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Reawakening: From the Origins of Economic Ideas to the Challenges of Our Time
Panel: Doubling Down on Failure: Subsidizing More One-Way Bets?

Financial Reform Is Working, But Deregulation That Incentivizes One-Way Bets Is Sowing the Seeds of Another Catastrophic Financial Crash

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The conference and panel topic could not be more timely: the deregulatory zeal of the 1990s and 2000s has returned to the US and the post-Brexit plans to protect the City in the UK sound like the pre-crash light-touch mentality that fueled global regulatory arbitrage. As a result, a foremost "challenge of our time" is to stop "subsidizing more one-way bets" and "doubling down on failure." However, rather than a "reawakening," too many signs point to a willed (or, often, purchased) amnesia: an increasingly deregulated and unregulated financial sector that looks a lot like 2004-2005 with nothing but ideological or self-interested claims that a crash like 2008 won't again follow. The result is incentivizing ***and*** subsidizing one-way bets, which guarantees another spectacular and costly failure.

Just nine years ago, the Lehman Brothers investment bank filed for bankruptcy and ignited the biggest financial crash since the Great Crash of 1929, almost 80 years prior. That calamity caused the worst economy since the Great Depression of the 1930s, costing the US more than $20 trillion in lost GDP,[2] to say nothing of the political, social and human costs, many of which continue to this day. Just seven years ago, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[3] was passed and has only been substantially implemented in the last couple of years. Indeed, many of the rules required by Dodd-Frank have not been finalized and many more have not been implemented or interpreted, much less enforced.

The evidence is, however, overwhelming that financial reform is working, that finance is more stable, that the risk of a crash or economic catastrophe in the US is greatly reduced, that banks are highly profitable and significantly increasing their lending, and that the economy is steadily growing. While more still needs to be done, the two primary goals of Dodd-Frank have been largely achieved thus

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1 Better Markets is a Washington, DC based non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more. See www.bettermarkets.com.

2 *See* Better Markets, The Cost of the Crisis $20 Trillion and Counting, (July 20, 2015), *available at* https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

3 12 U.S. Code Chapter 53.

far, despite relentless opposition from the financial industry and its allies. First, the most dangerous and unreasonable risks in the financial system have been greatly reduced and a financial crash is much less likely due to Dodd-Frank rules which:

- increase capital and liquidity,
- regulate derivatives,
- require living wills and stress tests,
- reduce counterparty exposure,
- protect financial consumers,
- police predatory conduct, and
- prohibit proprietary trading, among other reforms.

Second, to again serve their social purpose, justify their social costs and deserve their taxpayer backing, the rules have rebalanced and refocused the biggest, most dangerous banks ***to*** traditional banking activities and ***away*** from trading, which is little more than socially useless gambling designed to enrich a few thousand financiers and executives. As proved by record bank revenues and profits as well as increased lending to the real economy,[4] this has benefited not just the United States, but the entire financial system.

Importantly, these financial protection rules are focused primarily on the handful of uniquely dangerous financial institutions in the US and the world which have carved out a special exemption from the fundamental rule of capitalism that failure leads to bankruptcy.[5] These institutions are so gigantic, interconnected, leveraged, complex and critical to the basic functioning of society that they have become "too-big-to-fail" for fear of collapsing the entire financial system and leading to economic devastation on the scale of a second Great Depression. However, of the almost 6,000 banks in the US, only 41 have $50 billion or more in assets, less than 1% of all banks,[6] which is the threshold for most of the enhanced financial protection rules.[7] Thus, properly regulating this handful of too-big-to-fail institutions is manageable if there is the political will to do so.

Unsurprisingly with the tens of billions of dollars at stake for the too-big-to-fail firms, there is an all-out attack on financial reform in the United States (as exemplified by the first two financial regulation reports issued by President Trump's Treasury Department[8] and the passage by the House of

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4 See text and data infra note 49 and following.

5 This is not an academic rule, but foundational to capitalism, including in particular to market discipline and moral hazard. As the Vice Chairman of the Federal Deposit Insurance Corporation, Tom Hoenig, put in when discussing deposit insurance, "the threat of failure serves to ensure that banks remain more sensitive to risk, and it inhibits the industry from trending toward excessive risk." Tom Hoenig, "Deposit Insurance: Addressing the Moral Hazard Effect," October 11, 2017, https://www.fdic.gov/news/news/speeches/spoct1117.html .

6 "Biggest US Banks by Asset Size 2017," *Money Summit*, February 9, 2017, https://www.mx.com/moneysummit/biggest-banks-by-asset-size-united-states.

7 See Better Markets' Fact Sheet "Everything You Need to Know About the $50 Billion Threshold," (Updated November 28, 2016), https://bettermarkets.com/sites/default/files/50b%20Fact%20Sheet%20Updated%20Long%20Version%2011.28.16_0.pdf .

8 "A Financial System That Creates Economic Opportunities: Banks and Credit Unions", U.S. Department of the Treasury, June 2017, https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf; "A Financial System That Creates Economic Opportunities: Capital Markets", U.S. Department of the Treasury, October 2017, https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

Representatives of the CHOICE Act[9]), mostly under the pretext of reducing a claimed onerous burden from Dodd-Frank rules, which are, critics say, reducing economic growth. While the facts demonstrate that none of that is true, deregulation is proceeding apace.[10] This paper will first discuss a key example illustrating the dangerous developments in the US, which will likely once again lead to that handful of enormous financial institutions externalizing their costs, shifting them to taxpayers, while greatly increasing the likelihood of a crash.[11] The paper will then review the data demonstrating that the claimed basis for these deregulatory actions is baseless and conclude with a warning from two leading global financial statesmen about the dangers of deregulation and the need for leadership and courage to fight it. That is the challenge of our time.

Gutting the Financial Stability Oversight Council and the Dangerous Deregulation of AIG: Incentivizing a Bailout Culture and Cycle

One of the most important reforms of Dodd-Frank was the creation[12] of the Financial Stability Oversight Council (FSOC),[13] comprised of federal and state financial regulators[14] chaired by the Secretary of the Treasury with the mission to identify and respond to risks that threaten the financial stability of the United States. A primary mission of FSOC was to ensure that the shadow banking system was regulated. The key mechanism for FSOC to achieve that was by designating systemically significant nonbanks for heightened regulation if appropriate and after considerable data-driven analysis. Even then, such a nonbank could only be designated pursuant to a two-thirds vote of FSOC's ten voting members.

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9 H.R. 10 (2017)

10 For example, on October 12, 2017, the House Financial Services Committee "passed 22 bills to easy regulations." Patrick Temple-West "House Financial Services passes 22 bills to ease regulations." *PoliticoPro*, October 12, 2017, https://www.politicopro.com/financial-services/story/2017/10/house-financial-services-passes-22-bills-to-ease-regulations-163330

11 It should also be noted that the next financial crash will almost certainly be worse than the last one because the fiscal, monetary, political and social capacity to respond are all greatly reduced. For example, monetary policy in the US is fully extended with near zero interest rates and a $4+ trillion balance sheet and fiscal policy is constrained by deficits, debt and selective austerity hysteria.

12 See Better Markets Fact Sheet "The Financial Stability Oversight Council: Saving Taxpayers from the Next AIG and the Next Crisis" (Nov. 2015) https://bettermarkets.com/sites/default/files/Fact%20Sheet%20-%20The%20Financial%20Stability%20Oversight%20Council%20--%2011-2-2015.pdf and Testimony of Dennis Kelleher before the United States Senate Committee on Banking Housing, and Urban Affairs "FSOC Accountability: Nonbank Designations" (Mar. 25, 2015) https://bettermarkets.com/sites/default/files/Dennis%20Kelleher%20Testimony%203-25-15_0.pdf.

13 12 U.S. Code § 5321

14 The FSOC's voting members are: the Treasury Secretary; the Chair of the Federal Reserve Board of Governors (Fed); the Comptroller of the Currency; the Director of the Consumer Financial Protection Bureau; the Chair of the Securities and Exchange Commission (SEC); the Chair of the Federal Deposit Insurance Corporation (FDIC); the Chair of the Commodity Futures Trading Commission (CFTC); the Director of the Federal Housing Finance Agency; the Chair of the National Credit Union Administration Board; and an insurance expert appointed by the President and confirmed by the Senate. FSOC's non-voting members include the Director of the Office of Financial Research; the Director of the Federal Insurance Office; a state insurance commissioner selected by the various state insurance commissioners; a state banking supervisor selected by the various state banking supervisors; and a state securities commissioner selected by the various state securities commissioners. See notes supra 12 and 13.

While innumerable nonbanking institutions received massive bailouts in 2008-2009,[15] which by definition meant that they were systemically significant, the Obama administration only designated four systemically significant nonbanks for increased regulation before leaving office.[16] Two were and should have been entirely noncontroversial. One was AIG, which not only failed spectacularly and engaged in outlandishly irresponsible conduct, but also required an unlimited bailout that just happened to amount to $182 billion.[17] The other was GE, which, although with fewer headlines and less egregiousness, would have gone bankrupt without being bailed out as well. The other two were global insurance companies, Prudential and MetLife.[18]

However, as soon as they arguably gained the necessary two-thirds voting representation,[19] President Trump's appointees to the FSOC (plus Fed Chair Janet Yellen) voted to deregulate AIG,[20] the gigantic global financial firm that was at the center of causing and spreading the catastrophic 2008 financial crash. This "landmark move"[21] (technically, de-designating AIG as a systemically significant nonbank[22]) is the first major financial regulatory decision of the Trump administration and makes clear that the Trump administration's deregulatory rhetoric is going to become a reality. For many reasons, this is extremely unwise and makes another costly financial crash more likely and sooner rather than later.

First, designating systemically significant nonbanks is the critical reform[23] in ending the dangerous pre-crisis two-tiered regulatory system that enabled massive risks to build up unregulated and unseen in the shadow banking system until they blew up and required taxpayer bailouts to prevent the collapse of the global financial system and a second Great Depression. Pre-crash, banks were

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15 See SIGTARP Quarterly Report to Congress, July 21, 2009, https://www.sigtarp.gov/Quarterly%20Reports/July2009_Quarterly_Report_to_Congress.pdf.

16 See, generally, US Department of the Treasury, Financial Stability Oversight Council, Designations, https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx .

17 While the AIG bailout ultimately amounted to $182.5 billion, the amount of money that would be necessary to stop AIG's collapse and the contagion it would have unleashed when it was initially bailed out was unknown. The federal government, with the Fed in the lead, committed to any amount necessary to prevent that collapse and contagion, thus the bailout was unlimited.

18 The discussion here focuses on AIG, but both Prudential and MetLife are expected to be de-designated as well based on the statements and actions of officials in the Trump administration. If that happens, the result will be that not a single nonbank financial firm will be determined to be systemically significant or regulated as such.

19 The statute requires a two-thirds vote of the 10 voting members of FSOC to de-designate, which in this case would be impossible because there were three votes against de-designation and SEC Chair was recused from voting due to his or his law firm's prior representation of AIG. However, FSOC received a legal opinion that his recusal did not have to count toward the vote tally, allowing de-designation based on a 6-3 vote. See Zachary Warmbrodt, "AIG Escapes Tougher Regulation 9 Years After Bailout," Politico Pro, September 29, 2017.

20 Allistair Gray, Barney Jopson, and Ben McLannahan, "AIG freed from 'too big to fail' regulation", *Financial Times*, September 29, 2017, https://www.ft.com/content/263488f0-a48f-11e7-b797-b61809486fe2?sharetype=share.

21 Allistair Gray, "AIG sheds $150m in costs along with Sifi label" *Financial Times*, October 1, 2017, https://www.ft.com/content/31b36b9a-a662-11e7-93c5-648314d2c72c.

22 Financial Stability Oversight Council, "Notice and Explanation of the Basis for the Financial Stability Oversight Council's Rescission of Its Determination Regarding American International Group, Inc. (AIG)," *Washington: U.S. Department of the Treasury*, 2017), https://www.treasury.gov/initiatives/fsoc/designations/Documents/American_International_Group,_Inc._(Rescission).pdf.

23 See Testimony of Dennis Kelleher before the United States Senate Committee on Banking Housing, and Urban Affairs "FSOC Accountability: Nonbank Designations" (Mar. 25, 2015) https://bettermarkets.com/sites/default/files/Dennis%20Kelleher%20Testimony%203-25-15_0.pdf.

regulated by the Fed, FDIC, OCC and OTS, but financial firms engaging in very high-risk bank-like activities were lightly regulated, if they were regulated at all. Unsurprisingly, bank-like activities and their associated risks then migrated from the higher cost, regulated banking system to the lower cost, unregulated shadow banking system, which is where much of the crash was spawned. Making systemically significant banks and nonbanks alike internalize the costs of their high-risk activities via heightened regulation was intended to end these misaligned incentives and opportunities for regulatory arbitrage.

As then-Fed Chairman Ben Bernanke explained, that is exactly what AIG did: "AIG exploited a huge gap in the regulatory system. There was no oversight of [AIG's] Financial Products division. This was a hedge fund, basically, that was attached to a large and stable insurance company."[24] Given AIG did not reserve or post margin for the credit default swaps (CDS) it sold, it was also probably the most highly leveraged hedge fund in the world at the time as well as the most interconnected.

There was bipartisan and industry support in 2009-2010[25] for creating an entity to make sure that didn't happen again. FSOC was the result and it is the only governmental entity with the power and duty to analyze and regulate systemically significant nonbanks. Nevertheless, the Trump administration appears committed to neutering FSOC and using it as a mechanism to deregulate finance. This will lead to the recreation of the two-tier regulatory system and the revival of a dangerous and fragile shadow banking system as regulatory arbitrage incentivizes risk to again move out of the regulated banking system.

Second, the criticisms of FSOC and its regulation of systemically significant nonbanks doesn't match the reality. FSOC has been cautious to a fault in using its designation authority, particularly in light of the many nonbanks that had to be bailed out in 2008 and 2009.[26] Yet, during the entire Obama administration, FSOC only designated four nonbanks as systemically significant and, as mentioned above, two of the four (AIG and GE) were incontestable. Such minimal action proves that FSOC has not been some out-of-control, designation-happy entity, and this overly cautious approach was before the Trump administration.

As for the Trump administration, Treasury Secretary Mnuchin said, when announcing FSOC's deregulation of AIG, that "this action demonstrates our commitment to act decisively to remove any designation if a company does not pose a threat to financial stability." [27] The real question is whether the Trump administration will show equal zeal and speed in regulating systemic risks from nonbanks when they do exist or if they will even undertake the analysis.

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24 Torres, Craig and Hugh Son, "Bernanke Says Insurer AIG Acted Like a Hedge Fund," *Bloomberg*, March 3, 2009, http://www.smh.com.au/business/world-business/aig-acted-like-a-hedge-fund-bernanke-says-20090303-8nl5.html.

25 Testimony of Dennis Kelleher before the United States Senate Committee on Banking Housing, and Urban Affairs "FSOC Accountability: Nonbank Designations" (Mar. 25, 2015) https://bettermarkets.com/sites/default/files/Dennis%20Kelleher%20Testimony%203-25-15_0.pdf.

26 SIGTARP Quarterly Report to Congress, July 21, 2009, https://www.sigtarp.gov/Quarterly%20Reports/July2009_Quarterly_Report_to_Congress.pdf.

27 See note supra 20.

Third, as detailed by the members of FSOC who dissented from the vote[28], there's a very good case to be made that AIG is actually still a systemically significant nonbank that does not qualify to be de-designated on the merits. The Center for American Progress issued an extensive report coming to the same conclusion. [29]

Fourth, AIG is not just any systemically significant nonbank. Unsupervised in the years before the 2008 crash, AIG was one of the most reckless financial firms in the world and a leading cause of the crash. Indeed, there's a good case to be made that the crisis and crash would have been less severe, shorter and more manageable if AIG's actions hadn't enabled the fraudulent subprime bubble to be supersized: by the end of 2007, AIG had written $527 billion of insurance (called "credit default swaps" or CDS) on collateralized debt obligations (CDOs) and other subprime mortgage related derivatives and structured products, among other toxic assets. By one calculation, AIG developed a portfolio that totaled more than $2.7 trillion notional amount in credit derivatives, with $1 trillion in contracts with just twelve institutions as counterparties.[30]

Every time AIG sold a CDS, it enabled other reckless market participants (the buyers of the CDS) to keep packaging, selling and distributing worthless toxic assets because they were able to shift their risk of loss to AIG. This in turn created artificial demand for subprime mortgages, which kept the fee-based originate-to-distribute predatory mortgage mills running long after they should have collapsed. For accepting all this risk, inflating an historic subprime bubble and, ultimately, ruining so many lives, AIG collected billions in fees, virtually all of which dropped into the bonus pool for AIG's executives because it failed to set aside reserves for this CDS insurance, insanely claiming that it was inconceivable that it could ever lose even "one dollar."[31]

Of course, what really happened was that all these losses were ***not*** shifted to AIG, but were shifted to taxpayers and the American public. AIG and the other market participants enriched themselves, their shareholders and executives at the expense of the American people, who were forced to cover their losses with a $182 billion bailout. Brazenly, AIG used some of that bailout money to pay bonuses to some of the very executives who engaged in the reckless activities that bankrupted the company in the first place. Indefensibly, there was no accountability for a single AIG executive (or any other executive or supervisor on Wall Street for that matter). The guilty pocketed their bonuses and victimized Americans paid the bills. That's the definition of "subsidizing one-way bets": privatizing the gains and socializing the losses.

None of that is to deny that AIG has reduced its systemic footprint since the crash. But, that alone should not lead to de-designating AIG, which would require ignoring AIG's uniquely critical and despicable role in the 2008 crash. It would also require ignoring AIG's egregious recidivist history, which

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28 "Views of Financial Stability Oversight Council Members Regarding Rescission of Determination Regarding American International Group, Inc. (AIG)," October 2, 2017, https://www.treasury.gov/initiatives/fsoc/news/Documents/Member_Views.pdf.

29 Center for American Progress, "Deregulating AIG Was a Mistake," October 11, 2017, https://www.americanprogress.org/issues/economy/reports/2017/10/11/440570/deregulating-aig-mistake/.

30 Johan A. Lybeck, "A Global History of the Financial Crash of 2007-10," Cambridge University Press, December 5, 2011, https://www.amazon.com/Global-History-Financial-Crash-2007-10/dp/1107011493 .

31 "It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions." Joseph J. Cassano, AIG FP CEO, August 2007, quoted in Gretchen Morgenson, "Behind Insurer's Crisis, Blind Eye to a Web of Risks," The New York Times, September 27, 2008, http://www.nytimes.com/2008/09/28/business/28melt.html

was detailed by William D. Cohan in "The Fall of AIG: The Untold Story"[32] as well as in two books: Roddy Boyd's *Fatal Risk*[33] and Jesse Eisinger's new book *The Chickenshit Club*.[34]

Fifth, the issue isn't de-designation or having a so-called "off ramp" once designated. There is no "Hotel California" problem where you can check in, but you can't check out. Given GE's high risk financial activities before the crash and its 2008 bailout, it was appropriately designated as a systemically significant nonbank.[35] Post-crash, it dramatically and comprehensively de-risked, which led to it being de-designated by FSOC during the Obama administration pursuant to its procedures.[36] That was appropriate.[37] However, GE, unlike AIG, didn't have a history of taking enormous reckless risks, abysmal to nonexistent risk management and repeated management failures.

Where does all that lead? Should a firm designated as a systemically significant non-bank remain so forever? Of course not. How then to deal with AIG and other systemically significant non-banks, including those that de-risk? Former Goldman Sachs banker and current Bloomberg View Columnist Matt Levine wrote the most concise, sensible, appropriately broad and historically-informed answer to these questions,[38] which merits quoting in full:

> Part of the point of designating companies as 'systemically important financial institutions,' and imposing higher capital and regulatory requirements on them, is to make them stop being systemically important. 'Break up the banks,' people say, and one way to break up the banks is by making life difficult for the ones that stay un-broken-up.
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> And so a SIFI designation -- and also more generally its painful hangover from the financial crisis -- seems to have driven American International Group Inc. to divest businesses, shrink itself and improve its capitalization. 'This company has dramatically changed its risk profile and controls since the financial crisis,' says its chief executive officer. That's good!

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32 William Cohan, "The Fall of AIG: The Untold Story," *Institutional Investor*, April 7, 2010, https://www.institutionalinvestor.com/article/b150qdkrd30ggk/the-fall-of-aig-the-untold-story?ArticleId=2460649&single=true#.WdGfCVtSzmE. His book, "House of Cards: A Tale of Hubris and Wretched Excess on Wall Street," *Doubleday*, March 10, 2009, about Bear Stearns and the subprime mortgage market is also well worth reading: https://www.amazon.com/House-Cards-Hubris-Wretched-Excess/dp/0767930894 .

33 Roddy Boyd, "Fatal Risk: A Cautionary Tale of AIG's Corporate Suicide," *John Wiley & Sons, Inc*., April 5, 2011, https://www.amazon.com/Fatal-Risk-Cautionary-Corporate-Suicide/dp/0470889802.

34 Jesse Eisinger, "The Chickenshit Club: Why the Justice Department Fails to Prosecute Executives" *Simon & Schuster*, July 11, 2017, https://www.amazon.com/Chickenshit-Club-Department-Prosecute-Executives/dp/1501121367.

35 "Basis for the Financial Stability Oversight Council's Final Determination Regarding General Electric Capital Corporation, Inc.," July 8, 2013, https://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20General%20Electric%20Capital%20Corporation,%20Inc.pdf

36 Financial Stability Oversight Council "Basis for the FSOC's Rescission of Its Determination Regarding GE Capital Global Holdings, LLC," June 28, 2016, https://www.treasury.gov/initiatives/fsoc/designations/Documents/GE%20Capital%20Public%20Rescission%20Basis.pdf

37 Amrita Mainthia, "U.S. Regulators: GE Capital No Longer Systematically Important To The Financial System," GE Reports, June 29, 2016, https://www.ge.com/reports/u-s-regulators-ge-capital-no-longer-systematically-important-to-the-financial-system/.

38 Matt Levine, "SEC Hacking and Secret Accounts," *Bloomberg*, September 22, 2017, https://www.bloomberg.com/view/articles/2017-09-22/sec-hacking-and-secret-accounts.

> That was the point! And AIG has shrunk and transformed so much that now the U.S. Financial Stability Oversight Council is considering removing AIG's SIFI designation.
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> That's also ... sort of good? SIFI regulation is generally considered a second-best outcome: You'd prefer not to have any systemically important financial institutions whose failure could crash the economy, but if that's not possible, you should at least keep a close eye on them. If keeping a close eye on them encourages them to stop being systemically important, you should reward them for their progress. Giving firms a realistic off-ramp from SIFI status encourages them to shrink and become less systemic. If doing that *doesn't* get you out of SIFI status, then every existing SIFI will have no incentive to shrink, and every incentive to get bigger.
>
> On the other hand, you know, *it's AIG*. It was at the center of the global financial crisis, as an under-regulated non-bank that took on massive risks whose implications were not well understood by regulators or the rest of the financial system. It would not be totally unreasonable to say that its punishment for that should be to remain a SIFI for the rest of eternity.

He's right. That is the right outcome: regulate systemically significant nonbanks to protect the economy and deregulate them if, like GE, they appropriately de-risk (which will incentivize some to do so), but not AIG. Given AIG was so egregiously reckless, required an unlimited bailout, used part of the bailout to pay bonuses to some of the very executives who were involved in the insane risks the company took and was a recidivist miscreant, it should be kept on heightened watch for a very, very long time. Maybe not for "the rest of eternity," but certainly for more than a mere nine years after AIG's key role in blowing up the country's financial system and spreading contagion around the globe.[39]

FSOC's action will again leave AIG unsupervised as a reckless recidivist free to return to its high-risk gambling. This is ***not*** speculation: at the same time it was deregulated, the *Financial Times* reported[40] that "a team of federal officials who have been stationed within [AIG] to monitor its activities will be heading for the exit" and AIG can now go back to doing whatever it wants, including making large acquisitions, which the CEO said it is going to do. As Bloomberg News put it, "AIG Is No Longer Too Big To Fail, So Now It Wants To Get Bigger,"[41] which the *Financial Times* pointed out "will be a reversal for AIG, which since the crisis has shed assets around the world ... in a push to become smaller and simpler."[42] That, of course, was the basis FSOC just used to justify de-designating AIG, which is immediately changing course.

The net result: AIG will now be ***less*** regulated than before the 2008 crash. AIG will be "supervised" by state insurance regulators, which have no capacity to regulate a gigantic global financial company like AIG. Before the crash, AIG was ostensibly also supervised by the OTS as a Savings and Loan Holding Company (SLHC), which are now supervised by the Fed because the disreputable OTS was

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39 AIG's collapse had systemic global implications because 13 of its top 20 counterparties were non-US financial institutions: "AIG Discloses Counterparties to CDS, GIA and Securities Lending Transactions," March 15, 2009, https://www.nytimes.com/interactive/projects/documents/aig-bailout-disclosed-counterparties .

40 See supra notes 20 and 21.

41 Sonali Basak and Katherine Chiglinsky, "AIG Is No Longer Too Big to Fail, So Now It Wants to Get Bigger," *Bloomberg*, September 29, 2017, https://www.bloomberg.com/news/articles/2017-09-29/as-aig-sheds-too-big-to-fail-it-sets-sights-on-getting-bigger.

42 See supra notes 20 and 21.

eliminated in Dodd-Frank. However, in 2014, AIG deregistered as a SLHC and therefore is not subject to federal supervision.

Matt Levine again concisely captured how this action will incentivize a bailout culture that will lead to a bailout cycle:

> [G]iven AIG's centrality to the last crisis -- *and its* plans to start growing again-- it does seem a little ominous. What if the entire cycle plays out entirely within AIG? Regulations were loosened [in the years before the 2008 crash], AIG grew big and reckless, it crashed the economy [in 2008], regulations were tightened [2013], AIG got small and cautious [2016], everyone forgave it, regulations were loosened [2017], and now AIG can grow again. What comes next? [43]

It seems pretty clear that irresponsible risk taking, big bonuses, failure and more bailouts is "what comes next."

The message this sends to gigantic financial firms and their executives -- that recklessness and lawbreaking pays – could not be worse. The odds of AIG and other financial firms repeating their grossly deficient and irresponsible ways is almost certain given the perverse incentives created by the bailouts, lack of accountability and irresistible riches recklessness generates for executives.

When added to the other deregulatory moves the Trump administration is signaling (from Treasury, the SEC, the CFTC, the Fed and elsewhere), this action and attitude makes "subsidizing one way bets" the de facto policy of the Trump administration. It is difficult to see how this will not create a culture that will inevitably lead to more crashes and more bailouts. Why? Because "the entire cycle [**will not**] play out entirely within AIG" (as postulated by Levine above), but will infect all of Wall Street and finance as it did before.

That is the unsettling and undeniable truth behind former Citigroup CEO Chuck Prince's infamous quote: "As long as the music is playing, you've gotta get up and dance…."[44] Morgan Stanley's CEO John Mack made the same point after the crash when he said "We cannot control ourselves. You [lawmakers and regulators] have to step in and control the Street. Regulators? We just love them."[45] Once any one of the designated or non-designated systemically significant financial firms starts to engage in high-risk, high return activities, the competitive pressures due to rising revenues, profits, bonuses and stock prices will push them all into a competitive spiral without breaks, which can only be stopped – if at all – by unconflicted, courageous, "grown, intelligent people," as Fed Vice Chair Fischer stated (as discussed below).

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[43] Matt Levine, "SEC Hacking and Secret Accounts," *Bloomberg*, September 22, 2017, https://www.bloomberg.com/view/articles/2017-09-22/sec-hacking-and-secret-accounts (internal link omitted).

[44] Michiyo Nakamoto and David Wighton, "Citigroup chief stays bullish on buy-outs," *Financial Times*, July 9, 2007, https://www.ft.com/content/80e2987a-2e50-11dc-821c-0000779fd2ac.

[45] "Regulators? We Just Love 'em, says John Mack," *The Evening Standard*, November 19, 2009, https://www.standard.co.uk/business/regulators-we-just-love-em-says-john-mack-6744822.html ; "Morgan Stanley's Mack: 'We Cannot Control Ourselves," Dealbook, *The New York Times*, November 19, 2009, https://dealbook.nytimes.com/2009/11/19/morgan-stanleys-mack-we-cannot-control-ourselves/

The Claimed Basis for Deregulation is Contradicted by Data and Is Based on the False Choice Between Financial Protection Rules and Economic Growth

Remarkably, the stated reasons for the deregulatory actions of the Trump administration are baseless. The financial industry and its allies attacked financial reform generally and Dodd-Frank in particular as so burdensome and onerous that banks would not be profitable, which would lead to lower lending and therefore less economic and job growth. Those unending "sky-will-fall" claims have been bellowed by the industry in response to virtually every proposed law, rule and regulation since the Great Depression of the 1930s. They have been equally consistently disproved over the decades, including most recently, but that has not stopped the industry, its allies and the Trump administration from repeating them nonstop.

Contrary to these claims, it is simply not the case that financial protection rules, on the one hand, and bank profitability and lending as well as economic growth, on the other, are mutually exclusive. In fact, a strong banking sector and durable, sustainable economic growth require effective financial protection rules that ensure a balanced, competitive financial sector working in support of the real economy, jobs, savings, education, a secure retirement and a rising standard of living. In addition, financial crashes are the ultimate growth and job killer[46] (as proved by the costs of the 2008 crash[47]) and, as Wall Street titans Chuck Prince and John Mack admitted, without rules to stop the inevitable excesses of finance, another horrific crash is inevitable.

America's financial system is today much better capitalized and much less leveraged, with lower risk, than it was before the 2008 financial crisis,[48] while still lending to and supporting the productive economy and economic growth. This has been amply demonstrated. For example, the FDIC reported that the financial sector is seeing record profits, the rate of loan growth for the industry remains above the growth rate of GDP, and loan balances for community banks are up an astonishing 7.7 percent year-over-year.[49]

The FDIC Chairman reviewed this data in recent testimony before the Senate Banking Committee and noted "…[A]nnual increases in industry net income have averaged 7.8 percent per year since 2011. FDIC-insured institutions reported a record $171.3 billion in net income in 2016, marking a net increase of 44 percent over the past five years."[50] The American Banker also reviewed the evidence and concluded:

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46 "Wall Street is not a job creator. Wall Street is a job killer… of historic proportions," Better Markets, July 10, 2012: https://bettermarkets.com/blog/wall-street-not-job-creator-wall-street-job-killer%E2%80%A6-historic-proportions.

47 *See* Better Markets, The Cost of the Crisis $20 Trillion and Counting (July 20, 2015), *available at* https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

48 That is not to suggest that the capitalization of systemically significant financial institutions is adequate. It is not, as FDIC Vice Chairman Tom Hoenig has repeated detailed, most recently in a July 31, 2017 letter to Chairman Crapo and Ranking Member Brown of the Senate Committee on Banking, Housing and Urban Affairs, available here: https://www.fdic.gov/about/learn/board/hoenig/hoenigletter07-31-2017.pdf, and in his discussion of "owner equity capital" in "Deposit Insurance: Addressing the Moral Hazard Effect," October 11, 2017, https://www.fdic.gov/news/news/speeches/spoct1117.html .

49 "Quarterly Banking Profile: First Quarter 2017," Federal Deposit Insurance Corporation, https://www.fdic.gov/bank/analytical/qbp/2017mar/qbp.pdf.

50 Statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation, on Fostering Economic Growth: Regulator Perspective before the Committee on Banking, Housing, and Urban Affairs, United States Senate, June 22, 2017, https://www.fdic.gov/news/news/speeches/spjun2217.pdf.

> Republicans have repeatedly asserted that the 2010 financial reform law has increased the cost of consumer lending and cut off access to credit. ... Yet the available data indicates otherwise. Consumer credit has roared back in the six years since Dodd-Frank, with a 46% jump in outstanding consumer credit to $3.8 trillion. ... ***[T]he fact remains that mortgage, auto and credit card lending have all gone up since 2010***. [Mortgage] lending standards are as loose as they've been since the downturn. ... Auto lending has been on a tear since the financial crisis .... Credit card lending has returned to pre-crisis levels with total lending hitting an all-time high of $996 billion. ...[51]

Bloomberg reached a similar conclusion:

> Lending declined initially after 2008, when the entire banking industry was almost wiped out by the collapse of the U.S. housing market. But it's grown steadily since then, expanding by 6 percent a year since 2013, far faster than the economy. Banks now have a record $9.1 trillion of loans outstanding.[52]

The Federal Reserve Board Chair testified before the Senate Banking Committee that commercial and industrial lending has surged in recent years, along with industry profits:

> There's much more capital in the banking system. U.S. banks are generally considered quite strong, relative to their [international] counterparts. They built up capital quickly, partly as a result of our insistence that they do so, following the financial crisis….They're gaining market share and they remain quite profitable.[53]

Former Federal Reserve Board Chair Paul Volcker made similar observations in April 2017 in remarks to the Bretton Woods Committee:

> [C]laims that Dodd-Frank and other regulatory approaches have somehow gravely damaged the effective functioning of American financial markets, the commercial banking system, and prospects for economic growth simply do not comport with the mass of the evidence before us. Here we are in 2017 with a near fully employed economy, close to stable prices, bank profits at a new record, and the return on banking assets again exceeding one percent. Loans at both large and small banks are at new highs, double the pre-crisis years. In fact, loan growth has again been exceeding growth in nominal GDP.[54]

These statements and data, gathered years after Dodd-Frank was passed and substantially implemented, provide real-time, real-life evidence that financial protection rules have not damaged the banks or the economy. Rather, they have created the conditions for sustained economic growth,

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[51] Kate Berry, "Four Myths in the Battle over Dodd-Frank," *American Banker*, March 10, 2017, https://www.americanbanker.com/news/four-myths-in-the-battle-over-dodd-frank (emphasis added)

[52] Zeke Faux, Yalman Onaran, and Jennifer Surane,"Trump Cites Friends to Say Banks Aren't Making Loans. They Are," *Bloomberg*, February 4, 2017, https://www.bloomberg.com/news/articles/2017-02-04/trump-cites-friends-to-say-banks-aren-t-making-loans-they-are (emphasis added).

[53] Jeff Cox., "Yellen: Trump is completely wrong that banks aren't lending," *CNBC*, February 14, 2017, http://www.cnbc.com/2017/02/14/janet-yellen-banks-are-lending-and-quite-profitable.html.

[54] Remarks by Paul A. Volcker at the 2017 Annual Meeting of the Bretton Woods Committee, April 19, 2017, https://www.volckeralliance.org/sites/default/files/attachments/Paul%20Volcker_Bretton%20Woods%20Speech_19Apr2017.pdf.

broader prosperity and reduced inequality, which, if the financial protection rules are allowed to continue working, should become durable and sustainable.

Additional evidence of this comes from comparison to European banks: according to the European Banking Authority, "The EU banking sector continues to struggle with high levels of non-performing loans (NPLs), low profitability and efforts to restore confidence, notwithstanding the steady strengthening of the capital base."[55] What accounts for the difference between the US and European banks? The U.S. took comprehensive action to stabilize the financial system, as explained by President Trump's National Economic Council Chairman Gary Cohn, who spoke to Bloomberg TV in 2016 when he was serving as President of Goldman Sachs:

> Almost all US banks took our medicine [recapitalizing, restructuring and implementing financial reform rules] early. We went out and raised capital really early in the process and then we went out and raised capital a second time….We really built our balance sheet up. We really de-leveraged ourselves. We really built enormous excess liquidity….And we made ourselves as financially secure as we could. We're subject to enormously robust stress tests here in the United States, and I give the Fed enormous credit for what they've done in stress testing the major banks here in the United States. [It's t]o the point where no one should question the viability of the big U.S. banks. I think some of the European banks have been slow to getting themselves recapitalized and getting their financial balance sheet in the best place it can be.[56]

Mr. Cohn's emphasis on the importance of increased capital has been definitively established by recent robust data-driven academic work establishing that better capitalized banks have higher rates of lending and a lower cost of capital throughout the business cycle. In particular, Morris Goldstein's new book, *Banking's Final Exam: Stress Testing and Bank-Capital Reform*,[57] undertakes a rigorous review of the data and analysis, demonstrating that 14% to 18% capital levels for the 8 U.S. G-SIBs (and a sliding scale for smaller banks) would be appropriate with negligible impact on lending. The understated summary of the analysis is worth considering in full:

> At the heart of the banking industry's opposition to much higher capital requirements is the assertion that higher bank capital requirements will depress bank lending and thereby reduce output and employment in the economy. This assertion is increasingly at odds with the empirical evidence – as well as with the appraisals of senior bank supervisors….Better capitalized banks lend more, not less, than weakly capitalized ones. One recent impressive study, which looked at 105 large banks from advanced economies over the 1994-2012 period, finds that after holding other factors constant, a 1%-point increase in the equity to total assets ratio (i.e., the leverage ratio) is associated with a

55 "Risk Assessment of the European Banking System," European Banking Authority, December 2016, https://www.eba.europa.eu/documents/10180/1315397/EBA+Risk+Assessment+Report_December+2016.pdf.

56 Dakin Campbell, "U.S. Banks Safer Than Europeans Due to Early Medicine, Cohn Says," Bloomberg, February 9, 2016, https://www.bloomberg.com/news/articles/2016-02-09/u-s-banks-safer-than-europeans-due-to-early-medicine-cohn-says.

57 Morris Goldstein, "Banking's Final Exam: Stress Testing and Bank-Capital Reform," Peterson Institute for International Economics, May 2017, https://cup.columbia.edu/book/bankings-final-exam/9780881327052.

> 0.6% increase in total lending growth. With this empirical finding, a key pillar of the case against much higher capital requirements is taken away.[58]

Thus, the evidence proves that increasing levels of capital has little if any effect on increased lending costs and, therefore, lending and economic growth.

It cannot be denied that US banks and financial institutions are much stronger and more stable today as a direct result of financial protection rules, including but not limited to capital. Moreover, those financial firms are in a much better position to support the real economy and the evidence proves that they are doing so, with lending increasing at twice the rate of economic growth. Thus, while seeking to promote economic growth and jobs is a laudable goal and a social imperative, subpar performance is not related to lending, bank profitability or financial protection rules.[59]

Deregulating the Global Too-Big-To-Fail Financial Firms Is "Extremely Dangerous and Extremely Short Sighted," Requiring Grown, Intelligent, Unconflicted People to Step Up and Courageously Lead the Fight Against It

Some people are prone to exaggeration or overstatement. The Vice Chair of the Federal Reserve Board, Stanley Fischer, is not one of those people. He is the opposite. He is an urbane master of understatement, speaking in soft, measured tones, sometimes barely audible. He was described by the *Financial Times* in a lengthy interview as "self-effacing," "courtly, quietly spoken and unobtrusive." He is, however, a giant voice in finance and financial regulation and he had an important warning about the deregulatory zeal pervading Washington, DC today:

> It took almost 80 years after 1930 to have another financial crash that could have been of that magnitude. And now, after 10 years, everybody wants to go back to the status quo before the great financial crisis. I find that really extremely dangerous and extremely short sighted. …[T]he pressure I fear is coming to ease up on the large banks strikes me as very, very dangerous.[60]

He "criticized calls to ease up on stress testing, saying pressure to loosen standards on big banks was 'very, very dangerous.' He argued that the US had yet to deal with the so-called shadow banking system, which operates outside mainstream lenders, calling this a 'terrible mistake'"[61]:

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58 Morris Goldstein, Banking's Final Exam: Stress Testing and Bank-Capital Reform, *Peterson Institute for International Economics*, 2017, https://cup.columbia.edu/book/bankings-final-exam/9780881327052.; citing Gambacorta and Shin, *Why Bank Capital Matters for Monetary Policy*, Working Paper 558. Basel: Bank for International Settlements; see also Admati and Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do About it*, Princeton University Press, 2013; Admati and Hellwig *The Parade of Bankers' New Clothes Continues: 31 Flawed Claims Debunked*, Revised December 2015; and Tom Hoenig, "The Global Capital Index Semi-Annual Update, April 13, 2017, https://www.fdic.gov/news/news/speeches/spapr1317.html .

59 See, e.g., FDIC Vice Chairman Tom Hoenig data driven analysis showing that if "the 10 largest US Bank Holding Companies were to retain a greater share of their earnings earmarked for dividends and share buybacks in 2017 they would be able to increase loans by more than $1 trillion, which is greater than 5 percent of annual US GDP." July 31, 2017 letter to Chairman Crapo and Ranking Member Brown of the Senate Committee on Banking, Housing and Urban Affairs, available here: https://www.fdic.gov/about/learn/board/hoenig/hoenigletter07-31-2017.pdf,

60 Sam Fleming, "Stanley Fischer, Fed vice-chair, on the risky business of bank reform," Financial Times, August 16, 2017, https://www.ft.com/content/e7a9869c-819f-11e7-94e2-c5b903247afd.

61 Id.

> I am worried that the US political system may be taking us in a direction that is very dangerous…. One can understand the political dynamics of this thing, but one cannot understand why grown, intelligent people reach the conclusion that [you should] get rid of all the things that you have put in place in the last 10 years.

He called this "mindboggling." "Mindless" is probably a better word. The industry's self-serving and bonus-driven cries for deregulation are as understandable today as they were when Upton Sinclair memorably observed in 1934[62] that:

> It is difficult to get a man to understand something when his salary depends on his not understanding it.

That also explains the industry's purchased allies in elected office, its lobbyists, lawyers, PR spinners, academics and so many others. But all the other "grown, intelligent people" Mr. Fischer refers to should know better and should stand up to those letting their salaried-interests trump what is best for the country, the financial system and global stability.

Another understated, dedicated, but relentless and fearless public servant, FDIC Vice Chairman Tom Hoenig, has also recently issued a warning, calling for courage, "guts" and leadership to stand up to the enthusiasms and politics of the moment.[63] While specifically addressing "the role of bank supervision and capital in counterbalancing the moral hazard dilemma," his call to action is broadly applicable. He begins by quoting "Paul Warburg, a German-born New York banker during the Great Depression and an early advocate for the Federal Reserve System, [who] observed this phenomenon as he commented on the public's attitude leading up to the Great Depression": [64]

> In a country whose idol is prosperity, any attempt to tamper with conditions in which easy profits are made and people are happy, is strongly resented. It is a desperately unpopular undertaking to dare to sound a discordant note of warning in an atmosphere of cheer, even though one might be able to forecast with certainty that the ice, on which the mad dance was going, was bound to break. Even if one succeeded in driving the frolicking crowd ashore before the ice cracked, there would have been protests that the cover was strong enough and no disaster would have occurred if only the situation had been left alone."[65]

He wryly observes that "[s]uch attitudes can be as prevalent today as they were before the Great Depression. As they develop and as the crowd noise drowns out calls for prudence, supervisors and insurers must force the crowd from the proverbial ice." The same is true for responsible elected officials, regulators, policymakers and academics. As Mr. Hoenig notes, if they fail, they cannot hope to "protect the economy and the public from the inevitable correction and its resulting economic suffering." He correctly observes that "[i]t is exhausting work, and it is most difficult to accomplish in

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62 Upton Sinclair, "I, Candidate for Governor: And How I Got Licked", University of California Press, 1994, https://www.goodreads.com/book/show/262689.I_Candidate_for_Governor.

63 Tom Hoenig, "Deposit Insurance: Addressing the Moral Hazard Effect," October 11, 2017, https://www.fdic.gov/news/news/speeches/spoct1117.html .

64 Id.

65 Id., quoting Paul M. Warburg, The Federal Reserve System, Vol I, Addendum II, "The Stock Exchange Crisis of 1929," The Macmillan Company, 1930.

the boom period just before a crisis." When the "boom period" is fueled by White House and administration cheerleading, as it is now, the difficulty is exponentially magnified.

There is a great deal of wisdom in Mr. Hoenig's speech that is applicable far beyond the ground-level supervision of banks and role of bank supervisors (however important they are). "Information gathering and validation, experience, leadership, and true courage" are traits in increasingly short supply, but are desperately required by all those responsible for upholding and protecting the public interest, especially now when the "crowd noise [from Wall Street to Washington] drowns out calls for prudence."

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If anyone suggested that the US should take down half the protections put up around New Orleans after Hurricane Katrina in 2005 because ten years have passed and there hasn't been another catastrophic hurricane, everyone would correctly laugh at the idiocy of that notion. Yet, the equivalent of that in financial reform regarding Dodd-Frank is the prevailing ideology in the Trump White House, the administration more broadly and much of Washington.

Financial reform is working, but the Trump administration and others in Washington DC are sowing the seeds of the next crash by deregulation that incentivizes one-way bets, leaving taxpayers on the hook for finance's bets. This is extremely dangerous and short-sighted. As Fed Vice Chair Fischer suggests, grown, intelligent people need to "reawaken," stand up, speak truth to power and protect financial reform, for the sake of the economic security, opportunity and prosperity of the American people and the globe. As FDIC Vice Chair Hoenig points out, that is going to require leadership and real courage. That is the challenge of our time.