Testimony of David O. Beim
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Financial Institutions and Consumer Protection Subcommittee
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Introduction

My name is David Beim. From 1966 to 1990 I worked as an investment banker for The First Boston Corporation, Bankers Trust Company and Dillon Read & Co, with two years (1975-77) as Executive Vice President of the Export-Import Bank of the United States. In 1989 I began to teach as an adjunct at Columbia Business School, and in 1991 joined the faculty of that school as a Professor of Professional Practice.

At Columbia Business School I taught a number of MBA courses including Banking Fundamentals, International Business, Emerging Financial Markets, Corporate Finance, Business Ethics and Corporate Governance over the 25-year period 1989-2014. In addition I taught in a wide range of executive education programs. I retired from Columbia on June 30 of this year.

In 1997 I performed a consultancy study for the Federal Reserve Bank of New York ("NY Fed") regarding the effectiveness of its bank examination procedures. In that connection I interviewed a number of bank CEOs and senior NY Fed officials. My overall conclusion was that the NY Fed's examinations were too low-level, too bottom-up. I recommended that each examination should begin top-down, with a view of each bank's strategy for making money and the risks such a strategy would likely entail. That would provide a context for seeing whether such risks were indeed a problem for the particular bank. I believe that this study was well received and significantly affected the way examinations have since been conducted.

In the late spring of 2009 I received a call from Bill Dudley, President of the NY Fed, inviting me to conduct a new consultancy project, this one about systemic

risk. The United States, like all other countries, has had numerous banking failures over many years. But the events of 2008 were unlike ordinary bank failures – they represented a systemic financial collapse, in which the capital of almost all major financial institutions was exhausted simultaneously. We have not had a systemic financial collapse in the United States since 1931, and most people thought we would never have another.

The Federal Reserve had not seen these events coming, but neither had almost anyone else. Mr. Dudley wanted me to sit down with eight of his top Senior Vice Presidents and work together through the summer to determine what lessons had been learned, and what changes the NY Fed needed to make in its procedures or in its culture to better understand and foresee systemic problems, i.e. problems affecting not just one bank but all banks jointly. He emphasized that he wanted complete candor so that genuine reforms could be initiated.

The summary of our findings is as follows: "Our review of lessons learned from the crisis reveals a culture that is too risk-averse to respond quickly and flexibly to new challenges. Officers are intensely deferential to their superiors, similar to an army. Knowledge is too often hoarded in silos. Business organizations including banks have moved away from structured hierarchies in favor of more modern, flexible organizational forms, and [the NY Fed] needs to adopt some of these attributes to be effective in grasping and acting on systemic issues. This requires a significant degree of cultural change and has implications for human resources and management."

We found that NY Fed officers were excessively deferential to their superiors and that the entire organization was excessively deferential to the banks being supervised. There was huge emphasis on consensus. This is in sharp contrast to academic culture, for example, where disagreement and vigorous debate are highly valued. Among our recommendations was one giving officers more incentives for disagreement and contrarian thinking.

I delivered the final draft of our report in late summer, and Mr. Dudley seemed very pleased. The report was of course highly confidential and never intended for public distribution. However in 2010 the Congress created the Financial Crisis Investigative Commission (FCIC) to investigate the causes of the crisis. The FCIC subpoenaed a large number of documents from many agencies including the Federal Reserve, and ended by posting these on its website. In this way my confidential report was made public.

Last June I was called by a producer from National Public Radio, who said that its highly-regarded program *This American Life* wanted to interview me about the report. I agreed, since the document was already in the public domain, but said I would have to stay within the four corners of the document, which I did. Their story, which aired in late September, connected my report to the story of Carmen Segarra, a NY Fed examiner who was indeed contrarian and outspoken, but who was soon dismissed. At the time of the interview I knew nothing of Carmen Segarra. The program received a great deal of attention, and the present hearings reflect the high level of public interest in this subject.

Regulatory Capture

"Regulatory capture" is a provocative phrase describing an excessively close relationship between a regulator and the companies it regulates. But we need to be careful, since the phrase is used to describe two quite different situations:

1. In what I call the "strong form" of regulatory capture, regulation confers an economic benefit that companies actively want, for example by keeping prices high or restricting competition, and the regulator agrees to supply it to them.
2. In what I call the "weak form" of regulatory capture, regulation is negative for the companies, but the regulator does not strictly enforce the rules, and fails to control company behavior in the way intended by the law.

There is a large academic literature on the strong form of regulatory capture, dating from the 1970s.[1] The financial bailouts of 2008-9, which were undoubtedly a great benefit to the banks, have sometimes been called an example of regulatory capture of the Federal Reserve by the banks. I do not share this view, as the bailouts were an action of the entire U.S. government and not just one agency. They were an emergency action to prevent the U.S. financial system from total collapse, an event that could have brought us back to the 1930s. In my view this action was entirely in the public interest. If one bank fails it should be closed, but if all banks fail simultaneously the system needs to be rescued. All relevant modern governments believe the same and did the same. My 2009 report found no evidence that the NY Fed was putting the interests of banks ahead of the public interest.

We did, however, find a great deal of the weak form of regulatory capture, an obvious pattern of timidity toward the banks being regulated: "supervisors paid excessive deference to banks and as a result they were less aggressive in finding issues or in following up on them in a forceful way…A very frequent theme in our reviews was a fear of speaking up…Ideas get vetted to death."

No one should imagine that the Federal Reserve is unusual in this respect. All bank regulators face the same issue, as indeed do all regulators of economic activity. What causes this timidity? It seems to make a mockery of regulation. Why aren't regulators tougher?

I believe the answer is connected with the general insight, also first explored by economists in the 1970s, that both companies and government agencies are operated by individuals who have private interests, and that these private interests may drive institutional behavior in unexpected ways. For example, bribery happens to some degree in all countries and is an obvious example of the private goals of government officials undermining public goals.

- [1]The seminal article is George Stigler, 1971, "The theory of economic regulation," *Bell Journal of Economics and Management Science* 2:3-21.

But short of bribery, which is everywhere illegal, private goals of government officials can and do undermine public goals in dozens of subtle and legal ways. An individual bank regulator is a human being with ambitions and needs. First, of course, he or she wants to get ahead in the organization, and this generally means agreeing with bosses and colleagues – hence the emphasis on consensus. When an individual regulator disagrees with the position his agency is taking, shutting up and avoiding conflict probably serves his general goal of being well regarded by his colleagues.

More importantly, I believe that bright regulators in mid-career all harbor some hope that they will be offered a good job with one of the regulated companies. Large banks, like other large companies, pay higher salaries than government agencies, and this creates a powerful incentive for regulators to behave in a deferential manner toward such banks, so that he or she might be well regarded enough to be offered a job.

The NPR broadcast on the NY Fed played detailed recordings of conversations among NY Fed officials about regulating Goldman Sachs, in which the lead regulator, a man named Mike Silva, tells his colleagues that he is going to press Goldman hard but at the moment of truth behaves in a very timid manner toward that bank. Mr. Silva was actually part of the team of eight SVPs with whom I worked in producing my report. He is a bright, articulate man, and like most NY Fed officials is hard working and conscientious. However, in 2013 he left the NY Fed to join GE Capital. How could the possibility of an opportunity like this *not* have been in the back of his mind when he was making decisions about how tough to be with banks?

Information Asymmetry

Another factor that helps to explain the weak form of regulatory capture is information asymmetry: companies being regulated know a lot more about their businesses than the regulators who are supposed to control them. I witnessed this in my own career when I was the head of investment banking for Bankers Trust Company, which was regulated by NY Fed.

In 1979 I became very interested in swaps, a basic kind of derivative, when they were new and not well understood. I began to build a capacity in my department to offer swaps and we rapidly found our volume increasing. About a year later I got a polite call from the NY Fed asking if they could bring a team over to our bank so that we could explain swaps to them. I readily agreed, and spent several hours explaining swaps to them. However, even after this candid presentation, the officials had only an elementary understanding of swaps compared to the bankers who had been working with them full time. In short, the regulators often struggle to catch up with banks that are innovating and figure out what they are doing.

Information asymmetry puzzles many observers, including the NPR journalists who interviewed me about my NY Fed report. "Can't a regulator just demand the information, and don't the banks have to supply it?" they asked. Well yes, I would answer, but there is a difference between information and insight. Banks supply great quantities of data to regulators, but what do the data mean? What strategy is being pursued and how do these transactions contribute to the strategic goals? Real understanding requires more than numbers. You have to talk to the people involved to understand the meaning of the data.

I believe that regulators are deferential to banks in part because they need banks to share insights into the strategy and meaning of their transactions. Such insights can only be gained if the working relationship is collaborative, not confrontational. Confrontation usually leads to delivering the facts but not more.

I have not visited the NY Fed since my 2009 project, so I know little about what has happened there since, except for articles in the public press. The NPR broadcast about Carmen Segarra in September and the related story in Pro Publica[2] seem to confirm that the Fed is still surprisingly bland in enforcing its rules against big banks.

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[2] http://www.propublica.org/article/carmen-segarras-secret-recordings-from-inside-new-york-fed.

A subsequent article in Pro Publica concerning JP Morgan Chase[3] seems to show that the problems of effective regulation by the NY Fed have not yet been solved. The villain in this story is Dianne Dobbeck, who is portrayed as authoritarian and negative, blocking the NY Fed's own risk team from investigating the "London Whale" trading losses. The story claims that Ms. Dobbeck had her mind made up and did not want to hear negative information about the bank. This sounds like another example of weak-form regulatory capture.

What Can Be Done?

Regulatory capture, particularly in its weak form, is a widespread problem that goes way beyond banking and undermines much of our regulatory system. So let me come to the bottom line: what can be done about it?

There is quite a lot that the NY Fed and other regulatory agencies can do on their own, with no need for new legislation, many of them detailed in my report. Informational asymmetry can never be fully solved, but it can be alleviated by upgrading the staff, hiring bright and independent-minded people, giving them extensive opportunities to upgrade their skills and providing more explicit incentives for them to act in independent ways.

This means doing what the big banks have done: decentralize authority and give more responsibility for problem solving to lower-level officers. The culture should be less like an army and more open to questioning and challenging. I understand that the Federal Reserve is in fact moving in the opposite direction, centralizing more regulatory authority in Washington, which in my view is a mistake.

But the most important step to control regulatory capture is one that Congress can and should do: strengthen the "revolving door" laws by prohibiting all regulators from working in the regulated industry for fully three years after leaving government.

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[3] http://www.propublica.org/article/secret-tapes-hint-at-turmoil-in-new-york-fed-team-monitoring-jpmorgan.

The United States has a number of ethics laws that try to restrict various classes of government employees from moving to private sector companies with whom they have conducted government work for one year. However, these rules are usually narrowly written and have dozens of easy loopholes, so that in practice they seem to have little effect.

I am not an expert in such laws, but I quote the following from a Congressional Research Service publication:[4]

> Under amendments to the Federal Deposit Insurance Act, certain officers and employees of a "Federal banking agency or a Federal reserve bank," who are involved in bank examinations or inspections, are restricted from any compensated employment with those private depository institutions for a period of one year after leaving federal service. This restriction applies to employees who served for at least two months during their last year of federal service as "the senior examiner (or a functionally equivalent position)," and who exercised "continuing, broad responsibility for the examination (or inspection)" of a depository institution or depository institution holding company. These former employees are barred for one year from receiving any compensation as an "employee, officer, director, or consultant" from the depository institution, the depository institution holding company that controls such depository institution, or any other company that controls the depository institution, or from the depository institution holding company or any depository institution that is controlled by that the depository institution holding company.

This is narrowly written and restricts only the senior examiner from working for the very bank he examined. If you really want to push back against regulatory capture, the law needs to be greatly broadened: it should apply to all officers of a bank regulator working for any bank for a period of three years.

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[4] *Post-Employment, "Revolving Door," Laws for Federal Personnel* by Jack Maskell, Legislative Attorney, January 7, 2014.

Few bank regulators are offered jobs by the very bank they were regulating, but bank regulators as a group form a kind of community with all regulated banks, where many people know each other. No one can predict which individual will be offered a job by which bank, but it is highly predictable that some regulators will be offered a job by some banks. This likelihood affects the way all regulators deal with all banks – how could it not?

To reduce regulatory capture and stiffen the backbones of individual regulators, this easy revolving door must be stopped. This would force more individuals to make an identity decision early in their careers: am I a regulator for the long term or am I a banker?

Ethics laws in general and revolving door laws in particular tend to be unpopular with the people they affect, since they reduce choices. But the long-term effect would be a stronger boundary between the regulators and the banks. It would be a major step toward better regulation of banks, and I recommend it to you as the most important step you could take to reduce regulatory capture.