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The Federal Banking Regulators: Agency Capture, Regulatory Failure, And Industry Collapse During The 2008 Financial Crisis

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THE FEDERAL BANKING REGULATORS: AGENCY CAPTURE, REGULATORY FAILURE, AND INDUSTRY COLLAPSE DURING THE 2008 FINANCIAL CRISIS

by

JUSTIN REX

DISSERTATION

Submitted to the Graduate School

of Wayne State University,

Detroit, Michigan

in partial fulfillment of the requirements

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Approved by:

Advisor

Date

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DEDICATION

This dissertation is dedicated to my wife Marissa, whose love and support helped me through this process.

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CHAPTER 1: INTRODUCTION, OVERVIEW OF AGENCIES, AND DISSERTATION

OUTLINE

A. Introduction

- In a 2003 photo, the FDIC Vice Chairman John Reich, the Office of Thrift Supervision (OTS) Director James Gilleran, and three banking industry representatives stood around a stack of paper wrapped in red tape to announce a new plan to reduce the regulatory burden on the industry (Appelbaum and Nakashima 2008). Reich and the industry representatives held garden shears. Gilleran wielded a chainsaw.
- In 2004, the Office of the Comptroller of the Currency (OCC), the federal agency in charge of regulating nationally chartered banks, issued a rule that preempted nationally chartered banks from the growing number of state consumer protection laws attempting to combat predatory lending. Soon after, several national banks switched their charter to avoid the more strict state standards (Engel and McCoy 2010). In states where national banks were formerly subject to strong state anti-predatory lending laws, the lending standards of the preempted nationally banks declined significantly (Ding et al. 2011, 2012).
- In 2008 the Director and other senior officials at the Office of Thrift Supervision, the federal agency in charge of regulating the thrift industry, directed Bank United to illegally inflate its capital level in its public financial statements by making a capital infusion appear to happen earlier than it did (Treasury Office of Inspector General 2009e). The bank later failed. The OTS let five other institutions do the same.
- Despite the FBI's 2004 warnings of a mortgage fraud epidemic that could cause a financial disaster the size of the S&L crisis ("FBI warns of mortgage fraud 'epidemic': Seeks to head off 'next S&L crisis'" 2004), and despite the fact that 27 percent of all mortgages originated in 2006 were what the industry termed "liars loans" because lenders did not verify borrowers' ability to repay (Angelides et al. 2011), the Federal Reserve Board never exercised its unique authority to reign in lending standards for all mortgage lenders until 2009, a year after the 2008 financial crisis hit (Engel and McCoy 2010).
- The Federal Reserve also declined to exercise its regulatory authority to investigate lending abuses at the nonbank subsidiaries owned by the bank holding companies that the Fed also regulates. Over one quarter of subprime lending occurred at these subsidiaries. Former Fed governor Edward Gramlich likened the Fed's action on mortgage lending to "a city with a murder law, but not cops on the beat" (Johnson and Kwak 2010, 143).
- The reaction of the Fed, FDIC, OTS, and OCC to the growing mortgage crisis was to rely on non-binding interagency guidance, unenforceable in court, rather than issue binding formal federal rules (Engel and McCoy 2010). Though the OCC did issue one formal rule related to subprime lending prior to the crisis, the rule did not rein in "liars loans" that did not adequately document the ability of borrowers to repay.

- After in depth investigations of bank failures over the past two decades, the Inspectors General for the FDIC, the OCC, the OTS, and the Fed have all concluded that, “regulators knew lenders were engaging in hazardous business practices but failed to act until it was too late...In many instances, the financial overseers failed to act quickly to rein in runaway banks” (Dash 2009).
- The Financial Crisis Inquiry Commission, which was tasked by Congress to investigate the causes of the 2008 financial crisis, concluded that financial regulators were a key contributor to the crisis. “We concluded widespread failures in financial regulation and supervision proved devastating to the stability of the nation’s financial markets... In case after case after case, regulators continued to rate the institutions they oversaw as safe and sound even in the face of mounting troubles, often downgrading them just before their collapse. And where regulators lacked authority, they could have sought it. Too often, they lacked the political will—in a political and ideological environment that constrained it—as well as the fortitude to critically challenge the institutions and the entire system they were entrusted to oversee” (Angelides et al. 2011, xviii).
- Reflecting their poor performance on protecting consumers, Congress stripped the banking regulators of their consumer protection authority and handed it to the newly created Consumer Financial Protection Bureau, with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.
- The Act also eliminated what many saw as the worst of the banking regulators, the OTS, and consolidated its employees and functions under the remaining banking regulators.

Following high profile disasters and crisis, regulatory agencies are typically blamed for their perceived failures and are accused of being captured by the regulated industry. The 2008 financial crisis is no exception. As journalists, congressional committees, and scholars began to investigate the behavior of federal banking regulators in the decades before the crisis, they uncovered the examples of lax regulation above.

But are these isolated incidents indicative of capture? Are they evidence of a larger pattern of undue industry influence over these regulators who are supposed to protect a broader notion of the public interest? At minimum, this evidence suggests we need a deeper investigation into the performance of these agencies. This research attempts to do so through the perspective of capture theory. Did banks capture the federal banking regulators? If so, how? Answering these

questions helps us better understand the problems before the crisis with an eye toward finding solutions that can help prevent the next one.

B. Overview of Banking Regulators

Before discussing the theory of capture and my hypotheses about capture at the banking regulators further, I provide an introduction to the agencies below.

I. Who regulates whom?

During the years under study (1989-2011) there were four federal agencies tasked with regulating banks¹ that receive federal deposit insurance: The Federal Reserve System (the Fed), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).² Each regulates a separate segment of federally insured banking industry. The existence of four separate regulators is not a product of planning (Engel and McCoy 2010). Each was created under different historical circumstances and to address public problems at the time. Table 1 below details the historical circumstances under which each was created. It also includes the Federal Home Loan Bank Board, which was the predecessor agency to the OTS.

¹ The OTS technically regulates savings institutions, also known as thrifts. These institutions were historically parallel financial institutions to the commercial banks regulated by the other three agencies, with a separate public purpose (to expand home lending) and different rules. With the wave of financial deregulation that began in the 1980s through the financial crisis in 2008, the differences between thrifts and commercial banks shrank until the two were essentially operating under similar legislative constraints by the early 2000s. The one difference that remains is that thrifts are required to meet the qualified thrift lender test, which requires thrifts to keep 65% of their assets in mortgage and mortgage related products. Given the similarities, when I refer to the agencies or institutions collectively, I refer to all agencies as bank regulators and the institutions they regulate as banks, as is common in the literature and government reports.

² Congress closed the OTS with the passage of the 2010 Dodd-Frank Act. The OTS was officially closed in July 2011 and its authority and remaining employees were dispersed among the remaining regulators, primarily the OCC (Offices of Inspector General 2011).

Table 1: Systemic Crises and the Creation of Financial Regulators

New Regulator	Year Created	Systemic Event	Perceived Problem	Solution
Office of the Comptroller of the Currency (OCC)	1863	Panic of 1857	Failure of Private Clearinghouses that Processed State Bank Notes (circulated as currency)	Create Single National Currency Through System of Federally Chartered and Regulated Banks
Federal Reserve	1913	Panic of 1907	Series of Runs on Banks and Financial Trusts with Inadequate Reserves	Create Lender of Last Resort with Power to Regulate a National System of Bank Reserves
Federal Deposit Insurance Corporation (FDIC)	1933	Great Depression	Series of Runs on Banks by Small Depositors who Feared Full Value of Deposits Would Not be Honored	Create Limited Deposit Insurance to Maintain Depositor Confidence and Prevent Bank Runs
Federal Home Loan Bank Board (FHLBB)	1932 (closed in 1989)	Great Depression	Unstable mortgage market, Thrifts need liquidity to properly allocate mortgage lending funds	Create the Federal Home Loan Bank System and new agency to oversee System and thrifts
Office of Thrift Supervision (OTS)	1989	Savings and Loan Crisis of 1980s	Poor performance of FHLBB and conflict of interest as agency chartering, regulating and insuring thrifts	Create new Treasury Dept. agency to oversee thrifts and transfer remaining FHLBB functions to other agencies

Table taken from Jickling and Murphy (2010, 6), with some modifications and additions by the author.

Banks choose their regulator by choosing their charter type. Figure 1 below provides a visual representation of the regulatory landscape (Federal Deposit Insurance Corporation 2013a). Banks have the choice of a state or federal charter. If a bank chooses a state charter, its primary federal regulator is the Fed or the FDIC. If a bank chooses to be a member of the Federal Reserve System, its primary federal regulator is the Fed, and it is referred to as a state member

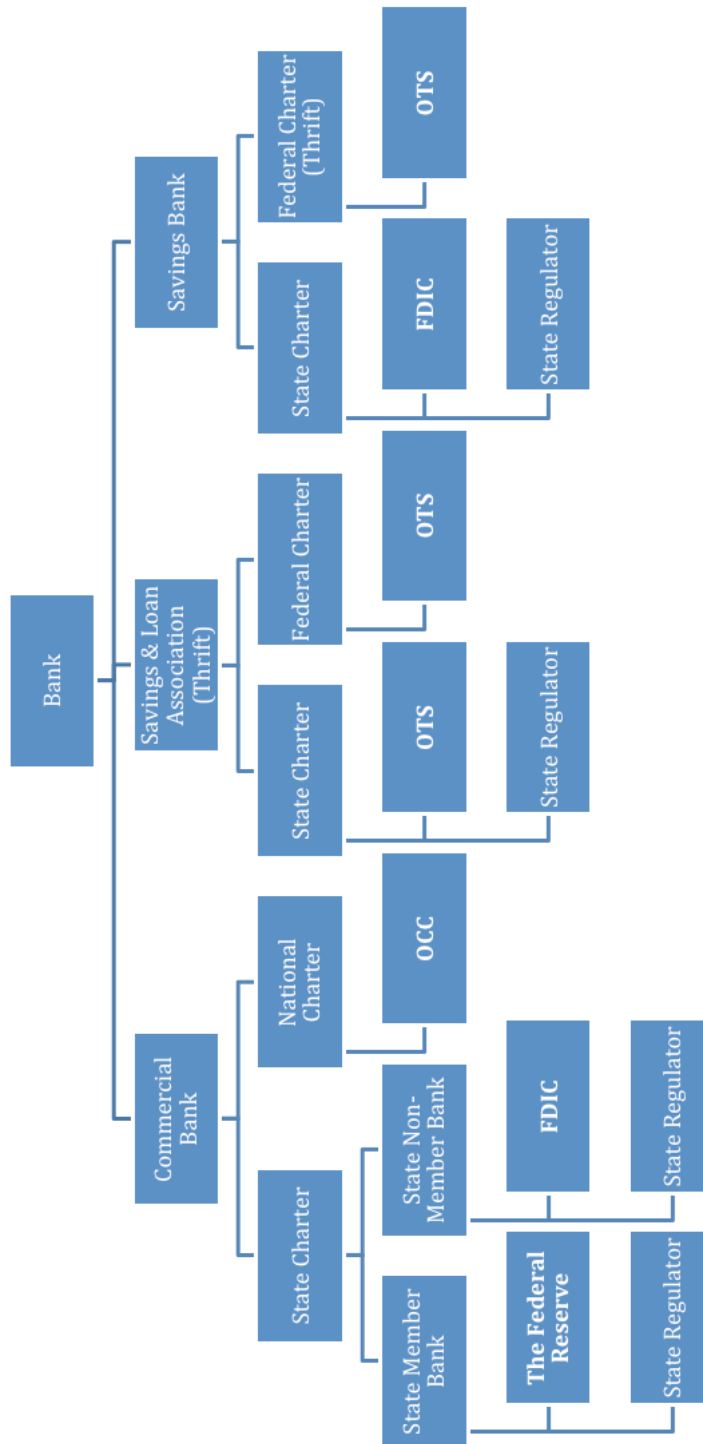
bank. If a bank chooses not to be a state member bank, its primary federal regulator is the FDIC, and it is referred to as a state nonmember bank. State banking regulators have overlapping regulatory authority with the Fed or the FDIC for state chartered banks.

If a bank chooses to be federally chartered, its primary federal regulator is the OCC, and is referred to as a national bank or national association. Federally chartered banks receive no state oversight, but do receive backup regulation from the FDIC in its role as deposit insurer. Whether a savings and loan association chooses a state or federal charter, it has the OTS as its primary federal regulator. State regulators also regulate state savings associations. Federally chartered savings associations receive no state oversight, but do receive backup regulation from the FDIC in its role as deposit insurer. The OTS regulates savings banks that choose a federal charter, without any state level oversight, while savings banks that choose a state charter are overseen by the FDIC and the relevant state regulator.

To complicate the regulatory landscape further, some of the federal regulators supervise the institutions that control banks, called holding companies. The Fed regulates bank holding companies and the OTS regulates thrift holding companies. Bank holding companies may control national or state chartered banks so it is possible for the Fed to supervise the holding company but the FDIC or the OCC to supervise some of the banks the holding company controls.

Thus the bank regulatory system is one of overlapping and competing regulatory jurisdictions that gives banks considerable latitude to choose their regulator.

Figure 1: Banks and their Primary Federal Regulator



II: Agency Structure

The agencies also differ in their key structural characteristics, as seen below in Table 2.

Table 2: Agency Structure and Mandate

	OTS	OCC	FDIC	Federal Reserve
Agency Type	Treasury Department Bureau	Treasury Department Bureau	Government chartered Corporation	Independent Regulatory Agency
Leadership	Single Director (ex-officio member of FDIC Board)	Single Director-Comptroller (ex-officio member of FDIC Board)	Five-Member Board (with a chairman)	Seven-Member Board of Governors (with a chairman)
Leadership selection	Presidential appointment with Senate confirmation	Presidential appointment with Senate confirmation	Presidential appointment with Senate confirmation	Presidential appointment with Senate confirmation
Constraints on leadership selection	Partisanship constraint as ex-officio FDIC board member	Partisanship constraint as ex-officio FDIC board member	No more than 3 members from one political party	Must represent diverse economic interests; no more than two from same district
Term Length	One five-year term	One five-year term	Six-year terms	14-year terms, staggered expiration (one every two years)
Source of Funds	Fees Assessed on Regulated Banks	Fees Assessed on Regulated Banks	Premiums assessed on insured deposit-taking institutions	Interest from the government securities purchased in the course of conducting monetary policy
Mandate Other Than Bank Supervision	Administering and Promoting the Thrift Industry	Administering and Promoting the National Banking Industry	Managing the Deposit Insurance Fund	Regulating the Money Supply

Table taken from Khademian (1992, 3), with modifications and additions by the author.

Office of Thrift Supervision

The OTS is a bureau within the Department of Treasury. A single director heads the agency. The Director serves a five-year term and is appointed by the president, with Senate approval. The appointment is for only one term. For revenue, the OTS now relies primarily on fees assessed on the banks it regulates, in addition to a small amount it earns from investment in Treasury securities. The agency's mandate is "To effectively and efficiently supervise thrift institutions to maintain their safety and soundness in a manner that encourages a competitive industry to meet America's housing, community credit and financial service needs and to provide access to financial services for all Americans" (Office of Thrift Supervision 2000, 1). The mission gives the agency competing demands in terms of both promoting a competitive industry and ensuring its safety and soundness.

Office of the Comptroller of the Currency

The OCC is also a Department of Treasury bureau. The Comptroller leads the OCC, who is a single executive at the top of the agency's hierarchy. The comptroller is selected by the president with Senate confirmation and serves for one five-year term. Like the OTS, almost all of its revenue comes from fees it assesses on the national banks it regulates, and the rest comes from investments in US treasury securities. The OCC's primary mission is to "charter, regulate, and supervise" national banks (Office of the Comptroller of the Currency 2013). It aims "to ensure that they operate in a safe and sound manner and in compliance with laws requiring fair treatment of their customers and fair access to credit and financial products" (Office of the Comptroller of the Currency 2013).

Since its creation, the OCC has also had a strong focus on promoting the national bank charter (Khademian 1992). When the OCC was created, the state banking system was already

well established and entrenched. The federal government needed a national banking system that could help it raise money through treasury securities and promote a stable currency. The goal of promoting a national banking system as an alternative to the state banking system was equally as important that national banks operated in a safe and sound manner. The OCC has gone through periods where it has allowed aggressive expansion of the industry by chartering large numbers of national banks and through periods of restraint and a focus on stability, in which far fewer are chartered (Khademian 1992). In the wake of the 2008 financial crisis, it has been accused of promoting the national banking industry too aggressively by preempting national banks from state consumer protection laws (Peterson 2005). Thus, like the OTS, the OCC is both a promoter of its regulated industry as well as protector of the broader public interest to make sure the industry operates in a safe, sound, and fair manner.

Federal Deposit Insurance Corporation

The FDIC is an independent government chartered corporation. In 1933, Congress passed the Glass-Steagall Act, which created the FDIC. The FDIC's task is to inspire public confidence in banks that was lost with the onset of the Great Depression (Federal Deposit Insurance Corporation 2013c). It does so by insuring customer deposits (increased to \$250,000 during the 2008 crisis), supervising and regulating banks, and using an orderly resolution process to limit the financial impact of a bank failure (Federal Deposit Insurance Corporation 2013c).

The FDIC was initially headed by a three-member board, consisting of a chairman, director, and the OCC's Comptroller, each appointed by the president with Senate confirmation. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 added a vice chairman and a seat for the director of the OTS. The director of the OTS and the comptroller each serve on the FDIC board according to their specified term length of five years. The

remaining members each serve six-year terms. With the advice and consent of the Senate, the president also selects two of these board members to be chairman and vice chairman, with each serving a five-year term in that role. No more than three board members can be from the same political party.

The FDIC is self-financing like the other banking regulators. Its primary source of revenue is the premiums it charges banks for deposit insurance. The FDIC charges these premiums on all insured banks, regardless of whether the FDIC is the bank's primary federal regulator. It also earns a small amount from investments in US Treasury securities.

Federal Reserve

Following a series of banking crises in the late nineteenth and early twentieth century, the Federal Reserve System was established in 1913 to act as the nation's central bank and lender of last resort to banks in an economy experiencing financial turmoil.

The Federal Reserve System has three key institutional components within its structure. At the top of the Fed is the Board of Governors. It is an independent regulatory agency that reports directly to Congress. It has seven members who are appointed by the president and confirmed by the Senate. They serve 14-year terms, which are staggered so that one term expires in January of even numbered years. "By law, the appointments must yield a 'fair representation of the financial, agricultural, industrial, and commercial interests and geographical divisions of the country,' and no two Governors may come from the same Federal Reserve District" (Board of Governors of the Federal Reserve System 2013). A governor can be reappointed only if the governor was appointed to fill out the remaining term of a previous member. Once a governor has served a 14-year term, the governor cannot be reappointed. Among the seven governors, the

president chooses a chairman and vice-chairman to serve 4-year terms. Unlike the FDIC, the Board does not have members from the heads of the other financial regulators.

The Board has several responsibilities. It monitors the economy carefully to keep abreast of developments that may inform its policy decisions. It supervises and regulates the Federal Reserve Banks (discussed below), makes key decisions about monetary policy, and has delegated power from Congress to interpret and implement most of the consumer protection laws related to consumer credit (which was transferred to the Consumer Financial Protection Bureau with the passage of Dodd-Frank). Some of its consumer protection regulations apply only to the insured state member banks directly under its supervisory authority, while others apply to all deposit taking and non-depository institutions involved in consumer credit. And, as mentioned previously, the Board supervises state-chartered member banks. Also under its supervisory wing are “bank holding companies (companies that control banks), the foreign activities of member banks, the U.S. activities of foreign banks, and Edge Act and agreement corporations (limited-purpose institutions that engage in a foreign banking business)” (Board of Governors of the Federal Reserve System 2005, 4). It regulates approximately 900 state member banks and 5000 bank holding companies (Board of Governors of the Federal Reserve System 2005).

The Federal Reserve System is divided into twelve regions, each with a Federal Reserve Bank in a major city. In addition, these banks have a combined total of 25 branches. These banks carry out the task of supervising and regulating banks, distributing the country’s physical currency, providing banking services to depository institutions and the government, providing research and information about the economy in their region, and assisting with monetary policy.

Federal Reserve Banks are mixed public private institutions. Each has a board with nine directors. Each board has three classes of directors, with three directors per class. Class A

directors are representatives of commercial banks in the region and are elected by the region's member banks. Class A directors may be executives of a member bank. Member banks in the region also elect Class B directors, while the Board of Governors appoints Class C directors. There is some attempt to avoid conflicts of interest for some directors. "No Class B or Class C director may be an officer, director, or employee of a bank or a bank holding company. No Class C director may own stock in a bank or a bank holding company" (Board of Governors of the Federal Reserve System 2005, 10).

The President of the Federal Reserve Bank of New York, four rotating presidents of the other 11 regional banks, along with all seven members of the Board of Governors make up the Federal Open Market Committee (FOMC), which makes decisions on monetary policy by making decisions about buying and selling government securities.

Both the Board of Governors and the FOMC exercise control over certain tools used to carry out monetary policy. According to the Federal Reserve Act, the goal of monetary policy is "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates" (Board of Governors of the Federal Reserve System 2005, 15). The FOMC does so through buying and selling government securities. The Board has sole authority over setting reserve requirements (the amount of money banks must set aside), and it has final approval for the discount rate (the amount the reserve banks charge other banks to borrow) set by regional Federal Reserve Banks.

The Board of Governors receives funds from fees it charges the Reserve Banks. The Federal Reserve Banks get funds mainly through interest they earn from the government securities they buy in the course of conducting monetary policy. The Reserve Banks also earn

interest from foreign currency investments, loans they makes to banks, and fees from providing banking services. Any profit the System makes is given to the Treasury.

III. Size of Regulated Population

The size of the regulated population varies by agency. Table 3 below shows the number of banks supervised by each agency over time. Table 4 shows the combined total assets under supervision (Federal Deposit Insurance Corporation 2013b).

Table 3: Number of Institutions Regulated, 1998-2010

Year	OTS	OCC	FDIC	Fed
1998	1,143	2,459	5,865	994
1999	1,102	2,366	5,742	1,010
2000	1,067	2,231	5,616	991
2001	1,020	2,137	5,484	972
2002	974	2,078	5,352	950
2003	928	2,001	5,318	935
2004	886	1,907	5,263	919
2005	862	1,818	5,245	907
2006	844	1,715	5,220	902
2007	826	1,632	5,197	878
2008	810	1,537	5,098	860
2009	765	1,462	4,941	844
2010	730	1,383	4,715	829

Table 4: Total Assets Under Regulation, 1998-2010 (in millions)

Year	OTS	OCC	FDIC	Fed
1998	817,223	3,183,118	1,217,934	1,310,353
1999	863,414	3,271,582	1,325,213	1,423,360
2000	933,972	3,414,579	1,468,152	1,644,645
2001	987,512	3,634,997	1,542,610	1,703,130
2002	1,012,646	3,908,098	1,651,068	1,862,875
2003	1,102,420	4,292,331	1,769,029	1,912,997
2004	1,348,976	5,601,668	1,878,489	1,275,490
2005	1,512,206	6,003,169	2,043,794	1,317,907
2006	1,463,950	6,829,269	2,160,523	1,406,487
2007	1,556,670	7,782,387	2,180,697	1,519,012
2008	1,231,858	8,478,798	2,282,713	1,853,915
2009	942,659	8,199,604	2,277,210	1,689,983
2010	933,026	8,432,251	2,259,073	1,697,034

Though the number of institutions regulated has dropped for each agency, the total assets regulated rose to peak before the financial crisis and dropped slightly thereafter. These trends can be attributed to industry consolidation through mergers and acquisitions, facilitated by laws that reduced barriers to interstate banking and bank branching (Angelides et al. 2011)

IV: Budget

As mentioned previously, all four regulators are self financed, based on fees charged to the industry, in the case of the FDIC, OCC, and OTS, and based on money earned in the course of conducting monetary policy, in the case of the Federal Reserve. This funding structure gives them considerable control over their budget relative to agencies that have to rely on the vagaries of Congress for appropriations. Consequently, an underfunded mandate is not of high concern for most of these agencies, and their funding structure insulates them from inadequate performance resulting from budgetary constraints, particularly the Fed and the FDIC.

The Federal Reserve has considerably more resources each year than it needs to carry out its supervision and regulation duties of state-member banks. Even after these expenses, and

others incurred carrying out its other functions, the Fed still turns over tens of billions of dollars to the Treasury each year in excess of its expenses. See Table 5 below (Board of Governors of the Federal Reserve System 2012).

Table 5: Federal Reserve Budgetary Resources (in millions)

Year	Current Income	Total Operating Expenses	Payments to Treasury
1989	22,249.3	1,446.5	21,646.4
1990	23,476.6	1,510.3	23,608.4
1991	22,553.0	1,605.6	20,777.6
1992	20,235.0	1,717.1	16,774.5
1993	18,914.3	1,850.9	15,986.8
1994	20,910.7	1,941.7	20,470.0
1995	25,395.1	2,021.7	23,389.4
1996	25,164.3	2,121.6	20,083.3
1997	26,917.2	2,172.2	20,659.0
1998	28,149.5	2,261.4	26,560.9
1999	29,346.8	2,378.9	25,409.7
2000	33,964.0	2,470.7	25,343.9
2001	31,870.7	2,657.8	27,089.2
2002	26,760.1	2,762.0	24,495.5
2003	23,792.7	2,865.3	22,021.5
2004	23,539.9	2,783.8	18,078.0
2005	30,729.0	2,868.3	21,468.0
2006	38,410.0	3,071.9	29,052.0
2007	42,576.0	3,289.0	34,598.0
2008	41,046.0	3,372.0	31,689.0
2009	54,463.0	3,539.3	47,431.0
2010	79,301.0	3,620.4	79,268.0

Similarly, the FDIC's funding via insurance premiums means it has adequate resources to carry out its duties year to year, or the ability to change premium levels to make sure it does. For example, in the wake of the 2008 financial crisis, the FDIC was able to triple its expense between 2007 and 2010 (see Table 6 below) to accommodate the increased workload. Similarly, even when the Deposit Insurance Fund has gone in the red, as it did in 2009 and 2010, the FDIC

used its authority to make banks prepay their premiums three years in advance to restore the balance (Vekshin 2009; Wutkowski 2009). Like the Fed, the FDIC's income dwarfs its yearly expenditures. See Table 6 below.

Table 6: FDIC Budgetary Resources (in millions)

Year	DIF Balance	DIF Income	Aggregate Budget	Total Actual Expenditures
1989		3,494.8		
1990	4,100	3,855.3		
1991	-6,900	5,886.5		1,420
1992	200	6,479.3		1,870
1993	14,300	7,354.5		2,000
1994	23,800	7,682.1		1,780
1995	28,800	5,229.2		1,370
1996	35,700	7,156.8		1,710
1997	37,700	2,165.5		1,380
1998	39,400	2,584.6		1,200
1999	39,700	2,416.7	1,220	1,160
2000	41,700	2,570.1	1,190	1,120
2001	41,400	2,730.1	1,120	1,040
2002	43,800	1,795.9	1,220	1,190
2003	46,000	2,173.6	1,100	1,040
2004	47,500	2,240.3	1,210	1,110
2005	48,600	2,420.5	1,180	1,050
2006	50,200	2,643.5	1,109	1,000
2007	52,400	3,196.2	1,120	1,010
2008	17,300	7,306.3	1,250	1,230
2009	-20,900	24,706.4	2,570	2,340
2010	-7,400	13,379.9	4,000	3,400
2011	11,800	16,342.0	3,880	2,830

The OCC and the OTS have a much smaller gap between their revenue and expenses, giving them relatively less wiggle room than the FDIC or the Federal Reserve. Still, both the OCC and OTS have the ability to set the fees they charge the industry, though the need to raise fees must be weighed against the risk of raising them too high such that they drive banks to

switch regulators. Table 7 below shows the budgetary resources for the OCC ("Budget of the United States Government" 2013).

Table 7: OCC Budgetary Resources (in millions)

Year	Total Revenue	Total Expenses	Unobligated Balance, year end
1994	389	376	16
1995	379	377	19
1996	377	370	26
1997	369	350	45
1998	385	357	73
1999	394	403	64
2000	403	406	263
2001	435	424	280
2002	449	417	313
2003	471	444	340
2004	508	449	399
2005	595	487	507
2006	648	557	598
2007	708	638	668
2008	741	674	735
2009	775	716	793
2010	794	740	847

Of all four agencies, the OTS faces perhaps the biggest relative threat that it will not have adequate budgetary resources to carry out its duties effectively. It consistently regulates the fewest institutions and has the fewest total assets under regulation in most years. We can also see that the gap between OTS revenue and expenses is much smaller than that of the OCC for most years. See Table 8 below ("Budget of the United States Government" 2013).

Table 8: OTS Budgetary Resources (in millions)

Year	Total Revenue	Total Expenses	Unobligated Balance, year end
1994	95	174	143
1995	192	164	56
1996	163	143	76
1997	145	137	84
1998	240	139	85
1999	143	155	142
2000	144	156	85
2001	161	166	77
2002	163	148	136
2003	174	154	159
2004	184	176	169
2005	214	193	196
2006	242	201	239
2007	243	219	264
2008	272	246	292
2009	247	234	309
2010	227	230	305

V: Staff

None of the four agencies regularly report the size of their examination staff in annual reports. Consequently, I filed FOIA requests with each agency to obtain these numbers, but met with limited success. The Federal Reserve request yielded examiner data back as far as they had record, to 1994. The FDIC responded that the data on examiners was not available. However, the FDIC Annual Reports provide staff information broken down by division within the agency. The FDIC numbers in the table below represent the total staff for the Division of Supervision and Consumer Protection, where examiners are housed.³ This number most likely overstates the

³ Prior to 2002, the Division of Supervision and Consumer Protection was two separate divisions, the Division of Supervision and the Division of Compliance and Consumer Affairs. For the earlier years, I combined the staff data from the two divisions.

actual number of bank examiners because it includes all staff in the division, which would include administrative staff and managers, in addition to examiners.

In a response to my OCC FOIA request, I was told the agency could not provide those numbers. In a few of its annual reports, the OCC did list the number of examiners, which are in the table below. The OTS did not write regular annual reports from which to obtain information, despite its congressional mandate to do so. The few annual reports it did write between 2007 and 2009 do contain some information on total staff levels, but without any breakdown. A FOIA request did not yield any information. The two data points on examination staff below were obtained via news reports (Blackwell and Garver 2002; Engel and McCoy 2010). See Table 9 below.

Table 9: Total Examiners/Total Examination Staff

Year	OTS	OCC	FDIC	Fed
1998			3,301	1,250
1999			3,327	1,216
2000			3,182	1,172
2001			3,102	1,242
2002	685		2,811	1,234
2003			2,797	1,239
2004	505	1,824	2,604	1,223
2005			2,541	1,291
2006			2,517	1,306
2007		2,061	2,557	1,313
2008		2,079	2,733	1,377
2009			3,168	1,491
2010			3,649	1,621
2011			3,719	1,826

Leading up to the financial crisis in 2008, we see a small decrease in the examination staff at the FDIC and a larger decrease at the OTS, though data are severely limited for the OTS. In contrast, we see a slight increase in the number for the Fed and the OCC.

To make for more meaningful comparisons across agencies, the next two tables show the number of examiners (or in the case of the FDIC, the total examination division staff) per institution regulated and per million dollars in assets under regulation.

Table 10: Total Examiners/Total Examination Staff Per Institution Regulated

Year	OTS	OCC	FDIC	Fed
1998			0.56	1.26
1999			0.58	1.20
2000			0.57	1.18
2001			0.57	1.28
2002	0.70		0.53	1.30
2003			0.53	1.33
2004	0.57	0.96	0.49	1.33
2005			0.48	1.42
2006			0.48	1.45
2007		1.26	0.49	1.50
2008		1.35	0.54	1.60
2009			0.64	1.77
2010			0.77	1.96

Table 11: Total Examiners/Total Examination Staff Per Million Dollars in Assets

Year	OTS	OCC	FDIC	Fed
1998			15.90	0.95
1999			14.42	0.86
2000			12.17	0.71
2001			11.03	0.71
2002	0.66		9.11	0.63
2003			8.41	0.61
2004	0.33	0.62	7.30	0.88
2005			6.52	0.89
2006			6.08	0.84
2007		0.43	6.09	0.76
2008		0.38	6.10	0.64
2009			6.87	0.74
2010			7.62	0.79

In 2004 (the only year where data from all four agencies are available) there is a significant difference in the number of examiners per institution; the OCC has almost twice as many examiners as the OTS and FDIC, while the Fed has close to three times as many. In contrast, for the number of examiners per million dollars in assets the FDIC is the leader. The OTS has the lowest ratio; half that of the OCC's and almost one third that of the Fed's.

Leading up to the financial crisis, the number of examiners per institution increased slightly. Yet, a different picture emerges for examiners per million in assets regulated. For all four agencies, we see that industry asset growth from 1998 to 2010 outpaced the increase in staff. I explore the issue of adequate examination staff in more depth in Chapter 3, where I study Inspector General reports that found staffing problems in some instances.

C. Conclusion and Plan for Dissertation

This chapter outlined the structure of federal banking regulation in the US for the years under study. Key features of the system include the existence of four federal banking regulators and the existence of a dual banking system where banks can be chartered by either states or federal regulators. I then examined key demographic information about the four regulators, including their history, structure, budget, and staff. The patchwork of banking regulators reflects the federal government's continuing need to create new regulators to solve problems that arose in the financial system over time. The agencies thus differ across a variety of key structural and demographic characteristics. Though, notably, the OTS and OCC share many similarities, including their placement as bureaus within the Department of Treasury, their funding via industry fees, and their dual mandate to both promote the regulated industry and protect the public and the deposit insurance fund by insuring the industry operates in a safe and sound fashion.

The rest of the dissertation proceeds as follows. In chapter 2, I discuss the complexities associated with determining whether an agency is captured. I discuss several cases of bank failure to explore precisely what does and does not indicate capture. Using these cases, I also develop a typology to distinguish between different types of capture. I then discuss past scholarship on capture and I outline several hypotheses about the likelihood that the federal banking regulators are captured.

In the remaining chapters, I examine whether and how the agencies were captured. In Chapter 3, I compare all four agencies by using content analysis to analyze regulatory problems identified by each agency's Inspector General in the reports they write about bank failures. I employ a coding framework that pays particular attention to behavior that does and does not provide evidence of capture.

In Chapter 4, I examine trends in public enforcement actions taken by each of the agencies between 1989 and 2011. I use a multiple interrupted times series design to see whether the enforcement output of the agencies responds to political controls and macroeconomic trends in expected ways. This analysis can help determine whether the agencies are responsive to actors other than the targets of regulation.

Because lax enforcement is one of the leading problems identified in analysis from the preceding chapters, in Chapter 5, I explore the causes of this laxity and link it to the level of discretion given to bank examiners. This analysis can help us better understand some of the root causes of capture. In Chapter 6, I compare the performance of the supervised institutions of all four agencies during the 2008 financial crisis using several performance measures. The OTS was closed with the passage of the Dodd-Frank financial reform legislation in 2010 because it was widely seen as the worst of the four agencies and perceived as captured. Therefore, it will be

interesting to see whether its performance really stood out as exceptionally bad. In Chapter 7, I draw overall conclusions about capture at the banking regulators and offer some suggestions to improve banking regulation going forward.

CHAPTER 2: CASES, THEORY, AND HYPOTHESES

A. Diagnosing Capture

Though capture *theory* has received considerable attention, scholars note that empirical scholarship on capture is often unsystematic (Carpenter 2013) and recent scholarship is scarce (Carpenter and Moss 2013a). Similarly, though scholars have developed *theories* about capture of financial regulators (Kwak 2013; McCarty 2013), empirical investigation of capture at these agencies is also scarce. More systematic empirical investigation is important because the occurrence of crises does not necessarily mean they were caused by regulatory failure or capture, even when journalists and anecdotal evidence claim so.

The promise of regulation is to manage risk, not eliminate it (Carrigan and Coglianese 2012). The occurrence of disasters and crises could be normal accidents (Perrow 1999) or the downside inherent in managing risk when it is not feasible or desirable to ban risky activity outright (Carrigan and Coglianese 2012). Scholars also need to be careful in diagnosing capture because observers are sometimes too quick to allege capture when agencies take actions with which they do not agree or after single instances of high profile, but atypical, industry friendly decisions (Carpenter 2013). The promise of regulation does not mean the agency will refrain from making any decisions that the regulated industry wants (or needs). In fact, the OTS and the OCC are explicitly given the mandate to both promote the banking industry as well as make sure the industry operates in safe and sound manner. Thus, we would expect OTS and industry preferences to sometimes overlap without necessarily meaning the agencies were captured.

Further, it is possible that what looks like a pattern of deference to the industry is really the product of the agency being responsive to public attention, Congressional legislation, presidential appointments, or any number of other signals from the political system (Carpenter

2013; Gordon and Hafer 2013; Wood and Waterman 1994). Any regulatory agency must balance a complex set of interests including being responsive to its own internal demands of expertise, and external demands from policy makers, the industry, and the public. Thus, scholars must be careful to delineate capture from the responsiveness we expect agencies to display.

What does a non-captured agency look like and how can we distinguish it from one that is captured? For example, is an agency captured if its enforcement output is unresponsive to political controls or is it merely an independent, well-insulated agency that is dedicated to its mission? Are increases in enforcement after crises evidence that an agency is *not* captured or evidence of too much laxity before the crisis and an agency attempting to cover up for past mistakes? Does agency capture always result in industry failures, disasters, or crises or would we expect the captured agency and industry to keep a lower profile? These considerations make the task of identifying agency capture difficult, but not impossible.

B. Typology and Cases

Despite this difficulty, crises and industry missteps are typically used as a proxy for regulatory failure and/or capture (Carrigan and Coglianesse 2012). But as the five cases I examine below demonstrate, industry failures and crises are not always a good indicator of regulatory failure. In turn, regulatory failure does not always indicate capture. Further, the cases illustrate the broader difficulties inherent in making accusations of capture, while providing hints about what capture is and what it is not. The five cases I examine are organized using the typology below, which varies by whether the bank failed and whether that failure was preceded by regulatory failures.

Figure 2: Typology for Cases of Bank Failure and Regulatory Failure

		<u>Bank Failure</u>	
		Yes	No
<u>Regulatory Failure</u>	Yes	Washington Mutual (OTS) Superior Bank (OTS)	HSBC (OCC)
	No	First National Bank of Georgia (OCC)	Fremont Investment & Loan (FDIC)

Washington Mutual

Washington Mutual (WaMu) was one of the largest institutions supervised by the OTS. It supplied 15 percent of the OTS's assessment revenue from 2003 to 2008. Because the OTS gets almost all its revenue from industry assessments, some observers speculated that WaMu was "too big to regulate" (Engel and McCoy 2010). Tough regulation risked driving WaMu to switch charters in search of lighter regulation, thereby starving the OTS of revenue.

WaMu failed for several reasons, according to a report by the Treasury and FDIC Offices of Inspector General (2010). Primarily, its management pursued a high-risk lending strategy that included concentrations in nontraditional and subprime mortgages, coupled with systemic underwriting weaknesses and liberal underwriting standards. Additionally, the management failed to develop an integrated risk management system to monitor and assess risk for its various component institutions. The more immediate reason for failure was the collapse of the mortgage market in mid-2007 along with other large bank failures in 2008. Consequently, investors and

depositors became worried about the health of WaMu. Withdrawals depleted funds and WaMu was eventually unable to maintain capital commensurate with withdrawals.

More specifically, by 2007 more than half of WaMu's loan portfolio consisted of pay option adjustable rate mortgages. These allow borrowers to choose whether to make a traditional principal and interest payment, an interest only payment, or a minimum payment that will add additional money to the principal if the minimum payment is below the interest due. WaMu compounded the risk of these already inherently risky products because approximately 73 percent of its pay option ARMs were "stated income" loans in which the borrower is allowed to write in his or her income on the loan application and does not have to provide any evidence to suggest the number is true. The industry sobriquet for stated income loans is "liars loans" (Black 2009). Similarly, WaMu had asset concentrations in subprime mortgages, home equity loans, and home equity lines of credit, all with a large percentage of stated income loans.

Furthermore, the bank did not always follow proper appraisal practices to insure the value of the property was accurate. Evidence suggests that WaMu was colluding with appraisal companies to inflate housing prices. Appraisal inflation was industry wide problem according to Andrew Cuomo, the NY Attorney General who filed a suit against a WaMu appraisal firm in November 2007 (Gutierrez 2007). After the suit was filed, the OTS launched its own investigation into WaMu's appraisal practices and found numerous instances where appraisers were inflating the values of properties without supporting documentation, along with other violations of appraisal regulations. As a result, the OTS prepared to take a formal enforcement action against WaMu, but the bank failed before the action was put in place.

Despite the large amount of risk the bank was taking on, it did not have a proper system in place to manage risk. Such a system would have been necessary to manage the thrift's

sprawling organization, which included mortgage origination companies it purchased and relationships with independent mortgage brokers and appraisers. To illustrate the importance of such a system, in addition to originating its own loans, WaMu was also buying a huge volume of loans from mortgage brokers. Yet, WaMu had only 14 employees monitoring over 34,000 brokers with which it did business. Problems with these brokers led to fraud losses of \$78 million in 2007 alone.

In sum, WaMu management concentrated in high-risk loans, loans made even more risky by the fact that it systematically ignored whether borrowers could afford to repay, and abrogated its responsibility to adequately manage the enormous risk the institution took on.

How did the OTS fail to limit WaMu's risky behavior and prevent its failure? Before explaining, it will be useful to briefly outline examination procedures at the OTS (and common to the other three regulators as well). Most banks are examined every 12-18 months. The outcome of the exam is a report of examination that details areas of supervisory concern and assigns a rating. The rating is called a CAMELS rating, based on the first letter of each of its six components: Capital adequacy, Asset quality, Management capabilities, Earnings sufficiency, Liquidity position, and Sensitivity to market risk. Each component is assigned a value between one and five, and the components are aggregated into an overall composite rating. The CAMELS rating indicates the level of risk the bank poses to the FDIC deposit insurance fund; institutions rated one or two pose little supervisory concern while those rated four or five pose significant supervisory concern. Highly rated banks have low CAMELS ratings and poorly rated banks (considered problem banks) have high CAMELS ratings.

The examination report and CAMELS rating serve as the basis for informal and formal enforcement actions. Informal actions are agreements between bank management and a regulator

that the bank will make certain corrective actions to decrease its risk profile. They are informal because they are *not* publicly disclosed and are *not* enforceable in court if the bank does not make the agreed upon corrective actions (General Accounting Office 1991). Formal enforcement actions *are* publicly disclosed and involve written notice to the bank or employees involved and the opportunity for a formal hearing before an administrative judge if the bank or individual is contesting the action. Formal enforcement actions include cease and desist orders, removal and prohibition orders against individuals, civil money penalties against institutions or individuals, and the removal of deposit insurance (GAO 2001). Ultimately, deposit insurance can be revoked and the bank can be shut down (Congressional Research Service 2006).

Beginning in 2003, OTS examiners began documenting underwriting deficiencies and problems with WaMu's oversight of third party brokers from which it was purchasing mortgages. The same underwriting and oversight problems were noted repeatedly in subsequent exams. Yet, the asset quality rating of WaMu remained at 2 until September 2008, when it was lowered to a 3, the same month the bank failed. According to the OIG,

We asked OTS examiners why they did not lower WaMu's asset quality ratings earlier. Examiners responded that even though underwriting and risk management practices were less than satisfactory, *WaMu was making money and loans were performing*. Accordingly, the examiners thought it would have been difficult to lower WaMu's asset quality rating. In this regard, OTS guidance provides that: "[if] an association has a high exposure to credit risk, it is not sufficient to demonstrate that the loans are profitable or that the association has not experienced significant losses in the near term." Given this guidance, the significance of single family residential lending to WaMu's business, and the fact that the OTS repeatedly brought the same issues related to asset quality to the attention of WaMu management and the issues remained uncorrected, we find it difficult to understand how OTS could assign WaMu a satisfactory asset quality 2-rating for so long. Assigning a satisfactory rating when conditions are not satisfactory *sends a mixed and inappropriate supervisory message to the institution and its board, and is contrary to the very purpose for which regulators use the CAMELS rating system* [emphasis mine] (Offices of Inspector General 2010, 20).

The same pattern played out for the OTS' rating of WaMu management. The problem of an integrated risk management control system was noted in 2004, and mentioned repeatedly in subsequent examinations. Yet the management component of the CAMELS rating continued to be given a 2 until it was lowered to a 3 in 2008.

Further, the OTS was relying on WaMu to monitor whether WaMu corrected OTS-identified problems instead of independently verifying corrections. At all other thrifts, the OTS used its own tracking system for corrections (US Senate Permanent Subcommittee on Investigations 2011). WaMu relied on its Enterprise Risk Issue Control System (ERICS) to monitor its progress, which in turn the OTS relied on. The OTS told the OIG that it had a "general sense" of whether WaMu was making progress on addressing problems, but that "examiners said that tracking progress was difficult given the size and complexity of WaMu" (2010, 30). WaMu used the OTS' dependence to its advantage by discontinuing the practice of noting which findings were repeat findings after 2006.

In total, there were 545 problems or findings identified by the examiners that needed correction between 2003 and 2008. Though the OTS developed a system of signing off on the ERICS reports once examiners determined that the corrections had been made, examiners could not provide the OIG with evidence that they had signed off on certain problems identified in three of the eight ERICS reports between 2003 and 2008. Thus, on top of not having an independent audit system, the OTS was doing incomplete work in verifying WaMu's audit system was accurate.

Even when the OTS did identify problems, it seemed unwilling to take forceful action early enough to prevent the problems from growing. OTS policy is that formal enforcement action should be taken when institutions are noncompliant with previous problems they pledged

to correct. Formal action is also warranted when the institution has a composite CAMELS rating of three when it is combined with weak management that does not have the ability or desire to correct deficiencies.

WaMu was downgraded to a CAMELS composite three in February 2008. The OTS asked the bank to enter into an informal enforcement action, called a Board Resolution. The Regulatory Relations Officer at WaMu created the first draft of the resolution and sent it to the OTS' West Region Director. The draft said that WaMu would make corrections related to the liquidity problems the bank was experiencing as a result of the beginnings of the financial crisis, but it did not mention anything about correcting previously mentioned problems examiners identified. Though other regional managers expressed concern about the lack of any mention of specific corrective actions to be taken regarding past concerns, the OTS Western Region Director approved WaMu's version of the resolution.

At the next exam in June 2008, WaMu was again rated a composite three and again given only an informal enforcement action, called a Memoranda of Understanding (MOU). This time the enforcement action required the bank to correct problems, along with submitting a capital plan, business plan, and certifying that it was in compliance with the enforcement action on a quarterly basis. Initially, the enforcement action required that WaMu get a consultant to review its risk management controls. But, after WaMu's review of the MOU draft, the OTS dropped the provision at WaMu's request. The OTS granted WaMu's request despite citing WaMu for poor risk management practices for five straight years! Further, WaMu was able to put pressure on the OTS to delay the issuance of the MOU, which was not issued until a week before WaMu failed, in September 2008.

The OTS never issued a formal, public enforcement action against WaMu. It issued only the above two informal, nonpublic enforcement actions, but even these were not until 2008, after years of uncorrected problems. According to the OIG, the informal enforcement actions “lacked sufficient substance to require action on the part of WaMu and were too late to make a significant difference” (2010, 29). Essentially, this lack of enforcement meant that WaMu operated under a system of self-regulation, whereby examiners documented problems with the bank and made recommendations for improvement, but never used the force it was given to compel WaMu to make the changes (US Senate Permanent Subcommittee on Investigations 2011).

Superior Bank

Not all instances of regulatory failure are instances of lax treatment of the industry. The OTS’s regulation of Superior Bank is a case in point. Superior failed in 2001 primarily because its rapid growth resulted in a risky asset concentration associated with its subprime mortgage securitizations, according to the Treasury OIG (2002). Superior was heavily involved in the nascent market of securitizing subprime mortgage loans to create mortgage-backed securities that could be sold to investors. One byproduct of the securitization process is an asset called an interest only residual. The residual is the money left over from the borrowers’ mortgage payments that has not been paid to investors and the other parties involved in the securitization process.

It was difficult to value the residuals because there was little historical data to rely on. The accounting practices at the time allowed banks to guess how much their residuals were worth in terms of future income and count the assets toward their capital level. Superior believed the residuals were worth a lot of money, using extremely optimistic assumptions that were

backed up by independent auditors. However, their valuation did not reflect the speculative nature of the investment. The OTS did not have enough data with which to challenge the bank's valuation.

While Superior was developing its asset concentration in residuals, the OTS, along with other banking regulators, was playing catch up with these new market trends and developing guidelines for asset securitization, residual assets, appropriate accounting standards, and subprime loans. The Treasury OIG describes the timeline:

It was not until December 1999 that Federal banking regulators had uniform guidance over asset securitizations and related residual assets...Additionally, the associated accounting complexities for this activity are reflected by the absence of any standard accounting guidance until the issuance of FAS [Financial Accounting Standard] No. 125 in 1996, and a series of subsequent clarifying guidance in 1998, 1999, and ultimately the replacement guidance, FAS No. 140, in 2000. As for the underlying subprime loans supporting Superior's residual assets, Federal regulators had not issued uniform guidance on subprime lending until March 1, 1999 (2002, 21).

While the Treasury OIG argues that the OTS could have used existing knowledge about the dangers of asset concentrations to raise more skepticism about Superior's asset valuations, it is clear that the OTS faced a difficult and complex regulatory environment. With the new practice of securitization, the OTS (along with the other banking regulators) was left behind for a short period by the rapid pace of market innovation. It took time to build the expertise and knowledge to better judge how risky the new asset really was. So, while we can place some blame for the failure on the slower than ideal regulatory system, it would be unfair to suggest that the OTS was unduly deferent to Superior, as was the case with WaMu.

First National Bank of Georgia

Complicating our picture further, not all bank failures are a result of regulatory failures. It is possible for a bank to fail despite appropriate regulation. What does appropriate regulation look like? Though it does not exclusively mean avoiding regulatory mistakes, in the case of the

OCC's supervision of First National Bank of Georgia, it did mean avoiding the examples of regulatory failures discussed above.

The OCC's regulation of FNB of Georgia stands in stark contrast to the OTS's regulation of WaMu, where the OTS was frequently used weak and delayed enforcement. According to the Treasury OIG,

OCC's supervision of FNB Georgia did not prevent a material loss to the Deposit Insurance Fund. However, we concluded that OCC's supervision of FNB Georgia was appropriate. OCC addressed the concentration in CREs [commercial real estate] and identified credit risk management issues in a timely manner. In addition, as the bank's capital levels deteriorated, OCC appropriately imposed PCA [Prompt Corrective Action] restrictions on the bank and took enforcement action (2012b, 2).

The bank failed despite the OCC's action because its aggressive growth strategy, asset concentrations, and poor credit risk management practices combined with a rapid decline in the real estate market with the onset of the 2008 financial crisis. Accordingly, there is little else that the agency could have been expected to do when this combination of events occur. As will be discussed in Chapter 3, many instances of bank failure at the OCC, as well as other regulators, were failures in which it would be inappropriate to conclude that the failure followed regulatory failure.

Hong Kong and Shanghai Banking Corporation United States (HBUS)

On the other hand, there can be regulatory failures in the absence of industry failures or crises. The recent case of HBUS provides instruction here. This case was investigated extensively by the US Senate Permanent Subcommittee on Investigations (2012). HBUS is a US-based subsidiary of HSBC, a Britain-based bank that conducts operations all over the world. After switching charters in 2004, HBUS became a nationally chartered bank under the supervision of the OCC.

Prior to switching charters, HBUS was a state chartered bank and under the supervision of the Federal Reserve and the New York State Banking Department. In 2003, the Fed and NY State Banking Department issued a formal enforcement action called a cease and desist order that required the bank to improve its anti-money laundering (AML) efforts. According to the Senate Committee report, “The Federal Reserve noted that AML deficiencies identified in prior examinations had not been corrected, that bank management was reactive rather than proactive with respect to its AML program, and that the [regulatory] compliance function had a lack of influence as evidenced by ongoing, uncorrected problems” (US Senate Permanent Subcommittee on Investigations 2012, 300). When the bank switched to OCC supervision, the OCC kept the bank under the provisions of the enforcement action.

However, in 2006, the OCC decided to lift the enforcement action, despite the fact that examiners continued to find many of the same deficiencies that had originally prompted it. Over the next several years, problems in the bank’s AML program lingered and the OCC gave it wide leeway to make corrections. Only when there were pending legal cases against the bank in 2009 did the OCC jump to take stronger action. In 2010, the agency issued a blistering 31 page supervisory letter to the bank detailing its AML deficiencies, including five violations of federal anti-money laundering laws and a backlog of over 17,000 uninvestigated suspicious activity reports related to money laundering. Soon after, the OCC issued a second cease and desist order to compel the bank to clean up its act, which replaced the same enforcement action it had lifted only four years prior.

The Senate Subcommittee investigation found that for over a decade the bank had consistently and pervasively violated AML laws, including laundering money for individuals and groups with links to terrorist organizations (including Al-Qaeda), helping countries like Iran

avoid sanctions by processing their transactions, and laundering money for the world's most violent drug cartels. Money laundering for a Mexican cartel was particularly eye opening: "The bank processed cash for Mexico's Sinaloa cartel, regarded as the most powerful and deadly drug gang in the world, among others. At least \$881m in drug trafficking money was laundered throughout HSBC accounts. In order to handle the 'staggering amounts of cash', the bank even widened the windows at some branches to allow tellers to accept larger boxes of money" (Rushe and Treanor 2012). One longstanding OCC AML examiner told the Senate Subcommittee that this was the worst case he had ever seen.

Despite these problems, "During the six-year period from 2004 to 2010, OCC officials did not take any formal or informal enforcement action to compel HBUS to strengthen its AML program, essentially allowing its AML problems to fester" (US Senate Permanent Subcommittee on Investigations 2012, 9). The lack of action by the OCC raised serious questions about its AML supervision over the bank: "At the time the OCC issued the [second] Cease and Desist Order, it had been conducting regular AML oversight of HBUS for six years, raising the issue of how such deep-seated AML deficiencies could have gone on at the bank without the regulator's taking action" (US Senate Permanent Subcommittee on Investigations 2012, 283).

Despite these problems, no individuals at HBUS or HSBC have been held legally accountable for the institutions' widespread money laundering program. However, the bank has replaced some individuals and others voluntarily stepped down, including HSBC's top regulatory compliance officer, who went off script to retire during his Senate testimony (Popper 2012). Ultimately, HSBC reached an agreement with the Department of Justice and was fined \$1.9 billion, about 5 weeks' profit (Taibbi 2013).

Fremont Investment and Loan

Finally, as a counterpoint, there are cases where there is no failure or crisis and no regulatory failure. In these cases, the input of good regulation coincides with the outcome of preventing a bank failure that causes a loss to the FDIC's deposit insurance fund. The cases of regulatory and industry failure get the most attention. These cases are colorful, grab headlines, and can make for good publicity for congressional committees. Congress even mandates that bank regulator Inspectors General write reports for large failures. Getting detailed information on cases of regulatory success is much more difficult, however, because these get much less attention and are not subject to the same public and congressional scrutiny. Failures, disasters, and crises averted receive little attention because a headline that reads, "Regulator continues to do its job" is unlikely to be written but also because it is difficult to know when a regulator has indeed prevented something bad from occurring.

These caveats aside, we can gather some information about successful banking regulation from what little information is available about Fremont Investment & Loan, a bank regulated by the FDIC. By 2006, Fremont became the nation's fifth largest subprime lender (Engel and McCoy 2010). As the subprime crisis unfolded in early 2007, many of its subprime loans were in trouble. At the same time, investors demanded that Fremont repurchase nonperforming loans it had originated (Engel and McCoy 2010). And in March 2007, the FDIC issued a strong formal enforcement action requiring Fremont to cease and desist from "engaging in a range of hazardous lending practices, including making low-doc and piggyback loans, requiring large prepayment penalties, engaging in misleading marketing, and lending without regard to borrowers' ability to repay" (Engel and McCoy 2010, 185). As a result, soon after the cease and desist order, Fremont shut down and sold its subprime lending unit (McKay and Paletta 2013).

Unlike many other banks, such as Washington Mutual discussed above, the FDIC prevented Fremont from continuing its risking lending after the first signs of the brewing crisis. Further, shutting down the subprime lending early stopped the flow of toxic risky mortgages from further polluting the broader financial system as investors seized up these toxic assets.

Good regulation isn't always the opposite of bad regulation or avoiding the mistakes of bad regulation. However, in the case of Fremont Investment and Loan, it appears one of the chief successes was to act forcefully and early, which was the exact opposite of what was done at the OTS in its regulation of WaMu and at the OCC in its regulation of HBUS. Though timely and tough enforcement action may not be a sufficient condition for regulatory success, it is certainly a necessary condition, as illustrated by the case of Fremont.

C. Defining Capture, Typology for Scope of Capture

How do we know when the above cases constitute capture? Before answering the question, it is useful to have a working definition of capture. Though there is no commonly accepted definition among scholars (Yackee 2011; Schlozman and Tierney 1986), most agree that capture includes influence over, or control of, agency decisions by a group regulated by the agency. Most scholars offer fairly broad definitions: the tendency of agencies over time to “relate their goals and objectives to the demands of dominant interest groups in the economy” (Bernstein 1955, 92); “the control of agency policy decision-making by a sub-population of individuals or organizations outside of the agency” (Yackee 2011, 5); “Capture...may be defined as responsiveness to the desires of the industry or groups being regulated” (Barkow 2010, 21); the ability of the regulated industry to secure rents by using regulation to create entry barriers to a market (Stigler 1971); capture is “shorthand for the phenomenon whereby regulated entities

wield their superior organizational capabilities to secure favorable agency outcomes at the expense of the diffuse public” (Bagley 2010, 2).

These definitions presume further definition of what constitutes the private interest of targets of regulation. In the context of the present study, private bank interest is the desire for less regulatory oversight, weak or lack of enforcement actions, and the ability to take on risk to increase compensation and profits. Generally speaking, we would expect a bank to not want to be told what to do by regulators.

Further, capture theory also presumes some notion of the public interest from which we can distinguish deviations toward the private interests of the regulated industry (Carpenter 2013). In the case of banking regulation, the public interest can be defined in a few ways. First, the general taxpaying public has an interest in preventing bank failures that could threaten the solvency of the deposit insurance fund. For example, during 1980s and early 1990s, the taxpayers were on the hook for the insolvency of the Savings Association Insurance fund during the S&L crisis and almost had to pick up the tab for the insolvency of the FDIC’s Deposit Insurance Fund. The final cost to taxpayers for the cleanup of the thrift industry was approximately \$124 billion (Curry and Shibut 1999). Thus, when regulators take actions that allow banks to engage in risky behavior, or fail to rein in risky behavior, the regulators are potentially compromising this first definition of the public interest to the extent the risk excessively puts the insurance fund at risk.

Of course, the public also has an interest in receiving consumer loans, such as mortgages, and an interest in banks making loans to businesses to maintain growth and health in the overall economy. Some risk taking by banks is in the public interest. As former OCC acting head John Walsh argues, "We can go too far in the direction of safety. Are we looking for a financial

system in which there is no chance of a bank failure or market malfunction? If so, it is going to be a very different, much more constrained system than anything we've ever had" (Rehm 2012). However, *excessive* risk taking is not. Thus, it might be called a "goldilocks problem," not too much risk, but not too little. Whether risk is excessive will have to be determined on a case-by-case basis by regulators.

The public interest can also be defined a bit more narrowly in the sense of the interest of consumers receiving fair and honest treatment by financial institutions. If banks are allowed to engage in predatory lending (GAO 2004), manipulate the terms of loans without the customer being aware (Black 2009), or push particular subsets of customers (such as by race) into riskier loans (Usborne 2012), then banks are not serving the public interest, and neither are the regulators who are allowing that behavior.

Additionally, the preceding cases help to distinguish what capture is and is not. First, obviously capture does not occur in cases where there is no regulatory failure. Second, the cases demonstrate that bank failure is not a foolproof indicator of regulatory failure, and thereby capture. Though failures and crises can be preceded by lax treatment of the regulated industry, failures can also occur as part of the risk inherent in the system. Thus, the FDIC's regulation of Fremont and the OCC's regulation of First National Bank of Georgia help us understand that failure can occur despite appropriate regulation and without capture. These cases also show what good, "non-captured" regulation might look like.

Thus, to look for indicators of capture we should examine the cases of regulatory failure. However, not all cases of regulatory failure are cases of capture. The case of Superior bank is an example of an overwhelmed, outpaced, outgunned agency but not necessarily a captured agency. Just like we would expect failures to occur under regulators supervising risky industries, we

would also expect that regulators overseeing a dynamic industry like banking and finance will sometimes need to update their expertise. While agencies are learning, some failures may occur. We could instead ban insured banks from investing in new types of assets until regulators develop the expertise to determine their risk. However, the cost of banning or slowing down certain types of asset investments might be outweighed by the benefits of a dynamic banking industry. Thus, we should expect failures like Superior to occur as part of the cost of allowing banks to engage in risky behavior and not necessarily accuse regulatory agencies of being captured when they are instead facing a tough task of regulating a rapidly changing industry. As will be explored in more detail in Chapter 3, there are other problems the agencies face that can be classified as regulatory failures but not instances of capture.

So we are now left with the cases of WaMu and HBUS. Can we establish that they captured their regulators according to the definitions above? Risk taking and failure alone do not mean WaMu captured the OTS. Some level of risk taking and credit extension to borrowers can still be consistent with the public interest. However, when the OTS allowed WaMu to shoulder excessive risk it did not act in the public interest. How do we know when risk levels are excessive? The management was so reckless, at least according to the FDIC, that the FDIC decided to pursue a civil lawsuit against three former WaMu executives, alleging that they "focused on short term gains to increase their own compensation, with reckless disregard for WaMu's longer-term safety and soundness" (Fitzpatrick and Eaglesham 2011). The case resulted in a settlement for \$75 million, though the FDIC originally sought \$900 million. The money came not from the executives' pockets, but from the executives' liability insurance policy and the bank's estate. Further, as the Treasury OIG explained, the OTS subverted the purpose of CAMELS rating system that was set up to protect the Deposit Insurance Fund by assigning

WaMu inappropriately high ratings. It would be difficult to construe the notion of the public interest to encompass such actions.

The OCC put little pressure on HBUS to force it to obey anti-money laundering laws. Put simply, the OCC did little to discourage illegal behavior, which is a prima facie case of failing to serve the public interest. *Any* level of money laundering is directly opposed to the public interest, particularly as represented in multiple pieces of legislation outlawing it. Further, the OCC could have argued that what looks like laxity is really a problem of resource constraints, the complexity of regulating in this area, or because Congress failed to delegate the agency the appropriate authority. Instead, by his own admission and based on his own expertise, the Director of the OCC has admitted to the OCC's failings. Said Curry, "The agency has been much too slow in responding and addressing what are significant weaknesses and violations at this institution," and that "examiners' conduct was troubling and reprehensible" (Popper 2012).

But based on regulation of one bank can we really conclude that an entire agency is captured? Our notion of capture needs more precision. Capture is often discussed at the level of the analysis of the agency as a whole. Scholars also discuss the severity of capture in qualitative terms, as in weak or strong capture (Carpenter and Moss 2013a). In contrast, I try to delineate the severity and type of capture by its scope along two dimensions: the scope within the regulated industry and the scope within the agency and/or policy system. See Figure 3 below.

Figure 3: Scope of Capture

Targets of Capture						
Examiners	Management	Executive	Agency Policy Domain	Whole Agency	Elected Officials	
Agents of Capture	Individual Bank	Targeted Agency Capture				Targeted Regulatory Capture
	Multiple Banks	Agency Capture				Regulatory Capture
	Industry	Agency Capture				Regulatory Capture

Within the regulated industry, the scope of those doing the capturing may be narrow, with one individual bank able to capture its regulator. The scope could widen to multiple banks, and in widest scope, involve most of the industry working in concert to capture a regulator.

Likewise, the scope can vary by whom or what is being captured. At the broadest level, targets of regulation may be able to capture the larger policy system, including Congress and the president. According to Johnson and Kwak (2010), the financial industry was able to do just that over the course of the last 30 years, calling the industry's triumph a "quiet coup" of the American political system (Johnson 2009). Others have argued that policymakers have created a bank regulatory system that encourages capture. The combination of banks being able to choose their regulator and the fact that two regulators (the OCC and OTS) get their funding almost exclusively from fees charged on the banks under their supervision, together can create a race to the bottom as banks move to where regulation is most lax (Barkow 2010; Ramirez 2000). If this account has merit, the agencies, despite their best efforts, may be implementing inherently captured regulatory policy.

Perhaps the best example of macro political capture is the government's treatment of HSBC in the aftermath of the \$1.9 billion money laundering settlement with the Department of Justice. Many were outraged that no individuals at HSBC were held individually accountable for their illegal behavior. Said Senator Elizabeth Warren at a hearing, "If you're caught with an ounce of cocaine, the chances are good you're going to jail. If it happens repeatedly, you may go to jail for the rest of your life. But evidently, if you launder nearly a billion dollars for drug cartels and violate our international sanctions, your company pays a fine and you go home and sleep in your own bed at night - every single individual associated with this - and I just think that's fundamentally wrong" (Parramore 2013).

The DOJ's settlement with HSBC caused worry that, not only are the largest financial institutions too big to fail, they are also too big to prosecute. Attorney General Eric Holder essentially admitted to the latter during testimony about HSBC and the broader difficulties of bringing criminal cases against large banks. "I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if we do prosecute — if we do bring a criminal charge — it will have a negative impact on the national economy, perhaps even the world economy. I think that is a function of the fact that some of these institutions have become too large" (Finkle and Blackwell 2013). The reason these banks are so large is that elected officials of both political parties spent the past several decades passing legislation that allowed financial institutions to grow ever larger (Angelides et al. 2011; Johnson and Kwak 2010).

We might call the above cases examples of cultural or systemic capture, or what I call regulatory capture. Depending on the scope within the industry, I refer to this type as targeted regulatory capture and more broadly, as regulatory capture, as seen in Figure 2. I define regulatory capture as disproportionate influence in a non-agency policymaker's decisions (president, Congress, courts) by a target of their regulatory authority so that the target receives favorable treatment that deviates from the public interest. The idea of regulatory capture is similar to Shapiro's (2010) concepts of political and sabotage capture, Wagner's (2010) concepts of institutionally and politically-based capture, and Carpenter's (2013) concept of statutory capture.

It is also useful to distinguish regulatory capture from a narrower notion of agency capture. I define agency capture as disproportionate influence in an agency's decisions by a target of its regulatory authority so that the target receives favorable treatment that deviates from

the public interest. In other words, what distinguishes regulatory capture from agency capture is whether the capture occurs over decisions reasonably within an agency's power or within the broader regulatory system. Like regulatory capture, agency capture varies in scope between targeted agency capture or agency capture, depending on its scope within the industry and the agency, as seen in Figure 2.

Agency capture may happen over the entire agency, such as when Huntington (1952b) argued that the railroad industry was able to get the Interstate Commerce Commission to equate industry interests with the public interest. More narrowly, targeted agency capture may happen with respect to a particular policy domain the agency is tasked to regulate. Some have argued that the bank regulators, particularly the OCC and the OTS, were captured by the industry with respect to subprime and predatory lending leading up to the 2008 financial crisis (Engel and McCoy 2010). The Permanent Subcommittee on Investigations argued in its report that the OCC's lax regulation of HBUS and HSBC was symptomatic of overall problems in its anti-money laundering efforts, suggesting that its entire efforts in this policy area might be captured (US Senate Permanent Subcommittee on Investigations 2012).

More narrowly still, actors at different levels within the agency may experience targeted agency capture. James Q. Wilson (1989) identifies three different levels of personnel within agencies: executives, managers, and operators. At the executive level of the banking regulators are board members or single directors and the Washington staff under them. In the middle of the hierarchy are managers who head regional offices as well as various field offices in each region. An example of targeted agency capture at these levels occurred when the director and regional managers at the OTS allowed six banks to illegally inflate their capital level by making a capital

infusion from their holding company appear to happen earlier than it did on its public financial statements (Treasury Office of Inspector General 2009e).

At the lowest level are bank examiners who function as “operators,” or what Lipsky (2010) called “street level bureaucrats,” who are on the front lines implementing policy by going into banks to conduct regular examinations. We know from previous research that it is important these operators be rotated because they have a tendency to be influenced by local pressure (Kaufman 1960). For example, Inspectors General uncovered evidence that at the OTS and the OCC that a lack of an examiner rotation policy contributed to weak supervision (Treasury Office of Inspector General 2009b, 2011c).

So were the regulatory failures in the OTS’s regulation of WaMu and the OCC’s regulation of HBUS actually cases of targeted agency capture? Capture seemed to have permeated all levels of the OTS hierarchy. The deference is evident in the way OTS Director John Reich referred to WaMu as his biggest “constituent” (US Senate Permanent Subcommittee on Investigations 2011, 210). And further in the way Reich was obsequiously apologetic to the CEO of WaMu when the OTS finally decided to take its second informal enforcement action against the thrift, just before its failure.

Kerry,

I'm sorry to communicate by email – I've left a couple of messages on your office phone, but I'm guessing you may be off for a long weekend.

I've been wrestling with the issue of an MOU versus a Board Resolution as a result of our conversation in my office last week. And I've decided that an MOU is the right approach for OTS to do in this situation

We almost always do an MOU for 3-rated institutions, and *if someone were looking over our shoulders, they would probably be surprised we don't already have one in place. ...*

So as much as I would like to be able to say a Board Resolution is the appropriate regulatory response, I don't really believe it is. I do believe we need to do an MOU. We don't consider it a disclosable event, and we also think the investment community won't be surprised if they learn of it, *and would probably only be surprised to learn one didn't already exist.*

Again, I'm sorry to communicate this decision by email, but I'm scheduled to be out of the office next week myself and wanted you to have this information.

Best regard, Kerry,

John

(US Senate Permanent Subcommittee on Investigations 2011, 210-211)

At the manager level, the OTS Western Region Director Darrell Dochow describes how he and the OTS ceased to be able to provide strong independent judgment of WaMu's risky assets.

Another [lesson] is when you get too close to an industry in terms of to get used to the kinds of products it originates, non traditional mortgages, interest only pay option negative ARMs [adjustable rate mortgages], they don't become so shocking because you see them at other institutions. I think that's a lesson that sometimes when you get to know a product you sometimes give it too much credence and you base too much on historical facts where other institutions have done it for 20 years and it's not been a problem. It's like, you know, things change in the future and there's always something new and different that you just don't think about at the time...It's a lesson that you can't get too close without knowing you're getting too close because you see the products, you see that historically other institutions have done well with them. It's a tough thing to admit but I think it's true (Dochow 2010).

Even though much of the problem with capture may rest with the director and management at the regional level, there is some evidence that the culture of deference permeated even to the examiners. Remarkably, the Examiner in Charge at WaMu in 2006 sent an email to

the Regional Director discussing the upcoming Report of Examination and sounded as if he were lobbying on behalf of WaMu.

Generally we feel that we are quite balanced and do not have any gloves on in our approach to our findings and conclusions at WAMU. We have some concern that if we press forward with some things ... we may run the risk of losing some credibility in terms of understanding the size and complexity of their business and looking as though we do not have a balanced perspective. My own fear is that we may not have done enough to communicate to you [the Regional Director] why we feel that the few negative things we have brought up through findings memos and meetings, while important to keep in front of management, are not so serious they wipe out all the right things the institution is doing in all those areas we reviewed and did not have any issues, nor should they negate the ongoing good progress in making improvements in a manner that seems reasonable given the size, complexity, and status of the institution (US Senate Permanent Subcommittee on Investigations 2011, 212).

He then proceeded to downplay serious problems WaMu was experiencing with a mortgage origination company it had just purchased, asked that fewer corrective actions be included in the body of the examination report (because he said the bank was not reading it anyway!), that the OTS have fewer meetings with the management because they were starting to “over meeting” the thrift, and that the final meeting of the examination process where the examiners discuss the examination report with the thrift board and management be done away with because it was unnecessary (US Senate Permanent Subcommittee on Investigations 2011, 212). It is remarkable that these comments came in 2006 after several years of uncorrected problems with management and asset quality and despite the fact that the OTS did not know how well the thrift was doing in making the changes requested because of its poor tracking system.

At the OCC, the evidence suggests that the OCC’s entire anti-money laundering efforts were captured. The problems of the OCC’s supervision of HBUS were larger than weak enforcement and extended to its overall supervisory approach to money laundering. According to the report by the Permanent Subcommittee on Investigation,

Problems include the OCC's decision to treat AML deficiencies as a consumer compliance problem rather than a management problem with safety and soundness implications; its practice of foregoing the citation of legal violations for the failure to comply with mandated components of a AML program; its use of narrowly focused AML examinations without also examining a bank's overall AML program; its failure to make timely use of informal and formal enforcement actions to compel AML improvements; and its use of Supervisory Letters that sometimes muted examination criticisms or weakened recommendations for reforms (US Senate Permanent Subcommittee on Investigations 2012, 284).

Essentially, the OCC's handling of AML deficiencies was set up to downplay the risk and severity of these infractions. Unlike other regulators, the OCC treated money-laundering violations as a consumer compliance issue rather than a safety and soundness issue. As a result, these violations would not affect the bank's CAMELS rating, particularly the Management rating. Consequently, any violations would not force it to pay higher insurance premiums because it would not lower the CAMELS rating. This decision also reduced the likelihood of receiving an enforcement action for safety and soundness concerns, which are also based on the CAMELS rating system.

D. Theory and Hypotheses

Capture Theory in General

How strong is the evidence that agency capture actually occurs? Early scholars were pessimistic that agencies could maintain strong regulation over the course of an agency's life cycle (Bernstein 1955). Early formal theorists in economics were skeptical as well, arguing that regulation is dangerous due to the likelihood of agency capture (Stigler 1971). Iron triangle theorists likewise thought that close connections between agencies, congressional committees, and the regulated were elite subsystems that excluded the broader public (Huntington 1952a). With the explosion of public/citizen interest groups in the 1970s, scholars grew less pessimistic about agency capture. More porous "issue networks" and more competitive "advocacy

coalitions” replaced the notion of iron triangles (Hecklo 1978; Sabatier 2007). Wilson’s (1980) case studies of a dozen regulatory agencies found little evidence of agency capture. Similarly, Wood and Waterman (1994) argue that iron triangles can be penetrated because key representatives of the public, like the president and congress, can influence and direct key bureaucratic outputs, like enforcement and inspections, with oversight and appointment tools.

Though capture theory fell out of fashion, recent events like the Gulf oil spill, coal mining disasters, and the 2008 financial crisis have renewed attention to the problems of regulatory failure and regulatory capture as scholars seek to draw lessons about whether these events are indicative of capture and if so, how to prevent capture from occurring in the future (Carpenter and Moss 2013b; Coglianese 2012).

Capture Theory: Financial Regulation

Though this recent attention to capture has added some much needed empirical evidence about regulatory capture in general, less is known about capture in financial regulation. James Kwak (2013) outlines a theory of “cultural capture” of financial regulators based on social-psychological explanations. He argues that regulators are more likely to adopt the positions and beliefs of 1) individuals they identify as being in their in-group, 2) individuals they believe are of a high social, economic, or intellectual status, and 3) individuals in their social network with whom they have a relationship. The close connection and revolving door between government and financial elites makes these dynamics possible. McCarty (2013) has formally modeled financial regulator capture based on the complexity of the policy area. Because financial regulation is so complex, agencies must rely on industry for information, making them too tolerant of industry-friendly policies. This theory reflects earlier research by Gormley (1986) that

suggests that the likelihood of capture increases to the extent a policy area is both highly complex and of low public salience.

Though capture can result from the inherent features of the policy domain, it can also be encouraged by the regulatory structure created by policy makers. Policymakers have created a system in which banks have considerable latitude to choose their regulator. The regulatory structure allows for both vertical and horizontal movement as banks can move horizontally among states or among federal regulators, as well as vertically by choosing a state or national charter (see Figure 1 above). Regulator shopping puts pressure on all four banking regulators and can create a race to the bottom as banks move to where regulation is most lax. “Consequently, these agencies do not have the same ability to make decisions free of political influence. They must pay heed to the regulated or lose the ability to exercise significant regulatory power. When a regulated industry has the ability to choose their regulator, a giant channel towards capture is opened” (Ramirez 2000, 534).

Charter shopping is not just a theoretical possibility. Several of the largest state-chartered banks moved to national charters within months after the OCC issued a rule in 2004 that exempted nationally chartered banks from state and local consumer protection laws. Although charter shopping can facilitate agency capture, it might also promote beneficial competition among regulators. For example, Rosen (2003) finds that banks are most likely to switch regulators when they are making business changes to their portfolios, that they perform better after switches, and there is little change in their risk profile after a switch. But Rezende (2012) finds evidence that a new regulator rates banks higher after a charter change, which suggests that regulatory agencies may compete for banks by treating them better after they switch charters.

In addition to systemic reasons for capture, the performance of specific agencies may be affected by the structure of their agency. Three structural differences are considered here: source of funds, mandate, and the existence of overlapping regulators. These structural differences seem likely to make the OTS and OCC more susceptible to capture than the FDIC and the Fed.

First, the OTS's and the OCC's funding via assessments on the banks they supervise makes them susceptible to capture, especially in combination with the industry's ability to move among regulators. Though their funding stream protects them from undue congressional influence—a potential source of capture—it also insulates the agencies from congressional budgetary controls that could push them to be less deferential to the industry. Regardless, the funding source makes them more susceptible to industry influence because they are sensitive to entry or exit by their biggest clients. For example, between 2004 and 2005, three large banks converted to national charters, raising the OCC's assessment revenue by 15 percent (Bar-Gill and Warren 2008).

This problem is particularly acute for the OTS, which regulates half as many banks as the OCC.⁴ For example, Washington Mutual was one of the largest institutions supervised by the OTS and its regulation assessments supplied 15 percent of the OTS's assessment revenue from 2003 to 2008 (Offices of Inspector General 2010). As discussed earlier in Chapter 2, OTS's lax regulation of WaMu contributed to its failure in 2008 (US Senate Permanent Subcommittee on Investigations 2011) leading some to suggest that it and other large institutions were too big for the OTS to regulate (Engel and McCoy 2010). Or at least it was too big a share of its budget for OTS to risk alienating WaMu.

⁴ At the beginning of 2007, on the eve of the financial crisis, the OTS regulated 826 institutions while the OCC regulated 1,632 (FDIC).

Because the FDIC is funded by premiums it assesses on all insured banks, its funding is the same no matter which agency a bank chooses as its primary federal regulator. And because it has been delegated authority to set its premiums and make banks prepay premiums multiple years in advance, it is able to maintain a stable budget with little industry influence. Likewise, the Fed has little concern that its budgetary source will affect the quality of its regulation. The Federal Reserve System is funded mainly through interest the Federal Reserve Banks earn from the government securities they buy in the course of conducting monetary policy. Even after supervision and regulation expenses, and other costs incurred carrying out its other functions, the Fed still turns over tens of billions of dollars to the Treasury each year in excess of its expenses.

Second, the OTS's and the OCC's mandates align them with the industry to a greater degree than the Fed and the FDIC. As discussed earlier, the OTS and OCC have a dual mission to both promote the competitiveness of the industry and to make sure the industry operates in a safe and sound manner and serves consumers and the community. In contrast the FDIC and the Fed do not have industry promotion in their mandate.

In particular, for the FDIC, "Defense of the fund is the core of its organizational character. The defense defines how well the agency meets expectations for performance and provides an internal focus for motivation, identification, and integration of complex functions" (Khademian 1996, 116). As one bank manager describes the differences between the OTS and the FDIC, "The FDIC view [is] flavored by safety and soundness above all else.... That's different from the OTS...which is told to *promote* home lending.... The FDIC didn't have promotion in its statute for anything, and so it is less aggressive.... The FDIC is not a chartering authority, it is an *insurer*" (Quoted in Khademian 1996, 125). The implication of these differing

mandates gives the OTS and the OCC legitimacy to pursue actions that promote industry expansion and competitiveness while the FDIC and Fed would not.

Third, the OTS, and to a larger extent the OCC, are insulated from overlapping regulation from state regulators. As seen above in Figure 1, when a thrift chooses a federal charter, it has the OTS as its consolidated regulator, but when it chooses a state charter it receives supervision from both the state banking authority and the OTS. When a bank chooses a national charter, it has the OCC as its consolidated regulator. Having one regulator can promote consistency and efficiency because national banks listen to only one regulator regarding their safety and soundness.

The OCC used this argument to justify preempting state consumer protection laws for national banks in 2004. Critics were worried that the OCC was instead trying to help national banks avoid stricter laws and punishment at the state level. As scholars have argued, additional layers of regulation from the states (Barkow 2010) or from proxy public interest advocates like attorneys general (Gormley 1982) can act as deterrents to agency capture. Though some evidence has shown that state regulators are more lax than the FDIC and the Fed (Agarwal et al. 2013), the evidence shows that states were much more aggressive in attempting to fight abuses in subprime and predatory mortgage lending than the OCC and the OTS (Peterson 2005; Spitzer 2008).

Not surprisingly then, previous investigations suggest the OTS and OCC stood out in their deference to the industry. When it came to combating the abuses of subprime and predatory lending, Engle and McCoy (2010) argue the OTS was the worst, followed closely by the OCC. For example, in 2006 when the four regulators agreed to interagency guidance on risky non-traditional mortgages, the OTS, unlike the other agencies, told its banks that they did not have to comply (US Senate Permanent Subcommittee on Investigations 2011). Despite lending abuses at

big national banks, the OCC “never instituted a single formal enforcement action against a big national bank for unsafe mortgages during the housing bubble” (McCoy 2010).

Others see the OTS as “the worst bank regulator” overall (Eisinger 2012). “In the parade of regulators that missed signals or made decisions they came to regret on the road to the current financial crisis, the Office of Thrift Supervision stands out” (Appelbaum and Nakashima 2008). Others argue that the OTS was captured because it “tellingly called the firms it oversaw ‘customers’ and failed to spot trouble brewing at some of the biggest financial crisis casualties, including Countrywide, Washington Mutual, IndyMac and the American International Group” (Swann 2011). And in the Senate Permanent Subcommittee on Investigation’s report on the causes of the financial crisis, they chose the OTS’ regulation of Washington Mutual Bank to typify the regulatory failure that contributed to the crisis. OTS’ poor regulation of Washington Mutual “stemmed in part from an OTS regulatory culture that viewed its thrifts as ‘constituents,’ relied on them to correct the problems identified by OTS with minimal regulatory intervention, and expressed reluctance to interfere with even unsound lending and securitization practices. OTS displayed an unusual amount of deference to WaMu’s management, choosing to rely on the bank to police itself” (US Senate Permanent Subcommittee on Investigations 2011, 161-162).

Similarly, others have argued that the OCC is too much of a cheerleader for the banks it regulates: “The Office of the Comptroller of the Currency is so lenient on the banks it is supposed to regulate that it could be mistaken for a division of the United States Chamber of Commerce” (Eisinger 2012). One former OCC staffer argues the agency suffers from “mission confusion” (Eisinger 2012). The most recent Comptroller, Thomas Curry admitted as much when he said during an interview that, “I hear there are concerns about the objectivity of the O.C.C. It’s

not an issue of technical skills. It's really an issue of refocusing our mission and our sense of purpose and making sure we look at things with basically a healthy skepticism" (Eisinger 2012).

Despite what looks like reassessment, other indicators show the agency may still be too close to the industry, even in the wake of the financial crisis. It has fought key provisions of the Dodd-Frank reform legislation, including attempting to gut the Volker Rule (which attempts to reduce speculative trading by insured banks) and resisted Dodd-Frank's specific provisions to reverse the OCC's preemption rules. The latter move led to rebuke from Treasury Secretary Timothy Geithner and the Obama administration for the OCC's refusal to follow the law (Davidson 2011). Further, displaying some of the same supervisory problems the OCC displayed for many of its bank failures, the Treasury Inspector General said the OCC failed to uncover the robo-signing scandal that permeated the bank industry as banks attempted to improperly foreclose on homeowners (Treasury Office of Inspector General 2012c) and reached a settlement with banks for the foreclosure scandal that appeared very favorable to banks, but not to borrowers (Morgenson 2013; Smith 2013).

Thus, one would expect the OTS and OCC to be more susceptible to capture, given previous investigation of the agencies, the combination of their revenue stream and charter shopping, their dual mandate, and their lack of or reduced oversight from other regulators.

E. Conclusion

This chapter began by describing the complexities involved in detecting regulatory failure and capture. Because observers often (incorrectly) infer regulatory failure after instances of industry failures and crises, I developed a typology to show that these do not always overlap. I drew from the cases of five regulated banks to illustrate this point. Then, drawing from the three cases of regulatory failure, I also established that regulatory failure and capture do not always

overlap. Indeed, some cases of regulatory failure are not indicative of capture. However, some are, and I used these two cases to help clarify the idea of capture by creating a typology to describe the scope of capture within the regulated industry and the policy system, and by distinguishing between agency and regulatory capture. After failures and crisis, regulatory agencies typically get the blame, but these cases illustrate the complexity of doing so with abandon.

I concluded with a discussion of capture theory and developed hypotheses about the propensity for capture at the banking regulators. Based on previous investigation of the agencies and key structural features, I concluded that the OTS and OCC are most susceptible to capture. Whether we can establish that agencies are indeed captured is the task of the next two chapters.

CHAPTER 3: OFFICE OF INSPECTOR GENERAL FAILED BANK REPORTS

A. Introduction and Hypotheses

In Chapter 2, I made a distinction between regulatory failure and capture. I also created a typology for types of capture. Chapter 2 also established the predictors of capture for banking regulators. These factors are the ability of banks to choose their regulator, a dual agency mission to both supervise and promote the regulated industry, conflicts of interest in an agency's funding, and the amount of overlapping jurisdiction from other regulators.

I now investigate these regulators' practices by using Office of Inspector General Reports (OIG) reports written about banks that failed under the supervision of each regulator. Among other things, these failed bank reports are required to assess any mistakes regulators made prior to a bank's failure. In what follows, I use content analysis to analyze regulatory problems identified in the reports. I employ a coding framework that pays particular attention to behavior that does and does not provide evidence of capture.

If regulated banks have captured the OTS and the OCC, the OIG should frequently find instances where OTS and OCC examiners are treating banks favorably with lax enforcement, as was the case with OTS's examination of Washington Mutual, discussed in Chapter 2. If the OTS and OCC were not captured, the OIG should find few problems, or when they do identify problems, these problems should indicate regulatory failure, such as errors in judgment or a lack of adequate resources.

Accordingly, I hypothesize that the OIG will frequently identify instances where OTS and OCC personnel were too lenient in their regulation of banks by using weaker enforcement actions than called for by agency guidelines. Second, I hypothesize that the OCC will be cited more frequently for instances of lax enforcement than the FDIC and the Fed. Third, I expect the

OTS will be cited more frequently for lax enforcement than the other three agencies, given that it exhibits the highest levels of the factors that predict capture.

B. Data

Generally speaking, information related to bank examinations is unavailable to the public. This information is exempt from the Freedom of Information Act (FOIA). FOIA Exemption 8 protects information “contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions” (5 U.S.C. § 552(b)(8)). “Except for Exemption 9, dealing with geological and geophysical information, no other FOIA exemption is industry— or agency—specific” (Administrative Conference of the United States 1995). Despite legal challenges, numerous court cases have upheld and solidified the exemption (Department of Justice 2009).⁵

However, information related to bank supervision is available for certain banks in government reports called Material Loss Reviews (MLRs). Section 38(k) of the Federal Deposit Insurance Corporation Improvement Act of 1991 requires the Office of Inspector General (OIG) to write MLRs. These reports, written by the respective OIG for each bank regulatory agency, examine bank failures that cause a significant loss to the deposit insurance fund. According to the legislation, a loss is considered material (meaning large) when it causes a loss to the insurance fund of greater than \$25 million or 2 percent of bank’s total assets. The Dodd-Frank

⁵ “Exemption 8’s protection of operating, condition and examination reports is generally seen as serving three primary purposes: (1) It protects banks—including both the examined bank and those that have relationships with it—from substantial harm that might be caused by disclosure of information and opinion about their condition; (2) It facilitates the free exchange of information between bank personnel and examiners and encourages bank examiners to be candid, and as necessary, immediately responsive, in their assessments of a bank’s financial position and operation; and (3) It protects the privacy of bank customers (e.g., depositors and borrowers)” (Administrative Conference of the United States 1995).

Act amended the threshold to \$200 million for 2010 and 2011, \$150 million for 2012 and 2013, \$50 million for 2014 and thereafter. The legislation required the OIGs to begin writing the reports for failures that occurred on or after July 1, 1993. The purpose of these reports is to (1) determine causes of an institution's failure that resulted in a loss to the insurance fund, (2) assess the quality of an agency's regulation, and (3) make recommendations that may help the agency improve its regulation in the future.

In addition to MLRs, the OIGs have also written similar reports for other bank failures. These reports are otherwise identical to MLRs, except they do not fit the technical definition because the bank, for various reasons, did not cause a loss to the insurance fund that met the specific threshold established by Congress.⁶ I included both MLRs and the reports that are functionally equivalent to MLRs in my study. I did this to compensate for the small number of reports and the lack of information generally on non-publicly disclosed bank regulation. I wanted to include as much information as possible. I analyzed a population of MLRs (and similar reports) for three of the four agencies: the OTS, OCC, and the Fed. The FDIC regulates three to

⁶ In some cases, these reports were initially intended to be MLRs, but Congress changed the monetary threshold with Dodd-Frank when the report was almost complete. Rather than not issue the report to the public, the OIG decided to complete the work and release the report as an in-depth review. Though not technically an MLR, the report served the identical purpose. Congress also gave the OIGs discretion to write in-depth reviews for failures that present "unusual circumstances". The definition of unusual circumstances was left to the discretion of the OIG. Typically, an OIG decided to write such reports in cases where a failure presented a novel banking activity or a peculiar relationship with affiliated institutions.

Also, the Treasury OIG decided to conduct two-pilot study MLRs prior to the onset of the July 1, 1993 requirement. The Treasury wrote one pilot-study MLR for a failure that occurred under the OTS in 1991 and another that occurred under the OCC in 1992. Lastly, the Treasury OIG wrote a report, functionally equivalent to an MLR, for the failure of Washington Mutual Bank, which was under the supervision of the OTS. Although the failure did not cause a loss to the deposit insurance fund because the bank was sold to JP Morgan Chase, the Treasury OIG along with the FDIC OIG, thought it important to write a report with the same content as an MLR, because the failure of Washington Mutual was the largest bank failure in history — an unusual circumstance.

five times more institutions than the other regulators. Consequently, it had a significantly larger number of failures that caused a material loss, and thus a larger number of reports—about four times as many. To create the subset of FDIC reports, I divided the reports into two time periods, 1993-2006 (failures before the recent financial crisis) and 2007-2011 (failures during the crisis). There were only ten reports for the earlier time period and 92 for the crisis period. For my analysis, I included all reports from the earlier time period (10) and took a random sample of reports for the crisis period (n=34) to reduce over-representing the dynamics of the financial crisis.

Table 12 below shows the total number of OIG reports included in my analysis as well as the breakdown by report type.

Table 12: OIG Reports Included in Analysis by Type and Agency

Report Type	OTS	OCC	FDIC	Fed
Material Loss Review	30	29	41	23
In-Depth Review	1	1	3	4
Pilot Study MLR	1	1		
Evaluation of Federal Regulatory Oversight	1			
Total (n=135)	N=33	N=31	n=44	N=27

Most of the reports are written about failures that occurred between 2007 and 2011, as seen in Table 13 below.

Table 13: OIG Reports Included in Analysis by Year

Year	OTS	OCC	FDIC	Fed
1991	1			
1992		1		
1993			1	1
1994		1	3	1
1995			2	
1996				
1997				
1998			1	
1999		1	1	
2000				
2001	1			
2002		2	1	
2003			1	
2004				
2005				
2006				
2007	1			
2008	5	3	4	1
2009	19	18	19	16
2010	3	4	10	4
2011	3	1	1	4
Total	33	31	44	27

C. Method of Analysis

I used content analysis to analyze the bank failure reports, “transforming written text into highly reliable quantitative data” using “systematic and objective criteria” (Singleton and Straits 2005). The OIG reports are usually divided into three major sections: reasons the bank failed, problems with regulation, and recommendations. For the purposes of this research, I focus mainly on the section identifying problems with agency regulation. The coding categories I created are a response to the question, “what supervisory weaknesses did the OIG identify?” Rather than use predefined categories or “standard categories”, such as those in a category dictionary, my categories emerged from reading the reports (Glaser and Strauss 1967).

To make sure categories are clearly defined, exhaustive, and mutually exclusive I created a codebook with clear definitions or rules for assigning my unit of analysis to a category (Singleton and Straits 2005). In the codebook below you can see examples drawn from the text that illustrate the type of language that caused something to be placed in a category. These categories are described in more detail in the following section where I detail the results of the content analysis.

Table 14: Codebook—Problems with Regulation

Code	Name	Description
10	Lax supervision/enforcement	<ul style="list-style-type: none"> Supervision/enforcement was weak, untimely Sample language: “We believe that the 2000 examination had established sufficient basis for using a more forceful enforcement action...” (Nextbank, OCC)
20	Poor information processing/decision making	<ul style="list-style-type: none"> Inadequate scope of investigation Failure to identify problems Failure to assign expert examiner Examiner not following guidance Sample language: “...examinations of management supervision, asset quality, and the SBA loan were not in sufficient depth...” (Mechanics National Bank) Sample language: “OCC did not fully identify...the bank’s management and lending problems...” (Mechanics National Bank)
30	Agency resource constraints	<ul style="list-style-type: none"> Resources Constraints <ul style="list-style-type: none"> Not enough examiners Problems of expertise <ul style="list-style-type: none"> Shortage of examiners with a particular area of expertise Lack of examiner experience with a novel bank activity Market innovation outpaced agency rules Sample language: “...there were resource constraints in the region...that...precluded them from accelerating the examination” (Mirae, 13)
40	Agency outmaneuvered	<ul style="list-style-type: none"> Fraud by bank Misleading accounting by bank Though the agency is taking appropriate enforcement measures, the bank not making corrections Sample language: “Alleged fraudulent accounting practices, uncooperative bank management and reported high profitability may have all served to mask the bank’s true financial condition from OCC examiners.” (Keystone, 1)
50	Supervision appropriate	<ul style="list-style-type: none"> OIG finds supervision to be appropriate—the bank failed for reasons unrelated to regulation or despite appropriate regulatory action Sample language: “Although OCC’s supervision did not prevent a material loss to the insurance fund, we concluded that its supervision of Integra was appropriate.”

My unit of analysis was any problem with an agency's regulation identified by the OIG. I recorded whether (yes/no) a particular regulatory problem appeared in a particular OIG report. I did not count the frequency with which a problem occurred within a particular report because the reports are not always consistent in their treatment of this. For example, in some instances, the failed bank report details an exact number of instances in which stronger enforcement could have been used. Other times, they simply refer to the need for stronger enforcement without specification of whether there were multiple instances where it was warranted. Thus, for comparison purposes, frequency is not used.

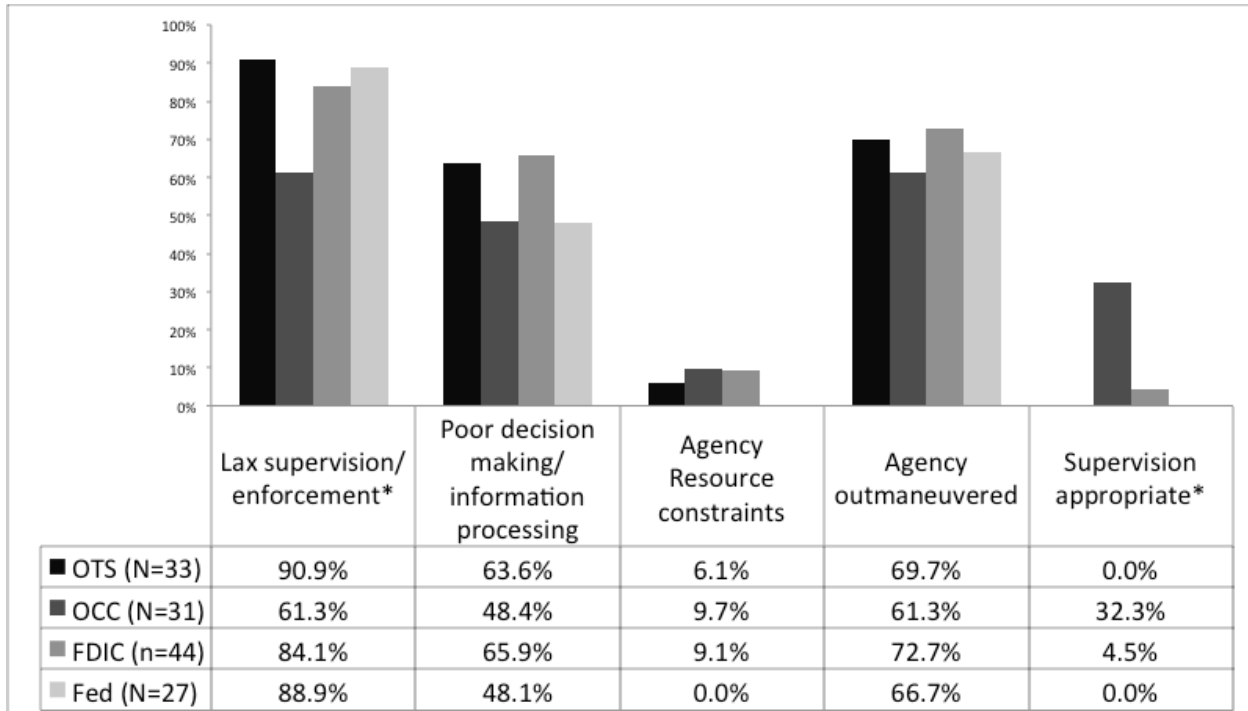
I also rejected intensity as a method for counting my units of analysis because of the difficulty of establishing objective criteria to measure intensity. In certain instances the report may use words like "shocked" or "egregious" in reference to a particular supervisory weakness, the language is not used consistently enough justify recording intensity. While it would be useful to know not just whether a supervisory weakness occurred, but also how important that weakness was to the bank's failure (for example), there does not appear to be any way to make this determination objectively based on the information given in the reports. The OIG appears to weight all weaknesses equally.

In using appearance as my system, two problems arise. Use of appearance assumes that the number of times a recording unit appears across reports is indicative of its importance and that each appearance is of equal importance (Singleton and Straits 2005). These assumptions are probably not correct, but the imprecision is unavoidable, given the limitations of the data available.

D. Results

Figure 4 below shows the breakdown of supervisory problems by category and by agency for all OIG reports analyzed for years 1991-2011.

Figure 4: OIG Identified Supervisory Problems 1991-2011



*Statistically significant difference among agencies (Chi-square, $p < 0.05$; Fisher's Exact Test, $p < 0.05$)

My first hypothesis was that the OTS and OCC would frequently be lax in their supervision and enforcement. The results of content analysis in Figure 1 above demonstrate that the OTS was often lax in its supervision and enforcement. But the FDIC and the Fed were lax almost as often. Although lax enforcement was common at the OCC too, its record was the best (or least poor) of the agencies. The OTS, FDIC, and the Fed were lax in their enforcement in between 84.1% and 90.9% of their failures compared to just over sixty percent for the OCC. This category includes instances where the agencies were guilty of using weaker enforcement actions than called for, delaying issuing enforcement actions, or issuing no enforcement action when one

was called for. Lax enforcement allowed banks to continue risky practices longer than they should.

By a substantial margin, lax enforcement was the most frequently identified problem at each agency. However, the analysis shows that the reports present competing depictions of the agencies, which counter the image that it is simply being deferential to the industry. For example, in 63.6% of OTS failures, and 48.4% of OCC failures, the IG found instances where the agencies made decision-making errors or failed to process information appropriately, such as having too narrow of a scope for the bank examinations or failing to accurately identify a bank's problems. Additionally, in a few instances, 6.1% of failures for the OTS and 9.7% for the OCC, each was overwhelmed by the industry because its resources were stretched when industry innovations outpaced examiner expertise.

Whereas the former categories assign partial blame to the agencies for a bank's failure, the outmaneuvered category attempts to capture instances where banks were making an agency's job unusually difficult, and thus instances where agencies should not be entirely faulted for the bank's performance. This recalcitrance occurred in just under 70% of the OTS's failures and just over 60% of the OCC's.

My second hypothesis was that the OCC would be lax in its supervision and enforcement more often than the FDIC and Fed. Contrary to my hypotheses, the OCC had substantively (but not statistically significantly)⁷ fewer failures in which the OIG identified problems of lax enforcement than the FDIC and the Fed. Further, the OIG deemed the OCC's regulation

⁷ A chi-square test for differences in proportions indicates that there are statistically significant differences between the agencies for lax enforcement (chi-sq. value =11.5, $p < .005$). A post hoc test shows that there is no statistically significant difference between the proportions for the OTS, FDIC, and Fed, but that there is a statistically significant difference between the OTS and OCC but not the OCC, FDIC, and Fed.

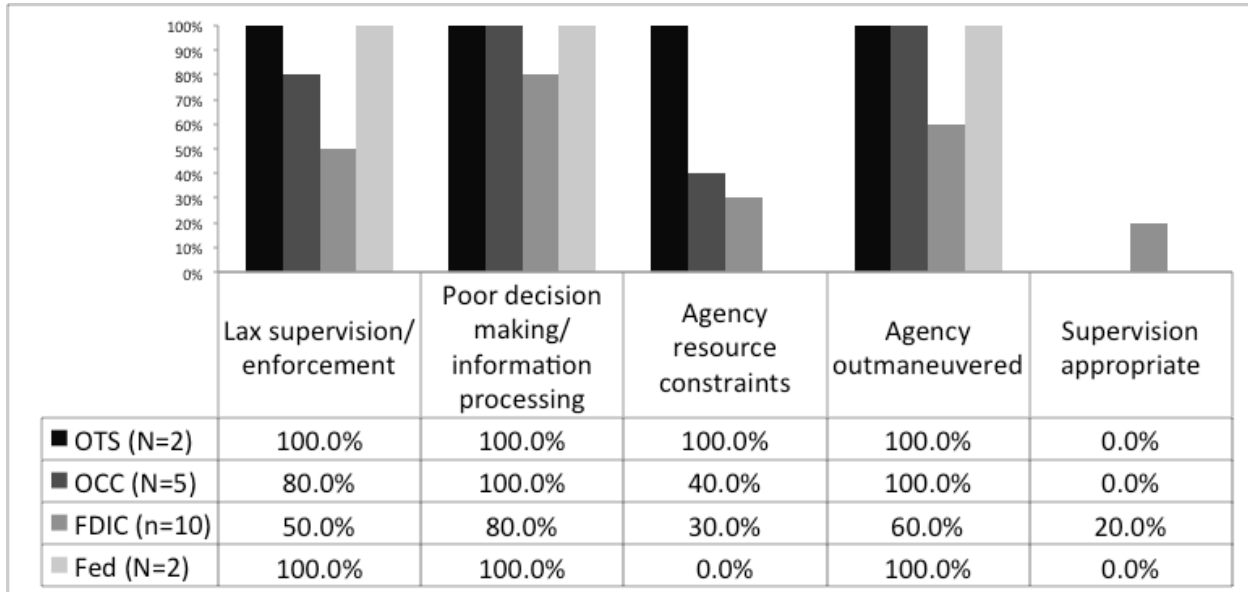
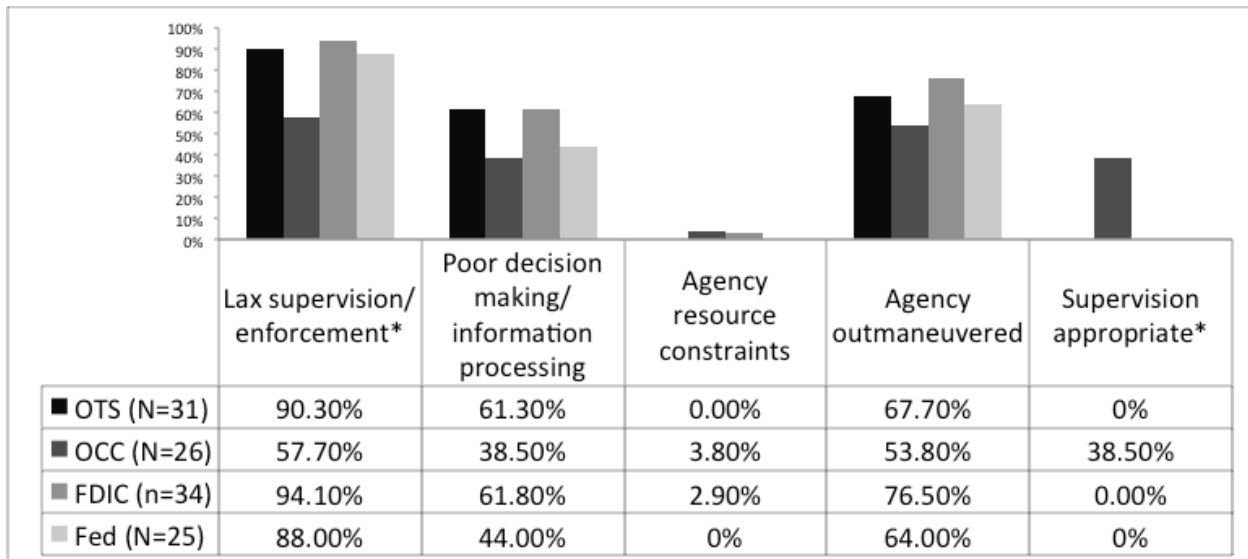
appropriate for substantively and statistically significantly more failures than the OTS, OCC, and the FDIC.⁸

My third hypothesis was that the OTS would be lax in its supervision and enforcement more often than the other three agencies. As expected, the OTS was substantively and statistically significantly more frequently lax than the OCC. Further, the OCC performed substantively and statistically significantly better for the appropriate supervision category. The Treasury OIG identified ten failures (32.3%) in which the OCC's supervision was deemed appropriate despite a bank's failure, but no such instances for the OTS. Unexpectedly, the OTS, FDIC, and the Fed all have a similarly high frequency of lax enforcement codes, between 84.1% and 90.9% of the failures, and are not statistically significantly different. Likewise, the three agencies had substantively and statistically similar frequencies for the appropriate supervision category.

Overall, these findings indicate that the OTS, FDIC, and Fed were similarly lax in their enforcement for failed banks, and that the OCC, surprisingly, stands out as the least lax.

To supplement this cross-sectional comparison, I compare the agencies longitudinally. I divide the time period into two sections, the "pre-crisis years" for years 1993-2006 and the "crisis years" for years 2007-2011. See Figures 5 and 6 below.

⁸ Fisher's Exact Test for differences in proportions indicates that there are statistically significant differences between the the proportions for the OCC and the OTS, FDIC, and Fed. There are no statistically significant differences among the OTS, FDIC, and Fed. Fisher's test was used because the expected cell count was not large enough to make a chi-square test appropriate.

Figure 5: OIG Identified Supervisory Problems, Pre-Crisis Years 1993-2006**Figure 6:** OIG Identified Supervisory Problems, Crisis Years 2007-2011

*Statistically significant difference among agencies (Chi-square, $p < 0.05$; Fisher's Exact Test, $p < 0.05$)

First, we can make comparisons among agencies within each time period. There were no statistically significant differences between any pair of agencies for any category during the pre-crisis period, likely due to the small sample size. Attributing any substantive differences among the agencies for this period should also be done with caution because of the small number of cases. The statistical and substantive results for the crisis time period are the same for the overall

combined results, with one change; the results show that the OCC had statistically significantly fewer failures with lax enforcement than both the FDIC and the Fed.

Second, we can also compare within each agency between the two time periods. In other words, were there significant increases or decreases for an agency in the frequency of a category between the two time periods? Statistically and substantively significant findings include the following:

- The OTS and FDIC decreased the proportion of failures with resource constraints between the pre-crisis and crisis years.
- The FDIC increased the proportion of failures with lax enforcement between the pre-crisis and crisis years.
- The FDIC decreased the proportion of failures where the OIG deemed its supervision appropriate between the pre-crisis and crisis years.
- The OCC decreased the proportion of failures with decision making problems between the pre-crisis and crisis years.

Except for the FDIC's increase in lax enforcement and decrease in appropriately supervised failed banks, the trends show improvement by the three agencies, while the Fed shows no change.

E. In Depth Category Description

In what follows, I describe each of the five categories in more depth and provide example to flesh out exactly what was occurring to indicate the above trends.

Lax Enforcement

What do the OIG reports on bank failures tell use about enforcement problems? First, the reports show that the regulators are guilty of using weaker supervisory actions than called for, at

least in the opinion of the OIG. This weakness includes supervisory actions of all types. At the lowest level, the IG's found cases where the agencies should have assigned lower CAMELS component or composite ratings to an institution, which could have eventually led to stronger informal or formal enforcement actions.

Additionally, agencies were even reluctant to bring informal enforcement actions against banks. Such cases provide an interesting challenge to the espoused preference of all four agencies of relying on informal over formal enforcement actions (General Accounting Office 1991). Part of their justification for using informal actions is that they can be enacted quickly, help maintain a cooperative relationship with the bank, and can effect change without getting the public unduly pessimistic about a bank's health. But if agencies are lax in using informal actions, then the justification for relying on informal action is weaker. The regulators' credibility declines when they do not use the supposedly preferred method in cases where it is justified.

Lastly, the reports identify cases where formal enforcement was warranted, but not used. In some instances we may be willing to accept weaker enforcement as long as the action produces results. But the OIG reports identify cases where weaker versions of enforcement are hard to defend: cases where banks are engaging in repeated violations of the law or repeatedly refusing to make corrections. When repeated problems occur, it is not clear the justification can stand because it should be clear to the agencies that their informal approach is not working. The case study of Washington Mutual discussed in Chapter 2 is a good example of the problems of lax enforcement (though perhaps the problems of laxity were more pronounced there than many other cases).

Poor Information Processing and Poor Decision Making

This category contains a variety of problems the OIG identified in their reports. Lax enforcement problems stemmed from instances when agencies did not take action based on known information. Information processing and decision making problems stemmed from what regulators failed to examine or consider and from information or problems they failed to uncover.

Problems of Scope

Most decision making problems result from the limited scope of bank examinations. This problem arises from decisions about what to include in an exam as well as how frequently to conduct an exam. There is considerably detailed guidance within the examination handbooks for each agency about how to conduct an exam, but there are few hard and fast rules. Consequently, like all aspects of safety and soundness supervision, examiners have considerable discretion over what is included in an exam, though agencies have standard operating procedures. Despite this standardization, the OIG reports identified many instances where the examinations should have been more comprehensive.

For example, though examiners have the authority to attend board meetings of regulated banks, they are not required to do so as part of the exam. In the case of Barnes Bank, supervised by the Federal Reserve, the OIG believes examiners should have attended a board of directors meeting, given the problems with the board and management the examiners had identified (Office of Inspector General 2010a). Doing so would have helped examiners better analyze and identify the problems the board had overseeing management that was engaging in high-risk behavior.

A second common problem of scope had to do with the frequency of exams. The frequency of examination was standardized across agencies in 1991 with the passage of the FDIC Improvement Act. Data showed that Federal Reserve banks outperformed those regulated by other agencies during the 1980s crisis in large part because the Fed examined its banks annually while the others did not. Though banks are now examined every 12-18 months, the regulators have the discretion over whether banks should be examined even more frequently. The OIG reports identified many cases where bank examinations should have been conducted more frequently or sooner than the annually scheduled examination due to risky bank practices.

For example, the Fed's Inspector General said Marco Community Bank should have been examined more frequently. Marco was a de novo bank (meaning it was in its first three years of operation), and problems were identified during its first two exams. These problems later became key ingredients to its downfall. The Fed put Marco on an annual examination cycle contrary to Fed guidance, which recommended de novo banks be placed on a 6-month examination cycle (Office of Inspector General 2010b).

Problem Identification

The next most common problems in this area were the failure to recognize a bank's problem or identifying a problem too late. These problems should be distinguished from cases where banks were intentionally misleading or engaging in fraudulent behavior, which belong in the outmaneuvered category discussed below. The present category includes only problems that could have been identified but were not.

A look at the details of the cases reveals idiosyncratic problems in each case. For example, in two cases, a narrow scope of investigation led to a failure to detect a problem. In the case of TierOne, the OTS did not conduct any site visits of the bank's loan production offices

(Treasury Office of Inspector General 2011e). A particular office originating poor quality loans was responsible for a majority of the bank's losses. In another case, the OTS did not recognize that Peoples First Community Bank was using its own funds to help keep borrowers' loans current, which eventually led to loan problems (Treasury Office of Inspector General 2011d).

In other cases, the lack of problem identification was more a matter of interpreting the information the examiners did have. For example, at Community Bank & Trust, the FDIC did not fully recognize the impact of underwriting and credit administration deficiencies on the overall health of the bank's loan portfolio. These deficiencies ultimately caused of the bank's failure. Lastly, in some cases, the agency remained unaware of a problem even though the bank was not actively attempting to hide it. For example at Temecula Bank, the FDIC did not identify a problem with a dominant board member who was exercising too much influence, despite the fact that this situation persisted for two years (FDIC Office of Inspector General 2010c).

Outmaneuvered

Whereas the former categories assign partial blame to the agencies for a bank's failure, the outmaneuvered category attempts to capture instances where banks were making an agency's job unusually difficult, perhaps impossible. Though agencies are attempting to regulate effectively, they are thwarted in various ways by the banks.

What type of behavior did banks engage in to be placed in this category? In a few instances, banks engaged in fraud that eventually led to their failure. For example, the OCC-regulated Keystone Bank claimed a half a billion in phantom assets on its balance sheet (Treasury Office of Inspector General 2000). Once this fraud was recognized, it led to Keystone's insolvency and failure.

In other instances, banks attempted to outmaneuver their regulators with misleading accounting and quarterly financial reporting. For example, one common tactic was for banks to apply their own interest reserves to loans in order to make the loans look current, even though borrowers were not current on their payments (Garcia 2010). This practice made the bank appear to have better earnings because it did not have to set aside as much capital (Garcia 2010). While the regulators appeared to often catch this practice in the course of their examination and require the banks to make corrections, the activity allowed banks to appear healthier in the short term. While, not as egregious as the instances of fraud, such practices require agencies to devote extra resources to accounting and auditing and make oversight more difficult. These practices show that agencies are dealing with sometimes misleading or deceptive entities.

The other major problem with banks is that they often refuse to comply with corrections agencies request and with various types of enforcement actions. The non-compliance sometimes continues despite the application of increasingly severe enforcement actions. However, in some cases, agencies fail to take increasingly severe actions when a bank is noncompliant. In such cases, more of the blame can be placed on the shoulders of the agency. In these instances, there is an interaction effect between uncooperative banks and weak agency enforcement.

For example, in the case of Keystone, the OCC had a recalcitrant bank management and board of directors that clearly ignored parts of a formal enforcement action (Treasury Office of Inspector General 2000). Yet, the OIG still finds instances when the OCC could and should have used even tougher enforcement actions, such as civil money penalties for individuals to make sure the bank complied. The OCC did not end up using all the tools in its bag to deal with this uncooperative bank.

Agency Resource Constraints

The problems identified in this category are twofold: not having enough examiners or not having examiners with the right expertise. Expert examiner shortages were partly caused by changes and innovation in the industry that outpaced agency expertise. As discussed with the example of Superior bank in Chapter 2, in such instances, agencies and their examiners were left playing catch up.

Examiner shortages also resulted from changes in examination practice and pressure by policy makers. Up until the early 1970s, all banks supervised by the OCC, FDIC, and the Fed were on a 12 month examination cycle regardless of their size or their financial health (FDIC 1997). Beginning in the mid 1970s, the OCC and the FDIC began placing more emphasis on offsite supervision (FDIC 1997). Quarterly bank financial reports submitted to the agencies now contained more information and the agencies developed more sophisticated computer models to aid analysis, requiring less onsite supervision. Both agencies also began shifting resources and attention to focus on problem banks that posed greater risk, those with the lowest CAMELS ratings. With fewer examinations and more sophisticated offsite analysis, there was no longer a need for as many examiners. The Fed did not follow suit, and maintained its yearly onsite examination cycle.

In addition, the Carter and Reagan administrations emphasized a reduction in the size of government. Reagan initiated a hiring freeze in 1981, which the OCC had to comply with as part of the Treasury Department (FDIC 1997). The FDIC voluntarily complied, even though it is an independent executive branch agency. The Fed did not. As a result, “from 1979 through 1984 both the FDIC and the OCC reduced their examiner resources: the FDIC’s field examination staff declined 19 percent, from 1,713 to 1,389, and the OCC’s declined 20 percent, from 2,151 to

1,722” (FDIC 1997, 426). This reduction happened at a time when assets under supervision *increased* at both agencies. The number of banks under supervision at the OCC increased as well. At the FDIC the number of banks decreased by 5 percent, but its examiners decreased much more (19 percent).

The OTS predecessor, the FHLBB, experienced similar examination and staffing trends. The number of examinations decreased sharply from 1980 to 1984; the number of examinations per billion dollars of assets regulated was cut in half (White 1991). The number of examiners decreased as well between 1980 and 1984 (Strunk and Case 1988). The number of examiners per thrift rose slightly, while the number of examiners per billion dollars of assets regulated fell by almost half.

The cuts took a toll on the agencies when the S&L and banking crisis unfolded in the late 1980s. For example, when the FDIC and OCC began hiring examiners again in the mid 1980s, they then had to deal with the problem of a shortfall of experienced examiners. “From 1986 to 1992, for example, approximately half of the supervisory staff at the FDIC consisted of assistant examiners with less than three years’ experience” (FDIC 1997, 427). Thus, when the banking industry was beginning to see a spike in bank failures, the experienced examiners were spending considerable time training new hires. Most of the examiner resource problems identified by the Inspectors General were in the early pre-crisis and are a legacy of these dynamics.

However, a few problems arose during the crisis period. For example, the FDIC had one case of resource constraints in the crisis period (2007-2011). The problem arose at Mirae bank, which failed in 2009. Based on its quarterly financial report to the FDIC, Mirae was flagged for more in depth offsite review and was a potential candidate for an accelerated examination (FDIC Office of Inspector General 2010b). The offsite review should have been conducted by the

regional office but was reassigned to a field office that not only conducted the review but signed off on it. “In one case, the same Supervisory Examiner who prepared the offsite review comments also approved them, having been delegated ARD [assistant regional director] responsibilities during that time. This represented a fundamental breakdown in the tenet of separation of duties and may have resulted in reduced supervisory attention to Mirae when there were strong indicators of the bank’s financial decline” (FDIC Office of Inspector General 2010b, 13). The delegation and lack of accelerated review appear to be due to resource constraints in the region, which was beginning to feel the effects of the financial crisis.

Regulation Appropriate

This category indicates cases where banks failed but the OIG concluded that the agency made appropriate supervisory decisions. This category highlights failures that present an alternative to the depiction of the agencies as captured. Sometimes banks can fail despite appropriate regulation.

The typical reason the OIG identified regulation as appropriate is that the agency did not make any of the mistakes discussed above, such as delayed or weak enforcement, or failure to identify problems. As discussed with the case of First National Bank of Georgia in Chapter 2, the OIG concluded that the bank failed despite the OCC’s actions because its aggressive growth strategy, asset concentrations, and poor credit risk management practices combined with a rapid decline in the real estate market with the onset of the 2008 financial crisis. Accordingly, there is little else that the agency could have been expected to do when this combination of events occur.

F. Discussion

What do the above results suggest about capture at the agencies? Results show that all four banking regulators were frequently deferent to banks that ultimately failed; at all four agencies, lax supervision and enforcement was the most frequently identified problem. This deference came at the expense of the public interest. Banks were allowed to take on excessive levels of risk that ultimately contributed to their failure and caused material losses to the deposit insurance fund.

The high frequency of lax enforcement at all four regulators provides evidence of targeted agency capture. Not only is the supervision and enforcement lax in the independent opinion of the Inspectors General, the agencies admitted to lax enforcement based on their own expertise. In their response included at the end of each OIG report, the agencies do not dispute the findings. For example, in the OTS's internal review of the failure of eBank, the OTS reached the same conclusions as the Treasury OIG. The internal OTS review found that "more timely and stronger enforcement action by OTS should have been taken to address repeat deficiencies" (Treasury Office of Inspector General 2011b, 11). The OTS could have argued that particularities of the case warranted less stringent enforcement, or that only with the view of hindsight can one argue that stronger enforcement was warranted. However, it instead agreed.

Yet, it is possible that the scope of capture within the industry is narrow. Even at the height of the recent financial crisis, the number of total failures was only approximately 1-2 percent of the regulated population for each agency (see Chapter 6 for more detail). The reports analyzed are a fraction of that percent. Cases like the OCC's regulation of money laundering at HBUS suggest that capture is a problem for non-failed banks as well, but information on banks

that have not failed is restricted. Thus, it is not possible to determine how pervasive capture is—only that it exists.

So do the reports suggest anything about the scope within the agency and the broader policy system? First, they provide information about the locus of capture in failed banks. Though the reports do not always specify, generally, the capturing occurs at the examiner and/or management level. In rare instances it occurs at the top of the agency hierarchy, as with the case of Washington Mutual.

Thus, the lax enforcement identified by the OIG is primarily indicative of targeted agency capture. However, it is difficult to disentangle how much can be attributed to the agency itself and how much can be attributed to regulatory structure, and thus be classified instead as regulatory capture. The OCC performed better than the other three agencies, or at least the OIG judged that adequately supervised 32.3% of its failed banks (see table 1 above). It did so despite being susceptible to capture, suggesting that targeted agency capture is occurring.

Though lax enforcement was expected, the frequency at some of the agencies was unexpected. The OTS, FDIC, and Fed did not differ substantively or statistically significantly in the frequency of lax enforcement. To the extent that the lax enforcement provides evidence that the OTS was captured, it provides evidence that the FDIC and the Fed were captured as well, and to a lesser extent the OCC. This finding is intriguing in that many observers singled out the Office of Thrift Supervision as the worst of the four regulators. Congress shared a similar opinion and closed the OTS with the passage of the Dodd-Frank Act in 2010. This finding suggests that the OTS was somewhat unfairly targeted as being at the bottom of the regulatory barrel. Though the OTS received lots of attention for high profile failures, the other agencies had failures where similar problems arose.

Although the most frequently cited problem the Inspectors General uncover at all four agencies is lax enforcement, the results present other problems that may signal systemic regulatory failure too. Other categories counter the image of agencies simply doing the bidding of the banking industry. The reports depict the agencies muddling through the technically complex task of regulating banks and making mistakes about the proper scope of their bank examinations or failing to accurately identify banks' problems. In some instances, lax enforcement and decision-making problems are not the fault of bank examiners but can be attributed instead to the well-known problems of being outgunned by the powerful regulated industry or a lack of agency resources. Lastly, these reports show instances where banks failed despite appropriate regulation by the agencies. Ultimately, though the reports provide evidence of targeted agency capture, they also provide a portrait of conflicted agencies trying to carry out the often messy, difficult, complex task of pursuing a notion of the public interest.

Moreover, commonalities in regulatory problems across agencies suggest that even if the OTS was rightly closed, some of the regulatory problems that led to its closure were not eliminated with it. The remaining regulators must still wrestle with the problems identified above in my content analysis, including problems of scope, lax enforcement, and problem identification. The similarities across agencies suggest there are some problems that cannot be addressed by changes in structure, leadership, and funding incentives. A common task environment can produce similar results despite structural and management differences across agencies.

G. Conclusion

The analysis in this chapter provides strong evidence for targeted agency capture at the OTS, FDIC, the Fed, and to a lesser extent, the OCC. To what extent is this finding a result of

dynamics in the larger political system? Do the agencies work in a subsystem cut off from macro controls from the broader policy system that have the potential to push their regulation toward the public interest? To what extent are political controls like the appointment of agency leadership by the President affecting these agencies? What will that information tell us about capture? I turn to these questions in Chapter 4.

CHAPTER 4: IRON TRIANGLES AND AGENCY ENFORCEMENT ACTIONS

A. Introduction

Chapter 3 examined failed bank reports to uncover evidence of capture. I focused on the interaction between agencies and their targets of regulation. I now broaden my focus to see how macro political actors can influence the agencies via appointing agency leaders. Are policy makers able to influence the agencies with new appointments? If so, perhaps agency behavior is better explained by the preferences of elected officials than those of the industry.

In this chapter, I study enforcement trends at the OCC and the OTS. These agencies provide the best test cases of capture given the theoretical assumptions discussed in Chapter 2. They are also places where appointments, to the extent they matter, have the greatest potential to influence agency behavior because each is led by a single director. The FDIC and Fed are led by multi-member boards, making political control via appointment more difficult, particularly in the case of the Fed where term expirations are staggered. Thus, I will use the OTS and the OCC as test cases for the efficacy of political control. If appointing agency leadership does not affect the work of these two agencies, it is unlikely to matter at the FDIC and Fed.

B. Hypotheses

One common form of capture theory states that capture occurs via iron triangles formed by bureaucracy, industry, and congressional committees that control policy making for a given area. The mutually beneficial rewards these actors exchange, including campaign donations, budgetary resources, information, and favorable regulation, make the triangle impervious to political control by Congress as a whole, the president, and the general public (Gormley and Balla 2007). Historical studies of policy making in banking have found that policy is typically made here in an elite subsystem that excludes the broader public (Worsham 1997).

Examining trends in agency enforcement actions for evidence of political control provides a way to test for existence of capture via an iron triangle (Wood and Waterman 1994). If enforcement trends shift in predictable ways, such as with new presidential appointments for agency leadership, especially those that reflect a change in political party, the agency is less likely to be captured. For example, any downward shift in enforcement output might instead be attributed to “electorally sanctioned pro-business regulation” rather than capture by the industry (Carpenter 2013). If however, enforcement output remains steady despite environmental changes one would expect to disrupt the output, something else may determine agency enforcement actions, potentially the targets of regulation themselves. Although evidence against external political control does not provide definitive proof that the agency is captured, it does suggest we should consider this possibility carefully.

Previous research by Wood and Waterman (1994) found evidence that the enforcement output reflected political control for a variety of regulatory agencies. Their research shows that appointments are one of the most important instruments of political control. Though patronage and expertise are factors in selecting agency leadership, a key influence on the choice for leadership is whether the leader reflects the president’s agenda and ideological interests (Wood and Waterman 1991). Thus, we would expect new appointments, particularly appointments from a president of a different political party, to alter an agency’s behavior. The OTS and OCC are Treasury Department bureaus and headed by a single director. Given the power invested in the director, one would expect the director to influence the direction of the agency.

Thus, I examine the way new appointments to the OTS and OCC affect enforcement output. I hypothesize that there will *not* be significant changes in the number of enforcement

actions when a new director is appointed, regardless of political party affiliation of the appointee or president appointing the director.

Previous research suggests that we should also expect salient events, particularly crises, to affect agency behavior, but the effect is conditional on the party of the president in office (Gordon and Hafer 2013). If an agency is strongly captured by the regulated industry, we would expect its enforcement to remain relatively unchanged in the face of a crisis where the public and other political actors will likely be calling for harsher treatment of the industry. I hypothesize that after the 2008 financial crisis the OTS and OCC will not increase their use of enforcement actions significantly in response to public outcry from the crisis.

C. Data

I examine trends in the agencies' formal enforcement actions since 1989, which is as far back as the agencies provide data. The data are available on each agency's website. I analyzed all the publicly available data on enforcement that specifies the date when the actions were taken.

Formal enforcement actions involve written notice to the bank or employees involved and the opportunity for a formal hearing before an administrative judge if the bank or individual is contesting the action (Congressional Research Service 2006). The banking regulators use cease and desist orders or written agreements that list corrective actions the bank must take. The agencies also have the power to remove bank employees from their position and prohibit them from further participation in the banking industry. The agencies can also level civil money penalties of up to \$1,000,000 per day depending on the severity of the violation and whether it is part of a pattern of misconduct (GAO 2001).

Additionally, the 1991 FDIC Improvement Act created new capital based restrictions on bank behavior and also gave regulators some new enforcement tools. The major provision

dealing with these tools is the Prompt Corrective Action provision of the law (PCA). It requires regulators to automatically place restrictions on banks when capital levels fell below certain thresholds and the bank does not or cannot increase capital. Ultimately, if capital falls low enough, an institution will be shut down before it becomes technically insolvent, in hopes to avert large losses to the Deposit Insurance Fund.

D. Data Analysis Methods

To analyze trends in formal enforcement actions I first test whether there are significant differences in the mean monthly enforcement actions among directors. I then use a multiple interrupted time series design (Cook and Campbell 1979; Lewis-Beck and Alford 1980; Mohr 1995). I use an OLS regression model that accounts for changes in intercept and slope between the time periods before and after an intervention. The dependent variable is the monthly number of enforcement actions. The first independent variable is a month counter beginning at 1 for the first observation and increasing by one for each subsequent observation. For each intervention (in this case a new OTS or OCC director) I include an intervention dummy variable that is 0 for observations before the intervention and 1 for observations after, and a slope counter that is likewise 0 before the intervention and counts upwards from 1 for each observation after. This model can be represented by the following equation:

$$\hat{y}_t = b_0 + b_1x_{1t} + b_2x_{2t} + b_3x_{3t} + b_4x_{4t} + b_5x_{5t} \dots + e_t$$

where y_t is the number of enforcement actions per month; x_{1t} is year counter ranging from 1 to n (the total number of observations); x_{2t} is a dummy variable that is 0 before the first intervention and 1 after; x_{3t} is slope counter that is 0 before the first intervention and 1, 2, 3...for months thereafter; x_{4t} is a dummy variable that is 0 before the *second* intervention and 1 after; x_{5t} is slope counter that is 0 before the second intervention and 1, 2, 3...for months thereafter...and so

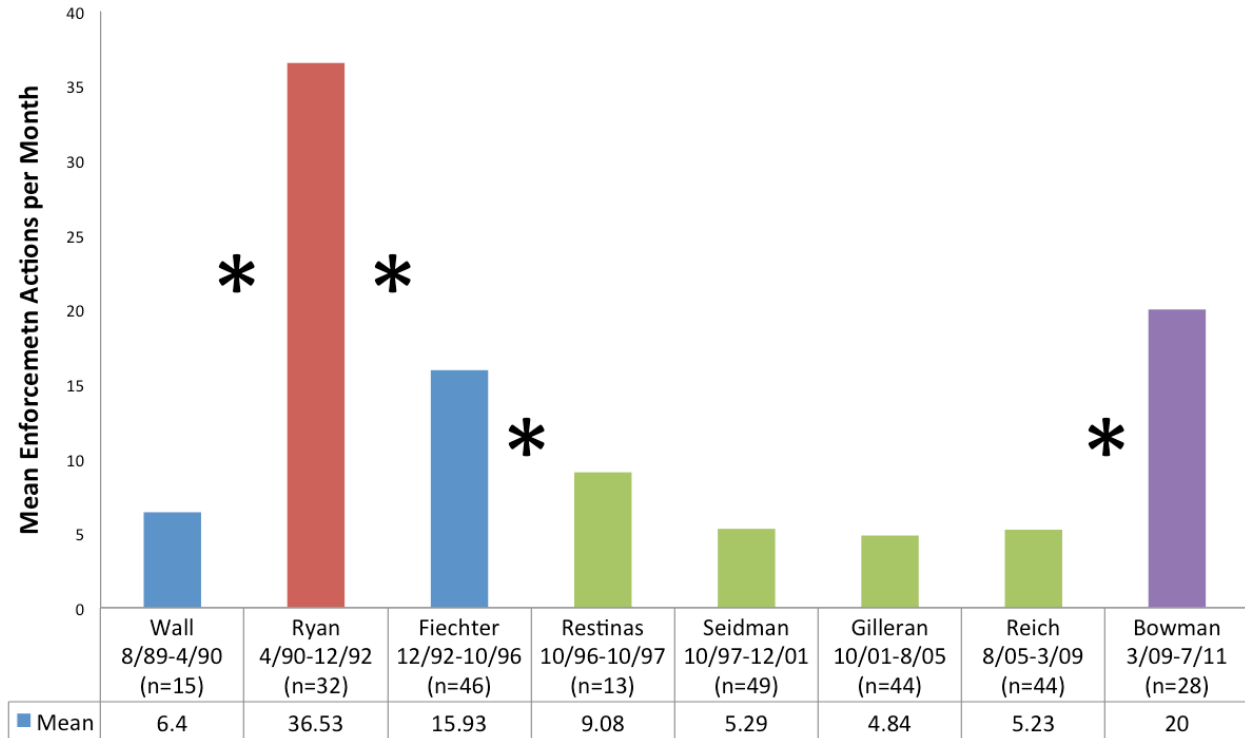
on for each additional intervention added to the equation; $b_0, b_1, b_2, b_3 \dots$ are parameters that will be estimated and e_t is the error (Lewis-Beck and Alford 1980). The even numbered parameters represent the short-term effects on the level/intercept of the trend while the odd numbered parameters capture the long-term effects on the slope of the trend (Lewis-Beck and Alford 1980).

E. Results

Mean Enforcement Actions by Director

As discussed in Chapter 1, the OTS is a bureau within the Department of Treasury. A single director heads the agency. The Director serves a five-year term and is appointed by the president, with Senate approval. The appointment is for only one term. Between the OTS's creation in August 1989 and its closure in July 2011, the OTS had eight directors that served longer than three months.⁹ Figure 7 below shows the mean monthly enforcement actions for each OTS director.

⁹ Salvatore Martoche served as interim director in 1990 for less than a month between M. Danny Wall and Timothy Ryan Jr. Richard Riccobono served as interim director for three months in 2005 between James Gilleran and John Reich. Scott Polokoff served as interim director for one month in 2009 between John Reich and John Bowman. Enforcement actions under these directors are combined with those of the preceding director because it is expected that enforcement output under an interim director would not change substantially because the interim director worked under their predecessor and would likely share a similar enforcement philosophy.

Figure 7: OTS Director Mean Monthly Enforcement Actions, 1989-2011

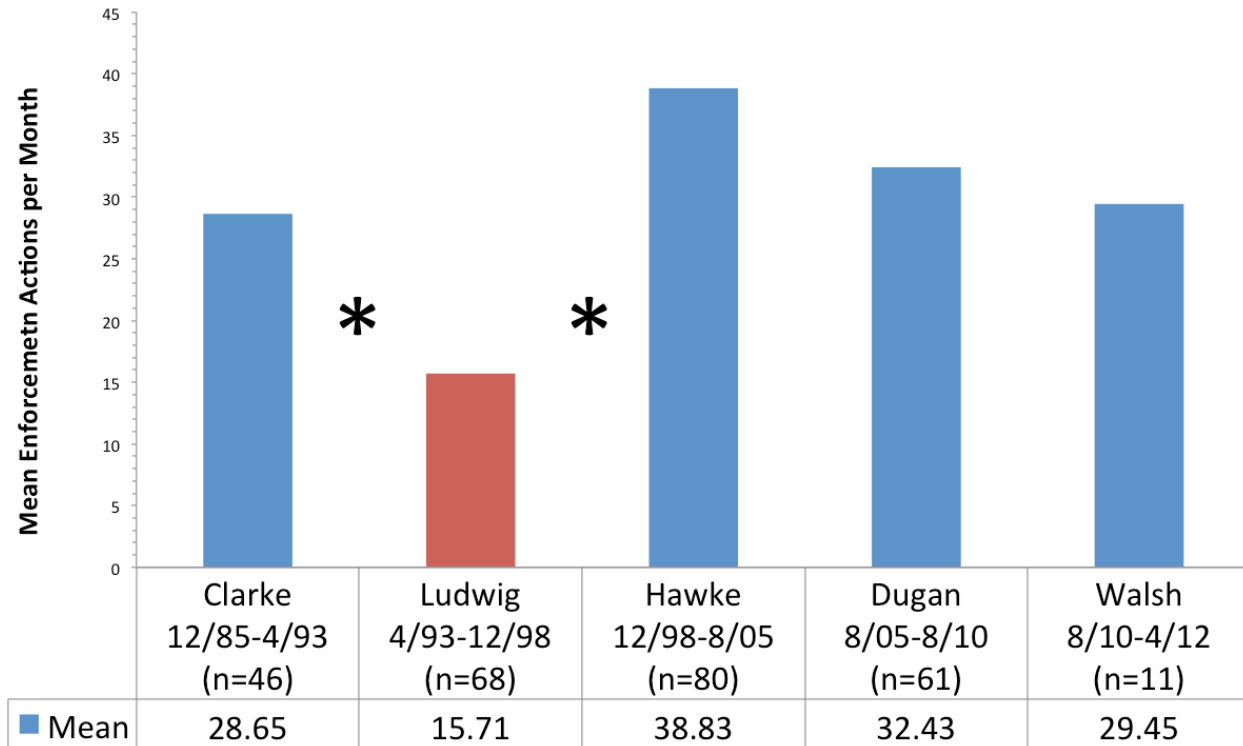
*Ryan has a statistically significantly different mean than all others (ANOVA, with Games-Howell post hoc, $p < 0.05$); Bowman has a statistically significantly different mean than all others, except Fiechter (ANOVA, with Games-Howell post hoc, $p < 0.05$)

The stars represent statistically significant changes in means between directors. The results show statistically significant increases in enforcement output associated with the appointments of Ryan and Bowman, and statistically significant decreases associated with the appointments of Fiechter and Restinas. These changes are likely an artifact of the OTS' industry cleanup after the savings and loan crisis and the 2008 financial crisis, rather than caused by changes in the director.

As discussed in Chapter 1, the OCC is a bureau within the Department of Treasury. A single director called the Comptroller heads the agency. The Comptroller serves a five-year term and is appointed by the president, with Senate approval. The appointment is for only one term. Between 1989 and 2011, the OCC had four directors that served full terms, and one director who

served as acting director beginning in August 2010.¹⁰ Figure 8 below shows the mean monthly enforcement actions for each OCC director.

Figure 8: OCC Director Mean Monthly Enforcement Actions, 1989-2011



*Ludwig statistically significantly different mean than all others (ANOVA, with Games-Howell post hoc, $p < 0.05$). The results show a statistically significant decreases in enforcement output associated with the appointment of Ludwig, and a statistically significant increase associated with the appointment of Hawke. As with the OTS, the decrease in enforcement under Ludwig is likely an artifact of the waning effect of the banking and savings and loan crises that plagued the industry in the late 1980s and early 1990s. However, the increase under Hawke is not associated with a crisis.

¹⁰ Julie Williams, the OCC's chief legal council, served as interim director in 1998 for 8 months in between Eugene A. Ludwig and John D. Hawke. Williams again served as acting Comptroller, stepping up from her role as Deputy Comptroller, to serve between Hawke and John C. Dugan in 2004-2005 for 10 months. Enforcement actions under these directors are combined with those of the preceding director because it is expected that enforcement output under an interim director would not change substantially in the short time period.

Interestingly, the results do not indicate an increase under Dugan, who was the director during the financial crisis, nor a drop off under Walsh after the economy stabilized and the crisis waned.

OTS Time Series Model

Figure 9 below shows a scatterplot of OTS enforcement between 1989 and 2011, broken down with different symbols representing enforcement under each director.

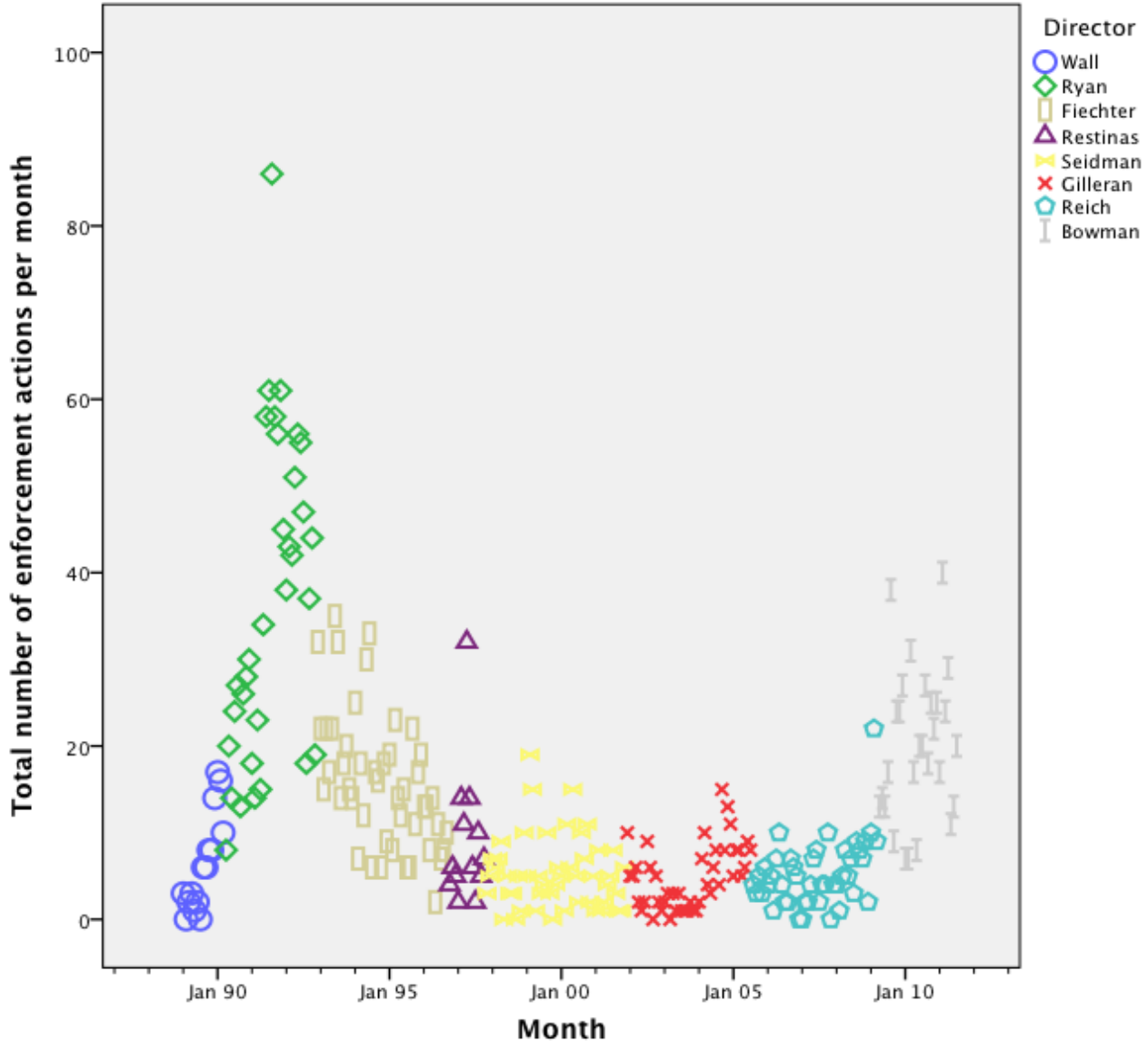
Figure 9: OTS Monthly Enforcement Actions, 1989-2011

Table 15 below shows the OLS regression output from the OTS multiple interrupted time series analysis.¹¹

¹¹ The Durbin-Watson statistic for the regression equation indicated the presence of positive first order auto-correlation, which can bias OLS parameter estimations (D-W=1.361). To fix this problem, I created a lagged variable of my dependent variable and included the lagged variable as an independent variable in my model. This change reduced the autocorrelation problem (D-W=2.137). The Durbin-Watson value is in the inconclusive region, just above the value for concluding there is no autocorrelation (2.07), but not high enough to reject the null hypothesis

Table 15: Regression Output for OTS Multiple Interrupted Time Series Model

Variables	B	Std. Error	t
Constant	-2.182	4.503	-.485
Month Counter	.771	.484	1.594
Ryan-Intervention	5.331	4.493	1.187
Ryan-Slope	-.261	.497	-.526
Feichter-Intervention	-16.094***	3.812	-4.222
Feichter-Slope	-.720***	.185	-3.893
Restinas-Intervention	.050	4.729	.011
Restinas-Slope	.262	.541	.483
Seidman-Intervention	-2.316	4.326	-.535
Seidman-Slope	-.063	.539	-.117
Gilleran-Intervention	-1.790	3.004	-.596
Gilleran-Slope	.093	.113	.825
Reich-Intervention	-3.341	3.085	-1.083
Reich-Slope	.001	.121	.005
Bowman-Intervention	6.314*	3.557	1.775
Bowman-Slope	.013	.189	.069
Lagged DV	.370***	.061	6.084
R-squared	.725		
Adjusted R-squared	.707		
No. Observations	270		

* p < 0.10; ** p < 0.05; *** p < 0.001

A visual inspection of the scatterplot above indicates that that the OTS clearly increased its enforcement output substantially after the savings and loan crisis of the 1980s and following the onset of the 2007-2008 financial crisis, particularly beginning in 2009 after the high profile

that there is no autocorrelation. Given the high degree of autocorrelation built into the model, and the inability of other methods to fix the problem, this level was deemed acceptable. The results of the second regression with the lagged variable are thus reported in Table 1.

collapse of Lehman Brothers and Bear Sterns and the bailout at the end of 2008. The regression output show that there was a statistically significant decrease in the level and slope of enforcement under the director Jonathan L. Feichter. By April 1994 the OTS publicly announced that it was shifting its enforcement efforts to active thrifts (Meredith 1994). It left any remaining enforcement for failed thrifts to the Resolution Trust Corporation, which had been set up by Congress to resolve the assets of failed thrifts (Meredith 1994). The only other statistically significant change in enforcement output was an increase in the level of enforcement under John Bowan, who became director in March 2009.

Overall, the results show that directors only occasionally made a significant impact on OTS enforcement output. Even for the directors where there is evidence of a significant change, the change is more likely a result of the crisis than the director. Interestingly, for the directors during the non-crisis years, between 1996 and 2007, there are no statistically significant differences despite the fact that Democratic president Bill Clinton appointed Restinas and Seidman and Republican president George W. Bush appointed Gilleran and Reich.

OCC Responsiveness to New Appointments

Figure 10 below shows a scatterplot of OCC enforcement between 1989 and 2011, broken down with different symbols representing enforcement under each director.

Figure 10: OCC Monthly Enforcement Actions, 1989-2011

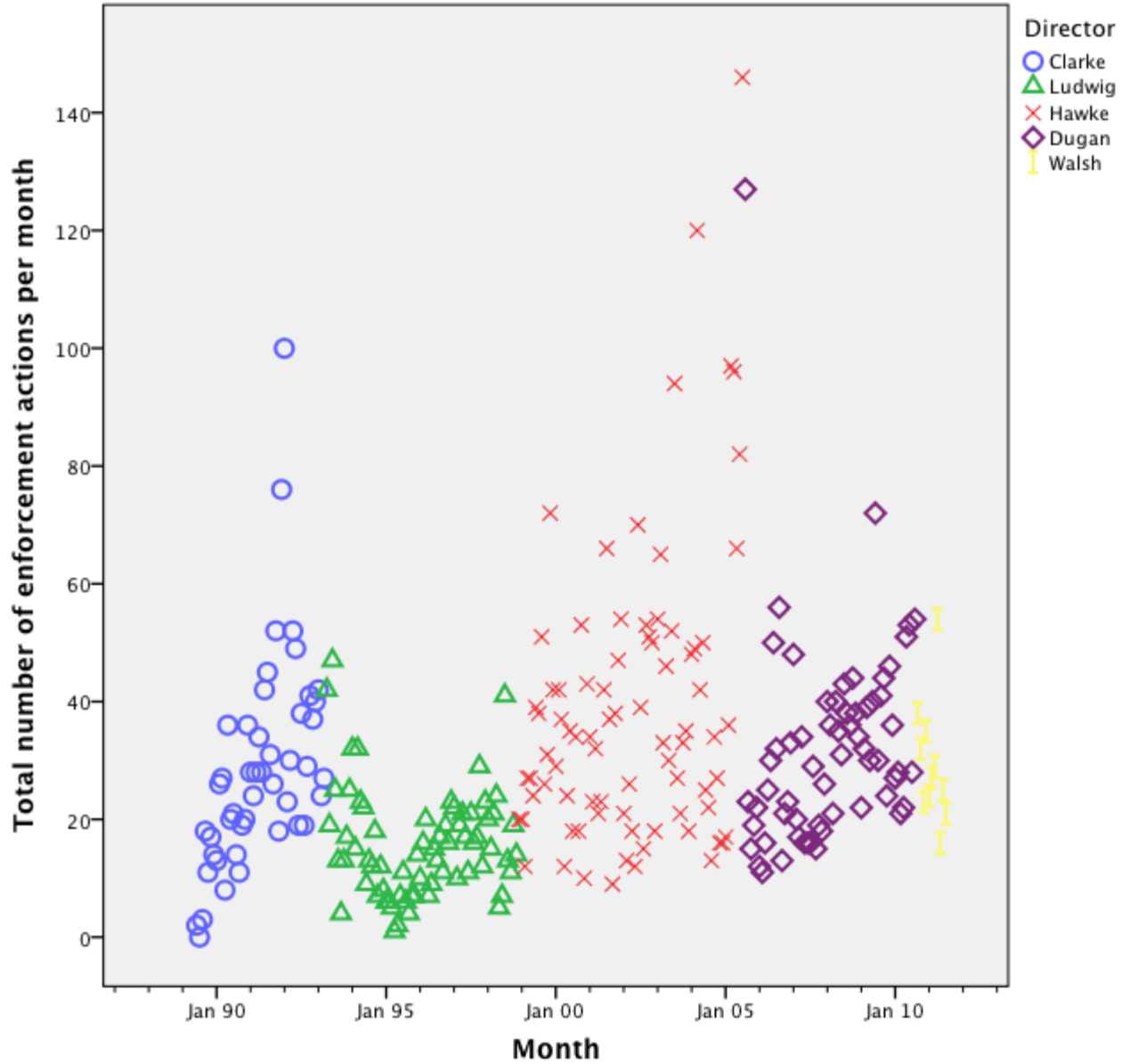


Table 16 below shows the OLS regression output from the multiple interrupted time series model.¹²

Table 16: Regression Output for OCC Multiple Interrupted Time Series Model

Variables	B	Std. Error	t
Constant	9.251*	5.229	1.769
Month Counter	.428**	.196	2.187
Ludwig-Intervention	-18.158**	6.551	-2.772
Ludwig-Slope	-.441**	.221	-1.992
Hawke-Intervention	5.388	5.500	.980
Hawke-Slope	.284**	.132	2.155
Dugan-Intervention	-21.554***	5.707	-3.777
Dugan-Slope	-.091	.146	-.621
Walsh-Intervention	-5.911	11.533	-.513
Walsh-Slope	-.504	1.589	-.318
Lagged DV	.339	.057	5.906
R-squared	.364		
Adjusted R-squared	.339		
No. Observations	265		

* p < 0.10; ** p < 0.05; *** p < 0.001

A visual inspection of the scatterplot above indicates that that the OCC increased its enforcement output substantially after the banking of the 1980s and early 1990s. The regression output shows that there was a statistically significant decrease in the level and slope of enforcement under comptroller Ludwig, who decreased enforcement as the crisis waned. Additionally, these results show a statistically significant increase in the slope associated with

¹² The Durbin-Watson statistic for the regression equation indicated the presence of positive first order auto-correlation (D-W=1.372), which can bias OLS parameter estimations. To fix this problem, I created a lagged variable of my dependent variable and included the lagged variable as an independent variable in my model. This change corrected the autocorrelation (D-W=2.038). The results of the second regression are thus reported above.

the appointment of comptroller Hawke and a statistically significant drop in the level of enforcement with the appointment of comptroller Dugan. In contrast to the OTS, neither a visual inspection nor the time series model indicate a jump in enforcement associated with the 2008 financial crisis.

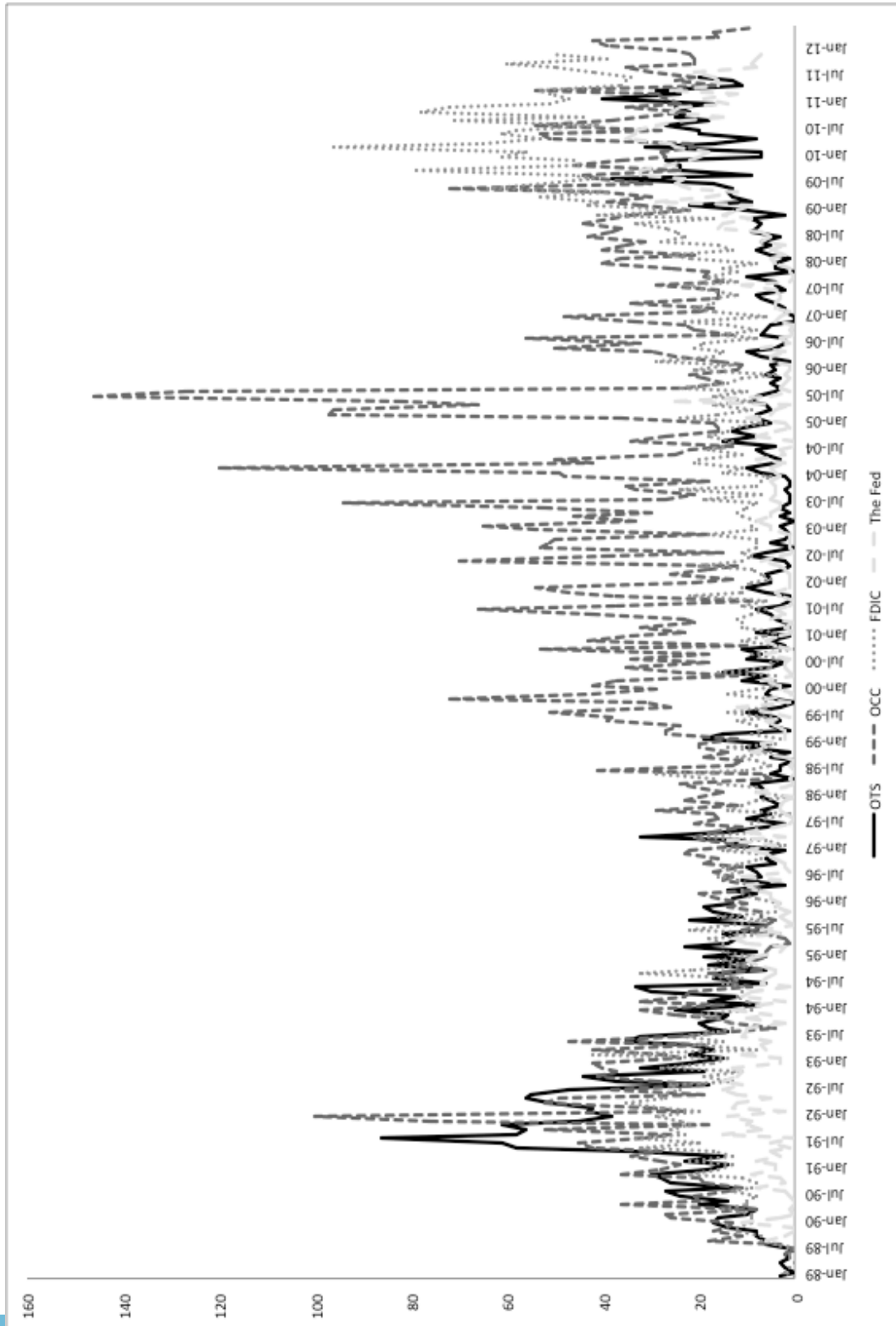
F. Discussion

The results above provide some evidence that the appointment of a new director matters. Analysis of enforcement trends shows that some director appointments affect enforcement output. At the OTS, there were substantial changes in enforcement under directors Feichter and Bowman and similar changes under Comptrollers Ludwig, Hawke, and Dugan at the OCC. This finding provides some support for previous research that suggests regulatory agencies are responsive to new appointments (Wood and Waterman 1994).

However, some of the change attributed to appointees is likely an artifact of financial crises. After the onset of the Savings and Loan crisis, enforcement increased substantially at the OTS and OCC and decreased back to regular levels thereafter. The statistically significant decreases in enforcement for Feichter at the OTS and Ludwig at the OCC are likely a result of the crisis. Likewise, the increase in enforcement under Bowman at the OTS is likely an artifact of the 2008 financial crisis. But, the substantial increase in enforcement under Hawke at the OCC, and the decrease under his successor, are not associated with any important economic events. In these cases, the appointment of new leadership is a more likely explanation.

The likely effect of crises on enforcement output is supported by looking at the effect these crises had on enforcement at the FDIC and the Fed. The figure below shows the enforcement trends for all four agencies.

Figure 11: OTS, OCC, FDIC, Fed Enforcement Actions/Month, 1989-2011



A multiple interrupted time series model reveals that there were statistically significant changes in enforcement at both the FDIC and Fed associated with the S&L and 2008 crises, as seen in the regression output tables below.

Table 17: Regression Output for FDIC Multiple Interrupted Time Series Model

Variables	B	Std. Error	t
Constant	1.029***	2.528	.407
Month Counter	.389***	.095	4.092
Intervention_S&L Crisis	-11.916***	2.856	-4.172
Slope_S&L Crisis	-.387***	.096	-4.037
Intervention_2008 Crisis	3.035	2.523	1.203
Slope_2008 Crisis	.536***	.081	6.624
Lagged DV	.319***	.058	5.538
R-squared	.735		
Adjusted R-squared	.729		
No. Observations	275		

* p < 0.10; ** p < 0.05; *** p < 0.001

Table 18: Regression Output for the Fed Multiple Interrupted Time Series Model

Variables	B	Std. Error	t
Constant	-.434	1.536	-.283
Month Counter	.192**	.067	2.875
Intervention_S&L Crisis	-4.146**	1.622	-2.556
Slope_S&L Crisis	-.202**	.067	-2.998
Intervention_2008 Crisis	1.703	1.384	1.231
Slope_2008 Crisis	.180***	.042	4.323
Lagged DV	.448***	.057	7.889
R-squared	.624		
Adjusted R-squared	.615		
No. Observations	267		

* p < 0.10; ** p < 0.05; *** p < 0.001

These results provide support for the possibility that crises rather than appointments are a better explanation for some of the observed variation in enforcement output.

What do these findings suggest about capture at the agencies? Evidence that some political appointments do not affect enforcement output is not direct evidence that either agency is captured. Weak political control creates the *potential* for the industry to exercise influence over the agencies outside of influence from macro political actors. Previous study of the banking regulators suggests that banking policy is typically made in a subsystem (Worsham 1997). However, the lack of an appointment effect could also mean that the agency has a strong, entrenched organizational culture that is dedicated to the agency's mission such that new directors are unlikely to effect dramatic change. And, as observed at the OCC, new appointments can affect subsystem policy by altering enforcement output.

Further, does the fact that all agencies had spikes only after the crises indicate they are being responsive to their environment? Or does it suggest they were too lax before the crises and are cleaning up a mess they should have prevented from happening in the first place? The evidence from the material loss review reports analyzed in Chapter 3 indicates that the agencies are often lax and delayed in issuing enforcement actions before a crisis. If the patterns found in the reports are indicative of larger trends in which the agencies get tough only after crises, it suggests *short term* capture before economic crises unfold. But one would not expect *strongly* captured agencies to increase enforcement so significantly after a crisis.

G. Conclusion

The results in this chapter provide some evidence that appointments can substantially alter agency enforcement output, particularly at the OCC. This finding suggests that the agency is not making policy in an iron triangle cut off from influence by the larger political system. On the other hand, the fact that several of the appointees, particularly at the OTS, did not significantly alter agency enforcement does not mean that enforcement is necessarily controlled by the industry. The agencies are structured independently via their funding from industry fees, so we might expect some degree of independence from political control. Alternatively, the agencies could instead be strongly and consistently committed to their mission, and thus unaffected by changes in leadership.

Economic crises are a strong rival explanation for some of the variation in enforcement observed under different directors. Following crises, all four agencies significantly increase their enforcement output. Delaying strong enforcement until after crisis may be indicative of capture. Yet, the last two chapters raise a deeper question: why were agencies not more aggressive before

crises? Chapter 5 explores the difficulty of taking strong actions, especially for financially successful banks before a crisis hits. Doing so suggests why and how agencies can be captured.

CHAPTER 5: RETHINKING THE SOURCE OF AGENCY POWER—THE COSTS AND BENEFITS OF AGENCY DISCRETION

A. Introduction

Scholars of the bureaucracy have long held that discretion is a key source of agency power. It is now widely accepted that the dichotomy between politics and administration is blurred and that the bureaucracy has a key role in both the execution of public policy and inevitably the making of public policy through the implementation process (Friedrich 1940). Yet, scholars remain divided about the efficacy and desirability of bureaucratic discretionary power. Proponents of discretion maintain that discretion is necessary for the effective implementation of policy and that it can make policy responsive to the variety of situations and clients the bureaucracy serves (see Friedrich 1940, among many others). Critics worry that bureaucratic discretion is difficult to square with traditional notions of democratic legitimacy and that unelected public servants can abuse their power and subvert the public interest in favor of private interests (see Finer 1941, among many others). Yet, in both cases, discretion is seen as a source of agency power, for better or worse.

The purpose of this chapter is to refine current understanding of the link between discretion and power by examining circumstances under which discretion can be a source of agency weakness. I argue that the banking regulators' discretion-based culture creates a complexity trap that contributes to capture. On one hand, the nature of the task makes regulating difficult using standard, across-the-board rules. On the other, the absence of such rules makes it difficult to take strong enforcement action against banks because examiners claim to need the hard and fast rules to justify taking action. The lack of standard rules undercuts the foundation the examiners need to take strong action. This finding is somewhat counterintuitive. It should

help scholars refine their understanding of the connection between agency discretion and power, inform debates about the desirability of bureaucratic discretion, and help us better understand the connection between discretion and capture.

B. Literature on Bureaucratic Discretion

Scholars of the bureaucracy agree that modern bureaucratic agencies are powerful actors, in the sense that they are policy making institutions with the ability to influence the authoritative allocation of values in society (Easton 1965) or, put differently, have influence over who gets what, when, how (Lasswell 1936). According to Meier and Bohte (2007), the bureaucracy has become a powerful policy making institution because: 1) Congress often delegates decision making to the bureaucracy, 2) the fragmented power structure of American government creates policy subsystems with opportunities for bureaucratic agencies to be major players, 3) the complex tasks that government undertakes require hierarchy and expertise, which bureaucracies often develop over time, and 4) implementing public policies, the bureaucracy's primary function, necessarily entails discretion. The first and fourth reasons in particular highlight the connection between discretion and power.

Yet, not all agencies have the same amount of power. Why do specific agencies have more power than others? In large part because agencies vary along the two key dimensions of agency power: the ability to extract resources from their environment and discretion/autonomy (Meier 1980; Meier and Bohte 2007). We can define autonomy as "the discretion to make decisions concerning agency activities" (Meier and Bohte 2007, 14). To the extent an agency has discretion, we expect the agency to be more powerful.

At the lowest levels of the bureaucracy, street level bureaucrats also gain power through discretion in their role as front line policy makers. For example, Lipsky (2010) argues that most

average citizens' interaction with government is not with elected representatives, but with public servants like teachers and police officers. "Each encounter of this kind represents an instance of policy delivery" (Lipsky 2010, 3). For Lipsky, these street level bureaucrats are central in policy delivery in many areas. Though the exercise of discretion at the point of service delivery, they become policy makers. Though Lipsky goes on to cite numerous pressures these street level bureaucrats face, such as inadequate resources or whether to implement policies uniformly or tailored to particular situations and individuals, he does not cite discretion itself as a source of weakness but rather as a source of strength that makes these street level bureaucrats central to policy making in the American governmental system.

Normative debates in public administration also reflect the belief that discretion leads to power. For example, in the famous debate between Carl Friedrich (1940) and Herman Finer (1941), they diverge sharply in their opinion over the appropriate type of accountability for the bureaucracy and the appropriate level of discretion it should have. However, they both agree that discretion empowers the bureaucracy. Friedrich believes that policy formation and implementation are inseparable: "politics and administration play a continuous role in both [policy] formation and execution, though there is probably more politics in the formation of policy, more administration in the execution of it" (Friedrich 1940, 6). This connection is also desirable. To effectively make and implement policy, the bureaucracy needs the discretion to meet the conflicting and rapidly changing demands of its environment. Why would Friedrich argue that discretion is necessary to help bureaucracy meet task demands if he does not think discretion gives the bureaucracy the power to do so? Thus he implicitly connects discretion and power. To counter critics who are worried about abuses of discretion-based power, Friedrich advocates for internal accountability via professionalism and expertise.

Though Finer agrees with the connection between implementation and policy making power, he disagrees with Friedrich's form of accountability. Instead, Finer argues for external democratic control over the bureaucracy by other branches of government. External control is necessary because, "the political and administrative history of all ages, the benevolent as well as the tyrannical, the theological as well as the secular, has demonstrated without the shadow of a doubt that sooner or later there is an abuse of power when external punitive controls are lacking" (Finer 1941, 337). While Finer offers another interpretation for the ends to which bureaucratic discretionary power will be put, at a basic level he agrees with Friedrich that discretion leads to power.

Subsequent scholarship has provided numerous other arguments on the sides of the discretion versus accountability debate, all of which implicitly or explicitly agree that discretion is a source of power. Opponents of discretion argue that it leads to

- Abuses of power (Ma 1990; Mitchell 1999),
- Arbitrary exercise of power that do not treat citizens equally under the law (Carrington 2005),
- Corruption (Kang 2005),
- A loss of citizen trust in government (Kang 2005),
- Decisions made without good information or attempts to get information that invade privacy (Carrington 2005).

Overall, these scholars agree that discretion gives bureaucrats the power to make poor, biased, or undemocratic decisions. However, all implicitly agree that discretion empowers the bureaucracy.

Proponents of bureaucratic discretion argue that

- Discretion is inevitable whether we like it or not (Friedrich 1940)

- Discretion can be more democratic than top down control because the bureaucracy can be responsive to specific needs of citizens (DeLeon and DeLeon 2002),
- Top-town rigidity encourages deviant behavior by bureaucrats (Carrington 2005),
- Less rigid implementation can create cooperative relationship between agency and client rather than a destructive and combative one (Bardach and Kagan 1982),
- Discretion can empower agencies and managers to make the bureaucracy more efficient, dynamic, and entrepreneurial (Osborne and Gaebler 1993).

Implicit in all these arguments is the belief that discretion empowers bureaucrats to make good policy decisions.

Overall, the literature reveals commonalities in the debate about discretion and accountability. On all sides, scholars agree that discretion is a key source of bureaucratic power, though they diverge on how well such power will be employed and the normative implications of this power.

C. Challenging the Link Between Discretion and Power

But what if scholars are wrong to think that there is always a direct connection between discretion and bureaucratic power? I find that under certain conditions, discretion can actually undermine bureaucratic power. What in theory is the discretionary freedom to pursue rival courses of action in reality is a narrowed set of options. I find that, under certain conditions, discretion can narrow options, paradoxically, in ways that favor industry friendly decisions. Under conditions of highly complex policies and low public salience for agency decision-making, discretion, rather than empowering public servants, actually empowers targets of that agency's decisions. It does so by undermining the rationale employees need to justify action against clients.

More specifically, I found that highly complex banking practices, coupled with broad regulatory discretion for bank examiners, provided examiners with little ammunition to challenge risky bank practices, particularly in the face of strong bank financial performance. The absence of rules, or only loose discretionary rules, does not empower financial regulators to follow whatever course of action they like in the absence of public accountability. Rather, discretion stripped the bank examiners of a legitimate basis on which to justify action. As we will see in the cases below, examiners that had a high degree of discretion to take enforcement actions, but felt constrained because they lacked clear agency rules on which to justify taking action. In the face of powerful banks that would surely challenge their actions, the examiners often decided against the high costs of enforcement.

D. Discretion-based Culture at Banking Regulators

The agencies I examined have a “culture of ad hoc discretion” (Carnell 1993) as a result of the complexity and variety of bank activities.

Bank regulators rely on relatively few written rules (regulations) concerning what banks can and cannot do. Banking is complex and varied; attempts to codify standards tightly would invite evasion, and cause confusion and inefficiency. Instead, emphasis is put on supervising and examining banks to determine whether they are being operated in a safe and sound manner, and that they conduct themselves in accordance with statutory and regulatory guidelines. Bank examiners receive considerable latitude and authority to make assessments in these matters and to order remedial actions (National Commission on Financial Institution Reform 1993, 22).

In fact, examiners are careful to distinguish bank supervision from regulation through across-the-board rules. Bank examination requires “flexibility and the use of examination policies rather than the application of across-the-board regulations” (Khademian 1996, 32).

Examiners contend that it is the art of assessing the unique combination of risks in each institution and rating its overall condition—from capital to management to earnings—that makes examination and supervision distinct from regulation. Supervision requires judgment in the application of agency policies; regulation requires the application of a standard or rule across the board to determine whether a bank is in compliance. And,

examiners add, it is the review and evaluation of the risk in a bank's portfolio of loans and its operation systems that distinguishes examination from an audit of financial statements or an accounting of financial activities (Khademian 1996, 26).

As one examiner puts it, "Notwithstanding people's perceptions of what we do, we are *not* auditors. We audit when necessary, but we are not auditors! [The exam] is a credit analysis, and that's basically finance...It's subjective. It's a true business art" (Khademian 1996, 27). Even the decision about whether to take enforcement decisions is largely left to examiners' and their supervisors' discretion, though agencies do have general guidelines for specifying when particular types of actions should be taken.

E. Asset Concentration

In almost all of the failures the Inspectors General studied (see Chapter 3), they cited asset concentrations as a reason for failure. Most of the asset concentrations were in assets involving commercial real estate. In addition, most of these concentrations were extreme asset concentrations, meaning well above the level of peer banks. Asset concentration has long been identified as a risky activity. The Treasury OIG notes that asset concentrations were one of many red flags associated with problem banks (CAMELS 4 or 5) in the 1980s and 1990s (Treasury Office of Inspector General 2002). As such, the agencies should have been attentive to concentrations thereafter. Asset concentrations were causes of failures in the pre-crisis period I studied (1993-2005) and were causes of failure in nearly all the failures during the crisis period under study (2007-2011).

Concentrations can be risky because "In general, concentrations of credit increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans. Therefore, concentrations may represent a substantial risk to the safety and soundness of the institution" (Board of Governors Office of Inspector General 2010,

10). In other words, the problem can be understood as a problem of putting too many eggs in one basket. If a bank concentrates its lending in assets tied to the housing or real estate market, and that market experiences a downturn, the concentration will compound the asset devaluation and the bank will have fewer assets elsewhere to absorb the loss.

Ocala National Bank: A case study in concentration risk

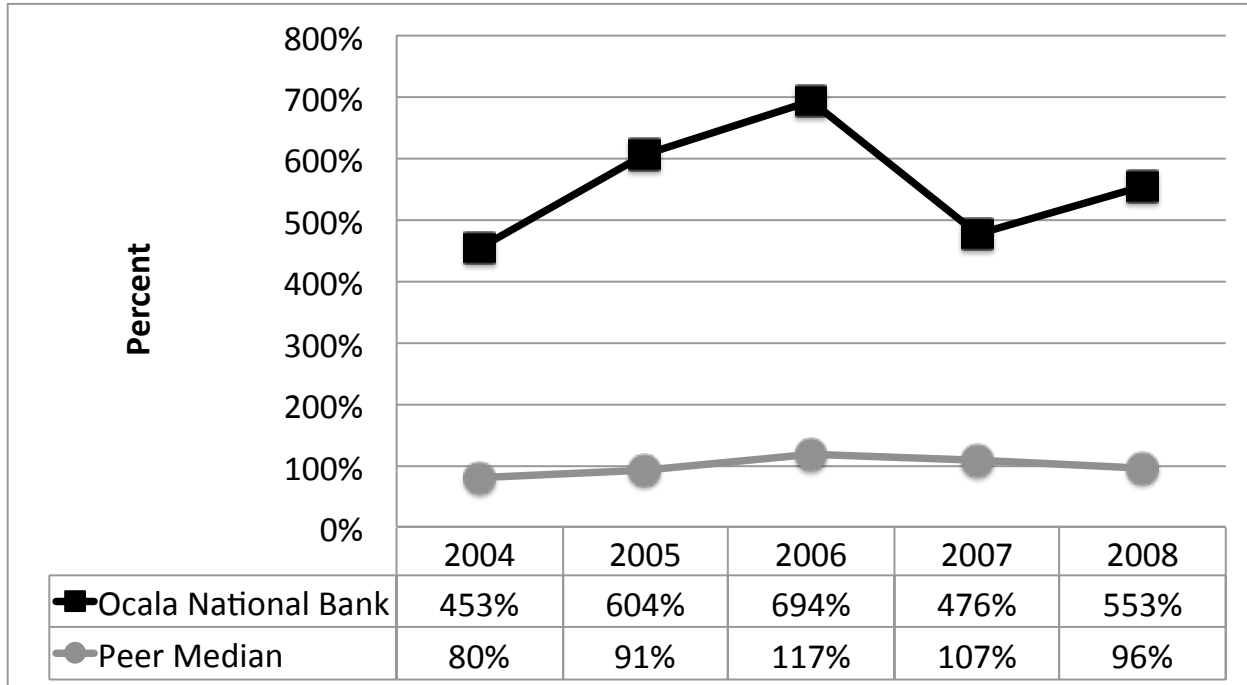
Before expanding our look at the problem of concentrations, I examine one case in depth, Ocala National Bank, regulated by the OCC. This case that typifies regulators' response to the problem of concentrations.

According to the Treasury OIG (2009a), Ocala failed because it had an asset concentration in construction and land development (CLD) loans, unsound credit risk management of this concentration, unsound underwriting and credit administration for its loans, an ineffective board and management that was dominated by the owner of the bank and his sons, as well as a strategy of aggressive growth. All of these problems were exacerbated by the real estate market decline with the onset of the financial crisis. With the downturn, the bank was unable to sell many of its CLD loans. Before the crisis hit, these loans were easily converted into mortgage loans on the secondary market. During the 2008 crisis, Ocala had to foreclose many of the properties and make large asset write-downs.

In 2004, the bank's owner's son took over the position of CEO and the bank began pursuing a strategy of aggressive growth. The CLD concentration grew over the next two years and by 2006, it had the highest concentration of any national bank in the country. As seen in the chart below, its concentration as a percentage of capital was four to seven times above that of its peers between 2004 and 2008. Furthermore, the concentration was in the riskiest type of commercial real estate, CLD. Compounding the risk further, the OCC repeatedly noted in its

examination reports over these years that the bank had poor underwriting and credit administration practices. These practices included exceeding the loan to value ratio in the amount of the property's value it lent to borrowers and failing to obtain property appraisals that met regulatory standards. The CLD loans constituted 93 percent of its total loans by 2005.

Figure 12: Ocala CLD Loans as a Percentage of Total Capital



(Treasury Office of Inspector General 2009a, 6)

How should we assess the OCC's supervision of these activities? The OIG concluded that the OCC should have taken earlier and stronger action to reign in the concentration as well as the bank's other deficiencies. They had the basis to do so as early as 2005, argues the OIG. Instead of using informal or formal enforcement actions, the OCC relied on moral suasion by making examination report recommendations that Ocala improve problems and set its own internal concentration limit. It was not until the end of 2007 that the OCC took an enforcement action against the bank.

Why did the examiners not take earlier and stronger action? Part of the reason is that the bank remained profitable for a while, and despite identified problems, the examiners did not think they could take stronger action in the face of this profitability. I discuss the problem of deference in the face of profitability in the next section as a different norm that contributed to capture. The other major reason examiners cite is the interagency concentration guidance. When asked by the Treasury OIG why the agency didn't take earlier actions, "The OCC Assistant Deputy Comptroller told [the OIG] that the interagency guidance on commercial real estate concentration did not establish concentration limits. Had there been regulatory concentration limits, concentration limits would have been enforceable, according to the official" (Treasury Office of Inspector General 2009a, 19). In other words, because the guidance left it to banks to set specific concentration limits and to examiners to urge them to do so, examiners did not feel they had the authority or grounds to make a reduction enforceable with an enforcement action.

Agency Guidance on Concentrations

The agencies have long had guidance for examiners to give advice about the risks of asset concentrations. Generally, each agency's guidance provides different percentage thresholds for when a concentration becomes something that should be closely monitored by examiners and commented on in each report of examination. The threshold is the asset concentration as a percentage of capital. Though the agencies set a baseline percentage where concentrations should become a concern, they do not set explicit limits. For example, the FDIC Manual of Examination Policies mandates "the listing [in the report of examination] of certain concentrations of assets including industry, product line, and type of collateral that exceed 100% of equity capital and loan loss reserves. While the listing of a concentration is for informational purposes, the

concentration may also be criticized or otherwise commented on where deemed appropriate by the examiner” (FDIC Office of Inspector General 1994, 23).

Because the agencies began to be increasingly concerned about concentrations in commercial real estate, the FDIC, the OCC, and the Federal Reserve initiated interagency guidance at the end of 2006 to address this specific type of concentration risk.

“According to...*Interagency Guidance on Concentrations in Commercial Real Estate, Sound Risk Management Practices*, an institution presents potential CRE [commercial real estate] concentration risk if it meets the following criteria: (1) total reported CLD [construction, land development] loans represent 100 percent or more of an institution’s total capital; or (2) total CRE loans represent 300 percent or more of the institution’s total capital, and the outstanding balance of the institution’s CRE loan portfolio has increased by 50 percent or more during the prior 36 months” (Board of Governors Office of Inspector General 2011, 13).

The guidance continued the trend of providing general guidance but not specific standards or concentration limits. As the Treasury OIG explains “The Federal Reserve and the other federal banking regulatory agencies issued interagency guidance that addressed concentrations in commercial real estate (CRE) lending and sound risk management practices. The guidance does not establish specific CRE lending limits; rather, it sets forth sound risk management practices that an institution should employ when it has CRE concentration risk” (Treasury Office of Inspector General 2012b, 17).

Though the OTS was not involved in the interagency guidance on commercial real estate, it initiated revised concentration guidance at the time, which replaced earlier guidance.

According to OTS’s October 2002 ND Bulletin 02-17, Concentrations of Risk, OTS examiners are to identify, report, evaluate, and develop an effective supervisory response concerning concentration of risk during examinations. Where supervisory concerns exist, examiners are to discuss them in the body of the ROE [Report of Examination] and promptly initiate appropriate corrective or supervisory action. ND Bulletin 02-17 required examiners to list specific concentrations of risk (defined as a higher-risk asset or liability whose aggregate total exceeds 25 percent of core capital) in an appendix to the ROE. ND Bulletin 06-14, issued in November 2006, superseded ND Bulletin 02-17 and

defines a concentration as a group of similar types of assets or liabilities that, when aggregated, exceed 25 percent of core capital plus ALLL [Allowance for Loan and Lease Losses. ND Bulletin 06-14 also requires that examiners identify concentrations that exceed 100 percent of core capital plus ALLL on the concentrations page in the ROE. Additionally, both ND Bulletin 02-17 and ND Bulletin 06-14 require examiners to comment on the following factors inherent in the thrift's operations that could aggravate concentration risk:

- lack of board of director policies on concentrations and established limits on riskier types of business activities,
- lack of oversight by the board of directors,
- lack of management depth or expertise,
- poor internal controls or underwriting processes,
- rapid growth unchecked by management review and established limits on activity, and
- inadequate management information systems to identify and monitor concentrations of risk (Treasury Office of Inspector General 2009c, 11-12)

During the financial crisis both the FDIC and the OTS created additional guidance on asset concentrations, but the guidance served more to reemphasize the principles of the earlier guidance and again did not offer more specifics on concentration limits.

OTS: To address the need for more guidance on concentration limits, in July 2009 OTS issued guidance to thrifts on asset and liability concentrations and related risk management practices. The guidance re-emphasized to financial institutions important risk management practices and encouraged institutions to revisit their existing concentration policies in light of the current economic environment. Under the guidance, OTS examiners are to review and scrutinize higher risk concentrations and pursue appropriate corrective or enforcement action when an institution does not maintain appropriate concentration limits or takes excessive risks. Specifically, OTS will monitor any institution with a concentration that exceeds 100 percent of core capital plus the Allowance for Loan and Lease Losses (ALLL) (Treasury Office of Inspector General 2009d, 14).

FDIC: The FDIC has also issued supervisory guidance addressing the risks associated with ADC lending and funds management practices. For example, the FDIC issued FIL-22-2008, Managing CRE Concentrations in a Challenging Environment, which reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. Specifically, the guidance re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices. It also articulated the FDIC's concerns regarding the need for proper controls over interest reserves used for ADC loans, stating that examiners have noted an inappropriate use of

interest reserves when the underlying real estate project is not performing as expected (FDIC Office of Inspector General 2011, 19).

Examiner Opinion

Why was the guidance inadequate? According to examiners, it did not give them adequate basis to rein in banks with risky concentrations. On one hand, the unspecific guidance made it difficult for examiners to determine whether a concentration was a problem. According to one OIG report,

“OTS examiners for Suburban told us [the Treasury OIG] that it was difficult to limit concentrations due to the lack of guidance. Regulatory guidance available at the time set only general limitations for loan concentrations; it did not set specific numeric thresholds, such as percentage of capital. This made it difficult for examiners to assess whether institutional limitations were appropriate. Examiners told us that regulatory guidelines for loan concentrations were needed” (Treasury Office of Inspector General 2009d, 14).

Examiners at the OCC agreed. In their supervision of the failed Union Bank, N.A. “examiners said that although the bank exhibited heavy concentrations in CRE lending, they felt that there was no clear guidance on what levels of concentration were excessive and posed a safety and soundness issue” (Treasury Office of Inspector General 2010, 13).

On the other hand, if examiners *did* determine that a concentration posed an undue risk to the bank, the guidance did not provide the appropriate basis to help examiners legally justify strong enforcement action. For example, according to OIG reports,

- “The OCC Assistant Deputy Comptroller told us that the interagency guidance on commercial real estate concentration did not establish concentration limits. Had there been regulatory concentration limits, concentration limits would have been enforceable” (Treasury Office of Inspector General 2009a, 19).
- FDIC “examiners indicated that the advisory nature of the Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices made it difficult for

them to impose a supervisory action requiring [Temecula Valley Bank] to reduce the high levels of CRE and ADC concentrations” (FDIC Office of Inspector General 2010c, 19).

- “OTS examiners for Bradford told us that it was difficult to limit concentrations due to a lack of guidance” (Treasury Office of Inspector General 2011a, 7).

OIG Assessment of Guidance

Some of the Inspectors General were critical of the guidance. After its assessment of all of the failed bank reports it wrote, the Fed’s OIG argues that the Fed should reexamine the interagency guidance on CRE concentrations to add more detail based on what was learned from failures during the financial crisis. In their review of MLR trends, the FDIC’s OIG was largely satisfied with the updated guidance the FDIC made for concentrations.

However, The Treasury OIG was more targeted in its criticism of the concentration guidance and believed it needs more specificity, particularly concentration limits. It argues that even the 2006 interagency guidance is still too vague to be appropriate for supervision and calls it inadequate (Treasury Office of Inspector General 2012a). The Treasury OIG, recommend that the “OCC work with its regulatory partners to determine whether to propose legislation and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determining an appropriate range of examiner response to high risk concentrations” (Treasury Office of Inspector General 2010, 16).

F. Deference to Financial Performance

Just as the agencies run into complexity problems in trying to develop standards for banks to follow, they also face a complexity challenge in trying to capture the overall risk of an institution when assigning a bank a CAMELS rating. Relying on clear, quantifiable performance

indicators is a way to reduce this complexity. We can see this tendency in the way examiners assign the management rating in the context of other more easily quantifiable variables.

Nowhere is the art of examination more evident than in judging management capability...the formal rating as part of CAMEL has been often predicated on the overall condition of the organization. Examiners can assess the financial condition of a bank based on its capital, assets, earnings, and liquidity. But management is difficult to assess independently...If a bank's CAEL components were 2, 1, 2, and 2, the M would be plugged in as a 2 also. Yet, as field office directors and as most managers in agency headquarters acknowledge, the condition of the bank does not necessarily show overall safety and soundness if management is not competent to deal with a major economic downturn, the collapse of a real estate market, or the consequences of volatile interest rates for rate-sensitive products. The problem with *not* relying on CAEL, however, is that the indicators for sound management are not clear (Khademian 1996, 37-38).

This tendency to reduce complexity by focusing on what can be clearly measured appears to be further narrowed by the agency's focus on financial performance as the best indicator of a bank's risk level and health. More specifically, another informal norm the agencies developed is to defer to banks in the face of high capital and profits, despite significant problems identified by examiners, and despite examination guidance against doing so. The agencies consistently waited to take enforcement action until indicators of financial performance showed deterioration rather than taking action when problems first surfaced.

But it was not just management problems that failed to show up in the CAMEL ratings; other quantifiable problems, like level of concentration, underwriting standards, and funding volatility failed to show up as well. Despite sophisticated analysis of a whole range of factors, a few measures tended to trump the others. The problem is that it is difficult to show that these other factors will necessarily lead to significant problems, *especially in the face of strong current financial performance*. As one examiner says "it's hard to hit someone over the head who is successful" (Khademian 1996, 38). Banks can easily point to their short-term success, and the regulators appear reluctant to challenge them. Yet this notion relies on an overly narrow

definition of what indicates success. The reason the banks use the CAMELS approach is that all components are supposed to factor into the overall risk assessment.

The danger in relying on capital is that it has long been known to be a lagging indicator of a bank's trouble (GAO 1991). Even though problems are brewing at a bank, it may take a while for those problems to be shown in a bank's capital level. The lag exists in part because it takes time for the effects of management problems to set in, but also because banks have developed ways to make their financial performance appear better than it otherwise would through accounting tricks, as indicated by many of the OIG reports in my dataset. Profits too may be a lagging indicator, as many of the MLRs showed that banks used various tactics to mask the deteriorating quality of their loans and the lack of current borrower payments, which helped delay recognition of losses for capital and earnings purposes.

Evidence of the Problem

Weak enforcement in the face of strong financial indicators is not a new phenomenon. The GAO identified the problem in their study of failures during the banking and S&L crises of the 1980s and early 1990s. One reason examiners gave for not using tougher enforcement is that banks appeared to be healthy as indicated by their capital and profits. "The reasons cited for not taking more forceful enforcement actions...were consistent with the regulators' reliance on capital as a measure of a bank's financial health and viability. Regulators clearly did not want to take an enforcement action that they believed would potentially damage the bank's ability to attract capital through injections, stock offerings, mergers, or acquirers; nor did they want to take action until capital levels fell below minimum standards" (GAO 1991, 37). While the former rationale seems more credible, the latter is evidence of the unwillingness to take action until there is a clear indicator of deterioration.

During the period between 1993 and 2011 under study, the problem grew larger. Each OIG noted the problem of excessive focus on current financial performance in meta-analyses of their failed bank reports. For example, according to the Fed's OIG, "Despite acknowledging and identifying many of the risks that ultimately caused the bank to fail, examiners appeared reluctant to take aggressive supervisory action until the bank's financial performance declined. The deteriorating economic conditions during the financial crisis demonstrated how quickly specific risks can affect a bank's condition, making it critical that such issues are addressed promptly. This supervisory risk highlights the need for forward-looking examinations" (Board of Governors of the Federal Reserve System 2011, 39).

The Treasury OIG also found cases of delayed enforcement due to capital and apparent profitability at both the OTS and OCC. The calcification of this mindset is illustrated best in the examples of Washington Mutual and Keystone National Bank (discussed in Chapters 2 and 3). In both cases the banks had a long history of egregious deficiencies and repeated failures to make agreed upon corrections. Yet, in both cases the examiners let profitability and capital levels stop them from taking the necessary action to rein in the reckless bank behavior.

Nothing in the rules prohibits examiners from taking action for problems identified despite strong current financial performance. In fact, agency enforcement guidance says that current financial performance should not override inherent risks identified by examiners. For example, the "OCC's enforcement action policy states that there is a presumption in favor of formal enforcement action when a bank faces serious problems or weakness, even if the problems have not yet resulted in a change of rating or have not been reflected in the bank's financial performance or condition" (Treasury Office of Inspector General 2009a, 18). Yet, without more explicit guidelines or requirements for taking action, the enforcement guidelines

may not translate into strong enforcement. For example, despite a range of problems identified at Ocala National Bank, top OCC personnel argued that, “there was no basis for formal enforcement action...because the bank was in good financial condition” (Treasury Office of Inspector General 2009a, 18). The fact that some examiners do not think they can do something that they actually can, shows how entrenched the mindset is.

The FDIC OIG has focused the most attention on this issue and proposed potential remedies. So, to illustrate the problem I discuss the findings of the FDIC’s IG below.

Forward Looking Supervision and the FDIC

One consistent trend the FDIC OIG identified in its analysis of failed bank reports is a lack of “forward-looking” supervision. According to the FDIC OIG, “In many cases, examiners identified significant risks but did not take timely and effective action to address those risks until the bank had started to experience significant financial deterioration in the loan or investment portfolios” (FDIC Office of Inspector General 2010a, 30). In general, the problem can be summed up as follows: the examiners placed too much importance on current financial performance and profitability and not enough emphasis on identified weaknesses. Despite weaknesses in management, asset concentrations, underwriting, and the like, examiners still assigned banks high CAMELS ratings. These ratings were not reflective of the inherent risk of the institution and instead more reflective of current financial performance, despite the fact that the identified risks posed considerable risk to the future health and viability of the institution, and thereby a risk to the insurance fund, the very problem the FDIC above all regulators is special tasked to monitor.

According to the FDIC OIG,

Based on that early work [in material loss reviews], we suggested that greater consideration of risk in assigning CAMELS component and composite ratings in addition

to reliance on current financial condition appeared to be needed. Risky behaviors that did not seem to have had a sufficient impact on CAMELS ratings included:

- Pursuit of aggressive growth in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans;
- Excessive levels of asset concentration with little risk mitigation;
- Reliance on wholesale funding to fund asset growth;
- Ineffective leadership from bank boards of directors (Board) and management;
- Inadequate loan underwriting and lack of other loan portfolio and risk management controls, including appropriate use of interest reserves;
- Allowance for loan and lease losses (ALLL) methodology and funding; and
- Compensation arrangements that were tied to quantity of loans rather than quality (FDIC Office of Inspector General 2010a, 4-5).

In effect the CAMELS ratings system works as a “point in time” snapshot assessment of a bank’s health rather than a prognosis of the institution’s future health. And as applied by examiners especially, the CAMELS rating did not reflect future risk.

When asked why the ratings of banks did not reflect the risks identified, examiners at the FDIC offered the same response as we saw above. “Examiners frequently explained that it was their perception that the apparent financial strength of an institution, expressed in earnings and capital, limited their options for addressing elevated risk profiles. Accordingly, in many cases, examiners did not downgrade the CAMELS ratings of financial institutions with high-risk business strategies until the bank had experienced significant financial deterioration” (FDIC Office of Inspector General 2010a, 12).

We can see the limits of the mindset examiners were bringing to their CAMELS ratings by contrasting this rating system with another used by the FDIC for its largest institutions. Unlike the other regulators, the FDIC uses a more dynamic, future risk oriented rating system for its largest banks, called the Large Insured Depository Institution (LIDI) rating. According to the FDIC’s Inspector General, “LIDI ratings consider future risks at an institution, where CAMELS rating, in practice, are more point-in-time measures of performance” (US Senate Permanent Subcommittee on Investigations 2011, 198). The FDIC Examination manual reads as follows:

The purpose of the LIDI program is to provide timely, comprehensive, and forward-looking analyses of companies with total assets of \$10 billion or more, on a consolidated entity basis. Timely and complete analysis of the risk profiles of these companies provides a proactive approach aimed at identifying and monitoring the largest risks to the insurance fund. Case managers prepare written reports that document the analysis and risk profile and supervisory strategies of large depository institutions. The analysis is comprised of four major areas:

- organizational structure and strategic focus of the company;
- overall risk profile and financial condition of the company;
- an identification and review of significant issues, current events, and challenges facing the company; and
- the review and development of a sufficient supervisory program to address the risk issues facing the company.

The FDIC developed the LIDI reports and associated rankings as an additional means to measure an institution's financial health beyond the CAMELS ratings. LIDI reports are used to inform FDIC senior management, the FDIC's Board of Directors, and other regulators about risks to the insurance fund as well as provide updates about the supervisory programs in place to respond to those risks. The Regional Director is responsible for assigning offsite ratings to companies in the LIDI program.

Washington Mutual was a case where examiners deferred to the banks financial performance despite years of consistent and uncorrected problems with assets and management. And in the case of WaMu, the FDIC's LIDI rating provided consistently more pessimistic opinions of the bank. Had there been more emphasis placed on the LIDI rating, or had the OTS used something similar, the examiners and the OTS would have had a more pessimistic outlook on WaMu's practices and might have been stronger in their attempts to get WaMu to make corrections.

So, in practice three of the four regulators do not have a dynamic picture of potential future risk, and even the FDIC monitors this risk only for its largest institutions. Thus, agencies emphasized current performance when supervising most deposit taking institutions. This point

should not be overemphasized, however. The regulators do not completely ignore future risks. They use various measures to try to capture what the CAMELS rating does not, such as indicators of potential adverse market conditions (Helfer 1996). However, the problem the OIG are picking up is that the CAMELS rating does not always incorporate such concerns. And because the CAMELS rating is a clear, concise, important signal to banks about their financial health at the heart of each agency's regular report of examination, it can be misleading and problematic when the rating does not indicate the concerns examiners have with a bank's risk.

In response to this problem, the FDIC began a training initiative to address the need for more forward-looking supervision in June 2009. "The purpose of the Forward-Looking Supervision initiative is to build upon the strengths of the supervision program, emphasize balanced and timely response to weak management practices and identified risks, and emphasize a forward-looking approach to examination analysis and ratings based upon the lessons learned from the recent institution failures" (FDIC Office of Inspector General 2010a, 7). Whether a more comprehensive change is needed remains to be seen.

G. Conclusion

In Chapters 3 and 4, I presented evidence of targeted agency capture indicated by the lax enforcement. What causes lax enforcement? The present chapter locates one cause at the heart of bureaucratic policymaking: finding the appropriate amount of discretion for agency personnel. The complex nature of banks and bank regulation necessitates a large degree of discretion for these regulators. However, this discretion comes at a cost—the extent to which agency rules are not specified can undermine the fervor with which agency personnel feel they can enforce sound behavior.

The implications of this finding are twofold. First, this finding helps to refine our understanding of the relationship between bureaucratic discretion and power. On one hand, proponents of bureaucratic discretion would have less justification defending discretion in certain instances if discretion leads to the dynamics I found. On the other, though my findings could be used to support arguments for limiting bureaucratic discretion, it introduces a new premise for doing so. Rather than the traditional argument that discretion leads to too much bureaucratic power, I instead argue that discretion can lead to too little power, and create an alternate route to bureaucratic capture.

Second, this finding has implications for our understanding of the causes of capture. A certain degree of discretion is inevitable and desirable for any agency, and perhaps more so for agencies regulating a complex policy area like banking. Yet, my findings indicate the dangers of not spelling out agency rules and regulations in more detail. Not doing so can undermine the justification to take action or lead to the development of norms that preclude strong action.

Too much discretion alone may be enough to dilute agency strength and contribute to capture. However, this danger is perhaps more apparent in a policy domain like banking regulation that is both highly complex and of low public salience (Gormley 1986), and where the industry has considerable power, in terms of both resources and expertise. Past scholarship suggests that highly complex and low salience policy areas are ripe for capture (Gormley 1986), partly because these areas give policy makers less incentive to be involved (Price 1978). Discretion provides agencies some latitude for forbearance and low salience provides some incentive. If regulators take strong enforcement action, the bank will resist vigorously while the taxpaying public “will hardly notice” (Carnell 1993, 115). In contrast, forbearance provides immediate, tangible benefits to the bank and personnel, with whom agency examiners and

managers regularly interact, while distributing any potential costs widely to taxpayers, costs that are not likely to arise until the distant future.

And if problems do eventually come to light the agency can make a showing of being tough with public enforcement action. “An agency can get better reviews from a single showy enforcement action than from twenty cases of forbearance avoided, even if avoiding forbearance does far more good than the symbolic enforcement. Enforcement is easy to understand and has minimal political costs while avoiding forbearance is obscure and risks sharp industry criticism. This puts a premium on slamming the barn door after the horse is gone, rather than latching it in the first place” (Carnell 1993, 115). This dynamic may explain why the Inspectors General found weak and delayed enforcement so often.

Lastly, discretion and the incentive structure may also interact with the larger human difficulty in assessing risk. A range of cognitive shortcuts and biases makes us poor assessors of risk (Kahneman 2011; Tversky and Kahneman 1974). Of particular relevance to my findings is the present bias. Because of the present bias “we tend to focus on today and neglect tomorrow...and fail to take steps that would impose small short-term costs but produce large long-term gains” (Sunstein 2013). This bias ties closely to the tendency for forbearance. Taking a strong action today is costly though it might prevent larger costs down the road.

In Chapter 7, I discuss possible remedies for these dynamics, including the GAO’s longstanding recommendation to make more detailed rules for the enforcement decision making process (GAO 1991) and introducing “regulatory contrarians” to the agencies that may be able to counter the tendency for lax enforcement and help counteract cognitive biases (McDonnell and Schwarcz 2011). However, before discussing conclusions and recommendations, I compare the four banking regulators on various performance measures. In Chapter 6, I examine the

relationship between capture and regulatory outcomes and the relationship between agency structure and outcomes. I then make an overall assessment of each agency's performance prior to and during the 2008 financial crisis.

CHAPTER 6: COMPARING AGENCY PERFORMANCE BY OUTCOMES FOR REGULATED BANKS, CONSUMERS, AND THE FINANCIAL SYSTEM

A. Introduction

When observers accuse regulatory agencies of being captured after disasters and crises occur, they are evaluating agencies based on the outcomes of regulated institutions. For example, when the BP oil spill occurred in the Gulf of Mexico in 2010, observers accused the Minerals Management Service of being captured based upon its inappropriate ties to industry lobbyists (Wang 2010). When 29 miners died in a West Virginia coal mine in 2010, investigators pointed to a decade of safety violations by the mining company and weak enforcement from the Mining Health and Safety Administration (Kindy and Eggen 2010). The same causal chain emerged after the 2008 financial crisis. The failure of financial regulators to foresee or forestall the crisis raised questions about the independence of their judgment (Johnson 2009; Johnson and Kwak 2010). Though agencies can be captured independent of industry failures (as discussed with the case of HSBC in Chapter 2), disasters and crises become more likely with the lax treatment capture entails.

This chapter embraces the potential connection between industry performance and agency performance by evaluating agencies based on a range of industry performance measures. These measures include how many of each agency's supervised banks failed or received bailout funds, how each agency's supervised banks treated consumers, and how each agency's supervised banks contributed to systemic risk in the financial system. I do so while being attentive to the fact that we cannot necessarily infer that industry failures are a sign of regulatory failures or capture. However, industry failures do provide a signal for potential poor agency

performance. Examining agencies in this way can be useful as long as we are careful not to draw unsupported conclusions and be attentive to rival hypotheses for poor industry performance.

This approach contrasts with that used in Chapter 3. There I used Inspector General bank failure reports to assess agency performance directly. These reports detailed a range of mistakes agencies made leading up to bank failures. Because so much of the information on bank supervision is restricted from the public due to Freedom of Information Act exemptions, observers are forced to rely on other, less direct measures of agency performance. Though I still use some additional evaluation of agency actions directly, the bulk of this chapter focuses on industry performance as a signal of agency performance.

I expect that poor regulated industry performance is more likely under a captured agency because of the lax treatment capture entails. Thus, I hypothesize that the OTS and the OCC should perform worse than the FDIC and Fed on a range of performance measures, given my expectation that the former two agencies are captured. I expect that capture will be reflected in poor agency performance. Already, Chapter 3 provided some evidence to refute this hypothesis. According to my analysis of Inspectors General reports, the FDIC and Fed performed just as poorly as the OTS, and the OCC was least often lax in its enforcement. Further, all four agencies performed similarly for decision-making and resource problems. In this chapter, I investigate whether the agencies converged in their performance for other measures.

B. S&L and Banking Crises

After the S&L and banking crises of the 1980s, the GAO assessed these four agencies' performance. The GAO found weak enforcement by all of them, mirroring the results I found in Chapter 3 for the 2008 crisis. More specifically, the GAO reported that the agencies were not

using their formal enforcement powers enough and instead relying on informal enforcement actions, which often proved less effective than formal ones in changing bank behavior.

The GAO study on FHLBB (OTS's predecessor) enforcement actions had three main conclusions: 1) formal enforcement actions were infrequently used and even when used the agency was not making them as harsh as they could be, such as by including civil money penalties, 2) the formal enforcement actions taken were often untimely, and 3) in instances where informal enforcement actions were used they proved less effective than formal actions in correcting problems.

The GAO report on the enforcement actions by the FDIC, the Fed, and the OCC reached similar conclusions. The GAO believes they should have been using stronger actions in over half of the banks in their sample: "These cases involved instances where (1) the underlying causes for problems were known but remained uncorrected and/or (2) the bank had a history of noncompliance with existing enforcement actions or of repeatedly violating banking regulations" (GAO 3).

Despite this similarity, banks did not fail at the same rate under each regulator. Data are available to compare the performance of the OCC, FDIC, and the Fed. Data show that Fed regulated banks performed much better than those regulated by the FDIC and OCC. "Between 1986 and 1991 the [deposit insurance] fund lost \$12.4 billion to protect depositors of failed banks or to inject capital into troubled ones. National banks under the supervision of the OCC accounted for 73 percent of the losses...FDIC supervised banks accounted for 35 percent of all losses during the same period, while Fed-supervised banks actually contributed more to the bank insurance fund through insurance premiums than was required to resolve those few state member banks that failed" (Khademian 1996, 7).

As discussed in Chapter 3, the FDIC and OCC reduced examinations and personnel in the 1980s, while the Fed did not. This reduction likely contributed to the poorer performance by the OCC and FDIC. “Whereas 97 percent of banks supervised by the Fed were examined on location every year, 64 percent of the FDIC’s banks received such examinations and only 36 percent or less of national banks supervised by the OCC” (Khademian 1996, 7). Combined with a reduction in personnel, the reduced examination frequency significantly contributed to bank performance (Gilbert 1993).

C. Conflicting Goals: Protecting Consumers

The bank regulators did a poor job protecting consumers in the decades before the 2008 crisis. The problem was in part legislative design. No agency had the primary task to represent and protect consumers in financial transactions. As Bar-Gill and Warren (2008) argue in an article making the case for an independent consumer-focused regulator,

Effective regulation requires both authority and motivation. Yet none of the many regulators in the consumer credit field satisfies these basic requirements. Federal banking regulators have the authority but not the motivation. For each federal banking agency, consumer protection is not first (or even second) on its priority list. By contrast, the FTC [Federal Trade Commission] makes consumer protection a priority, but it enjoys only limited authority over consumer credit markets (185-6).

Further, a large swath of financial institutions that treated consumers poorly, such as non-bank mortgage lenders, was left unregulated. This gap results in part from a regulatory paradigm that focused on the form of the institution more than the type of products it sells to consumers (Bar-Gill and Warren 2008). Even though non-bank lenders were offering the same products as banks, the former operated largely outside the scrutiny of federal regulators. Thus, though the Fed has authority to set rules for all mortgage lenders, federal regulators could enforce only against insured institutions (Bar-Gill and Warren 2008), compromising effective supervision.

In addition to the way regulation was structured, and perhaps in part encouraged by it, the banking regulators never developed a strong culture of consumer protection. In fact, they adopted the mandate somewhat reluctantly, amid worries that it would distract them from their traditional focus on the safety and soundness of banks. Thus, the task of protecting consumers was peripheral to the task of ensuring the safety and soundness of banks.

In theory, the banking agencies have authority to investigate new [consumer] products, to develop new regulations, and to police those new regulations. The relevance of such power, however, is diminished by the agencies' lack of interest in exercising this power. The problem is not one of immediate politics or a particular party in government. The problem is deep and systemic. These agencies are designed with a primary mission to protect the safety and soundness of the banking system. This means protecting banks' profitability. Consumer protection is, at best, a lesser priority that consists largely of enforcing Truth-in-Lending disclosure rules (Bar-Gill and Warren 2008, 190).

As former OTS director Ellen Seidman argued in congressional testimony about the causes of the crisis, the disclosure paradigm at the agencies did not serve consumers well (Seidman 2009). When the financial products are so complex, there is little chance any level of disclosure will help consumers understand them (Seidman 2009).

As a result of their focus, the agencies did not tend to be magnets for hiring tireless consumer advocates. As James Kwak explains,

Because people rarely became bank regulators in order to protect consumers, it was more likely that regulators thought of themselves as stewards of an efficient financial system or, more simply, identified with the bankers. This attitude was on display in 2010 when members of the CFPB implementation team arrived for an on-site visit to a major financial institution. As people were meeting each other, a company executive who had flown in from another office introduced himself to someone he thought was from the CFPB. "No, I'm one of you," the person corrected him. "I'm from the [bank regulatory agency]" (Kwak 2013, 16).

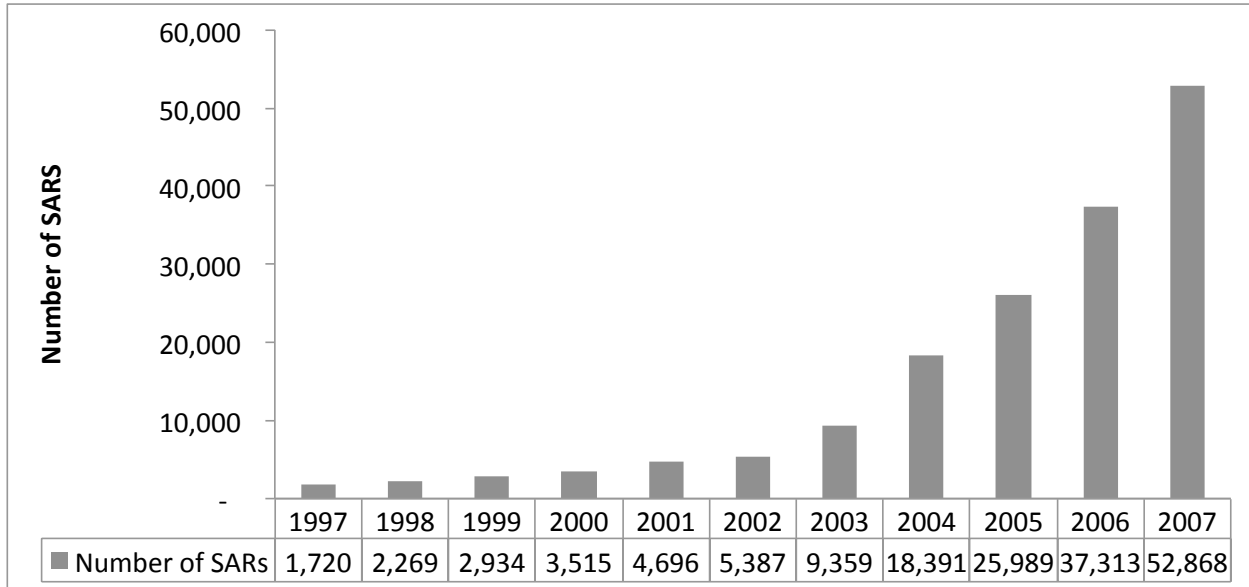
The lack of consumer focus was on display in the way the regulators did not aggressively combat abuses in the mortgage lending market. By 2004, the FBI was issuing public warnings about a mortgage fraud epidemic that could cause another collapse the size of the S&L crisis in

the 1980s ("FBI warns of mortgage fraud 'epidemic': Seeks to head off 'next S&L crisis'" 2004). Particular types of loans contributed to some of this fraud. Low documentation and no documentation loans, in which lenders may not verify or even ask for key aspects of a borrower's ability to repay, such as the possession of a job, income, or assets, were open invitations to fraud and came to be called "liar's loans" in industry parlance (Black 2009). By 2006, 27% of all mortgages originated were no-documentation or low-documentation loans (Angelides et al. 2011).

Another way to see the growing fraud epidemic, and a signal that should have triggered stronger agency action, is in the growth in Suspicious Activity Reports (SARs) filed by depository institutions to the Financial Crimes Enforcement Network (FinCEN), which is housed within the Treasury Department. A regulated institution files a SAR if it suspects mortgage market participants such as borrowers, appraisers, brokers, or sellers of engaging in mortgage fraud. Figure 13 below depicts the rapid increase in these reports between 1996 and 2007 (FinCEN 2008, 21).¹³

¹³ SARs do not capture the full extent of fraud in the mortgage market. Eighty percent of nonprime lenders are not required to report under the program—only FDIC insured institutions have to—and even then, there is underreporting (Angelides et al. 2011). Most institutions file few if any reports. "In all, 788 depository institutions and their subsidiaries filed 40,781 SARs on suspected mortgage loan fraud (6.8% of total SARs filed in the same period) during the period April 1, 2006 through March 31, 2007. The top 10 filers that listed mortgage loan fraud as a category account for 61% of these SARs, while the top 25 filers account for 87% of the total" (FinCEN 2008, 27).

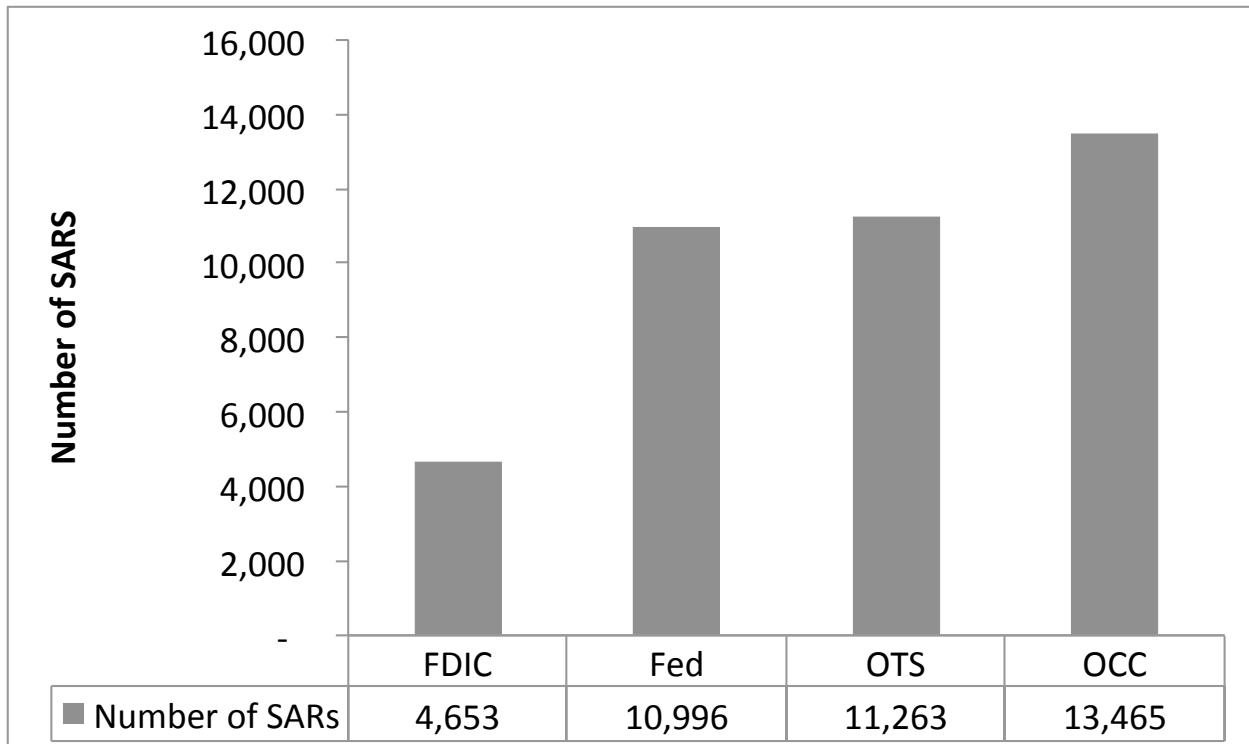
Figure 13: Number of Suspicious Activity Reports per Year



Misrepresentation of income/assets/debts is the most often cited type of fraud in the SARs.

Figure 14 below shows the number of SARs filed by institutions regulated by each federal agency for 2007 (FinCEN 2008, 27).

Figure 14: Number of Suspicious Activity Reports by Regulator



The FinCEN report indicates many simple ways lending institutions could have cut down on incidences of fraud, including conducting their own verifications of loan information instead of relying on brokers, conducting simple reasonability tests to see red flags like a borrower's income listed well above the profession's average, or comparing document signatures to detect identity theft.

How did the regulators respond? Of all financial regulators, The Fed had the unique authority to set industry wide standards for mortgage lending under the Home Ownership and Equity Protection Act (HOEPA) of 1994. Despite hearing reports of abusive lending, the Fed took little action, and what it did was merely symbolic. In 1999, along with other banking regulators it issued non-binding guidance for subprime lending. A 2005 Fed study found widespread evidence of lending problems, but it again reacted with inter-agency non-binding guidance in 2006 (Angelides et al. 2011). In 2001, after a governmental report from other agencies detailed predatory lending problems and public hearings under HOEPA in 2000, the Fed issued a rule under HOEPA that applied to only 1% of subprime loans (Angelides et al. 2011). Finally, the Fed changed rules under HOEPA in July 2008, after the crash already hit, creating some basic standards including that borrowers have the ability to repay loans (Angelides et al. 2011). The rules did not go into effect until October 2009. Former Fed governor Edward Gramlich likened the Fed's action under HOEPA to "a city with a murder law, but not cops on the beat" (Johnson and Kwak 2010, 143).

More prudent rules from the Fed could have stopped millions of "liar's loans" and other risky mortgage products from flooding the market. Instead, a lack of prudent lending standards created what white-collar criminologists call a "crime-facilitative environment" (Angelides et al. 2011, 160). During her testimony to the Financial Crisis Inquiry Commission, former FDIC chair

Shelia Bair argued, “I think nipping this in the bud in 2000 and 2001 with some strong consumer rules applying across the board that just simply said you’ve got to document a customer’s income to make sure they can repay the loan, you’ve got to make sure the income is sufficient to pay the loans when the interest rate resets, just simple rules like that . . . could have done a lot to stop this” (Angelides et al. 2011, 79). White-collar criminologist William Black puts the point more forcefully: “Nonprime lending is...inherently imprudent... How difficult was it for a regulator...to figure out that a business strategy of making ‘liar’s loans’ was imprudent?” (Black 2010, 18-19).

The Fed was also lax in monitoring and enforcement over the institutions it had authority to supervise. In part, this lack of enforcement resulted from statutory guidelines that gave the Fed supervisory authority over nonbank subsidiaries owned by bank holding companies (where the GAO (2004) estimates about one quarter of all subprime lending occurred) but not enforcement authority, which was delegated to the Federal Trade Commission. However, the Fed was not active in referring potential lending violations to those entities that could enforce penalties, the FTC or the Justice Department. Between 2000 and 2006, the Fed referred only three cases to the Justice Department related to lending violations. In fact, the Fed was not even using its authority to monitor and supervise the nonbank subsidiaries at all. They were essentially unregulated.

The OTS and OCC were similarly lax in protection consumers from mortgage lending abuses. Despite evidence that its banks were moving aggressively into the low/no documentation mortgage market, in the case of the OCC, and into risky adjustable rate mortgages, in the case of the OTS, each regulator issued few if any formal rules to regulate these practices. Both regulators have issued individual and joint non-binding guidance about lending standards to the

institutions they regulate. But, when the OCC spearheaded interagency guidance in 2006 on adjustable rate mortgages, the OTS was openly critical, though it eventually supported the rule. As discussed above, the guidance was intended to combat fraud in part, but it was also aimed at discouraging risky lending strategies that posed a risk to the safety and soundness of the institution (e.g., adjustable rate mortgages with low teaser rates that jumped rapidly after the first few years). Because the guidance was non-binding, institutions were still free to pursue risky lending.

The OTS did not adopt any formal rules related to subprime lending and the OCC adopted only one, in 2004. This rule was nominally for the purpose of reducing unfair and deceptive lending practices that paid no attention to borrowers ability to repay the loans. However, the rule still gave banks the freedom to determine the method to assess a borrower's ability to repay. This freedom allowed for OCC banks to still use low documentation or no documentation loans as adequate to verify the ability to repay. Yet, "Almost by definition, such loans did not entail any assessment of borrowers' ability to repay...These loans made it impossible for national banks to know whether borrowers could afford to repay" (Engel and McCoy 2011, 168-169).

Enforcement by these regulators was spotty as well. Before the crisis, the OTS took no formal enforcement actions against thrifts related to subprime lending. The OCC took only a few. In 2005, the OCC entered a consent order with Laredo National Bank to restrict its issuance of no/low documentation loans. The OCC issued the same order against two other medium-sized national banks, but these did not come until after the subprime market bottomed out in mid-2007. The five biggest national banks were heavily involved in no/low documentation loans but were never formally forced to stop. The OCC's only other enforcement action was against Loan Star

Capital Bank, which reimbursed borrowers for more than \$100,000 for abusive lending fees and closing costs (GAO 2004).

Although it is clear that these agencies were not regulating nonprime lending, whether the institutions these regulators oversee are significantly engaged in predatory subprime lending is a matter of contention. In a 2004 GAO report on predatory lending, the OTS and OCC said their institutions are not significantly involved in predatory lending.

However, many consumer groups, states and attorneys general claim that institutions regulated by the OTS and OCC were engaged in abusive forms of subprime lending. The OCC's lax rules and guidance allowed its banks and their subsidiaries to give out loans where borrowers stated their income and assets without verification and loans where borrowers had no income or assets or even a job. Only in 2007 did the Comptroller begin speaking out against these types of loans. Simultaneously, the OCC allowed banks to hold onto these risky loans but also encouraged them to securitize the loans and sell them off to investors, spreading the risk further into the financial system. Similarly, the OTS allowed its thrifts to engage in risky mortgage lending and did not begin openly pushing for tighter lending standards until 2007. In the meantime, the OTS was cutting its consumer compliance staff and standards. Beginning in 2001, the OTS laid off 69 examiners including 17.5 percent of consumer compliance examiners. This decision was in response to a general decline in fee revenues the OTS assessed on banks to fund the agency beginning in the late 1990s due to general market declines. It also ended separate examinations for consumer compliance and safety and soundness and instead allowed the thrifts themselves to conduct consumer compliance self-evaluations. In one estimate, the OTS had a "climate of laxity unmatched by any other federal banking agency" (Engel and McCoy 2010, 184).

In contrast, the FDIC “appears to have taken its oversight responsibilities more seriously than the OCC or OTS...the FDIC’s overall regulatory record during the subprime heyday trumped that of the OCC and OTS” (Engel and McCoy 2010, 184). As evidence, the FDIC “did not preempt state anti-predatory lending laws for the community bank it regulated. While a few FDIC-regulated banks got into trouble with subprime loans, for the most part FDIC institutions steered clear of those products. As a result, FDIC-regulated banks only had a small role in the unfolding subprime crisis” (Engel and McCoy 2010, 167).

Federal Regulators vs. the States

One could argue that it is easy to fault the regulators only with the benefit of hindsight. The aggressiveness with which the states attempted to combat the abuses in real time suggests otherwise.

The Fed’s reluctance to regulate unfair, abusive, and fraudulent forms of lending using its authority under HOEPA contrasts sharply with the activity of many states that were passing mini-HOEPA laws to combat mortgage lending problems. While eight states passed HOEPA laws that matched federal standards (which were likely attempts to preempt more aggressive city laws), many others passed laws with much tougher standards than federal ones. Ding et al. (2011) identify twenty-one states with strong anti-predatory lending laws. Many state laws attempted to ban certain highly risky types of mortgages outright. Georgia’s law even included a provision to make banks retain some of the credit risk of the loans they originated and/or securitized and sold off to investors to reduce the incentive for banks to originate risky loans. These laws restricted many things federal rules did not, including “charging or financing points and fees, credit insurance, prepayment penalties, balloon payments, negative amortization, determination or documentation of income or repayment ability, and/or significant counseling

requirements” (Ding et al. 2011, 5). Evidence indicates that these laws reduced the volume of risky loans and led to lower foreclosure rates (Ding et al. 2011).

Yet, both the OTS in 1996 and the OCC in 2004 issued preemption rulings that stated the nationally chartered institutions and their subsidiaries were subject to federal standards only. In a separate rule, the OCC even barred states from enforcing non-preempted rules against national banks (Engel and McCoy 2010). Given that federal standards were more lenient than the states’ standards, the national regulators effectively helped deregulate the mortgage market further (Peterson 2005). In part, the deregulation happened as institutions began switching to national charters once states began passing more aggressive laws (Engel and McCoy 2010). Both regulators saw growth in national charters and their total assets under regulation. Additionally, by creating an uneven playing field that advantaged nationally chartered banks and thrifts, financial institutions subject to state regulations were able to pressure states to roll back laws, as in Georgia. Evidence indicates that preemption had a negative effect on lending standards at preempted banks. Lending standards declined at OCC banks lending in states with strong anti-predatory lending laws after these banks were no longer subject to state law with the OCC’s 2004 preemption ruling (Ding et al. 2010).

Enforcement against lending abuses was also lax at the federal level. For example, between 1995 and 2007, “the OCC [did] not issued a public enforcement order against any of the eight largest national banks” and only issued thirteen orders against national banks for violating consumer lending laws. In contrast, “[d]uring 2003 alone, state officials initiated more than 20,000 investigations . . . [,] took more than 4,000 enforcement actions in response to consumer complaints about abusive lending practices,” and held lenders accountable to the tune of \$1

billion in penalties and restitution” (Arthur E. Wilmarth, Jr. quoted in Bar-Gill and Warren 2008, 193).

We can also measure the performance of federal agencies by comparing key outcomes to those of state regulators. For years 2006-2008, the loan default rates at federal thrifts regulated exclusively by the OTS were two to three times higher than for state thrifts (Engel and McCoy 2010). In 2006 and 2007, loan default rates were similar for nationally chartered banks regulated exclusively by the OCC and state banks, but by 2008, the rate at national banks was nearly double that of state banks (Engel and McCoy 2010). By this measure, institutions with dual state and federal oversight that were also subject to state consumer protection laws performed better.

Overall, the evidence above suggests that, with respect to combating consumer abuses in the years leading up to the financial crisis, the FDIC had the best record of the four agencies and the OTS had the worst, followed closely by the OCC. The Fed’s failure was perhaps most consequential because it failed to exercise its sole responsibility to put a floor on lending standards that rapidly raced to the bottom meaning that there were few to no lending standards at all.

Reflecting their poor performance, the Dodd-Frank Act created the Consumer Financial Protection Bureau (CFPB). The mission of the CFPB is to “make markets for consumer financial products and services work for Americans — whether they are applying for a mortgage, choosing among credit cards, or using any number of other consumer financial products” (Consumer Financial Protection Bureau 2013). Its responsibilities include collecting data to monitor the consumer finance market, writing and enforcing rules, and responding to consumer complaints, among others. The key change is that Bureau will unify what was a fragmented regulatory system. Consumer financial protection will be housed under one federal agency.

Before, enforcement was divided among 11 different federal agencies (Acharya et al. 2010). The CFPB is headed by a single director, who serves a term of five years after being appointed by the President with the advice and consent of the Senate. The agency is an independent bureau within the Federal Reserve System. Its funding comes from the Fed as well.

The legislation maintains states ability to fight on behalf of consumers. The CFPB can set a floor of regulatory standards, but a state may still set tougher standards for institutions within its borders (Acharya et al. 2010). But, the Dodd-Frank Act carved out some exceptions, leaving possibility open for some regulatory arbitrage as financial institutions could move their credit to institutions with assets amounts that leave them outside the scope of the bureau's supervision (Acharya et al. 2010). Further, "housing the Bureau within the Fed also sends a signal that bank solvency comes before consumer protection" (Acharya et al. 2010, 79). Taking the chief mandate to protect consumers out of the hands of the banking regulators who did so poorly will potentially put consumer protection on stronger ground than it once was at the banking regulators where it was given far less attention. However, the evidence is not clear that agencies with a more focused mandate will pursue the public interest better or that agencies with conflicting mandates cannot do the same (Carrigan 2013). For example, the Federal Trade Commission's regulatory vigor protecting consumers has varied widely over its history (Meier and Bohte 2007).

D. Systemic Risk

Because regulation of the financial system was divided across many agencies, no single agency had the authority, incentive, or the information to monitor risk to the entire financial system. Banks and lenders could proliferate risky loans, and no agency had the incentive to stop them. As long as federally regulated banks did not intend to hold onto the loans they bought or originated, the banking regulators were agnostic about the quality of the loans. If Wall Street or

Freddie and Fannie Mac were willing to securitize the loans and take them off the balance sheet of banks, the banking regulators did not pass judgment. Discussing agency policy on lending and loan securitization, former OTS Western Region Director Darrell Dochow said in an interview,

Dochow: Obviously agency policy, securitizations, you looked at recourse and liability but you didn't spend as much time looking at what was sold, especially if it was sold to an agency, because you thought it was gone and recourse was limited to standard reps and warranties. I think those are the lessons that have already been addressed by the regulators in some recent guidance and so forth.

Interviewer: If I'm looking at loans that are being sold without recourse, and the only way they come back is if there's a rep and warranty violation, which means it's an out and out fraudulent loan, I'm not so concerned about what's going on with those loans. I'm concerned with the ones that go on the books. Is that what you meant?"

Dochow: Yes

Interviewer: Whereas a sort of broader perspective, if it's a crap loan we should be concerned about it wherever it ends up.

This narrow focus translated into a failure to recognize systemic risk in the broader financial system. For example, in the case of Washington Mutual, the "OTS and the FDIC allowed Washington Mutual and Long Beach [mortgage company] to reduce their own risk by selling hundreds of billions of dollars of high risk mortgage backed securities that polluted the financial system with poorly performing loans, undermined investor confidence in the secondary mortgage market, and contributed to massive credit rating downgrades, investor losses, disrupted markets, and the U.S. financial crisis" (US Senate Permanent Subcommittee on Investigations 2011, 165).

In part to combat this silo-mentality and to combat the emergence of large financial institutions that pose systemic risk to the financial system, the Dodd-Frank Act created the Financial Stability Oversight Council (FSOC). "The Council is charged with identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States' financial system." The FSOC council has 10

voting members, comprised of the heads of the federal financial regulators and one independent member appointed by the President. The Act also created the Office of Financial Research within the Treasury Department as an information gathering office for the FSOC. The FSOC is tasked with researching and identifying sources of systemic risk (McDonnell and Schwarcz 2011). Lastly, the Act created the Council of Inspectors General on Financial Oversight, which is tasked with examining broad concerns to the financial system (McDonnell and Schwarcz 2011). Similar to the FSOC representation, it is comprised of the Inspectors General of the nine federal agencies that oversee the financial system.

As with the CFPB, the creation of these new agencies is in large part a response to gaps in design in the former regulatory system and the poor job the banking regulators did in monitoring the financial system and responding to the emerging threats that ultimately contributed to the financial crisis. Their creation is reflective of both poor regulatory design and poor regulation before the crisis.

E. Bank Failures During the 2008 Financial Crisis

Another way to assess performance of regulators is to look at how many of each agency's regulated institutions failed. One previous investigation found that there was little difference between the financial health and performance of banks supervised by the four federal banking regulators. This study compared the stock return performance between thrifts and commercial banks during the 2008 crisis and found that OTS supervised thrifts performed only "marginally worse" than commercial banks regulated by the other three agencies (Donelson and Zaring 2010). The same study compared the performance of banks that switched to thrift charters and vice versa. The authors found that the stock performance for the charter-switching institutions to and from the OTS was no different (Donelson and Zaring 2010). Lastly, the study examined

whether charter-shopping institutions were more likely to receive bailout funds. They found that institutions switching to a thrift charter were less likely to receive bailout funds than those switching from under the OTS's supervision (Donelson and Zaring 2010). Their data for charter-switching institutions, however, was limited to a small number of cases.

In the tables below, I expand on their work to ascertain any differences failure rates for the banks supervised by the four agencies. As discussed above, we know that during the last major financial crisis, their performance diverged. The Fed regulated banks performed much better than those at the FDIC and OCC. Table 19 below compares the percentage of supervised banks that failed under each agency. I use a percentage rather than the raw number of failures because each agency supervises a different number of banks.

Table 19: Percent of Institutions Regulated that Failed

2007	OTS	OCC	FDIC	The Fed
Number of institutions regulated*	844	1715	5220	902
Number of failures	1	0	2	0
Percent of banks regulated that failed	0.12%	0	0.04%	0
2008	OTS	OCC	FDIC	The Fed
Number of institutions regulated*	826	1632	5197	878
Number of failures	6	8	15	1
Percent of banks regulated that failed	0.73%	0.49%	0.29%	0.11%
2009	OTS	OCC	FDIC	The Fed
Number of institutions regulated*	810	1537	5098	860
Number of failures	22	30	80	16
Percent of banks regulated that failed	2.72%	1.95%	1.57%	1.86%
2010	OTS	OCC	FDIC	The Fed
Number of institutions regulated*	765	1462	4941	844
Number of failures	18	23	99	17
Percent of banks regulated that failed	2.35%	1.57%	2.00%	2.01%
2011	OTS	OCC	FDIC	The Fed
Number of institutions regulated*	730	1383	4715	829
Number of failures	6	11	64	11
Percent of banks regulated that failed	0.82%	0.80%	1.36%	1.33%
2007-2011	OTS	OCC	FDIC	The Fed
Mean number of institutions regulated	795	1545.8	5034.2	862.6
Mean percent of banks regulated that failed	1.35%	0.96%	1.05%	1.06%

*As of December 31, of previous year

Though the OTS' percentage is the highest for most years, the absolute number of failures is not substantively large enough to conclude that the OTS performed much worse. There is no statistically significant difference between any pair of agencies for the overall mean percentage of banks regulated that failed. Surprisingly, the regulators all performed similarly and they appeared to all perform fairly well, at least by the measure of how few institutions regulated actually failed.

A second way to compare each agency's performance is by the size of the loss its failures caused to the FDIC's Deposit Insurance Fund. Table 20 below shows the loss to the deposit insurance fund as a percentage of assets regulated. Because each agency has a different amount of assets under its regulatory authority, I again use a percentage to facilitate comparison across agencies.

Table 20: Loss to the Deposit Insurance Fund as a Percentage of Assets Regulated

2007	OTS	OCC	FDIC	The Fed
Total assets regulated (in thousands)	\$1,463,950,000	\$6,829,269,000	\$2,160,523,000	\$1,406,487,000
Number of failures	1	0	2	0
Estimated loss to DIF (in thousands)	\$150,698	0	\$33,520	0
Estimated loss/Total assets regulated	0.010%	0%	0.002%	0%
2008	OTS	OCC	FDIC	The Fed
Total assets regulated (in thousands)	\$1,556,670,000	\$7,782,387,000	\$2,180,697,000	\$1,519,012,000
Number of failures	6	8	15	1
Estimated loss to DIF (in thousands)	\$13,863,823	\$1,942,862	\$3,710,752	\$86,585
Estimated loss/Total assets regulated	0.891%	0.025%	0.170%	0.006%
2009	OTS	OCC	FDIC	The Fed
Total assets regulated (in thousands)	\$1,231,858,000	\$8,478,798,000	\$2,282,713,000	\$1,853,915,000
Number of failures	22	30	80	16
Estimated loss to DIF (in thousands)	\$11,671,158	\$5,057,426	\$16,484,542	\$3,909,107
Estimated loss/Total assets regulated	0.947%	0.060%	0.722%	0.211%
2010	OTS	OCC	FDIC	The Fed
Total assets regulated (in thousands)	\$942,659,000	\$8,199,604,000	\$2,277,210,000	\$1,689,983,000
Number of failures	6	11	64	11
Estimated loss to DIF (in thousands)	\$2,284,658	\$1,962,703	\$18,546,264	\$1,386,858
Estimated loss/Total assets regulated	0.242%	0.024%	0.814%	0.082%
2007-2010	OTS	OCC	FDIC	The Fed
Mean total assets regulated	\$1,298,784,250	\$7,822,514,500	\$2,225,285,750	\$1,617,349,250
Mean percent estimated loss to DIF	*0.52%	*0.03%	*0.43%	*0.07%

*Statistically significant difference between proportions, two-tailed difference in proportions test, $p < .05$

Again, the OTS has the highest percentage of losses for most years. But using this measure, we see that the overall mean percentages of financial losses are statistically significantly different from one another. The mean percent for the OTS and the FDIC are substantively significantly higher than that of the OCC and the Fed. These are small but important differences between the pairs of agencies. Overall, the federal regulators lost only a small percentage of the total assets under their regulation, but their performance differed.

A third way to compare the regulators' performance is by the percentage of their failures that cause a material loss to the FDIC's Deposit Insurance Fund. In other words, did one regulator have more large and costly failures? Table 21 below shows the raw number of bank failures that caused a material loss and the number expressed as a percentage of total institutions under supervision.

Table 21: Failures that Caused a Material Loss

2007	OTS	OCC	FDIC	The Fed
Number of institutions regulated	844	1715	5220	902
Number of failures resulting in a material Loss	1	0	0	0
Percent of banks regulated that failed, causing a material Loss	0.12%	0.00%	0.00%	0.00%
2008	OTS	OCC	FDIC	The Fed
Number of institutions regulated	826	1632	5197	878
Number of failures resulting in a material Loss	4	3	11	1
Percent of banks regulated that failed, causing a material Loss	0.48%	0.18%	0.21%	0.11%
2009	OTS	OCC	FDIC	The Fed
Number of institutions regulated	810	1537	5098	860
Number of failures resulting in a material Loss	18	18	59	14
Percent of banks regulated that failed, causing a material Loss	2.22%	1.17%	1.16%	1.63%
2010	OTS	OCC	FDIC	The Fed
Number of institutions regulated	765	1462	4941	844
Number of failures resulting in a material Loss	3	3	18	2
Percent of banks regulated that failed, causing a material Loss	0.39%	0.21%	0.36%	0.24%
2011	OTS	OCC	FDIC	The Fed
Number of institutions regulated	730	1383	4715	829
Number of failures resulting in a material Loss	3	1	4	3
Percent of banks regulated that failed, causing a material Loss	0.41%	0.07%	0.08%	0.36%
2007-2011	OTS	OCC	FDIC	The Fed
Mean number of institutions regulated	795	1545.8	5034.2	862.6
Mean percent that caused a material loss	0.73%	0.33%	0.36%	0.47%

As above, the OTS's percentage is higher than that of the other agencies for most years. There is, however, no statistically significant difference between any pair of agencies for the overall mean percentages for bank failures that caused material loss. Given the very small number of cases for which we have data, relying solely on statistically significant differences could distract our attention from important information. There are substantively interesting differences among agencies. For some years, the OTS's percent of supervised banks that failed and caused a

material loss is two to three times higher than that of the other agencies. For the overall mean percent, the OTS's percent is over two times larger than that of the OCC's and the FDIC's. The differences are also substantively important because they mean that the FDIC, OCC, and the Fed had fewer large failures that could potentially destabilize the financial system and cause major losses to the Deposit Insurance Fund.

F. Bailout Recipients

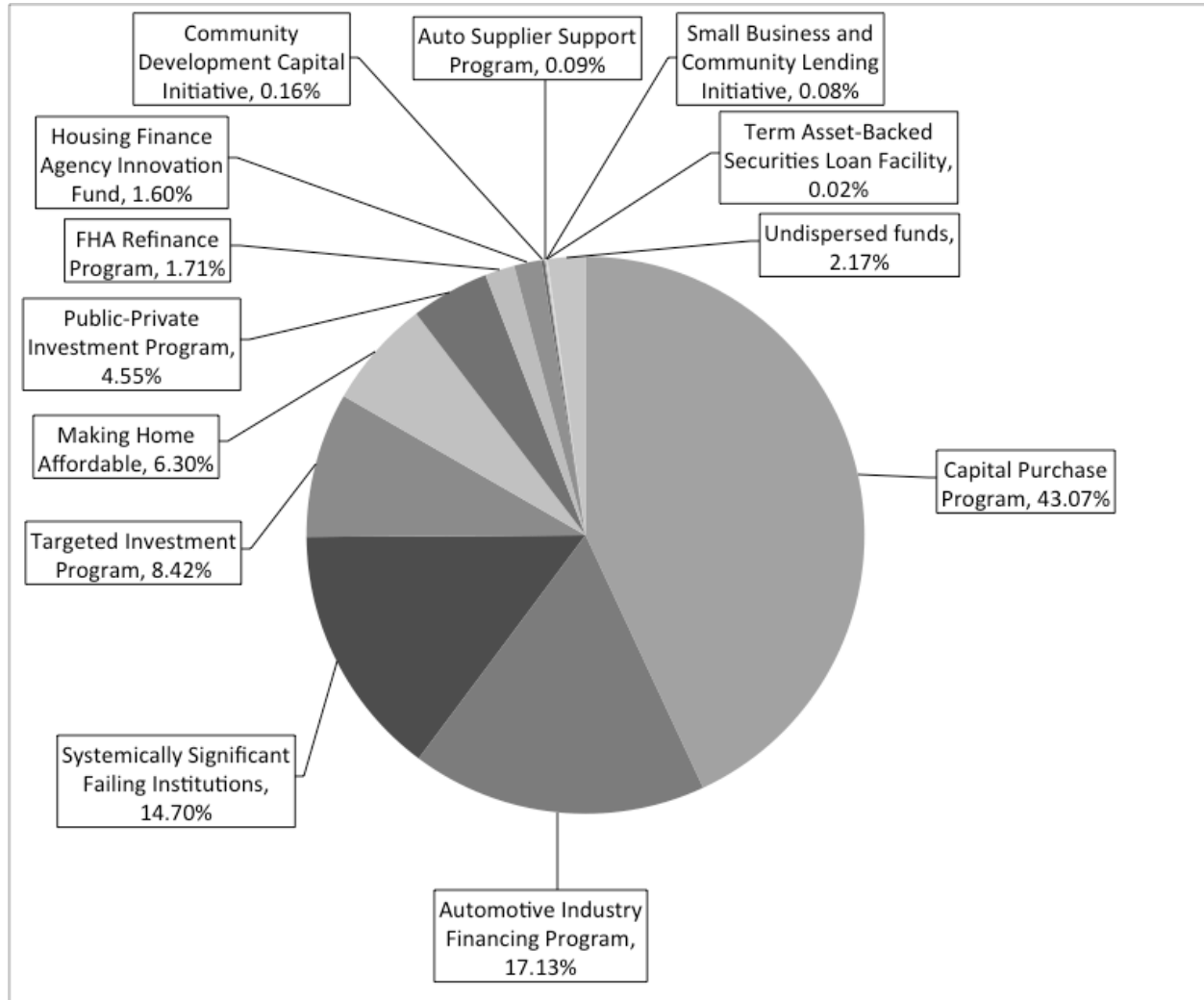
Lastly, we can compare agency performance by whether one regulator's banks were more likely to receive bailout funds. The bank bailout was part of the Emergency Economic Stabilization Act of 2008. The bailout portion of the legislation was called the Troubled Assets Relief Program, or TARP, and was run by The Treasury Department. The Act authorized the Treasury Secretary to use up to \$700 billion to "establish the Troubled Asset Relief Program (or "TARP") to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary" Title I, Sec. 101, (a) (1). The 2010 Dodd-Frank Act reduced the amount to \$475 billion. TARP also does not include the nearly \$200 billion that was allocated to bailout the government sponsored entities Fannie and Freddie Mac as part of the Housing and Economic Recovery Act of 2008.

As implemented by the Treasury, TARP had numerous component programs. Table 22 below lists these programs along with a brief description and size of the allocated funds. Figure 15 below provides a visual representation of the funding breakdown.

Table 22: Programs Within the Troubled Asset Relief Program (TARP)

TARP Programs	Brief Description	Funds Allocated	Percent of Total Funds
Capital Purchase Program	Treasury purchase of preferred bank stock	\$205B	43.07%
Automotive Industry Financing Program	Loans to the Auto Industry	\$81.3B	17.13%
Systemically Significant Failing Institutions	Money for AIG	\$69.8B	14.70%
Targeted Investment Program	More Money for Citi and Bank of America	\$40B	8.42%
Making Home Affordable	The Mortgage Loan Modification Plan	\$29.9B	6.30%
Public-Private Investment Program	Public-Private Toxic Asset Purchases	\$21.6B	4.55%
FHA Refinance Program	Refinancing Underwater Mortgages	\$8.12B	1.71%
Housing Finance Agency Innovation Fund	Money for States Hit Hardest by Crisis	\$7.6B	1.60%
Community Development Capital Initiative	Cheap Loans for Community Development Banks	\$783M	0.16%
Auto Supplier Support Program	Financing for Auto Parts Suppliers	\$413M	0.09%
Small Business and Community Lending Initiative	Program to Ease Small Biz Credit Market	\$368M	0.08%
Term Asset-Backed Securities Loan Facility	Fed loans to owners of top-rated asset-backed securities	\$100M	0.02%
Asset Guarantee Program	Limiting Losses for Citi and BofA	\$0	0.00%
	Total	\$464.7B (of \$475 available)	97.83%

Table information taken from Propublica's (ProPublica 2013) database with only slight modifications by the author. Dollar amounts are rounded so may not add exactly to total. Percentages are based on unrounded program totals.

Figure 15: Percent of TARP Funds Allocated to Each Program

For the analysis below, I focus on the Capital Purchase Program (CPP). The CPP is the program through which most banks received bailout funds and where the largest portion (43.07%) of TARP funds were allocated (ProPublica 2013). Most of the institutions that received bailout funds through the CPP were not banks, at least not directly. Though some banks received funds, most bailout recipients were bank or financial holding companies that have federally regulated banks as subsidiary institutions. Determining the primary federal regulator required untangling which banks were subsidiaries of these holding companies and whether in fact the bailout funds were given to the subsidiary institutions. I used the Fed's National Information

Center (The Federal Reserve System 2013) database to find the subsidiary institutions of the holding companies. I then used the same database to search for the primary federal regulator of the subsidiaries. I also made sure to search the institutions at the date they received funds because they may have reorganized or switched regulators between date of bailout receipt and present day. In most cases, the holding company had one banking subsidiary. In some cases, the parent company had multiple subsidiaries, each with different primary federal regulators.

Based on the best information available, the bailout money was typically used to increase the capital of subsidiary institutions. The Special Inspector General for the TARP (SIGTARP) conducted a survey of bailout recipients to determine how funds were used. Responses from the institutions and correspondence with SIGTARP staff suggest that bailout money was transferred to subsidiaries. Thus, my working assumption is that bailout money was typically used for increasing the capital of subsidiaries, and thus that the primary federal regulator had some influence on the likelihood of the need for these subsidiaries' bailout funds.

A total of 709 institutions, most of which were holding companies, received CPP funds. A look at Table 23 below shows that there were a total of 935 commercial banks, savings banks, and thrifts that received funds, when accounting for the banking subsidiaries of the holding companies. The table also breaks down the recipients by their primary federal regulator.

Table 23: Federal Regulator for Banks that Received CPP Funds

	OTS	OCC	FDIC	The Fed	Total
Number of bailout recipients supervised	73	167	552	143	935
Percent of total bailout recipients supervised	7.81%	17.86%	59.04%	15.29%	100%

How do these percentages compare to the percent of the total number of banks regulated by each agency? Comparing the percent of the bank population regulated to the percent of the bailout

recipient population regulated provides a metric by which to judge each agency's contribution to the bailout. If the primary federal regulator for a bank is unrelated to its likelihood of receiving bailout funds, we would expect the two percentages to be similar. Alternatively, if a regulator did a poor job supervising the risk of its institutions, we might expect its percent of institutions receiving bailout funds to be higher than its proportion of the overall regulated population. It is possible that any observed differences could result instead from an agency being more adept at getting bailout money for its clients. This latter explanation of potential differences is a reasonable alternative to the former one and will be discussed more below.

Table 24 below shows the proportion of the bank population regulated by each agency as of December 31 2008. Over 99% of CPP funds were dispersed between October 2008 and December 2009, so the choice of date provides a good snapshot of the bank population at the time. The table also presents the information from the previous table for the breakdown of bailout recipients by regulator.

Table 24: Proportion of Banks Supervised vs. Proportion Supervised Receiving Bailout

	OTS	OCC	FDIC	The Fed	Total
Number of banks supervised (Dec. 31 2008)	810	1537	5098	860	8350
Percent of total banks supervised	9.75%	18.51%	61.38%	10.36%*	100%
Number of bailout recipients supervised	73	167	552	143	935
Percent of total bailout recipients supervised	7.81%	17.86%	59.04%	15.29%*	100%
Difference	-1.94%	-0.65%	-2.34%	4.93%	

*Statistically significant difference between proportions, two-tailed difference in proportions test, $p < .05$

The results show that Fed regulated banks took more than their share of bailout funds, while FDIC, OTS, and OCC regulated banks took less. I used a difference of proportion test to determine whether there was a statistically significant difference between the proportion of the

bank population supervised and the proportion of the bailout recipient population supervised. Results showed that the difference in proportions was statistically significant for the Fed only, suggesting that the difference in the Fed-regulated institutions' use of bailout funds is statistically valid. A difference of nearly 5 percent suggests that the difference is also substantively significant.

G. Discussion

We would expect the banks supervised by captured agencies to perform poorly. Favorable treatment by the agency can lead to too much risk-taking, endangering a bank's health as well as the broader financial system. Independent of whether the agencies are captured, we would expect the agencies' performance to vary because each has a different structure and a different way they organize themselves to implement their task. I thus expected that the OTS and the OCC would perform worse than the FDIC and the Fed for a range of performance measures.

Surprisingly, the agencies performed similarly for the number of supervised banks that failed, with only slight variation. For the size of the asset loss these failures caused to the Deposit Insurance Fund, the OTS ranked the highest. Unexpectedly, it was the FDIC that was close behind the OTS for this measure and the OCC and the Fed that performed better. For the number of bank failures that caused a material (meaning large) loss to the Deposit Insurance fund, the OTS performed the worst, while the OCC performed similarly to the FDIC and the Fed.

With respect to protecting consumers, all four agencies did a poor job, though the FDIC may have performed somewhat better than the others and the OTS slightly worse than the others. Certainly all four had a worse record than the states in combating lending abuses by banks. The four agencies did a similarly poor job looking out for systemic risk to the financial system.

The bailout data suggest that the OCC, OTS, and the FDIC outperformed the Fed, whose banks took a higher proportion of bailout funds than its proportion of the bank population supervised. This finding is unexpected because after the S&L crisis it was the Fed's banks that had outperformed those of the other agencies. It is also unexpected because I hypothesized that the OCC and the OTS would be the agencies to stand out from the others for poor performance.

Alternatively, the Fed could simply have been more adept at securing bailout funds for its banks. This alternative explanation is unlikely for two reasons. First, if any of the regulators were in a strategic position to influence where the bailout funds went, it would likely be the OTS and the OCC, not the Fed, because the funds were doled out by the Treasury Department, of which the OCC and OTS are bureaus. Second, and alternatively, one could argue that the OTS would be the least able to help its banks secure bailout funds. The fact that it alone was closed by the Dodd-Frank reform legislation suggests it had lower political clout in Washington than the other agencies. However, the results do not support either of these theoretical possibilities. Another alternative hypothesis is that the Fed pressured its banks to apply for bailout funds more than the other agencies. This hypothesis is unverifiable because systematic information to determine how much pressure each agency put on banks to apply is not publicly available.

Overall, the results show more similarity than would be expected given the differences in each agency's funding, mandate, and structure. Why do the agencies share more similarities than differences in their performance? One explanation is that their examination schedule became standardized after the last crisis. Infrequent exams and staffing reductions at the OCC, FDIC, and OTS (then the FHLBB) were the best explanation for why fewer Fed supervised banks failed during the last banking crisis. With the passage of the FDIC Improvement Act in 1991, Congress mandated that agencies conduct on-site examinations every 12-18 months. This standardization

seems to have improved their supervision, or at least made their performance more consistent across agencies.

What do these results suggest about capture? It could be that all four agencies are captured and they all would have performed better if not for this fact. Alternatively, none could be captured and performed similarly as a result. Or results suggest that if some of the agencies are captured, it did not influence their performance to be significantly worse across a range of measures discussed in this chapter. More likely is the fact that each agency experienced *targeted* agency capture from particular banks, but the entire industry was not able to capture the regulators, and make one agency perform significantly worse than the others.

H. Conclusion

In this chapter, I used a variety of data to measure the banking regulators' performance, relying mainly regulated industry performance as a signal for agency performance. I reviewed research on agency and bank performance protecting consumers leading up to the 2008 crisis and protecting the financial system from systemic risk. I then used data to compare the number and size of bank failures under each agency as well as which agency's institutions were more likely to receive bailout funds. Performance across agencies showed more similarity than expected, given my expectations that the OTS, OCC, and their supervised institutions would perform the worst.

In Chapter 7 I discuss what these results, as well as those of the preceding chapters, mean for both theory about capture and the practice of banking regulation going forward.

CHAPTER 7: CONCLUSION

A. Introduction

Can bank regulation serve the public interest? Would the public interest be better served by no regulation at all? Allegations of capture are a challenge to regulation. For libertarians, it is a challenge to the value of regulation at all. Due to their pessimism about government's distorting influence on the economy and the likelihood of capture, many libertarians would rather see no or minimal regulation. From those further to the left, the accusation of capture is a challenge to reform regulation to better serve the public interest, not eliminate it.

To help determine which camp's recommendations are appropriate, Carpenter and Moss (2013a) make a useful distinction between strong and weak capture: "*Strong Capture* violates the public interest to the extent that the public would be better served by nonregulation of the activity in question...*Weak Capture* occurs when special interest influence results in a reduction of regulation's attainment of the public interest (relative to the counterfactual situation in which little or no special interest influence is exerted upon regulation), but the public interest is still being served by regulation, relative to the baseline of no regulation" (13-14).

The scope of capture typology I introduced in Chapter 2 can help us determine the source of capture and its scope to determine whether capture is so pervasive regulation is undesirable. For example, the implications for regulation are different if we find targeted agency capture, but not capture of the whole agency. Targeted agency capture suggests that the problem is not so pervasive that it is beyond remedy. With targeted agency capture the scope is limited within a subset of the industry and a subset of agency personnel. However, agency capture is more severe. Agency capture means the scope of capture is wide within most of the industry and most key

agency personnel. If the findings suggest agency capture, critics would have stronger evidence to justify that society could be better off without regulation.

Alternatively, (targeted) regulatory capture calls for fundamental political reforms to limit special interest influence in the elected branches or to give agencies more autonomy from coopted elected officials. As Meier (1997) has suggested, many of the problems we blame on the bureaucracy are really problems caused by the elected branches. Similarly, regulatory capture compels us to look outside the agency for remedies, not necessarily to get rid of the agency itself.

So, conclusions about the scope of capture have very different implications for remedying the problem and for our opinion about whether publicly interested regulation is even possible. Before discussing these implications, I review the key findings from the preceding chapters to see what they suggest about the scope of capture here.

B. Key Findings

In the preceding chapters I examined the behavior of the four federal banking regulators, elected officials, and the banks that are the target of their regulation searching for evidence for and against capture. In Chapter 3, I studied failed bank reports written by each banking regulator's Inspector General, where I focused on (targeted) agency capture. In Chapter 4, I examined the effect political appointees and economic crises had on agency enforcement output. In Chapter 5, I examined the role of examiner discretion in capture, which I found undermines the examiners' ability to justify strong enforcement actions. In Chapter 6, I examined the performance of the banking industry itself. I argued that the performance of banks directly supervised by each agency can reflect agency performance and indicate capture.

Because banking regulation is highly complex and of low public salience, and because banks have the ability to choose their regulator, which can encourage regulatory arbitrage, I

hypothesized that the four banking regulators could be captured. I hypothesized that the OTS and OCC were particularly ripe for capture because they 1) have a conflicting mandate that encourages them to both promote the competitiveness of their regulated banks and ensure their safety and soundness, 2) receive funding via assessments on the banks they supervise, making them sensitive to exit by their biggest clients, and 3) lack overlapping state regulation to act as a potential source of stronger regulation. Did the evidence examined support these hypotheses?

Targeted Agency Capture

To varying degrees, all four banking regulators exhibited strong evidence of targeted agency capture. My review of Inspector General failed bank reports in Chapter 3 found that, though the OTS was lax in its enforcement in over 90 percent of its failures, the FDIC and the Fed, surprisingly, were lax nearly as often. The OCC was also frequently lax, though less often than the other agencies (nearly 60 percent of its failures). This finding is not a strong endorsement of the OCC's enforcement record. Similar to Winston Churchill's opinion of democracy, we might say that the OCC was the worst enforcer, except for all the others. Overall, these reports provide clear support that the agencies were frequently lax in their enforcement and regulation. This conclusion is the independent opinion of the OIG as well as the admission of each agency, using its own expertise by concurring with the OIG conclusions.

Unfortunately, because the reports are for only a small number of banks and includes only failed banks, we cannot tell how many banks received such treatment. Depending on the bank examined, the scope of capture within the agency appears at all levels within the agency, at the examiner, manager, and executive levels. Again, because the data is limited, we cannot say how widespread capture is across all managers, examiners, and executives at each agency. Thus, there is not enough evidence to say that the entire agency is captured, but there is enough to conclude

that targeted agency capture exists within all four regulatory agencies. The agencies' poor performance in the policy areas of consumer protection and subprime lending examined in Chapter 6, further supports the conclusion of targeted agency capture because banks appeared to be able to capture one of the agencies' policy domains.

Regulatory Failure Versus Capture

Though lax enforcement is the most frequently cited problem in the OIG reports, they also show the agencies muddling through the technically complex task of regulating banks. The reports describe agencies making mistakes about the proper scope of their bank examinations or failing to accurately identify banks' problems. These mistakes suggest regulatory failure, but not capture. These problems are "innocent" mistakes, in the sense that they do not appear to be the result of industry lobbying or agencies catering to industry demands at the expense of the public interest. We might expect such mistakes to occur when agencies are supervising a technically complex policy area. These decision making errors contrast with the more deliberately risky decisions to not pursue strong enforcement.

It is important to note that these regulatory failures were often occurring in the context of lax enforcement. Often, they were occurring simultaneously with lax enforcement at the same bank. As seen in Table 25 below, most instances of the problems indicating regulatory failure occurred in instances where the agencies were also lax in their enforcement.

Table 25: Regulatory Failure in the Context of Targeted Agency Capture

	OTS (N=33)	OCC (N=31)	FDIC (n=44)	Fed (N=27)
Number of bank failures with poor decision making/information processing problems	21	15	29	13
Number of bank failures with both lax enforcement and poor decision making	18	13	24	10
Percent of poor decision making instances that occurred alongside lax enforcement	85.7%	86.7%	82.8%	76.9%

The table shows that most instances of regulatory failure occurred alongside lax regulation. However, there are a small number of bank failures where the primary problem was regulatory failure, not capture. These results add another dimension to the characterization of these agencies that capture theorists often miss.

Industry Failure Despite Adequate Regulation

There were also banks that failed despite agencies' best efforts. In these instances, the OIG deemed an agency's supervision appropriate even though the bank ultimately failed. These banks often failed because poor bank practices combined with an economic downturn. What bank practices contributed to failure? The OIG reports discussed in Chapter 3 also examined reasons for failure internal to banks. Problems with assets and management were frequently cited areas where problems occurred. Asset problems frequently occurred due to risky asset concentrations (which were discussed in detail in Chapter 5). Problems with management included poor risk management, poor underwriting, poor credit administration, aggressive growth, dominant board members, and the bank's unwillingness to comply with corrections suggested or required by regulators.

Identifying regulatory and industry failures shows that capture is the most frequent problem with regulation, but it is not the only one. Thus, though capture occurred, it may not be as pervasive as others have claimed, at least based on what we can conclude based on the available evidence. Even if it is as pervasive as others claimed and my results underplay its true extent, the accounts of captured financial regulators provide only a partial explanation of the problems at the agencies. They also downplay the extent to which there can be industry failures without regulatory culpability. Capture theory is just one among dozens of theoretical perspectives for interpreting the behavior of the bureaucracy (Hill 1991).

Mechanisms of Capture

How were some banks able to capture the regulators? My findings in Chapter 5 suggest that discretion is a mechanism that can explain lax enforcement. Bank supervision relies on few rules that are set in stone due to the complexity and diversity of the banking industry and its practices. This culture of discretion gives examiners and their managers flexibility to tailor their supervision to a particular bank's needs. However, a trade off is that a lack of clear agency rules strips examiners and managers of the clear justification for strong enforcement actions. Without these rules, examiners cannot always point to specific rules to justify enforcement recommendations. Contrary to much of the literature on bureaucratic discretion, which argues discretion is a source of power (Meier and Bohte 2007), I argue that reducing discretion could actually empower the banking regulators. In the section below discussing the implications for practice, I suggest how this might be done while still keeping much of the agencies' discretion-based culture intact.

Bank Performance and Agency Performance

Surprisingly, one measure showed that banks performed similarly regardless of their federal regulator. There was only slight variation for each agency in the number of their supervised banks that failed between 2007 and 2011. For other performance measures, there was small but substantively important variation across agencies in their supervised banks' performance. The variation came from some unexpected places. As expected, the agency with the largest losses to the Deposit Insurance Fund as a proportion of its total supervised assets was OTS. Unexpectedly, the FDIC had a loss to assets ratio similar to that of the OTS, while the loss to assets ratios for the Fed and the OCC were much smaller. Further, the highest proportion of bank failures that caused a very large loss to the Deposit Insurance fund occurred in the OTS supervised banks. Interestingly, for this measure, the OCC supervised banks performed similarly to those of the Fed and FDIC.

The agencies also diverged in unexpected ways in the proportion of their supervised banks that received bailout money. Bailout data suggest that banks supervised by the OCC, OTS, and the FDIC outperformed those supervised by the Fed, whose banks took a higher proportion of bailout funds than its proportion of the bank population supervised. Lastly, as seen above, according to the Inspectors General reports, the OCC was lax in its enforcement less often than the Fed, FDIC, and the OTS.

Given my initial hypotheses that the OTS and OCC were captured and that their supervised banks would perform worse as a result, these findings are surprising. The OTS's performance stood out alone as worse than the other three agencies for only one measure, for large bank failures. For other measures, there were one or more agencies that performed similarly to the OTS. In turn, the OCC was among the best or the best performer for each of the

measures examined. This evidence provides a small bit of vindication for the two agencies most heavily criticized after the 2008 financial crisis.

Most of these performance measures can, at best, suggest potential regulatory failure and capture, but they cannot prove it. As discussed above, banks can fail despite appropriate regulation or in conjunction with regulatory failure or capture. Relatively worse performance by one of the agencies could mean that one is more captured than the others. But they all could be equally captured or un-captured, according to this data. However, when banks fail, there is a good chance lax enforcement preceded the failure. Most of the failures for which we have detailed information from OIG reports showed evidence of lax enforcement and thus capture, as seen in Chapter 3. But without more detail about other failures, we cannot say for sure whether these failures indicate capture.

A useful solution would be to follow the recommendation that, at minimum, standard information for all failed banks should be public once they have failed (Administrative Conference of the United States 1995). Doing so would require Congress to amend the Freedom of Information Act. This information would allow the public, Inspectors General, and researchers to better analyze problems at the agencies while maintaining the protected sphere of information sharing between banks and regulators and to avoid a run on banks that can cause their failure. Doing so could be advantageous from the regulators' standpoint because the information could offer the opportunity to absolve them of blame. With that information, the public could see whether the failures were a result of something other than capture.

Responsiveness to Appointments and Economic Crises

Changing top agency leadership can affect agency behavior. The interrupted time series analysis in Chapter 4 provided some support that appointing new agency leadership affected

enforcement output. At the OTS, the leadership of Directors Feichter and Bowman affected enforcement output in a statistically significant way. At the OCC, the appointment of Comptrollers Ludwig, Hawke, and Dugan affected enforcement output in a statistically significant way.

However, the impact of some of these leadership changes is likely an artifact of enforcement increases due to the Savings and Loan crisis and the 2008 financial crisis. At the OTS, the decrease in enforcement under Feichter coincided with winding down enforcement in the wake of the S&L Crisis while the increase in enforcement under Bowman coincided with the onset of the 2008 financial crisis. For the four OTS directors in the interim years between the crisis, there were no significant changes in enforcement output, despite their being appointed by presidents of different political parties. Likewise, the decrease in enforcement under Ludwig at the OCC was likely a result of the decrease following the large spike in enforcement after the S&L and banking crises of the late 1980s and early 1990s. This interpretation is further supported by the fact that both the FDIC and the Fed showed statistically significant change in enforcement in the same direction at the time of both the S&L and 2008 crises. However, the significant increase in OCC enforcement actions under Hawke and subsequent drop under Dugan are not associated with a crisis and are thus more likely a result of these two appointments.

Evidence of the effect of appointments on patterns in enforcement is agnostic toward whether the agencies are captured. For example, the findings do not support that appointing a new director affected OTS enforcement output once we take into account the effect of economic crises. This finding could mean that OTS policymaking operates in an iron triangle where elected officials have little influence. Alternatively, the results could mean the OTS and its personnel are dedicated to its mission and that strong organizational culture allows it to remain so even with a

new appointment. On the other hand, appointments can matter, as evidence from the OCC demonstrates.

Should we expect appointments to matter? Some research suggests that the bureaucracy can operate in a dynamic manner by being responsive to a variety of inputs from elected officials and the policy system, including appointments (Wood and Waterman 1994). Another large body of research casts doubt on the ability of public managers to effect change (see for example Fernandez and Rainey (2006) for a review of the literature on the possibility of organizational change). Other research suggests that the characteristics of people in the bureaucracy are more determinative of bureaucratic outputs, as research on representative bureaucracy shows (Meier and O'Toole 2006). While my research does not attempt to settle disputes among these literatures, I do mention them to show that the resistance of the OTS's enforcement output to changes in appointments could mean a variety of things. Bureaucracies can be resistant or responsive to top personnel changes for a variety of reasons, only one of which is capture by the industry.

At the OCC, the results showed that two appointments affected enforcement output. The ability of political actors to influence enforcement output suggests that the OCC is not making regulatory policy in an iron triangle, and thus not captured. OCC enforcement showed a substantively and statistically significant rise with Clinton's second appointment, John Hawke and a substantively and statistically significant drop with George W. Bush's first appointment John Dugan. That the drop coincided with a change in party suggests that the agency was being responsive to changes in the partisan makeup of the elected branches, not the industry's demands. However, this line of reasoning assumes that the appointment itself was reflective of the public interest and that the industry had not captured the elected officials who made and

confirmed the appointment. This latter possibility means regulatory capture rather than agency capture could be present.

The responsiveness of agency enforcement to crises is evidence of capture, at least in the short term. Enforcement increases at the agencies retrospectively, after crises hit, indicating that they had the skill and capacity needed, but lacked the will to use it. Evidence from the failed bank reports examined in Chapter 3 suggests that the low level of enforcement before the 2008 crisis was evidence of short term capture whereby agencies were being lax and delayed in their enforcement. However, it is plausible that strongly captured agencies would not have increased their enforcement significantly after the crisis if the industry dominated the relationship. This increase suggests weaker capture in which the industry does not have an adequate grip on the agency to completely thwart a crackdown after a crisis hits. But when conditions are normal, the industry wealds enough influence to reduce agency intrusions.

Regulatory Capture

Because the data examined focus mainly on agency and industry performance, I cannot draw definitive conclusions about targeted regulatory capture or regulatory capture. I examined the elected branches only indirectly by studying appointment process as a mechanism of regulatory capture. As discussed above, two appointments affected enforcement output at the OCC. Because these changes coincided with appointments by presidents of different political parties, it is not clear whether the decrease is really evidence of capture or instead reflective of new regulatory philosophy, backed by the president, and ultimately the people who elected him.

The goal conflict and the perverse incentives inherent in the fee structure at the OCC and the OTS led me to hypothesize that these agencies were more susceptible to capture. But these structural features seem neither necessary nor sufficient to predict capture. The OTS and the

OCC, the agencies most susceptible to capture from these mechanisms, performed similarly to the FDIC and the Fed. One agency does not clearly stand out in the race to the bottom by banks seeking the friendliest regulator. The FDIC and the Fed do not have as strong budgetary pressures to keep banks under their primary supervision as the OCC and OTS, given that the latter two agencies are funded solely by fees charged to supervised institutions. If the OTS or OCC had been a clear leader in lax enforcement or poor performance of their supervised banks, I would have been more likely to conclude that their regulatory structure contributed to those outcomes, potentially signaling regulatory capture. But because the two did not significantly underperform the others, and the OCC actually outperformed the other agencies with respect to enforcement rigor, it is not clear their agency structure contributed to regulatory capture.

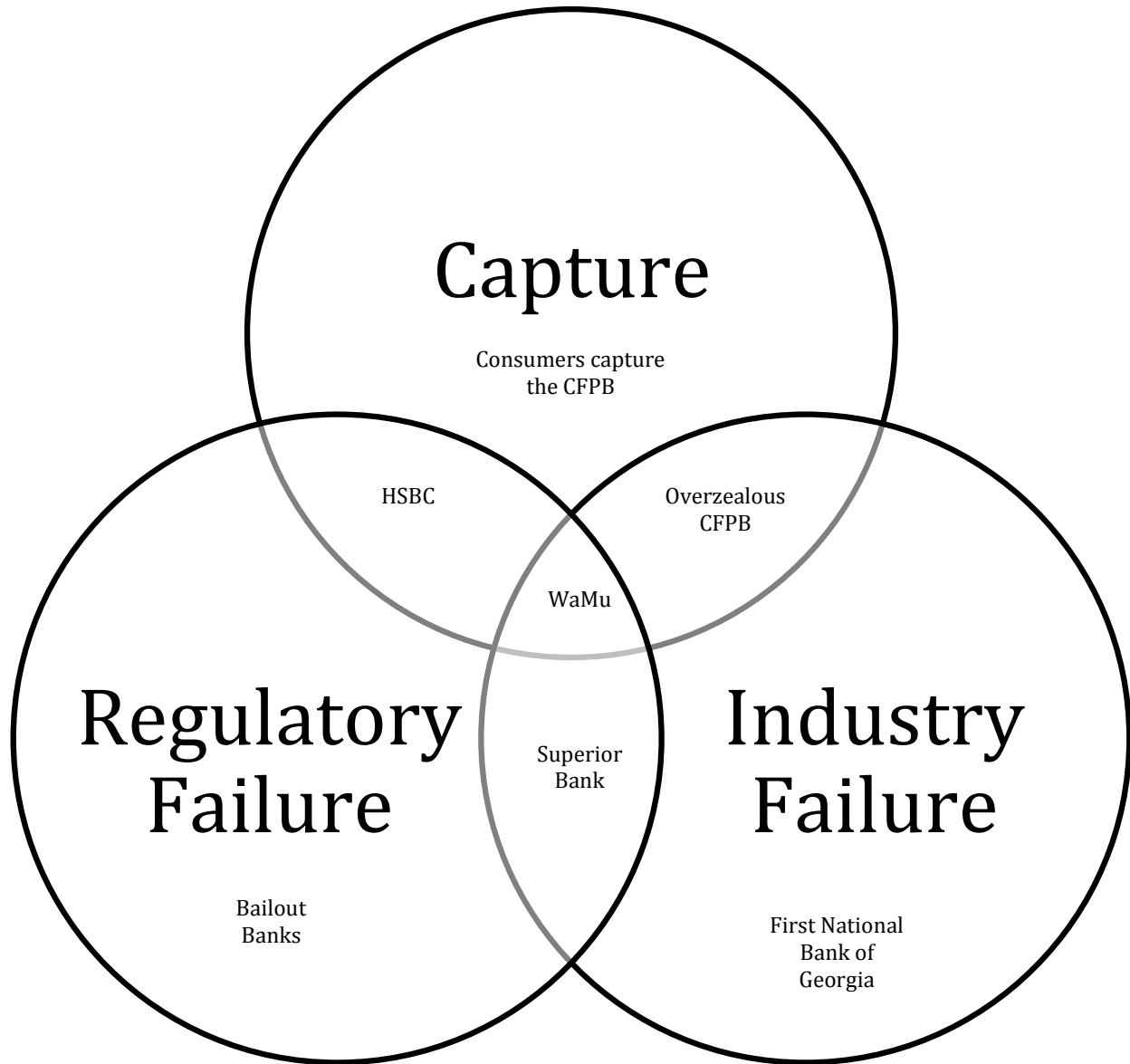
However, it is possible the banks have captured the overall regulatory structure by convincing policy makers to allow them the ability to select their regulator. How much pressure did agency competition for industry fees and regulatory arbitrage put on agencies to be lax? Given that agencies performed similarly, it is not clear. If the banking industry pressured policy makers to structure the OCC and OTS in such a way as to ensure they were easy on the industry, they did not get the desired outcome. But, regardless of funding source, all four have the incentive to maintain an adequate number of banks under their supervision to justify maintaining the authority to supervise part of the banking system. That pressure might encourage all four agencies to regulate less stringently than they otherwise would.

C. Implications for Theory

These findings have implications for both theory and practice. Below I discuss each in turn, as well as a few recommendations that could improve regulation.

Detecting Capture

How do we tell whether something is captured? My research affirms the work of other scholars who have cautioned that we cannot necessarily tell by observing disasters and reasoning backward that regulatory problems preceded it or even caused it (Carrigan and Coglianese 2012). Bad outcomes make us suspicious of regulatory failure or capture, but they are not direct evidence. Industry failures could be accidents that are part of the risk inherent in regulation (Carrigan and Coglianese 2012). Failures could be industry caused for which the regulators bear little or no blame. Or failures could be caused by poor agency decisions that fall short of agency capture. As illustrated in Figure 16 below, industry failure, regulatory failure, and capture can be mutually exclusive or overlapping events, so we must use caution when inferring that they two must occur together.

Figure 16: Venn Diagram—Industry Failure, Regulatory Failure, and Capture

As discussed in Chapter 2, First National Bank Of Georgia represents a case where the bank failed despite appropriate regulation from the OCC. Thus, there was industry failure without regulatory failure or capture. Superior Bank is a case where the OTS had expertise and decision making regulatory failures that ultimately contributed to the bank’s failure. Washington Mutual is a case where the three problems converged. WaMu failed, the OTS had numerous and consequential regulatory errors, and it was extremely lax in its enforcement.

The cases I investigated here do not fit neatly into the other categories of this Venn diagram, but clearly they are theoretically possible. I, therefore, describe examples to illustrate what might happen. There can also be capture without regulatory or industry failure. A theoretical example is consumer capture of the Consumer Financial Protection Bureau. Capture in this sense does not necessarily lead to industry failures and it would not represent regulatory failure because the Bureau was set up to serve the interests of consumers first and foremost. If the CFPB's regulation became too draconian, it could lead to industry failures, representing a case of both capture and industry failure. And as we saw with the case of money laundering at HSBC under the OCC's supervision, capture can overlap with regulatory failure when a bank captures its regulator in a fashion that does not lead to the bank's failure. This case illustrates that assuming agencies are not captured in the absence of bad outcomes can be just as problematic as automatically assuming they are when failures occur. Lastly, there can be regulatory failure without a bank failure, as was the case for many banks that received bailout funds.

Though the logic of inferring regulatory wrongdoing from industry failures is a seductive trap to fall into, we must use caution when doing so.

Capture on a Continuum

My research as well as other recent scholarship suggests that is useful to think of capture along a continuum (Carpenter and Moss 2013b). As mentioned at the outset of the chapter Carpenter and Moss (2013a) suggest thinking of capture as weak or strong. Doing so helps moves us beyond the false dichotomy of captured or un-captured agencies. The scope of capture typology I introduced can help us determine how strong capture might be by thinking of it along a spatial scope within the industry, agency, and elected officials.

While these suggestions help us consider capture in terms of degree or relative amount, time is also important. For example, early capture theorist Marver Bernstein (1955) incorporated a temporal component with his thesis about an agency's life cycle. He suggested that capture would tend to become more of a problem as the agency aged during its life cycle. As agency personnel lose their initial regulatory fervor, and Congress and the president are no longer as interested in the agency mission and are increasingly indifferent to the agency's budgetary needs, an agency will become increasingly reliant on the target of regulation for support, and thereby it will need to regulate the industry more favorably in return.

Likewise, my findings suggest that it is important to consider the scope of capture over time. My evidence suggests that capture in the financial industry could be cyclical rather than steadily increasing over time as the life-cycle thesis suggests. Enforcement tends to move with changes in the economy. Precisely when enforcement should be strongest, when the economy is booming, it tends to be weak, as illustrated by my time series analysis in Chapter 4. Just prior to the 2008 financial crisis and the S&L crisis, enforcement actions were low at all four agencies. Additionally, the OIG reports showed that enforcement was often lax because it was often delayed. I found that agencies tend to get strong too late or only after a crisis hits. This pattern suggests the need for counter-cyclical regulatory toughness.

Thinking of capture in marginal terms along the dimensions of space and time is useful because we might expect all agencies have to have a small degree of capture because they have to have a working relationship with those they regulate. A completely un-captured agency will make regulation difficult to impossible and promote deviance from targets. A completely adversarial relationship would be unworkable. Some degree of cooperation is necessary to promote information sharing (Bardach and Kagan 1982; Coglianese et al. 2004). But cooperation

can shift into cooptation. My evidence shows that there were clearly cases of more than cooperation.

The typology also helps to illustrate that allegations that the whole agency, either the OTS or the OCC, is captured may be overblown. The available evidence supports the fact that particular banks are able to capture particular agency employees at particular points in time and potentially for particular policy domains, such as subprime lending or money laundering. These findings need to be weighted against evidence that suggests regulatory failures and industry failures, as well as the evidence that the allegedly captured agencies performed similarly to those that were not accused of being captured. This fact should not downplay the significance of the evidence supporting capture or its contribution to the recent financial crisis, but it should add nuance to the stereotype of captured *agencies*.

The Relationship Between Agency Capture and Regulatory Capture

Despite my focus on the federal banking agencies and their problems, it is important that this focus not take away from the other problems in a poorly designed financial regulatory system, for which the agencies are not culpable. Congressional legislation allowed banks to become too big to fail, too interconnected to fail, too big to manage, and too big to prosecute (Angelides et al. 2011). Congressional legislation exempted derivatives from regulation (Johnson 2009). Congressional legislation created a fragmented financial regulatory system where no single agency had the mandate to look out for systemic risk or be attentive to abuses in consumer finance (Acharya et al. 2010). By the 1990s, both major political parties embraced deregulatory zeal such that there was little institutional opposition to financial deregulation (Hacker and Pierson 2010; Jacobs and King 2009). And failures of private institutions like the credit ratings agencies and banks themselves also contributed to the crisis (Angelides et al. 2011).

Though capture theory warns us to be attentive to agency behavior, it should not draw too much attention away from the larger political system of which regulatory agencies are only one component. Does agency capture make much difference within a system of probable regulatory capture? Perhaps. Though the agencies performed similarly on a range of performance measures, the OCC stood out as less often lax in its enforcement than the other three agencies and the Fed stood out as the agency whose banks were most likely to receive bailout funds. Thus, relatively captured or un-captured agencies may be able to make marginal differences within a captured regulatory system.

D. Implications for Practice

If agency capture is not so pervasive to make regulation hopeless, then what might we do to improve regulation? In other words, if the problem is improving regulation, how might we go about it?

Closing the OTS to Fix (Perceived) Agency Capture

The Dodd-Frank Act closed the OTS and dispersed its authority and employees among the remaining agencies, effective July 2011 (Offices of Inspector General 2011). Supervision for federal savings associations was transferred to the OCC, along with a majority of the OTS's employees. Rulemaking for federal and state savings associations was also handed to the OCC. Supervision of state savings associations was transferred to the FDIC along with a small number of employees whose work related to these entities. Supervision of thrift holding companies was transferred to the Fed, but the Fed did not receive any OTS employees.

The OTS was widely seen as the worst of the regulators, rightly or not. Its disfavor combined with a longstanding desire in the policy community to consolidate the banking regulators led to its demise (McTague 1989). Shortly after its creation in 1989, bills were

introduced to merge the OTS with the OCC. Several more were introduced over the following decades. There have been calls as early as 1971 to consolidate all the federal banking regulators into one comprehensive banking agency.

Will closing the OTS improve banking regulation? Despite the general assessment of the OTS and the longstanding consolidation proposals, my results suggest the OTS was scapegoated. It performed similarly to the other agencies, surprisingly, on a range of performance measures. Ironically, the policymakers decided to combine most of the OTS's authority and personnel with the OCC, the other agency that received the most accusations of capture. Compounding the irony, after the last S&L crisis, one reform was to eliminate the thrift industry regulator, transfer some of its functions to the other banking regulators, and create a new agency. That new agency was the OTS.

The Federal Home Loan Bank Board (FHLBB) oversaw the thrift industry before the savings and loan crisis of the 1980s. It was widely seen as captured and was "closed" with the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Its authority was dispersed among the other banking regulators and the newly created OTS. Its employees were transferred to the OTS. According to former Bank Board employees,

The day the OTS was created, they left the office, these agency [Bank Board] employees and they walked across the street to a hotel they turned on the TV, and they sat and watched the first President Bush stand up at a podium and declare 'never again will America allow any insured institution operate without enough money.' And then the agency employees watched as the President trashed their agency. The press conference ended, they turned off the TV, left the hotel, crossed the street, and went back to work. Pretty soon someone came by and changed the sign: The Office of Thrift Supervision" (This American Life 2009, 10-11).

Said one worker, "They didn't get rid of the agency on the org chart, they just renamed it" (Joffe-Walt 2010).

Whether the consolidation of many OTS functions and employees with the OCC is more than just window dressing remains to be seen. Eliminating the OTS and collapsing its employees and authority with an agency that performed only marginally better, is not going to fix any contributions the federal banking regulators made to the crisis. Given that the OCC's structural similarities to the OTS, in terms of a dual mandate, funding via fees on the supervised industry, and lack of overlapping regulation from the states, it is unclear how the OCC's supervision of thrifts will provide much of an improvement. However, as seen in Chapter 3, the OCC was less often lax in its enforcement, so the change could be an improvement. But as discussed in Chapter 2, the OCC had a poor record on consumer protection and preemption of stricter state consumer protection laws before the crisis. It has also had a poor record since the crisis handling the foreclosure scandal, combating money laundering, and making blatant attempts to disregard the Dodd-Frank Act's provisions against OCC preemption of state laws. Thus, the agency may not be much of an improvement.

Further, administrative reshuffling does not get rid of the problems that existed at all four regulators, including the problems that indicated regulatory failure and targeted agency capture. To combat those problems, additional reforms may be needed, as discussed below.

Altering Agency Discretion to Fix Targeted Agency Capture

As discussed in Chapter 5, the discretion-based culture at the agencies makes taking strong enforcement actions difficult because such actions need to be justified with more explicit rules. Combined with incentives for forbearance, the agencies were often lax in their enforcement. How can this incentive structure be changed? Twenty years ago the GAO conducted a study of the four agencies' performance in the wake of the S&L and banking crises and found similar results to those the Inspectors General found in their failed bank reports,

including weak and delayed enforcement. In response, the GAO recommended a “tripwire” approach be applied to agency enforcement decisions. The GAO argued the agencies should establish,

(1) industry wide measures of safety and soundness for asset, management, and earnings conditions to complement the capital standards; and (2) a prescribed set of increasingly strong enforcement actions to be taken when a bank does not satisfy these measures. Such measures established in regulation would provide benchmarks for all parties involved—bank managers as well as regulators. GAO believes such a “tripwire” system would help both regulators and bank management focus on problems that, if not corrected, will likely lead to capital deficiencies...such a system would eliminate some of the discretion presently available to both bank managers and regulators that appears to be leading to ineffective results. However, GAO also believes that regulators should continue to have discretion to waive specific enforcement actions so long as the reasons for such deviations have been justified, documented, and approved (GAO 1991, 8-9).

How would this system affect agency discretion? Though the bureaucratic politics literature tends to argue that there is a close connection between bureaucratic autonomy and power (Meier and Bohte 2007), when an agency faces a powerful client under conditions of high complexity and low public salience, changing the structure of autonomy could empower agencies to be stronger in their enforcement. In fact, according to the Inspectors General reports, many examiners said that, though they had a high degree of discretion to take enforcement actions, they felt disempowered because they lacked clear agency rules on which to justify taking action in many instances. In the face of powerful banks that would surely challenge the actions, the examiners often decided against the high costs of enforcement. Establishing an “opt out” system for enforcement whereby agencies are required to level enforcement when certain criteria are met or otherwise justify why no action should be taken could reduce the agencies’ tendency toward forbearance. Information gleaned from the Inspectors General failed bank reviews can be used to establish the tripwire criteria.

Leveraging OIG Data to Fix Industry Failure

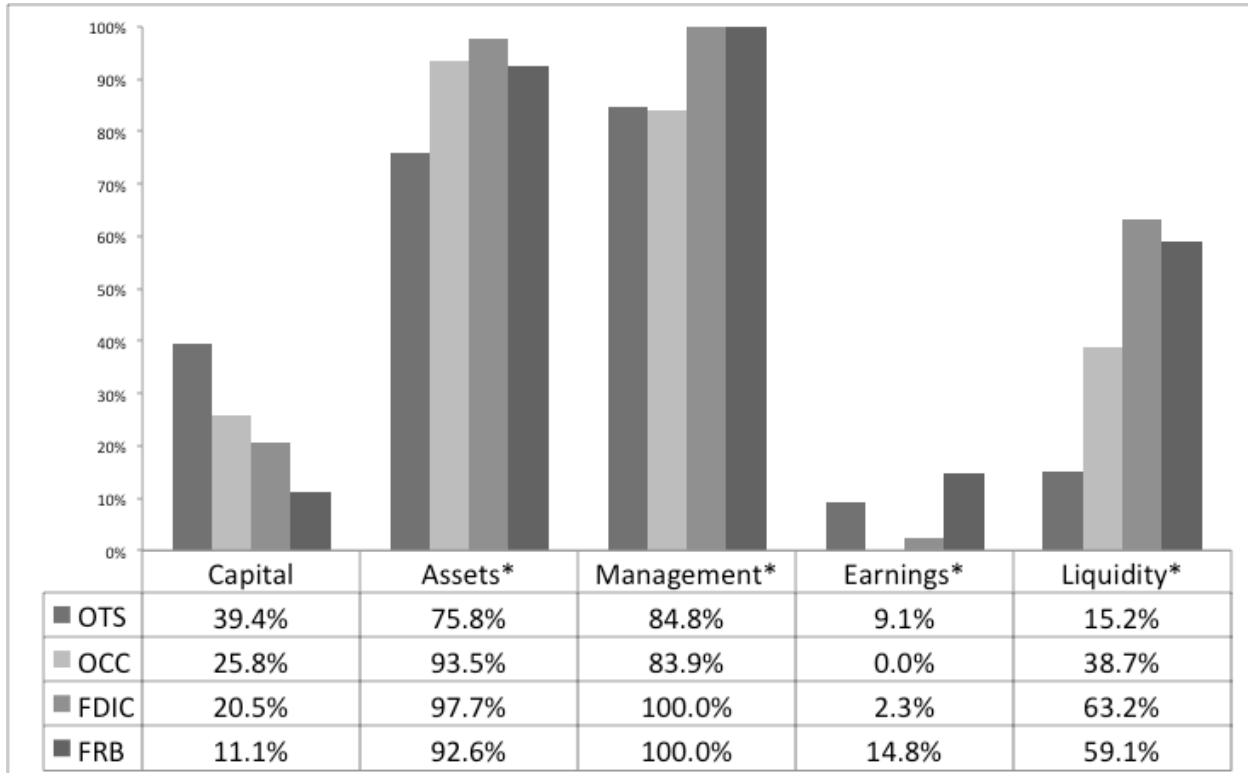
As discussed in Chapter 5, the agencies tended to rely too heavily on current financial performance in terms of capital and profits when assessing banks' risk level and issuing enforcement actions. Examiners had difficulty taking strong enforcement against banks that were well capitalized and profitable despite identifying problems that needed correction. If agencies hope to reduce the use of capital and profitability as the key indicators of success, they will need to establish a better evidentiary basis for showing that other factors can be grounds for taking enforcement action. Though the indicators of good management may not be as clear and quantifiable as capital or profits, patterns of what makes bad management can be gleaned from studying the OIG reports. Using these reports can establish the common patterns of behavior banks exhibit as they go down the road to failure, which could make stronger grounds to justify enforcement actions

Bank regulators have tended to point their finger at the quality of bank management as the key factor in bank failures (FDIC 1997). In an OCC study of bank failures in the 1980s (1988), it compared three groups of banks:

- Failed banks (171 between 1979 and 1987, 94 percent of all failures)
- Similarly situated banks that declined but were nursed to health (51 over the same period, had a CAMEL composite rating that moved from a 1 or 2, to a 4 or 5, and then back up again to a 1 or 2)
- Banks that did not have problems, despite problems in local economies (38 banks that maintained a CAMEL composite 1 or 2)

The study found that “while poor economic conditions make it more difficult for a bank to steer a profitable course, the policies and procedures of a bank’s management and board of directors have the greater influence on whether a bank will succeed or fail” (Office of the Comptroller of the Currency 1988, 1). Results showed that problems with management “played a significant role in the decline of 90 percent of the failed and problem banks” (Office of the Comptroller of the Currency 1988, 1). Specific problems included uninformed or inattentive boards and/or management, overly aggressive activity by boards and/or management, and management lacking in competence and integrity. Simply put, healthy banks have different internal practices by the board and management than failed banks, and they were healthy banks even in a similarly depressed economy. Despite experiencing similar economic conditions, healthy and recovering banks have management and boards of directors that are more competent and less likely to engage in risky or illegal behavior than those of failed or declining banks.

The OIG reports discussed in Chapter 3 also examined reasons for failure internal to banks. These category frequencies do not indicate better or worse overall performance by one of the agencies because we know from Chapter 6 that all agencies had a similar proportion of their supervised banks fail and cause a material loss to the Deposit Insurance fund. The category frequencies do indicate differences in the key areas where each agency’s supervised banks had problems. Figure 17 below shows the results of my content analysis of the bank problems the OIG identified, broken down by the CAMELS rating areas.

Figure 17: OIG Identified Causes of Bank Failure

*Statistically significant difference among agencies (Chi-square, $p < 0.05$; Fisher's Exact Test, $p < 0.05$)¹⁴

Problems with assets and management were the most frequently cited areas of concern. For the assets category, most problems were a result of risky asset concentrations (which were discussed in detail in Chapter 5). The leading problems identified within the management category included poor risk management, poor underwriting, poor credit administration, aggressive growth, dominant board members, and the bank's unwillingness to comply with corrections suggested or required by regulators. The fact that certain management problems are so clearly

¹⁴ For the assets category, post hoc analysis reveals that the OTS is statistically significantly different from the FDIC. For the management category, post hoc analysis reveals that the OTS and the OCC are statistically significantly different from the FDIC. For the Earnings category, post hoc analysis reveals that the OCC is statistically significantly different from the Fed. For the liquidity category, post hoc analysis reveals that the OTS is statistically significantly different from the FDIC and the Fed.

and consistently linked to bank failures should provide a stronger justification for taking forceful enforcement actions, even in the face of adequate capital and bank profitability.

Introducing Regulatory Contrarians to Fix Problems of Regulatory Failure

The suggestions above address problems of targeted agency capture and industry failure, but they may not fix problems related to the regulatory failures the Inspectors General identified. Introducing and/or strengthening the role of regulatory contrarians at the agencies can help with the latter problems. Regulatory contrarians have three key features: “First, they possess persuasive authority by virtue of their position, access to media and officials, or speaking engagements and reports. Second, they are affiliated with, and enjoy privileged access to, a regulatory entity but are nonetheless independent, as reflected in their budget, staffing, and/or priorities. Finally, they are tasked with studying the regulatory process, policy positions, and the regulated market and in some way reporting on deficiencies and potential improvements” (McDonnell and Schwarcz 2011, 1629). Examples include consumer representatives at agencies, agency ombudsman tasked with responding to public complaints, Inspectors General, and researchers employed by agencies (McDonnell and Schwarcz 2011). An advantage of having contrarians is that they can help combat problems agencies experience that contribute to poor regulation, such as cognitive biases like groupthink, and failures to respond to new risks and adapt rules accordingly (McDonnell and Schwarcz 2011).

Relative to my findings, the contrarians may be able to help agencies combat regulatory failures identified by the Inspectors General. One place where the federal regulators were slow to respond to market trends was on the consumer issues of subprime and predatory lending. As discussed in the previous chapter, the states had a much quicker and more aggressive response to

this problem. Contrarians with more authority to review and comment on these policies might push the agencies in a better direction.

The agencies also frequently had decision making errors about the proper scope for bank examination and failed to identify key problems at banks. More overview of select agency decision from Inspectors General instead of just post failure review could act as a better check against any systematic errors the agencies might be making. And because the contrarian has the role expectation to be critical and independent, they should have more incentive to do so.

E. Future Research Directions

My approach to evaluating the agencies has largely worked within the paradigm for how they organize themselves and conduct bank examinations. Put differently, my assessment has evaluated them by their own accepted standards. For example, the analysis of OIG reports was based on evaluating the agencies by the examination guidelines they set for how to conduct an examination and when to pursue enforcement actions. Assessing their performance based on bank failures is again assessing the agencies on a commonly accepted yardstick.

Yet, on another level, the agencies' entire examination paradigm may be flawed. Assessing the merit of this paradigm is beyond the scope of the present work, but it is a fruitful place for future research. The field of program evaluation offers useful ideas for considering the relative merits of the bank regulators' examination approach. This field is useful because the regulators are essentially engaging in program evaluation when they supervise banks. The regulators are judging the merit or worth of an object (Stufflebeam 2001), in this case the worth and merit of a bank and its personnel, and ultimately whether the bank should be shut down.

Stufflebeam (2001) identifies 22 evaluation approaches that emerged in the second half of the 20th century. Bank regulators use an accreditation/certification evaluation approach when

they examine banks. Stufflebeam (2001) describes this approach as follows: “Institutions, institutional programs, and personnel are studied to prove whether they meet requirements of given professions and service areas and whether they are fit to serve designated functions in society; typically, the feedback reports identify areas for improvement” (Stufflebeam 2001, 61). The key questions asked by accreditation evaluators are, “are minimum standards met?” and “how might performance be improved?” This model has often been used for accrediting educational programs. The examination approach of the bank regulators is strikingly similar. When bank examiners examine banks the approach is to determine whether a bank meets the requirements of each CAMELS area. The final product of the examination is a Report of Examination that details areas for improvement.

One key disadvantage of this approach is that it tends to focus on inputs and processes, at the expense of outcomes (Stufflebeam 2001). The focus becomes whether the program is meeting minimum accreditation standards rather than on the overall worth and merit of the program as judged by its outcomes. For example, the bank regulators were largely agnostic on the risk of various mortgage loans as long as consumers were informed of the terms. There was little judgment about whether these products should be offered at all. Other weaknesses include the fact that accreditation approach is “labor intensive, expensive, susceptib[le] to conflict of interest; overrelian[t] on self-reports and brief site visits; and... resistan[t] to independent metaevaluations” (Stufflebeam 2001, 80-89). As seen in many OIG reports, the banks took advantage of the fact that they self-report by sending the agencies quarterly information and often tried to mislead the agencies about their true health.

Overall, the accreditation model was judged by Stufflebeam as one of the top nine evaluation approaches that should continue to be used by future evaluators, but it was the

weakest of the nine. Though alternative evaluation approaches have weaknesses as well, there are many that rank much higher when judged against the standards outlined by the Joint Committee on Standards for Educational Evaluation (1994). One alternative is the consumer-oriented evaluation. This approach differs from the accreditation model because it is much more focused on the overall merit and worth of a program with its focus on outcomes. An independent expert should be assigned to reach a summative judgment about the program. Given that the bank personnel often seemed to lack the necessary independence from the industry, this approach could be useful.

For purposes of the practice of bank evaluation, the use of a weaker evaluation model suggests that an area for improvement is rethinking the evaluation/bank examination approach. For purposes of theory building, the use of an inferior model raises questions about why this model has been maintained and whether it is indicative of agency or regulatory capture.

F. Conclusion

Regulation can be properly structured to manage risk. But, we need to acknowledge that it can manage risk only, not prevent crises from happening entirely. Industry failures will occur even when the risk of failure is small (Perrow 1999) and they will only sometimes be the result of regulatory failure and capture. Just because we should expect some calamities to occur, does not mean we cannot learn from them to better guard against future ones. The findings in this dissertation have suggested a few ways to reduce the risk of failures by improving our understanding of the nature of agency and regulatory capture.

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ABSTRACT**THE FEDERAL BANKING REGULATORS: AGENCY CAPTURE, REGULATORY FAILURE, AND INDUSTRY COLLAPSE DURING THE 2008 FINANCIAL CRISIS**

by

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This dissertation examines the process of agency capture at four federal bank regulatory agencies leading up to the 2008 financial crisis: the Federal Deposit Insurance Corporation, the Federal Reserve, The Office of the Comptroller of the Currency, and The Office of Thrift Supervision. Though public administration and policy scholars have moved away from capture theory toward a more pluralistic understanding of agency policymaking, recent events like the Gulf oil spill, coal mining disasters, and the 2008 financial crisis have renewed attention to the role lax regulation plays in disasters and crises. As such, I set out to explore whether banks captured financial regulators, capture's causes, and potential recommendations for improving regulation.

To do so, I relied on multiple methods of analysis to investigate three data sources: 1) content analysis of Office of Inspector General reports about regulatory problems preceding bank failures, 2) interrupted time series analysis of trends in agency enforcement actions, and 3) a statistical comparison of the proportion of bank failures and bank bailout recipients supervised by each agency.

Evidence for capture is mixed. Interrupted time series analysis of trends over time in the agencies' enforcement actions show that the agencies are responsive to political controls and crises, not just the interests of the banking industry. Further, across performance measures, no agency's banks consistently performed the worst, which we would not expect to find if an agency were captured because of the lax treatment capture entails. On the other hand, enforcement increases at the agencies retrospectively, after crises hit, indicating capture in the short term. Though agencies had the skill and capacity needed to vigorously enforce their rules, they lacked the will to use it. Further, content analysis shows considerable evidence of lax enforcement for a large majority of failures across all four agencies. My analysis of these reports also reveals that the high degree of discretion given to bank examiners is a primary cause of capture.

My findings have implications for both theory and practice. With respect to theory, my findings run counter to, and help refine, the existing literature on public policy implementation, public administration, and bureaucratic politics. This literature suggests that discretion is a source of agency power. However, my findings indicate that in a policy area like banking regulation, which is highly complex and of low public salience, bureaucratic discretion undermines rather than enhances the power of regulatory agencies. The absence of detailed rules makes it difficult to take strong enforcement action against powerful clients because examiners need the hard and fast rules to justify taking action.

My findings also help scholars determine what is and is not capture by distinguishing among industry failure, regulatory failure, and capture. Though observers often fall into the trap of observing disasters and crises and inferring capture preceded these outcomes, we must be careful when doing so because these events can occur in the absence of capture and despite

appropriate agency supervision. Further, my findings also suggest that capture occurs on a continuum, which can vary in its strength and scope. To help determine the strength and scope of capture, I developed a scope of capture typology to establish the scope of capture within the industry, agency, and wider political system. This typology helps observers draw more nuanced and accurate conclusions about whether an agency is captured and the best place within the agency or the political system to make preventative changes.

With respect to practice, my findings suggest that the Office of Thrift Supervision, which is often singled out as the worst of the four banking regulators and was eliminated with the passage of the Dodd-Frank Act, was unfairly scapegoated. Many of the problems it had were just as prominent at the other three agencies, suggesting that the problems in banking regulation will not be eliminated by abolishing one agency.

AUTOBIOGRAPHICAL STATEMENT

Justin Rex graduated Bowling Green State University from in. 2008. He received a B.A. in both Political Science and Sociology and minored in Economics. He spent one undergraduate year studying abroad at the University of East Anglia, in England. He received an M.A. in 2010 from the Department of Political Science at Wayne State University, with a focus in American Politics. He finished his graduate career at Wayne State University in 2013, receiving a PhD in Political Science with concentrations in Public Policy, Public Administration, and Political Theory.