

Keynote Address

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KEYNOTE ADDRESS

BROOKSLEY BORN*

I am delighted to be with you for this important Symposium on issues relating to regulatory enforcement. I thought it might help to frame the discussion you will hear tomorrow about enforcement problems in the financial services area by describing the profound deregulatory forces that have been at work in the United States for more than thirty years.¹ Deregulation of financial services was one of the major causes of the 2008 financial crisis and underlies many of the enforcement difficulties we are experiencing today. Decades of deregulation have seriously undercut the rule of law as applied to the financial services industry.

My views on this issue are informed by my service as Chair of the Commodity Futures Trading Commission in the late 1990s, where I worked with your professor Michael Greenberger in an unsuccessful effort to impose much needed rules of the road on the enormous and dangerous over-the-counter derivatives market, a market which later played a significant role in the 2008 financial crisis. My service on the Financial Crisis Inquiry Commission (or “FCIC”) investigating the causes of that crisis brought home to me the devastating impact of the systematic dismantling of business regulation in the financial sector. The FCIC concluded that failures in financial regulation and supervision along with failures of corporate governance and risk management at major financial firms were prime causes of the financial crisis.²

In response to the Great Depression of the 1930s, this country put in place simple and commonsense regulations governing the fi-

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1. This speech was adapted from an earlier article, Brooksley Born, Foreword, *Deregulation: A Major Cause of the Financial Crisis*, 5 HARV. L. & POL’Y REV. 231 (2011).

2. FIN. CRISIS INQUIRY COMM’N, FINANCIAL CRISIS INQUIRY REPORT, at xviii–xix (2011) [hereinafter FCIC REPORT], available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

financial sector in an effort to protect the public from its excesses. We adopted federal deposit insurance for commercial banks and insisted that in return the banks abandon dangerous and speculative activities. We created federal oversight of securities and derivatives markets and subjected professionals in those markets to regulation. These regulatory actions did much to protect the economy and the public from financial disaster for seventy years.³

However, the lessons of the Great Depression were gradually forgotten. As the report issued by the FCIC documents, decades of deregulation and failure to regulate newly emerging financial markets, firms and products led to a financial system that was extremely fragile and vulnerable to a full blown crisis when the U.S. housing bubble collapsed in 2007 and 2008. Federal Reserve Board (“Fed”) Chairman Ben Bernanke told the FCIC, “Prospective subprime losses were clearly not large enough on their own to account for the magnitude of the crisis. Rather, the system’s vulnerabilities, together with gaps in the government’s crisis-response toolkit, were the principal explanations of why the crisis was so severe and had such devastating effects on the broader economy.”⁴

These vulnerabilities in our financial system were the direct result of a growing belief in the self-regulating nature of financial markets and the ability of financial firms to police themselves. Former Fed Chairman Alan Greenspan—a laissez-faire economist and an Ayn Rand disciple—championed these beliefs during his nineteen years in office. With support from large financial services firms, their trade associations and like-minded economists, he was able to persuade policymakers in successive presidential administrations, members of Congress, and federal financial regulators to support deregulatory efforts on the grounds that self-regulation was sufficient.⁵

The financial sector devoted enormous resources to its effort to convince federal policymakers of the need for such deregulation. In the decade leading up to the financial crisis, the sector spent \$2.7 billion on federal lobbying efforts, and individuals and political action

3. See generally Michael Greenberger, *Overwhelming a Financial Regulatory Black Hole with Legislative Sunlight: Dodd-Frank’s Attack on Systemic Economic Destabilization Caused by an Unregulated Multi-Trillion Dollar Derivatives Market*, 6 J. BUS. & TECH. L. 127, 129 (2011) (discussing the implementation of protective legislation, specifically the Commodities Exchange Act, in response to the Great Depression of the 1930s).

4. FCIC REPORT, *supra* note 2, at 27 (quoting Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Written Statement before the FCIC 2 (Sept. 2, 2010)).

5. *Id.* at xviii.

committees related to the sector made more than \$1 billion in federal election campaign contributions.⁶

As a result of these pressures, significant regulatory gaps developed in the financial system, including the lightly regulated shadow banking system that grew to rival the traditional banking system in size and importance and the enormous market in over-the-counter derivatives. A number of investment banks grew to be of systemic importance without adequate oversight. Institutional supervision of large bank holding companies, commercial banks and thrifts was gradually weakened, allowing them to engage in riskier activities. Mortgage lending standards deteriorated, and securitization of mortgage-related assets burgeoned with little regulatory scrutiny. These developments created the conditions that caused the collapse of the housing bubble to turn into a major financial crisis. As Fed Chairman Ben Bernanke told the FCIC, “As a scholar of the Great Depression, I honestly believe that September and October of 2008 was the worst financial crisis in global history, including the Great Depression.”⁷

These deregulatory actions not only contributed significantly to the financial crisis but also laid the groundwork for many of today’s enforcement problems. Let me describe a few examples of deregulation.

First, there was a failure to enforce needed mortgage lending standards. The FCIC found that there was an explosion in risky mortgage lending accompanied by a significant deterioration in mortgage lending standards in the years leading up to the financial crisis, with many mortgage lenders ignoring borrowers’ ability to repay their loans. Because lenders no longer held loans for the duration of the mortgages, but instead sold them to mortgage securitizers, they passed on the risks of the loans and had little incentive to maintain high lending standards. In addition, lenders made many predatory loans designed to impose high interest payments or other terms increasing the yield on the loans.⁸

The FCIC found that the Federal Reserve Board had the statutory authority to regulate the terms of mortgages issued by all lenders nationwide and to address predatory lending practices under the Home Ownership and Equity Protection Act of 1994.⁹ The Fed was well aware of the widespread abuses in mortgage lending practices,

6. *Id.*

7. *Id.* at 354 (quoting Interview by the FCIC with Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., 24 (Nov. 17, 2009)).

8. *Id.* at xvii, xxiii–xxiv, 125.

9. *Id.* at xvii; Pub. L. No. 103–325, §§ 151–158, 108 Stat. 2160, 2190 (1994).

having received reports from lenders, consumer advocates, and its own staff, but refused to exercise its authority to rein them in.¹⁰ Moreover, states were restricted from applying their laws prohibiting lending abuses to national banks and thrifts because federal supervisors had pre-empted state law.

Stemming the volume of risky mortgages might well have prevented the housing bubble that triggered the financial crisis or at least mitigated its effects. Current Fed Chairman Ben Bernanke told the FCIC that the failure to regulate the mortgage market during the housing boom “was the most severe failure of the Fed in this particular episode.”¹¹

Second, there was a failure to police mortgage securitization. The FCIC found that many of the risky mortgages were securitized and sold to investors around the world. Indeed, between 2003 and 2007, \$4 trillion of mortgage-backed securities and \$700 billion of mortgage-related collateralized debt obligations or CDOs were issued.¹² This mortgage securitization fueled the demand for risky mortgages and contributed significantly to the housing bubble.¹³

The large financial institutions creating and selling these securities were transferring the risks of the underlying poor quality mortgages to their purchasers. Those investors were lulled into a false sense of security because of the high credit ratings of the securities and the availability of credit default swap protection from large institutions such as insurance giant AIG. When the housing bubble burst, many of these securities were downgraded and lost most or all of their value.

The FCIC found that in a number of instances the securitizing firms sold the securities to investors without full and adequate disclosure of the quality of the loans.¹⁴ As the FCIC report states,

[F]irms securitizing mortgages failed to perform adequate due diligence on the mortgages they purchased and at times knowingly waived compliance with underwriting standards. Potential investors were not fully informed or were misled about the poor quality of the mortgages contained in some mortgage-related securities.¹⁵

10. FCIC REPORT, *supra* note 2, at 20, 93–94.

11. *Id.* at 3; *see also* Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Written Statement before the FCIC 27 (Sept. 2, 2010) (acknowledging that the Fed erred in failing to adequately supervise and regulate the mortgage market).

12. FCIC REPORT, *supra* note 2, at 127–29.

13. *Id.* at xxiii–xxiv.

14. *Id.* at xxii, 165, 169, 187.

15. *Id.* at 187.

The Securities and Exchange Commission (“SEC”), which has responsibility to ensure that adequate disclosures are made to investors, conducted little or no review of the disclosures on mortgage-related securities because of reliance on “shelf registration” provisions and exemptions from registration.¹⁶ Not only did the SEC fail to review the disclosures to investors concerning these securities, but state regulators had been pre-empted from doing so and so were unable to combat securitization fraud.¹⁷

Third, the over-the-counter (or “OTC”) derivatives market was deregulated by federal statute, and state laws governing it were pre-empted. The FCIC concluded that OTC derivatives contributed significantly to the financial crisis and that the market’s deregulation by the Commodity Futures Modernization Act of 2000 “was a key turning point in the march toward the financial crisis.”¹⁸ This deregulation was knowingly undertaken at the urging of large financial services firms and their regulators despite widely available information about the dire risks this market posed.

After this deregulation, the OTC derivatives market experienced explosive growth, expanding more than seven fold in the years leading up to June 2008, when it reached over \$650 trillion in notional amount, or more than ten times the gross domestic product of all the countries in the world.¹⁹ The FCIC found that this enormous deregulated market was characterized by “uncontrolled leverage; lack of transparency, capital, and collateral requirements; speculation; interconnections among firms; and concentrations of risk in this market.”²⁰

The FCIC concluded that OTC derivatives played several major roles in the financial crisis. Credit default swaps (or “CDSs”) are OTC derivatives contracts in which one party agrees to pay the other party in case of a default on an obligation such as a mortgage-related security. Investors in mortgage-related securities purchased CDSs from large OTC derivatives dealers such as AIG in order to protect themselves from default on the securities. The FCIC found that the re-assurance provided to investors by these CDSs fueled mortgage securitization and the housing bubble.²¹

In addition, CDSs were used to create synthetic CDOs, which were not actual mortgage assets at all, but rather were merely bets on

16. *Id.* at 169–70, 187.

17. *Id.* at 187.

18. *Id.* at xxiv.

19. *Id.* at 48.

20. *Id.* at xxiv.

21. *Id.*

mortgage securities. These bets significantly amplified the losses from the collapse of the housing bubble, multiplying the amount riding on real mortgage securities.²²

AIG's near failure because of its issuance of billions of dollars of CDSs on risky mortgage securities was one of the precipitating causes of the financial crisis. When AIG was unable to meet its obligations to post collateral on these CDSs, the government had to rescue it, ultimately committing more than \$180 billion to the rescue efforts because of concerns that AIG's collapse would trigger losses cascading through the financial system.²³

In addition to the role of CDSs in the financial crisis, the FCIC concluded that "the existence of millions of derivatives contracts *of all types* between systemically important financial institutions—unseen and unknown in this unregulated market—added to uncertainty and escalated panic, helping to precipitate government assistance to those institutions."²⁴ Because OTC derivatives contracts created interconnections between firms through counterparty credit exposures, the failure of one large financial firm had the potential of spreading losses and failures throughout the financial system. The lack of any federal or state rules of the road for this market led to widespread abuses that brought the financial system to the brink of disaster.

Fourth, there was a profound failure of federal supervision of financial institutions. The FCIC found that federal supervisors of bank holding companies and investment banks failed in their mission to preserve the safety and soundness of a number of systemically important financial institutions.²⁵ These institutions either failed or would have failed but for government assistance during the financial crisis.

Perhaps the most egregious supervisory failure related to the country's largest investment banks, which for the most part were allowed to grow with little or no supervision except with respect to their securities operations. In April 2004, the SEC adopted the Consolidated Supervised Entity (or "CSE") program under which the country's five largest investment banks voluntarily submitted themselves for the first time to prudential supervision.²⁶

22. *Id.* at xxiv–xxv.

23. *Id.* at xxv.

24. *Id.* at xxv (emphasis added).

25. *Id.* at xviii.

26. *Id.* at 150–54 (discussing and defining the involvement of the five largest investment banks in the CSE program).

Within four and a half years of the SEC's adoption of this so-called supervisory program, all of the five investment banks it purported to supervise had disappeared in the financial crisis: Lehman Brothers was bankrupt, Bear Stearns and Merrill Lynch had been acquired under emergency circumstances by large bank holding companies, and Goldman Sachs and Morgan Stanley had saved themselves by converting to bank holding companies supervised by the Federal Reserve. The investment banks were brought to the brink of failure by high leverage, insufficient liquidity, large exposures to risky mortgage loans and mortgage-related securities, interconnections through OTC derivatives trades, and an undue reliance on short-term borrowing in the commercial paper and repo markets. The SEC had utterly failed to supervise these institutions effectively. In terminating the program, then Chairman of the SEC Christopher Cox concluded that it had been "fundamentally flawed from the beginning."²⁷

In addition, federal banking supervisors failed to rein in the risky activities of some of the country's largest bank holding companies, including Bank of America and Citigroup. As the FCIC concluded, "[i]n 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."²⁸

These failures in banking supervision were another result of the prevailing deregulatory mindset at the Fed and other banking supervisors. As former director of the Fed's Division of Banking Supervision and Regulation Richard Spillenkothen explained to the FCIC, "[s]upervisors understood that forceful and proactive supervision, especially early intervention before management weaknesses were reflected in poor financial performance, might be viewed as i) overly-intrusive, burdensome, and heavy-handed, ii) an undesirable constraint on credit availability, or iii) inconsistent with the Fed's public posture."²⁹

Fifth, the safeguards of the Glass-Steagall Act of 1933, which restricted commercial banks' participation in securities markets, were abandoned. Bank supervision was significantly weakened as a result of a number of exceptions to the Glass-Steagall Act adopted by bank

27. *Id.* at 154 (quoting Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), *available at* <http://www.sec.gov/news/press/2008/2008-230.htm>).

28. *Id.* at xviii.

29. *Id.* at 54 (quoting Rich Spillenkothen, Notes on the Performance of Prudential Supervision in the Years Preceding the Financial Crisis by a Former Director of Banking Supervision and Regulation at the Federal Reserve Board (1991 to 2006), at 28, May 31, 2010, *available at* <http://fcic.law.stanford.edu/documents/view/1237>).

supervisors over a period of fifteen years. As banks experienced growing competition from investment banks and money market funds, they pressed their supervisors and Congress to allow them to enter into new activities. Supervisors issued rules permitting banks or their nonbank subsidiaries to engage in increasingly risky activities, including securities activities and OTC derivatives dealing.³⁰

By 1998, many of the restrictions of the Glass-Steagall Act had been effectively eroded, and Citicorp announced a planned merger with Travelers Insurance that would have violated the Act. In response, Congress enacted the Gramm-Leach-Bliley Act of 1999, repealing most of the remaining constraints of Glass-Steagall.³¹ In explaining the bank supervisors' support for this action, Eugene Ludwig, Comptroller of the Currency from 1993 to 1998, told the FCIC that the supervisors had an "historic vision, historic approach, that a lighter hand at regulation was the appropriate way to regulate."³² The Gramm-Leach-Bliley Act left banks as vulnerable to the collapse of the housing bubble as investment banks, and a number of large bank holding companies were brought to the brink of failure during the financial crisis.

* * *

The causative role of deregulation and inadequate regulation in the financial crisis demonstrates the fallacies of reliance on self-regulation in a field central to the American economy and the welfare of the American people. These same deregulatory forces have hamstrung financial regulators and enforcement authorities. During a period of 30 years, regulatory statutes were repealed, exemptions from rules were adopted or expanded, federal regulators failed to implement or enforce existing rules, and state law was pre-empted. Important new financial markets, firms, and products developed and grew outside the purview of laws and regulators.

Enforcement efforts today have been significantly impaired by this history of deregulation. Rebuilding a regulatory scheme designed for modern financial markets is the challenge the country now faces. The enactment of financial regulatory reforms in the Dodd-Frank Act in 2010 was an important first step in doing so.³³ However,

30. *Id.* at 34–35

31. *Id.* at 54–55; Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

32. FCIC REPORT, *supra* note 2, at 171 (quoting Interview by the FCIC with Eugene Ludwig, Promontory Fin. Group (Sept. 2, 2010)).

33. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in various sections of 12 U.S.C.).

it is imperative that those reforms be fully implemented through new agency regulations and then rigorously enforced.

Unfortunately, major change is difficult even under the best of circumstances and takes a great deal of time and effort. The culture, values and attitudes of Washington policymakers, financial regulators, and enforcement officials must undergo a profound transformation to embrace the need for financial regulation. Yet, there are strong forces dedicated to preventing this transformation.

Large financial institutions and their trade associations are engaged in a concerted effort to prevent full implementation and enforcement of the Dodd-Frank Act. The financial crisis left some systemically important institutions even larger than they were before the crisis through merger and consolidation in the industry, and these survivors are in many cases determined to preserve the lucrative business operations that deregulation allowed them. They are exercising their great political and financial powers to resist new regulation. Alan Greenspan has been joining the chorus by warning about dire consequences of some provisions of the Dodd-Frank Act.³⁴

Republican members of Congress, who almost uniformly opposed adoption of the Act, are in many cases supporting these industry efforts. Bills are pending in Congress that would repeal or weaken the Act. Industry and congressional efforts to persuade agencies to issue watered down regulations, create or broaden exemptions or otherwise fail to fully implement provisions of the Act are underway. Serious delays in implementation are occurring, and a number of lawsuits have been filed by members of the financial sector to enjoin rules from going into effect. Confirmation of federal financial nominees has been stalled or delayed. Moreover, Congressional threats to cut the funding of key regulators imperil regulatory reform. For example, the SEC and the Commodity Futures Trading Commission ("CFTC"), the agencies with responsibility to impose needed regulation on the OTC derivatives market, are threatened with cuts that would significantly impair their operations.

The political power of the financial sector is still enormous, but our policy makers must have the political will to resist these efforts to derail regulatory reform. If they do not learn from the financial crisis and insist on regulatory reforms addressing its causes, we all will be doomed to repeated financial crises. The American people deserve

34. Alan Greenspan, Op-Ed, *Dodd-Frank Fails to Meet the Test of our Times*, FT.COM (Mar. 29, 2011, 6:31 PM), <http://www.ft.com/intl/cms/s/0/14662fd8-5a28-11e0-86d3-00144feab49a.html#axzz2XdIbSxkA>.

better. It is now time to re-establish the rule of law governing the financial sector.

Thank you.