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ECONOMIC CRISES AND FINANCIAL REGULATION THROUGHOUT THE HISTORY  
OF THE UNITED STATES

RACHEL-PAIGE MUMENTHALER  
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Reviewed and approved\* by the following:

Robert Packer  
Professor of Political Science  
Thesis Supervisor

Gretchen Casper  
Professor of Political Science  
Honors Adviser

\* Signatures are on file in the Schreyer Honors College.

## ABSTRACT

It is necessary to ask why the restrictiveness of financial regulation varies throughout the history of the United States of America. This paper will seek to analyze through an interest group model approach how systemic economic shocks change the opportunity/threat environment of the financial services industry and the public to ultimately influence the American government in passing financial deregulation and regulation. After analyzing three relevant time periods—the Stock Market Crash of 1929 which led to the Great Depression and subsequent passage of the Glass-Steagall Act, the deregulatory trend starting in the late 1970s and cumulating in the late 1990s with the passage of the Gramm-Leach-Bliley Act, and the 2007 financial crisis, Great Recession, and subsequent passage of the Dodd Frank Wall Street Reform and Consumer Protection Act—and collecting campaign finance data, a number of conclusions can be made. First, the financial services industry continuously advocates for looser restrictions on higher risk/reward activities, leading toward deregulation or the weakening of existing pieces of legislations. Second, only in times of economic crises does the public become temporarily mobilized to counteract the influence of the financial industry to push for financial regulation and ultimately pass financial regulation. Third, even though there may be changes in terms of legislation, the gains that are made by consumers through their passed legislation may be lost in terms of regulatory enforcement due to the fact that the financial industry continues to lobby both regulators and legislators.

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## **Chapter 1**

### **Introduction**

With the 1933 passage of one of the most restrictive pieces of financial regulation in American history, the Glass Steagall Act, it was not until the late 1970s that the trend towards greater deregulation by the financial services industry occurred and was later accelerated with the Glass Steagall Act's repeal in 1999. Nine years later following its repeal, a wave of economic downturn hit the United States in 2008. As the housing bubble burst due to a sharp decline in real estate prices, homeowners experienced foreclosure and investors defaulted on risky subprime loans inducing the collapse of the largest investment banks in the world and signaling the start of the most significant economic decline since the Great Depression, the Great Recession. Three years later, Congress passed the most influential and most costly piece of financial regulation to the financial services industry since the Glass-Steagall Act in 1933, The Dodd-Frank Wall-Street Reform and Consumer Protection Act, which attempts to induce transparency and accountability on Wall Street to help protect investors. Therefore, it is important to ask why the restrictiveness of financial regulation varies throughout the history of the United States of America. This paper will seek to analyze through an interest group model approach how systemic economic shocks change the opportunity/threat environment of the financial services industry and the public to ultimately influence the American government in passing financial deregulation and regulation (Packer 2015).

The aim of this research is to determine why the degree of restriction in financial regulation historically varies in the United States. Briefly, it can be argued that financial markets

and economies are constantly in a cycle, however it is in those times where there is a systemic economic shock, a dramatic and sudden change in the economy, that the opportunity or threat environment of the financial services industry and public is altered. The logic is simple; after a shock occurs, the public becomes more aware of the negative externalities of the high-risk high-reward activities of the financial services industry that perhaps wish to share the risk with the public while privatizing their financial gains. Once the negative externalities of risky financial practices are realized, the creation of speculative bubbles and uncertainty, the public is more assertive in pushing their agenda and is therefore likely to advocate for new regulatory initiatives to correct market failure, increase their economic gains, and minimize economic losses. During a financial crises, there is a temporary period of near equality of attention given to news in the financial sector—normally, there is an asymmetric relationship between the financial services industry and public in terms of the interest given to financial news. This symmetric relationship temporarily shifts the balance of interest to the public and increases the net benefit of the public in acting collectively. While the financial services industry has clear and ever-present reasons to be attuned to the costs and benefits of regulation, the public does not. Indeed, the public is largely uninterested in the minutiae of regulation except during periods of financial panic and subsequent economic crisis. Therefore, even shortly after the passage of legislation, the financial services industry works to dampen the newly passed regulation by continuing to lobby Congress and the financial regulatory agencies as economic times return to normalcy (Packer 2015).

While this research has both economic and financial aspects to it, it is specifically relevant to the Political Science Department, as it will be focusing on the political outcomes of financial crises by examining the legislative policy outputs and the politics of interest group lobbying behind these outcomes. This study will analyze the economic and regulatory

environment beginning from the Great Depression until present day, with focus on crises including the Stock Market Crash of 1929, the trend towards deregulation beginning in the late 1970s and cumulating in the late 1990s, and the Housing Market Crisis of 2007. By looking specifically at these periods of time, it can be determined how these economic environments affected the assertiveness of two groups of lobbyists—the financial services industry and public—which then affected the regulatory or deregulatory outputs passed by Congress. Over the past eighty-five years, the United States has experienced times of great expansion and great loss and these eras have led to major regulatory overhaul. Therefore, it is imperative to determine the relationship between economic conditions and financial reform in the United States due to its direct impact on both Wall Street and Main Street and accordingly on the United States' domestic economy as a whole. By understanding the contrasting lobbying motivations of the financial services industry versus the public, scholars will be able to better predict regulatory and deregulatory policy outputs passed by the United States government following systemic economic shocks and changes in regulation following the passage of such legislation.

This thesis will first explain the literature surrounding this topic—primarily focusing on three scholar's arguments for why financial reform takes place including the procyclicality of financial reform, the Regulatory Sine Curve, and a change in culture on Wall Street, and will also discuss the Collective Action problem as an explanation for the motivation in interest group lobbying. Then through a case study approach, three relevant time periods will be analyzed—the Stock Market Crash of 1929 which led to the Great Depression and subsequent passage of the Glass-Steagall Act, the deregulatory trend starting in the late 1970s and cumulating in the late 1990s with the passage of the Gramm-Leach-Bliley Act, and the 2007 financial crisis, Great Recession, and subsequent passage of the Dodd Frank Wall Street Reform and Consumer

Protection Act. This study will be able to analyze the effects of economic conditions on interest group assertiveness by examining the economic atmosphere, discussing the positions advocated for by both interest groups, using data collected to measure the assertiveness of each group, and looking at their effect on policy outputs and further changes on those outputs. This thesis will then provide a discussion and overall conclusion based on the results of the research found.

## Chapter 2

### Literature Review

When analyzing the current literature on this topic, various scholars offer different reasons as to why and how financial reform is likely to occur. While academic McDonnell (2013) analyzes three models that he establishes all rooted in public choice analysis, Coffee (2012) attributes interest group sentiment, the Regulatory Sine Curve, and political exploitation as reasons why reform occurs after crises and is then eventually downsized, and scholars including Chappé, Nell, and Semmler (2012) believe that the Culture of Risk has come to dominate Wall Street and thus financial regulation. Furthermore, it is important to examine Olson's (1965) work describing the collective action problem to better understand motivations behind interest group lobbying.

McDonnell (2013) examines why financial regulation tends to be pro-cyclical and if there is anything that reverses or reduces the trend. The author discusses a number of arguments, including one that includes a tendency to over-regulate following crises and deregulate in good times as a useful corrective and another that sees deregulation in good times and regulation after crises because it is the only way regulation is politically feasible. He creates three models all rooted in public choice analysis—more concentrated interest groups are better able to organize to promote their preferred policies than diffused groups—and are compared on three dimensions including the regulatory demand side, regulatory supply side, and normative foundations.

Model 1 sees over-regulation following crises and excessive deregulation in boom periods but roughly the correct level of regulation over time. He attributes Olson's (1965) theory of interest groups to explain his reasoning—the idea that relatively small, concentrated interests should dominate effective lobbying. He states that because all political leaders wish to stay in power, they tend to favor the side with the concentrated interests and therefore because consumers and the general public are large and diffuse, the financial industry insiders have a greater expertise and will be able to lobby more effectively. He argues that during periods of great economic expansion, the general public does not understand nor care about financial regulation and therefore the collective action problem and free riding, or the belief that other individuals will work to enhance current conditions which leads to the inaction of individuals, prevents effective lobbying from taking place. He even states that during boom periods when regulations could usefully correct market excesses, politicians and regulators are captured by the financial services industry to loosen rules instead of tighten them. Because industry insiders do have a constant interest in regulations, as burdensome new rules can limit their ability to make profits and the strength of these interests combined with their small numbers and expertise allow the members to overcome the free rider problem, the financial services industry has a consistent interest in politicking. Therefore, the loosening of regulation could occur in the form of new laws or under-enforcement. In the wake of a crash however, this dynamic changes as the general public becomes more engaged and assertive, risks are highly salient, and politicians wishing to win reelection impose uninformed new rules in response to a public panic (McDonnell 2013).

Model 2 focuses on the bust phase, a period of economic contraction, and is more concerned with over-regulation following crises which ultimately leads to a long-term pattern of over-regulation and under-informed and over-reaching legislation. The author goes on to state

that reduced regulation does not occur at all and if it does, it is limited and temporary in nature and helps to counter a dominant long-term trend toward over regulation. He also states that within Model 2, interested groups, including regulators, continue to provide some significant pressure in favor of stronger or increased regulation due to the personal interests of the regulators (McDonnell 2013). Model 3 is concerned with excessive deregulation occurring in boom times and argues that this leads to a long-term pattern of overly weak regulation due to the ability of well-organized interests groups within the financial industry to capitalize on a new pro-market and anti-regulation cultural and political climate. McDonnell argues in this model that the public and politicians ignore financial regulation as it loses salience during boom times while the financial services industry is able to dominate capturing the regulators who become less afraid of public backlash. He further states that new financial products and markets go unregulated and restrictions on old products and markets gradually loosen and uses the late 1970s and lax regulation on new savings devices, money market funds, as an example (McDonnell 2013).

The author finds that the United States best fits with Model 1, and briefly uses historical cases to illustrate this. For example, he discusses the New Deal financial reforms, National Banking Act of 1933, and the crash that led to the Great Depression, deregulation in the 1980s and 1990s with the repeal of the Glass Steagall Act, and the most recent financial crisis of 2007-2008 and Dodd-Frank (McDonnell 2013).

While this study is helpful in terms of predicted regulatory outputs given a specific economic atmosphere, it is also very normative and does not provide a strong enough interest group argument. For example, what constitutes “the correct regulation”, “over-regulation,” or “under-regulation”? Furthermore, this study relies on brief examples throughout American history to create these models and does not fully use case studies to support the models being

argued. Therefore, while this literature provides three solid contrasting models, I seek to better explain McDonnell's Model I argument through the use of case studies and data collection. By further explaining the economic atmosphere's effect on policy outputs by more thoroughly looking at the assertiveness and arguments made by the financial services industry and consumer advocacy groups via case studies and data collection, McDonnell's arguments can be better solidified.

Second, Coffee's (2012) creation of the "Regulatory Sine Curve" and his explanation of interest group sentiment and political exploitation offer similar yet contrasting reasons as to why regulatory reform occurs. Coffee analyzes why Congress seems to only pass securities and financial reform legislation after a crash, who pushes for such reforms when the financial system breaks down, and how these reforms are downsized. His logic is simple: only in catastrophic market collapses can legislators and regulators overcome the resistance of the financial community to adopt comprehensive reform legislation. Like McDonnell, he argues that in the United States, investors and shareholders are numerous, dispersed and unorganized with potential political power diffused contrasting with the well-organized, incentive-driven, and powerful lobbying presence that the financial services industry holds. Because of these differences among groups, he declares that in crises, political entrepreneurs gain attention and electoral success by exploiting the popular discontent and aggregating the frustrations of citizens in an effort to secure election or reelection. Contrarily, after the financial crisis when some semblance of normalcy is apparent, political entrepreneurs will be more willing to take on a coalition of well-financed, tightly organized, business interest groups because politicians know that the dispersed investor community cannot maintain its passion for long. While this paper is fairly normative, it comes to many political and economic conclusions, the most significant

being his invention of the “Regulatory Sine Curve” which governs the intensity of the oversight exercised by financial regulators. He explains the curve by stating that regulatory oversight is never constant but increases after a market crash and then wanes as society and the markets turns to normalcy and political entrepreneurs who previously opposed powerful interest groups on behalf of the public also wane, and this leads to the erosion of statutes and commands after the passage, with core provisions remaining. The key implication of the Regulatory Sine Curve is the erosion of statute that will begin shortly after passage and Coffee argues that the greater the reliance on administrative implementation, the greater the erosion that will likely incur. Further, the key progression along the curve from intense regulation to lax enforcement is driven by a basic asymmetry between the power, resources, and organization of investors versus interest groups affected by the legislation, namely the financial services industry (Coffee 2012).

After explaining his theory, he then shows how Sarbanes-Oxley was downsized and then examines Dodd-Frank and why pieces of Dodd-Frank were created and how this could pose potential problems for the erosion of the law. He argues that because Dodd-Frank gives financial regulators broad power to restrict executive compensation, does not allow for bailouts to “Too Big Too Fail” institutions on the same discounted terms as before, shifts the trading of Over-the-Counter derivatives to exchanges and requires the use of clearinghouses, costs are extremely high to financial institutions and this along with the importance of administrative implementation and rule-making to enforce these rules will likely lead to greater downsizing of the bill than previous pieces of financial regulation. His study is essential in analyzing interest groups effect on politicians and thus on the passage and implementation of reform, and this is important in explaining the political economy of Dodd-Frank. Further, his analysis of interest groups and his creation of the Regulatory Sine Curve have the potential to be related to the political policy

outcomes after systemic economic shocks and trends, and will aid in support of my argument.

While his argument specifically emphasizes how politicians capitalize on a certain sentiment of investors after economic catastrophes in order to gain reelection, I will focus on how interest groups—the public and the financial services industry—capitalize on systemic economic shocks and trends to influence policy and how the balance of political power between industry and the public temporarily shift (Coffee 2012).

Third, Chappe, Nell, and Semmler provide a historical overview of the United States financial culture from the beginnings of Wall Street until 2008 to provide an example of the culture of risk that has developed overtime and attributes this change in culture to the gradual deregulation that occurred up until the Great Recession. Authors examine what they coin, “The Culture of Risk” where short-term goals, lavish compensation, reckless risk-taking, and speculation dominated Wall Street beginning in the 1980s. The authors argue that because of increased global competitiveness and aggressiveness, a higher degree of concentration ensued as a result of firm consolidation through mergers and acquisitions occurred in an attempt to remain profitable and survive in the changing landscape. With the end of the partnership model for most firms on Wall Street, the size of stock options and bonuses for top traders and bankers reached an unprecedented level and excessive executive pay and high bonuses contributed to excessive risk taking. Because there was more to gain from high volatility, more of a focus on a cheaply and efficiently done deal instead of creating a long-term relationship with clients, and a substantial decrease in underwriting fees, investment bankers began to turn to proprietary trading for larger sums of money. Along with the heavy use of computer and mathematical algorithms, the risk/reward system of Wall Street was heightened inducing a trend of under regulation with new derivative products and investment vehicles and deregulation argued by the financial services

industry. The scholars outlined a timeline—analyzing important periods of America’s financial history and relating that to the surrounding culture on Wall Street and how this new culture of risk within the structure of industry led to more lobbying activity. Specifically, the authors briefly look at the crash of 1929 and the regulatory overhaul and changes put in place, and then they analyze the deregulation of the 1980s and 1990s and then show how that created a culture of risk that eventually led to the Great Recession of 2007-2009 and the subsequent Dodd-Frank. The independent variable is the culture of Wall Street and the dependent variable is the policy outcomes, and they use the above case studies to support their theories. They find that technical fixes of specific mechanisms and products may not decrease systemic risk unless the current financial culture also changes to mirror this change in culture in regulatory reforms (Chappe, Nell, Semmler 2012). This study gives a fairly detailed overview of the change of culture of the financial services industry in the United States beginning since the Great Depression, and it differs from Coffee, McDonnell, and my argument of public choice analysis by attributing culture of Wall Street as a stimulus for regulatory outputs. While this article will be helpful when I analyze the trend of deregulation beginning in the late 1970s, my argument differs in that I attribute the trend to a squeeze in profit and forgone economic gain for the financial services industry as the main impetus for deregulatory reform instead of a “Culture of Risk” that this article describes. In conjunction, I will go into further detail of this trend by analyzing the events beginning in the late 1970s and cumulating in the late 1990s with the repeal of the Glass Steagall Act.

In addition to examining the different arguments that the above three scholars attribute to financial regulatory outputs, it is necessary to evaluate Olson’s theory of collective action and logic behind interest group lobbying to better understand the theory that I will seek to argue. The

author emphasizes groups, no matter large or small, primarily work for the common interest of members so long as the benefit of what they are advocating for is greater than the cost of lobbying for that interest—in both time and money. To begin, Olson states that the total gain of acting is dependent on the rate or level at which the collective good is obtained and the size of the group that is dependant on the value of the collective good to each individual. It is important to note that Olson measures size of group by the total assessed valuation of all group members for the collective good, rate or level of gain by the assessed valuation, and group gain as the size or valuation of the group multiplied by the rate or level of gain. According to his theory, the collective good will be provided if the total gain exceeds the total cost by as much as or more than the gains to the group exceeds the gains to that individual. If the marginal benefit for the group is greater than the marginal cost of not acting for the group, then the group will lobby. Olson declares that three separate but cumulative factors keep larger groups from furthering their own interests compared to smaller groups; first, the larger the group, the smaller the fraction of the total group benefit received by any member and thus the farther the group falls short of getting any optimal supply of the collective good if it does ever receive a collective good; second, because of the larger group and smaller share of total benefit going to each individual member, the less likely that any subset of the group will gain enough from the collective good to bear the cost and burden of acting or providing the good to other members if the gain is received; third, the more members in a group, the higher the costs of organization and thus higher barrier that must be overcome to obtain the collective good. Contrasting with large groups, smaller groups are able to provide themselves with collective goods because many members will find that their personal gain exceeds the total cost of providing some amount of the collective good, and in addition, the size of the individual member or the extent to which they will be benefited

by a given level of provision of the public good is greater in smaller groups than in larger groups (Olson 1965).

While Olson does not specifically relate his interest group argument to the public and the financial services industry's effect on regulation given a certain economic shock or trend, his work can be used as a framework to analyze my general argument that systemic economic shocks change the opportunity/threat environment of the financial services industry and the public to ultimately influence the government in passing financial deregulation and deregulation. More explicitly his theory relates to my argument in that normally there is an asymmetric relationship between the financial services industry and public in terms of attention and interest in financial news. Only after a financial crisis is there more of a symmetric relationship, where each side is keenly interested, and this temporary shift in the balance of interest to the public is due to the spillover effect of risky financial practices. Because of these negative externalities, the marginal benefit of the public for acting collectively becomes greater than the marginal cost of not acting and this increases the incentive to lobby on the part of the public because of the opportunity of political entrepreneurs. However, even after regulation is passed, as the interest of the public wanes and the interest of the financial services industry remains constant, the financial services industry is able to rollback and dampen the financial regulatory reform that was passed. Therefore, his theory on the collective action and free rider problems, the differences he outlines between small and large groups, and his valuation technique that determines whether a group will act or not can be easily translated to my argument.

Most political scientists and economists including Coffee (2012) and McDonnell (2013) find that after financial crises there is added regulation and after financial booms deregulation either dampens current financial regulation or politicians ensue deregulation through added

legislation. Although the above authors have made great strides in their conclusions there is yet to be a study that addresses this thesis in a more detailed manner with case studies and data looking at regulatory reform throughout the history of America. While Coffee's "Regulatory Sine Curve" and McDonnell's Model One explain the relationship between the economic atmosphere, group motivations, and political capitalization, my argument seeks to better explain and measure the assertiveness of interest groups, specifically the financial services industry and public, to demonstrate how the balance of power between industry and the public changes after a systemic economic shock. Additionally, Chappe, Nell, and Semmler's argument that a "Culture of Risk" led to the deregulation that peaked in the late 1990s and eventually to the Great Recession and subsequent Dodd-Frank legislation offers a contrasting concept to my own, but will aid in strengthening my thesis. Further, Olson's theory of collective action, valuation techniques, and outline between the differences between small and large interest groups provide helpful explanations that can be used as a framework to analyze my research question. Therefore, this thesis will base some research on other scholar's works, specifically Coffee's Regulatory Sine Curve and McDonnell's Model One but will also strengthen their arguments by approaching the study with new data and conclusions by focusing more on interest group assertiveness and effectiveness, examining campaign finance contributions, and by analyzing three periods of time— the Great Depression and Glass Steagall Act, the deregulatory trend beginning in the late 1970s and peaking with the passage of the Gramm-Leach-Bliley Act in 1999, and the Great Recession of 2007, Dodd-Frank.

## Chapter 3

### Theory

The argument to be made is periods of systemic economic shock change the opportunity/threat environment of the financial services industry and the public to ultimately influence their assertiveness towards advocating for regulatory or deregulatory policy legislation. Within this model, there are four actors—the financial services industry, the public, the government, and the regulatory agencies. Changes in economic policy require effort on the part of industry and the public, which are represented by lobbying groups within the financial services industry and consumer advocacy lobbying groups. A systemic shock can be classified as any event that affects aggregate outcomes, economy-wide resource holdings, and broad market returns, including a dramatic and sudden increase in inflation or steep recession.

Assuming collective action, the financial services industry has clear and ever-present reasons to be attuned to the costs and benefits of regulation, whereas the public does not. For example, high inflation can contract profit margins of banks when interest rate changes are limited by regulation. This may spur the financial services industry to engage in technological and product innovation that increases risk/reward which requires a loosening of regulatory restrictions. When times are good, the industry is more willing to take on additional risks and innovate new financial products as they assume that the opportunity cost of forgone profits of financial gain to be had is too high. As opportunities to increase their return induce additional risk and financial innovation, the financial services industry—highly informed, concentrated, organized, and driven—has even more of an incentive to lobby the government to either repeal

laws that are inhibiting them to capitalize on this specific environment or loosen regulation through regulatory inaction. Because the general public—uninformed, diffuse, unorganized, and apathetic—give too much emphasis on recent events and thus have no incentive to lobby the government for additional financial regulation, many of the new financial innovations and high risk/reward instruments tend to be unregulated or under regulated, giving way to the desires of the financial service industry. Conversely, a financial panic and subsequent recession can lead to companies in the industry shutting down and threaten the viability of surviving firms. This may spur efforts to secure government protection and public risk sharing. The public will demand greater accountability and a reduction of risky practices that lead to negative externalities. The financial services industry has a far greater incentive to act, and thus most changes in regulation are in their preferred direction.

While the public is largely uninterested in the minutiae of regulation, the public does begin to take action during periods of financial panic and subsequent economic crisis, including a steep recession. During this period of time, because credit is tight, lending is scarce, and profit margins are decreasing, consumers are more likely to be engaged and advocate for financial regulation in an effort to maintain their market share by lobbying the government. Therefore, as politicians tend to side with the more concentrated interest group in an effort to secure reelection, new regulatory initiatives will most likely be put into place as an effort to appease the general public. While politicians usually only hear from the financial services industry advocating for loosening regulation on higher risk/reward activities, when the negative externalities of these activities hit the public during periods of crisis, the balance of political power between industry and public temporarily shifts. When the externalities of the position of the financial services industry affect the larger number of consumers, only then are consumers mobilized enough to

provide counterweight to that financial services pressure on the government. Only after a financial crisis or economic shock do people act because the cost of not acting is too high and the group benefit of acting increases greatly. The only reason the public now wants regulation is because they witness the negative spillover effects of the risky financial practices by the financial services industry; if putting restrictions on their activities can stop the negative externalities of these practices, then the people will support the regulation and therefore the net benefit of acting for the group increases. It is when these “crises windows” are open for policy change that public advocacy groups are able to gain influence on politicians calling for new or restored restrictions on the higher risk/reward activities of finance. Only during these crisis windows, a brief period of time that serves as an opportunity for reform initiation, is the public attention to the consequences of regulation near the attention regularly paid by the financial services industry. Because industry always has the incentive to seek potential benefits or avoid dire costs and pay the time and money needed to push inert regulatory bodies and policymakers, the public rarely does except during crises. A negative systemic economic shock temporarily galvanizes public attention, transforming policymaking into politics. During these periods, the public pushes back on finance’s attempts of risk sharing and thus financial crises are the rare instances that show a change in how the political process is conducted. The issue for the public is that the heightened attention is temporary, whereas the financial services industry has an enduring interest in allowing access to high risk/reward opportunities. Therefore, even if regulation advocated for by public advocacy groups is passed, it will most likely be dampened by the financial services industry through their meetings with regulatory agencies and continued campaign finance contributions to Congress and undermined due to the regulatory process.

The argument outlined above, in conjunction with the pertinent literature, serves as an adequate framework to analyze economic atmosphere's effect on financial regulatory reform in the United States through a qualitative analysis. Assuming collective action, it can be argued that most changes in regulation are in the preferred direction of the financial services industry, and only in times of economic crises does the public become temporarily mobilized to counteract the influence of the industry and push for financial regulation. Thus more specifically, it can be argued that the financial services industry continually advocates for loosening restrictions on higher risk/reward activities thus leading to financial deregulation, and only during periods when the negative externalities of these activities reach the public during the periods of crisis, will the balance of political power between industry and public temporarily shift to thus leading to financial regulatory overhaul (Packer 2015). However, even after great regulatory change, because the financial services industry has a constant incentive to lobby for looser regulation and because of the asymmetric interest in financial practices between the financial industry and the public, the legislation passed will most likely be dampened and undermined due to the regulatory process.

## **Chapter 4**

### **Research Design**

When designing my research experiment, although my study is qualitative in nature, it is important to define, operationalize, and give significance to my predictor, intervening, and dependent variables in order to be able to measure how economic shocks affect interest group assertiveness and thus financial regulation and deregulation in the United States.

To begin, the predictor variable of this thesis is the systemic economic shock or crisis. There are four different categories of economic crises—inflation, hyperinflation, and currency crises, banking crises, debt crises, and speculative bubbles and crashes. It is necessary to define each type of category to be able to determine which type of shock occurs during my case studies. Reinhart and Rogoff (2011) mark banking crises by two types of events—bank runs that lead to closure, merging, or takeover by the public sector of one or more financial institutions, or if there are no runs, then the closure, merging, takeover, or large-scale government assistance of an important financial institution(s) that marks the start of a string of similar outcomes for other financial institutions. Speculative bubbles and crashes, is defined by Kindleberger (1987) as a sharp rise in the price of an asset or a range of assets in a continuous process, with the initial rise generating expectations of further rises and attracting new buyers interested in profits in the trading in the asset rather than its use or earning capacity, and this is usually followed by some sort of exogenous shock that leads to a significant drop in the total market value. Therefore, when analyzing the Great Depression and the Great Recession, it will be essential to define and

categorize the crises and measure the magnitude of the economic episodes by looking at the sharp declines in the GDP and stock market, the collapse of financial institutions, and the dramatic increases in unemployment. When looking at the trend towards deregulation starting in the late 1970s cumulating in the late 1990s, it will be helpful to describe the economic atmosphere or boom that occurred that led to deregulation and lax enforcement by the regulatory agencies.

The intervening variable in this study is the change in interest group assertiveness given an economic shock. Two umbrellas of interest groups will be discussed—consumer advocacy groups, who are more likely to promote financial regulation, and the financial services industry, who are more likely to promote financial deregulation. When analyzing interest group assertiveness on the passage of financial regulatory output, I will look at a different measure for each respective interest body. For the financial services industry, I will examine the campaign finance contributions to chairmen and ranking members of the Committee of Financial Affairs in the House of Representatives and the Banking, Housing, and Urban Affairs Committee in the Senate and their subcommittees. These specific committees were chosen due to the fact that these two groups oversee the financial services industry and originate most financial legislation. Specifically I will be looking at the top industry campaign contributions for the most recent election of the chairman and ranking members of committees and subcommittees from 1997-2014. These dates were based on the passage of financial deregulatory reform Gramm-Leach-Bliley in 1999 and regulatory reform Dodd-Frank in 2010. It will be interesting to see if campaign contributions increased or decreased from the economic good times in the late 1990s to the economic bad times during the financial crisis. If more money was spent by the financial services industry during the crisis and the passage of Dodd-Frank, it demonstrates the power of

economic crisis and galvanizing public support for change. If less money was spent by the financial services industry during the crisis and the passage of Dodd-Frank, then the financial services industry is not as assertive during economic shocks as it is during economic expansions and during deregulatory trends. If the stream of campaign contributions from the financial services industry remains constant throughout time, it will show that the financial services industry's interest and motivation remains constant. When looking at public mobilization, I will study the number of stories and composition of top stories in the news media during the financial crisis. This will serve as an indicator of how significant the issue was, how the public gained interest and wanted a change, and how there was a particular "crisis window" that politicians had to pass regulatory legislation. As scholar Beth Leech (2009, 2010) argues, the provision of information and other policy-related aid is the strongest source of interest group influence, and when measuring influence it is important to look at the composition of the group population, the tactics groups engage in, and their policy agendas. Because of this, I have determined that the most assertive groups in pushing for change in implementation of the laws after passage within the financial services industry and consumer advocacy groups are a function of the number of meetings they have attended with United States regulatory agencies the Commodities Futures Trading Commission, the United States Treasury, and the United States Federal Reserve Board. By looking at the meetings attended by these groups after the passage of Dodd-Frank, I will be able to determine the more assertive interest group and how that affects either the weakening or strengthening of provisions in the regulatory Dodd-Frank. To gauge the effectiveness of these interest groups, I will look at changes in the financial regulation or deregulation that I am analyzing in my case studies from the time it was passed until the present day. Therefore, in my first case study I will discuss the passage, implementation, and changes made since the initial

passage of the Glass-Steagall Act, in my second case study, I will discuss the passage, implementation, and changes made since the initial passage of the deregulatory pieces of legislation that were passed since the late 1970s, and in my third case study, I will discuss the passage, implementation, and changes made since the initial passage of the Dodd-Frank Act.

The dependent variable of this study is the financial regulatory or deregulatory policy outputs passed by the United States government. A policy output will be determined restrictive, tighter, or regulatory if a new piece of legislation is enacted that strengthens existing financial regulation or new legislation regarding a new regulation is enacted. A policy output will be determined nonrestrictive, looser, or deregulatory if a new piece of legislation is passed that weakens existing regulation or repeals existing regulation or if there is a lack of regulation regarding new financial instruments or practices. It is also necessary when looking at either the regulatory legislation passed to analyze the costs and benefits of passing it or not passing it from the perspective of the financial services industries and consumer advocacy groups in order to determine the motivation of each group for their respective stances and lobbying efforts behind the legislation. It will also be important to analyze how the piece of legislation has been dampened after its passage by the continued lobbying efforts of the financial services industry.

The general method of my experiment will analyze three periods of time. The first will examine the economic environment of the Great Depression in 1929 and the politics, interest group mobilization, and arguments behind the subsequent Glass-Steagall Act. The second case study will analyze the trend of deregulation that began in the late 1970s and cumulated in the late 1990s with the repeal of the Glass-Steagall Act through the passage of the Gramm-Leach-Bliley Act in 1999. The third case study will examine the economic environment of the Great Recession in 2007 and the politics, interest group mobilization, and arguments behind the subsequent

Dodd-Frank Wall Street Reform and Consumer Protection Act. I will categorize both crises and give a general overview of the economic atmosphere, and will further analyze both pieces of legislation and the politics behind each—learning what the respective positions for the financial services industry versus the positions of the consumer advocacy groups were in terms of policy arguments, the assertiveness of each group measured in campaign finance contributions and news stories for effect on policy outputs and measured in number of meetings attended in front of US regulatory agencies for effect on changes in legislation since passage, and the effectiveness of both groups by analyzing if they were able to get their policy passed by the government and how they have been able to affect financial legislation after the passage and why they took such positions. I will discuss the economic boom that led to such deregulation and eventually the Financial Crisis in 2007, which interest groups were lobbying and why they were lobbying during these twenty years, and the regulatory and deregulatory output that was produced as a result of the positions, assertiveness, and effectiveness of the two lobbying groups.

Because my general argument is that periods of systemic economic shock change the opportunity/threat environment of the financial services industry and the public to ultimately affect the government which responds in terms of deregulatory and regulatory policy outputs, my hypothesis can be outlined as follows:

**H1:** The financial services industry continuously advocates for looser restrictions on higher risk/reward activities, leading toward deregulation or the weakening of an existing piece of legislation.

**H2:** Only in times of economic crises does the public become temporarily mobilized to counteract the influence of the financial industry to push for financial regulation and ultimately pass financial regulation.

**H3:** Even though there may be changes in terms of legislation, the gains that are made by consumers through their passed legislation may be lost in terms of regulatory enforcement due to the fact that the financial industry continues to lobby both regulators and legislators.

If hypothesis one is confirmed, then there will be a consistent trend throughout American history since the Great Depression by the financial services industry advocating for deregulation on financial products and services with higher risk and reward ratios and higher leverage ratios through their respective meetings with regulators, meetings before Congress, and stances they take publicly. Therefore in the case studies, we should see the financial services industry advocate for deregulation after the Great Depression, during the 1970s, during the Great Recession, and post 2007 Financial Crisis. We should further see that to gauge the effectiveness, original pieces of financial regulation will be dampened by the efforts of the financial services industry including the Glass-Steagall Act and Dodd-Frank Act.

If hypothesis two is confirmed, then only after periods of economic crisis as defined by Reinhart, Rogoff, and Kindleberger will the public gain interest and be able to pass tougher financial regulatory legislation. Public interest will be measured by the media stories regarding the macroeconomic environment compared to years where there is not a crisis.

If hypothesis three is confirmed, then we should see the financial services industry out-lobbying consumer advocacy groups or the public by outspending them in terms of campaign finance contributions and attending more meetings with regulatory agencies, demonstrating their ability to affect passage and implementation of regulatory pieces of legislation following an economic crisis.

In the three case studies being analyzed, readers should see two periods of economic crisis—the Great Depression and the Great Recession—and the passage of two of the most restrictive pieces of financial regulation following that crisis—the Glass Steagall Act and Dodd-Frank—and one period of economic boom—the 1990s—followed by the passage of the most deregulatory piece of legislation passed by the US government—Gramm

## Chapter 5

### The Stock Market Crash of 1929 and Glass-Steagall Act

To understand why the degree of restrictiveness varies historically in the United States, it is necessary to analyze how systemic economic shocks change the opportunity/threat environment of the financial services industry and the public to ultimately influence the government in passing financial deregulation and regulation. As argued by my theory, only after financial crises is there a window of opportunity or period of near equality of attention given to news in the financial sector—normally there is an asymmetric relationship between the financial services industry and public in terms of the interest given to financial news. During a crisis, however, there is more of a symmetric relationship, and this temporarily shifts the balance of interest to the public and increases the net benefit of the public in acting collectively. While the financial services industry has clear and ever-present reasons to be attuned to the costs and benefits of regulation, the public does not. Therefore, in normal economic periods, the financial services industry should be inclined to lobby the government for looser restrictions. Because the public is uninterested in the minutiae of financial regulation, even shortly after the passage of regulatory legislation, the financial services industry works to dampen the newly passed regulation by lobbying the financial regulatory agencies and Congress. In the coming pages, this study will analyze three periods of time—the Stock Market Crash and Great Depression of 1929 and subsequent passage of regulatory output Glass-Steagall Act, the deregulatory trend beginning in the late 1970s and cumulating in the late 1990s with the passage of the deregulatory output Gramm-Leach-Bliley Act, and the Financial Crisis of 2007 and Great Recession and

subsequent passage of the regulatory output the Dodd Frank Wall Street Reform and Consumer Protection Act. It is necessary to first categorize and explain the economic time period, analyze the risky practices of the financial services industry that led to the economic crisis, examine the costs of regulation to the financial services industry during periods of normal economic times, discuss the mobilization of the public, and evaluate the passage and dampening of regulatory outputs to better explain and support the above theory.

In just two days, from October 28 to October 29, 1929, the Dow Jones Industrial Average dropped by nearly 25%, signaling the start of the Stock Market Crash and most devastating economic period around the world, the Great Depression. It is important to analyze the role that financial institutions had in the Crash and the severity of the Great Depression to understand why the government responded the way it did through its passage of the most restrictive piece of financial regulation, the Glass-Steagall Act (White 1990).

The Stock Market Crash of 1929 can be explained as both a speculative bubble/crash followed by a banking crisis. Kindleberger (1987) classifies a speculative bubble/crash as a sharp rise in the price of an asset or a range of assets in a continuous process, with the initial rise generating expectations of further rises and attracting new buyers interested in profits in the trading in the asset rather than its use or earning capacity, and this is usually followed by some sort of exogenous shock that leads to a significant drop in the total market value. Furthermore, Rogoff and Reinhart (2011) mark banking crises by two types of events—bank runs that lead to closure, merging, or takeover by the public sector of one or more financial institutions, or if there are no runs, then the closure, merging, takeover, or large-scale government assistance of an important financial institution(s) that marks the start of a string of similar outcomes for other financial institutions.

As the financial services industry took part in riskier practices through practice, role, and product innovation, the Federal Reserve created a trend of easy lending, and the public overinvested in the stock market, setting the stage for the financial panic that was about to ensue. Leading up to the crash of 1929, the accelerated growth of the 1920s resulted in the growth of the securities market, assisted by the establishment of new investment trusts and securities affiliates, which allowed firms to substitute stocks and bonds for commercial bank loans. Due to the rapid growth of the modern industrial world and these new innovations in banking, banks found their traditional role as intermediaries reduced as they increased their role as brokers between the savings public and industry. Many of the new clients they served lacked the experience and knowledge in buying stocks and thus created a favorable condition for a bubble in the stock market. In addition, the increase in money supply by the Federal Reserve and subsequent low interest rates on borrowing in the roaring twenties, allowed many bankers to invest in stocks with mostly borrowed money, as an investor only needed to provide a fraction of the required funds to reap the full capital gain, and this led to unwise speculation. In fact, by 1929, two out of every five dollars a bank loaned were used in the purchase of stocks. While many economists including Kindleberger attribute this boom to the rising supply of brokers' loans from non-bank sources, other economists including White (1990) attribute the boom to more favorable expectations of businesses through promised higher earnings and dividends due to technological and structural changes in industry during the 1920s. Therefore, it can be argued that because of both flexible credit and a favorable outlook of businesses due to technological innovation, investors flooded their money and banks money into the stock market, creating a bubble. In addition to this, banks took part in risky practices. In many cases, banks underwrote corporate stock offerings, and if they faced any difficulty in selling the stock, they would simply

buy it themselves with money drawn from depositors' accounts and many times without a depositor's knowledge—similar to modern day proprietary trading. The combination of risky financial practices by the financial services industry, easy lending, innovation in the role that financial institutions play, and a growing bubble in the stock market gave way to the financial panic that was about to ensue. With early signs of a recession in October, panic selling began, leading up to Black Tuesday. With 25% of the value of the stock market decreasing in just two days, runs on the banks were common and investors frantically began to sell off their stocks. When the market fell, the banks, whose margin requirement was only 10%, attempted to call in loans to be repaid but were unable to gain even a fraction of the money they lent out. Because the Federal Reserve cut the money supply by almost one-third, many banks suffering from liquidity problems defaulted, and in total over 9,000 banks failed during this time period.

As the most severe economic downturn in the history of the United States, it is necessary to analyze key economic indicators including the unemployment rate, Gross Domestic Product, the stock market, prices, and investment during this period of time. From 1929 to 1933, industrial production fell by 37%, prices decreased by 33%, and real fixed investment fell by 74%. From these figures, it is no surprise then that from 1929 to 1933, the unemployment rate went from 3.2% and peaked at 25%, remaining at around or above 15% for the rest of the 1930s. The stock market was hit particularly hard during this time period. The Dow Jones lost between \$8 billion and \$9 billion of its value and peaked at 381 in September of 1929 and bottomed out at 42 in 1932—realizing an 89% decline in the price of stocks. The Dow did not reach 381 again until 1955, twenty-three years later. American GDP fell by 30% while worldwide GDP fell by 15%.

Because of the negative externalities of risky financial practices including a changing role of banks from financial intermediaries to broker dealers, proprietary trading, easy credit, a margin requirement of 10% with no insurance of deposits, and a speculative bubble in the stock market, it is logical that the unemployed workers of America took to the streets to voice their despair. The Great Depression led to a series of social movements and protests that would eventually signal to the government that something needed to be done. By the beginning of the 1930s, unemployed men and women gathered in New York, Detroit, Cleveland, Philadelphia, Los Angeles, Chicago, Seattle, Boston, and Milwaukee, and marched under Communist banners that read “Work or Wages” and “Fight-Don’t Starve” demanding that the government take some sort of action. Furthermore, special interest groups formed to advocate for specific goals. For example, the Bonus Army was the assemblage of 43,000 marchers, 17,000 who of which were veterans from World War I, who in the spring and summer of 1932 gathered in Washington, D.C. to demand cash-payment redemption of their service. In 1932, a group known as the Farm Holiday movement in Iowa and Nebraska built road blocks on the highways leading to agricultural markets in Omaha, Sioux City, and Des Moines in an effort to try and raise the price of agricultural products by decreasing the supply of products (Piven & Cloward 2015). With the unemployment rate at an all time high and the public taking part in various social movements and protests, it is quite logical that in 1933 substantial reform to the banking system was passed by Congress with the hopes of restoring confidence in the banking system and economy.

In March of 1933, emergency legislation—the Bank Act of 1933 also known as the Glass-Steagall Act—was passed “to provide for the safer and more effective use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations, and for other purposes” in hopes that the Stock Market Crash of 1929 and the Great

Depression would never repeat itself (Mauers 2013). The important motivation for the act stemmed from a desire to restrict the use of bank credit for speculation, channel direct bank credit into more productive uses including industry, commerce, and agriculture, cut linkages between commercial and investment banks, and stop unprecedented bank runs, all of which were believed to be major causes of the Crash of 1929 and subsequent Great Depression. The four major provisions of the Act include the separation of commercial and investment banks, the Federal Deposit Insurance Corporation, Regulation Q, and the creation of the Federal Open Market Committee, all of which had various costs and benefits to both the financial services industry and the public.

It is of no surprise that Glass-Steagall came with extensive critiques from bankers, economists, and the Federal Reserve, as the added regulations were costly to these groups. Argued as a conflict of interest that led to speculative activities, commercial banks acting as investment banks and vice versa were prohibited with the first and main provision of the Act, which worked to separate the two entities. Believed to be one of the main causes of the Market Crash, with the passage of Glass Steagall, commercial banks, which take deposits to make loans, were no longer able to underwrite or deal securities, while investment banks, which underwrite and deal securities were no longer able to have close connections with commercial banks including common ownership and overlapping directorships and employees. More specifically, the Act prevents Federal Reserve commercial member banks from dealing in securities for customers, investing in non-investment grade bonds for themselves, underwriting or distributing non-government securities, and affiliating with companies or sharing employees with companies involved in such activities, while the Act prohibits investment banks from taking deposits. Furthermore, only 10% of commercial banks total income could stem from securities, and

commercial banks were only allowed to underwrite government issued bonds. This provision made certain that savings-and-loan type of banks were not engaging in speculative, risky trading with customer's deposits. In 1933, the separation was not controversial, as most individuals saw that this change would lead to a healthier system, however, as time went on, this became one of the most strongly debated topics by financial institutions and members of Congress (Maues 2013).

From the period of 1929 to 1933, as citizens were fearful that their banks would fail, they ran to the bank and pulled their deposits out, causing almost 10,000 banks to fail, and creating a self-perpetuating cycle that destabilized the economy and led to the Great Depression. As one of the main goals of the Glass Steagall Act was to stop unprecedented bank runs and restore public confidence, the Act created the Federal Deposit Insurance Corporation which guaranteed bank deposits up to a certain amount—initially beginning at \$2,500 and is now \$250,000 today—through a pool of money collected from the banks. Interestingly, this was the most controversial topic in the Act, as most of the opposition came from larger banks that believed they would end up subsidizing the smaller, more rural banks. Along with this argument and the argument of creating a moral hazard—a situation where borrowers have an incentive to take on more risk because they are protected against such risk—the provision was still passed, as the public who wanted to recover their losses from the Great Depression and who primarily blamed Wall Street and big banks for their hardship heavily supported the creation of the FDIC. More specifically, the act mandates that all Federal Reserve member become stockholders of FDIC, thus becoming an insured institution with required membership by national banks and voluntary membership by state banks (Maues 2013).

Along with the separation of commercial banks and investment banks and the creation of the FDIC, Glass-Steagall put restrictions on the rights of a bank officer and mandated Regulation Q. Prior to the Act, there were no restrictions in the rights of a bank officer of a member bank to borrow from that bank. Glass Steagall prohibited Federal Reserve member banks to issue loans to executive officers and required the payment of any outstanding loans in an effort to stop excessive loans by bank officers and directors for personal gain. Along with increased reporting and restrictions on loans to executive members of banks, Regulation Q was introduced. Regulation Q mandated that interest could not be paid on checking accounts and gave the Federal Reserve authority to establish ceilings on interest rates that could be paid on other types of deposits. It has been widely recognized that the payment of interest on deposits led to excessive competition among banks and caused them to engage in risky investment and lending practices to increase their income to be able to pay off interest. By prohibiting banks from paying interest on deposits within checking accounts and capping interest rates on other deposit accounts, the Act would be able to limit speculative activity, risky investment and loan sharking and encouraged customers to put their money into money market funds (Maues 2013). Additionally, because Regulation Q made a small exception for institutions specializing in mortgage lending by receiving a quarter-percent advantage over consumer deposits, this encouraged a flow of investment into the housing market (Sherman 2009).

Glass-Steagall also tightened reporting requirements for banks and created the Federal Open Market Committee. The Act instituted tighter regulation to the Federal Reserve member banks, requiring holding companies and other affiliates of state member banks to make three annual reports to both the Federal Reserve Board and Federal Reserve Bank in an effort to increase transparency and accountability and recognize any systemic risks. Furthermore, bank

holding companies that owned a majority of shares of any Federal member bank were now required to register with the Federal Reserve and obtain its permit to vote their shares in selection of directors. The creation of the FOMC, a committee within the Federal Reserve, gave members oversight to the open market operations, the buying and selling of United States treasury securities, conducted to ultimately have an effect on the interest rate and growth of the money supply. With the creation of the FOMC, the Federal Reserve was able to establish target interest rates to help curb inflation and increase employment—a necessary tool that would aid in the prevention of another Great Depression and help to lessen economic shocks or crises (Maues 2013). Because Glass Steagall was the most comprehensive and restrictive piece of financial regulation ever to pass through Congress, as time went on and the economy returned to normalcy, the Act lost its strength in the subsequent decades and was eventually repealed in 1999 with the Gramm-Leach-Bliley Act.

## Chapter 6

### The Deregulatory Trend of the 1970s-2000s and Gramm-Leach-Bliley Act

The financial reform in the first half of the twentieth century designed a banking system supported by regulatory agencies that were organized by financial activity and left room for some self-regulation by private institutions. In the years following the Great Depression, as economic times normalized with GDP becoming positive, the unemployment rate shrinking, and the stock market exceeding new heights, few changes were made to the regulatory framework that would tighten restrictions on financial institutions. In fact, beginning in the late 1970s, a tide of deregulation swept over the United States, as the pain of the Great Depression faded and the financial services industry lobbied to loosen regulation for fear of forgone opportunity cost of financial gain. This section will focus primarily on the dampening of Regulation Q specifically by the passage of the Depository Institutions Deregulation and Monetary Control Act in 1982 and the repeal of the Glass Steagall Act by the passage of the Gramm-Leach-Bliley Act of 1999. It is first necessary to briefly explain and analyze a short timeline of the deregulation that occurred during the late 1970s that peaked in the late 1990s to gain a sense of the trend in financial reform.

A brief historical overview of the deregulation that occurred beginning in the late 1970s will aid in the explanation of the transformation of Regulation Q and the repeal of the Glass-Steagall Act—two of the most important deregulatory initiatives in the twentieth century. In the 1978 Supreme Court case *Marquette vs. First of Omaha*, the Supreme Court ruled and allowed banks to export the usury laws of their home state nationwide, thus setting off a competitive

wage of deregulation, and resulting in the complete elimination of usury ceilings in various states across America. The interest rate ceiling imposed by usury laws imposed little costs on lending and banks in the beginning half of the twentieth century, however, when inflation increased in the 1970s, the ceilings set by usury laws became an important constraint and cost to banks. This ruling allowed national banks to effectively export the maximum interest rate regulations from one state to their nationwide facilities, incentivizing financial firms to relocate their businesses to states with the most financially friendly rules. Because businesses threatened state legislators that they would move their operations elsewhere, many states eliminated their usury ceilings in response to keep business in their home state. Although the Supreme Court did not repeal usury laws, by giving states individual jurisdiction among usury laws, nationally chartered banks were now able to relocate their operations to states with deregulated usury ceilings and export those regulations nationwide (Sherman 2009).

In 1980, Congress passed the Depository Institutions Deregulation and Monetary Control Act, which increased deposit insurance from \$40,000 to \$100,000, calls for the complete phase-out of interest rate ceilings on deposit accounts thus transforming Regulation Q, and gives thrift institutions new authority. As established in the Glass Steagall Act, Regulation Q placed limits on the amount of interest that banks could pay on savings accounts. Ostensibly, this was to prevent banks from paying so high an interest rate on deposits that they were forced to engage in risky lending practices to acquire the funds needed to make the interest payments. While perhaps useful during the low inflation environments of the 1930s through 1960s, the high inflation of the 1970s meant that real, inflation-adjusted interest rates on savings accounts were negative. In the late 1970s, inflation caused market interest rates to rise above the limits mandated by Regulation Q, and while the restrictions may have been prudent when inflation was between 3% and 4%,

when inflation reached 10%-11% investors were losing money by keeping funds in such depository institutions. Therefore, customers were withdrawing money from banks and into higher-paying money market accounts. As investors shifted their money out of regulated accounts in depository institutions, which paid lower interest rates, and in to thrift institutions, the financial position of various borrowers and lenders was strained to a point where some banks went bankrupt and others incurred large costs of developing new instruments in credit markets as a way to become more competitive. Because banks argued that the Regulation Q restrictions put them at an unfair disadvantage as new money market instruments threatened bank savings accounts as the major vehicle for consumer funds, Carter signed into law the Depository Institutions Deregulation and Monetary Control Act (Sherman 2009; Metzler 1975).

Because the newly passed Depository Institutions Deregulation and Monetary Control Act ousted interest rate ceilings on deposits, this removed the interest rate advantage that thrifts previously had and therefore, the thrift industry began to lobby the government for looser regulations to make them more competitive. With the passage of the Garn-St. Germain Depository Institutions Act of 1982, thrifts became almost completely unregulated, giving way to commercial lending and competition to money markets and mutual funds. While the Act intended to benefit the thrift industry specifically, it allowed them to enter new financial territory with new risks by offering thrifts to engage in commercial loans up to 10% of assets, a new account to compete directly with money market mutual funds, and expanded federal regulators' ability to deal with institutional failures. Following its passage, in 1989 Congress passed the Financial Institutions Reform and Recovery Act in the wake of the savings and loan crisis and established the Resolution Trust Corporation to close hundreds of insolvent thrifts, provide funds to pay out insurance to their depositors, and transfer regulatory authority from the Federal Home

Loan Bank Board to the Office of Thrift Supervision and the Federal Deposit Insurance Corporation, thus encouraging loan origination. 1994 brought about the Reigle-Neal Interstate Banking and Branching Efficiency Act which eliminated previous restrictions on interstate banking and branching (Sherman 2009).

In the late 1980s, came the transformation of Glass-Steagall. In 1986, the Federal Reserve reinterpreted the rule and allowed banks to derive up to 5% of gross revenue in investment banking business. By 1987 they loosened restriction again and overrode opposition from Chairman Paul Volcker to allow banks to trade commercial paper, municipal bonds, and mortgage-backed securities. When Alan Greenspan became Chairman of the Federal Reserve in 1987, he reinterpreted Glass-Steagall again to allow banks to deal in certain debt and equity securities as long as it did not exceed the 10% limit. By the late 1990s Glass-Steagall essentially became obsolete due to the continued lobbying practices of the financial services industry. In 1996, the Federal Reserve began to reinterpret the Act several times, allowing bank holding companies to earn up to 25% of revenues in investment banking from a previously stated 10%. Later in 1998, Citicorp, a commercial bank, merged with Traveler's Group, an insurance company that own an investment bank, to form the world's largest financial services company. Because the Glass-Steagall Act forbade commercial banks to merge with insurance underwriters, the institution had between two and five years to divest itself from any prohibited assets. While this should seem concerning, co-chairmen Sandy Weil stated that she believed over time the legislation would change, and one year later it did with the repeal of the Glass Stegall Act in 1999 (Sherman 2009).

In 1999, the Gramm-Leach Bliley Act passed which was the most deregulatory piece of financial regulation as it repealed the Glass-Steagall Act in its entirety. With the passage of the

Glass Steagall Act in 1933, commercial banks, which took deposits and made loans, were no longer able to underwrite or deal securities other than government securities, while investment banks, which underwrote and dealt securities were no longer able to take deposits, or have close connections with commercial banks including common ownership and overlapping directorships and employees. Passed twenty years after Glass-Steagall, the regulatory passage of the Bank Holding Act of 1956 applied the same separation to bank holding companies. Since both restrictive pieces of legislation were aimed at eliminating conflicts of interest, excessive risk taking, and speculation in banking and securities dealing, the acts were very effective in the sense that they minimized bank failures throughout the mid-twentieth century. As early as the 1960s, banks began to lobby Congress for looser restrictions as they competed with money market mutual funds and other financial innovations whose blurred lines between deposits and securities left commercial banks at a disadvantage. To remain competitive, commercial banks wanted to enter the municipal bond market and other securities markets to reap the financial gain that they were missing out on. In addition to the argument that they were at a strategic disadvantage, banks debated that with an increasingly globalized community, there was a constant fear that financial deregulation abroad would cause American firms to take their capital abroad. With the 1999 passage of the Gramm-Leach-Bliley Act, also known as the Financial Services Modernization Act, all restrictions against the combination of banking, securities, and insurance operations for financial institutions were repealed, and the decades and millions of dollars worth of lobbying by the financial services industry came to fruition. Because banking and insurance operations could be housed under the same entity, regulators from different agencies were responsible for overseeing different parts of the same institutions and it was argued that this could lead to gaps in oversight and increased systemic risk. Because of the rapid

growth in the 1990s of new types of derivatives instruments, which were used to hedge against risk or for pure speculation, clearinghouses or exchanges that would regulate these instruments would be costly for the financial services industry. Therefore, in addition to allowing commercial banks, investment banks, securities firms, and insurance companies to consolidate, the Act also prevented the Commodities Futures Trading Commission from regulating most over-the-counter derivative contracts, including credit default swaps. During this period of time, Treasury Secretary Robert Rubin and his predecessor Lawrence Summers, along with Federal Reserve Chairman Alan Greenspan saw no reason to interfere with new innovations in financial markets. Because most derivative instruments remained unregulated via their sale through the over-the-counter derivatives market, commercial banks became major players in the derivatives market and total outstanding nominal value of \$106 trillion in 2001 increased to \$531 trillion in 2008 (Sherman 2009). While the deregulatory trend was seen as a win for the financial services industry, it ultimately set the stage for the shadow-banking system, risky practices of speculation with derivative products, and proprietary trading that would ultimately lead to the fall of the American economy during the Financial Crisis of 2007.

## Chapter 7

### **The Subprime Mortgage Crisis and the Dodd Frank Wall Street Reform and Consumer Protection Act**

In 2007, an economic shock was felt throughout the United States. As the housing bubble burst due to a sharp decline in real estate prices, homeowners experienced foreclosure and investors defaulted on risky subprime loans inducing the collapse of the largest investment banks in the world and signaling the start of the most significant economic decline since the Great Depression, the Great Recession. First, it is necessary to understand the financial practices that were taking place that gave way to the crisis and the harsh economic indicators of the shock. Then it is important to analyze how the interest of the American public regarding financial news was increased and examine the actions, policy statements, and lobbying tactics of the financial services industry and public during and after this time. Finally, it is pertinent to study the core pillars of the subsequent piece of financial regulation, The Dodd-Frank Wall Street Reform and Consumer Protection Act, and evaluate the costs and benefits of the regulation to both the public and the financial services industry and the politics behind its passage and downsizing.

It is quite evident that the 2007 Subprime Financial Crisis was a mix of both a speculative bubble/crash followed by a banking crisis. Due to persistent current account deficits, the United States borrowed from surplus economies to finance their lavish spending, and this further increased American foreign indebtedness. Both the reluctance of the government to alter macroeconomic policies to reduce current account deficits and the risky financial practices of the financial services industry facilitated the development of financial weakness that led to the Great Recession. The flow of cheap and plentiful credit from surplus countries to the United States

allowed America and banks to borrow large volumes of money at low interest rates—creating credit conditions that lead to asset bubbles. In the United States, an asset bubble emerged in residential real estate; a \$1.4 trillion dollar surge in new mortgages between 2004 and 2006 along with a surge in investment in residential real estate as a share of GDP drove real estate prices up nationwide. Financial institutions channeled one-third of these funds into real estate with financial instruments that were not regulated. They then bundled mortgages with different risks into a single financial instrument that they could sell to investors through mortgage backed securities and collateralized debt obligations—structured asset-backed securities whose value is determined by fixed-income of the underlying assets. Because these instruments were made up of a diverse pool of mortgages, these instruments enabled investors to choose how much risk they were willing to hold in their real estate lending. Further, credit default swaps appeared to reduce the risk of mortgage lending by promising to repay the loans if the original borrowers did not. During this time, as investment banks sold securities to customers and then bet against those same securities, there was a sense that they were exceeding risk that they were taking on the initial position, otherwise they would not have made the bet against the original security. As mortgages were sliced up, repackaged, and securitized, everyone assumed this was a safe investment as interest rates remained low and the price of housing historically was known to continue to increase. When real estate prices collapsed by almost 25% during 2007, financial institutions that held these securities in large amounts suffered large losses on leverage due to falling prices created by debt-service difficulties. With foreclosures and defaults rising, insurance agencies that insured these assets could not pay the amount they promised to pay, and the largest banks in the world were reporting multi-billion dollar losses and defaulting. When the housing

bubble burst, this led to the collapse of the largest investment banks in the world, and pushed the world into a global recession (Oatley 2012).

Four risky practices and beliefs in particular performed by the financial services industry led to negative externalities felt by the public, which ultimately mobilized the public to act collectively. Proprietary trading, high leverage ratios as a function of a moral hazard, and a lack of transparency and accountability on exotic financial instruments all created a structurally weak economy and transferred the risk of these questionable practices and beliefs onto the public while keeping the reward and financial gain of these trends to the financial services industry. It is important to analyze each practice and trend and their negative spillover effects to determine how this put the public at risk and ultimately led to the mobilization and the passage of financial regulation that would then attempt to limit these practices.

The three following risky practices that will further be explained including proprietary trading, high leverage ratios, and the shadow banking system and over-the-counter derivatives market, were all exploited not only as a function of the presumed profit that these practices promised but also because of a belief by the banks and other large financial institutions that they were “too big to fail”. Many of the vulnerabilities that amplified the financial crisis were linked to this “too big to fail” problem. “Too big to fail” is the idea that a financial institution is so large, complex, and ingrained in the economy that to prevent failure the government must and will provide assistance in order to forgo the severe, adverse consequences that would occur if the institution were to fail. The existence of such institutions creates long run, systemic problems for an economy. First, a severe moral hazard is created; if creditors believe that an institution will not fail, they will not demand as much of a compensation for increased risk, and this in turn weakens market discipline and makes risk more desirable. The build up of risk increases the

possibility of a financial crisis and worsens a financial shock. Retrospectively, such an implicit guarantee of bank and other financial institution solvency lead investors to lend to these large institutions at a cheaper rate, and shareholders and managers rationally exploited this by taking on excessive debt and leverage leading up to the 2007 Financial Crisis (Coffee 2012). Second, the idea of “too big to fail” creates an uneven playing field between small and large financial institutions. If it is believed that these financial institutions are “too big to fail” then the idea of such solvency incentivizes smaller firms to grow to become “too big to fail” institutions and increases the market share of large firms artificially. Third, such large institutions create a major risk to the overall financial stability of an economy. For example, the failure of Lehman Brothers and the near failure of other large firms worsened the Financial Crisis and most recent recession. Not only did the failure induce a sharp decline in asset prices and stopped the flow of credit, it also disrupted both domestic and international markets and affected the overall macroeconomic stability of the United States economy. “Too big to fail” institutions are difficult to fix, as a promise by the government of nonintervention is difficult to confirm. In order to fix this issue, excessive risk taking needs to be curtailed and a resilient macroeconomic economy needs to be created through added regulation and oversight, all of which are costly to financial institutions (Bernake 2012). The assurance that a firm will be bailed out caused the financial industry to take part in a number of risky practices, the first of which being proprietary trading.

As defined in Dodd-Frank, proprietary trading is the purchasing or selling of stocks, bonds, options, commodities, derivatives, or other financial instruments by an insured depository institution, a company that controls an insured depository institution, or a bank holding company, for the trading book of such an institution; it does not including the purchasing or selling of stocks, bonds, options, commodities, derivatives, or other financial instruments on behalf of a

customer (“Proprietary Trading...” 2011). The Securities and Exchange Commission warns against the dangers of this high-risk high-reward practice by arguing that when banks trade for their own accounts, they disregard the interests of their customers, which leads to unnecessary risk taking. The agency further states that the speculative proprietary trading by deposit-taking institutions exposed a bank’s capital and FDIC deposits to unacceptable risks, ultimately led to massive losses for taxpayers, and was a key contributor to the financial crisis. In addition to putting the deposits of customers at risk because the firm trades for direct gain of the institution instead of commission dollars, proprietary trading also risks the protection of investors. Since banks that engaged in proprietary trading gathered information from their client’s investment activities and exploited them, these banks were able to use client trading information against client interests and create and market products that were secretly designed to fail all for the short-term gain of the institution (Aguilar 2013). However, due to the high volatility of profits and high risk associated with this practice, when trades go sour, they go really sour. In fact, in five quarters during the financial crisis, the six largest bank holding companies in the United States reported a combined \$15.8 billion loss from stand-alone proprietary trading, all of which were deposits by customers, and because of these huge losses due to excessive risk taking, American taxpayers had to bail out the banking system (“Proprietary Trading...” 2011). It is clear that practices like proprietary trading shifted risk onto the public while privatizing the reward of financial gain to the financial institutions.

Leading up to the financial crisis, many investment banks became highly leveraged, increasing their appetite for risky investments and decreasing their resilience in case of such losses, through their use of complex financial innovations including securitization vehicles and derivatives. Creditors advanced funds too cheaply and encouraged banks to become

overleveraged because they believed that these “too big to fail” banks would always be bailed out. This problem of moral hazard that led to unsustainable leverage ratios can be seen from 2003 to 2007, during which the top five investment banks in the United States including Goldman Sachs, Lehman Brothers, Morgan Stanley, Merrill Lynch, and Bear Stearns, had increased their leverage ratios—defined by the ratio of total debt to shareholder equity—so high and thus increased their vulnerability to financial shock. For example, from 2003 to 2007, the majority of the top five investment banks increased their leverage ratios ranging from 15 to 25 times levered to above 30 times levered. More specifically, Merrill Lynch doubled its leverage ratio from just above 15 times levered in 2003 to just above 30 times levered in 2007, Lehman Brothers showed accounting leverage of 30.7 times, Morgan Stanley increased its leverage from just above 22.5 times in 2003 to just below 32.5 times in 2007, Bear Stearns showed leverage of 32.5 times in 2007, and Goldman Sachs remained relatively constant with leverage under 25 times during this period of time. These five banking institutions reported over \$4.1 trillion in debt for the fiscal year of 2007—about 30% of the United States nominal GDP for 2007—and because of such statistics, it did not take long for banks to default and the American tax payers to bail-out the banks for their risky practices in hopes of saving the American economy. Once banks defaulted, were bailed out, and the credit crunch hit, America was in a recession. In April of 2009, U.S. Federal reserve vice-chair Janet Yellen explained how the paradox of deleveraging magnified the distress of the economy by stating, “...as balance sheet deleveraging has spread to nearly every corner of the economy [,] consumers are pulling back on purchases, especially on durable goods, to build their savings. Businesses are cancelling planned investments and laying off workers to preserve cash. And, financial institutions are shrinking assets to bolster capital and improve their chances of weathering the current storm (Yellen 2009).” It is evident that because

of the top five investment banks increasingly high leverage ratios due to their “too big to fail” belief, the negative externalities of these risky practices were felt by the public through a massive credit crunch and period of deleveraging—leading to a lack of investment, lower GDP, lower real wages, a crash in the stock market, and high unemployment rates for the American public.

Former Chairman of the Federal Reserve Ben Bernanke attributes a number of vulnerabilities that amplified the initial shocks in the economy to the shadow banking system, which gained importance in the ten years leading up to the financial crisis. Bernanke defines shadow banking as “[a system that] comprises a diverse set of institutions and markets that, collectively, carry out traditional banking functions—but do so outside, or in ways only loosely linked to, the traditional system of regulated depository institutions. Examples of important components of the shadow banking system include securitization vehicles, asset-backed commercial paper (ABCP) conduits, money market mutual funds, markets for repurchase agreements (repos), investment banks, and mortgage companies (Bernanke 2012).” The shadow banking system conducted an enormous amount of transactions and trading activity in the over-the-counter derivatives market, including collateralized debt obligations—structured financial products that pool together mortgages, bonds, and loans and repackage the assets into discrete tranches—, credit default swaps—insurance against non-payment as the swap transfers the credit exposure of fixed income products between parties—, synthetic credit default swaps, and interest rate obligations derived from mortgage backed securities, and these transactions totaled upwards of \$650 trillion dollars by 2008. Because these derivative products were sold “over-the-counter,” meaning that the trading is done directly between two parties without the supervision of any exchange or clearinghouse, many of these new products whose monetary value comprised of ten times the world’s GDP were unregulated by an exchange and their prices were not published for

the public. This meant that companies and financial institutions selling them were not required to maintain sufficient capital reserves to pay any potential claims, and because derivatives could be used as a source of off balance sheet financing, the true leverage of firms was hidden to the public. This lack of transparency and lack of regulation on these exotic instruments created an underlying systemic risk that ultimately led to a run on the shadow banking system when housing prices dropped and thus signaled the start of the 2007 Financial Crisis (Hera 2010). While trading these instruments over-the-counter, financial institutions and the government put the public at risk by creating a vulnerable and structurally weak economy, and therefore, when the shock occurred and the US economy went spiraling into a recession, the public was mobilized for change.

The negative externalities of these financial practices that transferred the risk onto the public and privatized the reward to the financial institutions can be seen not only in key economic indicators but also in the bail out and purchase of financial institutions using taxpayer dollars. Mortgage giants Fannie Mae and Freddie Mac were purchased by the government; investment bank Lehman Brothers went bankrupt; Bank of America purchased both Merrill Lynch—the world’s largest retail brokerage—and Countrywide Financial; JP Morgan Chase in a government-sponsored sale purchased Bear Stearns; federal regulators seized IndyMac Federal Bank indicating the failure of the largest regulated thrift; the government bailed out the world’s largest insurer, American International Group; federal regulators closed down Washington Mutual Bank in the biggest US bank failure in history; the New York Federal Reserve bailed out insurance agency AIG twice; Wells Fargo acquired Wachovia; and Congress passed a \$700 billion dollar bailout plan TARP—The Trouble Asset Relief Program—to bailout major financial institutions (USA Today 2013). As some of the world’s largest investment banks defaulted, were

purchased at fire sale by other investment banks, and were bailed out by the government using taxpayer dollars, a severe recession took place in America and the majority of those who were suffering were not the irresponsible, risk-taking financial institutions that were culpable for the mess.

The National Bureau of Economic Research classifies the Great Recession as the period of time between December 2007 and June 2009. Economic indicators including the unemployment rate, percent change in American Gross Domestic Product, change in real income earned and investment, and dramatic changes in the stock market offer insight into just how severe the Financial Crisis was. In December 2007, the national unemployment rate—defined as the number of unemployed individuals actively searching for a job divided by the labor force—was 5.0 percent, and it had been at or below that percentage since the previous thirty months. At the end of the recession in June 2009, unemployment reached 9.5 percent and peaked in October 2009 at 10.0 percent. Compared to previous recessions, there was a higher proportion of long-term unemployed individuals—those unemployed for twenty seven-weeks or longer—which gives way to the severity of this time period (USA Today 2013). Real Gross Domestic Product—as defined as an inflation adjusted measure reflecting the values of all goods and services produced in a given year—contracted in the third quarter of 2008 and did not return to growth until the first quarter of 2010. The stock market, as measured by the S&P 500 index fell fifty-seven percent from its October 2007 peak of 1,565 to its trough in March 2009 of 676. Additionally, the recession wiped out all middle class inflation-adjusted real income gains from the last fifteen years, leaving the median household income to \$49,445 in 2010, the lowest it has been since 1996. Residential private investment fell by fifty percent from its pre-crisis peak of \$800 billion in 2006 to \$400 billion by mid-2009, and non-residential investment fell to \$1,300

billion in 2010 from its peak of \$1,700 billion in 2008 (USA Today 2013). By categorizing the 2007 Financial Crisis as a banking crisis caused by a speculative bubble/crash, analyzing four trends that directly transferred the risk of financial practices to the public, including proprietary trading, a moral hazard and high leverage ratios, and the lack of regulation on exotic financial instruments, and examining the severe negative externalities of the systemic shock that were felt on Main Street, including a high unemployment rate, a stock market crash, lower real wages, a lack of investment, and lower GDP, it is clear that the public will mobilize to ask the government for a change in financial rules.

When looking at public mobilization and public engagement regarding the economy, it is necessary to analyze the percent of news reported that was focused on the economy, how closely news tracked economic events, whose voices were heard and whose were not in stories, the biggest catalysts for media attention, and the top economic news headlines during the 2007 Financial Crisis and Great Recession. A study by the Project for Excellence in Journalism found that the economy began to gain a fraction in news media beginning in August 2007 as reports of tightening in the housing market and Countrywide Financial's imminent bankruptcy began to make its way into the news. Local print newspapers were the first to report of economic troubles in their communities, and the beginning issue of concern was the housing market. Americans and their engagement in the economy increased greatly as the Great Recession became more severe. In August 2007, it was reported that 28% of Americans were paying close attention to the economy with 3% of news stories reported about the economy, and this figure increased by June 2008 as 49% of Americans now reported paying close attention to the economy with 12.2% of news stories being about the economy. Because of these figures, the study found that public opinion was not driving coverage of the economy for the public was more interested in economic

events than what percentage of news stories reported were about the economy. It was found that the biggest catalyst for media attention was external events including government reports, banking reports, and official testimony, and due to this, most of the stories regarding the severity of the economy were months behind on tracking events because most of the data relied on external agencies to report it. The stories that were closely in sync with events occurring depended on how easy the story was to tell—gas prices and bank defaults happened in real time and were thus easy to track whereas the cause of the financial crisis or severity of the crisis was a harder story to tell. While the majority of storylines came out of New York City or Washington D.C., print media did a better job of representing the public opinion of ordinary citizens regarding the economy than other forms of media. For example, ordinary people were quoted in 29% of print media compared to 19% of overall media, interest groups appeared in 14% of print media compared to 6% overall, unions appeared in 5% of print media compared to 2% overall, and 35% of newspaper stories were investigative compared to 20% overall. As media coverage on the economy increased, America's anxiety about the economy also intensified, however, it is not to say that the media manufactured this concern, but rather, the media reinforced the public's worries and confirmed the people's fears. In January of 2008, 26% of the American public believed the economy to be in good shape whereas 28% of Americans believed the economy to be in poor shape. That figure changed significantly and by March of 2008, just three months later, 12% of Americans believed the economy to be in good shape and 56% of Americans believed the economy to be in poor shape. From February 1 to August 31, 2009, the economic storylines with the top percent of economic newshole were bailouts and banking with 15%, the stimulus plan with 14%, the auto industry and its financial troubles with 9%, and the unemployment rate and housing sector with 6% respectively (“The Changing Narrative...”

2011). By seeing statistically that the American public's outlook on the US economy worsened from January 2008 to March 2008 and that almost half of the American public reported paying close attention to the economy with banking and bailouts as the most popular economic topic, it is clear that although the public did not trigger the majority of news, their increase in interest and worsened outlook signaled to politicians that there needed to be a change.

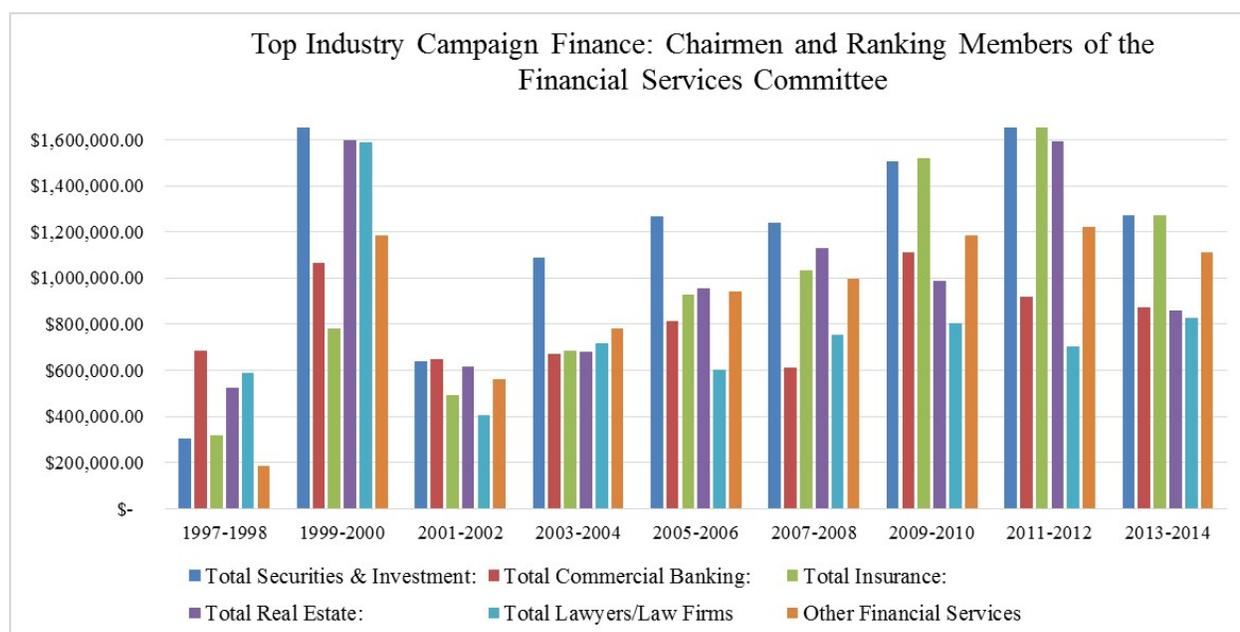
When analyzing lobbying in the financial services industry measured by the campaign finance contributions to chairmen and ranking members of the Committee of Financial Affairs in the House of Representatives and the Banking, Housing, and Urban Affairs Committee in the Senate and their respective subcommittees, the findings are very interesting. Beginning from 1997 to 2014, total campaign fundraising peaked for chairmen and ranking members of the Banking, Housing, and Urban Affairs Committee and subcommittee members during 1997-1998 with \$57,126,277 and in 2011-2012 with \$62,766,835 as compared to a mean of \$26 million excluding those two peaks. Furthermore, the Senate out-fundraised the House of Representatives Financial Service Committee in all elections except during 1999-2000, when chairmen and ranking members of the Financial Services Committee and subcommittee significantly outperformed their historical and recent trends, raising \$51,990,612 compared to a mean of \$15 million per campaign cycle excluding that peak. Across both the Financial Services Committee and the Banking, Housing and Urban Affairs Committee, the top five industry contributors include securities and investment—including securities, venture capital, private equity firms, broker-dealers, hedge funds, investment banking and stock exchange entities, and commercial investment—lawyers and law firms, real estate—including real estate agents, mortgage bankers and brokers, and real estate services—insurance—including companies and brokers and agents—

and commercial banks—including banking and lending institutions, commercial banks, and bank holding companies (Campaign Finance Influence Explorer 2015).

Securities and Investment contributions exceeded all other categories during campaign cycles for the Financial Services Committee except for during 1997-1998 when Commercial Banks contributed the most to campaign finance and during 2009-2010 when Insurance groups contributed the most to campaign finance. Similarly, Securities and Investment contributions exceeded all other categories during campaign cycles for the Banking, Housing, and Urban Affairs Committee except during 1997-1998 and 2011-2012 when Lawyers/Law Firms contributed the most to campaign finance. Furthermore, Securities and Investment contributed the most to the Banking, Housing, and Urban Affairs Committee during 2003-2004 and 2007-2008, and for the Financial Services Industry has been steadily increasing since 1997 but has since declined since 2013-2014.

For the Financial Services Committee, it is important to note that contributions by securities and investment peaked in 1999-2000 with \$2,417,114, contributions by commercial banking peaked in 2009-2010 with \$1,111,450, contributions by the insurance industry has been steadily increasing and peaked in 2011-2012 with \$1,651,369, contributions by the real estate industry had peaks in both 1999-2000 and 2011-2012 with \$1,597,932 and \$1,594,384, respectively, and lawyers and law firms contributions peaked in 1999-2000 with \$1,587,920. Contributions by the commercial banking industry were highest in 1999-2000, the time of the passage of the Gramm-Leach-Bliley Act and in 2009-2010, the time of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Contributions by the Insurance industry were highest in 2009-2010 and 2011-2012, which is logical as Dodd-Frank, passed in 2010, had severe implications for the insurance sector. In regards to the Real Estate industry, contribution

were highest in 1999-2000, the time of passage of the Gramm-Leach-Bliley Act and in 2011-2012, the time directly following the passage of Dodd-Frank. Further, the peak in contributions from the securities and investment industry in 1999-2000 shows how the financial services industry was continually lobbying for deregulation, as the Gramm-Leach-Bliley Act and repeal of the Glass-Steagall Act was finally passed (Campaign Finance Influence Explorer 2015).<sup>1</sup>

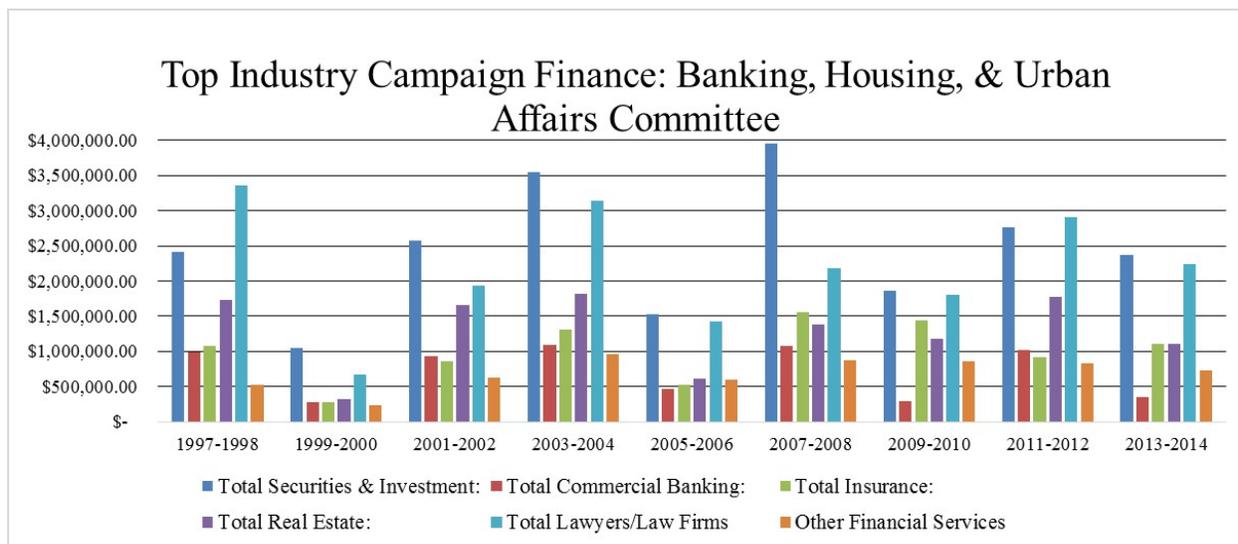


**Figure 1**

When looking at the Banking, Housing, and Urban Affairs Committee in the Senate, it is important to note that contributions by securities and investment peaked in 2007-2008 with \$3,949,103, contributions by commercial banking peaked in 2003-2004 with \$1,095,064, contributions by the insurance industry peaked in 2007-2008 with \$1,558,191, contributions by the real estate industry peaked in 2003-2004 with \$1,822,230, and contributions by lawyers and law firms peaked in 2003-2004 with \$3,145,756. Contributions by the commercial banking

<sup>1</sup> Campaign Finance Influence Explorer. 2015. Raw Data. 1818 NW Suite 300, Washington, D.C.

industry were highest in 2003-2004, 2007-2008, and 2011-2012, which makes sense during the financial crisis and after the financial crisis as Dodd-Frank places costly restrictions on the commercial banking industry. Contributions by the real estate industry were highest in 1997-1998, the time period leading up to the Gramm-Leach-Bliley Act, 2003-2004, the time period where housing prices were booming and investment banks invested heavily in mortgage-backed securities, and 2011-2012, the period after the passage of Dodd-Frank that places costly restrictions on the real estate industry. Contributions by the insurance industry were highest in 2007-2008, the period of time when AIG was bailed out by the government, and 2009-2010 the time period leading up to the passage of Dodd-Frank, which places costly restrictions on the insurance industry (Campaign Finance Influence Explorer 2015)<sup>2</sup>.



**Figure 2**

It is also necessary to analyze the overall percentage of contributions that securities and investment, commercial banks, lawyers and law firms, insurance firms, real estate services, and other financial services industry accounted for out of overall contributions to chairmen and

<sup>2</sup> Campaign Finance Influence Explorer. 2015. Raw Data. 1818 NW Suite 300, Washington, D.C.

ranking members of these respective committees. Given the database, it was only possible to see the top ten industry contributions for each Senator or Representative, and therefore, it is quite possible that the financial services industry contributed more to campaign financing than what has been discussed and what will be discussed. When looking at the percentage of campaign finance contributions that come from the financial services industry to chairmen and ranking members of the Financial Services Committee and the Banking, Housing, and Urban Affairs Committee and respective subcommittees, there is no clear pattern, however, there are key implications. From looking at the table below, both Senate and House committees saw an increase in the percentage of contributions from the financial services industry from 1997 until present day. While the percentages vary, it is important to see that the House Financial Services Committee and subcommittees has a higher percentage of contributions from the financial services industry in most congressional years excluding 1999-2000, 2001-2002, and 2005-2006 than the Senate Banking, Housing, and Urban Affairs Committee. Additionally, the percentage of contributions from the financial services industry peaked for the House Financial Services Committee in 2007-2008 with 46.47% of total contributions coming from the financial services industry, and peaked for the Senate Banking, Housing, and Urban Affairs Committee in 2005-2006 with 44.09% with its second highest percentage from the financial services industry coming in during 2007-2008 with 38.24%. Clearly, this shows that even after or during an economic crisis, the financial services industry will continue to contribute campaign donations to those on the Financial Services Committee and the Banking, Housing, and Urban Affairs Committee. In fact, percentage of contributions to the Financial Services Committee by the financial services increased greatly after the 2007 Subprime Mortgage Crisis, thus proving that during a crisis the financial services industry will increase their overall percentage of campaign contributions,

however, the interest of the public in pushing for regulation outweighs that of the financial services industry, and even after a financial crisis, the financial services industry will continue to push for deregulation and law that are in favor of their industry (Campaign Finance Influence Explorer 2015).<sup>3</sup>

Congressional Year	House	Senate
1997-1998	28.3%	17.63%
1999-2000	16.60%	19.76%
2001-2002	26.62%	29.03%
2003-2004	41.19%	33.49%
2005-2006	36.32%	44.09%
2007-2008	46.47%	38.24%
2009-2010	39.75%	24.44%
2011-2012	33.54%	16.27%
2013-2014	40.82%	20.14%

**Figure 3**

On July 21, 2010, President Obama stated, “These reforms represent the strongest consumer financial protections in history” after signing the Dodd-Frank Wall Street Reform and Consumer Protection Act—the most restrictive piece of financial regulation since the Glass Steagall Act of 1933. Along with these restrictions cause costs, and in total, the act has added \$21.8 billion in costs and 60.7 million paperwork burden hours to the financial services industry (Winkler, Batkins, Gitis, 2014). Dodd-Frank attempts to create a sound economic foundation to promote jobs, protect consumers, punish Wall Street and the culture of excessive bonuses, end bailouts for “too big to fail” institutions, and prevent another financial crisis. More specifically, Dodd-Frank attempts to achieve these goals through financial stability reform, agency and agency oversight reform, securitization reform, derivatives regulation, investor protection reform, Volcker Rule, compensation reform, and capital requirements. It is necessary to analyze

<sup>3</sup> Campaign Finance Influence Explorer. 2015. Raw Data. 1818 NW Suite 300, Washington, D.C.

each of the above provisions and analyze the costs and benefits to both the financial services industry and public to help explain their lobbying viewpoint and the actions that they took.

While there were numerous government bodies responsible for regulating financial institutions, without a governing body to oversee the regulatory agencies, gaps in regulation and oversight failures occurred, leading to the 2007 Financial Crisis. In regards to financial stability reform, Dodd-Frank creates the Financial Stability Oversight Council (FSOC) to oversee financial institutions. Chaired by the Secretary of Treasury with voting members consisting of the heads of Treasury, Federal Reserve, Options Clearing Corporation, Securities and Exchange Commission, Commodities Futures Trading Commission, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, National Credit Union Administration, and the Bureau of Consumer Financial Protection, the Council seeks to identify risks to U.S. financial stability that may arise from activities ongoing at financial institutions by collecting information necessary to assess the risk of the American financial system, identifying potential threats to U.S. financial stability including gaps in regulation, recommending heightened prudential standards for nonbank financial companies and large bank holding companies, and providing a forum for discussion and annual report and testimony regarding financial stability. While this measure is seen as beneficial for the public as increased oversight, transparency, and accountability will allow regulatory agencies to identify systemic risks, it is extremely costly to the financial services industry. With identified potential threats, heightened prudential standards, and increased reporting, banks and non-bank financial companies will be held responsible for the risky practices that resulted in excessive financial gain for Wall Street and extreme loss for Main Street and will have to spend more of their resources in finding loopholes so that they can engage in high-risk high-reward financial practices. It is estimated that Dodd Frank will cost the six

largest American banks \$70.1 billion in counting tightened capital rules, higher deposit-insurance premiums, interchange-fee restrictions, and supervisory assessments. The top three banks with the highest cost include Bank of American Merrill Lynch, Goldman Sachs, and followed by JP Morgan Chase.

With many governing regulatory agencies, the financial services industry was able to vary rules and standards that they abided by, increasing financial risk due to a varying degree of regulation and financial oversight, which assisted in the financial crisis. To correct this, Dodd-Frank attempts to reform agencies and agency oversight through the creation of the Financial Stability Oversight Council, Office of Financial Research within the Treasury, independent Bureau of Consumer Financial Protection within the Federal Reserve, Office of National Insurance within the Treasury, and Office of Credit Rating Agencies within the SEC. Along with the creation of several new agencies, thrift holding companies and subsidiaries of thrift holding companies will be regulated by the Federal Reserve, national banks and federal thrifts will be regulated by the Office of the Comptroller of the Currency, thrifts of all sizes will be regulated by the Federal Deposit Insurance Corporation, the Office of Thrift Supervision will be eliminated, the Securities and Exchange Commission will require registration of hedge funds managing over \$100 million in investment advisors and will require registration of municipal financial advisers, swap advisers, and investment brokers, and the Federal Reserve will have rule-making authority in prohibiting proprietary trading (“The Dodd Frank Act...” 2010). Because thrifts, hedge funds, and nonbank financial companies operated in an era with light regulations and light regulatory enforcement towards them, with increased regulations and oversight, not only will these groups incur more costs in efforts to try to find loopholes to be able to take part in risky practices that lead to high rewards, but these groups will also incur costs—

both time and money—with all of the added regulation and reporting requirements. The public and pro-reform groups find this provision, especially in regards to the Bureau of Consumer Financial Protection, extremely beneficial in that regulators are advocating on behalf of the public interest and not industry. Small banks are most concerned about the Bureau of Consumer Financial Protection as it gives authorization to the bureau to require reports from small banks including information regarding small business loans and mortgage data collection, which ultimately increase costs for small banks.

Dodd-Frank attempts to reform securitization by amending the registration, disclosure, and reporting requirements for asset-backed securities and other structured-finance products due to the fact that many financial institutions that held collateralized debt obligations and credit default swaps in 2007 either suffered large losses on leverage due to falling prices or defaulted. The new regulation calls for up to 5% of the risk to be retained by the securitizer, risk retention to apply to Collateralized Debt Obligations and similar instruments, the creation of different asset classes that are subject to different regulations, due diligence analysis by the securitizer prepared for the investors, the disclosure of asset-level detail and the fulfilled and unfulfilled repurchase requests across trusts, and other practices of credit risk retention. Because products including collateralized debt obligations and credit default swaps became dominated not by loans but by lower level tranches recycled from other asset-backed securities, they were credited with incentivizing lenders to make non-prime loans leading to the subprime mortgage crisis and Great Recession (“The Dodd Frank Act...” 2010). Through this provision, the public greatly benefits from increases in risk retention to financial services industry as this lessens the burden of risk that the public undertook leading up and during the Financial Crisis. Because financial institutions channeled over one-third of the \$1.4 trillion dollar surge in new mortgages between

2004 and 2006 into these financial products, banks will now have more risk to take on themselves, will experience increased costs for their respective firm in complying with these rules and in searching for loopholes, and might not be able to make as much gain as they were able to before due to the increased transparency and creation of asset classes with differing regulations.

Because the shadow-banking system and the large volume and value of transactions of over-the-counter derivatives helped lead to the financial crisis through its lack of transparency, lack of regulation, and ability to decrease financial institutions leverage ratios, Dodd-Frank attempts to reform this through increased derivative regulation. Dodd-Frank gives jurisdiction over swaps to the Commodities Future Trading Commission, gives the Securities and Exchange Commission jurisdiction over security-based swaps, does not allow for federal assistance—advances from any Federal Reserve credit facility—for swap-entities, mandates the use of clearinghouses for swaps, requires swap dealers and major swap participants to register as such to be subject to a regulatory regime, allows Federal banking regulators and regulators to set minimum capital requirements and initial and variation margin requirements for swap dealers and major swap participants, and mandates that swap dealers and major swap participants disclose the characteristics, material risks, and material incentives of the swaps. Perhaps one of the most contested and costly provisions of Dodd Frank to the financial services industry, by decreasing financial institution leverage ratios, mandating the use of clearinghouses and disclosure of risks and material incentives for swaps, and implementing minimum capital requirements, the financial services industry will experience increased costs to comply with regulations. The big banks have met with regulators and testified in Congress, arguing that they will suffer a competitive disadvantage if these regulations apply to their foreign arms (“The

Dodd Frank Act...” 2010). As of 2012, Bloomberg reported that Goldman Sachs had 62.0% of its \$134 billion in fair-value derivatives assets and liabilities in non-U.S. branches for international banking, while 77.0% of Morgan Stanley’s \$101 billion, 59.0% of JP Morgan Chase & Co.’s \$188 billion, 53.0% of Citigroup Inc.’s \$122 billion, and 50.0% of Bank of America Corp.’s \$125 billion were in non-U.S. operations (Brush 2012). Derivative regulation applied to these banks certainly affects large sums of revenue and profit for the firms and threatens to undercut their competitiveness in the global economy.

During the Financial Crisis, many clients and investors lost faith in those who had held their securities and/or funds, and in an attempt to restore confidence in the financial services industry, Dodd-Frank aims to reform investor protection. The Act creates the Investor Advisory Committee to consult initiatives to promote investor confidence and gives the Securities and Exchange Commission increased powers including being self-funded, allowing the SEC to engage in consumer testing, giving the SEC oversight of private funds managed by investment advisors, allowing the SEC to facilitate the provision of clear investor disclosures regarding the term relationships with broker-dealers and investment advisors and disclosures of conflicts of interest, and gives the SEC power to create a fiduciary standard for broker-dealers that provide investment services (“The Dodd Frank Act...” 2010).

When looking back at the Financial Crisis, it is clear that proprietary trading—putting customer’s deposits at risk for the benefit of the financial institution—was a clear cause that not only transferred the risk of this practice directly to the public while privatizing the financial reward to the institution, but was also one of the main reasons, as discussed, as to why the crisis occurred. The Volcker Rule, perhaps the most strongly debated provision of Dodd-Frank, attempts to end proprietary trading. The Volcker Rule prohibits a banking entity from engaging

in proprietary trading and acquiring or retaining any equity or ownership interest in a hedge fund or private equity fund, mandates that a nonbank financial company that engages in proprietary trading or fund activities will be subject to additional capital requirements and quantitative limits, and prohibits that any underwriter, sponsor, purchaser, or placement agent have a material conflict of interest with respect to any investor in a transaction. In regards to capital requirements, Dodd-Frank gives the Federal Reserve authority to establish prudential standards for supervised nonbanks and bank holding companies with total consolidated assets at or above \$50 billion including leverage limits, risk-based capital requirements, liquidity requirements, and stress test requirements, and prohibits these institutions from having a debt to equity ratio greater than 15 to 1 (“The Dodd Frank Act...” 2010). The Volcker Rule, as it prohibits proprietary trading is perhaps the most costly provision of Dodd Frank to financial institutions. By prohibiting banks from proprietary trading, banks will lose out on billions of dollars of revenue that they were making due to this regulation. Additionally, raising the requirements on capital are extremely costly for financial institutions as it reduces leverage and thus the profitability of banks. Banks will now have to raise more capital not by expanding their debt financing but rather by expanding their balance sheet while accumulating capital, which requires banks to withhold dividends from shareholders and could potentially put downward pressure on bank shares. While some risky credit lines will become unavailable for consumers, the majority of the public will benefit from a more risk-averse banking system. Additionally, financial institutions might be prohibited from maintaining inventories of stocks, commodities, bonds and derivatives to facilitate trades for their customers which could affect hedging positions and proves that market-making under the new rule could be costly.

Due to the trend towards incentive-based compensation at financial institutions leading up to the Great Recession, senior management focused on short-term results ignoring long-term risks, and this significantly increased the risk and decreased the transparency that financial institutions used in their practices. Dodd-Frank attempts to reform this compensation by mandating the release of proxy statements of their executive officers that must be approved by shareholders, mandating the disclosure of the median annual total compensation of all employees and the ratio of the median employee total compensation to the CEO total compensation, and mandating the disclosure of the company's financial performance versus the compensation paid to executives ("The Dodd Frank Act..." 2010). While this benefits the public as increases transparency, corporate officers and financial institutions will find this very costly and intrusive, as many executives whose bonuses are quite lavish will now have to release their compensation.

While pro-reform and consumer groups advocate for Dodd-Frank, there exists a number of costs not only to the financial services industry, but also to low-income consumers and smaller banks that are not in the category of "too big to fail". As banks increase their capital ratios, deleverage, tighten underwriting standards, and comply with Dodd-Frank, they have cut \$70 billion in credit in three years as of 2013. This has disproportionately affected lower-income consumers, with 40% of families in these categories reporting credit card cancellations in addition with having their limits reduced or being denied a new credit card; additionally, to make up for the added costs of regulations, bank fees have increased, some of which have increased by 25%. In 2009, 76% of banks offered free checking accounts, and as of 2012, only 39% of banks do. While checking accounts are free as long as the individual has a certain amount of money in the account, many lower income customers are unable to meet this requirement. With the added regulations of Dodd-Frank making mainstream banking more expensive, lower income

individuals in society are being pushed into nontraditional financial arrangements due to the added costs of Dodd-Frank (McCloskey 2013). As a cut of credit by \$70 billion by the big banks hurts lower income consumers, it also hurts smaller banks. Because small banks hold money with larger banks, an increase in regulations on larger banks and a cut of credit will raise costs of borrowing for smaller banks. This along with an uneven regulatory playing field has accelerated bank consolidation due to the increasingly complex and uncoordinated regulatory system that has been created. Small banks are spending more on compliance in the wake of Dodd-Frank, with more than 80% of small banks experiencing an increase of more than 5% in compliance costs since 2010. Small banks are responding by cutting their product lines, contemplating mergers with other banks, and rethinking whether to offer residential mortgages and home equity lines of credit (Peirce 2014). In regards to discontinuing services, residential mortgages have been cut by 5.9%, mortgage servicing products by 5.0%, home equity lines of credit by 4.5%, overdraft protection by 2.7%, and credit cards by 2.7% (Peirce 2014). A study at Harvard declared that community banks, or banks with less than \$10 billion in assets, lost 6% of their share of U.S. banking assets from mid 2006-2010, and since mid 2010 to present day, their market share has decreased by 12% (Pierce, Robinson, Stratmann 2014).

As economic indicators return to normal levels, with the unemployment rate hovering around 6.0%, GDP growing at an annualized rate of above 2.0%, and the Stock Market at all time highs with the S&P 500 above 2,000 points, the interest of the public in financial regulation and the economy has waned, while the financial services industry has clear and ever-present reasons to stay attuned to such financial minutiae. Because the benefit of acting collectively is now less than the cost of acting for the public but the benefit of acting collectively remains even greater than the cost of acting for the financial services industry, the financial services industry

has continued to lobby both Congress through campaign finance contributions and lobby the regulatory agencies through meetings in order to dampen the provisions of Dodd-Frank.

In addition to collecting the data of total contributions to campaign finance by the securities and investment industry from 1996-2014, I also more specifically, collected the campaign finance contributions to chairmen and ranking members of the Committee of Financial Affairs in the House of Representatives and the Banking, Housing, and Urban Affairs Committee in the Senate and their subcommittees. I found that campaign contributions from investment and security firms, lawyers and law firms, the insurance industry, commercial banks, and the real estate industry continued to increase even after and during the Financial Crisis and Recession. In fact, during the financial crisis and after percentage of contributions coming from the financial services industry to the House Committee peaked in 2007-2008 with 46.47%, and continued to sustain at high levels with 39.75% in 2009-2010, 33.54% in 2011-2012, and 40.82% in 2013-2014. In regards to the Senate Committee, percentage of contributions coming from the financial services industry to the Banking, Housing, and Urban Affairs Committee decreased to 38.24% in 2007-2008 from its peak of 44.09% in 2005-2006, but continued to remain at higher levels post-crisis than pre-crisis. This data demonstrates how even though the campaign finance from the financial services industry peaked during the years either leading up to the passage or during the passage of Dodd-Frank, Congress still was able to pass the legislation due to the crisis window and the temporary shift in the balance of interest in financial news from the financial services industry to the public.

When analyzing interest group mobilization and its effect on regulatory changes in legislation after the passage of financial regulation, it is necessary to look at the meetings attended by interest groups with regulatory agencies to explain how and why they have been able

to make a change regarding the principal provisions. By looking at the meetings attended by interest groups, we can see that even though there may be changes in terms of legislation, the gains that are made by consumers through their passed legislation may be lost in terms of regulatory enforcement due to the fact that the financial industry continues to lobby both regulators and legislators.

The Sunlight Foundation, a nonprofit, nonpartisan organization that advocates for open government, conducted a study from July 2010 to June 2013 that logged the number of meetings that active interest groups—groups that attended five or more meetings—had with the Commodities Futures Trading Commission, United States Treasury, and the United States Federal Reserve regarding the topic of Dodd-Frank, and their results are consistent with my theory and the Regulatory Sine Curve. According to the Sunlight Foundation, Goldman Sachs was the most active organization attending 222 meetings with the top issue of derivatives market and products, followed by JP Morgan with 207 meetings with the top issue of the Volcker Rule, then Morgan Stanley with 175 meetings with the top issue of derivatives market and products, Bank of America with 156 meetings with the top issue of derivatives market and products, and Citigroup with 134 meetings with the top issue of derivatives market and products. Goldman Sachs and JP Morgan alone participated in fifty percent more meetings than the top twenty most active pro-reform groups. It was logged that active financial institutions attended to 2,118 meetings while pro-reform groups appeared only in 153 meetings, law and lobbying firms largely working in service of financial institutions appeared in 707 meetings, and energy and agricultural corporations whose end products are derivatives appeared in 381 meetings. When looking at the top twenty five most active organization as measured by the number of meetings that they appeared before the Federal Reserve, the Treasury, and the CFTC, twenty-one out of

the twenty-five organizations were financial institutions or financial trade groups, with exceptions being three prominent law firms and one government affairs organization. When looking at meetings by agency, the financial sector companies were present at 90% of meetings at the Federal Reserve, 82.7% of meetings with the Treasury, and 74.8% of meetings with the CFTC compared to pro-reform groups attending 3.3% of meetings with the Federal Reserve, 13.7% of meetings with the Treasury, and 4.4% of meetings with the CFTC. For financial organizations, the topics with the most meetings included issues regarding self-registration, followed by the Volcker Rule, the Consumer Financial Protection Bureau, and derivatives markets and products. On the other hand, pro-reform groups reached the peak of participation on the implementation of the Consumer Financial Protection Bureau being present at 26% of 137 meetings, while only attending 16% of meetings pertaining to business conduct standards, 9% of meetings regarding the Volcker Rule, 4% of meetings relevant to position limits, and being absent at every single meeting regarding the topic of the derivatives markets and products (Drutman 2013). This data is consistent with my hypotheses.

It is no surprise that because the financial sector continued to outspend pro-reform groups in campaign contributions and that they were almost 14 times more active than pro-reform groups as measured through number of meetings with regulatory agencies attended that they were able to roll back many of the key provisions of Dodd-Frank. First, given the determined participation by financial firms on derivatives, it is not surprising that the Commodities Futures Trading Commission and the Securities and Exchange Commission caved into industry pressure by raising the derivatives regulatory oversight threshold from the originally proposed \$100 million to \$8 billion. This increase of eighty times exempted 85% of companies that would have been covered and subject to registration and regulation under the original threshold. Furthermore,

the rules on swaps gained an increasing amount of loopholes; one initially promised rule preventing federally insured banks from trading in risky derivatives ultimately changed to exempt a large number of swaps market from the new law. In addition, Wall Street won broad exemptions for mutual funds, insurers and trusts, and secured a numerical exemption that allows banks to gamble up to three percent of their “Tier I” capital, a number for big banks that stretches to billions of dollars. The Consumer Financial Protection Bureau went from being a powerful, independently run agency headed by Elizabeth Warren to a smaller bureau within the Federal Reserve run by Richard Cordray. Dodd’s Frank attempt to end “Too-big-to-fail banks” and bailouts through mandating certain financial institutions to pay \$19 billion in an advance FDIC-style fund that would cover the costs of any future bailouts was overridden when the Senate changed the bill to state that the FDIC would first use taxpayer money for any bailouts and then recover that money from Wall Street through a specific assessment process. Congress recently passed legislation that repealed a key provision of Dodd-Frank and thus now permits the continuation of implicit federal tax subsidies for derivative investments that hedge risk and enable proprietary speculation. In regards to the proxy access rule, Wall Street lobbyists from the Business Roundtable and the Chamber of Commerce sued the Securities and Exchange Commission and won the case stating that the agency had not done proper cost-benefit analysis before it instituted the rule, and thus killed the rule. Position limits set by Dodd-Frank that were designed to prevent any one speculator from holding more than 25% of a commodities at a given time was ultimately battled against in Court with Wall Street winning—killing the rule and allowing for no position limits. In addition to regulatory discretion by the regulatory agencies, and changed bills by Congress, in 2012 Congress also cut a significant amount of money, \$35 billion, from the Financial Services Committee in the House, which oversees much of the

regulatory apparatus that enforces Dodd-Frank. In conjunction, Congress froze the Commodities Futures Trading Commission's budget despite the fact that the agency went from regulating \$40 trillion in assets to \$340 trillion in assets due to Dodd Frank. Along with taking the law to court, passing new legislation to overturn rules, cutting budgets, and having regulatory agencies loosen requirements, lobbyists also have delayed the passage and implementation of many provisions of Dodd-Frank, one including the most strongly debated topic, the Volcker Rule, which attempts to end proprietary trading (Taibii 2012).

## **Chapter 8**

### **Data Analysis**

When analyzing the data collected and the case studies discussed, a number of significant conclusions can be made in regards to my original theory and outlined hypotheses. My theory argues that systemic economic shocks change the opportunity/threat environment between the financial services industry and public, which is indicated by temporarily creating a symmetric level of interest in regards to financial news and regulation; this symmetric level of interest ultimately causes the government to tighten financial regulation; while the financial services industry has clear and ever present reasons to be attuned to regulation, the public does not, and as financial times return to normal, public interest in regulation wanes. Because the asymmetric level of interest is restored, financial industry lobbyists are able to roll-back the financial regulation that was put in place both by continually increasing campaign finance contributions and by meeting with regulatory agencies to curtail regulatory enforcement and weaken regulatory discretion. When looking at the case studies analyzing the Great Depression and subsequent Glass-Steagall Act, the deregulatory trend beginning in the 1970s and cumulating in 1999 with the passage of the Gramm-Leach-Bliley Act, and the Financial Crisis of 2007 and subsequent Dodd-Frank Act, and examining data regarding campaign finance contributions to chairmen and ranking members of the Banking, Housing and Urban Affairs and Financial Services Committees, a number of conclusions can be made.

Throughout American history since the Great Depression, there has been a consistent trend by the financial services industry advocating for deregulation on financial products and

services with higher risk and reward ratios through stances taken publicly, meetings with Congress and regulatory agencies, and continued campaign finance contributions to members of the House and Senate who originate financial legislation. My first hypothesis states,

**H1:** The financial services industry continuously advocates for looser restrictions on higher risk/reward activities, leading toward deregulation or the weakening of an existing piece of legislation.

This can be confirmed through my case studies analyzed and data regarding campaign contributions and meetings with regulatory agencies collected. As explained in my case study, after the Great Depression and passage of the Glass-Steagall Act, the legislation was continually lobbied against by the financial services industry and eventually dampened during the 1970s and the ultimate repeal of the Act through the passage of the Gramm-Leach-Bliley Act in 1999. Similarly, even through and post Financial Crisis of 2007 and Great Recession, the financial services industry continued to lobby both Congress via campaign finance contributions and increased meetings with regulatory agencies. For example, as seen in my data, campaign finance contributions by the financial services industry continued to increase in the House Financial Services Committee and the Senate Banking, Housing, and Urban Affairs Committee. For instance, as previously discussed, in regards to the House, the total amount of contributions from the financial services industry—securities and investment industry, commercial banking industry, insurance industry, real estate industry, lawyers and law firms, and miscellaneous finance—continued to increase and have a positive trend from 1997 to present day. This can be seen in the percentage of contributions coming from the financial services industry. The percentage continued to remain above 25.0% excluding 1999-2000 for the House and peaked in 2007-2008 with 46.47% and overall increasing from 1997 to present day. While the pattern is not

as clear in the Senate, the percentage of campaign contributions from the financial services industry continued to make up a high level with 38.24% of total campaign contributions coming from the financial services industry in 2007-2008. Additionally, it was logged that financial institutions attended to 2,118 meetings with the CFTC, Fed, and Treasury, while pro-reform groups appeared only in 153 meetings post Dodd-Frank. Along with these increased campaign finance contributions and meetings attended, the dampening of Dodd-Frank has occurred, demonstrating that because the financial services industry constantly has an incentive to advocate for deregulation and weakening of existing regulation, when the asymmetric interest in regards to financial news and financial regulation is restored between the financial services industry and public, industry will beat the public (Drutman).

In American history, it has been exemplified that only after and during periods of economic shock that the benefit of acting collectively outweighs the costs of acting collectively for the public, temporarily mobilizing the public and creating an interest in financial regulation symmetric to that of the financial services industry. This in turn leads to the passage of financial regulation, as all leaders wish to stay in power, and the increase of interest in financial news by the public increases the costs to the government of not strengthening existing regulation or creating more restrictive financial policies. My second hypothesis states:

**H2:** Only in times of economic crises does the public become temporarily mobilized to counteract the influence of the financial industry to push for financial regulation and ultimately pass financial regulation.

This can be confirmed through the case studies explained and the data collected. First, after the Stock Market Crash of 1929 the financial regulatory framework was put in place for the United States. It was only after the Subprime Financial Crisis of 2007 in 2010, that another piece

of financial regulation almost as restrictive as the Glass-Steagall Act was passed—the Dodd-Frank Act. The mobilization of the public can be seen in their increased attention to financial news and changed outlook on the economy. It was reported in January of 2008, that 26% of the American public believed the economy to be in good shape whereas 28% of Americans believed the economy to be in poor shape. That figure changed significantly and by March of 2008, just three months later, 12% of Americans believed the economy to be in good shape and 56% of Americans believed the economy to be in poor shape. This change to a more negative outlook was complemented with an increase in financial interest—as it was reported in August 2007 that 28% of Americans paid close attention to the economy and increased by June 2008 as 49% of Americans reported that they paid close attention to the economy (“The Changing Narrative...”). This increased mobilization and interest temporarily outweighed the financial contributions to chairmen and ranking members of the House Financial Services Committee and Senate Banking, Housing, and Urban Affairs Committee and subcommittees as contributions from the financial services industry greatly increased during the Crisis and post-crisis, as seen in the percentage of contributions from the financial services industry. Additionally in regards to the House Committee, contributions from the commercial banking industry peaked in 2009-2010, contributions from the insurance industry were highest during 2009-2010 and 2011-2012, contributions from the real estate industry peaked in 2011-2012, and contributions from the securities and investment industry continued to increase year over year, exemplifying that even with a high percentage of money coming from the financial services industry, the public sentiment and mobilization outweighed industry to get regulation passed. Further, even though the contributions to the Senate Committee remained high as seen in the data above, Dodd-Frank could still be passed even though the financial services industry disagreed with the bill.

However, because contributions either remained high or increased after the passage of Dodd-Frank, and industry continued to lobby agencies via meetings, legislation was dampened. This shows that even with contributions continuing to pour in from industry, Congress still passed stricter regulation to appease the public.

Post-financial crisis, it has been evident that regulation becomes more dampened due to constant pressure from the financial services industry. Hypothesis three states:

**H3:** Even though there may be changes in terms of legislation, the gains that are made by consumers through their passed legislation may be lost in terms of regulatory enforcement due to the fact that the financial industry continues to lobby both regulators and legislators.

This prediction has been confirmed by the case studies and data collected. While the restrictive policies including the Glass Steagall Act and Dodd-Frank Act were enacted, passed and enforced shortly after the Stock Market Crash of 1929 and the Financial Crisis of 2007, they were also later dampened—Glass Steagall being dampened completely via the passage of the Gramm-Leach-Bliley Act and Dodd-Frank although passed five years ago has seen a number of changes that weaken the initial form of passage. This is a result of constant pressure from the financial services industry as analyzed in the case studies above; both campaign finance contributions to the House and Senate committees and subcommittees that originate financial legislation continued to increase from the financial services industry and the number of meetings the financial services industry had with the regulatory agencies in charge of implementing Dodd-Frank outweighs that of pro-reform groups by almost fourteen times. This demonstrates that even though legislation has been passed, the financial services industry has access to the legislators that have access to the laws and may completely undermine its original form.

## **Chapter 9**

### **Conclusion**

The aim of this research was to determine why the degree of restriction in financial regulation historically varies in the United States. Specifically, this thesis explained through an interest group model approach how systemic economic shocks influence the degree of assertiveness and the opportunity/threat environment of the financial services industry and public that ultimately determines the passage of financial regulation or financial deregulation by the American government, and the regulatory discretion and enforcement of the regulatory agencies thereafter the passage. As argued by my theory, only after financial crises is there a window of opportunity or period of near equality of attention given to news in the financial sector—normally there is an asymmetric relationship between the financial services industry and public in terms of the interest given to financial news. During a crisis, however, there is more of a symmetric relationship, and this temporarily shifts the balance of interest to the public and increases the net benefit of the public in acting collectively. While the financial services industry has clear and ever-present reasons to be attuned to the costs and benefits of regulation, the public does not. Therefore, in normal economic periods, the financial services industry will be inclined to lobby the government for looser restrictions. Because the public is uninterested in the minutiae of financial regulation, even shortly after the passage of regulatory legislation, the financial services industry works to dampen the newly passed regulation by lobbying the financial regulatory agencies.

The following four hypotheses can be confirmed by the case studies discussed and data collected and explained by my proposed theory.

**H1:** The financial services industry continuously advocates for looser restrictions on higher risk/reward activities, leading toward deregulation or the weakening of an existing piece of legislation.

**H2:** Only in times of economic crises does the public become temporarily mobilized to counteract the influence of the financial industry to push for financial regulation and ultimately pass financial regulation.

**H3:** Even though there may be changes in terms of legislation, the gains that are made by consumers through their passed legislation may be lost in terms of regulatory enforcement due to the fact that the financial industry continues to lobby both regulators and legislators.

When testing these hypotheses, my research design included both qualitative and quantitative aspects. This study analyzed the economic environment beginning from the Great Depression until present day via three case studies, focusing on crises including the Stock Market Crash of 1929 and the Subprime Mortgage Crisis of 2007, and the trend towards deregulation beginning in the late 1970s and cumulating in the late 1990s. First, I classified and defined the economic shock and/or the economic environment surrounding the time period being analyzed and examined the popular trends in practices by the financial services industry at that time. Second, I discussed the stances of the public and the financial services in regards to financial regulation and deregulation, and discussed the costs and benefits of the proposed and existing pieces of financial legislation. Then, I looked at the change in interest group assertiveness, looking at the financial services industry and public, given an economic shock.

The financial services industry group assertiveness was measured by both campaign finance contributions to the chairmen and ranking members of the House Financial Services Committee and the Senate Banking, Housing, and Urban Affairs Committee and subcommittees from 1997 until 2014 to capture their influence on the passage of financial legislation in the US government, and by number of regulatory agency meetings attended post-Dodd-Frank to capture their influence on regulatory discretion. On the other hand, public assertiveness was measured by both the composition and number of news stories in the media during the most recent financial crisis to capture the influence that public sentiment had over the passage of financial regulation, and the number of regulatory agency meetings attended by pro-reform groups post Dodd-Frank to capture their influence on regulatory discretion and to demonstrate how public interest wanes. Finally, to gauge the effectiveness of the momentum of these interest groups, I looked at changes in the original piece of financial legislation and how the original piece of legislation was dampened or if the piece of legislation was able to passed or not.

When examining potential flaws, a few aspects of the research design could have been executed more accurately and more efficiently if given more time and more data. In regards to analyzing campaign finance contributions, I only looked at the chairmen and ranking members of the House Financial Services Committee and the Senate Banking, Housing, and Urban Affairs Committee and subcommittees. It would be more accurate if I was able to analyze every member of the House and the Senate, and then break that down into the different committees and subcommittees, as more committees than the two I listed have originated financial reform and have jurisdiction over differing financial services. Furthermore, given the dataset I used, I was only able to look at the top ten industry contributions, and therefore it is most likely that I underreported the contributions that the financial services industry contributes to campaign

finance. It would be a more robust study to have been able to see all industries for a Representative or Senator in order to gain a more accurate look at the percentage of total campaign contributions and total contributions from the financial services industry. Ideally, it would have also been interesting to look at campaign finance before, during, and after the Stock Market Crash of 1929 and after the start of the deregulatory trend beginning in the late 1970s, however, that data is unavailable. When analyzing public sentiment and mobilization, perhaps it would have been more accurate to analyze the number of news stories regarding the economy and public sentiment before and after the financial crisis of 2007 and Great Recession and not just during these time periods. Additionally, given more time, it would have been interesting to discuss and analyze testimony from the financial services industry and pro-reform groups before Congress to better explain their positions regarding the financial legislation being discussed.

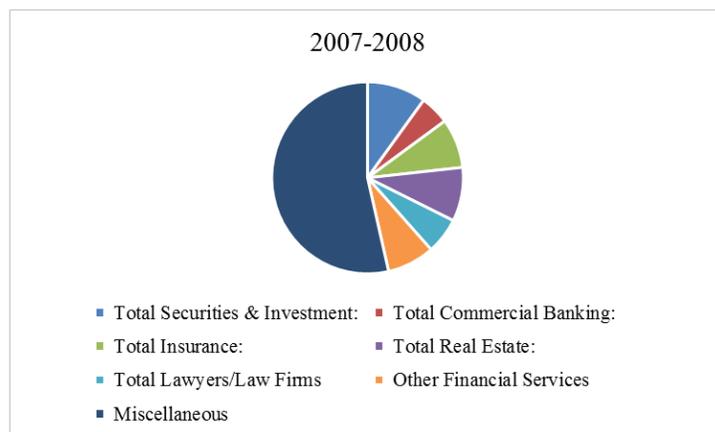
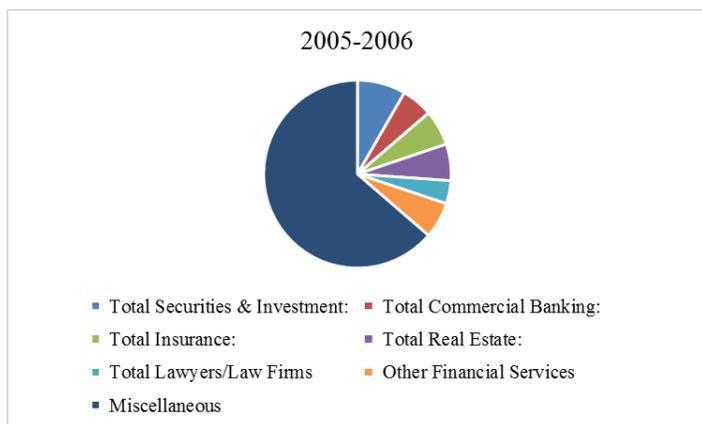
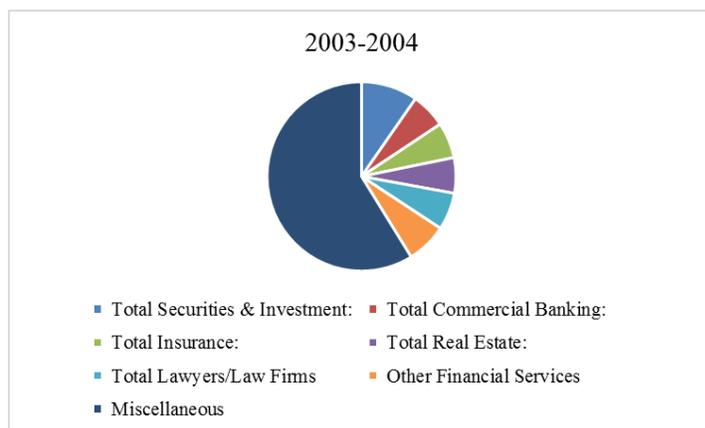
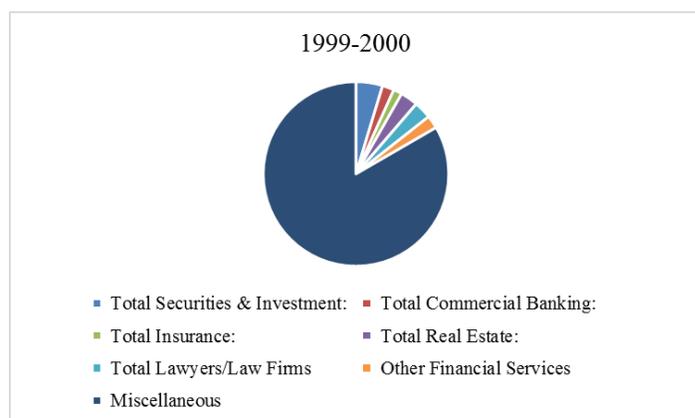
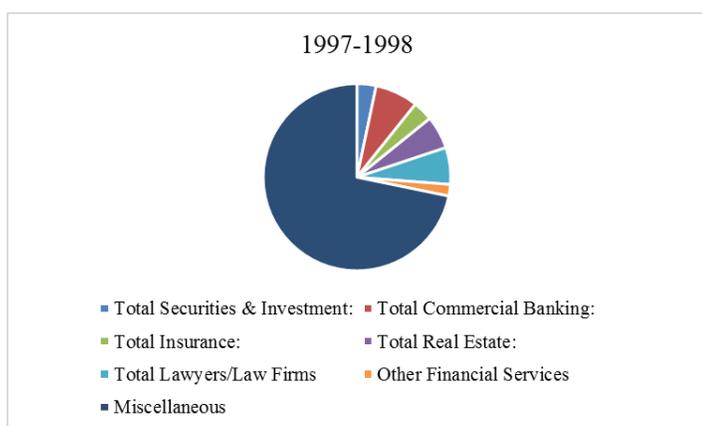
The importance of understanding the connection between systemic economic shocks and impending financial legislation and the regulatory discretion of the regulatory agencies and the politics behind it is apparent. By realizing that the financial services industry continuously advocates for looser restriction on risk/reward activating, leading toward the deregulation or the weakening of an existing piece of legislation, that only in times of economic crises does the public become temporarily mobilized to counteract the influence of the financial industry to push for financial regulation and ultimately pass financial regulation, that only during periods of economic crisis are regulatory agencies forced to make regulation more restrictive, and that only in periods of extraordinary economic gain and extraordinary economic shocks will major changes in the financial regulatory regime occur, the public and investors will be better able to predict financial regulatory trends. It is imperative to determine the relationship between economic conditions and financial reform in the United States due to its direct effect on both

Wall Street and Main Street and accordingly on the United States' domestic economy as a whole. By understanding the contrasting lobbying motivations of the financial services industry versus the public, scholars will be able to better predict regulatory and deregulatory policy outputs passed by the United States government following systemic economic shocks and how that legislation changes following its passage.

While this thesis offers a general quasi-experiment on the effects of economic atmosphere on the opportunity/threat environment of the financial services industry and public, which ultimately affects American financial regulatory output and regulatory discretion, there exists a number of areas of research that would be beneficial to examining this type of relationship. For example, it would be interesting to go more in depth regarding campaign finance contributions from the financial services industry to members of Congress and the stances that those members of Congress took to the particular piece of legislation. Further, it could be interesting to see what types of social movements occurred during and after the crisis that pushed for a stance on a particular economic crisis or financial piece of legislation.

## Campaign Finance Data

### The House of Representatives Financial Services Committee<sup>4</sup>



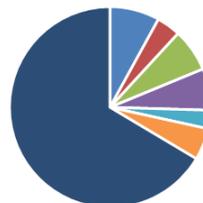
<sup>4</sup> Campaign Finance Influence Explorer. 2015. Raw Data. 1818 NW Suite 300, Washington, D.C.

2009-2010



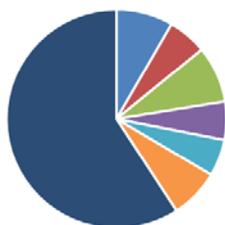
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- Total Lawyers/Law Firms
- Miscellaneous
- Total Commercial Banking:
- Total Real Estate:
- Other Financial Services

2011-2012



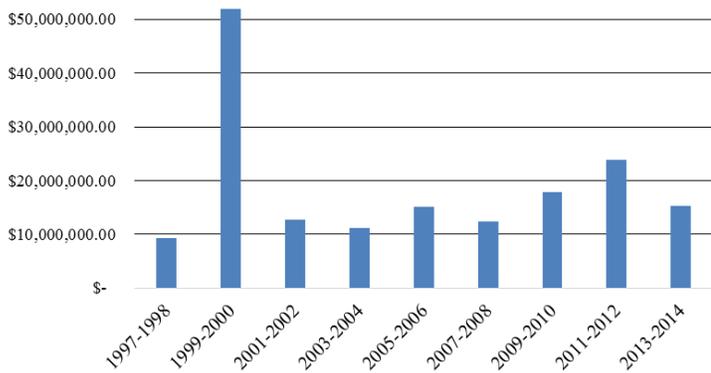
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2013-2014

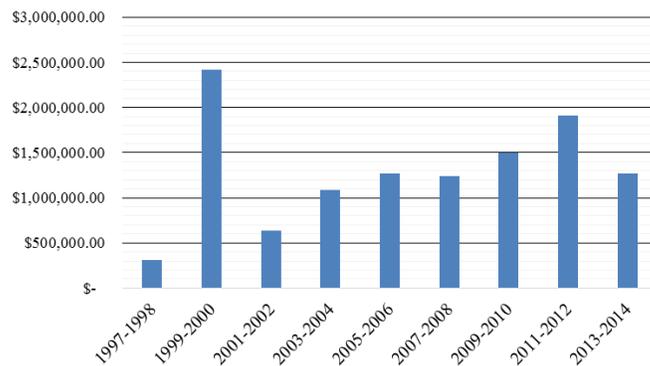


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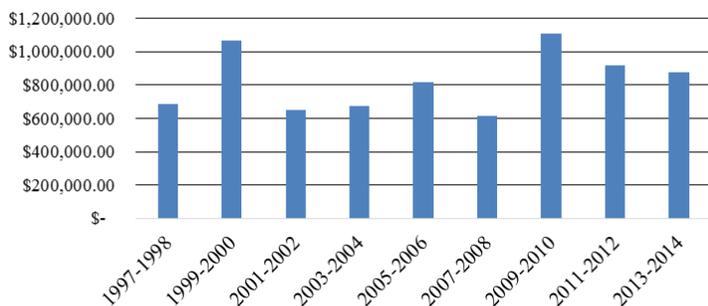
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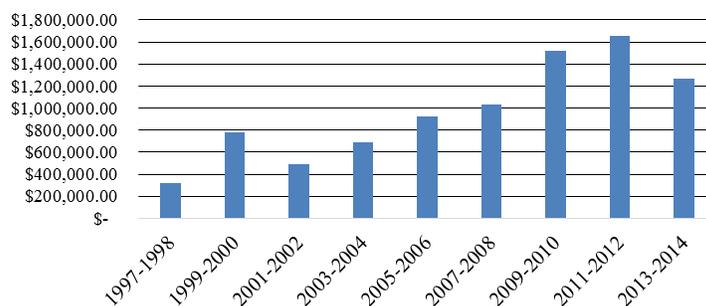
**Total Securities & Investment: Chairmen and Ranking Members: Financial Services Committee**



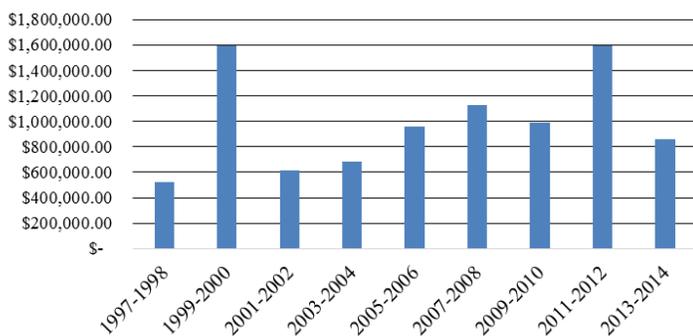
**Total Commercial Banking: Chairmen and Ranking Members of the Financial Services Committee**



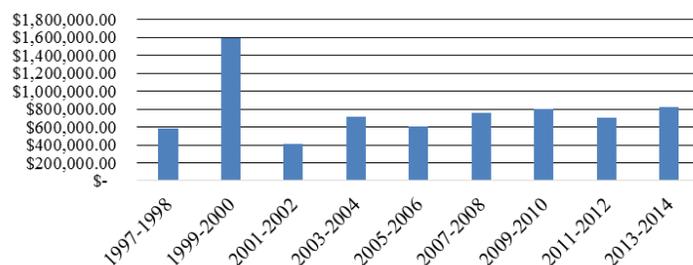
**Total Insurance: Chairmen and Ranking Members of the Financial Services Committee**



**Total Real Estate: Chairmen and Ranking Members of the Financial Services Committee**

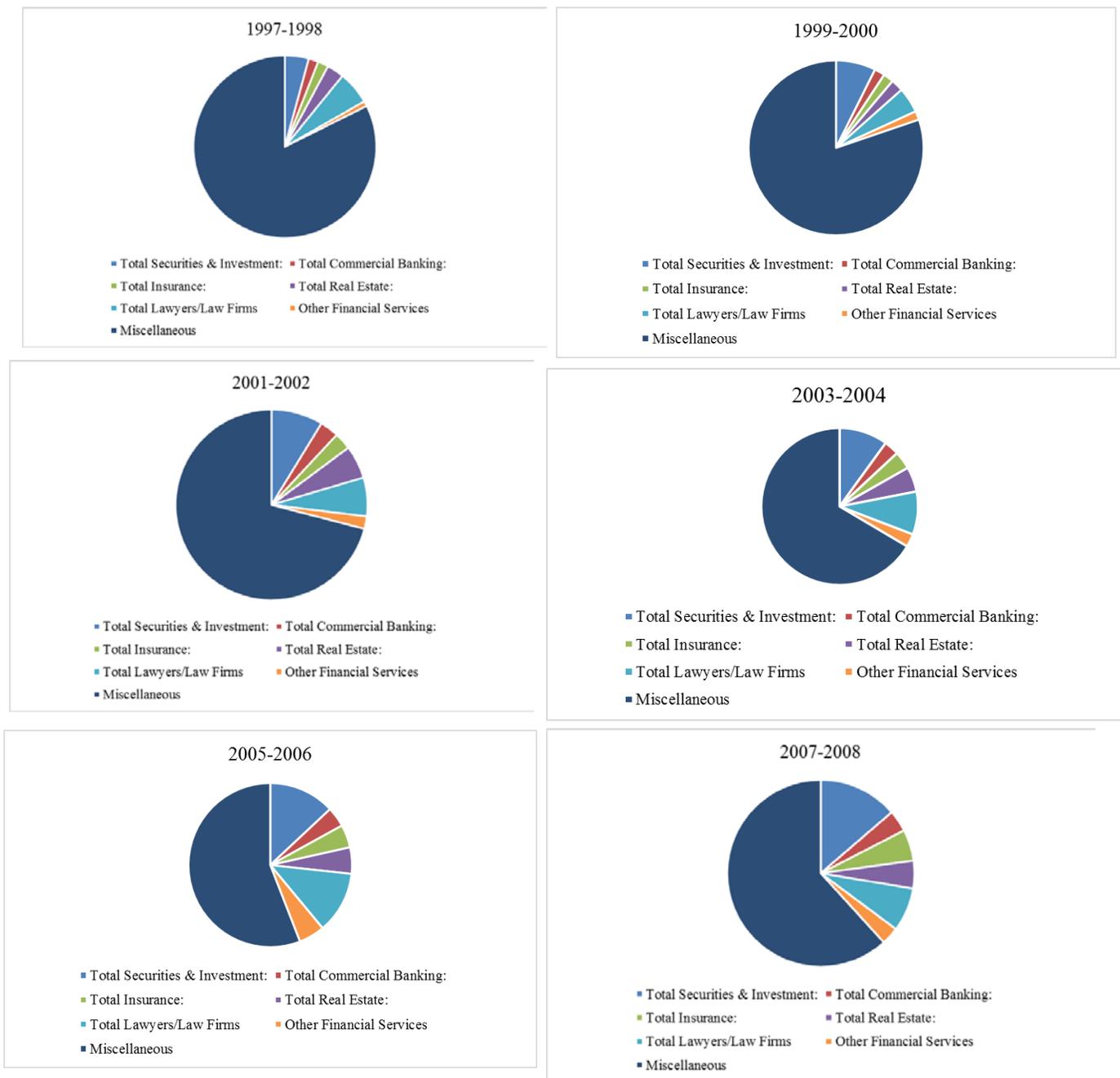


**Total Lawyers/Law Firms: Chairmen and Ranking Members of the Financial Services Committee**



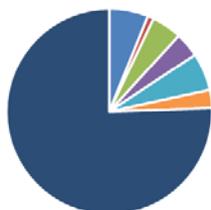
## Campaign Finance Data

### The Senate Banking, Housing, & Urban Affairs Committee<sup>5</sup>



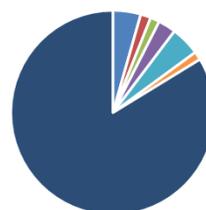
<sup>5</sup> Campaign Finance Influence Explorer. 2015. Raw Data. 1818 NW Suite 300, Washington, D.C.

2009-2010



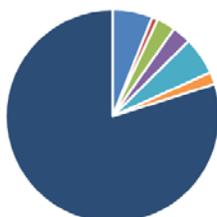
- Total Securities & Investment: ■ Total Commercial Banking:
- Total Insurance: ■ Total Real Estate:
- Total Lawyers/Law Firms ■ Other Financial Services
- Miscellaneous

2011-2012

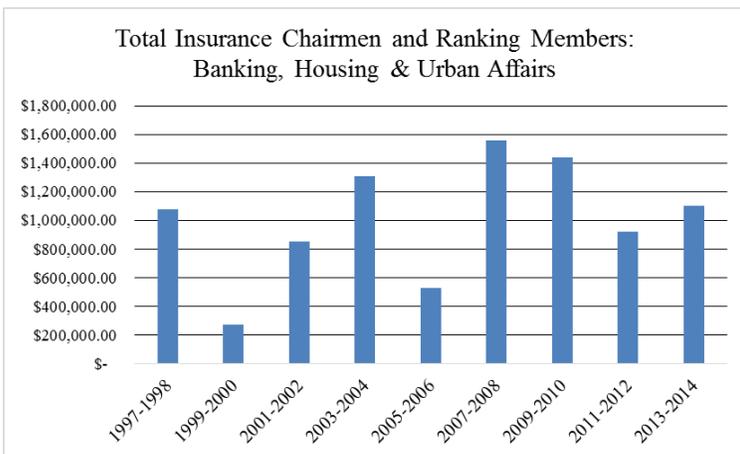
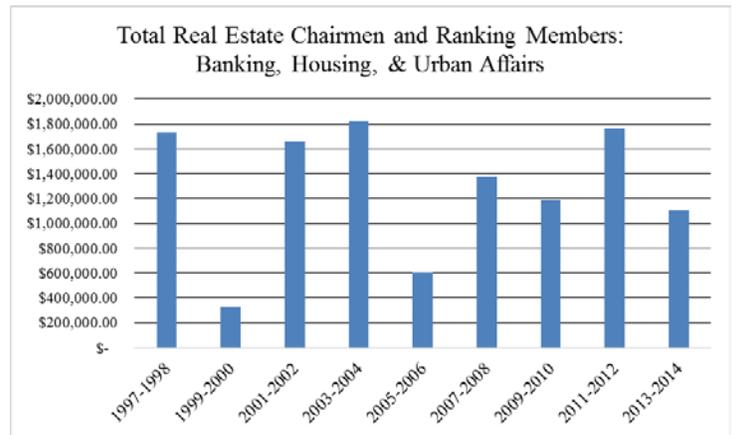
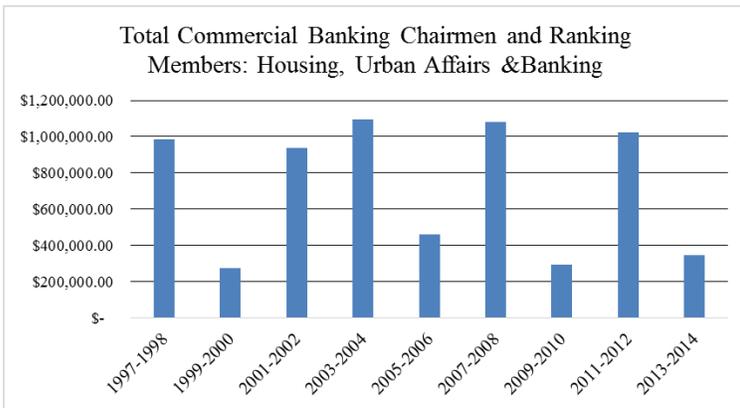
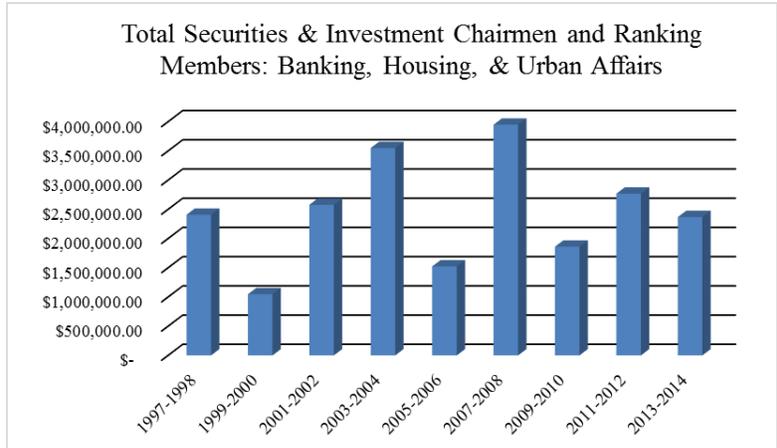
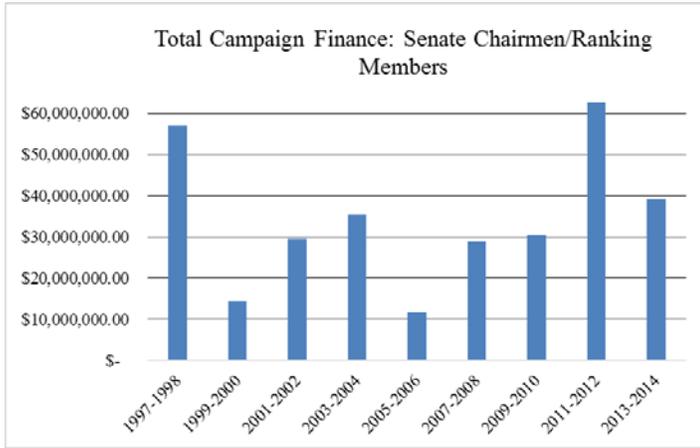


- Total Securities & Investment: ■ Total Commercial Banking:
- Total Insurance: ■ Total Real Estate:
- Total Lawyers/Law Firms ■ Other Financial Services
- Miscellaneous

2013-2014



- Total Securities & Investment: ■ Total Commercial Banking:
- Total Insurance: ■ Total Real Estate:
- Total Lawyers/Law Firms ■ Other Financial Services
- Miscellaneous



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## ACADEMIC VITA

Rachel-Paige Mumenthaler  
rachel-paige@comcast.net

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### **EDUCATION:**

#### **The Pennsylvania State University, Schreyer Honors College**

Bachelor of Arts in Economics  
Bachelor of Arts in International Political Economy  
Minors in Spanish and Business in the Liberal Arts  
Weiss Breakthrough Scholar  
Paterno Fellow

#### **Universidad de Sevilla—Summer 2013**

CIEE Summer Language and Culture Program

### **PROFESSIONAL EXPERIENCE**

#### **Investment Banking Analyst with PNC Loan Syndications, May 2014-August 2014**

- Built out a financial model of a leveraged acquisition buyout to include financial projections and merger synergies, created an Enterprise Value Peer Analysis Model, used Moody's Rating Model and Methodology to rate the merged company, created a Peer Capitalization Table, structured a syndicated loan, and presented project to senior management
- Created a lender presentation for a bank meeting, assisted in researching and writing Confidential Information Memorandums for various companies and deals, assisted in creating deal comparables for multiple corporations and PNC led deals

#### **Finance Intern at Live It partnered with Surge Business Development, January 2104-May 2014**

- Assisted with month-end financial reports, audits, accounts receivable, accounts payable, bank statement reconciliation, yearly forecasting and projection efforts, and product development for this technology start-up company

#### **Legislative Assistant and Campaign Finance Intern for Senator Michael J. Stack, June 2011 –August 2012**

- Raised funds by contacting donors for the Senator's gubernatorial campaign
- Represented the Senator at various events in Philadelphia, including press conferences and meetings and wrote press releases
- Worked with City Planning in determining logistics for a new park and sat in on Senate Appropriations Committee meetings
- Assisted the coordination of the annual Senior Expo by contacting more than 100 participating organizations and businesses

#### **Intern at the Montgomery County District Attorney's Office, June-August 2010/May-June 2011**

- Shadowed an Assistant District Attorney in the Pre-Trials Unit
- Scrutinized the law by witnessing over one hundred hours of court proceedings including jury, bench, and sentencing trials
- Assisted senior interns with legal research

#### **Volunteer at Obama For America, March-November 2008**

- Made over 2,000 phone calls, knocked on hundreds of doors, registered hundreds of voters, and trained volunteers
- Was awarded to meet Barack Obama and Michelle Obama in April of 2008

### **EXTRACURRICULAR ACTIVITIES**

**College of the Liberal Arts Envoys President, Former Secretary, January 2012-Present**

**Penn State College Democrats Club Fundraising Chair, Former Events Chair, Campaign Chair**

**Economics Association, August 2013-Present**

**Sorority Phi Mu Beta Mu/Pledge Class President, January 2013-Present**