REFRAMING FINANCIAL REGULATION

Enhancing Stability and Protecting Consumers

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Source: Hester Peirce and Benjamin Klutsey, eds., *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers*. Arlington, VA: Mercatus Center at George Mason University, 2016.

INTRODUCTION
Market-Based Financial Regulation

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The financial system exists to facilitate the transfer of capital from savers and investors to people and companies in want of capital and to spread risks among individuals and entities with varying appetites for risk taking. The financial markets are the main channel for providing access to capital, which in turn fuels economic activity. However, our current regulatory system does not improve market functioning. A better approach is possible, but it requires a willingness to revisit our current regulatory models and ask whether they are working as intended to foster financial stability, support economic growth, and protect consumers.

A regulatory approach that relies on—rather than represses—the market's inherent dynamism, competition, and sensitivity to customer demand offers great promise and is the subject of this book. Financial markets transmit abundant amounts of information containing valuable signals to providers and consumers of financial products and services. Market participants glean this information as they go about their day-to-day business. The late economist Friedrich A. Hayek calls this "the knowledge of the particular circumstances of time and place."[1] This book's underlying theme is that the knowledge of the particular circumstances of time and place is essential to effective financial regulation. It is not government regulators who possess this knowledge, but private market participants. Accordingly, regulation that takes that knowledge into account must come from the bottom-up, not the top-down. For instance, the knowledge of intelligent, well-intentioned government regulators cannot determine what financial products or services are appropriate for different types of consumers, the interest rates lenders should charge on various loan products, which financial technologies best address customers' needs, or which investments should populate investor portfolios. Consumers respond to firms' offers by buying or refusing to buy, and firms take into account market participants' needs in the design of products and services. This dynamic feedback process provides discipline as customers move away from options that do not serve them well and firms cut back on products their customers do not like.

THE ROLE OF FINANCIAL MARKETS

Allen and Yago have pointed out that in ancient societies "access to capital . . . was limited to rulers, priests, craftsmen, and merchants."[2] Because of market competition and entrepreneurial innovations, our modern financial system has evolved to provide capital access to people from all walks of life, and it is still evolving to further expand access. This transformation of the financial system, in conjunction with technological change, has meaningfully affected people's lives. Individuals conduct banking transactions, obtain mortgages, and finance small businesses online. Face-to-face is giving way to the mobile interface, a development that further democratizes capital access.

By expanding access to capital, financial markets foster economic growth. As technological and societal barriers fall, capital increasingly can flow to its highest and best use. Based on an edited compilation of research across many countries, Demirgüç-Kunt and Levine conclude that "overall financial development tends to accelerate economic growth, facilitate new firm formation, ease firm access to external financing, and boost firm growth."[3] Other analyses also show that economic growth tends to follow the development of a robust financial market system, fueled by a strong legal and institutional infrastructure.[4] However, ill-considered financial regulation creates new barriers that prevent individuals and businesses from obtaining the capital they need and thus stands in the way of individual prosperity and economic growth.

FINANCIAL REGULATIONS

The United States has a long history of banking and financial crises. Over the past 180 years we have had at least fourteen severe banking crises.[5] The legacy of these crises is an ever-growing rulebook. Hence, contrary to popular narratives, the financial services industry is among the most regulated areas of our economy. Prior to the last financial crisis, total regulatory restrictions related to the financial services sector had expanded annually from 1999 to 2008 for a total increase of 23 percent.[6] Since the crisis, the regulatory framework has grown even larger and more complex, especially with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010 (Dodd-Frank).[7] Using the Mercatus Center's online dataset, our colleagues Patrick A. McLaughlin and Oliver Sherouse show that the scale of new rules promulgated under Dodd-Frank substantially exceeds any previous set of regulations governing financial markets.[8] According to McLaughlin and Sherouse, Dodd-Frank adds a total of nearly 28,000 new restrictions to the body of US financial regulations.

Many of these postcrisis regulations rely on the limited knowledge and interventionist hand of financial regulators. Regulators who are situated outside the markets are unable to collect and analyze the "knowledge of the particular circumstances of time and place" with the necessary speed and completeness to carry out the obligations with which Congress has charged them. Regulators—suffering from their innately constrained view of the financial system—were not able to anticipate and react to the events that led to the crisis.[9] Indeed, their actions may have inadvertently made the crisis worse. In addition to placing impossible expectations on regulators, as this book explains, the bulked-up financial regulatory structure provides a false sense of security, distorts competition, and impedes capital flows.

THE MUDDLED OBJECTIVES OF FINANCIAL REGULATION

Financial regulation suffers from the unclear objectives that guide it. Sound financial regulation provides the framework within which a healthy financial system can thrive and change to effectively meet the needs of individuals, corporations, governments, and the economy as a whole. Today's financial regulators seem to be striving for multiple amorphous goals, including eliminating risk, creating a failure-free financial system, and directing capital to satisfy noneconomic objectives.

Risk taking must be part of the financial system. As former US Securities and Exchange Commission (SEC) member and contributor to this volume Daniel M. Gallagher noted in a 2014 speech before the Institute of International Bankers, "In the capital markets, there is no opportunity without risk—and that means real risk, with a real potential for losses."[10] Thus, people who provide capital to an enterprise sign on to sharing in the potential gains and losses, and the regulatory framework should not stand in the way.

Market discipline is a missing ingredient in the regulation of the financial system. Financial institutions and products must be allowed to disappear when they do not meet the needs of their customers. Failure, perhaps counterintuitively, can enhance the long-term health of the financial system.[11] A well-regulated but competitive financial system manages failure to minimize devastating consequences to households and the economy, while bidding an unsentimental farewell to failed firms and welcoming in their place new entrants with products and services that meet customer needs.

Attempts to eliminate failure also deprive individuals, firms, and markets of the valuable lessons in failure.[12] Citing Milton Friedman, Russell Roberts notes that capitalism is a profit and loss system where "profits encourage risk taking [and] losses encourage prudence."[13] When this risk-reward calculus is appropriately incorporated in decision-making, firms and investors effectively learn lessons from previous actions. In their research, Bouwman and Malmendier explore "whether a bank's capitalization and risk appetite are affected by the economic environment and outcomes it has faced, and survived, in the past."[14] In a nutshell, their research shows that "past macroeconomic and bank-specific shocks experienced (and survived) by a financial institution appear to affect its capitalization and risk taking, suggesting that experiences propagate into the future and generate some form of institutional memory."[15] Institutions and their managers who have been through crises tend to learn from them and benefit from these lessons by exhibiting more careful lending behavior and becoming more capitalized, which makes them resilient in the next crisis.

The financial regulatory framework should not be used to direct capital toward favored causes or away from disfavored ones. Financial regulators now actively craft macroprudential strategies for the whole financial system that override the decision-making of individual institutions. Whether it is providing incentives to make mortgage loans that a lender would not otherwise make, discouraging the provision of financial services to certain types of businesses, or subsidizing economically unsound lending to politically favored industries, financial regulation and regulators affect how capital is allocated in our economy. A properly designed regulatory system allows capital to flow to its highest and best use, as determined by market participants' expressions of value.

Our financial regulatory system needs to be reoriented to meet the objective of providing the framework within which individuals and institutions come together freely to engage in mutually beneficial financial transactions. This book offers market-oriented ideas to allow financial markets to flourish as they dynamically supply capital to meet the constantly changing needs of consumers, investors, and businesses. Each chapter raises concerns about the existing regulatory framework and offers substantive reform ideas. The book is not intended to be a comprehensive plan for replacing our current top-down regulatory apparatus. Rather, we intend to ignite a conversation about reimagining the existing framework and replacing it with a more effective organic approach to regulation. Consistent with the goal of inspiring debate over these important issues, the book offers a variety of viewpoints and different ideas about how to reform the regulatory structure.

Part 1 deals with bank capital and deposit insurance, two tools used to foster prudence and financial stability. In chapter 1, Mercatus Center–senior affiliated scholar Arnold Kling discusses the introduction of risk-based capital in the United States, identifies the weaknesses in this approach, then discusses alternative ideas to improve financial regulations, including reducing the tax advantage of debt and incentivizing managers to make prudent choices. In chapter 2, Mercatus Center Senior Research Fellow Stephen Matteo Miller reviews the effectiveness of capital regulations in US banking history and looks at alternative, simpler capital requirement proposals instead of a capital regime that focuses on risk weights. Thomas Hogan and Kristine Johnson focus on deposit insurance in chapter 3 and make the case that government-provided deposit insurance fosters moral hazard by eliminating the incentives for depositors to monitor bank activities. They consider alternatives, including private forms of deposit insurance.

Part 2 presents a diverse set of views on addressing failure at large financial institutions in a way that minimizes disruption to the overall financial system and does not rely on taxpayer bailouts. Pointing out the persistence of the too big to fail (TBTF) problem and the flaws in Dodd-Frank's Orderly Liquidition Authority provisions, American Enterprise Institute Fellow Peter Wallison argues in chapter 4 that traditional bankruptcy mechanisms work and carefully monitored, adequate capital levels are the best way to address TBTF. Alternatively, in chapter 5, Garett Jones, Associate Professor of Economics and BB&T Professor for the Study of Capitalism at the Mercatus Center, George Mason University, notes the strong political temptation to bail out failing firms during crises and argues for precrisis commitments to "nonutopian alternatives to 100 percent bailouts." These alternatives include the bail-ins Jones has discussed in prior work.

Part 3 discusses the securities and derivatives markets. In chapter 6, the Honorable Daniel M. Gallagher surveys the federal oversight regime governing the operations and conduct of broker-dealers. Highlighting that the regime is comparatively more market-oriented than some other areas of the financial system, he recommends conducting economic analysis of proposed new regulatory burdens and a return to truly self-regulatory organizations. In chapter 7, J. Christopher Giancarlo, a commissioner of the US Commodity Futures Trading Commission (CFTC), reviews the requirement under Dodd-Frank that swaps be executed on regulated trading platforms. This chapter analyzes the flaws in the CFTC's implementation of the swaps trading regulatory framework and proposes a more effective, less top-down alternative that better aligns regulatory oversight with inherent swaps market dynamics.

In chapter 8, Hester Peirce and Vera Soliman of the Mercatus Center look at the new regulations that require mandatory clearing of over-the-counter derivatives through central counterparties (CCPs). They suggest that regulatory reforms have unintentionally destabilized the financial markets and outline an alternative regulatory model that would allow the derivatives markets to develop through market mechanisms complemented by principles-based regulation and robust reporting. Chapter 9 gives a historical account of the evolution of stock exchanges and trading platforms; Edward Stringham, Kathryn Wasserman Davis Professor of Economic Organizations and Innovation and Deputy Director of the Shelby Cullom Davis Endowment at Trinity College, uses lessons from history to show that the rules and regulations of private exchanges can effectively reduce fraud and facilitate financial transactions.

In chapter 10, Holly A. Bell, Associate Professor of General Business at the University of Alaska Anchorage, discusses the concerns regulators have about algorithmic trading and outlines cooperative solutions for addressing human and technology errors. In particular, she proposes confidential self-reporting to learn how technology errors occur, how they affect markets, and how they can be addressed. Bell also suggests that regulators allow for the emergence of competing trading venues, platforms, and software to provide different (and potentially superior) services to investors. Chapter 11 examines the law and economics of securities offerings and mandatory disclosure requirements. In this chapter, David Burton, Heritage Foundation Senior Fellow in Economic Policy, questions how well the existing system works and suggests reforms to enhance the ability of the securities markets to serve investors and issuers.

Dodd-Frank substantially changed consumer finance regulation by introducing a new federal regulator and reopening debates that have played out at the state level for the past century. Given these changes, part 4 discusses the current consumer finance regulatory regime and offers market-based ways to think about fostering effective, dynamic, consumer-centric markets. In chapter 12, Todd Zywicki, Foundation Professor of Law and Executive Director of the Law & Economics Center at George Mason University's Antonin Scalia Law School, distinguishes between market-reinforcing regulations and market-replacing regulations and argues that the latter approach limits choice and competition. In chapter 13, Thomas W. Miller Jr., Professor of Finance and Jack R. Lee Chair of Financial Institutions and Consumer Finance at Mississippi State University's College of Business, and Harold A. Black, Professor Emeritus at the University of Tennessee, Knoxville, argue that interest rate caps limit consumer choice and thus harm the consumers they are supposed to help. They propose four concrete actions for policymakers and academics seeking to improve consumer well-being.

Over the past few decades we have seen a plethora of welfare-enhancing innovations in the financial markets. Part 5 looks at some of these innovations and provides a way forward that allows beneficial financial innovation to occur. In chapter 14, William Luther, Assistant Professor of Economics at Kenyon College, considers the popular justifications for regulating Bitcoin and offers simple guidelines for regulators to keep in mind. In chapter 15, Houman Shadab, Professor of Law and Co-Director, Center for Business and Financial

Law at New York Law School, reviews new technologies that foster improved access to capital, facilitate consumer payments, and simplify personal finance. Shadab outlines principles for fostering a pro-innovation, pro-consumer regulatory approach. In chapter 16, J. W. Verret, Associate Professor of Law at George Mason University's Antonin Scalia Law School and Mercatus senior scholar, argues against the excessive federalization of corporate governance and proposes to allow states and municipalities greater latitude to experiment with different approaches.

Finally, part 6 concludes with a chapter that examines whether there is a role for economic analysis in financial regulations. For the past several years there has been vigorous debate, with some skeptics arguing that the unique nature of financial markets means that economic analysis of financial regulations is either impossible or must at least be conducted much differently than for other types of regulations. In chapter 17, Senior Research Fellow Jerry Ellig and Vera Soliman of the Mercatus Center explain why economic analysis is not only possible but important in financial regulation.

One notable omission from this book is an alternative to the broken housing finance system that relies so heavily on the notoriously troubled government-sponsored entities. The late Dwight Jaffee of University of California, Berkeley, who was working on exactly such a piece, passed away during the drafting of this book. We will greatly miss Jaffee's careful and creative approach to these matters. The Mercatus Center at George Mason University will continue to investigate market-based regulatory approaches in housing finance and other areas that did not make it into this book.

NOTES

1. Hayek, "Use of Knowledge in Society."
2. Allen and Yago, *Financing the Future*, 10.
3. Demirgüç-Kunt and Levine, *Financial Structure and Economic Growth*, 11.
4. See Shin, "Financial Markets."
5. Calomiris and Haber, *Fragile by Design*, 5; Jalil, "New History of Banking Panics."
6. McLaughlin and Greene, "Did Deregulation Cause the Financial Crisis?"
7. Pub. L. No. 111–203, 124 Stat. 1376 (2010).
8. McLaughlin and Sherouse, "Dodd-Frank Wall Street Reform."
9. See, for example, Barth, Caprio, and Levine, *Guardians of Finance*; Roberts, "Gambling with Other People's Money"; and Kling, *Not What They Had in Mind*.

10. Commissioner Daniel M. Gallagher, Remarks Given at the Institute of International Bankers Twenty-fifth Annual Washington Conference, March 3, 2014.
11. For a discussion of the value of systems that thrive on failure, see Taleb, *Antifragile*.
12. For a discussion of the salutary role that failure can play, see McArdle, *Up Side of Down*.
13. Roberts, "Gambling with Other People's Money," 6.
14. Bouwman and Malmendier, "Does a Bank's History Affect Its Risk-Taking?"
15. Ibid., 5.

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