Competition and Coordination in Bank Regulation: the Financial Crisis of 2007-09

Abstract: The ability of businesses to shift regulatory jurisdictions has long raised questions about whether this generates a regulatory race to the bottom (RTB). Prior to the Financial Crisis of 2007-09, the structure of U.S. federal bank regulation raised similar questions, as banks could choose their regulator and regulators received fees for assessing banks. I investigate this question, through the theoretical lenses of bureaucratic structure, regulatory capture and bureaucratic reputation. Relying on quantitative and qualitative data, I find that the initial regulatory structure did induce a regulatory RTB, but once the Financial Crisis had begun, reputational fears on the part of federal agencies reversed the race, as the regulators strengthened standards and brought more enforcement actions. The paper ultimately shows that multiple theories help to explain what is going on with regulatory RTBs.

The ability of businesses to choose their regulators or to shift jurisdictions in order to avoid strict regulatory standards has always raised the question of whether such business mobility results in a “race to the bottom” (RTB) in regulatory standards. The RTB story is that if businesses can choose their jurisdiction, regulators will weaken standards, and compete with each other, so that their individual jurisdictions do not lose the economic growth and job opportunities that come with regulating those businesses. Much of the RTB-related research has focused on environmental regulation and while some research has been on American bank regulation (Corder 2009; Engel and McCoy 2011; Rosen 2003, 2005; Whalen 2002), our understanding of the dynamics of regulatory competition in this area is far less developed. Because banks can choose their regulator and some federal and state bank regulators are funded by bank assessment fees, critics maintain that regulators have to compete in order to attract banks to their regulatory system. If the banking industry is shrinking, then the regulator incentive is to compete and to weaken standards, but the overall picture is more complex, as regulator behavior is also influenced by concerns of reputation and relationships with those in the bank industry.

Existing studies of RTBs in bank regulation are useful, but have not given a full accounting of what influences potential RTBs in bank regulation. First, studies by economists analyze whether banks seek weaker regulatory standards or enforcement by switching regulators (Rosen 2003, 2005; Whalen 2002). In these bank-focused studies, the regulators are static actors, but if they have incentives to compete, they also represent dynamic actors whose actions require examination. Moreover, these studies proceed based on an assumption that, in order for an RTB to exist, banks must switch regulators in search of the lightest touch regulation and a high proportion of those banks must then fail. However, if regulators are truly competing to lower standards, banks that were considering flipping

charters may become content where they are, if they benefit from weakened standards. Thus, banks do not need to change their chartering agency for a weakening of regulations to occur.

In political science and law, some accounts have been descriptive (e.g. Corder 2009), and some very thorough in their analysis of bank and regulator activity (e.g. Engel and McCoy 2011), yet in neither case has there been a theoretical framework regarding political institutions and the incentives of regulators. It is insufficient to simply assume that the regulatory structure automatically motivates regulators to weaken regulations in order to attract banks. Only if the regulators are motivated to compete with each other to bring banks under their respective regulatory umbrella, is it logical to expect an RTB in standards and enforcement. Thus, we must ask what incentives are generated by the regulatory structure: do the regulators want to compete or coordinate with each other?

In this paper, I argue that the potential for regulatory competition depends on the interaction of several important phenomena. First, regulators will look to the bank industry, as the number of banks overseen by each regulator determines the amount of revenue, and therefore the budget size. As the number of banks shrinks over time, sources of revenue for regulators decrease, which increases the incentives for regulatory competition. Regulatory competition will come more naturally to Republican appointees, those with a background in finance or banking, or more generally those vulnerable to "cultural capture". Cultural capture is a phenomenon in which regulators view the world of finance through a lens that is sympathetic to those within the industry (Davidoff 2010; Kwak 2013). This sympathetic view is cultivated largely by repeated interactions between bankers and regulators who share similar ideologies and professional backgrounds with those bankers.

There is a limit to how loose regulatory policy can be, as too much risk in the system leads to bank failures and ultimately, the same diminishing sources of bank revenue that regulators had hoped to avoid. However, the nature of regulator action will depend on what

the agency is facing. A need to reduce risk in the system will be met with more symbolic proposals, such as non-binding guidance documents, thus continuing a de facto RTB. However, legislative proposals that threaten the very existence of the agency will be met with stronger standards and increased enforcement actions. In other words, when dealing with actual financial system problems, regulators will continue to be influenced by cultural capture, but legislative or bureaucratic threats to an agency's turf will produce robust responses in the form of more enforcement actions, as the agency scrambles to show why it should not lose its role as a regulator. Thus, the nature of the banking industry will affect the potential for an RTB, but so will the potential for cultural capture, as will concerns of agency reputation.

The paper contributes to the literatures on public administration and financial regulation by integrating theories of RTBs, cultural capture and reputation and illustrating how they applied to each regulatory agency leading up to and immediately after the financial crisis. Other research has treated each of these theories disparately in their treatment of financial regulation. In this paper, I attempt to bring them together to illustrate how each of them matter and under what circumstances. The paper proceeds as follows. First, I explain the structure of financial regulation in the U.S. and why it creates the potential for a regulatory RTB. Second, I develop my theory of financial RTBs, explaining the role of the bank industry, cultural capture and agency reputation. Third, I present my qualitative analysis of regulatory standards and enforcement levels from 2001 through 2009. Finally, I conclude by suggesting what future studies of financial regulation might examine.

The Bank Industry and the Regulatory Environment

The structure of financial regulation in the U.S. has caused observers to ask whether it produces an RTB in regulatory standards and the financial crisis of 2007-09 renewed this

question with vigor. In the dual banking system, banks can choose to be regulated at the federal level by the Office of Comptroller Currency (OCC), or by the Office of Thrift Supervision (OTS)[1] if they are thrifts or savings and loans (S&Ls), although they may easily switch from a national bank to an S&L, or they may choose to be regulated at the state level. State regulated Federal Reserve Board (FRB) member banks are also regulated by the FRB, while state regulated non-FRB members are regulated by the Federal Deposit Insurance Corporation (FDIC). The OCC, the OTS and state agencies are funded by assessment fees collected from the banks and consequently, critics maintain that the system effectively forces OCC, OTS and the states to compete for banks.

Research has found that banks do switch charters because they seek greater specialization in their regulator and because of legislative changes (Rosen 2003, 2005), but also when they have a high share of risky assets, low supervisory ratings or when they are about to experience an enforcement action (Whalen 2002). The latter study provides support for the RTB hypothesis, but these studies primarily examine the role of banks and not of regulators. If regulators are motivated to compete, they may relax their standards and banks may never need to switch charters. Thus, analyses that omit the role of regulators lack a potentially crucial piece of evidence. Recent accounts of the financial crisis of 2007-09 have attributed the crisis partly to regulatory competition, but without fully analyzing the surrounding political institutions or the incentives of regulators (Corder 2009; Engel and McCoy 2011).

The potential for an RTB in banking regulation depends on the interaction of a number of important factors, but the first feature is a shrinking bank industry. Quite simply, the more banks that a given regulator supervises, the larger will be the potential source of funds for that regulator. As that number of banks declines, either because of bank failures or

[1] As of October, 2011, the Office of Thrift Supervision was merged into the Office of Comptroller Currency, as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

mergers, it decreases the sources of revenue for the regulator and puts pressure on them to find new banks to regulate. One method by which regulators can make their own charter more attractive is by advertising laxity in regulatory standards. If banks believe that a given charter is going to present them with a lighter touch, they may be convinced to switch charters, or banks that had considered changing may decide to stay put.

Weakening standards will come more easily to particular types of regulators. Appointees of Republican presidents or people with strong backgrounds in banking and finance are more likely to be sympathetic to the plight of the banking industry and will prevent regulatory standards from becoming onerous. The ability of agency chiefs to shift direction, scope and quantity of regulatory outputs has been well documented in previous research (e.g. Nathan 1983; Whitford 2005; Wood and Waterman 1994). These studies reveal the direction of regulatory outputs depending on particular regulators, but Kwak (2013) reveals the relational mechanisms behind such behavior by arguing that regulators are likely to view the world through the lens of the banker when they share similar professional and ideological backgrounds, or similar social and intellectual circles. The problem is neatly summarized by Steven Davidoff: “These men and women (regulators) may believe they are doing their best, but their worldview is affected by the people they interact with” (2010).

However, what happens when there is a considerable build-up of risk in the financial system, so much so that it becomes impossible for even regulators to ignore? This is precisely what happened in 2006 and 2007, as alarm bells driven by a steadily increasing foreclosure rate in the housing market became louder. Regulators will not ignore these warning signs, but will deal with them in a way that allows them to stay within the intellectual consensus. Formal enforcement actions that downgrade bank performance or tighten capital requirements can dampen stock price and profit margins. Therefore, regulators will prefer a conciliatory approach, whereby they urge bankers to strengthen

underwriting standards and monitor risk, without actually imposing any hard requirements or penalties. As long as the main threat is simply a significant build-up of risk in the financial system, culturally captured regulators are likely to avoid stronger enforcement actions and to pursue voluntary approaches for managing risk.

This does not mean, however, that regulators will never bring strong enforcement actions. The consequences from excessive risk in the financial system can be failing banks, which can bring bank bailouts, job losses, soured investments, depressed economic growth and damaged reputations to regulators. The political repercussions of financial crises can be catastrophic, as agencies might become downsized, consolidated or even outright abolished. In these situations, regulators realize that appearances matter and while bringing strong enforcement actions at this point may represent too little, too late, it has the appearance of doing something serious, potentially serving as a reputation-saving device. Carpenter (2010) has demonstrated that between 2008 and 2010, the FRB did not increase enforcement actions as a result of the mounting bank failures in 2008, but rather only after Congress began deliberations in 2009 about the creation of a new financial consumer protection agency that threatened to take away power and responsibility from the FRB. This is a clear example of bank regulators responding more forcefully to threats to their survival, rather than to catastrophic shifts in their task environment. I hypothesize that a similar relationship existed for all four bank regulators, including the FRB, leading up to and after the financial crisis. In other words, regulators respond to rising foreclosure rates with concern, but also with continued voluntary and consensual measures. However, crisis-induced threats to agency turf will goad regulators into taking stronger enforcement measures in order to salvage their reputation.

Research Design

This paper examines whether the institutional structure of bank regulators results in RTBs in regulatory standards. The dependent variable is represented by changes in residential property mortgage standards that involved just the OTS and OCC, as well as those that involved all four regulators. Standards can be changed unilaterally within one agency, but for larger scale changes that affect all four agencies, they must agree to the changes as a collective regulatory body. Thus, changes in standards can happen as a result of individual agency change, as well as collective agency decision making. The second dependent variable is enforcement actions across the four agencies.

I examine the time period of 2001 through 2009 because it offers a window on what occurred before and after the crisis and it gives variation on all the key variables (independent variables are discussed below). In order to collect data on the first dependent variable (standard changes), I examined the Federal Register and for more detailed context, performed a Lexis-Nexis search for articles on each agency in the trade publication *The American Banker*. Within both sources, I looked for changes to standards of residential mortgage regulatory standards. Numerous changes arose in the search, so consequently, I sampled four major changes from the search that together present significant variation across the variables. For changes just made by the OCC and OTS, I examine federal preemption of anti-predatory lending laws in 2003 and 2004. For changes that affect all four agencies, I examine changes to the Community Reinvestment Act (CRA) in 2004-05 and the creation of interagency guidance on "nontraditional" mortgage loans in 2005-07. Finally, for the post-crisis period, I examine mortgage-related rule changes proposed by the FRB in 2008. For enforcement actions, I examine all enforcement actions from each agency, data gathered from each website of the four regulators.

The independent variable of interest is the latent concept of regulators' incentives to either compete or cooperate. I operationalize this concept by examining the number of banks

regulated by both the OCC and the OTS. If both these numbers decline, then holding all else constant, we ought to expect a weakening of regulatory standards and/or a decrease in enforcement actions (the dependent variables). I also present a qualitative account of the budget situation of both the OTS and OCC which would be influenced by the number of banks each agency regulates. The budgets in turn would affect regulatory standards. We would not expect enforcement actions, the second dependent variable, to increase over time when agencies are facing tight budgetary times. They would be more eager to attract banks with a light regulatory touch.

To examine the effect of political appointments and potential cultural capture, I describe the professional and appointment background of each agency chief, and then describe the actions and statements of each of these appointees during negotiations over regulatory standards. To evaluate the impact of reputational concerns on RTB potential, I look at the task environment as well. Risk and foreclosure rates are gauged by measuring the proportion of adjustable rate mortgages (ARMs) issued by banks, as well as the proportion of delinquent mortgages. ARMs carry more risk, as rising interest rates mean more is owed on the mortgage, and as payments become too difficult to make, delinquent mortgages rise as well. As hypothesized, rising foreclosure rates should bring regulator concern, but changes to standards that still fit within the intellectual framework of light touch regulation. Only threats to bureaucratic turf galvanize agencies to create tougher standards in order to save reputation. We should expect to see a similar dynamic with enforcement actions, in that they only notably increase when there is a legislative threat to an agency's turf.

Finally, the methods employed here are qualitative with some quantitative data. First, the events described require thick description and do not always fall into one time category, thus rendering time series analysis more difficult. It is also difficult to capture the effects of appointed regulators through dummy variables. The lengthy period of regulatory standard

negotiation means that it is crucial to capture the actions and statements of the regulators during the period, which is more feasibly done by tracing the regulators' backgrounds to their behavior during the negotiations and to the final outcome. Still, even then it is worth noting that disentangling the precise effects of cultural capture from the effects of the institutional structure is difficult. Observing cultural capture means observing the motivations of regulators which means understanding what is in their head. The best we can do to disentangle these effects is a detailed explanation of their actions, along with an understanding of the institutional environment. Finally, capturing the regulators' reactions to the task environment is also captured in greater depth through analysis of particular actions during the negotiations.

Incentives to Compete and Agency Budgets

The incentive of regulators to compete depends on the structure of the market for banking. Competition between agencies will be the more likely outcome if revenue sources (banks) dwindle over time and if banks can easily switch regulators.[2] In the 1980s, as the restrictions on interstate banking were lifted, the number of bank mergers increased, as did the number of bank failures (Blair and Kushmeider 2006). The increase in bank failures has been directly attributed to deregulatory initiatives such as the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Act of 1982 (Krause 1994; Meier and Worsham 1988). The net effect of these laws, whether through merger or failure, was to reduce the number of banks in the system. Recent data, shown in Figure 1, indicate that the number of banks regulated by the both the OTS and OCC

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[2] Because OCC and OTS-regulated banks are the ones directly affected by the number of banks they regulate through their funding structure, I focus primarily on those two regulators in this section.

continued to decline throughout the 1990s and 2000s.[3] For the regulators, fewer banks meant less money in assessment fees, which resulted in smaller operating budgets.

FIGURE 1 HERE

The budget issues were particularly acute for the OTS soon after George W. Bush became president. The OTS-regulated Superior Bank of Chicago failed in July 2001, while in 2002, the bank Charter One switched to an OCC-regulated, national bank charter, doubling the OTS operating deficit for 2002 (Garver 2002). By 2004, 42 percent of the federal thrift industry's total assets were held by five federally chartered thrifts (Rehm 2004), making the OTS budget highly dependent on a small number of banks. In order to expand the number of revenue sources, the OTS would have to make itself more attractive to potential as well as existing holders of the federal thrift charter. In late 2001, the Bush Administration appointed to head the OTS James Gilleran who had extensive experience in banking and accounting and had served as Superintendent of Banks under two Republican governors in California from 1989 through 1994. His background indicated that he would be more likely to favor a light regulatory touch, a position supported by his stated goal "to allow thrifts to operate with a wide breadth of freedom from regulatory intrusion" (Appelbaum and Nakashima 2008). He pledged not to raise the fees of bank examinations (Kline 2002) and he instead cut staff by 20 percent, including 69 examiners responsible for assessing bank compliance with safety, soundness and consumer regulations (Anason and Blackwell 2002; Blackwell and Garver 2002).

[3] The data in Figure 1 come from the FDIC's Statistics on Depository Institutions. For the OTS, the number reported is the end-of-year number of federally chartered savings institutions reporting. For the OCC, the number reported is the end-of-year number of federally chartered commercial banking institutions reporting.

Budget problems in the OCC were not as problematic as they were in the OTS, but they were still significant in 2001. The OCC was headed by John D. Hawke Jr., a Clinton appointee who had also served in the Administration's Treasury. Hawke's background did not lead indicate a strong endorsement of deregulation, but budgetary constraints dictated otherwise. In 2002, the OCC raised its assessment fees, while at the same time cutting back on staff and reducing the number of district offices (Anason and Blackwell 2002). As a result of the OCC's increased assessment fees, the agency's budgetary picture was brighter as 2002 concluded, yet it still faced a similar problem to the OTS: a small number of large banks made up a disproportionate share of each agency's regulatory remit, and therefore its operating budget as well.

The OCC also faced increasingly high levels of competition from state bank regulators. Bank assessment fees levied by the OCC and OTS had always been substantially higher than those of their state-level counterparts (Blair and Kushmeider 2006), as the secondary supervision offered by the FRB and FDIC to state-chartered banks was free to the banks. This often led to the charge from OCC and OTS that state-chartered banks received a "federal subsidy" (Blackwell 2000). In 2000, Hawke expressed irritation at the fact that state bank regulators were openly promoting their charters and in some cases, telling state banks how much they could save with a state charter instead of a national one (Blackwell 2000), so he responded by trying to dissuade national commercial banks from switching to state charters (Carter 2001).

In summary, both the OCC and OTS had incentives to compete and attract banks into their fold in the early 2000s, but this incentive was probably stronger for the OTS as its very survival was on the line. Additionally, James Gilleran was a strong believer in a light regulatory touch for the banks, which more easily enabled him to attract banks to the OTS charter through weakened regulatory standards.

Incentives to Compete and Changes in Agency Administration

The OTS and OCC made themselves more attractive to banks through federal preemption of state legislation. When federal regulators issue preemption rules, it means that businesses regulated by federal agencies only need abide by federal regulations, and not by state laws. Thus, if federal laws have less punitive effects on banks for violating consumer protection or capital requirement laws than do state laws, preemption weakens the regulatory burden for banks and works in their favor. At the core of the bank regulation preemption debate in the early 2000s was the question of whether federally regulated banks and thrifts had to abide by state consumer protection laws that dealt with predatory lending. Predatory lending has been defined previously as involving one or more of the following problems:

> "Loans structured to result in seriously disproportionate net harm to borrowers; harmful rent-seeking; loans involving fraud or deceptive practices; other forms of lack of transparency in loans that are not actionable as fraud; and loans that require borrowers to waive meaningful legal redress" (Engel and McCoy 2002).

Existing federal protection for consumers from predatory lending had been limited (Corder 2009; Engel and McCoy 2011), inviting states to create their own anti-predatory lending laws (APL laws). Between 1999 and 2006, 29 states wrote their own APL laws. Moreover, state attorneys general were willing to prosecute lenders, as 38 states settled with Household Finance for $484 million in 2002, over its predatory, deceptive and fraudulent practices (Peacock 2004). Preemption of state law would effectively provide a shield from such state regulation and enhance the appeal of a federal charter. Gilleran and Hawke knew that if one agency preempted state APL laws, it had the potential to make the preempting agency's charter more attractive. The non-preempting agency would then have to be concerned about the threat of departing banks. For both agencies, this concern was acute for small banks, as large banks could weather state litigation, but such lawsuits could have a

catastrophic effect on smaller banks. Thus, the threat of predatory lending laws could be enough to make smaller banks switch charters in order to avoid such enforcement actions.

In January, 2003, the OTS pre-empted APL laws in four states (Blackwell 2003a; Moyer 2003) with the OCC following with blanket pre-emption in January, 2004. Smaller, multi-state banks did experience significant benefits as a result of the change (Whalen 2004), but state attorneys general were highly critical of the OCC's preemption decision, as they claimed that the OCC lacked the supervisory capabilities to monitor the behavior of all national banks by itself (Bautista 2004).

In summary, both agencies, concerned about potentially losing banks to their fellow regulator, took steps to shield the banks they regulated from state APL laws, thus each enhancing the attractiveness of their own charter. Such maneuvers may have been consistent with Gilleran's beliefs on banking and regulation, yet this was not the case with the OCC, given Hawke's background as a Democratic appointee. Overall, this illustrates how powerful the need to attract more banks for each regulatory charter was.

Coordination on Regulatory Guidance

The competition between regulators was also illustrated by the four bank regulators struggling to coordinate their policies in the market for subprime mortgage lending. Such coordination took place between 2004 and 2007 with respect to the Community Reinvestment Act (CRA) and to non-traditional, adjustable rate mortgages (ARMs). Before proceeding, it is necessary to discuss the FDIC and FRB appointees. Appointed by President Bush to lead the FDIC, Donald Powell had been President and CEO of First National Bank of Amarillo, Texas and had an extensive record of service in the financial industry, thus making him a knowledgeable insider. The FRB was headed by Alan Greenspan, who had been appointed by President Reagan in 1987 and had worked for both the Nixon and Reagan

Administrations. As a result of his Republican background, Greenspan's approach to banking and regulation was well suited to the Bush Administration.

First, the regulators sought to revise CRA rules and guidance which detailed how the law was to be implemented. The CRA was designed to ensure that banks did not deprive poor or minority borrowers of access to credit. All banks underwent examinations to ensure CRA compliance, but banks whose assets were less than $250 million had a simplified and streamlined examination. Prior to 2004, medium-sized banks with assets between $250 and $500 million began to complain about the burdens of complying with the CRA (Linder 2004), so the four regulators agreed in early 2004 to raise the asset examination threshold from $250 million to $500 million (Gordon 2004). Despite the proposal's acceptance from smaller banks, the OTS further raised the asset examination threshold for thrifts to $1 billion, with Gilleran stating that he felt "very strongly about reducing regulatory burden" (Blackwell and Bergman 2004).

The decision forced the surprised regulators to decide whether they wanted to follow the OTS or stay with the $500 million threshold. The FDIC was initially supportive, but also proposed a new community development examination for banks with assets between $250 million and $1 billion (Bergman 2004). The OCC initially wavered, fearing further criticism after its pre-emption of state APL laws, but ultimately agreed with the FDIC that the content of the streamlined exam should be changed (Blackwell 2004). Consequently, the three regulators agreed in July, 2005 to raise the asset examination threshold to $1 billion, but they also agreed to the different test for banks with between $250 million and $1 billion in assets (Bergman and Thomson 2005). Thus, even though the content of the examination was changed, the OTS still ultimately drove the process by staking out a stronger position on regulatory relief and moving the other regulators away from their ideal positions.

In the second area of policy coordination, the regulators dealt with “exotic” or “non-traditional”, subprime mortgage loans. These loans required little documentation to apply, were interest-only, and/or had adjustable payment schedules that deferred payments heavily. They often contained an introductory period, typically two to three years, in which a low or “teaser” interest rate was applied, but once this period finished, the monthly amount owed by the borrower jumped considerably, especially after the FRB raised the benchmark interest rate from one to five percent between 2004 and 2006. In 2005, bank regulators began to express concern about the effects of subprime loans and the subsequent likelihood of rising home foreclosures.

In order to evaluate the inter-agency guidance, it is necessary to point out new agency appointments, as well as changes in the task environment. First, at the OTS, Gilleran was replaced by John Reich who had been appointed to the FDIC Board in 2000 by President Clinton[4] after serving for 11 years as an aide to Republican Senator Connie Mack. Before that, Reich spent 23 years in community banking in Illinois and Florida and was President and CEO of National Bank of Sarasota, Florida (Office of Thrift Supervision 2005). Thus, his professional experience came from banking itself, rather than bank regulation, indicating that his sympathies were with the banking industry and a light-touch regulatory approach.

Taking over at the OCC in August, 2005 was John Dugan who had experience in the George H.W. Bush Administration Department of Treasury and as a lobbyist for the banking industry (Blackwell and Davenport 2005). The professional experience of both Reich and Dugan suggested that they would not seek to strengthen regulatory standards. At the FDIC, new chief Sheila Bair had been a professor of finance, an acting head of the Commodity Futures Trading Commission, and counsel to the Senate Judiciary Committee and to Senator Robert Dole (Adler 2006). Thus, while she worked in Republican administrations, her

[4] The FDIC Board of Directors consists of five members and one political party may not hold more than three of the seats. The heads of the OTS and OCC are typically included among the five members.

experience was more regulator than banker. Finally, at the FRB, Alan Greenspan was replaced by Ben Bernanke, a Republican, who had been an academic economist, until he was picked by President Bush to be first, a governor of the FRB, then Chair of the Council of Economic Advisers (Stolberg 2006). Bernanke did not have particularly outspoken views about bank regulation. Susan Bies was also a member of the FRB Board of Governors and was the most active FRB representative in the negotiations over non-traditional mortgage guidance. Having been appointed by President Bush in 2001, Bies had a career both as an economist and a banker (Hager 2002).

The decision to propose changes to guidance on non-traditional mortgages reflected changes in the task environment, as the level of risk in the banking system had risen substantially. Figure 2 illustrates the proportion of adjustable rate mortgage (ARM) loans issued by banks regulated by OTS, OCC and FDIC/FRB, relative to the total assets regulated by each agency. Between June, 2003 and March, 2005, ARM loans as a percentage of OTS-regulated assets increased from 24.05% to 31.56% and between June, 2003 and September, 2005, ARM loans as a percentage of OCC-regulated assets jumped from 3.11% to 4.41%. The proportion of risky loans overseen by both regulators was rising. Foreclosures and delinquent payments would not start to rise dramatically until 2006 (see Figure 3), but some regulators recognized that the rising benchmark interest rate would spell trouble for loans with introductory teaser rates. In separate speeches in October, 2005, John Dugan and Susan Bies both warned about the “payment shock” that ARM borrowers would experience when interest rates suddenly spike (Beckner 2005).

FIGURE 2 HERE

FIGURE 3 HERE

In 2005, the regulators sat down to examine the problem of non-traditional mortgage products, agreeing to issue guidelines rather than binding standards, so that potential homeowners would not have restricted access to credit. They were also concerned with reaching a solution that might reduce risky banking activity while accommodating the business needs of banks. On December 20, 2005, the four agencies released guidance that covered all nontraditional and exotic mortgage products after which affected parties had 60 days to comment (Hemingway 2005). 60 days turned into several months, as different interests disagreed over the content of the guidance. Bank representatives thought it too prescriptive and inflexible, while consumer and community groups argued that the effects of particular mortgage products needed to be clearer (Federal Register 2006). After the Senate Banking Committee called the regulators to Capitol Hill in September, 2006 to explain the slow progress (Kaper 2006), the revised guidance was finally issued in the Federal Register on October 4, 2006. To emphasize the re-release of the guidelines, Dugan urged that the guidelines not be watered down and apply to all mortgage originators (OCC 2006).

The new guidance still not did mention several mortgage products by name, such as 2/28 loans and other “hybrid ARMs”. 2/28 loans staked borrowers to a fixed rate for the first two years, while floating to variable rates for the remaining 28 years. Borrowers then experienced significant payment increases, a problem exacerbated by the rising benchmark rate. Five members of the Senate Banking Committee asked that hybrid ARMs specifically be made part of the guidance (Adler and Kaper 2007), but this request by the Senate revealed divisions between the regulators. Sheila Bair wanted to mention specific products, while John Reich and Susan Bies did not and many banking representatives also warned that the industry changed so quickly, that highly specific guidelines could become quickly outdated (Adler and Kaper 2007). The stalemate persisted into early 2007 and as foreclosures continued to rise, the newly elected Democratic Congress applied more pressure on the

regulators. In May, 2007, Dugan responded by raising the issue of stated income loans which were issued on the basis of stated rather than verified income and had accounted for 50 percent of subprime loans in 2007 (Hopkins 2007b). The speech led regulators to add one more revision to the guidance released in June, 2007 which specifically cautioned against 2/28 and stated loans and called on lenders to use fully indexed rates when underwriting mortgages. The guidance faced severe criticism from members of the banking industry who claimed that it was too harsh (Hopkins 2007a) and that it would unnecessarily restrict the supply of credit (Zibel 2007).

In summary, these episodes of interagency collaboration are illustrative of several important things. First, during the CRA discussions, the task environment for regulators had not yet reached a critical point with respect to risk or foreclosures, which is why members of the OTS were able to drive the negotiations and lighten the standards for medium-sized banks. The OTS had recovered from the budget deficit it experienced in the early 2000s, but given the ideological leanings of its leaders, it still wanted to attract more banks by weakening standards. For the "non-traditional mortgage" guidance, regulators could see that risk was building in the housing market and that borrowers were suffering from "payment shock" because of rising, variable interest rates. Due to diverse regulator preferences, the negotiations dragged on for nearly two years, yet the foreclosure rate continued to rise during this time. Regardless, the regulators opted only for a voluntary, non-binding document. Additionally, as Figure 4 indicates, enforcement actions remained largely at the same level through 2007 and did not escalate alongside the increasing foreclosure rates.

The continuation of light touch regulatory policy can be attributed to two things: first, most of the regulators believed that the problem with foreclosures could be contained and would not escalate into a broader crisis. Second, the ideological and professional backgrounds of the regulators in question dictated that they would select policies that would

allow banks to continue what they were doing, even if the regulators had hoped they would behave somewhat differently. Thus, the voluntary nature of the guidance, as well as the stagnant enforcement levels, effectively allowed the RTB to continue through 2007. I discuss regulator activity and agency reputation for 2008 and 2009 in the next section.

FIGURE 4 HERE

The Crisis and its Aftermath

Through 2007, regulators were increasingly concerned with the building risk in the housing market. They gave speeches illustrating this concern, but for two key reasons, they refrained from taking robust enforcement action against the banks that were causing risk to build up. First, most of these regulators had backgrounds in finance, worked closely with bankers and preferred to find cooperative solutions that would not generate animosity in their working relationships. Cooperative solutions were also in tune with the financial industry/regulator collective belief that too much regulation restricted credit access, and that housing bubbles could be treated without too much difficulty. Second, even if there were warning signs in 2007, no retail bank was in immediate danger of failing and therefore there was little danger from Washington either. Senator Chris Dodd and Congressman Barney Frank voiced displeasure over perceived agency foot dragging in the guidance negotiations, but there were no real threats to the agencies.

By the middle of 2008, investment and retail banks alike began to fail and foreclosures continued to rise. The FRB issued binding rules, designed to make mortgages more transparent and understandable for consumers, but enforcement actions for the FRB and other agencies only experienced a minor increase. Regulator behavior only began to change in 2009 when Congress initiated legislative proposals that included a possible new consumer

protection agency. Before 2009, there had been no financial consumer protection agency, even though the four existing regulators were responsible for both protecting consumers and promoting the health of the banks. Thus, when the Democratic House of Representatives introduced the idea of a new, independent financial regulator, the existing regulators saw it as a threat. If we re-examine Figure 4 for all four agencies, we see that the most significant increase does not come until June, 2009—three months after the legislative introduction of the new bureau—and it continues through the end of 2009. In addition to the increase in enforcement actions witnessed through 2009, the leaders of each agency also spoke as if they were responding to new threats. The FRB started to issue consumer finance proposals in 2009 and OCC's Dugan said shortly after the new agency was proposed: "If Congress believes that the consumer protection regime needs to be strengthened, the best answer is not to create a new agency…the better approach is for Congress to reinforce the agencies' consumer protection mission…" (Dugan 2009).

For the OTS, its very survival was on the line. Numerous analyses of the financial crisis had asked whether the OTS was too lenient in its attempts to bring in fees, as many politicians and observers began to speak out against "charter shopping". Senator Dodd stated, "it is clear that we need to end charter shopping where institutions look around for the regulator that will go easiest on them" (2009). Senator Charles Schumer publicly made a similar argument (2008) and Sheila Bair supported consolidating federal bank regulators, but keeping the dual-banking system (2009). Thus, for the OTS, the most significant threats were proposals that would merge federal regulators because this meant either elimination or merger for the OTS. In his testimony before Congress in March, 2009, the Acting Director Scott Polakoff suggested that there should be separate federal regulators for commercial banks and for community banks (Polakoff 2009), a model that would provide a role for the

OTS. John Bowman, the next Acting Director, defended the OTS in July and argued that it had not promoted charter shopping (Bowman 2009).

In summary, the RTB in financial regulatory standards appeared to end in 2009, but it was not because regulators decided to hold banks to account. The culmination of home foreclosures in the financial crisis, combined with Democrats assuming full control of the presidency and Congress in early 2009, led to legislative discussions about drastic financial reforms—reforms which would eventually become the Dodd-Frank Act of 2010. This proposed legislation posed threats to nearly all the regulators, but in different ways. The FRB and OCC felt most threatened by the possible creation of a new federal consumer protection agency, while the OTS was more concerned about being abolished or merged into the OCC. These concerns manifested themselves in the public comments from the agency leaders, but also in the significant increase in enforcement actions seen across the four agencies.

Discussion

Many politicians suspected that the financial crisis of 2007-09 was partly aided by the institutional structure of bank regulation. Allowing banks to choose their regulators, while funding regulators through bank assessment fees, would force regulators to compete for banks, thereby creating an RTB. This paper has addressed whether there was an RTB and the role played by the institutional structure.

The evidence indicates that the institutional structure did play a role, but it was not the only factor and this structure worked in tandem with other factors to produce an RTB that was eventually reversed. The precarious financial positions of the OTS and OCC did initially produce an RTB, as both agencies attempted to make themselves look attractive to banks, through maneuvers, such as federal preemption. However, culturally captured regulators would have been happy to create more lax standards regardless. OCC head John D. Hawke

Jr. was a Democratic appointee, but his counterpart in the OTS, James Gilleran, was very much a banking insider who believed in a lack of regulatory intrusiveness. As time progressed, the Bush Administration was able to make its mark with more like-minded regulators, notably John Dugan in the OCC and John Reich in the OTS. The four regulators, and Dugan in particular, paid close attention to the rising levels of risk in the financial system yet their proposed action never suggested anything beyond voluntary guidance. Thus, the proposed changes still fit the prevailing view of the finance industry, the RTB was allowed to continue, and even rising foreclosure rates through 2007 were not enough to introduce binding standards or to increase enforcement actions. Indeed, only an executive and legislative threat to regulator turf in 2009 goaded the regulators into ratcheting up enforcement levels and "showing their best faces to their audiences…" (Carpenter 2010).

Much research on regulatory policy tends to focus on particular theories as having the potentially best level of explanatory power for particular phenomena. In this paper, I have asked whether an RTB existed in American federal bank regulation prior to the financial crisis. The answer required examining multiple theories of regulation that worked together and at times, had more explanatory power than other theories. The influence of institutions helped us to understand the initial drive to an RTB, but cultural capture theory helped us to understand how institutions and personal backgrounds combine to produce particularly business-friendly policies. Finally, agency reputation theory helped us to understand the reason why and when an RTB might stop. Future studies of bank regulation and the post-financial crisis world will likely need such dynamic examinations that take into the account the effects of various theories on bank and regulator behavior.

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