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The Myth of Financial Market Deregulation

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Abstract

The myth that the 2008 financial crisis was caused by financial market deregulation has persisted for far too long. By every objective metric, there has been no substantial reduction in financial regulations in the U.S. during the past 100-plus years. There have certainly been many changes to federal rules and regulations during the past few decades, and some have allowed financial firms to engage in activities from which they were previously restricted. But these changes did not result in a lack of regulation, and virtually all financial market activity has taken place under the watchful eye of federal regulators since at least the 1930s. True deregulation would establish a market where no government agency regulates the types of products and services people are allowed to produce and purchase. This type of financial market does not currently exist in the U.S., and it certainly did not exist prior to the 2008 crisis. Financial regulators have increasingly micromanaged financial firms' activities despite the fact that this approach has repeatedly failed to prevent financial market instability.

Key Points

- The notion that U.S. financial market deregulation caused the 2008 crisis is demonstrably false. There has been no appreciable reduction in either the scope or the volume of financial regulation during the past 100-plus years.
- Deregulation would have established a market where no government agency regulates the types of products and services that people are allowed to produce and purchase. If this type of financial market ever existed in the U.S., it certainly has not since the 1930s.
- The polar opposite of a deregulated market has existed, and Congress has consistently allowed regulators to micromanage financial companies to an ever greater extent.
- Virtually all capital market activity—even that which contributed to the 2008 crisis—takes place under the watchful eye of federal regulators.
- Failure to acknowledge the damage that the regulatory state can create, as well as the limit of what it can achieve, will surely lead to future crises.

A persistent myth regarding the 2008 financial crisis is that it was caused by deregulation of financial markets. All such claims are wrong. From an aggregate perspective, the industry has always been regulated, and there has never been a substantial reduction in financial regulations in the U.S. during the past 100-plus years. Instead, this time period has included an ever-expanding regulatory framework in financial markets, both in terms of volume and depth. Congress has imposed more regulation on financial markets and expanded the type of regulation. Over time, the regulatory framework has morphed to allow regu-

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lators to micro-manage financial companies to an ever greater extent.

For decades, capital market firms have been among the most heavily regulated businesses in the U.S., and virtually all of their activities—including those that contributed to the 2008 crisis—take place under the watchful eye of federal regulators. Close supervision has even been a main feature of the so-called deregulatory changes enacted by Congress and regulatory agencies. It is, therefore, completely erroneous to blame the crisis on unregulated financial markets. Regardless of how one labels recent changes to the regulatory framework, there is no reason to believe any of those changes will prevent future financial crises.

The False Narrative of Deregulation

The role of deregulated financial markets was central to the political narrative that explained the 2008 financial crisis. For instance, shortly after the crisis, House Speaker Nancy Pelosi stated that "the Bush Administration's eight long years of failed deregulation policies have resulted in our nation's largest bailout ever, leaving the American taxpayers on the hook potentially for billions of dollars."[1] Similarly, in the second presidential debate that year, Barack Obama asserted that "the biggest problem in this whole process was the deregulation of the financial system."[2] At best, these types of statements are a complete mischaracterization of policy changes during the Bush years.

Regulation can be measured in many different ways, but various metrics show that financial markets were not deregulated during the Bush Administration. In terms of rulemaking—that is, the promulgation of specific rules by regulatory agencies—federal financial regulations imposed a net cost on the economy for the eight years of the Bush Administration. In other words, even though some federal regulations during these eight years reduced burdens, the overall impact of the rulemakings *increased* the cost of regulation. Data provided by the agencies themselves show that the major regulatory changes (defined as those with an economic effect of $100 million or more) cost the economy more than $2 billion (in constant 2010 dollars) from 2001 to 2008.[3]

It is also helpful to examine the total budget of regulatory agencies because much of their work takes place in day-to-day activities rather than in formal rulemaking activities. Excluding the Securities and Exchange Commission (SEC), the total budget of federal financial regulators increased from approximately $2 billion in fiscal year (FY) 2000 to almost $2.3 billion in FY 2008.[4] During the same period, the SEC's budget increased from $357 million to $629 million.[5] Total staffing at these agencies basically remained steady during this period, at close to 16,000 employees.[6] Thus, federal financial regulators' budgets increased, and their staff levels were not cut.

All of these statistics for the Bush Administration are broadly consistent with longer-term trends as well. For example, outlays for banking and financial regulation increased from $190 million in 1960 to $1.9 billion in 2000, while staff rose from approximately 2,500 employees to more than 13,000.[7] That is, long-term trends in both budget outlays and

1. Laura Litvan and Brian Faler, "Congress Pushes for Bigger Role in Resolving Financial Crisis," Bloomberg, September 16, 2008, http://www.bloomberg.com/apps/news?pid=20601103&sid=aNQo2I5pPjdA&refer=us (accessed October 21, 2008).

2. "Transcript of Second McCain, Obama Debate," CNNPolitics.com, http://www.cnn.com/2008/POLITICS/10/07/presidential.debate.transcript/ (accessed January 8, 2016).

3. The total is from updated versions of agency-provided data used in James L. Gattuso, "Red Tape Rising: Regulatory Trends in the Bush Years," Heritage Foundation *Backgrounder* No. 2116, March 25, 2008, http://s3.amazonaws.com/thf_media/2008/pdf/bg2116.pdf. The figure includes regulations promulgated by the Federal Reserve, the Securities and Exchange Commission, and the Department of the Treasury.

4. These figures are adjusted to constant 2000 dollars. See James L. Gattuso, "Meltdowns and Myths: Did Deregulation Cause the Financial Crisis?" Heritage Foundation *WebMemo* No. 2109, October 22, 2008, http://www.heritage.org/research/reports/2008/10/meltdowns-and-myths-did-deregulation-cause-the-financial-crisis#_ftn5.

5. Ibid.

6. Ibid.

7. These dollar figures are in constant 2000 dollars. See Veronique de Rugy and Melinda Warren, "The Incredible Growth of the Regulators' Budget," Mercatus *Working Paper* No. 08-36, September 2008, pp. 3–4, http://mercatus.org/sites/default/files/publication/WP0836_RSP_The_Incredible_Growth_of_the_Regulators_Budget_0.pdf (accessed November 17, 2015).

staffing suggest that regulation has been increasing steadily for decades. Not surprisingly, many who claim that deregulated financial markets caused the crisis ignore these types of metrics and, instead, point to specific legislative changes. In virtually all cases, though, these legislative changes have been mischaracterized as deregulatory.

Legislation Did Not Deregulate

In the wake of the 2008 financial crisis, Senator Elizabeth Warren (D–MA) gave reporter Dan Rather the following explanation about the crisis' cause:

> It gets to be the early 1980s...and what do we do? Instead of saying "new products," we need to change regulations to "adapt," we take a different path...we say "let's deregulate"…. We begin to break down the old regulations, we say "who needs regulations, they're so poky, so old," so we go with this idea of let's get rid of regulation and what happens...and where do we end up? In the biggest crisis since the Great Depression.[8]

Again, the notion that financial market participants—whether banks or non-bank financial firms—were allowed to engage in unregulated activity is completely wrong. Ironically, what actually took place was much closer to what Warren insists did not take place. As markets changed, so did the regulations. And there have certainly been many changes to federal rules and regulations during the past few decades.

Broadly speaking—and in many specific instances—these changes gave regulators *more* authority to tell financial firms what they can do and how they can do it.[9] While some of these changes expanded the types of regulated activities in which certain firms could engage, only an extremely naïve view of the regulatory framework could consider these changes deregulatory. In virtually all instances, federal regulators were the official overseers of financial firms' activities both before and after the regulatory environments were changed. The following list provides a detailed summary of the most frequently cited regulatory changes that, supposedly, deregulated financial markets.[10]

The 1999 Gramm–Leach–Bliley Act (GLBA). One of the most often-repeated claims is that the GLBA caused excessive risk-taking because it repealed the Glass-Steagall Act, the 1933 law that separated commercial and investment banking.[11] However, the GLBA only amended the Glass–Steagall Act, and it did not create an unregulated segment of the financial industry.[12] Specifically, only four sections of Glass–Steagall implemented the so-called separation of commercial and investment banking. The GLBA repealed Sections 20 and 32 of the 1933 act, and left Sections 16 and 21 intact.[13]

8. Dan Rather Reports, "Elizabeth Warren Explains the Effect that Deregulation Has Had on Our Financial System and Economy," 2009, https://www.youtube.com/watch?v=PS3C5WvVPvA (accessed December 9, 2015).
9. A 2014 House Financial Services Committee report identified several recent legislative and regulatory changes that "gave federal regulators broad new powers over banks, mortgage lenders, and other financial services companies." Aside from the implementation of the Basel capital accords, the report identified the following changes: the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 (P.L. 102–242), the Home Ownership and Equity Protection Act (HOEPA) of 1994 (P.L. 103–325), the 2001 Bank Secrecy Act amendments in the USA PATRIOT Act (P.L. 107–56), the Sarbanes–Oxley Act of 2002 (P.L. 107–204), and the Fair and Accurate Credit Transactions Act of 2003 (P.L. 108–159). See "Failing to End 'Too Big to Fail': An Assessment of the Dodd–Frank Act Four Years Later," report prepared by Republican Staff of the Committee on Financial Services, U.S. House of Representatives, 113th Congress, 2nd Session, July 2014, pp. 3–4, http://financialservices.house.gov/uploadedfiles/071814_tbtf_report_final.pdf (accessed February 4, 2016).
10. See, for example, Matthew Sherman, "A Short History of Financial Deregulation in the United States," Center for Economic and Policy Research, July 2009, http://www.cepr.net/documents/publications/dereg-timeline-2009-07.pdf (accessed December 8, 2015). Sherman describes all of the bills analyzed in this *Backgrounder* as deregulatory. For an explanation of various regulatory rulemakings as well as legislation, see Arnold Kling, "Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008," Mercatus Center, 2009, http://mercatus.org/publication/not-what-they-had-mind-history-policies-produced-financial-crisis-2008 (accessed January 10, 2016).
11. See, for example, Kevin Cirilli, "Warren Calls for Return of Glass-Steagall," *The Hill*, July 14, 2015, http://thehill.com/policy/finance/247929-warren-calls-for-return-of-glass-steagall (accessed November 19, 2015).
12. The commonly used term "Glass–Steagall" actually refers to four sections of the Banking Act of 1933. There are many misconceptions surrounding the Glass–Steagall Act, and it is doubtful that the 1933 law made financial markets any safer in the first place. For instance, the definitive study of the Glass–Steagall Act states that "the evidence from the pre-Glass-Steagall period is totally inconsistent with the belief that banks' securities activities or investments caused them to fail or caused the financial system to collapse." See George Benston, *The Separation of Commercial and Investment Banking* (New York: Oxford University Press, 1990), p. 41.

Sections 16 and 21 *generally* prohibited banks from underwriting or dealing in securities[14] and investment banking firms from accepting demand deposits, respectively. Sections 20 and 32, on the other hand, *generally* prohibited commercial banks from affiliating with investment banks. Each of these Glass–Steagall sections included exceptions, so the separation between commercial and investment banking was never absolute.

After the GLBA, banks could legally affiliate with a company engaged in securities underwriting or dealing, but these different entity types could not engage in unregulated commercial or investment banking.[15] The GLBA also amended the Bank Holding Company Act of 1956, the law which gave the Federal Reserve the responsibility of regulating all bank holding companies (BHCs).[16] The GLBA allowed BHCs to engage in a broader range of financial activities, and it did so by explicitly defining many financial activities. Section 103 of the GLBA, for example, specified various activities and also vested the Fed and Treasury with discretionary authority to determine whether an activity was financial in nature.

The GLBA required BHCs to register with the Federal Reserve if they wanted to legally engage in these activities. Additionally, a BHC could only be approved to operate after the Fed certified that both the holding company and all its subsidiary depository institutions were well-managed and well-capitalized, and in compliance with the Community Reinvestment Act (CRA), among other requirements.[17]

Much More to the GLBA. The Glass–Steagall amendments in the GLBA garner most of the headlines, but the law contained five unrelated titles that, in many instances, increased financial regulations. Title IV of the GLBA prohibited the creation of new thrift-holding companies as well as the sale of existing thrift-holding companies to any non-financial firm. Title V instituted new privacy and disclosure regulations (including new civil penalties),[18] and Title VI amended the capital rules for banks in the Federal Home Loan Bank (FHLB) system.[19] Title VII implemented many provisions, including new CRA requirements for banks and the requirement that ATM operators post fee notices both on the machine and the screen.

The 1980 Depository Institutions Deregulation and Monetary Control Act (DMCA). The DMCA is cited as a deregulatory bill mainly because the act phased out interest rate ceilings on savings and time deposits at commercial banks and thrifts, a price control that had been in place since the 1930s.[20] For roughly 30 years the ceiling had little impact because it was kept above short-term market rates. In the 1960s, however, Congress tried to use this price control to stop interest rates from rising and to

13. GLBA Section 101. A copy of the 1999 Act is available at Authenticated U.S. Government Information, S. 900, 106th Congress, 1st Session, http://www.gpo.gov/fdsys/pkg/BILLS-106s900enr/pdf/BILLS-106s900enr.pdf (accessed January 8, 2016).

14. The practice of *underwriting* securities refers to assuming the risk that an issue of securities (stocks, for example) will be fully sold to investors; the practice of *dealing* securities typically refers to holding an inventory of securities to facilitate trades (buying and selling) for customers.

15. The GLBA shifted the regulatory framework to functional regulation. Under this new structure, whether a bank, insurance company, or broker-dealer engaged in a securities-related activity, the activity would now be regulated by the same financial regulator rather than three separate agencies. See Norbert J. Michel, "The Glass–Steagall Act: Unravelling the Myth," Heritage Foundation *Backgrounder* No. 3104, April 28, 2016, http://www.heritage.org/research/reports/2016/04/the-glasssteagall-act-unraveling-the-myth..

16. Dafna Avraham, Patricia Selvaggi, and James Vickery, "A Structural View of U.S. Bank Holding Companies," Federal Reserve Bank of New York *Economic Policy Review* (July 2012), p. 67, http://www.newyorkfed.org/research/epr/12v18n2/1207avra.pdf (accessed January 22, 2014).

17. See Code of Federal Regulations, Title 12, Ch. II § 225.82, http://www.gpo.gov/fdsys/pkg/CFR-2013-title12-vol3/pdf/CFR-2013-title12-vol3-part225.pdf (accessed January 8, 2016).

18. Federal Trade Commission, "In Brief: The Financial Privacy Requirements of the Gramm-Leach-Bliley Act," https://www.ftc.gov/tips-advice/business-center/guidance/brief-financial-privacy-requirements-gramm-leach-bliley-act (accessed December 9, 2015).

19. The main changes made the FHLBs' capital structure more permanent by requiring members to invest their capital for five years, and also subjected FHLBs to new leverage and risk-based capital requirements. See Thomas J. McCool, "Federal Home Loan Bank System: An Overview of Changes and Current Issues Affecting the System," U.S. Government Accountability Office, 2005, GAO–05–489T, http://www.gao.gov/assets/120/111492.pdf (accessed December 9, 2015).

20. The Banking Acts of 1933 and 1935 outlawed interest payments on demand deposits and gave the Fed the authority to set interest rate ceilings on time and savings deposits for member and non-member banks, respectively. See R. Alton Gilbert, "Requiem for Regulation Q: What It Did and Why It Passed Away," Federal Reserve Bank of St. Louis, February 1986, pp. 22–37, https://research.stlouisfed.org/publications/review/86/02/Requiem_Feb1986.pdf (accessed December 8, 2015).

expand mortgage credit. The policy failed to achieve either objective, as acknowledged in the DMCA, and by the 1970s interest rates rose sharply.[21] The DMCA left the prohibition of paying interest on *demand deposits* in place, though the 2010 Dodd–Frank Act eliminated the ban. Thus, even if these price controls are viewed as financial regulations, the DMCA did not remove all such rules.

Regardless, the DMCA also included several provisions which increased regulations. For instance, the DMCA made *all* depository institutions subject to the Fed's deposit reserve requirements. Prior to this change, only Federal Reserve member institutions were subject to the Fed's reserve regulations. As per the DMCA, regardless of whether a bank or thrift chose to be a member of the Federal Reserve System, it was required to hold its reserves in an account at its Fed District Bank, subject to the Fed's rules.[22] While the question of membership is largely ignored now, the Fed was losing member banks for more than two decades leading up to the passage of the DMCA.[23] The DMCA also established nationwide Negotiable Order of Withdrawal accounts and All Savers certificates, new financial accounts subject to specific regulations. The All Savers certificates, for example, had a floating interest rate ceiling equal to 70 percent of the yield on one-year Treasuries.[24]

The 1982 Garn–St. Germain Depository Institutions Act. The Garn–St. Germain Act is frequently cited as deregulatory because it allowed certain thrifts to make commercial loans, a practice from which they were previously restricted. Viewed in the proper context, however, the act was an acceleration of the 1980 DMCA, an expansion of thrifts' regulated activities, and a rescue bill for the thrift industry. Titles I and II of the act, for instance, enhanced the powers of the Federal Deposit Insurance Corporation (FDIC) and Federal Savings and Loan Insurance Corporation (FSLIC) to provide aid to failing and failed institutions.[25] Title III—the main source of the bill's deregulatory characterization—authorized thrifts (and other depository institutions) to undertake several new practices.

Title III authorized, among other activities, federally chartered savings and loan institutions (S&Ls) and savings banks to make commercial loans. Title III also permitted federally chartered S&Ls to offer demand deposits to their loan customers, a practice previously allowed only at commercial and mutual savings banks. However, the statute required that these institutions conduct these activities subject to the rules and regulations of the Federal Home Loan Bank Board. Put differently, the act did not allow thrifts to make loans or offer demand deposits in a *deregulated* manner. That is, the act did not permit the firms to conduct these activities in the absence of rules and regulations.[26]

Title III also created the money market deposit account (MMDA), a concession designed to allow banks to better compete with (non-bank) money market mutual funds. While there were no interest rate ceilings on these accounts, MMDAs were subject to other rules, such as minimum account balances and limits on the type and number of transfers. Title IV has also been referred to as deregulatory because it "relaxed" certain safety and soundness limitations on the size of loans that national banks could make to any single borrower.[27] It makes little sense to call this change deregulatory, though, because Title IV merely raised the *maximum allowed*

21. Thrift institutions (mutual savings banks and savings and loan institutions) were not subject to the rate ceiling until 1966. See Gilbert, "Requiem for Regulation Q."

22. The Fed administers these rules under Regulation D; see Code of Federal Regulations, Title 12, Chapter II, Subchapter A, Part 204.

23. Between 1970 and 1978, roughly 300 banks left the Fed system, and the ratio of members' deposits to total bank deposits fell from more than 80 percent to 72 percent. Richard Timberlake, "Legislative Construction of the Monetary Control Act of 1980," *American Economic Review*, Vol. 75, No. 2 (1985), Papers and Proceedings of the Ninety-Seventh Annual Meeting of the American Economic Association, pp. 97–102, http://www.jstor.org/stable/1805578?seq=1#page_scan_tab_contents (accessed October 20, 2015).

24. Gilbert, "Requiem for Regulation Q," p. 33.

25. See Gillian Garcia et al., "The Garn-St. Germain Depository Institutions Act of 1982," Federal Reserve Bank of Chicago *Economic Perspectives*, Vol. 7, No. 2 (March 1983), pp. 3–31.

26. Arguably, allowing S&Ls to make demand deposits made the regulatory environment more confusing because the legal definition of a bank had to be altered to prevent S&Ls from coming under the direct regulatory authority of the Federal Reserve. See Garcia et al., "The Garn-St. Germain Depository Institutions Act of 1982."

27. Ibid., p. 8.

percentage from 10 percent to 15 percent of an institution's capital and surplus. After the act was passed, all national banks' loans still had to comply with the rules and regulations promulgated by their primary regulator.

The 1994 Riegle–Neal Interstate Banking and Branching Efficiency Act (IBBEA). The IBBEA is typically cited as deregulatory because it removed restrictions on interstate branching by banks. While the IBBEA did remove the federal restrictions preventing banks from opening interstate branches, the act did not allow these newly branched banks to function in an unregulated environment. In other words, the same banking activities were regulated by the same banking regulators both before and after the IBBEA was passed. The IBBEA stipulated that some of the key branching activities newly allowed, such as a bank holding company acquiring a bank outside its home state, were regulated by the Federal Reserve.[28]

Others, such as interstate bank mergers, had to be approved by the appropriate federal regulator (either the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board, or the FDIC).[29] The IBBEA provided regulators some level of discretion in these new activities, and it also placed several statutory restrictions on interstate banking, such as nationwide and state concentration limits on total deposits at one institution.[30] Before the Civil War, bank regulation was largely a state matter, and a few states allowed interstate banking. However, limited interstate travel and communication opportunities made interstate banking impractical relative to the 20th century.[31] Thus, interstate branching was relatively less important in years past. Regardless, under the new framework implemented by the IBBEA, virtually all banking activity remains regulated, and banks are supervised and examined by more than one regulator.

Currently, state agencies and at least seven federal regulators—the Federal Reserve, the FDIC, the SEC,[32] the Commodity Futures Trading Commission (CFTC), the Consumer Financial Protection Bureau (CFPB), the Federal Housing Finance Agency (FHFA), and various agencies within the U.S. Department of the Treasury[33]—*could* supervise, examine, or otherwise regulate a bank. In general, federally chartered banks are subject to supervision by the OCC, an independent bureau of the U.S. Department of the Treasury. State-chartered banks that choose to be members of the Federal Reserve System are subject to oversight by both the Fed and state regulators. However, non-Fed member state-chartered banks that are insured by the FDIC are subject to oversight by the FDIC and state regulators.[34]

The 2000 Commodity Futures Modernization Act (CFMA). The CFMA is usually cited as the bill which prevented the CFTC from regulating over-the-counter (OTC) derivatives, such as swaps. The CFMA did, in fact, prevent the CFTC from regulating many OTC derivatives, but the CFTC did not regulate these derivatives prior to the passage of the CFMA. A main purpose of the CFMA was to clarify which regulator—the CFTC or the SEC—would regulate *single stock futures contracts*. These

28. Section 101 of IBBEA.
29. Section 102 of IBBEA. The Federal Deposit Insurance Act (Public Law 81–797; 12 U.S. Code Chapter 16, as amended) defines the appropriate federal banking agency for purposes of which agency regulates which bank (12 U.S. Code §1813(q)), and also determines which federal agency is responsible for approving mergers between particular banks (12 U.S. Code §1828(c)(2).)
30. 12 U.S. Code § 1831u (b)(2).
31. For more on the history of federal and state bank regulation, see Christian Johnson and Tara Rice, "Assessing a Decade of Interstate Bank Branching," Federal Reserve Bank of Chicago, April 2007, https://www.chicagofed.org/publications/working-papers/2007/wp-03 (accessed December 9, 2015).
32. If the bank sells investments to customers, it will also be subject to regulation by the Financial Industry Regulatory Authority (FINRA).
33. Besides the OCC, the Financial Crimes Enforcement Network and the Internal Revenue Service impose a wide variety of information reporting and due-diligence requirements on financial institutions. Two of the above named agencies, the CFPB and the FHFA, did not exist when the IBBEA was passed, but at least some of their authority was vested in other (existing) agencies, such as the Department of Housing and Urban Development (HUD) and the Federal Trade Commission (FTC). The Housing and Economic Recovery Act of 2008 created the FHFA, and the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act created the CFPB.
34. Additionally, the Fed is the primary regulator of all bank holding companies, even though such holding companies are also subject to state regulations. Furthermore, the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) requires that any FDIC-insured state bank not engage in any activity impermissible for national banks. 12 U.S. Code § 1831a.

financial products have features of both securities and commodities, items that fall under the separate jurisdictions of the SEC and the CFTC.[35]

The main issue concerning the CFTC's regulatory authority over swaps dealt with legal uncertainty for swaps that could be construed as futures under the Commodity Exchange Act, possibly voiding the contracts if they were traded off exchange (that is, in the OTC market).[36] While the CFMA did prevent the CFTC from regulating OTC swaps, it did not prevent these swaps from being regulated. In fact, the bulk of the swaps market, even the infamous credit default swaps (CDS) associated with the 2008 financial crisis, were regulated by banking regulators.[37]

Over-the-Counter Swaps Were Regulated. Historically, the interest rate and foreign exchange swaps used by large banks have accounted for more than 80 percent of the OTC derivatives market.[38] Federal banking regulators, including the Federal Reserve and the OCC, constantly monitor banks' financial condition, including the banks' swaps exposure.[39] Even the very first iteration of the Basel capital requirements, implemented in the late 1980s, required banks to account for their swaps when calculating regulatory capital ratios. In particular, capital had to be held against the *credit-risk equivalent* to the swaps, essentially treating them as other loans in their risk-adjusted assets.[40]

Simply put, none of these transactions took place outside of bank regulators' purview, and there is no shortage of public acknowledgements attesting to this fact. For instance, a 1993 Boston Federal Reserve paper notes, "Bank regulators have recognized the credit risk of swaps and instituted capital requirements for them and for other off-balance-sheet activities, as part of the new risk-based capital requirements for banks."[41] Similarly, a 1996 OCC guidance bulletin notes:

> Bank management must ensure that credit derivatives are incorporated into their risk-based capital (RBC) computation. Over the near-term, the RBC treatment of a credit derivative will be determined on a case-by-case basis through a review of the specific characteristics of the transaction. For example, banks should note that some forms of credit derivatives are functionally equivalent to standby letters of credit or similar types of financial enhancements. However, other forms might be treated like interest rate, equity, or other commodity derivatives, which have a different RBC requirement.[42]

Just before the recent crisis, a 2006 OCC report stated:

> As a result, derivatives activity is appropriately concentrated in those few institutions that have made the resource commitment to operate the business in a safe and sound manner. Further, the OCC has examiners on site in these large banks to

35. Chairman Arthur Levitt, U.S. Securities and Exchange Commission, "Testimony Concerning S. 2697, The Commodity Futures Modernization Act of 2000," testimony before the Committee on Agriculture, Nutrition, and Forestry and the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, June 21, 2000, https://www.sec.gov/news/testimony/ts112000.htm (accessed December 9, 2015).
36. Ibid.
37. For more on derivatives regulation, see Norbert Michel, "Fixing the Dodd–Frank Derivatives Mess: Repeal Titles VII and VIII," Heritage Foundation *Backgrounder* No. 3076, November 16, 2015, http://www.heritage.org/research/reports/2015/11/fixing-the-doddfrank-derivatives-mess-repeal-titles-vii-and-viii.
38. International Swaps and Derivatives Association, "The Value of Derivatives," 2014, http://www2.isda.org/about-isda (accessed June 23, 2015).
39. Until 1974, the U.S. Department of Agriculture regulated the futures market, and the first federal statute regulating futures was the Grain Futures Act of 1922. The Commodity Futures Trading Commission was created in 1974 soon after newspaper reporters blamed a steep increase in food prices on speculative trading. See Roberta Romano, "A Thumbnail Sketch of Derivative Securities and Their Regulation," *Maryland Law Review*, Vol. 55, No. 1 (1996), http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2985&context=fss_papers (accessed June 22, 2015).
40. Katerina Simons, "Interest Rate Structure and the Credit Risk of Swaps," Federal Reserve Bank of Boston, *New England Economic Review* (July/August 1993), https://www.bostonfed.org/economic/neer/neer1993/neer493b.pdf (accessed June 22, 2015). Simons also points out that "to the extent that swaps replace on-balance-sheet obligations of counterparties, they reduce rather than increase the credit risk in the financial system."
41. Ibid.
42. Office of the Comptroller of the Currency, "Credit Derivatives," *OCC Bulletin* 1996-43, August 12, 1996, http://www.occ.gov/news-issuances/bulletins/1996/bulletin-1996-43.html (accessed October 13, 2015).

> evaluate the credit, market, operational, reputation and compliance risks in the derivatives portfolio on an ongoing basis.[43]

Even the controversial CDS used by the failed company American International Group (AIG) took place under the watchful eye of the Office of Thrift Supervision, a federal banking regulator whose responsibilities Dodd–Frank transferred to the OCC, the Fed, and the FDIC.[44] The notion that these swaps transactions took place in some shadowy room where regulators had no clue what was going on, is absolutely false. Furthermore, banking regulators remain responsible (under the new Basel III requirements) for certifying that banks are meeting their regulatory capital ratios, even when they use swaps. Nonetheless, Title VII of Dodd–Frank gives the CFTC and the SEC explicit authority to regulate the OTC swaps markets.[45]

The 2004 Amendment to the SEC's Net Capital Rule. Sections 8(b) and 15(c)(3) of the 1934 Securities Exchange Act introduced a net capital rule for broker-dealers, a rule that dictated the type and amount of liquid assets that broker-dealers had to maintain. The rule was amended several times after 1934, including a major adjustment in 1975 after a series of firm failures in the late 1960s and early 1970s, and also in 2004.[46] The 2004 rule change has been blamed for allowing broker-dealers to raise their leverage, but data show that major investment banks were actually more highly leveraged in 1998 than in 2006, just prior to the 2008 crisis.[47]

Regardless of how the rule change impacted firms' leverage, it is, once again, highly misleading to characterize this amendment as deregulatory. The main component of the rule change was one that permitted an alternative method for computing deductions under the broker-dealer net capital rule.[48] It is true that the rule allowed firms to use mathematical models to calculate their net capital requirements, but these firms were still subject to a minimum capital rule. Furthermore, companies electing to use the alternative approach were also subjected to "enhanced net capital, early warning, recordkeeping, reporting, and certain other requirements."[49] Firms electing the alternative method were also required to implement and document an internal risk-management system.

The overall intent of the rule change was to allow the SEC to regulate holding companies on a consolidated basis, much like the Federal Reserve does with bank holding companies.[50] As such, the change only applied to holding companies that did not already have a principal regulator, and it did not undo any leverage restrictions.[51] If anything, the rule change represents a clear case of regulatory failure rather than deregulation. In fact, the SEC's Inspector Gen-

43. Comptroller of the Currency Administrator of National Banks, "OCC's Quarterly Report on Bank Derivatives Activities, First Quarter 2006," http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq106.pdf (accessed October 13, 2015).
44. See Dodd–Frank Title III, 12 U.S. Code Subchapter III. Also see Board of Governors, FDIC, OCC, "Joint Implementation Plan: 301–326 of the Dodd–Frank Wall Street Reform and Consumer Protection Act," 2011, http://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/pub-other-joint-implementation-plan.pdf (accessed December 19, 2015).
45. Section 701, Subtitle A (Regulation of the Over-the-Counter Swaps Markets), U.S. Code Title 15, Chapter 109, Subchapter I.
46. See 17 CFR 240.15c3-1 for the current rule. For a history of the rule's development, see Nicholas Wolfson and Egon Guttman, "The Net Capital Rules for Brokers and Dealers," *Stanford Law Review*, Vol. 24, No. 4 (1972), pp. 603–643.
47. U.S. Government Accountability Office, "Financial Markets Regulation: Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and across System," GAO–09–739, July 2009, p. 41, http://www.gao.gov/new.items/d09739.pdf (accessed January 8, 2016), and Andrew Lo, "Reading About the Financial Crisis: A 21-Book Review," *Journal of Economic Literature*, Vol. 50, No. 1 (March 2012), pp. 151–178, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1949908 (accessed January 8, 2016).
48. "Securities and Exchange Commission: Alternative Net Capital Requirements for Broker-Dealers that Are Part of Consolidated Supervised Entities, Final Rules," *Federal Register*, Vol. 69, No. 118, June 21, 2004, http://www.sec.gov/rules/final/34-49830.pdf (accessed December 18, 2015).
49. Ibid., p. 34428.
50. See Securities and Exchange Commission Office of Inspector General, "SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program," Report No. 446-A, September 25, 2008, p. 5, http://www.sec.gov/about/oig/audit/2008/446-a.pdf (accessed December 18, 2015).
51. Erik R. Sirri, "Speech by SEC Staff: Remarks at the National Economists Club: Securities Markets and Regulatory Reform," U.S. Securities and Exchange Commission, April 9, 2009, http://www.sec.gov/news/speech/2009/spch040909ers.htm (accessed December 18, 2015).

eral Report stated that "it is undisputable that the CSE [Consolidated Supervised Entities] program failed to carry out its mission in its oversight of Bear Stearns because under the Commission and the CSE program's watch, Bear Stearns suffered significant financial weaknesses and the FRBNY [Federal Reserve Bank of New York] needed to intervene...to prevent significant harm to the broader financial system."[52]

More directly, the report noted:

> Overall, we found that there are significant questions about the adequacy of a number of CSE program requirements, as Bear Stearns was compliant with several of these requirements, but nonetheless collapsed. In addition, the audit found that TM [the SEC's Division of Trading and Markets] became aware of numerous potential red flags prior to Bear Stearns' collapse, regarding its concentration of mortgage securities, high leverage, shortcomings of risk management in mortgage-backed securities and lack of compliance with the spirit of certain Basel II standards, but did not take actions to limit these risk factors.[53]

In fairness, there is no reason to think that regulators have superior knowledge compared to other market participants when it comes to measuring financial assets' risk. In fact, regulator-assigned risk weights under the Basel rules proved incorrect and contributed to the meltdown in the banking sector.[54]

Lack of Focus on Systemic Risk Also a Myth. A common response to financial disturbances is that regulators have to do a better job of regulating firms' safety and soundness to prevent the next crisis. This view is related to the deregulation myth because its proponents claim that the absence of particular *types* of regulations caused market instability. In the wake of the 2008 crisis, sympathetic policymakers argued that regulators could improve market stability in the future if only they would broaden their focus to monitor *systemic risk*, rather than simply concentrate on individual firm risk.[55] Supposedly, this new focus can better prevent financial difficulties at any one institution from carrying over into the broader economy. At best, the claim that this policy shift is a *new* focus is highly misleading, while true on technical grounds. Otherwise, it is demonstrably incorrect that regulators have not previously monitored systemic risk.

It is true, for example, that the new Basel III capital rules employ some systemic risk (macro-prudential) regulations that were not previously used in the U.S. But this fact is barely relevant because the concept of regulators focusing on systemic risk is anything but new. One of the main justifications for creating the Federal Reserve and instituting federal banking regulations in the first place was to prevent problems in the financial sector from spilling over to the broader economy. These new macro-prudential tools are only the latest attempt at finally creating the "right" set of regulations.

The Fed, Congress, and the U.S. Treasury have openly discussed their roles in stemming economy-wide systemic risk and financial stability for decades.[56] Regulators' explicit focus on systemic risk was clear during, for example, the 1984 congressional hearings related to the bailout of the Continental Illinois National Bank. At those hearings, Todd Conover, head of the OCC, testified that the bank supervisor's role was to maintain *systemic soundness*.[57] Conover went on to testify:

52. Securities and Exchange Commission Office of Inspector General, "SEC's Oversight of Bear Stearns and Related Entities," p. viii.

53. Ibid.

54. Norbert J. Michel and John L. Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem," Heritage Foundation *Backgrounder* No. 2905, April 23 2014, http://www.heritage.org/research/reports/2014/04/basel-iii-capital-standards-do-not-reduce-the-too-big-to-fail-problem?ac=1.

55. See, for example, David Beim and Christopher McCurdy, "Federal Reserve Bank of New York Report on Systemic Risk and Bank Supervision," August 18, 2009, discussion draft, p. 14, https://publicintelligence.net/federal-reserve-bank-supervision-report/ (accessed December 19, 2015).

56. For instance, systemic-risk concerns were mentioned in Federal Reserve testimony before the House Subcommittee on Economic Stabilization in 1991, shortly after the Basel I accords were accepted. John P. LaWare, testimony before the Subcommittee on Economic Stabilization, Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, May 9, 1991, https://fraser.stlouisfed.org/docs/historical/federal%20reserve%20history/bog_members_statements/laware_19910509.pdf (accessed November 18, 2014).

> Our [the OCC's] supervision of banks of all sizes has been enhanced by the establishment of an Industry Review Program. This program includes a computerized information system to collect data on industry concentrations in individual bank portfolios and *the banking system as a whole*.[58] (Emphasis added.)
>
> In addition to the more frequent examinations we have undertaken, the examiners will also monitor trends and developments in the banks between examinations. This new approach results in near-constant supervision of each of our large banks. We are now better able to identify and devote attention to items of supervisory concern in individual large banks and significant practices emerging in *the large bank population as a whole*.[59] (Emphasis added.)

Furthermore, the OCC was not the only federal regulator concerned with systemic risk prior to the 2008 crisis.[60] For example, in 1996, the Federal Reserve specifically accounted for system-wide risk in its new rating system for financial institutions known as the CAMELS rating. Prior to this change, the Fed used a "CAMEL" rating; the 1996 change merely added the "S" which stood for *sensitivity to market risk*.[61] Another popular response to financial disturbances is that regulators only need to implement higher or better capital requirements in order to prevent the next crisis.

A Cautionary Tale on Capital Requirements. Many policymakers believe that instituting higher statutory capital requirements will result in increased financial stability. As with the macro-prudential focus, the increased capital requirement is really just another attempt at imposing the "right" rules and regulations to reduce financial instability. While plausible, history suggests that policymakers should not depend on better statutory capital requirements to prevent future crises. One major effort toward accomplishing such a goal was the 1983 International Lending Supervision Act, a law that gave federal regulators the explicit authority to regulate banks' capital adequacy, and to define what constitutes adequate capital levels.[62] Soon after the act was passed, OCC director Todd Conover testified in a congressional hearing:

> Under regulations proposed by the OCC and the FDIC, all banks, regardless of size, would be required to maintain a minimum ratio of primary capital to total assets of 5.5 percent. The implementation of this regulation will require over 200 national banks to raise a total of over $5 billion in new capital. The Federal Reserve has proposed similar guidelines on capital.
>
> Stricter regulatory capital requirements will strengthen the trend towards stronger capitalization of the nation's largest banks. For example, in the first quarter of 1984 the average ratio of primary capital to total assets stood at 5.67 percent for the holding companies of the 11 multinational banks supervised by the OCC. This is almost 16 percent higher than the average level at those banks two years ago.[63]

In 1988, federal regulators adopted the first iteration of Basel rules, requirements specifically

57. *Hearings Before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs*, U.S. House of Representatives, September 18, 1984, p. 209, https://fraser.stlouisfed.org/docs/historical/house/house_cinb1984.pdf (accessed December 19, 2015).
58. Ibid., p. 214.
59. Ibid., p. 216.
60. Conover's testimony also contradicts the notion that federal regulators were hamstrung because they were unable to obtain the proper information from each other. Conover testified: "I would say, first of all, that we have the tools to get the information that we need. Do we need any new enforcement powers or tools of that nature? I honestly don't think so…but we have cease and desist powers, civil money penalty powers, authority to remove officers." Ibid., p. 338.
61. The remaining letters of the acronym are as follows: Capital adequacy, Asset quality, Management administration, Earnings, and Liquidity. See news release, "Uniform Financial Institutions Rating System," Federal Reserve Board of Governors, December 24, 1996, http://www.federalreserve.gov/BoardDocs/press/general/1996/19961224/default.htm (accessed November 18, 2014).
62. 12 U.S. Code § 3907. Ultimately, the federal agencies jointly decided to use the Basel requirements as their guidelines for what constitutes adequate capital.
63. *Hearings*, p. 219.

designed to better match capital requirements to the risk level of financial assets.[64] Regulators were in the process of implementing the supposedly improved Basel II rules, but the 2008 financial crisis exposed those rules as flawed.[65] Regulators then stopped that process and, instead, went to work on developing Basel III.

There is little reason to expect the latest set of Basel rules to perform better over the long term because all three iterations rely on similar types of subjective risk assessments based on historical events.[66] No similar set of rules or requirements can fully protect the market from unforeseen financial disturbances. In one sense, instituting higher capital requirements is the equivalent of requiring firms to hold enough capital to cover the losses experienced in the previous crisis. At the very least, mandating legally required capital ratios should not be viewed as superior to allowing market participants to determine which levels of capital are adequate.

Conclusion

The myth that the 2008 financial crisis was caused by financial market deregulation has persisted for far too long. There has been no appreciable reduction in either the scope or the volume of regulation in U.S. financial markets during the past 100-plus years. Even the regulatory changes that did take place during the Ronald Reagan and George W. Bush Administrations cemented an ever-expanding financial regulatory framework. Some of these changes did allow financial firms to engage in activities that were previously prohibited, but they were only permitted to do so under the watchful eye of regulators.

True deregulation would establish a market where no government agency regulates the types of products and services people are allowed to produce and purchase. This type of financial market does not exist in the U.S., and Congress has increasingly moved the regulatory framework in the opposite direction since at least the 1930s. Virtually all financial firms' activities—even those that contributed to the 2008 crisis—take place in an extensive regulatory framework. It is completely erroneous to blame the crisis on unregulated financial markets. Doing so has only allowed Congress to further expand regulators' authority to micromanage financial companies' activities, and Americans are not better off because of it.

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64. These rules were crafted based partly on the "risk-bucket" approach developed by the Federal Reserve in the 1950s, and the Fed (jointly with the FDIC and OCC) amended these rules in 2001 so that banks could hold even less capital for highly rated (privately issued) mortgage-backed securities. After the 2001 rule change, certain AA-rated and AAA-rated asset-backed securities were given the same low-risk weight (20 percent) as agency-issued mortgage-backed securities. For more on the risk-bucket approach, see Howard D. Crosse, *Management Policies for Commercial Banks* (Englewood Cliffs, NJ: Prentice Hall, 1962), pp. 169–172. The later amendment regarding the lower weight for highly rated private-label mortgage securities was known as the recourse rule. See J. Friedman and K. Wladimir, *Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation* (Philadelphia, PA: University of Pennsylvania Press, 2011), p. 69.
65. Paul H. Kupiec, "Basel III: Some Costs Will Outweigh the Benefits," American Enterprise Institute *Financial Services Outlook*, November 2013, http://www.aei.org/outlook/economics/financial-services/banking/basel-iii-some-costs-will-outweigh-the-benefits/ (accessed December 19, 2015).
66. Michel and Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem."