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# Regulatory Capture: Why It Occurs, How to Minimize It

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# REGULATORY CAPTURE: WHY IT OCCURS, HOW TO MINIMIZE IT

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*Gerard Caprio discusses the problem of regulatory capture, the undue influence of regulatory agencies by members of the industries they regulate, by identifying some examples of weak or non-existent regulation throughout the financial sector in both the United States and abroad. In an attempt to explain why regulatory capture occurs, Caprio uses the notion of "home-field advantage" from the world of sports. He argues that, much like referees overseeing a particular sport, regulators are influenced by a host of factors while still genuinely believing that they have acted in an unbiased manner. Finally, he suggests the concept of a "Sentinel" that would work to correct the regulators' bias in favor of the financial sector.*

## I. INTRODUCTION

The crisis that began in 2007, much like the Great Depression, has spawned a large literature on its causes, and has already led literally to thousands of pages of new regulations (just in Dodd-Frank, let alone in other countries). Reminiscent of the movie, *Casablanca*, all of the usual suspects (the causes) have been rounded up, except that for this crisis, the most popular explanation is that they all did it, meaning that a perfect storm of factors, which no one could possibly have predicted, occurred. The lesson drawn is that we need many, many new rules to prevent each of these from happening again, which is the reaction after each crisis. Much like the military, the result is that our generals are well placed to fight the last war.

Rather than a perfect storm, this explanation is better regarded as a perfect excuse. In the kitchen sink of factors listed as playing a role in the crisis, the one that gets the least, if any, attention is the role of

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regulators. This oversight is unfortunate, because regulatory inaction was an important factor and one that needs to be addressed. In the *Guardians of Finance: Making Regulators Work for Us,* my co-authors James Barth, Ross Levine, and I ask: What really happened in the crisis?[1] Why did it happen? And how can we fix it? In this brief paper I will review our answers. To summarize, our views are that regulators had the power to act, they had the evidence that something was going on, but they did not act. The question is: Why not? In addition to the various forms of economic capture, we suggest a form of psychological bias that in the world of sports explains "home field advantage." We also draw on the sports world to suggest a possible remedy in the world of finance, namely a form of instant replay for financial regulators. It is a controversial idea—many suggest that it is not practical. However, we see no other way to begin to hold regulators accountable. Legislatures have shown that they (alone) cannot do this job. Without some monitoring and/or reporting on regulatory behavior, we fear that regulatory accountability will remain just as it has been—virtually inconsequential—and that crises will continue to periodically wreck economies.

## II. REGULATORY INACTION

A large literature has detailed the warning signs of a crisis. A notable feature in the run-up to the crisis was the destruction of information. In the U.S. anyone with a television or with access to virtually any other media outlet saw advertisements for so-called NINJA[2] loans, namely those that required no documentation of income, jobs, or assets. So, although there was a lot of financial innovation going on that hid some of the risk-taking, on the other hand the public and the regulators had proof right in their faces every day that something very different was happening in the industry. Record leverage levels—certainly visible in aggregate data, even though individual bank data were polluted by the use of off-balance sheet

1. James R. Barth, Gerard Caprio Jr., & Ross Levine, GUARDIANS OF FINANCE: MAKING REGULATORS WORK FOR US (2012) [hereinafter GUARDIANS OF FINANCE].

2. The abbreviation "NINJA" means No Income, No Job or Assets, referring to loans that did not require any documentation of these key borrower attributes. Such loans were also referred to as "no documentation" or even "liar loans," meaning that the borrower (or the loan broker) could write down any information that would facilitate loan approval.

entities—were visible to any who cared to look. Similarly, the record pay in the financial sector, though not quite as visible, was known to the regulators, as they were having a harder time retaining qualified personnel. All of these warning signs should have told them that excessive risks were being taken. Since their job is to look out for society's welfare, they should have been worried about this risk-taking, so worried as to cause them to intervene aggressively to stop it, which is what the public, the people for whom they work, would have wanted.

In the *Guardians of Finance*, we spend quite a bit of time detailing the underperformance by regulators at the Federal Reserve, the Office of the Comptroller of the Currency, the FDIC, and the SEC, so these examples will not be reviewed here. One related item that recently re-emerged, however, was evidence of Alan Greenspan's unwillingness to intervene. In the *Guardians of Finance*, we note that in 2004 Greenspan's Fed was informed by a confidential FBI report suggesting that widespread fraud was occurring in mortgage markets. Despite the report, it chose not to act. More recently, in the wake of the LIBOR scandal, we learned from Greenspan,

> [t]hrough all of my experience, what I never contemplated was that there were bankers who would purposely misrepresent facts to banking authorities. . . . You were honorbound to report accurately, and it never entered my mind that, aside from a fringe element, it would be otherwise. I was wrong.[3]

Perhaps candidates for regulatory positions first need to be asked if they understand why financial institutions might have an incentive to disguise their true condition! The SEC under Christopher Cox unfortunately behaved as if it too were opposed to enforcing the regulations with which it was charged. Without any significant accountability, regulators can both ignore basic incentives and choose not to enforce regulations.

While it is true that recognizing a bubble is oftentimes difficult, Figure 1 shows the unprecedented nature of housing prices in the U.S.

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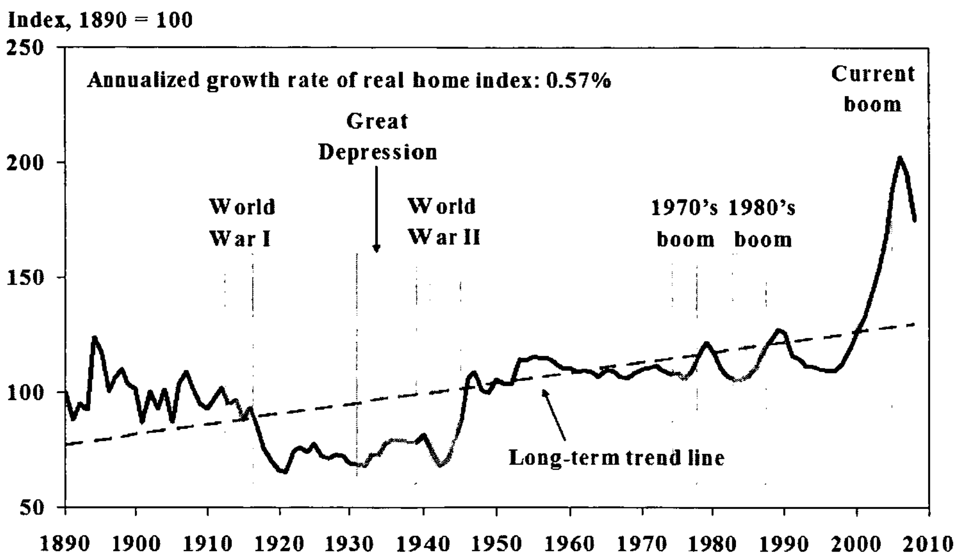
3. Liam Vaughan & Gavin Finch, *LIBOR Lies Revealed in Rigging of $300 Trillion Benchmark*, BLOOMBERG, Jan. 28, 2013, http://www.bloomberg.com/news/2013-01-28/libor-lies-revealed-in-rigging-of-300-trillion-benchmark.html?src=longreads&buffer_share=65f56&utm_source=buffer.

through the early to mid-2000s. In the U.S. we have housing data going back to the 1890s in real terms. By 2004, although no one at the time could have predicted the turning point, it should have been clear that it was not likely that housing prices could continue their rise, yet the assumption of continued increases were built into many of the mortgages that were being originated at the time. Although many in the market were myopic, forgetting the past behavior of housing prices, this figure [Figure 1] makes clear that what goes up does indeed come down, or as Charles Kindleberger used to say, "Trees do not grow to the sky."

**Figure 1. Housing Booms and Busts**[4]




Less well known in the U.S. is the evidence from other countries' crises. The early 2000s saw housing bubbles not just in the U.S., but also notably in Ireland and Spain. If the U.S. had experienced an increase in its housing stock commensurate with that seen in Ireland, there would be about another few million empty houses today, which makes it easier to understand the magnitude of the increase in Ireland's housing stock. And Spain's boom, although a bit smaller in terms of the increase in supply, was characterized by an even greater price rise.

4. James R. Barth, THE RISE AND FALL OF THE U.S. MORTGAGE AND CREDIT MARKETS: A COMPREHENSIVE ANALYSIS OF THE MARKET MELTDOWN 68 (2009).

In Iceland, Ireland, and the United Kingdom, there was much less securitization than in the U.S., but the common features were excessive risk taking and a form of regulatory abdication, even in many continental European countries. The crisis was not just confined to the countries that were originating and selling risky (mostly mortgage) securities, as a large percentage of U.S. mortgages were held abroad.[5] True, those purchasing AAA-rated securities can say that they were doing so because of their high rating and high rate of return. But why were their regulators not asking questions like, "If these securities are paying rates of return above that of AAA-rated securities, should we believe that they're really AAA?" There is no record of that question being posed, yet many of their banks (UBS being a notorious example) needed government support.

I happen to find the foreign crises much more interesting because they were much simpler to observe, yet the regulators in those countries failed just as spectacularly as those in the U.S. In the fall of 2008, Irish bankers claimed that their funding difficulties were solely due to the handling of Lehman, and convinced the government to offer their creditors a blanket guarantee. Similar allegations were made in other countries. Subsequently, in Ireland, Iceland, and in the United Kingdom, official reports have recanted this view and instead assert that their crises were fully home grown.

Certainly that was the case in Ireland. Patrick Honohan, appointed Governor of the Central Bank a year after the guarantees were given out, produced a report in early 2010 stating that the regulatory approach in the early 2000s was excessively deferential and accommodating.[6] One example was the oversight of Anglo-Irish Bank, which had been growing by about forty percent a year in real terms for the decade up to 2007—even though bank supervisors are taught early in their careers that no bank survives even a fifteen to twenty percent growth rate for long, as management cannot prudently control a bank doubling in size every 3-5 years, much less one doing so every twenty months! Supervisors also found that a third of the bank's loans were made on an exceptions basis, meaning the bank was violating its own lending criteria. Yet, all that the Irish regulator did was to write a letter to the bank, let two and one-half years go by without a reply, and then

5. *Id.* at 31-32.
6. GUARDIANS OF FINANCE, *supra* note 1, at ch. 5.

took no further action. Similar inaction was seen in Iceland, where regulators admitted to a Parliamentary Commission that, after neglecting to act for so long in the wake of unsafe banking practices, they continued to do so in part because they saw that the practices had not produced any problems, while also not wishing to call attention to their earlier failure to act.[7] All this, and United Kingdom regulators even gave Northern Rock their approval to adopt the advanced IRB (most sophisticated risk modeling) approach to calculate minimum capital requirements and to pay an increased dividend within months of the run on that notoriously overleveraged and underfunded bank.

Regulatory bias seems to continue today. In the case of the famous "Morgan Whale," excessive risk taking led to a $6 billion dollar loss in 2012,[8] yet according to public statements, regulators were not even close to recognizing the source of those risks.[9] In early 2013, leaked allegations by supervisors at the Bank of Spain disclosed that warnings to their superiors about the Spanish banks were being ignored; an investigation is ongoing.[10] The money laundering arrangements between Standard Charter and Iran were taken up and exposed by state regulators; federal regulators were not involved.[11] And regulatory authorities neglected the LIBOR scandal for years, as evidenced in Greenspan's sentiments quoted above.[12] Recall from the film *Casablanca* that Inspector Renault also was "shocked to find that there was gambling going on," just as he was collecting his winnings.[13]

The examples outlined above are part of a larger trend in weak to non-existent governmental regulation in the financial sector. My co-authors and I highlight regulatory inaction in some previous crises—notably the Savings and Loan crisis in the 1980s—in the *Guardians of*

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7. *Id.*

8. Maureen Farrell, *Senate on London Whale: Worse Than We Thought*, CNN MONEY (Mar. 15, 2013), http://money.cnn.com/2013/03/14/investing/jpmorgan-senate/index.html.

9. The statement of Senator Carl Levin is an example. *See id.*

10. Tobias Buck, *Bank of Spain Rejects Audit Allegations*, FIN. TIMES, Jan. 10, 2013, http://www.ft.com/intl/cms/s/0/1c89626a-5b4e-11e2-8ccc-00144feab49a.html#axzz2a5pdmvV2.

11. Jessica Silver-Greenberg, *British Bank in $340 Million Settlement for Laundering*, N.Y. TIMES, Aug. 14, 2012, at A1, *available at* http://www.nytimes.com/2012/08/15/business/standard-chartered-settles-with-new-york-for-340-million.html?pagewanted=all&_r=0.

12. Vaughan & Finch, *supra* note 3.

13. CASABLANCA (Warner Bros. 1942).

*Finance.*[14] As the evidence suggests, lax regulatory oversight, or regulatory decisions that appear to favor bankers at the expense of the public, appear to be the norm.

## III. CAPTURE, BY ANY OTHER NAME

Why would regulators be so deferential to banks? The cause might, of course, be regulatory capture, a theory discussed by many economists since George Stigler first published his famous piece, *The Theory of Economic Regulation.*[15] In addition to outright bribes, regulators might be enticed by the prospect of a much better paying job in the private banking sector in exchange for current light supervision. We have no doubt that the latter occurs, notwithstanding the limits that some countries impose before regulators can join banks, and even bribery or other forms of favors (e.g., the so-called Keating Five in the U.S. Savings and Loan crisis) must occur in some circumstances. Yet the puzzle to my co-authors and I—each of us worked in and later with different regulatory agencies—is that we saw dedicated and highly competent staff, who did not take jobs in the private sector and appeared to be scrupulously honest, seemingly doing their job as well as possible. Why would those regulators act as if they were biased?

The answer, we believe, is found in the world of sports. In *Scorecasting: The Hidden Influences Behind How Sports Are Played and Games Are Won*, Moskowitz and Wertheim explore "home field advantage," namely that over all refereed sports, throughout history—and they have over 100 years of data on baseball—home teams win more games than visiting teams do. The conventional answer as to why there is a home field is the psychological effect of the crowd on the players. Moskowitz and Wertheim use data and examples to debunk this myth. For instance, they argue that in basketball (soccer) the influence of the fans on the players should be at its peak during a foul shot (penalty kick), when the action is focused on the player and the ball and, of course, the fans. When the visiting player is attempting to score, the crowd is trying to exert its influence to distract that player. When it is the home team's turn, the crowd is silent. Wertheim and Moskowitz

14. GUARDIANS OF FINANCE, *supra* note 1, at ch. 6.

15. *See generally* George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

show that the percentage of foul shots made (penalty kicks scored) is identical for visiting and home teams. In other words, the crowd has no detectable influence on the players, even at the point when its influence is considered to be at its maximum.

So, if it is not the impact of the fans on the players, what accounts for home field advantage? Another typical answer is the possible differences in weather. Teams from the South regularly are said not to play well in the cold and vice versa. The authors rule this out as well with data, but also with the observation that home field advantage is seen when "cross town teams" (e.g., the New York Mets and the New York Yankees) are playing one another. And the home field advantage is not explained by travel fatigue—it did not change over 100 years in baseball, despite the advantages today of air travel, and it occurs in Dutch soccer, where distances are insignificant. Moskowitz and Wertheim debunk other purported explanations as well.

Instead of all of these possible factors, they find that home field advantage results from the psychological effect of the crowd on the officials, and they have a lot of data to support this claim.[16] The examples I like the best are from baseball: electronic cameras "painting" the strike zone revealed that zone to be significantly larger when the visiting team was at bat, even though the umpires insisted (and truly seemed to believe) they were calling the game in an unbiased fashion.[17] What the authors believe is happening is that referees and umpires are human and want to be liked, so that they end up siding with the home team—which is why umpires who move from the home stadium of the Yankees to the home stadium of the Mets soon switch allegiance and call games in favor of the latter, while insisting that they are without bias.[18] In soccer, Moskowitz and Wertheim showed that when the home team was slightly behind (ahead), the number of penalty minutes, the time during which they might catch up (fall behind), was larger (smaller), whereas when the home team was ahead or behind by a large amount, there was no significant impact on the penalty time.[19] The authors argue that across all refereed sports, psychological capture is an

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16. Tobias J. Moskowitz & L. Jon Wertheim, SCORECASTING: THE HIDDEN INFLUENCES BEHIND HOW SPORTS ARE PLAYED AND GAMES ARE WON (2011).

17. *Id.*

18. *Id.*

19. *Id.*

important explanation.

We believe that this same force operates in the game of financial sector regulation, where the regulators perform the function of the referees. In this game, between the financial services industry and the public, those same groups are in the stands as well, however, the public is sitting in the 'nosebleed' seats, so far removed from the game that they cannot even see what is happening, much less understand it or exert any influence on the regulators. The bankers and their nonbanking counterparts are in the plush, close-in box seats, and they have the greatest influence on the regulators. The resulting psychological bias explains why even seemingly honest, well-intentioned regulators side with the industry, and yet genuinely believe that they are unbiased. That regulators' meetings and phone calls with the bankers have exploded in the 2000s, while their meetings on regulatory matters that are open to the public have shrunk to virtually nil, is symptomatic of this influence.[20]

## IV. DEALING WITH CAPTURE

Regardless of whether regulators are biased in favor of industry because of financial or psychological factors—or even as was seen in some transition countries, because they feared for their lives—what might be next asked is, "Why do they get away with it?" We argue that it occurs because the public does not have the information, incentives, and skills to monitor the financial system. Most members of Congress (Senator Elizabeth Warren and a few others to the contrary, notwithstanding) do not have the staff or skills to do so, nor are most legislators willing to risk a reduction in the political contributions they receive from the industry, which much prefers lax regulation. In some countries, regulators are left to police themselves, which is the approach in the Dodd-Frank legislation, as embodied in the Financial Stability Oversight Council (FSOC). Here, the idea is that the regulators meeting together will watch over each other. This ignores the fact that there have been interagency groups of financial regulators since the 1970s that have not succeeded in countering "home field advantage" in

20. Victoria McGrane & Jon Hilsenrath, *Fed Writes Sweeping Rules from Behind Closed Doors*, WALL ST. J., Feb. 21, 2012, at A1, *available at* http://online.wsj.com/article/SB10001424052970204059804577225122892450312.html.

banking. As professors, we know that if we let our classes grade themselves, it would be rare for anyone to obtain a grade below A. We would expect that same behavior at FSOC; regulators have told us that they would not speak out against another regulatory agency in these fora. And in countries with a single regulator, letting the agency police itself is equivalent to letting the students set their own grades. The result will not surprise anyone.

So what could work to limit regulatory bias? Again the answer comes from the world of sports. When baseball umpires were told that electronic cameras were observing their every call, home field advantage went away—the strike zone became the same size for the visiting team and the home team. Across sports that have adopted instant replay, home field advantage has shrunk dramatically to almost zero. At Wimbledon in June 2012, there was one particularly egregious call (I recall that it was in favor of Andy Murray, the British player). Immediately the call was reversed by the linesman. He corrected himself, just as the television audience was seeing on instant replay that the linesman's revised opinion was exactly correct. John McEnroe, commenting on the match on U.S. television, said that with instant replay, "You might as well call it right the first time because they're going to catch you anyway." This effect is precisely what is needed in the world of financial regulation.

Thus, in the *Guardians of Finance*, we propose borrowing from sports the concept of instant replay.[21] In order to do that, what we think the public needs is some type of informed, expert group that would hold regulators accountable. Our corrective mechanism is a small watchdog group, borrowing from James Madison, which we call the Sentinel.[22] This agency would have no regulatory authority whatsoever, but rather resembles the post-airplane crash teams that investigate the accident: the only power is to produce a report, whose credibility relies on the skills of the team and their access to all information. However, in finance, rather than waiting until after a crisis, we argue that this group should be in office continuously and issuing a report regularly seeking to identify key systemic risks in the system and asking what regulators are doing about them. Had a Sentinel existed in say 2004, it might have been able to reveal that the Fed had what was then a confidential report

21. GUARDIANS OF FINANCE, *supra* note 1.
22. *Id.*at ch. 8.

from the FBI showing widespread fraud in the mortgage markets and did not do anything about it. In fact, the possibility of that disclosure might have induced the Fed to take action. Or, an Irish Sentinel could have exposed the fact that the Irish regulator had all the evidence that the Anglo-Irish Bank was taking absurd risks and yet chose not to act.

Are there credible alternatives to a Sentinel that would correct regulators' bias in favor of the bankers? One response to the idea of the Sentinel is to recommend instead "fixing the regulator." Unfortunately, this misses the point. No vetting process, no oath of office, not even legislation requiring intervention will work. As we noted in the *Guardians of Finance*, notwithstanding the FDICIA legislation that required prompt corrective action, the FDIC's own material loss reviews disclosed that in a large number of cases the FDIC intervened only months after it had the requisite information, and this was for small, domestic banks.[23] Although we discuss the possibility of using deferred pay for regulators, which might be forfeited if they did not do their job well, the writing and enforcing of such a contract poses very difficult problems.[24] If poor performance is defined too generally, the regulator might try to eliminate all risk taking in the industry, which clearly would hurt economic performance. Or if the regulator's performance was to be reviewed by a panel of experts, that possibility would make it very hard to fill the position, as who would be willing to be exposed to arbitrary judgments, except for a massive base salary?

A Sentinel seems more likely to work than the above alternatives, but of course would not guarantee better regulation, and it would be difficult to make it effective. It would have to possess the power to demand all the information that the regulator has—not to divulge all of it—but to provide an independent, informed assessment of what the regulator is doing, and it would need the power to have regulators removed or otherwise penalized for failure to comply. Even if the public had all of the information available to the Sentinel, it would not have an idea—or perhaps far too many ideas—of how to interpret the massive data. The Sentinel also would need to house a mix of financial sector skills, such as financial economists, bankers, financial

23. For an example of a Material Loss Review Report, see OFFICE OF INSPECTOR GEN., OFFICE OF AUDITS AND EVALUATIONS REPORT NO. AUD-12-014, MATERIAL LOSS REVIEW OF TENNESSEE COMMERCE BANK, FRANKLIN, TENNESSEE (Sep. 2012), *available at* http://www.fdicoig.gov/reports12/12-014AUD.pdf.

24. GUARDIANS OF FINANCE, *supra* note 1.

lawyers, forensic accountants, and to limit revolving door incentives it would need to pay highly attractive salaries, likely with long prohibitions on moving to the private sector.

Many people tell us this is impractical. We agree. It would be hard to do. Regulators after all are human, and however they feel about accountability in general, they do not want someone looking over their shoulder. As noted, the industry itself does not want tougher regulators. And in most countries, especially the United States, high salaries for public officials are unpopular—even apparently if it means saving trillions of dollars periodically. However, until we are willing to create and pay for a Sentinel, the game of financial regulation is likely to resemble the game of soccer, one of the few sports without instant replay. Recall the notorious "Hand of God," the World Cup soccer match in which Diego Maradonna, playing in Latin America for Argentina against England, used his fist to punch the ball into the goal. The referee, with an unobstructed view, ruled it to be a legal "header." I don't know if he was concerned about his life, if he was bribed, or if he was psychologically biased by the crowd. I just want to get him to call the game honestly, and with instant replay you would at least have a chance of having that outcome. Until there is a Sentinel in the financial sector, we are likely to continue to have regulators who rule in favor of the financial industry.