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Money and Banks in the American Political System

In *Money and Banks in the American Political System*, debates over financial politics are woven into the political fabric of the state and contemporary conceptions of the American dream. The author argues that the political sources of instability in finance derive from the nexus between market innovation and regulatory arbitrage. This book explores monetary, fiscal, and regulatory policies within a political culture characterized by the separation of business and state, as well as mistrust of the concentration of power in any one political or economic institution. The bureaucratic arrangements among the branches of government, the Federal Reserve, executive agencies, and government-sponsored enterprises incentivize agencies to compete for budgets, resources, governing authority, and personnel.

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Money and Banks in the American Political System

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To the memory of my grandmother, Pauline Noga Lucas, who taught me to never forget the human cost of the Great Depression

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Preface

The outrage that ordinary Americans feel over the 2008 financial crisis has not only persisted, it has intensified. Many people are angry because the U.S. government resolved the immediate threat to the financial system by issuing massive handouts to the very segment of the private sector that caused it in the first place. For some both inside and outside the financial services industry, the government should have let companies that made poor business decisions go bankrupt. For others, the government should have assisted individuals and companies caught up in the crisis with different types of intervention than it did. In July 2010, Congress passed a major piece of reform legislation attempting to make sure that such a crisis would never happen again. Yet before the ink on the bill was even dry, some vowed to work to repeal it. The media labels anti-bank sentiment as "populist," yet people's reactions are far from irrational or exaggerated. In the wake of the crisis, the benefits and burdens of the U.S. financial system do not appear to be evenly spread across the American taxpayer base or across industries. A coherent political reaction did not organize because political parties and interest groups have not been able to channel popular sentiment to promote reform in the same way they do in other policy issue areas.

Economic treatments of the American financial system emphasize the role played by markets and the accumulation of leverage in contributing to periodic crises. This book questions the role that U.S. *political* institutions play in making the system prone to episodes of instability. It does not just consider past crises, as important as they are, but the players, institutions, and politics that will surround crises to come. While many simplistic explanations for the political power of Wall Street rest with the size of corporate contributions to politicians' campaigns and the overall amounts paid to lobbyists in Washington, these explanations are too easy. Many industries, such as pharmaceuticals and oil and gas, also donate large sums and employ high-level government relations experts in Washington.

This book takes the view that a comprehensive understanding of how financial politics operate requires an understanding of finance and economics *combined with* an understanding of the political institutions that govern the system. American political culture has fostered an institutional separation between the business of banking and the operations of government throughout U.S. history; nonetheless, the work of the two are deeply connected to each other. Only a combination of changes in the operations of banks and securities firms, regulatory agencies of the government, and macroeconomic policy will yield solutions to the problem of economic governance in a capitalist, democratic environment. Therefore, this book borrows understandings of the policy process from other issue areas, such as health care and the environment, that have a rational component, an organic cultural component, and a bureaucratic component. But to understand the issue area of finance, the book highlights what makes money – and the politics surrounding it – different.

In a nutshell, history shows that the evolution of institutional arrangements among financial markets and the government have provided both a source of instability and innovation as each responds to developments in the other. Therefore, the problems in adequately regulating banking activities are not limited to the asymmetry of the financial sector relative to the rest of the economy, or its outsize lobbying budgets and campaign contributions. Political institutions and regulation channel competition in the banking industry that, in turn, plays a significant role in the structure of market transactions and interest groups representing market participants. Groups then approach federal and state legislatures that write the laws providing statutory justification for the regulation, in most cases seeking to preserve whatever advantages they hold in the marketplace. The Federal Reserve holds a special place among political institutions insofar as it plays a role in management of the macroeconomy through monetary policy and acts as a regulator. Thus, the Federal Reserve possesses its own internal cultural and bureaucratic interests with respect to multiple mandates that can compete with each other. When the Federal Reserve is added to the picture of political institutions, it is apparent that the three branches of government distribute power differently in the financial area but do not eliminate politics from it. The policy process, and thus the rewriting of regulation, is in constant motion and subject to revision. Moreover, since the policy process operates at both the state and national levels, opportunities to circumvent any one obstacle abound.

Misperceptions persist because few comprehensive studies exist. Academic departments in universities divide the topic among themselves. Economics texts fail to explore the inner workings of the political institutions that make it possible for markets to function. American politics texts devote only cursory attention to economic relationships because they are not usually high on the popular agenda and require some specialized knowledge. This book fills that gap by looking inside the Congress, presidency, Treasury, and Federal Reserve to see how and by whom they are influenced. In my view, many political disputes arise within institutions, but they also occur among agencies concerning the distribution of jurisdiction. Therefore, this book considers how institutions function internally, how they interact with each other during the normal course of the business cycle, and how they act during a crisis. Offering an accessible yet nuanced description of financial politics in American government, it provides a framework for understanding the distinct features of the American government's checks and balances as they apply to monetary, fiscal, and financial regulatory policy, as well as their connection to the banking system through the Federal Reserve.

In outlining this framework, I begin with Graham Allison's models of the political process in the American state.[1] I have augmented Allison's understanding with more recent works on American political development and bureaucratic politics to broaden its scope within the domestic financial context.[2] Allison's work is a good place to start because it is a scholarly approach that is used widely in graduate schools of government and public policy, business, and other professional training programs where the objective is to prepare for practice, not theory. As with Allison's original work, the audience for this book comprises both students and colleagues: colleagues who have a professional need to understand how the government intervenes, or does not, in the financial services sector, and students who are either political scientists seeking to deepen their knowledge of

[1] Graham Allison and Philip Zelikow, *Essence of Decision: Explaining the Cuban Missile Crisis*, 2nd ed. (New York: Longman, 1999).

[2] Some major works include Stephen Skowronek, *Building a New American State: The Expansion of National Administrative Capacities 1877–1920* (New York: Cambridge University Press, 1982); Richard Franklin Bensel, *The Political Economy of American Industrialization 1877–1900* (New York: Cambridge University Press, 2000); Susan Hoffman, *Politics and Banking: Ideas, Public Policy, and the Creation of Financial Institutions* (Baltimore: Johns Hopkins University Press, 2001); Marc Allen Eisner, Jeffrey Worsham, and Evan J. Ringquist, *Contemporary Regulatory Policy*, 2nd ed. (Boulder, CO: Lynne Rienner, 2006); Marc Allen Eisner, *Regulatory Politics in Transition* (Baltimore: Johns Hopkins University Press, 1993).

economic policy or economics or finance majors seeking to understand the functioning of the political structures that surround their field.[3]

As with Allison, the argument of this book is deliberately unfinished; it offers an invitation for the reader to join the discussion about where the most significant problems arise in terms of economic and governmental policy and how they should be resolved.[4] Moreover, an approach that offers different conceptual understandings of the political process allows the reader to observe what is going on from different vantage points, each with its own strengths and limitations.

My own interest in writing this book derives from the dual worlds of scholarship and practice. My first academic work was in international political economy, particularly the politics of stock markets. Hoping to broaden my base of inquiry, yet build upon what I had already investigated, I traveled to Washington, DC, as a congressional Fellow in the 110th Congress where I worked on the staff of the House Committee on Financial Services. At the beginning of my assignment in January 2007, the earliest signs of the 2008 financial crisis appeared. My interest grew more pronounced the next academic year, which I spent teaching at Case Western Reserve University in Cleveland, Ohio. By the beginning of 2008, the *Cleveland Plain Dealer* reported that nearly 24,000 people had lost their homes in Cleveland, and nearly 10,000 of the city's houses had been abandoned. Comparatively, in the New Orleans suburb of St. Bernard Parish, Hurricane Katrina destroyed about 13,700 homes and displaced 35,000 people. But Cleveland did not receive disaster relief, presidential visits, or public efforts to assist those devastated by the foreclosure storm.[5]

In 2008, I returned to Washington as a Fellow at the Woodrow Wilson International Center for Scholars. The next week, Lehman Brothers declared bankruptcy and Congress began to debate the Emergency Economic Stabilization Act creating the Troubled Asset Relief Program (TARP) that provided an unprecedented amount of money to the financial system. In November, Barack Obama was elected president and a new administration assumed control of the apparatus of the executive branch. Early in 2010, I was a Fulbright Visiting Chair at the Munk Centre of the University of Toronto. While residing in Canada, my understanding of financial politics was placed in sharp contrast to the different industrial structure, regulatory framework, and political culture of my host country.

3 Allison and Zelikow, *Essence of Decision*, xi.
4 See Graham T. Allison, *Essence of Decision: Explaining the Cuban Missile Crisis* (New York: Little, Brown, 1971).
5 See John Kroll, "The Foreclosure Crisis," *Cleveland Plain Dealer*, January 20, 2008, http://blog.cleveland.com/metro/2008/01/the_foreclosure_crisis_how_it.html (accessed April 12, 2012).

Each of these experiences gave me a deeper understanding of financial politics and the "inside the beltway" operations of our nation's capital because each provided such a different vantage point. Most Washington "insiders" move among positions on Capitol Hill, to presidential administrations, to agencies like the Treasury and the Federal Reserve, to think tanks, and to governmental affairs departments of banks and financial services firms. As a researcher, I had the opportunity to interact with policymakers and academic fellows in the Washington think tank community. This world is separate and distinct from the financial markets in New York and housing markets in Cleveland, yet politics, financial markets, and ordinary Americans are profoundly dependent on each other. The effects of what happens in American financial markets are felt in other countries. My goal for this book is to "connect the dots" from the local, to the national, to the international banking system and show how the political pieces fit together.

The first chapter introduces the study of the political process surrounding finance at the intersection of institutions, regulations, and market innovation. It also introduces the concepts that will be developed later in the book with respect to the policy process, innovation in the financial sector, regulatory arbitrage, and the institutions of government in the United States, relative to other capitalist, industrial democracies. The second chapter presents a brief historical background to the political institutions surrounding the financial system, and the third explains the evolution of the banking industry. The fourth, fifth, and sixth chapters break down the monetary, fiscal, and regulatory policy domains as they are situated among the legislature, presidential administration, executive branch agencies, and Federal Reserve System. The seventh and eighth chapters consider how these institutions work in relation to each other, both in the normal course of the business cycle and in the 2008 crisis. The crisis of 2008 receives particular attention because its resolution has played a role in constructing the arrangement of political institutions going forward. The ninth chapter places the U.S. system into its international context. The tenth, concluding, chapter returns to the themes of the book and lays out the policy problems that will be confronted in coming years.

As a result of the crisis in 2008, we learned that a stable financial system is indispensable to the broader American economy. In the current era, most American workers' pension and retirement plans are defined contribution – not defined benefit – plans. The value of retirement funds is thus directly tied to the performance of the individual investments in them. The greatest single individual investment that most Americans will make remains their home. The reality of these new arrangements is such that the social welfare of ordinary American people is bound to the complexities of the governance of financial institutions in more significant ways than ever before. At the same time, individuals in the financial services industry have received higher levels of compensation partly because they have taken higher risks and devised innovative products that have expanded credit to wider segments of the public. Speculative activity is a necessary part of that system and also a danger to it.

The new reality of individual connection to an interconnected financial system operates within a long-standing political culture forged through civil and world wars, and across more than two centuries. Hence, this book does not provide a comprehensive understanding of the policy process that operates in order to "fix" it. It clearly defies a quick fix. Rather, in providing an understanding of the process, policymakers, students, and professionals can begin to see ways that degrees of stability have been achieved among actors over extended periods of time in American history. Only then can readers begin to formulate their own ideas for the best mix of market and regulatory features to come.

Acknowledgments

As the financial crisis unfolded from late 2008 to 2009, I was asked to answer questions in a variety of forums about the functioning and operations of the U.S. political economy. Just as any teacher knows that she does the best job when answering questions posed by intelligent students, I know how great my debt is to the cohort of Fellows and policy scholars with me at the Woodrow Wilson International Center for Scholars; participants at Munk Centre seminars sponsored by the Centre for International Studies when I was a resident there; and students and colleagues at Case Western Reserve University.

I could not begin to understand the political system in this area myself were it not for the willingness of the American Political Science Association and the House Committee on Financial Services to take me on as a congressional Fellow. Thus, I am deeply appreciative of my own "teachers" on the Hill – Jeff Biggs, Barney Frank, Daniel McGlinchey, Scott Morris, Jeanne Roslanowick, and Jim Segel – who instilled in me a great respect for our legislature and the people who make it work. Among them I am particularly grateful to Daniel McGlinchey for always demonstrating that the practice of politics has a heart as well as a soul and to Jim Segel for reminding us of the motto "don't let the perfect be the enemy of the good."

This book would never have taken shape without the input from numerous brown bag sessions organized by Lucy Jilka and episodes of *Dialogue* produced by John Tyler at the Wilson Center. In order to prepare for them, I thank David Biette, Joe Brinley, John Dysland, Kent Hughes, David Klaus, George Seay, Amy Wilkinson, and Don Wolfensberger. Once the outline for the project began to unfold, I appreciated the efforts of Dagne Gizaw, Michelle Kamalich, Jenny Ross, and Janet Spikes at the library of the

Wilson Center, and Krista Box at the library of the Federal Reserve Board of Governors, who ensured that I had access to the materials I needed. I also appreciated what I learned about the way that politics in Washington work from many informal conversations with Ray Ahern, Bob Burson, Randy Henning, Amy Kiesel, Bill Krist, Mike Rosenbaum, Marty Weiss, and Joe White.

I would not have had time to write the manuscript were it not for the generosity of the Munk Centre. Many thanks go to Lou Pauly for his constant willingness to share insights across the U.S.–Canada divide, and to Tina Lagopoulos for her help while I was there. I also thank the "Canadians" who study the political economy of finance – Randy Germain, Eric Helleiner, Bessma Momani, Tony Porter, and Tim Sinclair – who have shaped my understanding of the American role in the financial world.

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Abbreviations

ABA	American Bankers Association
ABCP	asset-backed commercial paper
AIG	American International Group
A-IRB	advanced internal ratings–based
ARM	adjustable rate mortgage
ASF	American Securitization Forum
BIS	Bank for International Settlements
CBO	Congressional Budget Office
CD	certificate of deposit
CDO	collateralized debt obligation
CDS	credit default swap
CEA	Council of Economic Advisers
CEBS	Committee of European Banking Supervisors
CEO	chief executive officer
CFPB	Consumer Financial Protection Bureau
CFMA	Commodity Futures Modernization Act
CFTC	Commodity Futures Trading Commission
CMO	collateralized mortgage obligation
CP	commercial paper
CPFF	Commercial Paper Funding Facility
CPP	Capital Purchase Program
CRA	Community Reinvestment Act
DIDMCA	Depository Institutions Deregulation and Monetary Control Act of 1980
ECB	European Central Bank
EFSF	European Financial Stability Facility

EMTA	Emerging Markets Traders Association
EMU	European Monetary Union
EOP	Executive Office of the President
EU	European Union
FAC	Federal Advisory Council
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FHLB	Federal Home Loan Bank
FHLMC/Freddie Mac	Federal Home Loan Mortgage Corporation
FIO	Federal Insurance Office
FNMA/Fannie Mae	Federal National Mortgage Association
FOMC	Federal Open Market Committee
FRBNY	Federal Reserve Bank of New York
FSAP	Financial Sector Assessment Program
FSOC	Financial Stability Oversight Council
G7	Group of 7
G8	Group of 8
G20	Group of 20
G30	Group of 30
GAAP	generally accepted accounting principles
GAO	Government Accountability Office
GDP	gross domestic product
GMAC	General Motors Acceptance Corporation
GNMA/Ginnie Mae	Government National Mortgage Association
GSE	government-sponsored enterprise
HAMP	Home Affordable Modification Program
HOEPA	Home Ownership and Equity Protection Act
HUD	Department of Housing and Urban Development
IASB	International Accounting Standards Board
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
IndyMac	Independent National Mortgage Corporation
IRA	individual retirement account
IRB	internal ratings–based
ISDA	International Swaps and Derivatives Association
JEC	Joint Economic Committee
LTCM	Long-Term Capital Management

MBS	mortgage-backed securities
MOU	memorandum of understanding
NABE	National Association for Business Economics
NBER	National Bureau of Economic Research
NCUA	National Credit Union Administration
NEC	National Economic Council
NOW	Negotiated Order of Withdrawal
NSC	National Security Council
OCC	Office of the Comptroller of the Currency
OECD	Organisation for Economic Co-operation and Development
OFHEO	Office of Federal Housing Enterprise Oversight
OFR	Office of Financial Research
OIRA	Office of Information and Regulatory Affairs
OMB	Office of Management and Budget
OTC	over-the-counter
OTS	Office of Thrift Supervision
PAC	political action committee
QE	quantitative easing
S&L	savings and loan
Sallie Mae	Student Loan Marketing Association
SAP	Statement of Administration Policy
SBA	Small Business Administration
SEC	Securities and Exchange Commission
SED	Strategic Economic Dialogue
SGP	Stability and Growth Pact
SIFMA	Securities Industry and Financial Markets Association
SIV	structured investment vehicle
SPV	special-purpose vehicle
TARP	Troubled Asset Relief Program
VaR	Value at Risk
WaMu	Washington Mutual
WHO	White House Office