

Five Minutes on the ‘Guardians of Finance: Making Regulators Work for Us’¹
Remarks for the “Teach-in on the Occupy Movement” at Brown University, 10/12/2011

Ross Levine

1. Introduction

I applaud the outrage being expressed in venues around the country concerning the massive redistribution of wealth from the many to a very few in response to the financial crisis of 2008. Although I do not have the privilege to be the spokesperson for any group or movement, I have been asked to speak this afternoon because I have been conducting research on finance and financial regulation for over two decades.

It is from this narrow, limited capacity that I want to make two points. First, much research indicates that the major financial regulatory agencies too often do not act in the interests of the public at large. They too often act in the interests of the financial services industry that they regulate.

Second, the country is not fixing the problem with financial regulation. We need institutional changes that more effectively compel financial regulators to work for us. Instead, the current public policy strategy—as embodied in the Dodd-Frank Financial Reform Act that was signed by President Obama in 2010—gives the same agencies that piloted us into this economic storm more power. But, the problem is not too few regulations. The problem is not too few regulators. And, the problem is not too little regulatory power.

The problem is that existing regulatory agencies do not use their ample powers properly. The problem is that our institutions do not adequately compel financial regulators to work for us. *Yet, no political party addresses this fundamental defect with the financial regulatory apparatus.*

2. The revolving door

On the first point—that financial regulators are not working for us, let me give a few examples of the revolving door between private financial institutions and official agencies that will get you angry. Then, I will explain what should really scare you.

The Federal Reserve is the major regulator of financial institutions in the US. The Fed, however, is by formal institutional design NOT independent of the banks it regulates. The banks help CHOOSE the Fed’s leaders. Indeed, the current president of the New York Federal Reserve is a former Goldman Sachs partner. A former president of the New York Federal Reserve is currently a partner at Goldman Sachs. In fact, every past president of the New York Federal Reserve went to work for a private financial institution after leaving public office, except its first president, Benjamin Strong, who died in office. But, before presiding over the New York Fed, Mr. Strong was the president of Bankers Trust.

¹ James Barth, Gerard Caprio, and Ross Levine. 2012. *Guardians of Finance: Making Regulators Work for Us*. Cambridge, MA: MIT Press.

The revolving door spins rapidly at the Treasury too. Robert Rubin was the head of Goldman Sachs, then the Secretary of the Treasury under Clinton, then a senior executive at Citibank. When Citibank failed in 2008, Rubin resigned, walking away with over \$100M in compensation. Henry Paulson was the CEO of Goldman Sachs and then Secretary of the Treasury under Bush. Larry Summers was the Treasury Secretary under Clinton. Then he took a job on Wall Street, making \$5million a year—for working one day a week. Later, he returned to DC to head Obama’s economic team.²

I could go on. I really could go on and on (and do so in my book with James Barth and Jerry Caprio).

But, I want to make a deeper—and scarier—point. I do not believe that ANY of these individuals abused his official position. I believe that each of these individuals carried out his official duties in an honorable and honest manner. I do not think the core problem is corruption. I think the problem is deeper.

3. Home field advantage

The problem is conformity.³ Psychology finds that social pressures exert a powerful force that unconsciously shapes human beliefs. Conformity causes people’s opinions to coincide with those of the group. People genuinely and honestly embrace the group’s opinions. They do not *believe* they are biased.

² Let me be clear, I am not arguing that bankers are evil or that their greed is a primary cause of the crisis. The data do not support such an argument. And, James Barth, Gerard Caprio, and I argue against this premise in our book, *Guardians of Finance: Making Regulators Work for Us*. Furthermore, my goal is not to vilify Goldman Sachs (or any other private financial institution for that matter). Goldman is a premier, if not *the* premier, investment bank. My goal is simply to illustrate that there are close connections between Wall Street and Washington.

Let me also be clear about the financial sector. An ample body of research suggests that a well-functioning financial system is necessary for economic prosperity, for expanding economic opportunities, and for alleviating misery. A well-functioning financial sector is crucial for promoting human welfare (See Levine, Ross. 2005. “Finance and Growth: Theory and Evidence.” In the *Handbook of Economic Growth*, Eds., Aghion, P. and S. Durlauf, 1A, pp. 865-934, North-Holland Elsevier, Amsterdam). I am simply noting that the mixture of financial regulations frequently causes the financial sector to malfunction. See, for example, *Rethinking Bank Regulation: Till Angels Govern* by James Barth, Gerard Caprio, and Ross Levine, Cambridge University Press, 2006.

³ On this, see the wonderful book by Tobias J. Moskowitz and L. Jon Wertheim, 2011, *Scorecasting: The Hidden Influences Behind How Sports are Played and Games are Won*, New York: Crown Archetype.

The problem is not that regulators are corrupt. The problem is that regulators are human—and hence they innately and genuinely adopt the views of the group in which they operate most often and most comfortably. That group is the financial services industry.

Just like referees, umpires, and officials in sports are demonstrably biased in favor of the home crowd; financial regulators are demonstrably biased in favor of the crowd surrounding them. The financial services industry typically enjoys a home field advantage. The public is stuck up in the bleachers—if they can even get a ticket to the “game.” And, their voices are rarely heard down on the field where the real decisions are being made.

From this perspective, regulatory bias is a natural human manifestation of the current institutional structure in which the financial services industry surrounds the regulators. This has two daunting implications. One, giving the regulators more power is not the answer because lack of power does not account for regulatory bias. Two, legislating against corruption is not a complete answer either because corruption is not the core source of regulatory failure.

4. Making the regulators work for us

We need institutional reforms that give the public both a more *informed* and a stronger voice. We need to mitigate the home field advantage by giving the public “courtside seats.”

Unfortunately, that is impossible given the current institutional structure. The public is INCAPABLE of making the regulators work for us because the public has neither the information nor the expertise. There is no way for the public to get an independent, informed, and expert assessment of financial regulation. Without such an independent, informed, and expert assessment, the public CANNOT be effective.

We can change this—and I make detailed proposals for doing so in a forthcoming book. But, improving regulation will face a serious and well-financed opposition.