Another Race to the Bottom? Venue Shopping for Regulators in the American Financial System

Colin Provost
School of Public Policy/Dept. of Political Science
University College London
c.provost@ucl.ac.uk

In public policy, whenever a business has the opportunity to choose its regulator, the question arises as to whether such opportunities lead to a “race to the bottom” in regulatory quality. Such concerns have been commonplace in international trade, where environmental and labor groups fear that more relaxed regulatory standards in developing standards can lead to industries in developed nations uprooting their businesses from home and relocating to developing nations where the costs of doing business are potentially cheaper. A number of scholars have examined the extent to which a race to the bottom truly exists (see e.g. Barajas et al 2007; Domínguez-Villalobos and Brown-Grossman 2007; Prakash and Potoski 2006; Vogel 1995), and much of this research that such fears are not entirely justified. Similar debates have taken place within the United States about whether manufacturers will move from one state to another in order to avoid stringent regulations (Potoski 2002; Woods 2006). Woods finds that mining companies may be induced by weaker regulations to move (2006), but Potoski fails to find similar patterns in clean air policies, more broadly (2002).

In the wake of the recent financial crisis, similar questions have arisen about American financial regulation. In the American dual-banking system, banks can choose to be regulated at the federal level by the Office of Comptroller Currency (OCC), or by the Office of Thrift Supervision (OTS) if they are thrifts or savings and loans (S&Ls). They may also choose to be regulated at the state level, which involves obtaining a charter in a particular state and establishing headquarters there. If the bank is a member of the Federal Reserve Board (FSB), and has a state charter, it is also regulated by the Federal Reserve. If it is regulated at the state level, but is not a member of the Federal Reserve Board, then it is also regulated by the Federal Deposit Insurance Corporation.
(FDIC). Because some of these agencies are funded by assessment fees collected from the banks that they regulate, critics of the system maintain that regulators essentially have to compete in order to attract banks to their regulatory system. This presents questions over whether banks exploit differences in agency regulatory policy by seeking to be chartered by the agency with the most relaxed regulations.

This is a highly pertinent question in the wake of the financial crisis. If it is true, as many observers have asserted, that the financial crisis began in the United States, it occurred because of two processes, broadly speaking. First, banks and thrifts made mortgage loans to thousands of people who did not qualify for them, and often created these loans under deceptive or fraudulent auspices. Such loans became known as subprime loans, and the worst of these were known as predatory loans. For the banks, making such loans while knowing there was a high chance that the borrower would default, represented the classic definition of moral hazard. This practice of irresponsible lending was further enabled by the second process, known as securitization. With securitization, bonds were created from mortgage loans and sold as investment products, thus giving the impression that the risk created from making such loans was safely diffused through global financial markets. For this whole process to occur, poor lending practices came first and it is worth asking whether regulatory competition enabled these processes.

In the context of the financial crisis, much of the evidence presented for the existence of “charter shopping” has come from high-profile anecdotes, involving banks, some of which were heavily involved in sub-prime mortgage lending, that switched regulators, apparently in order to avoid enforcement actions. In late 2008, the
Washington Post reported that the OTS weakened its regulatory standards in order to induce some commercial banks to switch to savings and loan charters and come under the supervision of the OTS (Appelbaum and Nakashima 2008). As an example, the article reported that Countrywide Financial had switched from OCC supervision to OTS supervision in order to obtain a lighter regulatory touch. Two months later, the Post reported that, “at least 30 banks since 2000 have escaped federal regulatory action by walking away from their federal regulators and moving under state supervision…” (Appelbaum 2009).

Such episodes have led many observers to propose the elimination of charter shopping, through either consolidation of agencies or changes to agency funding structure. Although financial reform proponents in Congress and the White House have since tempered their enthusiasm for a single financial regulator, many of these proponents clearly believe that the ability to choose regulators played a key role in creating the financial crisis. At a Senate Banking Committee hearing in September, 2009, the Chairman, Senator Christopher Dodd, said that, “it is clear that we need to end charter shopping where institutions look around for the regulator that will go easiest on them” (2009). In the immediate wake of the crisis, Senator Charles Schumer made a similar argument at a meeting of the Securities Industry and Financial Markets Association (2008). And Sheila Bair, the chairwoman of the FDIC, showed support for the idea of consolidating federal bank regulators, although she wants to preserve the dual-banking system, in which federal and state chartering agencies exist (2009).

On the other hand, observers within the financial sector deny that banks switch regulators in order to obtain more favorable regulation. A report by the American
Banking Association presents data that show that banks rarely flip charters, if at all, and that recent guidance documents for the different banking agencies promote uniformity that can help to eliminate the incentive for regulatory arbitrage (2009). Others present evidence that in the 2000s, banks that did change their charters did so in numerous different directions (state to federal, federal to state and federal to federal), which contradicts the idea that they are moving towards one particular regulatory with the lightest touch (Brubaker 2009). Finally, others have argued that banks will choose the regulator that best fits their business model (Bowman 2009), and that if a failing bank attempts to shift regulators in order to escape enforcement action, its high-risk status will prevent it from successfully shifting.

Little previous research exists on the question of whether the fragmented structure of financial regulation in the United States promotes a race to the bottom. Those studies that do exist (Rosen 2003, 2005; Whalen 2005) provide thorough, although ambiguous, findings about the question of a race to the bottom. However, beyond that, these studies suffer from three primary shortcomings. First, they do not cover the period from 2004 onward, which is now widely considered to be the period in which sub-prime mortgage accelerated. Second, these studies examine the situation solely from the perspective of the banks by examining the decision calculus of each bank to switch regulators, according to the banks’ assets, liabilities and relative risks. This is no doubt essential to such a study, but it fails to capture the movements of regulators to try and attract banks into their fold. Third, these studies proceed based on an assumption that, in order for a race to the bottom to exist, two things must happen: first, banks must switch regulators in search of the lightest touch regulation and a high proportion of those banks must then fail.
However, if regulators are truly competing to lower standards, banks that were considering flipping charters may suddenly be content where they are, if they are the beneficiaries of newly weakened standards. Thus, banks do not necessarily need to change their chartering agency in order for a systematic weakening of regulations to occur.

In this paper, I depart from the quantitative models employed by Rosen and Whalen to provide a qualitative approach in which I evaluate the activities of federal banking regulators in the 2000s to determine whether they engaged in destructive competition and whether this ultimately had an impact on banking performance. In particular, I examine the behavior of the OTS and the OCC. The paper proceeds as follows. In the first section, I discuss the literature on regulatory races to the bottom, and use delegation and principal/agent theory to explain why financial regulation is different from other fields of regulation already studied in this other area. In section two, I then discuss the motivations of banks to shop for regulators, but more importantly, the motivations of bank regulators to attract banks into their regulatory orbit. In section three, I discuss the activities of the OTS and OCC, and in Section 4, I discuss the resultant behavior of banks and the effects of the OTS and OCC regulatory styles.

**Regulatory Races to the Bottom and the Delegation of Bureaucratic Authority**

The question of whether races to the bottom exist in regulatory standards has been examined before, but mostly in environmental regulation. In the international arena, the typical fear of environmentalists, organized labor and consumer advocates is that where diverging regulatory standards exist between two countries that are engaged in free trade,
companies will relocate to the country with weaker standards, in order to save on regulatory compliance costs and thereby increase profits. This issue was of particular concern in the early 1990s, when the North American Free Trade Agreement (NAFTA) was drafted, signed and implemented. Of course, the fear of a race to the bottom is not limited to the international arena. At the American state level, scholars have also inquired as to whether such dynamics exist in air pollution regulation (Potoski 2002) and mining regulation (Woods 2006).

However, fears of a race to the bottom have proven to be unfounded to a large extent. In the international arena, David Vogel has found that in trading relationships, developed nations with strong regulatory standards can actually influence developing nations to raise their regulatory standards as well, if the developed nation has strong consumer and environmental movements, as well as a large market to which the developing nations wants access (1995). In their study of business participation in the voluntary, emission-reduction standard, ISO 14001, Prakash and Potoski find a similar effect, in that countries with high levels of ISO participation can business in trading partner countries to also sign up to ISO 14001 and voluntarily reduce their emission levels (2006). However, at the American state level, Woods does find that states weaken their mining regulations in order to attract the business of mining companies (2006).

While cross-national and cross-state regulatory standards in the environmental arena have been examined to evaluate potential declines in standards, the same questions have rarely been applied in the area of financial regulation. Whether or not there is a domestic race to the bottom in regulatory policy depends in part on delegation of regulatory policy. In the United States, the manner in which agencies regulate business
depends on how legislative and executive principals (Congress and the President) oversee the agencies themselves. Principal-agent theory is based on the assumptions that an agent (a regulatory agency) who is hired by the principal (Congress or the President) has an information advantage over the principal(s) and will exploit this advantage to either shirk or pursue policy in its favored direction (although see Waterman and Meier 1998). Consequently, both the executive and legislative branches can and do employ a variety of ex-ante and ex-post mechanisms to steer bureaucratic behavior. McCubbins, Noll and Weingast (1987, 1989) argue that Congress “hard-wires” agencies with policy preferences that fit the preferences of the enacting coalition. Similarly, Terry Moe argues that interest groups fight each other through their representatives in the executive and legislative branches to create bureaucratic structure that best suits their policy needs (1989).

Among the numerous factors that influence the manner in which authority is delegated to regulatory agencies are the salience and complexity of the issue in question (Gerber and Teske 2000; Gormley 1986; Ringquist et al 2003). When policies are complex, politicians will delegate authority to bureaucrats whose expertise in the policy area in question is greater than their own. This is the classic motivation for delegation, and we see it in policy areas, such as environmental regulation and more importantly, financial regulation. However, if policies are salient, then politicians care more about policy outcomes and are more reluctant to delegate unvarnished authority to agencies. Thus, when policies are both salient and complex, politicians must balance the uncertainty of policy outcomes against the uncertainty of bureaucratic behavior—what Kathleen Bawn refers to as the trade-off between technical and procedural uncertainty.
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Regardless, environmental regulation’s status as a salient policy is partly what has prevented races to the bottom in that area. For example, Vogel demonstrates that consumer and environmental groups—more likely to be present for salient policies—are able to mobilize to boycott particular products, thus preventing the degradation of regulatory standards (1995).

While it is true that salience can be a dynamic concept and can vary over time, financial regulation is typically considered to be a complex and not salient policy issue (Gormley 1986), typically made salient only in times of economic crisis. In this instance, politicians are happy to delegate nearly unfettered authority to bureaucrats, as the costs of bureaucratic drift are not as significant for non-salient policies. Evidence from 2001-2006 supports the idea that financial regulation fit this characterization. After September 11, 2001, national security and foreign policy became the driving focus of the Bush Administration and indeed the 2004 election was deemed by many to be a referendum on Bush’s handling of these policies. With respect to complexity, many scholars have argued that financial regulation is so complex that regulatory agencies actually have to delegate authority further to private standard setting bodies or to the businesses themselves, in the form of self-regulation (see e.g. Mattli and Buthe 2005). This reality fit the Bush Administration narrative nicely as the Administration downplayed punitive regulatory policies and sought business-friendly policies in many other agencies, including the Environmental Protection Agency (Provost et al. 2009), the Equal Employment Opportunity Commission (Nicholson-Crotty and Nicholson-Crotty 2009) and the Department of the Interior (Provost and Teske 2009).
In this paper, I argue that both the nature and the institutional structure of financial regulation enabled a race to the bottom in regulatory standards. This race was enabled by the lack of salience of financial regulation, the willingness of the Bush Administration to allow banks to regulate themselves, and the need for banking agencies to fund their own activities, and thus their own survival. Some scholars have examined whether multi-national banks shop for different national venues in order to find the lightest touch regulation (see e.g. Houston et al 2009), yet a relatively small number of studies have asked the same question with regard to bank regulation within the United States. The answer to such a research question is important for at least two reasons. First, if a race to the bottom in regulatory standards truly exists, it increases the likelihood of bank failures occurring, which points to the need to prevent regulatory failures from occurring. Second, the American financial industry is large and significant enough that, as the financial crisis has demonstrated, it has the potential to affect economies throughout the rest of the world as well. Thus, the institutional structure of American financial regulation has implications for the global economy.

**The Motivations of Banks to Shop for Regulators**

The question of whether there is a race to the bottom in American financial regulation is borne out of the dual banking system, which allows banks to choose between regulators at the state or federal level. Rosen claims that banks switch regulators for one of three main reasons: to gain additional powers, to save on regulatory compliance costs or to enable nationwide expansion more easily (2005). Experts within the financial industry have claimed that the first and third reasons are the predominant...
motives for charter flipping, ie that banks will change charters when they believe it will best fit their business model. The second motive points more towards the possibility of a race to the bottom. However, saving on compliance costs could represent a range of different banks. Some banks may be simply trying to save on compliance costs, while others may be trying to evade regulatory action altogether by flipping charters. Indeed, the case of Countrywide Financial has fueled the idea that fragmentation in the American regulatory structure leads to a weakening of overall standards. Countrywide, when facing regulatory action from the OCC, transformed itself into a thrift and shifted its charter from the OCC to the OTS in 2007, before then being bought out by Bank of America in 2008.

Rosen (2003, 2005) and Whalen (2002) both examine the decisions of commercial banks and thrifts to flip charters and both find, to varying extents, that banks that carry higher proportions of risky assets are more likely to flip charters. In addition, Whalen finds that banks that experience formal enforcement actions are also more likely to switch charters. Rosen concludes that despite these findings, there was no decline in regulatory standards over time because bank failures did not rise as a result of charter switches (2005). However, Rosen, whose study encompasses the longest period of time, does not account for 2004 onward, which is the period where subprime mortgage lending exploded. Subprime mortgages were essentially home loans offered to people who could not necessarily afford the loans, which is the classic definition of moral hazard in banking. Both the OTS and OCC have been condemned by various observers for their roles in the crisis, but did the crisis occur because of failures within each agency or because of decline in standards spurred by regulatory competition?
The Motivations of Regulators to Attract Banks

As I stated in the introduction, the institutional structure of American financial regulation presents a situation in which some observers may perceive that banks can shop for their regulators. This scenario is created primarily by two institutional features: the presence of multiple regulators, at the state and federal level, and the requirement that agencies collect their operating budgets not from legislative appropriations, but from fees levied on the banks which they regulate. These institutional features, when combined with the economic consequences of laws that liberalized banking in the U.S. during the 1980s and 1990s created a situation in which the weakening of regulatory standards became ever more likely.

Regulators may feel they have to fight for “clients” or banks, if the number of banks decreases over time, thereby decreasing regulator budgets. In the 1980s, as the restrictions on interstate banking were lifted, the number of bank mergers increased, as did the number of bank failures (Blair and Kushmeider 2006). In past research, the increase in bank failures has been directly attributed to deregulatory initiatives such as the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Act of 1982 (Krause 1994; Meier and Worsham 1988). The Riegel-Neal Interstate Banking and Branch Efficiency Act of 1994, on the other hand, removed most remaining geographical restrictions on banking and resulted in greater consolidation within the industry. The net effect of these laws, whether through merger or failure, was to reduce the number of banks in the system. For the regulators, fewer banks meant less money in assessment fees, which resulted in smaller operating budgets. The resulting
need to get competitive was particularly acute for federal bank regulators, as bank
assessment fees levied by the OCC and OTS had always been substantially higher than
those of their state-level counterparts (Blair and Kushmeider 2006).

**The Ensuing Regulatory Competition**

Declines in assessment fees spurred the OCC and OTS to make themselves more
attractive to banks. One major method by which both agencies attempted to bring more
banks under their respective regulatory umbrellas was to pre-empt state legislation.
Federal pre-emption is where Congress, the President or members of the executive
branch issue rules that supersede state rules. In this specific case, when federal regulators
issue pre-emption rules, it means that businesses regulated by federal agencies only need
abide by federal regulations, and not by state laws. Thus, if federal laws have less
punitive effects on banks for violating consumer protection or capital requirement laws
than do state laws, pre-emption weakens the regulatory burden for banks and works in
their favor.

In 1996, the OTS promulgated rules that stated that its member institutions did not
have to follow state lending laws. At the time, the reach of state lending laws was rather
narrow (McCoy 2009), but in 1999, North Carolina enacted the first state anti-predatory
lending law. Predatory lending has been defined previously as involving one or more of
the following problems:

“Loans structured to result in seriously disproportionate net harm to borrowers;
harmful rent-seeking; loans involving fraud or deceptive practices; other forms of
lack of transparency in loans that are not actionable as fraud; and loans that
require borrowers to waive meaningful legal redress” (Engel and McCoy 2002).
Predatory lending does not necessarily have to happen in the subprime mortgage market, but it is far more likely to happen there than in the prime mortgage market. Technically, federal protections for consumers from predatory lending were already in place, as Congress had passed the Federal Home Ownership and Equity Protection Act of 1994, but the reach of this law was limited (Corder 2009; McCoy et al 2009), thus making it ineffective and inviting states to create their own laws, dealing with predatory lending. While the OTS had pre-empted state laws that existed as of 1996, it had not pre-empted any of the recent state legislation, but in January, 2003, the OTS announced that they were pre-empting the New York Predatory Lending Law and the Georgia Fair Lending Act (Blackwell 2003). The OTS decision to pre-empt was significant, as 29 states had written anti-predatory lending laws by 2006.

At the time of the OTS decision in 2003, there was speculation that the OCC would soon follow with its own pre-emption decision, perhaps to ensure that OCC-chartered banks would not jump ship to the OTS (Blackwell 2003). In January, 2004, the OCC announced that it was also promulgating rules pre-empting state lending laws, claiming that uniform, national regulations would make for a more efficient regulatory structure with fewer transaction costs for business. State attorneys general were highly critical of the OCC’s preemption decision, as they claimed that the OCC lacked the supervisory capabilities to monitor the behavior of all national banks by itself (Bautista 2004). However, OCC Director John D. Hawke Jr. knew that if states were still able to bring predatory lending cases against national banks, the OCC might lose some of its banks to the more relaxed thrift charter. After all, state attorneys general had proven that they were willing and well-coordinated in the enforcement of anti-predatory lending
laws. In 2002, 38 states settled with Household Finance for $484 million, over Household’s predatory, deceptive and fraudulent practices (Peacock 2004). Pre-emption would prevent federally regulated banks from experiencing such legal actions. The act of preemption may not have aroused as much controversy with state attorneys general and consumer advocates if the OCC and OTS had replaced state enforcement laws with their own equally rigorous standards. However, both agencies preferred to rely primarily on guidelines and consensual regulatory styles, rather than strict enforcement mechanisms (McCoy et al 2009).

Beyond preemption, the OTS engaged in a variety of activities that appeared to have the purpose of making it more competitive within the financial regulatory structure. In early 2002, the OTS was reeling from the failure on its watch of Superior Bank, as well as the shift of Charter One Financial Inc. from an OTS to an OCC charter (American Banker 2002). The events created an atmosphere where rumors swirled that the OTS might be ripe for abolition. Thus, as soon as he was appointed in late 2001, Director James Gilleran was determined to lift regulatory burdens from thrifts and make his agency more attractive to banks that were considering converting to charter thrifts. Gilleran’s stated goal was “to allow thrifts to operate with a wide breadth of freedom from regulatory intrusion” (Appelbaum and Nakashima 2008).

Prior to Gilleran’s appointment, OTS-regulated banks were examined for both safety and soundness (ie sufficient capital reserves) and for compliance with federal consumer protection laws, such as the Federal Truth in Lending Act, the Community Reinvestment Act, and the Gramm-Leach-Bliley Act. However, in an attempt to streamline the examination process, Gilleran had the exams merged into one, while
requiring that thrifts perform “self-evaluation” compliance exams on themselves, before the newly combined examination (Blackwell and Garver 2002). This maneuver coincided with significant cuts in agency staff in 2002 that were designed to meet budget shortfalls from previous years, but nonetheless landed more heavily on staff involved in compliance examinations (Blackwell and Garver 2002). Additionally, in July 2004, Gilleran announced that he was quadrupling the asset limit for examinations administered under the Community Reinvestment Act (CRA) from $250 million to $1 billion (Blackwell 2004). This new rule enabled all banks with assets under $1 billion to take a simplified version of the CRA exam. While the decision was a surprise at the time—one not agreed to by the other banking regulators—both the OCC and FDIC proposed similar adjustments in the autumn of 2004 in order to keep up with the OTS’s decision.

**The Wider Regulatory Environment**

The actions of the OTS and OCC of course did not occur in a vacuum. In addition to the individual incentives that each agency had to compete for “customers” in the form of banks, the broader political environment contributed to their actions, most notably through the phenomenon of securitization. Securitization is the process by which commercial banks and thrifts sold their mortgage loans to investment firms, primarily on Wall Street, which would then be sold in the form of mortgage loan bonds to investors.¹ The ability of investment banks to sell these bonds as investments then depended, to a significant degree, on the ratings they received from credit ratings agencies (CRAs). If the bonds received good ratings, then commercial banks benefitted from the sale to investment banks, investment banks benefitted from the sales to investors and everyone

¹ For a more extensive discussion of precisely how securitization works, see Eggert (2002, 2009).
was convinced that risk was spread safely throughout the financial system and that adverse consequences would only result if the entire American housing market collapsed at once.

The process of rating mortgage loan bonds raised its own questions about whether CRAs were systematically weakening ratings standards. Just as with banking regulators, incentives and the potential for competition are crucial to the activities of CRAs as well. First, CRAs are not regulators, rather they are private enterprises, who make money by grading the securities of investment banks. Thus, as many others have claimed, CRAs have an inherent conflict of interest, in that they are judging the value of products, while being paid by the manufacturers of those products (Rom 2009).

CRAs do have incentives to at least appear to be independent, as their reputations diminish in value, the more they are perceived to be captured by investment banks. Yet, the reputation incentive may have been swamped by other factors prior to the credit crisis. Just as a decreasing number of banks increased competition among bank regulators, the SEC found that 12 underwriters accounted for 80 percent of the residential mortgage-backed securities and collateralized debt obligations that CRAs were examining (SEC 2008). Consequently, the downgrading of securities was not a common occurrence prior to the crisis, largely due to CRAs fear of damaged relations with investment houses (Chan 2010; Lewis 2010). Moreover, recent evidence has shown that when investment assets are simple, information is more complete and investment banks do not necessarily gain by venue shopping, because ratings are similar. However, when assets are complex, it raises the probability that CRAs will assign different values to
these assets, thus increasing the incentive for investment banks to shop for favorable ratings (Skreta and Veldkamp 2009).

The potential problems with CRAs were not viewed as problems from 2004 to 2006 as the housing market continued to boom. Indeed, the risky subprime lending was not perceived as a problem at all by many observers in the financial community, as securitization allegedly helped spread risk safely throughout the financial system. Such beliefs were reinforced by rhetoric from economic policy makers, most notably, then Federal Reserve Chairman, Alan Greenspan. In 2004, he implicitly validated much of the activity in the lending and securities markets:

“Concentrations of risk are more readily identified, and when such concentrations exceed the risk appetites of intermediaries, derivatives and other credit and interest rate risk instruments can be employed to transfer the underlying risks to other entities. As a result, not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient” (2004).

Thus, with the Bush Administration, economic elites and the wider financial community all believing that a new method of risk containment had been discovered, it is easier to understand why the OTS and OCC both believed that they could loosen consumer protections and capital controls to allow banks to flourish.

**A Race to the Bottom?**

As indicated before, the only extant research on financial regulatory races to the bottom have primarily examined the decisions of banks to switch charters, working under the assumption that if banks evade regulatory action by switching charters, there is a systematic weakening of standards occurring. While there is truth to this, charter switching does not necessarily need to occur for there to be regulatory competition in a
negative direction. Large differences remain in assessment fees between federal and state regulators and some banks may genuinely feel that their regulator best fits their business model. In this case, banks might be more inclined to lobby their regulator to align its standards with other agencies, rather than threaten to leave. If regulators oblige, then there is a systematic weakening of standards, without charter flipping, as banks are then happy to remain with their primary regulator.

By examining the behavior of the OCC and OTS, it is clear that they both weakened their regulatory standards throughout the 2000s, often in response to each other’s actions. The effect on banking behavior was that subprime lending continued to rise, particularly in the thrift sector. Subprime lending is characterized primarily by terms that promise low monthly payments up front (often called “teaser rates”), which can rise dramatically and suddenly later on. Adjustable-rate mortgages (ARMs) were popular products with many subprime lenders because it allowed it allowed lenders to promise up-front rates tempting enough to reel in borrowers, which could later be raised to make up the difference. ARMs had a high rate of default and yet they composed large portions of many banks’ portfolios. Between 2004 and 2006, subprime loans and ARMs constituted over half of the portfolio of Washington Mutual, an OTS-regulated thrift whose failure in 2008, was the largest in American history (McCoy et al 2009). Over half of the assets of Downey Savings and Loan, which also failed in 2008, also constituted ARM loans.

With these subprime products being churned out an increasingly rapid pace, home foreclosures eventually started to rise, as did bank failures by 2008. At least one study has found that the OCC’s rules, before they were struck down by the U.S. Supreme Court
in 2008, led to a higher number of home foreclosures in those states where laws were pre-empted (Ding et al 2010). The implications from this study are that, if the states had not been pre-empted in their enforcement of anti-predatory lending laws, risky lending practices may have been curtailed, resulting in fewer home foreclosures.

The more revealing outcome variable here is the performance of banks as a result of such administrative changes. One study has gathered data on which banks had the highest level of loans that were 30 days past due or in accrual (McCoy et al 2009), and found that from 2006-2008, both federal banks (OCC regulated) and federal thrifts (OTS regulated) had worse performing loans than did state banks or thrifts. These trends become more pronounced, moving towards 2008, with federal thrifts far outpacing other types of institutions in under-performing loans. This finding is not particularly surprising, as the OTS was vilified in the popular press in 2008-09 for presiding over such high-profile failures as Washington Mutual, Indy Mac Bank, Wachovia, Downey Savings and Loan and AIG (due to its ownership of a thrift). The effects of the crisis have extended beyond 2008, as OTS presided over 20 thrift failures in 2009, compared with six in 2008 (OTS 2010).

**Discussion**

The financial crisis occurred because a number of factors were at work simultaneously, but squarely in the middle of the crisis were the regulators, the OTS and OCC, and the administrative policy changes they made. The structure of the American banking system, in which regulators are funded through assessments they collect from banks, combined with the dwindling number of banks forced the OCC and OTS to
compete for their respective survivals. This need was particularly acute for the OTS in early 2002, as rumors swirled of its potential abolition or merger with the OCC. Additionally, the growing phenomenon of securitizing mortgage loans into mortgage loan bonds appeared to many to be the magic bullet for risk, as numerous observers, including Alan Greenspan, concluded that securitization safely spread risk throughout the financial system. This widely held belief, combined with the agencies’ need for “business” led both the OCC and OTS to engage in a variety of administrative maneuvers that ultimately made it easier for commercial banks and thrifts to engage in subprime, and often predatory, lending. The results were higher foreclosure rates, a higher rate of bank failures and the financial crisis.
References


