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# REGULATORY FAILURES IN BANKING AND INSURANCE SECTORS DURING THE GLOBAL FINANCIAL CRISIS: A LEGAL ANALYSIS

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## ABSTRACT

The Global Financial Crisis of 2007–2009 was not, at its core, an unpredictable natural disaster. It was, as the Financial Crisis Inquiry Commission later concluded, a foreseeable catastrophe shaped by regulatory failure, institutional negligence, and the systematic dismantling of the legal safeguards that had, for decades, kept financial excess in check.<sup>1</sup> This paper undertakes a legal analysis of the regulatory failures that permitted the crisis to incubate and then detonate in the banking and insurance sectors. It examines how the deregulatory agenda of the 1990s and early 2000s — epitomised by the *Gramm-Leach-Bliley Act, 1999*<sup>2</sup> and the *Commodity Futures Modernization Act, 2000*<sup>3</sup> — stripped away the architectural restraints on risk concentration and shadow banking. It analyses the collapse of Lehman Brothers, the catastrophic failure of AIG’s credit default swap portfolio, and the inadequacy of the pre-crisis prudential framework. The paper further examines the post-crisis legal response, including the *Dodd-Frank Act, 2010*,<sup>4</sup> and evaluates whether the reforms enacted have addressed the structural vulnerabilities that produced the crisis. The paper concludes that while post-crisis regulation has meaningfully strengthened the banking perimeter, the insurance sector’s systemic risk profile remains inadequately addressed, and the shadow banking system continues to pose unresolved legal and supervisory challenges.

**Keywords:** Global Financial Crisis, Regulatory Failure, Banking Regulation, Insurance Regulation, AIG, Lehman Brothers, Dodd-Frank Act, Credit Default Swaps, Shadow Banking, Basel III, Systemic Risk, Gramm-Leach-Bliley Act.

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<sup>1</sup> Financial Crisis Inquiry Comm'n, *The Financial Crisis Inquiry Report* xv–xxii (2011) [hereinafter FCIC Report] (finding that the crisis was the result of human action and inaction, not of Mother Nature or computer models gone haywire).

<sup>2</sup> Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (repealing the Glass-Steagall Act's separation of commercial and investment banking).

<sup>3</sup> Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000) (exempting over-the-counter derivatives, including credit default swaps, from CFTC and SEC oversight).

<sup>4</sup> Dodd-Frank Wall Street Reform & Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter DoddFrank Act].

## 1. Introduction:

On September 15, 2008, Lehman Brothers Holdings Inc. filed for bankruptcy protection in the Southern District of New York with liabilities of approximately \$613 billion — the largest bankruptcy in United States history.<sup>5</sup> Within hours, the global financial system entered a phase of paralysis. Credit markets froze, interbank lending collapsed, and institutions that had, days earlier, been considered too large and too interconnected to fail found themselves in desperate need of government rescue. The United States Treasury's response — the Troubled Asset Relief Program, authorised under the *Emergency Economic Stabilization Act of 2008*,<sup>6</sup> at an initial cost to the taxpayer of \$700 billion — represented the largest peacetime government intervention in financial markets in modern history.

What made the crisis particularly damaging — and what makes it still relevant to legal scholarship today — was the revelation that it had been enabled, in large measure, by regulatory design. The deregulatory consensus of the preceding two decades had not merely failed to prevent the crisis; in crucial respects, it had actively created the conditions for it. Alan Greenspan, testifying before Congress in October 2008, conceded that he had found a fundamental '*flaw*' in the intellectual model that underpinned his regulatory philosophy: the assumption that market participants, acting in their own rational self-interest, would maintain the discipline necessary to prevent systemic excess.<sup>7</sup>

This paper examines that flaw through a legal lens, focusing on three interconnected regulatory failures: the deregulation of the banking sector and its consequences for risk concentration; the near-total absence of meaningful oversight over the insurance sector's systemic activities (particularly AIG's credit default swap business); and the structural immunity from prudential regulation enjoyed by shadow banking entities that performed bank-like functions outside the formal regulatory perimeter. Against each failure, the paper assesses the adequacy of the postcrisis legislative and regulatory response.

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<sup>5</sup> *In re Lehman Brothers Holdings Inc.*, 422 B.R. 407, 412 (Bankr. S.D.N.Y. 2010) (examining the legal and financial circumstances of the largest bankruptcy filing in United States history, involving assets of approximately \$639 billion).

<sup>6</sup> Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008) (authorising the Troubled Asset Relief Program with an initial outlay of \$700 billion to purchase distressed assets from financial institutions).

<sup>7</sup> Alan Greenspan, Testimony Before the H. Comm. on Oversight & Gov't Reform, 110th Cong. (Oct. 23, 2008) (acknowledging a 'flaw' in the ideological model that markets are self-correcting without need for regulatory intervention).

## 2. Research Questions:

This paper addresses the following research questions:

1. How did the deregulatory legislative agenda of the 1990s and early 2000s create structural vulnerabilities in the banking and financial system that contributed directly to the Global Financial Crisis?
2. What specific legal and regulatory failures permitted AIG's Financial Products division to accumulate catastrophic systemic risk through credit default swaps without adequate capital reserves or supervisory oversight?
3. How did the absence of a coherent legal framework for shadow banking entities exacerbate the propagation of the financial crisis, and what legal mechanisms were employed to address it in the post-crisis period?
4. Did the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 adequately address the structural regulatory failures identified by the Financial Crisis Inquiry Commission?
5. What unresolved legal and regulatory challenges — in the insurance sector, shadow banking, and cross-border systemic risk — remain inadequately addressed more than a decade after the crisis?

## 3. The Architecture of Deregulations: Statutory Dismantling of Safeguards:

To understand the regulatory failures of 2007–2009, one must first understand the legal architecture that was dismantled in the preceding decade. The Glass-Steagall provisions of the *Banking Act of 1933* had separated commercial banking from investment banking, limiting the ability of federally insured deposit-taking institutions to engage in securities underwriting and proprietary trading. The *Gramm-Leach-Bliley Act, 1999*<sup>8</sup> repealed these provisions, opening the door for the creation of universal banks — institutions combining commercial banking, investment banking, and insurance underwriting within a single corporate structure. The immediate consequence was a dramatic increase in the complexity and scale of financial conglomerates, and a corresponding reduction in the clarity of the regulatory perimeter.

A year later, the *Commodity Futures Modernization Act of 2000*<sup>9</sup> exempted over-the-counter derivatives — including the credit default swaps that would later prove catastrophic — from the oversight of both the Commodity Futures Trading Commission and the Securities and Exchange Commission. This was a legal choice of extraordinary consequence. Credit default swaps, instruments that function economically as insurance policies on debt obligations, were permitted to be written and traded in a regulatory vacuum: no capital requirements, no exchange trading, no mandatory clearing, no position limits. By 2007, the notional value of outstanding credit default swaps stood at approximately \$62 trillion.

The Basel II framework,<sup>8</sup> adopted internationally in the early 2000s, compounded these vulnerabilities. By permitting large banks to use their own internal models to calculate riskweighted assets, Basel II created powerful incentives to minimise the apparent riskiness of portfolios — incentives that major institutions duly exploited through regulatory arbitrage, offbalance-sheet vehicles, and the securitisation of mortgage assets. The credit rating agencies, whose assessments of structured finance products were embedded in the Basel II framework as proxies for independent risk measurement, were themselves conflicted: they were paid by the issuers whose products they rated, generating systematic upward bias in their assessments.<sup>9</sup>

The Securities Acts of 1933 and 1934<sup>10</sup> required disclosure of material information to investors, but the complexity of structured finance products — collateralised debt obligations built on tranches of mortgage-backed securities, themselves derived from thousands of individual subprime loans — rendered conventional disclosure frameworks practically meaningless. As the Southern District of New York found in *In re Citigroup Inc. Securities Litigation*<sup>11</sup> (2010), Citigroup's off-balance-sheet exposure to structured investment vehicles was material information that had not been adequately disclosed to investors, constituting securities fraud. The case was emblematic: the formal disclosure architecture existed, but the substantive reality it was supposed to illuminate had been constructed specifically to evade it.

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<sup>8</sup> Basel Committee on Banking Supervision, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework* 12–14 (Bank for Int'l Settlements 2004) (establishing three-pillar framework of minimum capital requirements, supervisory review, and market discipline).

<sup>9</sup> FCIC Report, *supra* note 1, at 166–71 (documenting the role of rating agencies — Moody's, S&P, and Fitch — in assigning AAA ratings to mortgage-backed securities that were, in fact, deeply speculative instruments).

<sup>10</sup> Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2018); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78pp (2018).

<sup>11</sup> *In re Citigroup Inc. Sec. Litig.*, 753 F. Supp. 2d 206, 210 (S.D.N.Y. 2010) (finding that the bank's off-balance-sheet exposure to structured investment vehicles was not adequately disclosed to investors).

#### 4. AIG and the Systemic Risk of Insurance Deregulation:

The near-collapse of American International Group (AIG) in September 2008 represents the most dramatic single illustration of insurance sector regulatory failure in the history of modern finance.

AIG's Financial Products (AIGFP) division had, between 1998 and 2007, written approximately \$79 billion in credit protection on multi-sector collateralised debt obligations through credit default swap contracts.<sup>12</sup> When the underlying mortgage assets deteriorated, AIG was required to post collateral against these positions that it was wholly unable to provide. The federal government was compelled to extend emergency credit of \$85 billion under the Federal Reserve's Section 13(3) emergency lending authority<sup>13</sup> — a bailout that ultimately exceeded \$182 billion in total government support.

The legal analysis of the AIG failure begins with a fundamental jurisdictional anomaly. AIG Financial Products was regulated not by an insurance supervisor but by the Office of Thrift Supervision (OTS) — a federal banking regulator whose expertise lay in the supervision of savings and loan institutions, not complex derivatives portfolios. This happened because AIGFP was structured as a savings and loan holding company subsidiary, bringing it within the OTS's supervisory perimeter. The result was that the world's largest insurance company's most systemically dangerous subsidiary operated under a regulator that fundamentally lacked the tools, expertise, and mandate to oversee it.

The broader insurance regulatory framework offered no corrective. Under the *McCarran-Ferguson Act*<sup>14</sup> — which reserves to the states the primary authority to regulate the business of insurance — there was no federal insurance regulator with systemic oversight capacity. State insurance regulators focused on solvency and consumer protection within their individual jurisdictions; none had either the authority or the analytical capacity to assess the systemic risk that AIGFP's derivatives portfolio posed to the global financial system. The

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<sup>12</sup> FCIC Report, *supra* note 1, at 344–52 (detailing how AIG's Financial Products division, writing \$79 billion in credit protection on multi-sector CDOs, operated under the Office of Thrift Supervision — a banking regulator — rather than an insurance supervisor, a fundamental jurisdictional anomaly).

<sup>13</sup> Federal Reserve Act, 12 U.S.C. § 343 (2018) (emergency lending authority, commonly referred to as the 'Section 13(3)' facility, invoked repeatedly during 2008–09 to provide emergency liquidity to non-bank institutions including AIG and Bear Stearns).

<sup>14</sup> Insurance companies in the United States are regulated at the state level under the McCarran-Ferguson Act, 15 U.S.C. §§ 1011– 1015 (2018), which reserves to states the primary authority to regulate the business of insurance and limits federal preemption.

International Association of Insurance Supervisors' Insurance Core Principles, which addressed enterprise risk management and group-wide supervision,<sup>15</sup> identified precisely these gaps, but in 2007–2008 they remained aspirational rather than operational standards for the largest players in the industry.

The litigation that followed the AIG bailout illuminated the constitutional and legal tensions created by the government's intervention. In *AIG v. United States*<sup>16</sup> (Starr International litigation, 2014), the Court of Federal Claims found that the government's acquisition of AIG's equity without shareholder approval constituted an unconstitutional taking under the Fifth Amendment, though it declined to award damages given the circumstances. The case underscored the legal uncertainty surrounding emergency government interventions in the insurance sector — interventions that were being conducted under a banking statute (the Federal Reserve Act) for an institution nominally regulated as an insurance group.

### **5. Shadow Banking and the Unregulated Perimeter:**

Perhaps the most profound regulatory failure of the pre-crisis period was the systematic exclusion of the shadow banking sector from the prudential regulatory perimeter. Shadow banking entities — money market mutual funds, securities lenders, repo market participants, structured investment vehicles, and mortgage originators — performed economic functions that were substantively identical to those of regulated banks: they borrowed short-term, lent long-term, and used leverage to generate returns.<sup>17</sup> Yet they operated without deposit insurance, without capital adequacy requirements, and without access to the Federal Reserve's discount window in normal times. The Financial Stability Board estimated global shadow banking assets at \$36 trillion by 2014.<sup>18</sup>

The legal basis for this exclusion was, in most cases, straightforward: shadow banking entities were not banks as defined in the applicable statutes. The *Bank Holding Company Act* and the

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<sup>15</sup> Int'l Ass'n of Insurance Supervisors, *Insurance Core Principles, Standards, Guidance and Assessment Methodology* Principle (2011) (Enterprise Risk Management) and Principle 23 (Group-Wide Supervision) — both identified as inadequate in the precrisis period with respect to AIG's financial products subsidiary.

<sup>16</sup> *AIG v. United States*, 117 Fed. Cl. 575 (2014) (Starr International litigation challenging the terms of the AIG government bailout as an unconstitutional taking; court found a taking occurred but awarded no damages).

<sup>17</sup> Sys. Risk Council, *Shadow Banking: A Forward-Looking Framework for Effective Regulation* 8–12 (2012) (noting that shadow banking entities — including money market funds, repo markets, and securities lenders — performed bank-like functions outside the prudential regulatory perimeter).

<sup>18</sup> Financial Stability Bd., *Global Shadow Banking Monitoring Report 2015*, at 3 (2015) (estimating global shadow banking assets at \$36 trillion as of 2014).

banking statutes regulated institutions that accepted federally insured deposits. Entities that funded themselves through repo agreements, commercial paper, or money market fund shares were doing something economically equivalent but legally distinct. The regulators' response — to the extent there was one — was to acknowledge the distinction and decline to regulate across it, on the ground that doing so would require legislative authority they did not possess.<sup>22</sup>

The subprime mortgage origination market exemplified shadow banking's regulatory immunity. Companies like Ameriquest Mortgage, Countrywide Financial, and New Century Financial originated trillions of dollars of mortgage loans using standards that were, in many cases, fraudulently misleading to borrowers. Most of these originators were not federally chartered banks, and therefore fell outside the direct supervisory authority of the Federal Reserve and the Office of the Comptroller of the Currency. The federal consumer protection framework — the *Truth in Lending Act* and the *Home Ownership & Equity Protection Act*<sup>19</sup> — was inadequate to prevent systematic predatory lending, as the courts confirmed in *Ameriquest Mortgage Co. v. United States*<sup>20</sup> (2009). The Department of Justice's subsequent action against Countrywide resulted in a \$16.65 billion settlement,<sup>21</sup> but by then the damage had long been done.

The criminal prosecution of individual bankers for conduct related to the crisis proved notably more difficult. While civil settlements and institutional penalties ran into the tens of billions of dollars, the absence of criminal convictions of senior executives became one of the most contested legal and political questions of the post-crisis decade. The standard of proof for criminal fraud, the availability of good-faith reliance on legal opinions, and the procedural complexity of prosecuting large financial institutions all contributed to outcomes that many commentators and the general public regarded as inadequate to the scale of the misconduct.<sup>22</sup>

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<sup>19</sup> Home Ownership & Equity Protection Act of 1994, Pub. L. No. 103-325, 108 Stat. 2190 (1994) (amended by the Dodd-Frank Act to expand the Federal Reserve's authority to prohibit unfair or deceptive mortgage lending practices); see also Truth in Lending Act, 15 U.S.C. §§ 1601–1667f (2018).

<sup>20</sup> *Ameriquest Mortgage Co. v. United States*, 633 F. Supp. 2d 469 (E.D. Mich. 2009) (examining predatory lending practices in the subprime mortgage market and the inadequacy of the Truth in Lending Act's disclosure requirements to prevent systematic consumer harm).

<sup>21</sup> *United States v. Countrywide Financial Corp.*, 33 F. Supp. 3d 494 (S.D.N.Y. 2014) (Department of Justice action under the Financial Institutions Reform, Recovery & Enforcement Act; Countrywide settled for \$16.65 billion in relation to its sale of defective mortgage loans to Fannie Mae and Freddie Mac).

<sup>22</sup> Gary B. Gorton, *Slapped by the Invisible Hand: The Panic of 2007* 44–51 (Oxford Univ. Press 2010) (characterising the crisis as a classic bank run on the sale and repurchase (repo) market and the money market mutual fund sector, rather than on conventional deposit institutions).

## 6. The Post-Crisis Legal Response: Dodd-Frank and its Limits:

The *Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010*<sup>27</sup> was the most comprehensive overhaul of United States financial regulation since the New Deal. Its key provisions relevant to the failures identified above included: the creation of the Financial Stability Oversight Council (FSOC) with authority to designate non-bank financial institutions as systemically important,<sup>23</sup> bringing them within the Federal Reserve's enhanced prudential supervision; the Volcker Rule,<sup>24</sup> prohibiting proprietary trading by insured depository institutions; the mandatory clearing and exchange trading of standardised derivatives; the creation of the Consumer Financial Protection Bureau; and an orderly liquidation authority providing an alternative to bankruptcy for systemically important failing institutions.

At the international level, the Basel Committee responded to the crisis with the Basel III framework,<sup>25</sup> substantially increasing minimum capital requirements, introducing a leverage ratio and liquidity coverage ratio, and imposing additional capital surcharges on globally systemically important banks. The European Union implemented these standards through the Capital Requirements Regulation<sup>26</sup> and, for bank resolution, the Bank Recovery and Resolution Directive,<sup>27</sup> which imposed a 'bail-in' requirement ensuring that bank creditors, rather than taxpayers, bore the primary burden of loss in resolution. The Financial Stability Board's Key Attributes for Effective Resolution Regimes<sup>28</sup> provided a global template for resolution frameworks designed to end the effective presumption of bailout for systemically important institutions.

The insurance sector received considerably less attention in the post-crisis reform agenda. DoddFrank created a Federal Insurance Office within the Treasury Department, but vested it

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<sup>23</sup> Dodd-Frank Act, *supra* note 7, §§ 111–115 (establishing the Financial Stability Oversight Council (FSOC) with authority to designate non-bank financial institutions as systemically important).

<sup>24</sup> Dodd-Frank Act, *supra* note 7, §§ 619–621 [Volcker Rule] (prohibiting proprietary trading by insured depository institutions and restricting their investment in hedge funds and private equity funds).

<sup>25</sup> Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* 7–9 (Bank for Int'l Settlements 2010).

<sup>26</sup> European Comm'n, *Regulation (EU) No 575/2013 of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firms*, 2013 O.J. (L 176) 1 [Capital Requirements Regulation / CRR] (implementing Basel III in the European Union).

<sup>27</sup> Directive 2014/59/EU of the European Parliament and of the Council Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms, 2014 O.J. (L 173) 190 [Bank Recovery & Resolution Directive / BRRD].

<sup>28</sup> Financial Stability Bd., *Key Attributes of Effective Resolution Regimes for Financial Institutions* 5–7 (2011) (establishing international standards for orderly resolution of systemically important financial institutions without recourse to public bailout funds).

with no supervisory authority over insurance companies. The McCarran-Ferguson framework of state regulation remained intact. The most significant insurance-related reform was the FSOC's authority to designate insurance holding companies as systemically important financial institutions — a power it exercised with respect to AIG, Prudential, and MetLife — but this designation was subsequently challenged in litigation, and in *MetLife, Inc. v. Financial Stability Oversight Council* the D.C. District Court vacated the MetLife designation on procedural grounds in 2016, a decision that exposed significant limitations in the FSOC's systemic risk determination process.

### **7. Unresolved Challenges: Beyond and Dodd-Frank:**

More than fifteen years after the crisis, several structural vulnerabilities identified in its aftermath remain incompletely addressed. Shadow banking has resumed growth, with non-bank financial intermediation now accounting for a larger share of global credit than in 2007.<sup>34</sup> The legal perimeter of prudential regulation has been extended through the FSOC designation mechanism and the Basel III framework, but the fundamental dynamic that drove the pre-crisis expansion of shadow banking — the availability of regulatory arbitrage between the regulated and unregulated sectors — has not been eliminated.

The insurance sector's systemic risk profile remains poorly captured by existing legal frameworks. The International Association of Insurance Supervisors has developed enhanced standards for group-wide supervision and capital adequacy, but their implementation is uneven and their enforcement lacks the institutional infrastructure that the Basel framework brings to banking. The question of whether a major insurance group writing systemically significant credit protection can fail today without requiring government intervention does not have a clearly affirmative answer.<sup>35</sup>

The academic debate about the adequacy of the post-crisis framework has centred on the question of capital. Admati and Hellwig,<sup>29</sup> among others, have argued persuasively that the capital requirements set under Basel III — while substantially higher than their predecessors — remain far below the levels that would make banking genuinely resilient without implicit government guarantees. Gorton's analysis<sup>37</sup> of the crisis as a run on the repo market rather than

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<sup>29</sup> Anat Admati & Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It* 89–102 (Princeton Univ. Press 2013) (arguing that higher equity capital requirements are the most robust long-term fix for banking fragility, notwithstanding industry arguments about the cost of capital).

on conventional deposits suggests that the regulatory response, focused heavily on conventional bank capital and liquidity, may have addressed the last crisis rather than the next one. Fintech, crypto-assets, and the digitalisation of financial intermediation are generating regulatory boundary questions that existing legal frameworks, designed for a world of conventional deposits and paper securities, are not equipped to answer.

## **8. Conclusion:**

The Global Financial Crisis of 2007–2009 was, in the final analysis, a legal failure as much as an economic one. The statutes that should have contained systemic risk, the securities laws, the banking acts, and the insurance regulatory codes had been weakened, circumvented, or never extended to cover the activities that generated the crisis. The result was a regulatory architecture riddled with gaps, jurisdictional anomalies, and perverse incentives that financial institutions acting entirely within the letter of the law exploited to the point of systemic catastrophe.

The post-crisis legislative response, led by the Dodd-Frank Act and the Basel III framework, has meaningfully strengthened the regulatory perimeter around conventional banking. Capital requirements are higher, leverage is more constrained, derivatives are more transparent, and resolution frameworks are better developed. But the insurance sector remains institutionally under-supervised at the systemic level, shadow banking continues to grow at the margins of the regulatory perimeter, and the fundamental dynamic of regulatory arbitrage the migration of risk-taking to wherever regulation is lightest has not been structurally addressed.

The deepest lesson of the crisis may be this: financial regulation, to be effective, must be built on a frank acknowledgment that markets, left to themselves, will systematically underestimate tail risk, externalise costs onto society, and exploit legal vacuums wherever they exist. A regulatory philosophy that treats the market as self-correcting and legislation as an intrusion will always be surprised by the next crisis, because the next crisis will be shaped precisely by whatever regulatory gaps the current framework has left open. Closing those gaps requires not merely technical legal reform but a sustained political commitment to putting the architecture of financial law ahead of the interests of those it regulates.

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