy standards, added new capital and liquidity standards, and set a floor on how much internal models could reduce a bank’s risk-weighted assets. Bankers often refer to the December 2017 modifications to Basel III as Basel IV but regulators do not.


\[202\] U.S. Treasury, A Financial System That Creates Economic Opportunities: Banks and Credit Unions, June 2017, pp. 37-56, 141-147. A related set of rules address bank liquidity, which includes the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR).

\[203\] Basel II allow large banks to assign their own risk weights based on internal models. Basel III sets a floor on the degree to which banks can use internal risk models to reduce risk-weighted assets.
require large banks to maintain minimum risk-based capital and leverage ratios after a projected
decline in the value of assets due to hypothetical adverse financial and economic scenarios, and
to have capital plans approved by regulators before paying dividends or engaging in stock
buybacks. 204  Section 165 of the Dodd-Frank Act (DFA) requires U.S. bank regulators to impose
tougher capital regulations on large banks. 205  The toughest of these apply to G-SIBs, of which
there are currently eight in the U.S. 206

Basel III establishes minimum ratios for risk-based capital, leverage and TLAC but does not
address the structure of national stress tests. There are two sets of international standards. One
set applies to all banks and U.S. regulations are comparable to them. A second set of
international standards places additional requirements on G-SIBs. Here U.S. rules exceed
international standards, as shown in Table 3.2. The U.S. G-SIB capital surcharge is effectively
double the international standard due to a higher surcharge scale and a stricter formula
determining the applicable surcharge. The leverage ratio applied to U.S. G-SIBs is also about
double the international standard. U.S. TLAC rules require higher minimum amounts of long-
term debt and use stricter eligibility criteria than the international standard. In practice, U.S.
stress tests can require U.S G-SIBs to hold even higher amounts of capital than prescribed by the

204 There are two parts to the stress tests. The Dodd-Frank Act requires banks with more than $50 billion in assets
to assess their capital adequacy under three scenarios (baseline, adverse and severely adverse). The Comprehensive
Capital Analysis and Review (CCAR) applies to bank holding companies. It assesses capital adequacy under
different levels of stress and requires capital plans to be prepared that must be approved by regulators before firms
can make capital distributions to shareholders.
205 Defined as any banks with assets exceeding $50 billion.
206 As of November 2018, the eight U.S. G-SIBs were JPMorgan Chase, Bank of America, Citigroup, Wells Fargo,
U.S. G-SIB capital rules, which mean that Table 3.2 likely *underestimates* the degree to which U.S. regulations exceed international standards.\(^{207}\)

Table 3.2: Comparison International Standards and U.S. Capital Rules for G-SIBs

<table>
<thead>
<tr>
<th>Capital Rule</th>
<th>International Standard (Basel III)</th>
<th>U.S. Regulation</th>
</tr>
</thead>
</table>
| G-SIB capital surcharge | • G-SIB surcharge of 1.0-2.5%  
• Applicable rate depends on five factor scoring methodology | • G-SIB surcharge of 1.0-4.5%  
• Stricter scoring scale due to use wholesale funding as a factor |
| Leverage ratio      | • 3.0%                                                                                           | • 5.0% for bank holding companies  
• 6.0% for insured depository institution subsidiaries |
| TLAC                | • Leverage: 6.75%  
• Risk-based: 18% of risk-weighted assets plus regulatory capital buffers  
• Long-term debt: 33% of TLAC | • Leverage: 9.5%  
• Risk-based: 18% of risk-weighted assets plus regulatory capital buffers  
• Long-term debt: higher of 6.0% of risk-weighted assets plus G-SIB surcharge and 4.5% of total leverage |
| Stress test         | • No standard                                                                                     | • Quantitative and qualitative minimum requirements to be maintained under adverse economic and financial conditions |

Source: Adapted from U.S. Treasury, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions*, Table 3, p. 42.

### 3.6 Analysis

Given policymakers’ concern for the international competitiveness of U.S. banks, it is surprising the United States put in place G-SIB capital rules that exceed international standards. An earlier section discussed three possible explanations: (i) U.S. rules are not in fact stronger than international standards ("sham regulation" thesis); (ii) U.S. rules are stronger but they are not

\(^{207}\) This occurs because the stress test process is opaque, complex and requires the use of overly conservative assumptions. See U.S. Treasury, June 2017, pp. 49-50, 53 and JPMorgan Chase, *2016 Annual Report*, pp. 21-22.
expected to affect bank competitiveness despite the added cost ("no impact" thesis); and (iii) U.S. rules are stronger, and they are expected to affect international competitiveness, but the tougher rules are necessary to maintain financial stability ("justified impact" thesis). Each of these explanations generates four key (but differing) observable implications (see Table 3.1 in a prior section) and this section assesses the degree to which the observable implications of each thesis is consistent with why the U.S. adopted gold-plated regulations. For purposes of brevity, the focus is on the G-SIB capital surcharge, although the other components of the gold-plated capital regulations are discussed where appropriate.

3.6.1 Expert third-party assessments

U.S. regulators proposed the G-SIB capital surcharge in December 2014.\textsuperscript{208} Financial analysts noted that the rules exceeded international standards. For instance, Fitch Ratings wrote that the "[…] newly proposed rules establishing capital surcharges for the largest U.S. banks are more onerous than international proposals"\textsuperscript{209} and S&P Rating Services said that the rules "[…] could impair the competitive position of U.S. banks versus international peers".\textsuperscript{210} Likewise, a major accounting firm concluded that U.S. G-SIBs will be "[…] subject to significantly higher surcharges than its global peers".\textsuperscript{211} Two research reports from European investment banks also concluded that the U.S. G-SIB capital surcharges were much more stringent than Basel III due to

\begin{itemize}
\item \textsuperscript{210} Standard & Poor’s Rating Services, “Key Regulations Impacting the U.S. Banking Industry,” Feb. 2015, p. 9.
\item \textsuperscript{211} PWC, “First Take: Key Points from the Fed’s Final G-SIB Surcharge Rule,” July 22, 2015.
\end{itemize}
the inclusion of the wholesale funding factor.\textsuperscript{212} Finally, in a statement of support for the new regulation, the Systemic Risk Council, a U.S.-based lobby group composed of former regulators committed to strong bank regulation, applauded the Federal Reserve for bringing in a rule that went beyond the international standard.\textsuperscript{213} Americans for Financial Reform, another pro-regulation lobby group, also provided support for rules that “exceed the Basel minimum surcharge by several percentage points.”\textsuperscript{214}

In 2016, the BCBS assessed U.S. compliance with the Basel III G-SIB framework as part of its Regulatory Consistency Assessment Program (RCAP).\textsuperscript{215} The report determined that U.S. implementation rules were “compliant” with international standards, the highest grade available. In making this determination, the BCBS review methodology does not consider overcompliance but the report nevertheless notes that the U.S. framework “[…] generally results in higher minimum capital requirements […]” for U.S. G-SIBs compared to Basel III.\textsuperscript{216} This is because U.S. rules include short-term wholesale funding as a measure of systemic importance, which is not part of the Basel III methodology. In 2017, the BCBS issued a consultative paper to revise the G-SIB assessment framework and, as part of the review, asked if short-term wholesale

\textsuperscript{214} Americans for Financial Reform, Comment letter to the Federal Reserve, April 3, 2015.
\textsuperscript{216} Ibid., p. 5.
funding should be added to the assessment methodology.\textsuperscript{217} This request reflects recognition by the BCBS that U.S. G-SIBs face higher capital surcharges.

In sum, assessments by third parties rule out the “sham regulation” thesis. Of the approximately 15 reports by financial experts on the U.S. G-SIB capital surcharge I reviewed, not one suggests that the U.S. G-SIB surcharge is less stringent than or even on par with Basel III.\textsuperscript{218} Further, civil society groups, who have been among the strongest advocates for tougher regulation, have acknowledged that U.S. rules exceed international standards. With the “sham regulation” thesis eliminated, the remainder of this section considers only the “no impact” and “justified impact” theses.

\subsection*{3.6.2 Actions by legislators}

Since 2010, the House and to a lesser extent the Senate have held hearings to examine the impact of the Dodd-Frank Act and attendant regulations on the international competitiveness of U.S. financial institutions and markets.\textsuperscript{219} Of particular interest to legislators has been the

\begin{itemize}
  \item The full list is available from the author.
\end{itemize}
competitiveness implications of regulations governing capital and liquidity, derivatives, proprietary trading and insurance. However, apart from two hearings—one in 2011 and the other in 2014—Congressional interest in capital regulations has focused almost exclusively on the impact of Basel III on community and regional banks, which have few operations outside the U.S., and the potential impact of applying similar international standards to U.S. insurance companies. For community banks, legislators’ questions focused on the heightened administrative compliance burden arising from the complexity of the new capital rules and the proposed exclusion of trust preferred securities (TruPS) from the definition of capital. For insurance companies, the chief concerns were the appropriateness of applying a capital regulatory framework developed for banks to insurance companies, the criteria to designate insurance companies as systematically important financial institutions, and the perceived willingness of U.S. authorities to embrace regulations developed by international bodies. Almost without exception, legislators did not make statements on nor ask witnesses about the competitive impact of the gold-plated G-SIB capital rules on the competitiveness of U.S. banks during Congressional hearings.

The chief exception to legislators’ apparent lack of interest in the international competitiveness of U.S. banks occurred at a 2011 hearing by the House Financial Services Committee.220 The

Republicans had recently taken chairmanship of the committee and used the hearing to link rules hurting the competitive position of U.S. financial banks with the slow economic recovery.

Representative Biggert (R-IL) offered comments typical of Republican legislators:

[...] if we unnecessarily constrain American financial institutions through unlevel standards to those of their international competitors, businesses will migrate to international competitors. And if we restrict our financial institutions from providing innovative and competitive products to consumers, consumers will look elsewhere. It is counterproductive if the most stringent regulation of our U.S. financial institutions drive business overseas and shifts risky behavior to unregulated sectors of the economy. We must find the right balance. U.S. jobs and our economy depend on it.  

This comment highlights the linkage Republican legislators attempted to draw between international competitiveness and a broader set of policy concerns, such as innovation and job growth. Such linkages were part of a concerted effort by Republicans to discredit the Dodd-Frank Act by arguing that the post-2009 financial sector reforms extended the government’s reach too far and that the Act was slowing the economic recovery.

Democrats, for their part, acknowledged the legitimacy of competitiveness concerns but cautioned regulators not to weaken rules that would undermine financial stability.

Representative Frank (D-MA) called on regulators to recognize that critics of the Dodd-Frank Act have two motivations when raising competitiveness issues: “[...] one is not to be regulated in a way that puts [U.S. banks] at a disadvantage vis-à-vis...foreign competitors, and two is the desire not to be regulated.”  Representative Waters (D-CA) went further with her concerns: “If we want to water down financial reform in order to entice firms to locate in the United States, we

222 Ibid.
may find the only thing we have accomplished is ensuring that the next bailout recipient is headquartered in the United States.”

Legislators’ modest concern about the impact of capital rules on narrow competitiveness issues is also evident in a lack of legislative action to weaken the U.S. G-SIB capital rules. The Financial Choice Act of 2016—the Republican’s signature piece of legislation to overturn the Dodd-Frank Act—does not eliminate any of the gold-plated capital rules for G-SIBs. Indeed, the Financial Choice Act sets out the possibility of even more stringent capital requirements as an option for banks, though banks submitting to tougher capital rules would escape other regulatory requirements. The Financial Choice Act passed the House but was never considered by the Senate because the bill lacked the necessary support. Instead, a less ambitious bipartisan bill to reform the Dodd-Frank Act was passed by the House and Senate in 2018. The Economic Growth, Regulatory Relief and Consumer Protection Act of 2018 (the “Crapo bill”) eased the regulatory burden on small and regional banks, but left G-SIB capital surcharge and other elements of the U.S.’s gold-plated capital regulatory regime largely unchanged. Moderate Democrats would not have supported the bill otherwise. In their comments supporting the Crapo bill, they focused on how it would help small banks, which moderate Democrats said were “too small to succeed” under the stricter regulations contained in the Dodd-Frank Act.

---

223 Ibid.
224 Two minor changes benefitted the G-SIBs. First, the two G-SIB custodial banks (State Street and Bank of New York Mellon) benefitted from a technical change that excluded central bank deposits from the denominator in the calculation of the enhanced SLR. Second, all G-SIBs benefited from another technical change that allowed some municipal securities to qualify as High Quality Liquid Assets for the liquidity coverage ratio.
The actions of legislators are consistent with the “no impact” thesis. While several Congressional hearings examined capital rules and the competitiveness of U.S. financial institutions and markets, only two tackled the issue of the U.S. G-SIB’s capital rules in any depth. But even in these instances, the primary goal of the hearings was for Republicans to bolster their case to repeal the Dodd-Frank Act rather than to establish clear evidence that the U.S. G-SIB capital rules were harming the competitiveness of U.S. banks or to propose recommendations to mitigate this problem. Republicans opposed the Dodd-Frank Act largely on ideological grounds and looked for any opportunity to cast it in a negative light. That legislators have not passed, nor attempted to pass, legislation to bring the U.S. G-SIB capital regulations in line with international standards further supports the “no impact” thesis.

3.6.3 Public statements and private comments by regulators

The U.S.’s fragmented regulatory structure, where the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) each oversee parts of the U.S. banking system, means that U.S. regulators do not always have a unified position, though divergence is tempered by requirements in the Dodd-Frank Act for the three agencies to work together on some regulatory areas and to consult on most others. The U.S. Treasury also plays a policymaking role as Chair of the Financial Stability Oversight Council, a member of the Financial Stability Board, the home department for the OCC, and the Treasury secretary’s involvement in the selection of the heads of the regulatory agencies, who are appointed by the President. International competitiveness issues are most relevant to the
Federal Reserve because it oversees foreign banks operating in the U.S. and U.S. G-SIBs, which are the most internationally active U.S. banks. Treasury’s participation in the FSB also makes Treasury sensitive to international competitiveness concerns.

June 2011 was a critical period in the development of the U.S. G-SIB capital surcharge. International efforts to establish a standard G-SIB capital surcharge were underway at the BCBS, where the U.S. push for a meaningful surcharge met fierce resistance from globally active banks and from Germany and France.\(^{226}\) Complicating matters was that the U.S. itself was divided, with the FDIC supporting a top rate of 4.0%, the Federal Reserve 3.0%, Treasury 1.5% and the OCC 1.0%.\(^{227}\) The OCC sought a lower rate because it felt that a higher rate was not necessary to achieve financial stability and because it could choke off the economic recovery.\(^{228}\) At a meeting of the BCBS on June 26, 2011, a consensus emerged that the G-SIB capital surcharge would have a top rate of 2.5%,\(^{229}\) which was less than the Federal Reserve and FDIC sought but was higher than what some European countries proposed. The last holdouts were Germany and China and Japan were also initially lukewarm on a G-SIB capital surcharge but came on side when it was agreed that the surcharge would be based on interconnectedness as well as size. Both countries have large domestically focused banks, which are less interconnected than U.S. and European banks, and thus would face lower surcharges. Brooke Masters, “Big Banks Take Hit on Capital Surcharge,” *Financial Times*, May 12, 2011. Interview 15, regulator, October 1, 2018.

\(^{226}\) All three regulatory agencies are members of the BCBS. Treasury is not but as a member of the FSB, which ultimately approves international standards adopted by standard-setting agencies such as the BCBS, its views matter. Deborah Soloman, “FDIC’s Bair: New Capital Rules Won’t Hurt Lending, *Wall Street Journal*, June 10, 2011, and Bair 2012, pp. 269-272.


\(^{228}\) Basel III in fact leaves open the possibility for a 3.5% rate, but this would only be applied if banks with the current highest G-SIB rating scores were assessed much higher scores in the future.
the OCC. Pressure from the Fed and FDIC secured the OCC’s support and Germany quickly fell into line as well.²³⁰

U.S. regulators’ position on the G-SIB surcharge came under scrutiny at a hearing by the House Financial Services Committee on June 16, 2011.²³¹ When asked about the U.S. approach to capital regulations, Lael Brainard, who at the time was Treasury’s chief point person on international regulatory affairs, said: “By moving first and leading from a position of strength, we are elevating the world’s standards to ours. For financial markets that are more globally integrated than ever, we need financial reforms that are more globally convergent than ever.”²³² In her written statement, as well as in response to questions, Brainard made it clear that while the U.S. would continue to push for the toughest measures possible, maintaining a level playing field was important in order to reduce opportunities for regulatory arbitrage where U.S. firms shifts activities to jurisdictions with weaker regulation. John Walsh, then acting head of the OCC raised similar points:

[…]

it is certainly true that if the same high standards are not adopted by all countries and enforced with the same vigor, U.S. institutions could be left at a competitive disadvantage. Our challenge, then, is to address the problems that led to the financial crisis without undermining the ability of banking institutions to support a strong national economy or placing U.S. institutions at an unfair competitive disadvantage internationally.²³³

²³⁰ Bair 2012, pp. 269-272.
²³¹ Financial Regulatory Reform: The International Context, Hearing before the House Committee on Financial Services, June 16, 2011, Serial No. 112-93
Shelia Bair, head of the FDIC at the time, a long-time advocate for tougher capital requirements, and set to step down from the FDIC in two weeks, expressed less concern for the international competitiveness implications of tougher U.S. regulation. In her remarks to the Committee, Bair said:

U.S. economic competitiveness is a broad concept, of which financial industry competitiveness is only one part. The short-term profitability of financial institutions should not be confused with our international competitiveness. Many of the regulatory gaps and lapses which occurred pre-crisis were rationalized as the way to strengthen our international competitive position. What we discovered was that sacrificing safety and soundness in the name of global competition made both the financial institutions themselves and the broader economy worse off.²³⁴

Bair has gone further more recently. In response to a question about tougher U.S. capital rules potentially harming the competitiveness of U.S. banks, she replied: “The argument is out there but I don’t think anyone could raise it directly with me and keep a straight face.”²³⁵ Of the nine current and former regulators I interviewed who were involved in the development of the G-SIB capital surcharge,²³⁶ only one said that the U.S. rules currently undermined the competitiveness of U.S. banks,²³⁷ and three said that they felt, if anything, the surcharge would enhance U.S. competitiveness by making U.S. institutions and markets safer.²³⁸

²³⁴ Statement by the Honorable Shelia Bair, Chairman, Federal Deposit Insurance Corporation to Financial Regulatory Reform: The International Context, Hearing before the House Committee on Financial Services, June 16, 2011, Serial No. 112-93.
²³⁶ Interview 9, former regulator, September 26, 2018, Interview 15, regulator, October 1, 2018, Interview 16, former regulator, October 2, 108, Interview 18, former regulator, October 9, 2018, Interview 20, former regulator, October 10, 2018, Interview 26, former regulator, October 24, 2018, Interview 27, former regulator, October 24, 2018, Interview 35, former regulator, November 7, 2018 and Interview 43, former regulator, November 20, 2018.
²³⁷ Interview 27, former regulator, October 24, 2018. Of note, this person worked for the banking industry at the time of the interview.
²³⁸ Interview 9, former regulator, September 26, 2018, Interview 15, regulator, October 1, 2018 and Interview 26, former regulator, October 24, 2018.
While Bair had left the FDIC by the time the final U.S. G-SIB capital surcharge was issued in June 2015, her call for tougher measures was heard. The proposed surcharge was almost double Basel III. Of note, when the proposed surcharge was issued, the Federal Reserve did not acknowledge that the competitive position of U.S. banks would be hurt. The Federal Reserve instead addressed the competitiveness issue by saying only that the capital surcharge would “increase the resiliency of the largest U.S. banking organizations, which is likely to result in lower costs of funding for these institutions and a safer, more stable U.S. financial system”.

The Fed also noted that other jurisdictions, including Sweden, Switzerland and the Netherlands, had also implemented G-SIB surcharges in excess of Basel III. In other words, the Fed’s position was that U.S. financial institutions would not be disadvantaged by tougher U.S. rules. The Federal Reserve went on to say that “it continues to monitor the effects of its regulations on the competitiveness of U.S. G-SIBs”, suggesting that it could be open to changes in the future if the gold-plated rules were later found to be undermining the ability of U.S. banks to compete.

Two former Fed officials said that international competitiveness was not a major concern as the U.S. rules were being developed. According to one, this was because the banks themselves did not attach much importance to it in their private discussions with regulators. The other said that Daniel Tarullo, then the Fed governor responsible for financial regulation, did not see competitiveness as a major concern.

---

240 Ibid.
241 Interview 16, former regulator, October 2, 2018.
242 Interview 18, former regulator, October 9, 2018.
The election of President Trump brought changes to Treasury’s views on the competitiveness issue. Trump promised major changes to the Dodd-Frank Act shortly after his election and, in February 2017, issued an Executive Order listing seven core principles to guide the reform process, which was to be led by Treasury. Two of the principles dealt explicitly with international competitiveness: (i) “[e]nable American companies to be competitive with foreign firms in domestic and foreign markets”; and (ii) “[a]dvance American interests in international financial regulatory negotiations and meetings”. 243 Treasury subsequently released three reports with recommendations on regulatory changes to, among other things, promote the competitiveness of U.S. financial institutions and markets. 244 The report on the U.S. banking system specifically identified the U.S.’s tougher G-SIB capital rules as potentially making U.S. banks less competitive, but held back from calling for specific changes to them.

In 2018, the Federal Reserve, now led by Trump appointees, proposed changes to ease two parts of the G-SIB capital regime: the enhanced SLR and the TLAC requirements. 245 Both changes would bring U.S. rules more in line with Basel III, though they would not close the gap entirely. The change to the enhanced SLR is especially significant since for some banks this is the binding constraint on the minimum amount of capital they are required to hold. 246 The effect of these changes would be to reduce the amount of capital held by insured depository institutions by an

246 Ibid., p. 3.
estimated $121 billion, or 20 percent.247 Of note, the stated rationale for the changes was not to improve the competitiveness of U.S. banks. Instead, it was to halt large banks from exiting low margin but critically important businesses, such as repo financing, central clearing services and taking custody deposits, which the Fed said may be having “an adverse effect on safety and soundness.”248 It could be argued that making these services more widely available also enhances the competitiveness of the U.S. economy, yet neither the written justification for the proposed rule change in the Fed’s notice, nor subsequent statements by the Federal Reserve Vice Chairman for Supervision on the regulation of large banks, make this claim.249 This suggests that efforts to weaken the U.S. G-SIB capital regulations were not principally motivated by a desire to improve the competitiveness of the U.S. financial sector. Current and former regulators confirmed that this was the case.250 Former Fed officials in particular stressed that the enhanced SLR had become the binding capital constraint on some G-SIBS, which was never their intention.251 They believed that risk-weighted capital rules (and not the leverage ratio) should be the binding constraint on the business decisions of banks.

The actions of regulators are consistent with the “no impact” thesis. U.S regulators have repeatedly acknowledged the importance of maintaining a level playing field to ensure that U.S banks are not placed at a competitive disadvantage and to limit opportunities for regulatory

248 Ibid., p. 6.
250 Interview 15, regulator, October 1, 2018, Interview 16, former regulator, October 2, 2018, Interview 18, former regulator, October 9, 2018, Interview 27, former regulator, October 24, 2018, Interview 26, former regulator, October 24, 2018.
251 Ibid.
arbitrage. In its notice announcing the G-SIB capital surcharge, the Federal Reserve dismissed competitiveness concerns by saying that the tougher capital requirement could actually lower the cost of funding to banks and that other countries also went beyond international standards. When changes were made to ease G-SIB capital requirements, they were not justified as a way to improve the international competitiveness of U.S. G-SIBs. Collectively, this evidence supports the view that regulators believed that tougher U.S. capital rules would not disadvantage U.S. G-SIBs and is thus consistent with the “no impact” thesis.

3.6.4 Comments by banks

The Federal Reserve issued the proposed rule for the G-SIB capital surcharge in December 2014. In its notice, the Fed acknowledged that the proposed rule would be tougher than the international standard and sought responses to 33 questions, including: “What are commenter’s views on how the proposed G-SIB surcharge would impact the competitive position of G-SIBs relative to their foreign peers?” Of the 18 substantive comments filed with the Federal Reserve, only two commented on the competitiveness implications of the proposed G-SIB capital surcharge. The Center for Capital Markets Competitiveness (CCMC), a unit of the U.S. Chamber of Commerce, addressed the question most directly, arguing that the rule continued a trend where the U.S.’s largest banks are regulated differently from comparable banks in other


253 There were 21 comments in total but one merely asked for an extension to file their comment and two others were from non-expert members of the public providing short statements in support of the rule. The rest were from financial industry trade groups (7), civil society organizations (6), and individual companies (5).
countries and that this may prevent domestic customers from accessing the “[…] forms of capital that other global actors may”. 254 They also wrote that the G-SIB capital surcharge in particular will “[…] place [U.S. G-SIBs] at a further economic disadvantage, create a drag on our financial services sector, and raise the cost of capital for all businesses”. 255 What is notable about the CCMC’s response is not so much these claims, which are concerns frequently raised by the business groups to oppose tougher regulatory measures. Rather, it is the lack of any specifics about which markets, products or institutions will be affected and the absence of any empirical evidence to back these general claims.

In a substantive joint submission running over 50 pages, the Clearing House, the Securities Industry and Financial Markets Association (SIFMA), and the Financial Services Roundtable (FSR), the three leading trade associations for the largest banks, argued that the Federal Reserve had not provided any support to justify the G-SIB capital surcharge exceeding international standards, or why a different scoring methodology (which is the main reason for the higher surcharge) is necessary for U.S. banks. 256 The letter identifies several conceptual and practical difficulties with the design, calculation and implementation of the G-SIB surcharge but, like the CCMC response, does not discuss in detail the impact of the surcharge on international competitiveness nor provide empirical evidence to support its general claims. Instead, the letter contains statements like the following:

254 Letter by Tom Quaadman, Vice President, Center for Capital Market Competitiveness, April 1, 2015.
255 Ibid.
256 Letter by David Wagner, Executive Managing Director and Head of Finance, The Clearing House Association, Kenneth Bentsen, Jr., President and CEO, SIFMA, and Rich Foster, Senior Vice President & Senior Counsel for Regulatory and Legal Affairs, FSR, April 2, 2015.
requiring U.S. GSIBs to maintain inordinately high amounts of capital, whether in general or as a result of specific activities, will impose costs not only on GSIBs, but on customers that rely on GSIBs for financial services, investors, markets and on the broader economy. These effects will be felt not only at the individual institution level but also on the U.S. economy as a whole, yet the Proposal does not appear to provide any meaningful analysis or consideration of these costs.257

Statements by banks support the “no impact” thesis. Even though the Federal Reserve specifically asked commenters to address the international competitiveness issue, only two letters did so, both from trade groups. Two U.S. G-SIBs also sent their own comment letters, noting that they had worked with and largely agreed with their trade associations, but neither commented on international competitiveness, instead focusing on other implications of the rules.258 This, along with the fact that the most intentionally oriented G-SIBs, such as JPMorgan Chase, Citigroup and Goldman Sachs, did not file comment letters, suggests that the impact on their competitiveness was not of utmost concern. Additionally, where international competitiveness concerns were raised, they were of a general nature and provided no analysis to support their claims. This again suggests that the banks’ opposition to the G-SIB surcharge was more about preventing an additional regulatory cost than about maintaining their competitive position in global markets.

3.7 Discussion

The previous section examined three possible explanations for gold-plated U.S. regulations. The first was that U.S. regulations do not actually exceed international standards—they only appear

---

257 Ibid.
258 Letter by State Street, April 2, 2015 and Wells Fargo, April 2, 2015.
to be so. Assessments by financial experts and statements by groups advocating for strong regulation of the financial sector are inconsistent with the “sham regulation” thesis. Another explanation for U.S. gold-plated rules is that regulators felt that tougher measures were needed to achieve financial stability and imposed them knowing that the rules would adversely affect the international competitiveness of U.S. institutions and markets. However, the “justified impact” thesis is contradicted by claims from regulators that competitiveness should not be affected. Further, banks did not make international competitiveness concerns central to their efforts to weaken the G-SIB capital rules, nor did legislators attempt to roll back the gold-plated rules through legislative changes. Instead, the evidence is consistent with the “no impact” thesis: Regulators felt that tougher measures were needed to achieve financial stability and that these measures would not adversely affect the competitive position of U.S. G-SIBs despite the added cost.

3.7.1 Contributing factors

The adoption of U.S. gold-plated regulations was likely facilitated by the particular political and financial conditions in place when the gold-plated rules were adopted. By the mid-2010s, U.S. banks had largely recovered while European banks, their chief global rivals, were continuing to deal with losses arising from both the 2007-09 financial crisis and the 2010-12 euro crisis.\textsuperscript{259} Their much greater profitability enabled U.S. banks to use retained earnings, as well as tapping equity markets, to meet higher capital requirements and to absorb the large fines imposed by U.S

\textsuperscript{259} Of the 29 banks listed as G-SIBs by the FSB in 2013, 16 were from Europe.
and other authorities in connection with operational improprieties during the 2000s.\textsuperscript{260} Between 2010 and 2017, U.S. banks increased their share of a number of key markets in Europe (see Table 3.3 on next page). Over the same period, the market share of foreign banks operating in the U.S. declined slightly. Among the largest 50 banks operating in the U.S., only eight are foreign owned and their share of total U.S. domestic assets dropped to 8.6 percent (from 9.1 percent) and their share of total domestic branches dropped to 9.4 percent (from 11.1 percent).\textsuperscript{261} Also, while Chinese banks have continued to grow rapidly in size—indeed the world’s four largest banks by assets are based in China—most of their growth has taken place within China.\textsuperscript{262}

Chinese banks have been more cautious in their efforts to expand internationally than Japanese banks during their heyday in the late 1980s and early 1990s. In an important study, Singer found that regulators act on international competitiveness concerns only when their domestic financial institutions are under pressure from foreign competitors.\textsuperscript{263} Thus, a favorable financial climate may have given U.S. regulators more space to adopt regulations exceeding international standards.

\begin{flushright}
\textsuperscript{260} According to analysis by the Financial Times, U.S. authorities had imposed fines of $150 billion on U.S. and European G-SIBs. By far the largest was paid by Bank of America, totaling more than $50 billion. RBS was the most heavily fined European bank, with fines totaling about $12 billion. Kara Scannell, “US Haul from Credit Crisis hits $150 billion,” Financial Times, August 6, 2017.

\textsuperscript{261} Figures calculated by author from Federal Reserve, “Insured U.S. Chartered Commercial Banks That Have Consolidated Assets of $300 million or More by Consolidated Assets.”

\textsuperscript{262} In 2013, only the Bank of China and the Industrial and Commercial Bank of China were listed as G-SIBs and, even then, in the lowest category. By 2017, 4 of 30 G-SIBs were Chinese banks, though all were in the bottom-two categories.

\textsuperscript{263} Regulating Capital, 2007.
\end{flushright}
Table 3.3: Share of Selected Markets in Europe, Middle East and Africa (EMEA)

<table>
<thead>
<tr>
<th></th>
<th>U.S. banks</th>
<th>European banks</th>
<th>Other banks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2010</td>
<td>2017*</td>
<td>2010</td>
</tr>
<tr>
<td>Fixed income, currencies and commodities (FICC) trading</td>
<td>44%</td>
<td>48%</td>
<td>50%</td>
</tr>
<tr>
<td>Equities trading</td>
<td>40%</td>
<td>53%</td>
<td>53%</td>
</tr>
<tr>
<td>Investment banking</td>
<td>51%</td>
<td>62%</td>
<td>37%</td>
</tr>
</tbody>
</table>


A second contributing factor was public opinion. U.S. G-SIBs are deeply unpopular in the United States, as they are seen by the public as responsible for the extensive job losses and home evictions that followed the financial crisis.\(^{264}\) The massive taxpayer support banks received and the lack of criminal prosecutions of senior bank executives further eroded public support for banks, as did the large bonuses they received while average American’s were still struggling. No legislator wanted to be seen currying favor with the largest U.S. banks, which gave policy autonomy to regulators to impose tougher regulations. But while there was great public anger at the largest banks, this anger did not extend to regional and community banks, who were able to paint themselves as victims of the financial crisis and as important sources of the credit needed to assist the economic recovery. Small banks enjoy disproportionate influence with legislators due to their strong grass-roots lobbying capabilities, and there was bipartisan support to ensure that the post-2009 regulatory reforms did not overly burden them.\(^{265}\) Small banks were able to use

---

\(^{264}\) Karlyn Bowman, “Public Opinion 10 Years After the Financial Crash,” American Enterprise Institute, Sept 2018.

\(^{265}\) Interview 1, former congressional staff, September 12, 2018, Interview 4, civil society organization, September 18, 2018, Interview 6, former congressional staff, September 20, 2018, Interview 9, former congressional staff and regulator, September 26, 2018, Interview 14, former congressional staff, October 1, 2018, Interview 25, former
these concerns to escape the toughest measures in the Dodd-Frank Act and to obtain further regulatory relief, such as that provided by the recently passed Crapo bill. In their support of measures to assist small banks, legislators from both parties were quick to state that the regulatory relief would only benefit community and regional banks, and that G-SIBs continued to face demanding regulation. In effect, legislators were able to use their continued commitment of being tough on the big banks as political cover to ease the regulatory burden on small banks.

### 3.7.2 Other possible explanations

Three additional explanations are considered briefly. One is that the U.S. may have been able to adopt gold-plated standards because other countries home to internationally active banks adopted similar regulations, thereby lessening the adverse impact of U.S. gold-plating on U.S. banks. Indeed, as noted earlier, the Federal Reserve identified Switzerland, the Netherlands and Sweden as other countries with G-SIB capital surcharges in excess of Basel III. However, of the 29 banks on the original 2013 list of G-SIBs prepared by the FSB, only 4 (Credit Suisse, UBS, ING and Nordea) are based in these countries. Most of the banks the U.S. G-SIBs compete with internationally are based in countries with lower G-SIB capital requirements for their local banks.

---

industry executive, October 23, 2018, Interview 38, industry executive, November 8, 2018, Interview 45, industry executive, November 28, 2018 and Interview 48, former congressional member, December 10, 2018.

266 Federal Register, August 14, 2015, p. 49092.

267 Financial Stability Board, “2013 Update of Globally Systemically Important Banks (G-SIBs), November 11, 2013. This list is revised annually, and no additional Swiss, Dutch or Swedish banks have been added to the list.
Another possible explanation is that higher capital requirements, rather than hurting the competitive position of U.S. banks, in fact advantage them. Again, the Federal Reserve hinted at this possibility when it stated that U.S. G-SIBs may enjoy “lower costs of funding” as a result of the tougher rules.\footnote{268 Federal Register, August 14, 2015, p. 49092.} Some current and former regulatory officials also said that tougher capital requirements, if anything, make U.S. firms and markets more competitive by making the financial system safer.\footnote{269 Interview 9, former congressional staff and regulator, September 26, 2018, Interview 15, regulator, October 1, 2018, and Interview 26, former regulator, October 24, 2018.} The link to competitiveness here is that higher capital requirements increase confidence in banks subject to these requirements, which in turn make them more attractive to consumers and, possibly, investors. This explanation is contradicted, however, by recent efforts by the Trump administration to lower capital requirements, as reflected in recent proposals to ease the enhanced SLR and the stress tests.\footnote{270 U.S. Federal Reserve, “Rule Proposed to Tailor ‘Enhanced Supplementary Leverage Ratio’ Requirements, Press Release, April 11, 2018 and U.S. Federal Reserve, “Federal Reserve Board Announces it Will Limit the Use of the ‘Qualitative Objection’ in its Comprehensive Analysis and Review (CCAR) Exercise, Effective for the 2019 Cycle,” March 6, 2019.} This explanation is further contradicted by the behavior of U.S. G-SIBs. U.S. G-SIBs have not only continued to engage in extensive lobbying efforts in support of less onerous requirements, but have also pursued costly adjustments to their operations to lower their G-SIB scores and, consequently, the applicable G-SIB capital surcharges. For instance, JPMorgan Chase, by adjusting its balance sheet and operations, reduced its G-SIB capital surcharge from 4.0% in 2014 to 2.5% in 2018.\footnote{271 Credit Suisse, “JP Morgan Chase & Co,” Equity Research, October 8, 2015 and Ben McLannahan, “JPMorgan Urges Fed to Loosen Capital Shackles, Financial Times, February 27, 2018.} Several foreign banks have engaged in similar behavior, though some of this restructuring has been motivated by the need to deal with underperforming business units and not by a singular desire to
reduce the applicable G-SIB capital surcharge. Such behavior is inconsistent with the view that higher capital requirements make banks more competitive.

A slightly Machiavellian version of this argument is that the U.S. regulators deliberately pushed for higher capital rules at BCBS, and subsequently adopted tougher capital requirements than Basel III required, as a means to confer a competitive advantage on U.S. banks. European G-SIBs are less able than their U.S. counterparts to raise capital, so they instead have to meet higher capital standards by reducing to the size of their assets. This would mean retreating from capital-intensive business lines like equity underwriting and trading in fixed income, currencies and commodities (FICC). However, one U.S. regulator directly involved in these discussions categorically denied that this consideration played any role in shaping U.S. thinking about the amount of capital G-SIBs should hold. Other former regulators confirmed that the U.S. position on required capital levels was driven by sincere beliefs about what was necessary to ensure the safety of U.S. banks. Lastly, if U.S. regulators see higher capital adequacy requirements as a competitive advantage, then why have they recently sought to weaken them under a president who is unabashedly pursuing an “America first” agenda?

A third possibility is that more stringent capital adequacy rules were part of a “grand bargain,” where tough capital rules were adopted in exchange for weaker rules elsewhere. However, there

272 Deutsche Bank, for instance, has struggled with profitability, and has exited several businesses that were not covering their cost of capital. This had the effect of reducing its G-SIB score.
273 Interview 15, regulator, October 1, 2018.
274 Interview 9, former congressional staff and regulator, September 26, 2018. Interview 16, former regulator October 2, 2018, Interview 18, former regulator, October 9, 2018, Interview 26, former regulator, October 24, 2018, Interview 27, former regulator, October 24, 2018.
is little evidence of a grand bargain taking place. In fact, major parts of the post-2009 financial sector regulatory reforms were negotiated independently of each other. While reaching a consensus on these major policies required trade-offs within each policy area, there were few deals across cut across major policy areas. Participants attributed this to the complexity of the issues, which meant that most legislators, congressional staff and technical experts tended to focus on only a small set of issues.275 This pattern continued during the rule writing phase, where small groups of technical experts from relevant agencies drafted narrow sets of rules with little regard for other rules outside their purview. Jamie Dimon of JPMorgan Chase has been highly critical of the lack of coordination within and across regulators when new rules were developed.276

3.8 Conclusion

The globalization of financial markets has made it more difficult for national authorities to adopt tough prudential regulations without placing local firms and markets at a competitive disadvantage relative to foreign rivals. International standards like Basel III were agreed to in order to help policymakers balance these conflicting objectives by encouraging all states to enact similar regulatory measures. Nevertheless, on occasion, states have adopted gold-plated rules that place higher compliance costs on local firms. This is surprising because such rules are

275 Interview 1, former congressional staff, September 12, 2018, Interview 2, former congressional staff, September 13, 2018, Interview 6, former congressional staff, September 20, 2018, Interview 9, former congressional staff and regulator, September 26, 2018, Interview 11, former administration official, September 27, 2018, Interview 14, former congressional staff, October 1, 2018, Interview 35, former regulator, November 7, 2018, Interview 42, former congressional member, November 19, 2018.

vigorously opposed by affected firms, and legislators are reluctant to undermine the competitiveness of their domestic financial sector because of its importance to the national economy. In the mid-2010s, the U.S. imposed on its largest banks capital adequacy requirements exceeding Basel III. I found that these more stringent rules were adopted because regulators believed that they were necessary to promote financial stability and that they would not adversely affect the competitiveness of large U.S. banks despite the added cost. A supportive economic and political environment contributed to this outcome.

A potential weakness of my study is the use of statements by regulators confirming my chief finding. When justifying regulations, these officials have an incentive to downplay the potential costs. Getting at the sincere views of regulators is difficult. To address this limitation, I looked to additional observable implications that did not have this feature, such as those based on the actions of legislators and the comments of bankers, to support my findings.

As governments grapple with public demands for greater economic and environmental protections, this study provides insights into how regulatory authorities may be able escape the constraints that globalization places on them. One is for regulatory authorities to directly challenge assertions that the gold-plated rules will have a material impact on the competitiveness of local firms. Affected firms will inevitably raise competitiveness concerns as part of their efforts to oppose new regulations. When these are limited to general claims lacking strong empirical support about possible future effects, then policymakers will have greater scope to impose gold-plated rules. A firm’s competitiveness is affected by many factors so that the impact of one gold-plated regulatory measure may not be large enough to materially
disadvantage local firms, even in highly globalized industries. Another lesson for regulatory authorities is to look for appropriate windows of opportunity to push for tougher measures. Businesses whose financial position is healthy and improving are better able to absorb higher compliance costs and will have difficulty demonstrating that their competitiveness is under immediate threat. Regulators are also likely to have more success adopting gold-plated regulations if targeted firms are unpopular with the public, although history has shown that the public’s intense anger can fade quickly, which may leave windows too small to pass gold-plated regulations or, if they are adopted, allow them to be repealed once the public is no longer paying attention.
Chapter 4: Veto Points Under Conditions of High Issue Salience: The Volcker Rule and Post-Crisis U.S. Financial Sector Regulatory Reforms

Institutions play a critical role in shaping national economic policies and accounting for policy differences across countries and issue areas. One institutional feature that has received considerable scholarly attention is veto points, which are decision points in a policymaking process where a proposed policy change must be approved. Along with the closely related concept of veto players, a key finding of this scholarly work is that the likelihood of policy change declines as the number of veto points or veto players increases. This occurs because opponents of policy change are provided with more opportunities to defeat policy proposals or because it is more difficult for policymakers with heterogeneous preferences to locate a new policy that they collectively prefer to the status quo. This finding suggests that policymakers in some countries will find it more difficult than those in others to alter policies in response to changing economic conditions and social forces, and that within countries it may be more difficult to implement policy change in some issue areas than others. This finding has also been

shown to have broader implications on a wide range of political phenomena, such as government duration,\textsuperscript{281} the credibility of public agencies,\textsuperscript{282} and national policy alignment with multinational agreements.\textsuperscript{283}

Independent of the veto points literature, Pepper D. Culpepper\textsuperscript{284} has more recently argued that processes shaping economic policy outcomes may be impacted by the degree of issue salience; that is, how closely the public is paying attention. When issue salience is low, politicians help block proposed policies that business interests do not support. Politicians do so because they seek financial and other resources from the business community to support their electoral efforts and because they rely on businesses for information and expertise to develop policy proposals. When the public is unaware, politicians need not fear the electoral consequences of supporting policies favoring business priorities. Conditions of high issue salience generate a different political dynamic. When the public is paying attention, often the result of greater media attention prompted by a crisis, politicians will be less willing to act on behalf of business interests to block policies they do not like. This is because under conditions of high issue salience, politicians must be responsive to public preferences to avoid harsh criticisms that could adversely affect their electoral prospects.

\textsuperscript{281} Tsebilis 2002, Chapter 9.
\textsuperscript{284} 2011.
Culpepper’s seemingly simple insight calls for a re-examination of the logic of veto points and, in particular, consideration of whether veto points have the same impact on economic policy outcomes under conditions of low and high issue salience. The central task of my paper is to bring together these two bodies of work. The veto points framework assumes that veto points act as barriers to policy change. This assertion is reasonable when issue salience is low, since politicians can be more responsive to interest groups preferring the status quo when the public is unaware of policy developments. However, when issue salience is high, preserving the status quo may not be popular with the public if the reason for the heightened attention is due to a crisis. In this case, an angry public will demand policy change to prevent future crises from occurring. I argue that under the conditions of high issue salience and public demands for an end to the status quo, pro-reformers may be able to use veto points to bring about tangible policy change. Politicians need to respond to the public’s preference for change if they want to avoid public criticism that could harm their electoral prospects. This creates opportunities for pro-reformers to use veto points to get what they want by withholding support from policies they find inadequate.

To support my argument, I show that the Volcker Rule, a signature piece of the post-2009 financial sector regulatory reforms in the United States, owes its existence and strength to the effective use of veto points by pro-reformers, who pushed for tougher measures to regulate, monitor and enforce the financial sector. In January 2010, President Obama put the Volcker Rule on the reform agenda by stating that it was essential to the administration’s efforts to rein in reckless behavior by the banks, a position he repeated often in the period leading to passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010. Senators
Merkley (D-OR) and Levin (D-MI) ensured tough legislative wording in the Dodd-Frank Act and Commissioners Gensler, Chilton and Stein ensured tough measures in the final rule, which was adopted in December 2013. These efforts were aided by timely civil charges filed against Goldman Sachs and large trading losses at JP Morgan Chase, which were widely covered by the media and used by pro-reformers to illustrate the need for the Volcker Rule. Paul Volcker, former Chair of the Federal Reserve, played a crucial role formulating the initial policy, advocating for its inclusion in the Dodd-Frank Act, and threatening to withhold public support for anything less than a meaningful rule.

My analysis is based in part on contemporaneous media reports, speeches and memoirs of key participants. In addition, about 50 interviews with current and former regulators, congressional members, aides and staff, industry executives and representatives of civil society organizations were conducted between September and December 2018, mostly in Washington, D.C. (Details are found in the appendix.)

The chief contribution of my paper is to demonstrate how strategic actors are able to use veto points to bring about policy change. Under specific conditions—high issue salience and a public demanding change—pro-reformers may be able to use their ability to prevent the passage of symbolic policy proposals as leverage to bring about tangible policy change. The use of veto points to facilitate (rather than to constrain) policy change has received little attention in the

comparative politics literature on veto points and veto players. A second contribution is a detailed examination of the political factors leading to implementation of a key financial reform that followed the 2007-09 financial crisis. The Volcker Rule is an interesting case because, despite widespread public support for greater regulation of the banking sector,\textsuperscript{286} many of the conditions often associated with policy change were absent: financial experts were divided on the need for the Volcker Rule, the U.S. Department of Treasury opposed it, the regulatory agencies were lukewarm at best on the idea, the large banks lobbied heavily against it, and the rule is highly technical and not easily explained. While the Volcker Rule has received scholarly attention from lawyers,\textsuperscript{287} it has been largely overlooked by political scientists and thus we lack a clear understanding about how proponents of the Volcker Rule were able to use the political process to bring about a major policy change opposed by powerful interests.\textsuperscript{288} Further, I examine all three phases of the policymaking process that produced the Volcker Rule – agenda setting, legislation, and rule-writing – while other contributions have more limited coverage.

The chapter is divided into four sections. The first section reviews the concept of veto points and how it has been applied to economic policymaking. The second section lays out my argument about how veto points can be used by strategic actors to promote policy change under conditions of high issue salience and public demands for change. The third section examines the

\textsuperscript{286} Bowman, 2018, p. 13.
development of the Volcker Rule. This section begins with a description of the Volcker Rule and a discussion of its importance. This is followed by a detailed examination of three key veto points in the policymaking process: agenda setting, passage of the legislation, and adoption of the final rule. The political dynamics at each veto point are examined to show how pro-reformers were able to exploit veto points to push through tangible policy change over the opposition of the large banks and the U.S. Treasury Department. Lastly, the fourth section summarizes my findings and identifies future avenues of research.

4.1 Veto Points

Veto points are decision points in a policymaking process where a proposed policy change must be approved. Most policymaking processes have multiple veto points, which arise from constitutional rules and from formal and informal practices adopted by decision-making bodies. Constitutional rules set out the entities with legal authority in a polity to pass or overturn a policy change and, to some extent, the rules by which decisions are made. Formal practices are rules adopted by the decision-making bodies themselves that further codify decision-making processes. These rules are not specified by a country’s constitution and can be changed by a body’s membership. An example is the U.S. Senate’s cloture rule, which requires the approval

---

of at least 60 senators to limit debate in order for a bill to proceed to a floor vote. Informal practices are unwritten norms that guide decision-making procedures. An example of an informal rule is the Hastert rule in the U.S. House of Representatives, a rule adopted by House Republicans requiring a majority of the party when in power to support a bill before it can proceed. Because policymaking processes are composed of multiple steps, it may take months or even years for a proposed policy change to clear all veto points. For instance, the Volcker Rule was placed onto the reform agenda in January 2010, but the final rule was not formally adopted until December 2013, a span of almost four years. The time dimension can be important because a proposed policy change initiated in a period of high issue salience may not pass through all the veto points before fading from the public’s attention or facing a change in the partisan composition of decision-making bodies.

Veto points provide opportunities for opponents to block a proposed policy change. When a proposed policy change reaches a veto point, interest groups that do not support the policy appeal to participants in the policymaking process to reject it. Interest group power is not so much a function of their material resources but rather their ability to access these veto points. In general, as the number of veto points increases, the likelihood of policy change decreases. This is because opposition groups are afforded more opportunities – more “kicks at the can” – to defeat proposed policy changes. As well, the transaction cost associated with policy development and implementation increases with the number of veto points by forcing

---

290 Immergut 1990, pp. 397-98. Because Immergut examined the influence of comparable interest groups (the medical lobby) in three countries, she does not consider the possibility that some societal groups may be better able to exploit veto points than others. For instance, many argue that business groups wield greater power than consumer groups. See Lindblom 1977 and 1982.
policymakers to deal with the same issues at multiple spots in the policymaking process and by requiring policymakers to address a wider range of demands by affected parties. Another complication is that more veto points are often (though not necessarily) associated with longer policymaking periods, which allows for changes in the political environment in which policy decisions are made. A decline in issue salience or a change in the partisan composition of decision-making bodies in favor of those preferring the status quo are two examples of changes to the policy environment that reduce the potential for policy change.

Veto points are similar but not identical to veto players, which are defined as “an individual or collective actor whose agreement is required for policy decisions.” 291 Both veto points and veto players provide opportunities for opponents to defeat proposed policy changes and both argue that the potential for policy change declines as their numbers increase. 292 Further, veto players are often the principal actors at veto points. A key difference between them is their analytical focus. The veto points framework places greater emphasis on the preferences and behavior of interest groups, and on their interaction with political actors, thereby facilitating “a wider analysis of political agency around these key decision-making junctures.” 293 Tsebelis, the principal architect of veto player theory, acknowledges the importance of interest groups in the policymaking process but does not incorporate them into his work. 294 In practice, the veto point

292 Veto player theory also predicts that the potential for policy change decreases as the ideological distance between veto players increases and with the cohesion of policy positions among the constituent units making up a collective veto player. See Tsebelis 1995 and 2002.
approach calls on researchers to detect the reasons for defeated policy changes by looking at
critical junctures, rather than building and testing formal theories about the likelihood policy
change occurring.\textsuperscript{295} This means that veto points are better used as a framework of analysis to
understand particular policy outcomes than as a predictive theory. Indeed, detailed qualitative
case studies tend to employ the veto points framework,\textsuperscript{296} whereas large-n quantitative studies
rely much more on the veto player approach. A second key difference of particular importance
to quantitative studies is how the number of veto points or veto players is counted. Under
reasonable scenarios, the number of veto points in a particular policy area may be more or less
than the number of veto players.\textsuperscript{297}

The use of veto points and veto players as analytical frames are part of a broader research
program on the role of institutions in shaping economic policies, with a particular focus on the
ability of governments to enact policies to deal with exogenous economic shocks and to account
for policy differences among countries responding to common economic forces. Some of the
specific economic policies this literature has addressed include: welfare spending,\textsuperscript{298} income

inequality, budget structures, health care, trade, electricity infrastructure, taxation, central bank gold sales, capital controls, and monetary institutions. The veto points and veto player literature has also sought to generate insights into other policies and political phenomena, including: the protection of migratory birds in Canada and the U.S., party funding in Germany, waste packaging in Europe, hospital autonomy reforms in Malwi, legislative

309 Koss 2008.
310 Haverland 2000.
311 Tambulasi 2015.
output, education, judicial reform, climate change, conflict and terrorist activity, civil wars, and environmental compliance costs.

The comparative politics literature on veto points and veto players has largely focused on how they act as barriers to policy change, with empirical studies providing strong support for the theory’s core prediction: the likelihood of policy change declines as the number of veto points or veto players increase. However, given that this is a probabilistic relationship—veto points and players do not necessarily prevent policy change—it is surprising how little attention has been paid to how political actors may be able to overcome these barriers. A notable exception is Birchfield and Crepez, who argue that not all veto points are equal. They find that collective veto points, which occur in “institutions where the different political actors operate in the same body and whose members interact with each other on a face to face basis,” facilitate policy change because they have a shared responsibility for governing. In contrast, and consistent with other studies, competitive veto points, which occur “when different political actors operate

through separate institutions with mutual veto power,” tend to inhibit policy change.\textsuperscript{319} Another exception is the experience of transition economies, where more veto points and players have been shown to be associated with larger policy changes.\textsuperscript{320} Gehlbach and Malesky theorize that this may have happened because under certain circumstances special interests may find it too expensive to compensate veto players to maintain the status quo as the number of veto players increases.\textsuperscript{321} Lastly, Vogel argues that veto points may help to bring about policy change because they provide more access points for supporters of diffused interests to have their voices heard.\textsuperscript{322}

The American politics literature on vetoes has also identified conditions where veto points can be overcome. Keith Krehbiel, for example, argues that legislative gridlock can be avoided if the status quo is extreme relative to the ideal points of the president and the filibuster veto in the Senate.\textsuperscript{323} Likewise, Charles Cameron argues that bargaining in an environment of incomplete information can lead to legislative change when government is divided.\textsuperscript{324}

This paper further explores how veto points can be overcome by asking whether the political dynamics of policymaking differ under conditions of low and high issue salience, a question that has not been addressed by the existing literature. The next section takes up this question and

\textsuperscript{321} 2010.
\textsuperscript{324} \textit{Veto Bargaining: Presidents and the Politics of Negative Power} (New York: Cambridge University Press, 2000).
argues that under conditions of high issue salience and a public unhappy with the status quo, veto points can facilitate rather than hinder policy change.

4.2 Veto Points under High Issue Salience

This section describes how issue salience changes the political dynamic at veto points for two pivotal groups: pro-reformers and pro-status quo. I argue that high issue salience and a public demanding policy change make it difficult for policymakers to support the status quo and, thus, lessens their ability to block policy change. However, the expected type of policy change will depend on the capabilities of those pushing substantive policy change. If pro-reformers lack the ability to block policy proposals, then a symbolic policy change is likely. If, instead, pro-reformers are able to block policy proposals, then a tangible policy is expected. This is because pro-reformers can block a symbolic policy change, the preferred option of the pro-status quo group when issue salience is high, leaving them with the choice of accepting a tangible policy change or no change at all. When issue salience is high and the public demands change, the pro-status quo group, particularly moderates, fear being blamed if proposed policy reforms are defeated and thus accept a tangible policy change.

4.2.1 How does issue salience change the political dynamics at veto points?

The extant literature on veto points offers theoretical and empirical support that veto points tend to preserve the status quo by providing opponents of proposed a policy change with opportunities to defeat it. Multiple veto points along a policymaking process provide opponents more
opportunities to stop policy proposals they do not support, and multiple veto players at any given veto point make it difficult to craft new policies satisfying the preferences of all players. *Central to both propositions about veto points acting as barriers to policy change is that policymakers are prepared to continue with the status quo.* This assertion is reasonable when issue salience is low—when the public is neither aware of nor cares about an issue—but it does not hold if issue salience is high and the public is demanding policy change. When the public is not paying attention, elected officials and the media are more likely to defer to the expertise of issue-area participants.\(^{325}\) This is because many issue areas are highly technical and it is costly for the media and elected officials to develop the necessary policy expertise to understand, report on or support policy change. Reliance on entrenched interest groups for expertise makes policymakers more receptive to their positions, as well as providing these groups with advanced notice of proposed policy changes and privileged access to the policymaking process.\(^{326}\) Further, proponents of the status quo are often collectively concentrated and face large individual costs if an existing policy is changed whereas the beneficiaries tend to be collectively dispersed and enjoy only small individual benefits.\(^{327}\) This provides opponents of policy change greater incentive to make their voices heard, and the lack of public scrutiny makes it easier for policymakers to respond to their demands. Scholars have provided ample evidence that these factors have made it difficult to put in place regulations opposed by the financial sector.\(^{328}\)

\(^{325}\) Culpepper 2011.

\(^{326}\) Johnson and Kwak 2010, Bell and Hindamoor 2015.

\(^{327}\) Olson 1965 and Stigler 1971.

\(^{328}\) Johnson and Kwak 2010, Moschella and Tsigou 2013 and Helleiner 2014.
Issue salience increases following crises due to extensive media coverage. This tends to be accompanied by criticism of existing policies, which are seen to be a cause of the current crisis, hampering efforts to deal with the crisis, or insufficient to prevent future crises. Mobilization efforts by political entrepreneurs offer another way to increase the salience of an issue, although their efforts are particularly effective after a crisis, which provides a focal point for the policy changes they seek. When the public begins to pay attention to an issue, elected officials find it difficult to remain uninformed about the issue or to defend the status quo. The media, constituents adversely affected by the crisis, and pro-reform groups will question elected officials about their positions on the crisis, who will find it easier to answer these questions if they acknowledge problems with the status quo and offer (or at least support) new policies. With issue salience high, elected officials direct their staff to keep them briefed on the issue, to accept meetings with pro-reform groups and constituents affected by the crisis, and to develop new policies where they can claim credit. At the same time, groups benefiting from the status quo have less access to the policymaking process as elected officials distance themselves from these now unpopular groups. Further, their status as subject experts is undermined by their association with the crisis.\(^{329}\)

Because high issue salience is often prompted by a crisis, electoral considerations are not the only factor motivating policymakers to seek (or at least be more willing to accept) policy change. A change in their sincere beliefs about what policies will best deliver the outcome they desire may occur as well. Crises reveal deficiencies in existing policies, which make policymakers

\(^{329}\) Culpepper 2011, p. 179.
more receptive to new ideas as they seek answers as to why the crisis occurred and how it could have been prevented. For electoral officials, most of whom have limited understanding of complex policy areas such as financial services, this may lead to new sincere beliefs about what policies work best. In the case of banking, politicians may be more willing to place tougher rules on banks after a crisis in the belief that this will help prevent future crises.

Unelected policymakers, such as the heads of regulatory agencies, also behave differently under conditions of high issue salience. Their actions are closely scrutinized by the media, forcing regulators to acknowledge the possibility that their actions (or inactions) contributed to the crisis. Further, elected officials attempt to deflect blame onto regulators by criticizing them publicly in the media, speeches, press releases and letters to agency heads, as well as during committee hearings. This puts regulators on the defensive, opening space for the consideration of alternative policies. Their own reflections on the causes of the crisis may also lead to changes in regulators’ sincere beliefs about the policies best able to produce desired outcomes. Lastly, the heads of regulatory agencies may be replaced by new officials whose policy beliefs are more closely aligned with the new policy priorities of elected officials.

In sum, the policymaking environment is markedly different when issue salience is high and a public demanding a break from the status quo. When the public is paying attention, politicians face unwanted criticism of their support of current policies or of resisting policy change popular with the public—criticism that may undermine electoral support in primaries or elections. Likewise, unelected policymakers face public rebuke or replacement if they continue to defend the status quo. The different political environment upends a central premise of the veto point
framework; namely, that rejecting policy change enhances, or at least does not harm, the electoral prospects of politicians and the autonomy and reputation of regulators. If the public demands policy change and elected officials fear harsh criticism if they defend the status quo, as is the case when issue salience is high, then power shifts from those supporting the status quo to those advocating for policy change. This is because doing nothing may prompt criticism of their policy stance, which may have primary or electoral consequences. Pro-reform legislators and advocacy groups will call out defenders of the status quo for their unwillingness to make changes demanded by the public at a time when the public is paying attention. Likewise, if regulators fear that their autonomy and reputation will be undermined by defending the status quo, then they will become more receptive to policy change.

4.2.2 **Symbolic or tangible policy change?**

When the status quo is no longer tenable, policymakers have two options to respond to the public’s demand for policy change. The first is to embrace *symbolic policies*—policies designed to give the appearance of change to the public but that do not address the underlying problem in a substantive way.³³⁰ A symbolic policy is one where the enacting legislation or agency rule has an ambiguous objective, lacks clear obligations for behavioral changes by targeted actors, and does not provide adequate resources to agencies to monitor or enforce compliance. Symbolic policies satisfy the publics’ demand for change when they are unable to assess the effectiveness of policy proposals, either because the public lacks the knowledge to make this judgement for

---

themselves or, more likely, because credible arbiters of policy effectiveness have not emerged. Symbolic policies are favored by policymakers who are largely satisfied with the status quo but who fear being seen defending it. Policymakers may be satisfied with the status quo out of sincere beliefs and/or because they represent or are supported by constituencies benefitting from the status quo. We will refer to these policymakers as the pro-status quo group, and they tend to be largely composed of ideological moderates and conservatives.

A second option available to policymakers is to seek tangible policies, which are policies that are designed to address the root problem of an issue area through meaningful regulatory change. A tangible policy has a clear objective, contains specific obligations for behavioral change by affected parties, and provides adequate resources for monitoring and enforcement. Tangible policies are favored by policymakers who sincerely believe in the need for meaningful policy change and/or because they represent or are supported by constituencies harmed by the status quo. We will refer to these policymakers as the pro-reform group, and they tend to be largely composed of economic progressives.

The shift from a low to high issue salience environment has an asymmetrical effect on the policy preferences of the two groups. For the pro-reform group, there is no change. This group is composed of policymakers who have typically been long-time advocates of tougher regulation but who lack the ability to bring it about during periods of low issue salience. Their policy preference ordering when issue salience is low is: tangible policy change > status quo > symbolic policy change. The status quo is preferred to symbolic policy change because pro-reformers do not want to sanction the appearance of change when in fact little will take place. When issue
salience is high, the policy preference ordering of the pro-reform group does not change: the status quo is still preferred to a symbolic policy change. Why? In a period of high issue salience, pro-reformers do not fear electoral repercussions of supporting the status quo over a symbolic policy change because they can claim credit for standing up to proponents of the status quo. This is possible because much of their electoral support comes from constituents seeking substantive policy change or taking their cues from policy change advocates.

In contrast, high issue salience results in a different preference ordering for the pro-status quo group:

- Low issue salience: status quo > symbolic policy change > tangible policy change
- High issue salience: symbolic policy change > tangible policy change > status quo

When issue salience is low, the pro-status quo group prefers the least amount of change. However, when issue salience is high and the public demands change, then the status quo becomes the least preferred option because of the public’s dislike of current policies and the need of the pro-status quo group to be seen to be responding to these concerns. Symbolic policy change is preferred to tangible policy change because it allows the pro-status quo group to claim credit for responding to public demand without altering current practices in a meaningful way.

This part of my argument contains a surprising prediction: of the two pivotal groups, the pro-status quo group fears the status quo more than the pro-reform group when issue salience is high and the public demands change.³³¹ Spatial theory would suggest that this should not happen.

³³¹ Paul Quirk identified this anomaly.
This is the result of the asymmetrical effect of high issue salience and a public demanding change on the expected payoffs of each group. In the case of the pro-reform group, accepting a symbolic policy change would be seen as capitulating to industry interests, making them vulnerable to charges of being unwilling to fight for tough regulation. Their reputation among key supporters is enhanced by their unwillingness to go along with symbolic policy change. In the case of the pro-status quo group, particularly moderates, they fear being blamed for continuation of the status quo at a time when the public is paying attention and wants change. In effect, under these new conditions, they are worse off by sticking with their initial ideal point, i.e., the status quo.

The type of expected policy change depends on the degree of issue salience and on the ability of the pro-reform group to block policies they do not support at veto points (see Table 4.1 on next page). Under conditions of low issue salience, pro-reformers face tremendous challenges to secure policy change because the pro-status quo group is able to use veto points to block it. This is because policymakers do not pay a penalty for supporting the status quo when issue salience is low. The public is not paying attention nor is making demands for policy change so the political environment is favorable to business interests. This is not to say that policy change cannot occur when issue salience is low, but rather that veto points lessen the possibility of policy change when the public is unaware.

\[332\] For example, a change in elite opinion in the absence of high issue salience drove policy change favorable to consumers in the trucking, airline and telecommunications industries in the 1970s. See Derthick and Quirk 1985.
Table 4.1: Expected Policy Outcomes

<table>
<thead>
<tr>
<th>Capability of Pro-reform Group</th>
<th>Issue Salience &amp; Public Demanding Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Low</td>
</tr>
<tr>
<td>No Veto Power</td>
<td>Status quo</td>
</tr>
<tr>
<td>Veto Power</td>
<td>Status quo</td>
</tr>
</tbody>
</table>

* Veto power = ability of pro-reformers to block a policy proposal.

The political dynamics at veto points change when issue salience is high and the public demands policy change because the status quo becomes less attractive to the pro-status quo group. Elected officials must take action, or at least be seen to be taking action, or they risk severe criticism that may have electoral consequences. However, the likely policy outcome in this new political environment depends on the capabilities of the pro-reform group and, in particular, their ability to block policy proposals. *If the pro-reform group lacks the ability to block a proposed policy, then symbolic policies are expected to be adopted.* Why? A symbolic policy change is expected because: (i) the pro-status quo group benefits from being able to claim credit for implementing a policy change, even a symbolic one; (ii) most of the public is unable to differentiate between a symbolic and tangible policy change, which is often the case in highly technical policy areas such as banking; and (iii) the pro-reform group is unable to block adoption of a symbolic policy. Under these conditions, the pro-status quo group has an advantage over the pro-reform group in securing their policy preference, making a symbolic policy change more likely.

However, *if the pro-reform group has the ability to block a symbolic policy change, then a tangible policy is expected.* In this case, a symbolic policy change is not possible because the pro-reform group will not allow it. The pro-reform group is able to threaten blockage without
upsetting their supporters by justifying this action as preventing the adoption of an ineffective policy. Standing firm against “window dressing” efforts will appeal to their constituents. When they do so, this leaves the pro-status quo group the choice: accept a tangible policy change or use their veto power to preserve the status quo. The symbolic policy option is no longer available. But under conditions of high issue salience, the status quo option is less attractive than tangible policy change because doing nothing will harm their electoral prospects since the public expects a response to the crisis. Moderates, who tend to support the status quo over big policy changes, are especially vulnerable. High issue salience is likely to have the biggest impact on their constituents since they tend to be less ideological and less partisan than those backing politicians on the far left or right, and thus are receptive to the arguments of policy change advocates in the immediate post-crisis period. Further, moderates will remain vulnerable to criticisms from pro-reformers by the occurrence of refocusing events, which are incidents well covered by the media that remind the public about the problems associated with the crisis, such as a scandal or large trading loss at a bank. Refocusing events offset the tendency of issue salience to decline before a policy clears all the veto points in the policymaking process.

In sum, veto points are less of a barrier to policy change when issue salience is high and the public wants to break with the status quo. The type of policy change—symbolic or tangible—depends on the capabilities of the pro-reform group. If the pro-reform group does not have veto power, then symbolic policy change is expected. If the pro-reform group has veto power, then

333 Political supporters of the status-quo coalition will be unpersuaded by this argument. They will continue to see the symbolic policy as being effective because of motivated reasoning, party cues or other factors beyond the scope of this paper.
tangible policy change is expected. This is because those supporting the status quo, particularly moderates, cannot afford to defend the status quo when the public is aware of an issue and wants change, and a symbolic policy change can be blocked by the pro-reformers.

4.3 Volcker Rule

In this section I first define the Volcker Rule, demonstrate its significance and describe the policymaking process associated with the post-2009 financial sector reforms. I then provide a detailed analysis of three major veto points through which the Volcker Rule traversed, showing how progressive Democrats were able to use them to bring about tangible policy change.334 The first veto point involved placing the Volcker Rule on the reform agenda. Despite being proposed in January 2009 and having the support of political advisors in the Obama administration, the Volcker Rule was not part of the Treasury’s proposed reforms (June 2009), the first reform bill tabled in the Senate (November 2009), nor the bill passed by the House (December 2009). Over opposition by Treasury, President Obama insisted in January 2010 that the Volcker Rule be part of the financial sector regulatory reforms, although he left it to Treasury and Congress to determine the precise wording. The second key veto point occurred at the conference committee to reconcile the House and Senate bills (June 2010). Progressive Democrats were able to use this veto point to block Treasury’s attempt to insert weak legislative language into the final Act. The third key veto point came in Fall 2013 when regulators were under tremendous pressure from the

334 The Volcker Rule passed through more than three veto points. I focus on the ones that advanced a meaningful Volcker Rule. Other veto points are referenced in the discussion but are of less interest because they did not contribute to the outcome I am seeking to explain.
White House to issue the final rule. Democratic commissioners at the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) were able to use this veto point to secure a strong rule despite significant opposition from the largest banks and generally lackluster support from the agencies themselves.

### 4.3.1 What is the Volcker Rule?

The Volcker Rule is set out in Section 619 of the Dodd-Frank Act and in a joint set of rules issued by several regulatory agencies. Its primary goals are to constrain risk-taking by large banks and to limit conflicts of interest in their dealings with clients. The Rule prohibits banks from engaging in proprietary trading and severely restricts their ability to invest in hedge and private equity funds. Proprietary trading occurs when banks engage in the purchase or sale of securities on their own behalf. Banks trade securities to profit from short-term price changes, facilitate underwriting activities, support market-making activities, and hedge risk exposures.

The Volcker Rule is intended to stop banks from engaging in speculative short-term trading while still permitting them to buy and sell securities as part of their underwriting, market-making and hedging activities—activities that are explicitly permitted by the Dodd-Frank Act. The line between these activities is not clear-cut, which makes it difficult to craft precise rules permitting “good” trading but prohibiting “bad” trading. Hedge funds and private equity funds

---


337 Section 619 (d).
are co-mingled funds that often use leverage and hold illiquid securities, and are considered high-risk investments. They could also be used to circumvent restrictions on proprietary trading. Banks invest in hedge and private equity funds for profit and to support their asset management businesses. The latter requires “seed capital” to launch new funds and uses co-investment in the funds to attract outside investors. The challenge for regulators is to write rules that meet two competing objectives: to allow legitimate business activities that meet client needs and support well-functioning capital markets, and to prohibit activities that pose significant risks to banks and the financial system.

Estimates of the cost of the Volcker Rule to the large banks vary widely but are all large. Standard & Poor’s, a credit rating agency, estimated that the Volcker Rule could reduce profits at the largest eight banks by $2-10 billion per year. Financial analysts covering individual banks estimated that overall revenues for the each of the largest banks would decline by 2-15 percent, depending on the bank. Trading revenues reported by the largest banks have dropped sharply since 2009. The Office of the Comptroller of the Currency (OCC) estimated that the industry would face annual administrative costs of $400-500 million to comply with the reporting and

338 The sources of variation depend on what is counted and assumptions regarding how rules will be interpreted by regulators and how banks will react to them.
340 The largest decline (in relative and absolute terms) was for Goldman Sachs, which according to financial analysts, could expect revenues to decline by about $4.5 billion. Sanati 2010.
341 The biggest declines have been to revenues from fixed income, commodities and currency (FICC) activities. Fixed income is where much of the Volcker Rule regulations hit hardest. For the largest global banks, FICC revenues declined by almost 50 percent between 2009 and 2014. There are many factors behind this decline—more stringent capital rules and lower market volatility are two—but the Volcker Rule has been cited as a factor as well. See Boston Consulting Group, “Global Capital Markets 2014: The Quest for Revenue Growth,” May 2014, and Tracy Alloway and Michael MacKenzie, “Finance: The FICC and the Dead,” Financial Times, August 11, 2014.
monitoring requirements of the Volcker Rule. 342 While the expected costs of the Volcker Rule are large, proponents claim that the benefits of “de-risking” large banks more than justify them, although monetary estimates of these benefits have not been prepared.

The Volcker Rule is extraordinarily complex and there was a great deal of contestation during both the legislative and rule-writing phases over the definition of terms, scope of their application, implementation dates, and compliance procedures. Regulators took three and half years to write the final Volcker Rule. At its core, the process pitted progressive Democrats and consumer groups who wanted to crack down on excessive risk-taking by banks against Republicans, large banks and even moderate Democrats, who argued that doing so would undermine the health of U.S. capital markets. 343 The final Rule was issued in December 2013 with most of the rules coming into effect in July 2015. 344 The importance of the Volcker Rule is summed up nicely by a former Treasury official, “You’d have to go back to the New Deal for a rule that would have as profound an impact on financial markets as the Volcker Rule. If you add it all together, it’s going to increase costs, decrease revenue and profits and potentially scare off your most productive employees.” 345

---

342 The OCC also estimated that the banks could face one-time loses of up to $3.6 billion from divesting from covered funds, although this probably did not happen given the continued recovery in asset prices and the willingness of the Fed to extend the divestment date. OCC, “Analysis of 12 CFR Part 44,” March 20, 2014.

343 To some degree, the fight over the Volcker Rule was a proxy for reinstatement of the Glass-Steagall Act, a proposal that was never seriously considered during the legislative phase. As Shelia Bair remarked when the final Volcker Rule was issued, “It might have been easier to restore Glass Steagall. But there was not enough political support for that.” Cited in Peter Eavis and Ben Protess, “Pressure Builds to Finish Volcker Rule on Wall St. Oversight,” New York Times, November 17, 2013.

344 The Volcker Rule officially came into effect in April 2014 but the Fed extended the conformance date to July 2015.

The Volcker Rule is a signature piece of the Dodd-Frank Act. Other key measures in the Dodd-Frank Act are the creation of two new agencies (the Financial Stability Oversight Council (FSOC) and the Consumer Financial Protection Bureau (CFPB)), tougher prudential measures (including higher capital requirements) for large financial institutions, the introduction of a new resolution regime to deal with the bankruptcy of non-deposit-taking institutions, regulation of over-the-counter derivatives, limits on the Federal Reserve’s emergency lending authority, and an overhaul residential mortgage rules. Each part targets one or more supervisory lapses, industry practices or regulatory inadequacies that were seen to be causes of the financial crisis. The Dodd-Frank Act is the most far-reaching and complex piece of financial sector legislation since the 1930s, running close to 900 pages and requiring regulators to undertake 88 studies and to write 398 rules.\textsuperscript{346}

\textbf{4.3.2 The U.S. policymaking process}

The U.S. policymaking process is fragmented with a number of veto points. All U.S. legislation must be approved by the Senate, the House of Representatives and the President to become law. This gives each body the opportunity to propose or reject legislation. During the period in which the Dodd-Frank Act was under consideration by Congress—approximately June 2009 to July 2010—the Democrats held the Presidency and controlled the House. Democrats also held a supermajority in the Senate until January 2010, when Scott Brown (R-MA) was elected to take

\textsuperscript{346} Davis Polk, \textit{Dodd-Frank Progress Report}, September 2013. Reference is often made to the Dodd-Frank Act running over 2,000 pages but this figure refers to the large-font congressional bills used during mark-up.
the seat vacated by Edward Kennedy (D-MA). This left the Democrats with 59 seats, which required them to secure the support of at least one Republican senator to pass financial sector reforms. In addition, there was a sizeable contingent of moderate Democrats in both the House and Senate who were wary of the far-reaching changes sought by progressive Democrats, including the Volcker Rule.

Additional fragmentation of the policymaking process comes from the need for multiple regulatory agencies to write detailed rules to implement financial legislation and from the varied decision-making structures at these agencies. Despite its length, the Dodd-Frank Act delegates considerable rule-making authority to regulatory agencies. Indeed, noted legal scholar John Coffee Jr. describes the Dodd-Frank Act as a “skeletal structure with few affirmative commands and is heavily dependent on administrative implementation.” As a result, the strength of the Volcker Rule is determined not only by the legislative wording in the Act but also by the final rules approved by the regulatory agencies. A second complicating factor is that multiple agencies had to jointly approve the Volcker Rule, each with its own mission, culture and decision-making procedures. The five agencies were the three primary prudential regulators (the Federal Reserve (the Fed), the Federal Deposit Insurance Corporation (FDIC) and the OCC) and the two principal market regulators (the SEC and the CFTC).

Efforts to reform U.S. financial sector legislation were located in four arenas. The first was the U.S Treasury, which led the administration’s efforts. Timothy Geithner, then Treasury secretary, 

347 2012, p. 1065.
and his staff were given considerable autonomy from Obama and his political advisors, though the National Economic Council, headed by Lawrence Summers, provided extensive comments on Treasury’s draft proposals. Treasury released its proposed reforms in June 2009. The second arena of legislative reforms was the House Financial Services Committee, chaired by Representative Barney Frank (D-MA). The HFSC worked closely with Treasury on their bill, which was passed in December 2009. The third arena was the Senate Committee on Banking, Housing and Urban Affairs, chaired by Chris Dodd (D-CT). The Senate Banking Committee worked more independently from Treasury as Dodd sought to craft a bipartisan bill. Unlike the House, where Republicans refused to participate in any meaningful way, Dodd established four bipartisan working groups to develop the Senate bill. While the final Senate bill passed in May 2010 had only four Republican supporters, many important provisions had strong bipartisan support.348 The final legislative arena was the conference committee to reconcile the House and Senate bills, which was held in June 2010.

A surprising feature of the policymaking process to reform U.S. financial sector regulation was the high degree of independence with which major parts of regulatory reforms were developed during the legislative phase.349 Each of the major policy areas, such as consumer protection, resolution mechanisms, derivatives regulation and the Volcker Rule, were negotiated separately.

348 For example, the sections dealing with systemic risk, prudential regulation and resolution mechanisms (Titles I and II), were the product of a compromise between Dodd and Shelby, and were approved by a 93-5 vote.
349 Interview 1, former administration official, September 12, 2018, Interview 2, former congressional staff, September 13, 2018, Interview 6, former congressional staff, September 20, 2018, Interview 9, former congressional staff, September 26, 2018, Interview 11, former administration official, September 27, 2018, Interview 14, former congressional staff, October 1, 2018, Interview 35, former regulator, November 7, 2018, Interview 42, former congressional member, November 19, 2018.
In practice, this meant that while there was considerable deal-making within each area to forge majority support, there were few deals cutting across areas. Participants attribute this to the complexity of the issues, which meant that most legislators, congressional staff and technical experts tended to focus on only a small set of issues. The House bill, in fact, was drafted as a series of 12 bills that were only later merged into a single bill at the request of Dodd, who said that he would never get multiple bills through the Senate.\(^{350}\)

### 4.3.3 Veto point #1: Putting the Volcker Rule on the agenda

The origins of the Volcker Rule lie in a January 2009 report by the Group of 30,\(^{351}\) which offered 18 recommendations to improve the stability of the financial system.\(^ {352}\) One of these called for “[l]arge, systemically important banking institutions […to…] be restricted in undertaking proprietary activities that present particularly high risks and serious conflicts of interest. Sponsorship and management of commingled private pools of capital (that is, hedge and private equity funds in which the banking institutions’ own capital is commingled with client funds) should be prohibited and large proprietary trading should be limited by strict capital and liquidity requirements.”\(^{353}\) Advocates of the Volcker Rule argue that these activities amount to little more than gambling with taxpayer-supported funds, that they are of no benefit to the real economy,

---

\(^{350}\) Interview 9, former regulator, September 26, 2018, Interview 42, former congressional member, Nov. 19, 2018.

\(^{351}\) The G30 is a non-profit international organization composed of academics and senior representatives from the private and public sectors. It frequently issues recommendations to improve the global governance of the international financial system.


\(^{353}\) Group of 30, 2009, p. 28. This proposal was not called the “Volcker Rule” until January 21, 2010. I have used the term retrospectively for clarity proposes.
that they create unacceptable conflicts of interest with clients, and that they foster a culture of trading over intermediation, which presents significant risks to a stable financial system.354 There was a consensus among participants interviewed for this study that positioning the Volcker Rule as a means to prevent banks from gambling with taxpayer funds would be popular with the public, despite some noting that this framing presents an inaccurate picture of what banks actually do and what the Volcker Rule is likely to achieve. As one former regulator put it, the Volcker Rule “became a poster child for preventing banks from doing bad things.”355

Despite Paul Volcker’s status as a former Chair of the Federal Reserve and Chair of President Obama’s Economic Recovery Advisory Board, he had little influence on early policy discussions within the administration on financial sector reform.356 He first presented his ideas on financial reform to the Senate Banking Committee in early February 2009,357 where his call for limits on proprietary trading and investments in hedge and private equity funds garnered little interest.358 Further efforts to advance his proposal in the months following also failed to capture the attention of policymakers. Former congressional staffers and administration officials attribute this to fierce opposition to the idea from Treasury secretary Tim Geithner and National Economic Council director Larry Summers, who actively sought to sideline Volcker from the

354 Interview 16, former regulator, October 2, 2018, Interview 17, former congressional aide, October 4, 2018, Interview 51, knowledgeable expert, December 18, 2018. See also Cassidy 2010 and Merkley and Levin 2011.
355 Interview 19, former regulator, October 9, 2018.
356 Volcker’s apparent lack of influence on the financial sector reform process during 2009 was widely reported by the media. Responding to media reports that Volcker was losing clout, he famously quipped, “I did not have any influence to start with.” Louis Ucitelle, “Volcker Fails to Sell a Bank Strategy,” New York Times, October 21, 2009.
358 Interview 3, former administration official, September 17, 2018.
policy reform process.\textsuperscript{359} Geithner and Summers, who led the administration’s efforts to reform financial sector regulations, opposed the Volcker Rule on the grounds that proprietary trading and investments in hedge and private equity funds were not contributors to the financial crisis, the ban would not have prevented the crisis had it been in place, and the ban could impair market liquidity.\textsuperscript{360} They also believed that the complexity of these activities would necessitate an unworkable set of rules to deal with the many grey areas between permitted and prohibited activities, and that higher capital requirements on large banks—a top priority for Treasury—would prevent the worst excesses without banning legitimate and essential activities.\textsuperscript{361}

The Volcker Rule was not included in the administration’s proposed policy reforms released in June 2009.\textsuperscript{362} Indeed, participants involved with drafting Treasury’s White Paper said that it was never seriously considered.\textsuperscript{363} Paul Volcker was so dismayed by its absence that he refused to attend the media briefing announcing Treasury’s proposed reforms saying that if he was asked whether he supported the proposals he would say “no”\textsuperscript{364} The Volcker Rule was also not part of the first proposed Senate bill (November 2009) nor the final House bill (December 2009), though the former called for a study on proprietary trading (which Merkley intended as a placeholder for stronger measures)\textsuperscript{365} and the latter allowed the Federal Reserve to ban proprietary trading if it

\textsuperscript{359} Interview 6, former congressional staffer, September 20, 2018, Interview 51, knowledgeable expert, December 18, 2018.

\textsuperscript{360} Geithner 2014, p. 414.


\textsuperscript{362} U.S. Treasury, June 17, 2009.

\textsuperscript{363} Interview 3, former administration official, September 17, 2018, Interview 35, former regulator, November 7, 2018, Interview 37, former administration official, November 8, 2011.

\textsuperscript{364} Cassidy 2010.

\textsuperscript{365} Merkley and Levin, 2011, p. 531-33.
was necessary to mitigate existing or foreseeable threats to the large banks or the stability of the U.S. financial system.\textsuperscript{366}

The administration’s position on the Volcker Rule began to shift in Fall 2009. Obama’s approval rating in opinion polls was falling as the economy struggled to recover. There was also growing anger at the banks as they reported high profits and bonuses at a time when the unemployment rate still exceeded 10 percent.\textsuperscript{367} Further, no senior bank executive had been held to account for the economic damage the banks had caused. It was also becoming clear to Obama’s political advisors that the health care reforms were unlikely to give the Democrats a lift in the polls. With a view to the 2010 mid-term Congressional elections, still a year away, Obama’s key political advisors, plus Vice-President Joseph Biden, pushed for a more populist approach to financial reforms.\textsuperscript{368} The Volcker Rule was seen as attractive for many reasons beyond its prudential value: Paul Volcker was immensely popular with progressive Democrats, whose support was needed to pass reform legislation; the rationale for the rule – to stop banks from gambling with taxpayer-supported funds – could be framed in a way that would resonate with the public; and the Volcker Rule was seen as a consolation prize for progressive Democrats and consumer groups for the absence of structural reforms, such as reinstatement of the Glass-Steagall Act.\textsuperscript{369}

\textsuperscript{366} This is known as the Kanjorski amendment, which was added to the House bill late in the process. Rep. Kanjorski (D-PA) had been speaking with Volcker about his proposal since March 2009. Jonathan Weisman, “Policy Pivot on Banks Followed Months of Wrangling,” \textit{Wall Street Journal}, January 22, 2010.

\textsuperscript{367} Cassidy 2010.

\textsuperscript{368} David Axelrod and Austin Goolsbee, two key Obama advisors, supported the Volcker Rule. They were the key conduits, along with Biden, to placing the proposal before Obama. Interview 11, former administration official, September 27, 2018, Interview 32, former administration official, November 6, 2018, Interview 35, former regulator, November 7, 2018, Interview 47, former administration official, December 6, 2018, Interview 51, knowledgeable expert, December 18, 2018.

\textsuperscript{369} Interview 3, former administration official, September 17, 2019; Interview 4, civil society organization staff, September 18, 2018, Interview 5, Interview 11, former administration official, September 27, 2018, Interview 17,
On October 28, 2009, Obama invited Volcker to meet with Geithner, Summers and Biden. Biden urged Geithner and Summers to support Volcker’s proposal. Obama sided with Biden and instructed Geithner to draft the rule. Obama’s rhetoric against the banks had become more populist around this time, with more emphasis on “demonizing Wall Street.” Volcker met again with Geithner and Summers on December 23 and 24, and at the end of the meetings Geithner agreed to publicly back Volcker’s proposal. A general proposal on the Volcker Rule was sent to Obama in early January, with both Geithner and Summers offering their support, although former administration officials and congressional staff noted that behind the scenes Geithner continued to work against it by pushing for large statutory exemptions and greater discretion for regulators to determine how the rule would be applied, and by lobbying congressional opponents of a tough Volcker Rule to stand their ground.

On January 21, 2010, President Obama announced that the Volcker Rule should be part of the financial reform legislation. The announcement followed closely on the heels of Scott Brown’s surprise victory in the Senate special election in Massachusetts to fill the seat vacated

References:

370 Davis 2010.
371 Interview 32, former administration official, November 6, 2018, Interview 47, former administration official, December 6, 2018 and Interview 51, knowledgeable expert, December 18, 2018.
374 Weisman 2010.
375 Interview 8, former congressional aide, September 26, 2018, Interview 10, former congressional member, September 27, 2018, Interview 11, former administration official, September 27, 2018, Interview 26, former regulator, October 24, 2018, Interview 28, former congressional member, October 31, 2018, Interview 34, former congressional aide, November 7, 2010, and Interview 35, former regulator, November 7, 2018.
by Edward Kennedy. Republicans were highly critical of the proposal, arguing that the Volcker Rule was more about politics than economics.\footnote{Geithner repeatedly denied this charge. When asked by a PBS reporter if the Volcker rule was politically motivated, Geithner responded, “That’s not what’s behind this. […] We provided the recommendations to [Obama] two weeks ago.” Cited in Catherine Rampell, “Geithner on the Bank Proposal,” \textit{New York Times}, January 21, 2010.} Indeed, the media cast the Volcker Rule as a significant break from the more centrist approach of the administration to financial reforms and as a means to shore up its political support.\footnote{Cho and Appelbaum 2010.} Paul Volcker stood behind Obama at the news conference announcing the Volcker Rule but only after first receiving an advanced copy of Obama’s prepared remarks. He was skeptical of the administration’s commitment to bring about a meaningful rule and his attendance was conditional on how it was to be presented. However, without Volcker’s knowledge or consent, Obama’s political advisors altered the President’s remarks at the last minute by calling the proposal the “Volcker Rule” and using more populist language to frame its importance.\footnote{Interview 51, knowledgeable expert, December 18, 2018.}

Obama’s intervention marked a critical point in the process that brought the Volcker Rule in place by forcing Volcker’s proposal onto the reform agenda after being ignored for about a year by Treasury, Dodd and Frank. It was opposed by Treasury and the large banks as both unnecessary and unworkable. Volcker’s proposal was also absent from the initial Senate and final House bills, more because Dodd and Frank thought it lack sufficient support to pass than from opposition to the idea. By giving such prominence to his support for Volcker’s proposal, Obama ensured that Dodd could not leave it out of the Senate bill; doing otherwise risked a White House veto of the overall reform bill. Obama and his political advisors reiterated the
importance of the Volcker Rule to reforming the financial sector as the revised Senate bill proceeded. For instance, when the press reported in late February that Dodd was willing to consider excluding the Volcker Rule from the Senate bill, David Axelrod, one of Obama’s key political advisors and a strong supporter of the Volcker Rule, said “As an administration, we’re as committed to the rule as the day the president announced it.” President Obama later raised the importance of the Volcker Rule as a key reform to safeguard the financial system in a major address on the Wall Street reforms. Obama’s message to Congress was clear: the financial reform bill needed to include a Volcker Rule.

Obama’s decision to label the proposal the “Volcker Rule,” and to have Paul Volcker stand beside him when the policy was announced, also made it difficult for Congress to ignore his proposal. Paul Volcker had emerged as a “folk hero” among Democrats pushing for much tougher regulation of the large banks. By tying Volcker so closely to the financial reforms, Obama ensured that any legislation lacking Volcker’s imprimatur would not be supported by progressive Democrats; in effect, Volcker’s approval would signal meaningful regulatory reform. This meant that Dodd could not ignore the Volcker Rule. If the final bill did not address proprietary trading and investments in hedge and private equity funds, then Paul Volcker would be unlikely to support the bill and Dodd would have difficult passing it.

---

In sum, faced with declining popularity, and poor electoral prospects for Democrats in the upcoming 2010 mid-term election, President Obama acted against the early advice of his Treasury secretary and key economic advisor to propose a significant policy change. If Obama had not forced the Volcker Rule onto the reform agenda, it is unlikely to have become part of the Dodd-Frank Act. However, while Obama’s actions all but guaranteed a Volcker Rule would be enacted, continued opposition from Treasury and lukewarm support by regulators could have resulted in weak legislative wording amounting to little more than a symbolic policy. Thus, the debate shifted from whether a Volcker Rule should be included in the Dodd-Frank Act to what form it should take. As we will see in the next section, it took the concerted efforts of a couple of Democratic senators, aided by timely charges laid by the SEC against Goldman Sachs, to create the conditions that ensured the Volcker Rule became a tangible part of the Dodd-Frank Act.

4.3.4 Veto point #2: Enacting the Volcker Rule

Both Dodd and Frank, while cautiously supportive of the Volcker Rule, were unhappy about the timing of Obama’s announcement. Frank said that if he had known the administration was going to push this proposal, he would have included it in the House bill passed just five weeks earlier. He was also unsure if he had the votes, since it was not popular with moderate Democrats. Dodd was similarly conflicted. While he publicly supported the proposal, he

---

383 Interview 48, former congressional member, December 10, 2018.
384 Interview 6, former congressional staff; September 20, 2018, Interview 42, former congressional member, November 19, 2018.
also said, “…it does come up late, and the idea that the administration made such a major point a week or so ago, seemed to many to be transparently political and not substantive. And it’s adding to the problem of trying to get the bill done. I don’t want to go to the floor of the United States Senate begging for the 60th vote. I’m not going to do that.”

Progressive Democrats were elated and quickly coalesced their support for the Volcker Rule. Senator Merkley contacted Volcker shortly after Obama’s announcement offering to champion it in the Senate. Merkley, at the time a little-known senator, then enlisted the help of Senator Carl Levin, a well-respected chair of the Permanent Subcommittee on Investigations, to back his efforts. Merkley and Levin, with later assistance from Senator Jack Reed (D-RI), were instrumental in securing a strong Volcker Rule in the Dodd-Frank Act. They took advantage of the spike in media coverage arising from SEC charges against Goldman Sachs to draw attention to the Volcker Rule. Merkley and Levin also helped to frame the Volcker Rule as a means to stop the banks from gambling with funds backed by taxpayers. These efforts hampered Treasury’s efforts to insert weak language into the provision setting out the Volcker Rule by casting doubt on the willingness of progressive Democrats to support the Dodd-Frank Act if a meaningful Volcker Rule was not included.

Competing visions regarding the content of the Volcker Rule soon emerged after Obama’s announcement. On one side was Treasury, which was now forced to accept that a Volcker Rule


386 Interview 51, knowledgeable expert, December 18, 2010.
had to be part of the final reforms, but who nevertheless worked to make it as weak as possible. As one former administrative official put it, “Treasury always vehemently opposed the Volcker Rule.” Their legislative proposals sought to narrow the scope of the Volcker Rule by limiting which entities, instruments and activities would be covered, and by pushing for regulators and Treasury to have considerable discretion over whether and how the regulations would be written, applied and enforced. On the other side were Merkley, Levin and Volcker, who directed their staff to develop legislative wording that would ensure a meaningful Volcker Rule. These two efforts operated largely independent of each other until the last stages of the legislative process. In part this was because Merkley and Levin were not members of the Senate Banking Committee, which oversaw efforts to draft the Senate bill on financial reform.

Soon after Obama’s announcement, Treasury worked closely with the Senate Banking Committee to draft legislative language for the Volcker Rule. In February and March, there were media reports that Dodd was prepared to accept a weak Volcker Rule to secure the necessary votes for the Senate bill. On March 4, 2010, Treasury provided the Senate Banking Committee with text that would have limited coverage and provided only the authority but not the obligation to agencies to regulate proprietary trading. In response, Merkley and Levin, along with three other Democratic senators, proposed the Protect our Recovery through Oversight of Proprietary (PROP) Trading Act on March 10, 2010. The bill had the support of

387 Interview 11, former administration official, September 27, 2010.
388 Interview 9, former congressional staff, September 27, 2018, Interview 17, former congressional aide, October 4, 2018, Interview 51, knowledgeable expert, December 18, 2018.
390 Merkley and Levin 2011, p. 534.
Paul Volcker and consumer groups but was never tabled on the Senate floor. Dodd released the Senate’s financial reform bill a week later. While the bill contained provisions for a Volcker Rule that were stronger than what Treasury proposed, progressive Democrats and consumer groups felt it did not go far enough.391

Efforts to secure a tougher Volcker Rule were given a boost on April 16, 2010, when the SEC filed civil charges against Goldman Sachs, a large U.S. investment bank, for improprieties related to the structuring and trading of securities linked to sub-prime mortgages.392 Merkley immediately issued a statement using Goldman Sachs’ alleged misdeeds as justification for a tough Volcker Rule.393 Two weeks later, Levin’s Permanent Subcommittee on Investigations held hearings on the Goldman Sachs charges, which provided a platform to further promote the need for the type of Volcker Rule sought by Merkley and Levin.394 Levin also raised the case at the regular Tuesday meeting of Democratic senators to call for their backing of a tough Volcker Rule.395 While not all policymakers nor financial experts agreed that Goldman Sachs’ behavior supported the case for the Volcker Rule, they all considered the SEC’s charges as a pivotal event

391 Interview 8, former congressional aide, September 26, 2018. See also Merkley and Levin 2011, p. 535.
392 The case involved alleged misstatements and omitted facts related to the issuance of ABACUS-2007-AC1, a synthetic collateralized debt obligation (CDO) structured at the request of a hedge fund to allow a short position to be taken against the security. Without admitting to any wrongdoing, Goldman settled the case in July 2010 and agreed to pay a $550 million penalty. See SEC, “Goldman Sachs to Pay Record $550 million to Settle SEC Charges Related to Subprime Mortgage CDO, Press Release, July 15, 2010.
395 Interview 37, former administration official, November 8, 2010.
that changed the tenor of the debate. As one former Senate staffer put it, “Levin’s hearings rekindled everyone’s anger at the big banks. This helped to hold-off lobbying pressure to kill the Volcker Rule.” A former congressional aide added that the Levin hearings were key to “keeping the Volcker Rule alive” by changing the media narrative that banks were not only gambling with taxpayer funds but that they were also betting against their own clients. This was a “powerful narrative to push the Volcker Rule forward” and “provided significant ammunition for staffers to use against opponents”. This made it more difficult for moderate Democrats to oppose a tough Volcker Rule.

Once the Senate reform bill reached the floor, Merkley and Levin proposed an amendment in line with the PROP Trading Act. The amendment was supported by Paul Volcker and had the backing of Dodd. The first attempt to have a vote on the Merkley-Levin amendment died when Senate Republicans refused to allow a vote on it. Dodd and Richard Shelby (R-AL), the ranking Republican member on the Senate Banking Committee, had agreed that no amendments would be considered without bipartisan support. Merkley and Levin then “offered a second-degree amendment to an unrelated pending amendment” backed by Republicans, which its

396 Interview 17, former congressional aide, October 4, 2018, Interview 18, former regulator, October 9, 2018, Interview 37, former administration official, November 8, 2018, Interview 43, former regulator, November 20, 2018, Interview 45, industry official, November 28, 2018.
397 Interview 5, regulator, September 18, 2018.
398 Interview 17, former congressional aide, October 4, 2018.
399 Interview 48, former congressional member, December 10, 2018.
400 Merkley and Levin 2011, p. 537.
402 Interview 9, former congressional staff, September 26, 2018.
Republican sponsors promptly pulled. The Senate bill, which contained a weak version of the Volcker Rule, passed with the support of four Republican votes. Scott Brown was one of them, but only after he got assurances that the Volcker Rule would not restrict the investment options of Massachusetts’ based financial institutions.

Proponents of a tough Volcker Rule continued to press their case in the conference committee to reconcile the House and Senate bills in June 2010. Behind the scenes there were extensive discussions between Merkley and Levin on one side and Treasury and Scott Brown on the other. Jack Reed was also involved since neither Merkley nor Levin were conference committee participants. Merkley and Levin sent their preferred language to Treasury, which had been prepared in consultation with Volcker. Volcker was not directly involved in the negotiations but was consulted frequently by Merkley and Levin. Brown sought three changes: (i) asset managers and insurance companies would be exempt from the Volcker Rule; (ii) banks would be permitted to invest in hedge and private equity funds under some conditions; and (iii) banks would have up to seven years to divest from prohibited funds. These measures were important to Fidelity Investments and State Street, two large Boston-based financial institutions, and Brown wanted to claim credit for delivering them. At the same time, Brown was supportive of the overall Senate bill—it was popular in Massachusetts—and he was aware that asking for too

404 Javers and Budoff Brown 2010.
405 Interview 8, former congressional aide, September 26, 2018, Interview 51, knowledgeable expert, Dec. 18, 2018.
406 Interview 34, former congressional aide, November 7, 2018, Interview 51, knowledgeable expert, Dec. 18, 2018.
407 Interview 8, former congressional aide, September 26, 2018.
much could threaten passage of the bill in the Senate. The other two likely Republican supporters of the final bill, Senators Susan Collins (R-ME) and Olympia Snowe (R-ME), had other priorities for what they wanted in the bill and were not active participants in discussions on the Volcker Rule.

Treasury, which sought a weak Volcker Rule, revised the text provided by Merkley and Levin to reflect Brown’s and their own preferences. While the Democratic leadership signed off on the wording, Reed rejected it after consulting with Merkley and Levin. The Volcker Rule was one of the last items to be addressed by the conference committee and Reed’s rejection prevented the reform bill from moving forward. He also indicated that, without stronger provisions, progressive Democrats could withhold their support for the final bill. Further negotiations ensued, with discussions about the amount of hedge and private equity funds that banks would be able to hold proving to be especially difficult. After two hours of heated discussion a compromise was reached to toughen the legislative language on the Volcker Rule. This included a lower statutory exemption for investments in hedge and private equity funds and less regulatory discretion about what activities would be covered by the rule than what Treasury sought. Volcker agreed to the legislative compromise, though he later admitted that, “The [rule] went from what is best to what could be passed.”

408 Interview 6, former congressional staff, September 20, 2018, Interview 34, former congressional aide, November 7, 2018.
409 Interview 8, former congressional staff, September 26, 2018.
410 Interview 37, former administration official, November 8, 2018.
411 Interview 8, former congressional staff, September 26, 2018.
412 Interview 51, knowledgeable expert, December 18, 2018. See also Kaiser 2013, p. 347.
413 Uchitelle 2010.
In sum, Obama’s support for the Volcker Rule ensured that some kind of Volcker Rule would be part of the Dodd-Frank Act; the efforts of Merkley and Levin ensured that the legislative wording was meaningful. They were helped by the civil charges against Goldman Sachs filed by the SEC, which was widely covered by the media and provided a vivid account of the type of unseemly bank conduct the Volcker Rule was intended to prevent. But as the legislative process neared completion, the Volcker Rule took on another role. For progressive Democrats, the Volcker Rule, along with other key measures such as the CFPB and derivatives regulation, became a litmus test of the Democratic leadership’s resolve to pass meaningful policy reforms.\footnote{Interview 37, former administration official, November 8, 2018.}

Progressive Democrats were able to use their threat to withhold support for the final bill to ensure that a meaningful Volcker Rule was contained in the Dodd-Frank Act.

Attaching Volcker’s name to the rule gave him a degree of veto power over its content.\footnote{Interview 51, knowledgeable expert, December 18, 2018. See also, Cassidy 2010.} The Volcker Rule deals with activities that are extraordinarily complex and assessing the expected impact of any set of proposed rules was beyond the ability of most legislators. As a result, Volcker’s support amounted to a “good housekeeping seal of approval” among progressive Democrats.\footnote{In practice, there were six key people progressive Democrats looked to for affirmation of the legislative wording: Merkley and his senior aide Andrew Green, Levin and his senior aide Tyler Gellasch, and Volcker and his senior aide Anthony Dowd.}

The administration also knew that passing a reform bill without Volcker’s support would cast doubt on its efforts to address the problems revealed by the financial crisis. But Volcker’s veto power had limits because of the need for Dodd to secure the support of at least
some Republicans to pass the Senate bill. This opened the door for Brown to win concessions for his constituents, though he too faced constraints. Even with Treasury’s backing, Brown believed that pushing too hard against the Volcker Rule could lead to a defeat of the entire reform bill, a bill he largely supported and that was popular in his home state. Brown believed that his prospects for re-election in two years would suffer if he were held responsible for the Dodd-Frank Act not passing.417

4.3.5 Veto point #3: Implementing the Volcker Rule

The Volcker Rule became a key part of the Dodd-Frank Act, which was signed into law by President Obama on July 21, 2010. But before the Volcker Rule could enter into force, the Act first instructed the Financial Stability Oversight Council (FSOC) to prepare recommendations to guide the development of the regulations. These were released on January 18, 2011.418 The Act then required the three prudential regulators (the Fed, FDIC, OCC) and the two market regulators (SEC, CFTC) to draft a common set of rules.419 This gave each agency a veto over the final rule, although the location of the veto within each agency depended on their governance structure. The head of the OCC has the sole authority to approve new rules. At the Fed and FDIC, new rules are approved by their Boards. On regulatory matters, these boards tend approve

417 Interview 34, former congressional aide, November 8, 2018.
418 Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge & Private Equity Funds.
419 In fact, the Dodd-Frank Act permits each of the five agencies to issue separate rules, provided they consult with the others. However, the agencies agreed to issue a common set of rules to ensure their consistent application. Interview 38, industry official, November 8, 2018.
recommendations made by the senior agency official proposing the rule.\footnote{Interview 49, former regulator, December 11, 2018.} The SEC and CFTC are governed by five-member bipartisan commissions, with proposed rules requiring majority approval. Commissioners are appointed by the president, with three of the five selected from the president’s party. As we will see, the governing structure of the market regulators, along with a significant market loss at JPMorgan Chase that received extensive media coverage and that undermined the credibility of a key opponent and pressure from the White House to complete the rule by a specific time, enabled progressive Democrats to secure a tough Volcker Rule despite considerable industry opposition and generally lackluster support from Treasury and the regulatory agencies themselves.

The process to draft the Volcker Rule was long and laborious, taking more than three years to finish. The first proposal was issued on October 11, 2011,\footnote{OCC et al. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, October 2011.} although it was far from complete. The proposal was over 500 pages and contained hundreds of questions for stakeholders on issues where regulators could not agree. By one count, there were 1,300 questions on 400 topics.\footnote{James B. Stewart, “Volcker Rule, Once Simple, Now Boggles,” New York Times, October 21, 2011.} In effect, it became a dumping ground for controversial provisions.\footnote{Ben Protess, “Volcker Rule Divides Regulators,” New York Times, October 16, 2011.} Despite extensive lobbying by the financial sector prior to the draft rules being released,\footnote{According to Krawiec and Liu 2015, the regulatory agencies held 448 meetings to discuss the Volcker Rule between July 2010 and October 2011. The vast majority were with individual financial institutions or trade groups and law firms representing them. Only 19 were held with public interest groups. There were a further 948 meetings after the draft Rule had been issued. Public interest groups were more active during this period, meeting with regulators on 108 occasions, although this still only accounted for about 11 percent of the meetings regulators held with interested parties.} banks argued that the proposed rules went too far: they would reduce market liquidity, raise borrowing costs, slow economic

\footnote{}
growth and put U.S. banks at a competitive disadvantage. A bank-sponsored study released shortly afterwards estimated that the Volcker Rule, by reducing market liquidity, would cost investors $10 billion to $315 billion in one-time market losses, would increase investors’ annual trading costs by $1 billion to $4 billion, and would raise borrowing costs to U.S. corporate issuers by $2 billion to $43 billion per year. Foreign governments were also highly critical of the proposal, especially Canada, Japan and the EU. They felt that the Volcker Rule had significant extraterritorial reach, which would prevent their own banks from engaging in activities permitted by home-country regulations, and that the Rule could reduce liquidity in their government bonds.

Progressive Democrats and consumer groups complained that the proposed regulations did not go far enough. Many wanted the Volcker Rule scrapped entirely in favor of reinstating the Glass-Steagall Act, which would ban all investment banking activities by commercial banks. Others wanted the complexity reduced so that banks could not game them. Among them was Paul Volcker, who said, “I’d write a much simpler bill. I’d love to see a four-page bill that bans

426 Oliver Wyman, “The Volcker Rule Restrictions on Proprietary Trading,” February 2012. In Congressional testimony, Daniel Tarullo dismissed these findings by saying “I think we all need to be a little wary of the false precision that is sometimes associated with analytical advocacy.” Mary Schapiro, head of the SEC, echoed this view: “It is not clear to me how well grounded that study is.” Cited in Shahien Nasirpour, “Fed Seeks to Allay Volcker Rule Concerns,” Financial Times, January 18, 2012a.
proprietary trading and makes the board and chief executive responsible for compliance.”

Frank made similar comments in testimony to the House Financial Services Committee.

Progressives got a major boost in their push for tougher rules in May 2012 after JPMorgan Chase revealed that it lost $6.5 billion on its risk management activities (the “London Whale” incident). It re-ignited media coverage and public interest in the Volcker Rule by providing a concrete example of the risks associated with proprietary trading. It also undermined the credibility of a key opponent. To this point, JPMorgan Chase had enjoyed the best reputation among the large banks with policymakers because it had weathered the financial crisis well, had not been associated with any major scandal, and had cooperated with policymakers as they worked to limit the damage arising from the failure of other banks during the depths of the financial crisis. Jamie Dimon, JPMorgan Chase’s Chief Executive Officer, had been the leading industry critic of the Volcker Rule but his credibility was seriously eroded by the trading loss. Dimon acknowledged as much when he said that the incident “plays right into the hands of a whole bunch of pundits out there.” Progressives frequently brought up the “London Whale” in their calls for a tough Volcker Rule and many insiders cite the “London Whale” as a pivotal event in bringing about a tough Volcker Rule.

428 Stewart 2011.
430 It acquired this label from the nickname of the trader (Bruno Iksil) involved with the losses. JPMorgan Chase originally reported losses of $2 billion but the final figure was $6.5 billion. The bank was later fined $920 million by the OCC for poor internal controls and misleading statements to regulators. Jesse Hamilton and Cheyenne Hopkins, “Volcker Rule Costs Tallied as U.S. Regulators Press Deadline,” Bloomberg, September 30, 2013.
432 Interview 17, former congressional aide, October 4, 2018, Interview 18, former regulator, October 9, 2018, Interview 19, former regulator, October 9, 2018, Interview 20, former regulator, October 10, 2018, Interview 21, former regulator, October 15, 2018, Interview 38, industry official, November 8, 2018, Interview 43, former
“London Whale” undermined talking points from opponents that only a weak Volcker Rule was necessary.\textsuperscript{433} A former regulator added that it provided “fuel injection during a key period when decisions were being made. Memories were fading and this brought concerns back to the front. […] It came at a good time to strengthen the regulations. Banks had mostly recovered, the financial system was stable and TARP monies had mostly been paid back.”\textsuperscript{434}

The biggest impact of the “London Whale” was to support the case for stricter rules on banks’ hedging activities. Under the proposed rules, banks would have been able to hedge on an “aggregate” or “portfolio” basis, which would allow them to net risks exposures and hedge multiple risks at once. Industry officials and regulators privately said that the “London Whale” trades would have been permitted under the proposed rules.\textsuperscript{435} In contrast, progressives wanted each hedge to be for a specific risk and for the banks to demonstrate that the hedging strategy and the risk being hedged were correlated. As we will see, the “London Whale” incident, by keeping the issue of proprietary trading in the public eye, and by providing a specific example of how lax rules can lead to problems, helped those regulators to defeat the aggregate hedging approach.

Work on the final Volcker Rule dragged on for another 18 months. This was due to several factors. One was the overall complexity of the issue. While the legislative language drew a

\begin{flushleft}
\small
\textsuperscript{433} Interview 17, former congressional aide, October 4, 2018.
\textsuperscript{434} Interview 48, former congressional member, December 10, 2018.
\end{flushleft}
clear line between proprietary trading (prohibited) and market-making and hedging activities (permitted), in practice these activities overlap.\textsuperscript{436} This required regulators to address hundreds of hypothetical situations identified by practitioners.\textsuperscript{437} Another challenge was forging a consensus among agencies serving different purposes. As two former regulators put it, in admittedly simplified and exaggerated ways:

The FDIC is an insurance company and wants to avoid failures at all costs. The OCC is a chartering authority and wants to encourage banks to charter nationally. It has no responsibility for liquidation. The Fed worries about markets and systemic stability. It worries about regulatory effects on bank activities. […] The SEC focuses on broker dealers and their dealings with clients. They seek smooth market operations and clear disclosure.\textsuperscript{438}

The agencies have different cultures and missions. They do not speak the same language. The SEC is disclosure based and is willing to let institutions engage in risky behavior so long as they disclose it. The SEC wants firms to have the right to do bad things so long as it is disclosed. This conflicted with bank regulators who wanted some activities prohibited. The agencies have different ways of looking at the world. Where you stand on an issue depends on where you sit.\textsuperscript{439}

These operational and cultural differences led to different views about what form the rules should take. A third challenge was the large number of rules that the agencies were required to write by the Dodd-Frank Act—by one count almost 400.\textsuperscript{440} With limited resources the agencies had to prioritize which ones should be written first. Apart from the FDIC, the Volcker Rule was not a priority because it was seen as a cumbersome, heavy-handed way to contain systemic

\textsuperscript{436} Interview 16, former regulator, October 2, 2018. Underscoring this view is Jamie Dimon’s famous quip: “If you want to be trading you have to have a lawyer and a psychiatrist sitting next to you determining what was your intent every time you did something.” Quoted in Ben Portess, “Jamie Dimon Shows Some Love for the Volcker Rule,” \textit{New York Times}, May 21, 2012.
\textsuperscript{437} Interview 19, former regulator, October 9, 2018, Interview 48, former congressional member, December 10, 2018.
\textsuperscript{438} Interview 16, former regulator, October 2, 2018.
\textsuperscript{439} Interview 19, former regulator, October 9, 2018.
\textsuperscript{440} Davis Polk 2013.
It was not a priority for Geithner either, who remained Treasury secretary and head of the FSOC until January 2013.

In August 2013, three years after President Obama signed the Dodd-Frank Act into law, he called on the five regulators to complete their work writing the rules to implement the Act. He and progressive Democrats were growing frustrated by the fact that about one-third of the regulations required by the Dodd-Frank Act had yet to be issued. A month later Jack Lew, the new Treasury Secretary, met with the heads of the five regulatory agencies to establish a timetable to finalize the Volcker Rule and other outstanding regulations by year-end. He later gave cover to regulators to make compromises on the Volcker Rule by calling on them to “err on the side of doing a little more and then correct it if you’ve gone too far.” The importance of the Volcker Rule to Obama and Lew was that it had become a proxy for the lack of progress on implementing the Dodd-Frank. In this way, the Volcker Rule not only represented a commitment by the administration to take a hard line on the banks but by Fall 2013 it took on larger symbolic importance by representing the administration’s commitment to fully

441 Interview 16, former regulator, October 2, 2018, Interview 20, former regulator, October 10, 2018, Interview 24, former congressional staff, October 23, 2018, Interview 26, former regulator, October 24, 2018, Interview 38, industry official, November 8, 2018, Interview 39, former regulator, November 13, 2018, Interview 49, former regulator, December 11, 2018.
443 Davis Polk 2013.
444 Hamilton and Hopkins 2013.
446 For example, Senators Merkley and Levin (joined by 20 other Democratic senators) sent a letter to the regulators complaining that the “ongoing failure to implement [the Volcker Rule] has left […] our economy of greater risk of another financial crisis.” Scott Patterson, “Senators Criticize Volcker Rule Delays,” Wall Street Journal, October 25, 2012.
implementing the Dodd-Frank Act.\textsuperscript{447} Several insiders credit pressure from the White House to forcing the agencies to overcome their differences.\textsuperscript{448} As one regulator put in bluntly, “Jack Lew’s efforts helped to push it over the finish line. He made it clear that it was a White House priority.”\textsuperscript{449}

In November 2013, as the Volcker Rule was being finalized, Democratic commissioners at the SEC and CFTC went public with their views that the draft wording was inadequate. At the SEC, Kara Stein, a newly appointed commissioner, said that she would vote against the Rule unless the hedging exemption was tightened to establish a tighter link between hedging strategies and the assets being hedged.\textsuperscript{450} The draft circulating at the time had removed the “reasonably correlated” language from the hedging exemption rule, a move supported by the banks and the Fed.\textsuperscript{451} Stein also pushed for tighter compensation rules on traders involved in market-making and hedging activities, and CEO attestation of compliance with the Volcker Rule.\textsuperscript{452} Her efforts were backed by Merkley and Levin, who continued to advocate for strong regulations.\textsuperscript{453} Paul Volcker also made himself available to the media to support these efforts.\textsuperscript{454} Without Stein’s support, it would be difficult to get the three votes needed for the SEC to pass the Rule.

\begin{flushright}
\textsuperscript{448} Interview 15, regulator, October 1, 2018. Interview 17, former congressional aide, October 4, 2018, Interview 49, former regulator, December 11, 2018.
\textsuperscript{449} Interview 15, regulator, October 1, 2018.
\textsuperscript{450} Eavis and Protess 2013 and Patterson and Ackerman 2013.
\textsuperscript{451} Ibid.
\textsuperscript{452} Eavis and Protess 2013.
\textsuperscript{453} Patterson and Ackerman, 2013.
\textsuperscript{454} Interview 51, knowledgeable expert, December 18, 2018.
\end{flushright}
Support for a stronger Volcker Rule also came from Bart Chilton, a Democratic commissioner of the CFTC, working closely with CFTC Chair Gary Gensler, another a Democratic appointee.\textsuperscript{455} They not only supported Stein’s call for tougher hedging rules but also sought to tighten rules on market-making activities and to make it more difficult for U.S. banks to engage in prohibited activities in their foreign operations.\textsuperscript{456} These issues were discussed and largely rejected by the other agencies at a meeting of the FSOC. Weaker language on these provisions was then sent to Chilton, who refused to support them.\textsuperscript{457} He went public with his concerns, saying he would not support the Volcker Rule in its current form.\textsuperscript{458} This threatened adoption of the final rule since Gensler needed Chilton’s support for CFTC approval and the two Republican commissioners opposed any Volcker Rule. Faced with this stalemate, and pressure from President Obama and Treasury secretary Lew to have the Volcker Rule completed before year-end, the other agencies relented, giving Stein and Chilton much of what they wanted.\textsuperscript{459} The five regulatory agencies jointly issued their tougher-than-expected Volcker Rule on December 10, 2013.

In sum, Stein, Chilton and Gensler succeeded in strengthening the Volcker Rule because it could not go ahead without their support and there was tremendous pressure to finalize the Rule by the end of 2013. This gave them veto power at a critical juncture in the development of the Volcker Rule. Their position was strengthened by the “London Whale” incident, which not only brought

\footnotesize
\textsuperscript{455} Gensler’s criticisms of the Volcker Rule infuriated the prudential regulators, who believed that his objections should have been raised earlier. The CFTC had not been closely involved in the Rule’s development and only became engaged as the deadline to vote on the Rule was nearing. Scott Paterson, “Regulators Divided Over ‘Volcker Rule,’ Weigh Going it Alone,” \textit{Wall Street Journal}, November 22, 2013 and Andrew Ackerman, “Gensler’s Last-Minute Gamble Pays Off,” \textit{Wall Street Journal}, December 10, 2013.
\textsuperscript{456} Ackerman 2013.
\textsuperscript{457} Interview 21, former regulator, October 15, 2018 and Interview 49, former regulator, December 11, 2018.
\textsuperscript{458} Interview 21, former regulator, October 15, 2018. See also Paterson 2013.
\textsuperscript{459} Interview 21, former regulator, October 15, 2018.
renewed media attention and public interest to the Volcker Rule, but also undermined the credibility of a key opponent. Prior to the rule-writing phase, the Volcker Rule had already become a measure of the administration’s willingness to adopt policies opposed by the large banks. The Volcker Rule continued to play this role during the rule-writing process but took on added significance as a marker of the administration’s commitment to implementing the Dodd-Frank Act in full.

### 4.4 Conclusion

The Volcker Rule overcame many obstacles to become a key part of the financial reforms put in place by the U.S. following the 2007-09 financial crisis. The Volcker Rule was opposed by the large banks and the U.S. Treasury, had few friends within the regulatory agencies, and financial experts were divided on its usefulness. Successful implementation of a meaningful Volcker Rule lay in the ability of proponents to exploit veto points under conditions of high issue salience and a public demanding change. At key junctures in the agenda setting, legislative and rule-writing phases of the policymaking process, progressive Democrats and their allies were able exploit veto points under conditions of high issue salience to extract tougher measures. This was possible because sticking with the status quo was not an option for policymakers, and pro-reformers – and Paul Volcker in particular – defined what degree of change was acceptable. The strategic use of veto points to bring about policy change has received little attention from the extant literature on veto points and veto players, which has instead emphasized their role as barriers to policy change. My finding supports Culpepper’s assertion that the political dynamics
of policymaking differ under conditions of low and high issue salience and demonstrates that issue salience has relevance to the impact of veto points on the likelihood of policy change.

It is worth noting that even under conditions of high issue salience and a public demanding change, pro-reformers face limits on their ability to use veto points to bring about tangible policy change. Three strategies helped their efforts. First, Paul Volcker, supported by Senators Merkley and Levin and their staff, functioned as political entrepreneurs. Not only did they provide technical expertise to develop the proposal and to address the concerns of critics, but they were also instrumental in framing its importance in the public sphere in a way that resonated with average voters: the need to stop banks from gambling with taxpayer-supported funds. The importance of their role as political entrepreneurs, however, is not as extensive as that played by Elizabeth Warren with respect to creating the CFPB.\(^\text{460}\)

Second, pro-reformers were able to take advantage of two key mis-steps by the large banks to reignite media attention and interest in the Volcker Rule, even if many financial experts believed that the problems revealed by the Goldman Sachs and JPMorgan Chase incidents were unrelated to the activities that the Volcker Rule was designed to prevent.\(^\text{461}\) Both events received extensive media coverage and re.awakened public attention to the misdeeds of the large banks. Through speeches, media interviews and committee hearings, pro-reformers used these events to remind

\(^{460}\) Kastner 2018.
\(^{461}\) Interview 36, knowledgeable expert, November 7, 2018.
the public about the importance of a tough Volcker Rule to meaningful regulatory reforms of U.S. banks.

Third, the Volcker Rule was positioned as a measure of the administration’s commitment to being tough on the banks. The public was angry at the large banks and wanted to see their ability to take risk pared back. There were also persistent doubts about the willingness of policymakers to enact policies opposed by the large banks and the Volcker Rule became a litmus test of the administration’s willingness to do just that. This framing by pro-reformers made it difficult for policymakers to reject the Volcker Rule, despite opposition from Treasury. This framing also helped to put moderates in an untenable position: if they stayed firmly behind a weak Volcker Rule, and this led pro-reformers to pull their support for the Dodd-Frank Act, then it would be the moderates and not the pro-reformers who would take the blame for the defeat of the financial reforms.

A question beyond the scope of this paper is why other proposed reforms popular with the public failed to result in tangible regulations. In other words, why were progressive Democrats able to exploit veto points to bring about a tough Volcker Rule but were unable to secure, for example, adoption of Obama’s proposed Financial Crisis Responsibility Fee, another proposal popular with the public. The simple answer is that progressive Democrats were unable to secure legislative support from moderates. But this, of course, raises the question: Why were

---

462 On January 14, 2010, President Obama proposed the Financial Crisis Responsibility Fee, a special tax on the large banks to raise about $90 billion over 10 years to offset the cost of the Troubled Asset Relief Program. The tax was never adopted.
moderates unwilling to support these proposals? Part of the explanation likely lies in the
difficulty of proposing any new taxes, which is a non-starter for Republicans and even for some
moderate Democrats. All Republicans have signed pledges to not increase taxes and fear they
would not survive primary challenges if they supported one. Underscoring this point, a last-
minute special assessment on the largest banks to ensure that the Dodd-Frank Act would be
revenue neutral was rejected by Scott Brown, forcing the conference bill to be re-opened to allow
an alternative funding mechanism to be put in place. However, even if Senate Democrats had
not needed Republican support, insiders noted that a special tax on the banks had little support
among moderate Democrats. The same was true in the House, where the sizeable New
Democrat Coalition, a grouping of business-friendly Democrats, did not support a special tax on
the banks. Further examination of progressive initiatives failing to secure the support of
moderates would augment the scope conditions under which pro-reformers are able to exploit
veto points to bring about tangible policy change.

463 The Congressional Budget Office scored the Dodd-Frank Act as costing taxpayers approximately $20 billion
over 10 years. Most of this was linked to the imputed cost to Treasury of a line of credit to be extended to the FDIC
to support the new resolution mechanism. To pay for it, a special assessment on the large banks was inserted into
the conference bill at the last minute. Brown found out about the levy after the conference had closed and said that
he would no longer support the bill unless it was removed. The conference bill was briefly re-opened on June 29 to
replace the special assessment with an alternative funding that relied on a non-cash accounting maneuver.
464 Interview 1, former congressional staff, September 12, 2018, Interview 2, former congressional staff, September
13, 2018, Interview 23, civil society organization staff, October 18, 2018, Interview 32, former administration
official, November 6, 2018, Interview 33, former congressional aide, November 6, 2018, Interview 38, industry
official, November 8, 2018, Interview 40, civil society organization staff, November 11, 2018, Interview 43, former
regulator, November 20, 2018, Interview 44, former congressional staff, November 21, 2018, Interview 47, former
administration official, December 6, 2018, Interview 48, former congressional member, December 10, 2018.
465 Interview 23, civil society organization staff, October 18, 2018, Interview 32, former administration official,
November 6, 2018, Interview 38, industry official, 2018, Interview 42, former congressional member, November 19,
2018, Interview 47, former administration official, December 6, 2018.
Another question warranting further investigation is the degree to which the argument advanced in my paper travels beyond financial services regulation. A useful effort in this regard might be to revisit one or more quantitative studies on veto points or players where the data set can be divided into low and high issue salience periods or issue areas. For my argument to hold, the estimated impact of veto points or veto players on policy change should be statistically different under conditions of low and high issue salience, with high issue salience periods or issue areas being associated with a higher likelihood of policy change if also accompanied by a public unhappy with the status quo. Additional qualitative studies would add to our knowledge of how the causal mechanisms work. One fruitful area here would be to examine policymaking after major transportation or environmental accidents, which tend to be periods of high issue salience and public demand for policy change.

In closing, the Volcker Rule shows that business interests do not always win. The banking industry devoted considerable efforts to keeping the Volcker Rule out of the Dodd-Frank Act, and failing that, to limit its reach and impact. While they secured some wins, the Volcker Rule as adopted and implemented was a major defeat. My findings add to a broader body of literature that has identified conditions that constrain business influence.466 I have contributed to this work by showing that veto points, under conditions of high issue salience and a public demanding

change, provide opportunities for pro-reformers to bring about meaningful change even when strongly opposed by business interests.
Chapter 5: Conclusion

A commonly held view is that large banks occupy a privileged position in the policymaking process because of their considerable instrumental and structural power. The media tends to focus on the army of bank lobbyists plying Congressional hallways, the ease with which they are able to secure meetings with key policymakers and their staff, and the large amount of campaign funds they funnel to elected officials, directly and through their political action committees. Much is also made of the “revolving door” as professionals move back and forth between banks and the agencies that regulate them. Scholars focus on these channels of influence too, but also on the structural power of banks, which results from the “capture” of policymakers by the entities they regulate. Capture occurs when policymakers internalize the policy preferences of banks because of their importance to economic activity or for cultural reasons, such as a belief that bankers are the “smartest people in the room” or a desire to have amicable relations in their interactions with bankers. Both forms of power can lead to regulations that advance the interests of banks more than those of the public.

My dissertation both confirms and refutes this popular trope. The first paper (Chapter 2) shows that the desire to stabilize the financial sector following the events of September 15, 2008, and recognition of the crucial role played by institutional investors to make this happen, helped to limit the types of reforms policymakers were willing to consider. Policymakers were not lobbied by institutional investors nor did they meet with them. Instead, policymakers favored policies that would restore confidence in the financial sector and opposed policies that could make bank securities unattractive to investors. This did not stop regulatory change from happening, but it
did limit the scale and scope of what took place. Other factors contributed to this result as well but the key contribution of my first paper is to identify an additional mechanism to explain why the financial reforms that followed the 2007-09 financial crisis brought about only incremental rather than transformational change.

My second two papers focus on the limits of large banks to prevent the adoption of policies they oppose. Paper two (Chapter 3) documents the importance U.S. policymakers attach to maintaining the competitiveness of the financial sector, which scholars have identified as a potential barrier to passing tough regulations. However, I find that this concern did not prevent the U.S. from imposing capital adequacy requirements on large U.S. banks exceeding international standards. The main reason for this was that policymakers did not believe these gold-plated rules would adversely affect U.S. financial institutions and markets. Competitiveness concerns by the large banks could be more easily dismissed because U.S. banks were in better financial shape than their chief international rivals and because the large banks remained unpopular with the public.

My third paper (Chapter 4) challenges the notion that veto points exclusively aid reform opponents. I show that under conditions of high issue salience and a public that wants an end to the status quo, pro-reformers can use veto points to bring about policies opposed by the banks. At three critical junctures in the policymaking process, pro-reformers were able to push forward the Volcker Rule, a policy strongly opposed by the banks because it prohibited proprietary trading and placed limits on investment in hedge and private equity funds. Two conditions must be met for veto points to be exploited by pro-reformers. First, the public must be aware of the
issue and want a break from the status quo. Second, the pro-reform coalition must be able to block symbolic policy changes.

Several implications of the three papers are worth highlighting. First, the findings of my latter two papers (Chapter 3 and 4) add to a growing body of literature that has sought to identify conditions that limit the influence of the business community on policy outcomes. These conditions fall into six categories: economic circumstances, distribution and intensity of interests, ideas, economic institutions, political institutions and public awareness (see Table 5.1 at end of chapter). These conditions seldom work alone; indeed, cases of policy outcomes that have gone against the preferences of powerful business groups frequently have two or more conditions present. Because policymakers have some ability to tailor policy details—for example, when they are proposed, their scope of application, and transition measures—a greater understanding of the circumstances of when and where these conditions are likely to be present, and of how they interact with each other, would aid policymakers in delivering policies that better reflect public preferences.

Second, my findings highlight the complexity of financial sector regulations and the forces that shape them. Scholars of regulation often seek to assess the overall character of the regulatory regime governing a particular industry or activity, but this focus can mask considerable variation within a regulatory regime. My dissertation has shown that while the post-2009 reforms failed to bring in transformational change, it did deliver a number of meaningful changes to specific areas while largely ignoring others. Table 5.2 (at end of chapter) shows the patchwork character of the post-2009 policy reforms in the United States. Many political scientists would likely speculate
that this variation is attributable to legislative bargains, where strong regulation of some activities was accepted in exchange for weaker regulation of others. However, this was not the case. In the United States, at least, there is a high degree of segmentation in the development of particular regulations. Efforts to bring about the CFPB, for instance, were largely independent of efforts to establish a new resolution regime. Likewise, there was little interaction between efforts to put in place tougher capital adequacy rules and development of the Volcker Rule. The same can be said of international regulatory standards, where independent standard-setting bodies with jurisdiction over different financial institutions and markets operate with a high degree of autonomy, though consultation among them has improved with the creation of the Financial Stability Board in 2009. One implication of regulatory segmentation is that there does not appear to be a “grand theory” to account for variation within regulatory regimes. Idiosyncratic factors are important, which may explain why, for instance, scholars of international financial regulatory standards have predominantly focused on the political processes shaping particular regulations, such as capital standards, accounting standards, and macroprudential regulation. Another implication is that more comparative work, particularly across regulatory areas, could help to develop mid-level theories about when powerful business groups can get what they want and when they can’t. Lisa Kastner’s work on consumer regulation and the financial transaction tax in Europe and the U.S. is an example of the type of work that I believe could deliver meaningful insights into this question.467

467 2018.
Third, this dissertation raises questions about the possibility of pro-actively managing emerging systemic risks, what some have termed “anticipatory governance”.\(^{468}\) The post-2009 reforms are in many ways the antithesis of anticipatory governance—they were a response to a crisis rather than the product of a deliberative process seeking to reduce systemic risks or increase systemic resiliency to prevent a crisis. Despite frequent warnings about excesses in the financial system and known regulatory gaps,\(^{469}\) little was done to address them prior to the 2007-09 crisis. Instead, it took a serious financial crisis, and the resulting heavy economic toll inflicted on millions of Americans, to prompt policymakers to act. While the post-2009 reforms have made the system safer, they are currently being rolled back by the Trump administration, particularly the enforcement activities of the CFPB.\(^{470}\) In addition, there was much hope that newly adopted macroprudential regulatory measures would be used to counter the pro-cycle bias of financial markets and institutions, but there is little evidence that policymakers are willing to use them.\(^{471}\) This suggests that anticipatory governance has not taken hold. The reasons for this are likely manyfold, though the unwillingness of policymakers to face immediate and certain costs in the form of strong criticism by affected parties and slower economic growth in exchange for the uncertain benefit of a possible crisis avoided is a key barrier. As former Federal Reserve


\(^{469}\) For instance, in 1998, Brooksley Born, then head of the CFTC, warned about problems in over-the-counter derivatives markets but her efforts to regulate these activities were vigorously opposed by the Treasury secretary and other regulators. Likewise, in 2005 Raghuram Rajan, then chief economist at the IMF, told the world’s central bankers that there was more risk and leverage in the system due to poorly aligned incentives, and that these risks were being left unaddressed. See his “Has Financial Development Made the World Riskier?” Paper presented to the Federal Reserve Bank of Kansas City annual conference, Jackson Hole. August 2005.


Governor William McChesney Martin said many years ago, it is tough to order “the punch bowl removed just when the party is really warming up”.472

https://fraser.stlouisfed.org/title/448/item/7800
Table 5.1: Constraints on Business Power

<table>
<thead>
<tr>
<th>Area</th>
<th>Constraints on power</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Economic context</td>
<td>1. Business is dependent for most of its profits on access to a single market controlled by the state (Culpepper and Reinke 2014)</td>
</tr>
<tr>
<td></td>
<td>2. Economy is strong so that legislators have less need to cater to business interests (Vogel 1983)</td>
</tr>
<tr>
<td></td>
<td>3. Economy has experienced a crisis which undermines business credibility (Baker 2013a, Blyth 2002, Hacker and Pierson 2002)</td>
</tr>
<tr>
<td></td>
<td>4. Sector is unimportant to the overall economy</td>
</tr>
<tr>
<td>2. Interests</td>
<td>5. Heterogeneous preferences, i.e., business community is unable to organize or battles each other openly (Olson 1965, Vogel 1983, Smith 2000, Woll 2014).</td>
</tr>
<tr>
<td></td>
<td>6. Entire business community unified. This occurs only on salient, partisan and ideological issues where legislators are responsive to the public (Smith 2000)</td>
</tr>
<tr>
<td>4. Institutions – Economic</td>
<td>10. Neo-corporatism and coordinated market economies provide non-business actors greater access and say in policymaking (Katzenstein 1985, Hall &amp; Soskice 2001)</td>
</tr>
<tr>
<td></td>
<td>11. State capitalism: major investments are made by state-owned enterprises and, thus, private sector investments are less important to national economic activity</td>
</tr>
<tr>
<td>5. Institutions - Political</td>
<td>12. Centralized state authority, which reduces ability of business to play off one subnational government (or regulator) against another (Hacker &amp; Pierson 2002)</td>
</tr>
<tr>
<td></td>
<td>13. Multiple veto players lessen business’ ability to bring about new policies that promote their interests (but does enhance power to stop new policies against their interests) (Tsebelis 1995)</td>
</tr>
<tr>
<td></td>
<td>14. Strong campaign financing laws (Blyth 2002)</td>
</tr>
<tr>
<td></td>
<td>15. Weak bureaucracy (Tiberghien 2007)</td>
</tr>
<tr>
<td>6. Public opinion and</td>
<td>16. Issue has high salience and public opposes business interests (Culpepper 2011)</td>
</tr>
<tr>
<td>awareness</td>
<td></td>
</tr>
</tbody>
</table>

Source: Author.
Table 5.2: U.S. Financial Re-regulation Initiatives Post-2009 (as of 2016)

<table>
<thead>
<tr>
<th>Policy Goal</th>
<th>Broad regulatory area</th>
<th>Regulatory sub-issue area</th>
<th>Strength of U.S. Rules as of 2016*</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Stronger prudential standards</td>
<td>A. Raise capital adequacy standards</td>
<td>1. Risk-based capital ratios</td>
<td>Strong</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Liquidity coverage ratios</td>
<td>Strong</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3. Net stable funding ratios</td>
<td>Strong</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4. Leverage ratios</td>
<td>Strong</td>
</tr>
<tr>
<td></td>
<td>B. Enhance supervisory capabilities</td>
<td>1. Consolidation of regulatory agencies</td>
<td>Weak</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Enhanced powers and obligations for regulatory agencies</td>
<td>Mixed</td>
</tr>
<tr>
<td></td>
<td>C. Macro-prudential regulation</td>
<td>1. Agency assigned to monitor systemic risks</td>
<td>Strong</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Measures to counter procyclical tendencies (e.g., CC buffers, LTV ratios)</td>
<td>Weak</td>
</tr>
<tr>
<td>II. Ending Too Big to Fail</td>
<td>A. Reduce likelihood of SIFI failures</td>
<td>1. SIFI-specific capital surcharges (and other related capital rules)</td>
<td>Strong</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. SIFI-specific enhanced supervision (e.g., stress tests)</td>
<td>Strong</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3. Limits on business powers (e.g., Volcker Rule)</td>
<td>Strong</td>
</tr>
<tr>
<td></td>
<td>B. Lessen impact of SIFI failures</td>
<td>1. Structural reforms (e.g., “ring fencing”)</td>
<td>Weak</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Institutional size limits</td>
<td>Weak</td>
</tr>
<tr>
<td></td>
<td>C. Improve resolution of problem-SIFIs</td>
<td>1. Special resolution frameworks for financial institutions</td>
<td>Strong</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Resolution plans e.g., “living wills”</td>
<td>Strong</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3. Cross-country info sharing &amp; mutual recognition arrangements</td>
<td>Mixed</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4. Total loss absorbing capital requirements (TLAC)</td>
<td>Strong</td>
</tr>
<tr>
<td>D. Other initiatives</td>
<td>1. Bank levies (taxes) on large institutions or risky activities</td>
<td>Weak</td>
<td></td>
</tr>
<tr>
<td>III. Expanding regulatory coverage</td>
<td>A. Institutions</td>
<td>1. Hedge funds</td>
<td>Weak</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Credit rating agencies</td>
<td>Weak</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3. Shadow banking</td>
<td>Mixed</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4. Reforming government sponsored enterprises (e.g., Fannie Mae)</td>
<td>Weak</td>
</tr>
<tr>
<td>B. Markets and products</td>
<td>1. Financial derivatives (focus on OTC derivatives)</td>
<td>Strong</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. Commodity derivatives (focus on exchange-traded derivatives)</td>
<td>Weak</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. Financial benchmarks</td>
<td>Mixed</td>
<td></td>
</tr>
<tr>
<td></td>
<td>4. Securitized products</td>
<td>Weak</td>
<td></td>
</tr>
<tr>
<td>C. Practices</td>
<td>1. Executive compensation</td>
<td>Weak</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. Higher conduct and appointment standards for executives</td>
<td>Weak</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. Corporate governance</td>
<td>Mixed</td>
<td></td>
</tr>
<tr>
<td></td>
<td>4. Accounting, auditing and disclosure</td>
<td>Strong</td>
<td></td>
</tr>
<tr>
<td>IV. Greater consumer protection</td>
<td>A. Treatment of consumers</td>
<td>1. Product disclosure, protection against fraud and misuse, protection of data and privacy, promoting competition</td>
<td>Mixed</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Single-agency focus</td>
<td>Strong</td>
</tr>
<tr>
<td>B. Deposit insurance</td>
<td>1. Coverage, limits and funding</td>
<td>Strong</td>
<td></td>
</tr>
</tbody>
</table>

Source: Author.

* These are subjective assessments by the author. Strong regulations are those that: (i) are materially tougher than prior to the crisis; (ii) have high industry compliance costs; or (iii) are tougher than those in other developed economies or international standards.
Bibliography


Carpenter, Daniel and David A. Moss, eds. 2014. Preventing Regulatory Capture: Special Interest and How to Limit It (Cambridge: Cambridge University Press).


Davis Polk. various years. Dodd Frank Progress Report.


Dependency of Ideational Adverse Selection,” British Journal of Politics and
International Relations 17:461-493.

Underpinnings, and Legitimacy in Global Monetary and Financial Governance,”
International Affairs 84(3):535-554.

Requirements for Global Systemically Important Bank Holding Companies,” Federal
Register 79(243) (December 18):75473-75496.

Requirements for Global Systemically Important Bank Holding Companies,” Federal
Register, 80(157) (August 14): 49082-49116.

Edition.

Supplementary Leverage Ratio Standards Applicable to U.S. Globally Systemically
Important Bank Holding Companies and Certain of Their Insured Depository Institution
Subsidiaries, (April 5).

U.S. Federal Reserve Bank of Minneapolis. 2016. The Minneapolis Plan to End Too Big to Fail.
November 16.

Concentration Limits on Large Financial Companies, January.

on Proprietary Trading & Certain Relationships with Hedge & Private Equity Funds.
January.


U.S. General Accountability Office. 2014. Dodd-Frank Regulations: Regulators’ Analytical and
Coordination Efforts. GOA 15-81. December.

Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and
Private Equity Funds, October.


Appendix: Interview Methods

1. Sample Frame

The initial sample frame was composed of 120 people. This was sourced from congressional records, media reports, and lists of conference speakers. In addition, participants were asked at the end of each interview for the names of people I should contact for my study. This added only another 7 people as the vast majority of recommendations were on my original list.

2. Response Rate and Type

The total contact list was 127 people. Of this, 20 were not contacted because they were sitting members of congress (with no plans to retire in 2018) or current contact information could not be found. As a result, 107 people were contacted for this study. Each person was contacted for an interview request by email, with 1 or 2 follow-up requests to non-respondents. Table A.1 provides a breakdown of the response rate by category. Overall, of the 107 people contacted, 51 agreed to an interview, which is a response rate of 48 percent.

Table A.1: Response Rate

<table>
<thead>
<tr>
<th>Category (at 2009-2010)</th>
<th>Original List</th>
<th>Requests Sent</th>
<th>Agreed</th>
<th>Declined</th>
<th>No Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administration*</td>
<td>15</td>
<td>11</td>
<td>7</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Congressional members</td>
<td>18</td>
<td>11</td>
<td>4</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td>Congressional aides and staff</td>
<td>38</td>
<td>32</td>
<td>14</td>
<td>3</td>
<td>15</td>
</tr>
<tr>
<td>Regulators</td>
<td>27</td>
<td>25</td>
<td>10</td>
<td>6</td>
<td>9</td>
</tr>
<tr>
<td>Industry</td>
<td>15</td>
<td>15</td>
<td>7</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>Civil society organizations</td>
<td>4</td>
<td>4</td>
<td>3</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Knowledgeable experts**</td>
<td>9</td>
<td>8</td>
<td>5</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>127</td>
<td>107</td>
<td>51</td>
<td>17</td>
<td>39</td>
</tr>
</tbody>
</table>

* White House and Department of Treasury.
** Think tanks, academics, private-practice lawyers, independent lobbyists/consultants and journalists.
3. Saturation

Saturation was reached among and across all categories with respect to Dissertation Paper #2 (US capital adequacy rules) and #3 (the Volcker Rule). Saturation for Dissertation Paper #1 (Incrementalism) was not achieved due to insufficient participation by key administration officials.

4. Interview process

Interviews were conducted using a semi-structured questionnaire on a not-for-attribute basis between September and December 2018, mostly in Washington D.C. (One participant requested that the interview be conducted on a background basis.) The precise list of questions depended on the subject’s experience and the amount of time available for the interview. In addition, some questions for later participants differed in response to new information from earlier participants. In all cases, simultaneous note-taking was used to record the interviews.

473 Saturation is defined as the point where “[…] respondents are restating the same causal processes as previous interviewees, […] there is agreement across networks (or predictable disagreements) and […] recommendations for further interviewees mirror the list of people the researcher has already interviewed.” See Erik Bleich and Robert Pekkanen, “How to Report Interview Data,” in Lanya Mosley, editor, Interview Research in Political Science (Ithaca: Cornell University Press, 2013), p. 91.
5. Format and length of interviews

Table A.2: Participant Profile

<table>
<thead>
<tr>
<th>Interview</th>
<th>2009-2010 Position</th>
<th>Current Position</th>
<th>Date</th>
<th>Length (minutes)</th>
<th>Mode</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>HFSC staff</td>
<td>Knowledgeable expert</td>
<td>12/09/18</td>
<td>90</td>
<td>In person</td>
</tr>
<tr>
<td>2</td>
<td>HFSC staff</td>
<td>Knowledgeable expert</td>
<td>13/09/18</td>
<td>105</td>
<td>In person</td>
</tr>
<tr>
<td>3</td>
<td>Administration</td>
<td>Knowledgeable expert</td>
<td>17/09/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>4</td>
<td>Civil society org.</td>
<td>Civil society org.</td>
<td>18/09/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>5</td>
<td>SBC staff</td>
<td>Regulator</td>
<td>18/09/18</td>
<td>105</td>
<td>In person</td>
</tr>
<tr>
<td>6</td>
<td>SBC staff</td>
<td>Industry</td>
<td>20/09/18</td>
<td>50</td>
<td>In person</td>
</tr>
<tr>
<td>7</td>
<td>Regulator</td>
<td>Regulator</td>
<td>25/09/18</td>
<td>80</td>
<td>In person</td>
</tr>
<tr>
<td>8</td>
<td>Congressional aide</td>
<td>Knowledgeable expert</td>
<td>26/09/18</td>
<td>45</td>
<td>In person</td>
</tr>
<tr>
<td>9</td>
<td>SBC staff</td>
<td>Retired</td>
<td>26/09/18</td>
<td>90</td>
<td>In person</td>
</tr>
<tr>
<td>10</td>
<td>Congressional member</td>
<td>Knowledgeable expert</td>
<td>27/09/18</td>
<td>75</td>
<td>In person</td>
</tr>
<tr>
<td>11</td>
<td>Administration</td>
<td>Knowledgeable expert</td>
<td>27/09/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>12</td>
<td>Confidential</td>
<td>Confidential</td>
<td>27/09/18</td>
<td>45</td>
<td>In person</td>
</tr>
<tr>
<td>13</td>
<td>Knowledgeable expert</td>
<td>Industry</td>
<td>29/09/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>14</td>
<td>HFSC staff</td>
<td>Knowledgeable expert</td>
<td>01/10/18</td>
<td>45</td>
<td>Telephone</td>
</tr>
<tr>
<td>15</td>
<td>Regulator</td>
<td>Regulator</td>
<td>01/10/18</td>
<td>45</td>
<td>In person</td>
</tr>
<tr>
<td>16</td>
<td>Regulator</td>
<td>Retired</td>
<td>02/10/18</td>
<td>95</td>
<td>In person</td>
</tr>
<tr>
<td>17</td>
<td>Congressional aide</td>
<td>Knowledgeable expert</td>
<td>04/10/18</td>
<td>90</td>
<td>In person</td>
</tr>
<tr>
<td>18</td>
<td>Regulator</td>
<td>Industry</td>
<td>09/10/18</td>
<td>50</td>
<td>In person</td>
</tr>
<tr>
<td>19</td>
<td>Regulator</td>
<td>Regulator</td>
<td>09/10/18</td>
<td>90</td>
<td>In person</td>
</tr>
<tr>
<td>20</td>
<td>Regulator</td>
<td>Knowledgeable expert</td>
<td>09/10/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>21</td>
<td>Regulator</td>
<td>Knowledgeable expert</td>
<td>15/10/18</td>
<td>50</td>
<td>In person</td>
</tr>
<tr>
<td>22</td>
<td>Industry</td>
<td>Retired</td>
<td>15/10/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>23</td>
<td>Civil society org.</td>
<td>Civil society org.</td>
<td>18/10/18</td>
<td>75</td>
<td>In person</td>
</tr>
<tr>
<td>24</td>
<td>SBC staff/K.E.</td>
<td>Knowledgeable expert</td>
<td>23/10/18</td>
<td>45</td>
<td>In person</td>
</tr>
<tr>
<td>25</td>
<td>Industry</td>
<td>Retired</td>
<td>23/10/18</td>
<td>90</td>
<td>In person</td>
</tr>
<tr>
<td>26</td>
<td>Regulator</td>
<td>Retired</td>
<td>24/10/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>27</td>
<td>Regulator</td>
<td>Industry</td>
<td>24/10/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>28</td>
<td>Congressional member</td>
<td>Retired</td>
<td>31/10/18</td>
<td>35</td>
<td>Telephone</td>
</tr>
<tr>
<td>29</td>
<td>Industry</td>
<td>Industry</td>
<td>5/11/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>30</td>
<td>Industry</td>
<td>Industry</td>
<td>5/11/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>31</td>
<td>Industry</td>
<td>Industry</td>
<td>5/11/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>32</td>
<td>Administration</td>
<td>Knowledgeable expert</td>
<td>6/11/18</td>
<td>15</td>
<td>Telephone</td>
</tr>
<tr>
<td>33</td>
<td>Congressional aide</td>
<td>Knowledgeable expert</td>
<td>6/11/18</td>
<td>50</td>
<td>In person</td>
</tr>
<tr>
<td>34</td>
<td>Congressional aide</td>
<td>Industry</td>
<td>7/11/18</td>
<td>45</td>
<td>In person</td>
</tr>
<tr>
<td>35</td>
<td>Admin/Regulator</td>
<td>Knowledgeable expert</td>
<td>7/11/18</td>
<td>55</td>
<td>In person</td>
</tr>
<tr>
<td>36</td>
<td>Knowledgeable expert</td>
<td>Knowledgeable expert</td>
<td>7/11/18</td>
<td>55</td>
<td>In person</td>
</tr>
<tr>
<td>37</td>
<td>Administration</td>
<td>Industry</td>
<td>8/11/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>38</td>
<td>Industry</td>
<td>Industry</td>
<td>8/11/18</td>
<td>85</td>
<td>In person</td>
</tr>
<tr>
<td>39</td>
<td>HFSC staff</td>
<td>Industry</td>
<td>13/11/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>40</td>
<td>Civil society org.</td>
<td>Civil society org.</td>
<td>13/11/18</td>
<td>65</td>
<td>In person</td>
</tr>
<tr>
<td>41</td>
<td>Knowledgeable expert</td>
<td>Knowledgeable expert</td>
<td>16/11/18</td>
<td>75</td>
<td>In person</td>
</tr>
<tr>
<td>42</td>
<td>Congressional member</td>
<td>Knowledgeable expert</td>
<td>19/11/18</td>
<td>60</td>
<td>In person</td>
</tr>
<tr>
<td>43</td>
<td>Regulator</td>
<td>Industry</td>
<td>20/11/18</td>
<td>80</td>
<td>In person</td>
</tr>
<tr>
<td>44</td>
<td>HFSC staff</td>
<td>Regulator</td>
<td>21/11/18</td>
<td>75</td>
<td>In person</td>
</tr>
<tr>
<td>45</td>
<td>Industry</td>
<td>Industry</td>
<td>28/11/18</td>
<td>50</td>
<td>Telephone</td>
</tr>
<tr>
<td>46</td>
<td>HFSC staff</td>
<td>Knowledgeable expert</td>
<td>4/12/18</td>
<td>15</td>
<td>Telephone</td>
</tr>
<tr>
<td>47</td>
<td>Administration</td>
<td>Knowledgeable expert</td>
<td>6/12/18</td>
<td>15</td>
<td>Telephone</td>
</tr>
<tr>
<td>48</td>
<td>Congressional member</td>
<td>Retired</td>
<td>10/12/18</td>
<td>50</td>
<td>In person</td>
</tr>
<tr>
<td>49</td>
<td>Admin/regulator</td>
<td>Knowledgeable expert</td>
<td>11/12/18</td>
<td>50</td>
<td>In person</td>
</tr>
<tr>
<td>50</td>
<td>Knowledgeable expert</td>
<td>Knowledgeable expert</td>
<td>17/12/18</td>
<td>35</td>
<td>Telephone</td>
</tr>
<tr>
<td>51</td>
<td>Knowledgeable expert</td>
<td>Knowledgeable expert</td>
<td>18/12/18</td>
<td>60</td>
<td>Telephone</td>
</tr>
</tbody>
</table>