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Finance For The People

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We are now at a critical juncture in the effort to revise the structure of financial regulation in the U.S. Senator Christopher Dodd, Chair of the Senate Banking Committee, after months of seeking a compromise that would generate bipartisan support, has put forward his own version of a reform bill. Predictably, we hear the chorus of the wounded argue that the bill will stifle the competitiveness of U.S. financial institutions, retard financial innovation, send jobs overseas and limit the abundant options consumers and businesses now enjoy. John Boehner, leader of the House Republicans, urged a conference of bankers to stand up to "punk staffers" advising his colleagues. That's amazing, given that the financial services industry has spent something like $1 million per member of Congress lobbying on financial reform issues, which by some estimates amounts to about five active lobbyists per Congressperson. To which we say, take a deep breath and try thinking beyond the end of your nose. What's good for the system is ultimately good for you.

Regulation is always a tricky business characterized by inherent imperfections. It's very easy to get regulation wrong, and the law of unintended consequences is quick to make itself felt when new regulation is put in place. But remember that nearly three years have passed since the beginning of the financial crisis, the worst since the 1930s, and amazingly nothing of substance has yet been done to prevent the next one. The basic flaws in our financial system remain, compounded by new problems created by the bailouts and rescues themselves: The share of the U.S. financial system in the hands of financial firms deemed too big to fail is now substantially larger than it was before the crisis. So unless the basic flaws that created the crisis have magically gone away, we are more vulnerable that ever to a new disaster somewhere down the road. Against this background it is hard to argue that the reforms now on the table represent some sort of headlong rush to regulation.

How wary should we actually be about overregulating the financial markets? Let's take a step back and consider the elements of the financial architecture that keep markets functioning smoothly.

The most important is market discipline. This is the notion that the markets will reward efficient firms and punish firms that are thought to be excessively risky. Survival of the fittest, most efficient firms is assured by the Darwinian forces of competition. Market discipline does work--the failure of the 220-year old firm Barings in 1995, the failure of the hedge fund Long-Term Capital Management in 1998 and the failure of CIT Financial in 2009 are all examples. But market discipline requires some things that are missing in the business of financial intermediation.

First, transparency is critical. Market participants have to know what firms are doing and what their risk exposures are so that their shares and debt can be valued properly. For market discipline to be effective requires fair, accurate and timely reporting--an essential insight that led to the creation of the SEC in the 1930s.

Second, even with good financial disclosure, monitoring financial firms is costly, which implies the need for expert regulatory oversight.

Third, we can use markets to enhance discipline. For example, some have advocated that financial firms should be required to issue subordinated debt on a regular basis to let the debt markets assess their fitness just as stock price does in the case of equity markets.

Finally, even if we find effective ways to deal with costly monitoring, asymmetric information and the like, market discipline only works up to a point. Most importantly, it is rendered completely useless by the notion that some firms are too big or to complex or too interconnected to fail. Nor does market discipline have a way to deal with the systemic risks created by financial intermediation in modern complex financial firms. Failures in one firm can threaten the health of the entire financial commons. In short, financial markets do not deal well with large aggregate shocks nor can they deal with systemic risk.

For all of these reasons, financial institutions and markets require direct supervision. Correctly conceived, direct supervision is a complement to market discipline. But it is pretty well established that financial institutions have a very narrow view of their own interests. Nor can they expect to deviate very much from this narrow view in a hypercompetitive market place where winning and losing is measured in basis points and the long term is after lunch.

Indeed, there have been a few times in history where financial firms have been called on to act to together for the common good. J.P. Morgan famously locked a gathering of top bankers in his library overnight in 1907 to get them to collaborate in extinguishing a financial panic. The president of the New York Federal Reserve gathered a group of bankers together in 1998 to get their cooperation in an orderly liquidation of Long-Term Capital Management. And Treasury Secretary Henry Paulson tried in vain to get the large financial institutions to formulate a rescue plan for Lehman Brothers in 2008.

In the past banks in many countries were protected from competition by entry restrictions and price controls, in return for which they accepted the domestic regulations that were imposed on them. In today's global economy that is no longer feasible, and banks' ability to operate across national jurisdictions can help them to avoid regulations. The ease with which Lehman Brothers was able to arbitrage regulation of the repo market between New York and London--and stay alive longer and inflict greater losses before its inevitable collapse--is the most recent object lesson.

Should we then worry that "overregulation" in response to the financial crisis will drive business away from U.S. financial markets?

Only two years before the onset of the 2007-09 crisis, two major reports--one commissioned by then Treasury Secretary Henry Paulson (Committee on Capital Markets Regulation, 2006) and the other commissioned Mayor Michael Bloomberg and Senator Charles Schumer of New York and carried out by the consulting firm McKinsey--argued for significant additional U.S. deregulation to avoid losing large parts of wholesale financial intermediation to London and other financial centers based on "evidence" (much of it seriously flawed) that this migration was already well underway. Reading those reports in light of what happened to the financial system shortly afterward is nothing short of astounding. The "elegant whining" that permeated both reports was obviously mistimed, coming as it did only months before the roof fell in on the U.S. system, in part attributable to failures in a weakened regulatory architecture.

The U.S. has no reason to participate in a regulatory race to the bottom in response to competitive forces. Despite their recent problems, the two major financial centers in the world remain New York and London. Why? The answer is simple--good institutions, good legal systems and a commitment to good regulation. Even during the worst periods of the crisis there was a flight to "safety" from investors around the world. What was "safe"? U.S. Treasury bills.

There may well be competition from financial centers in Asia, but it will not undermine the preeminence of the U.S. and the U.K. anytime soon. Both have a strong vested interest in maintaining strong regulatory structures that work. Both made mistakes that led to the crisis, but both have the incentives to put a better system in place. If they succeed, both will continue to be places where those with weaker institutions will want to do business, if only because the cost of capital will be lower.

Regulation in the public interest has as its principal objective the maintenance of a financial system that is safe, sound and equitable--one that is resistant to collapse and avoids contamination of the payments system and credit allocation (and therefore the real economy)--is hard to "game," and provides a level playing field for participants without precluding the failure of institutions that are not competitively viable or are poorly managed. A tall order indeed.

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