American Enterprise Institute for Public Policy Research

August 2008

On the Issues

The Rush to Reregulate

By Robert W. Hahn and Peter Passell

Tighter regulation of the financial markets is almost certainly in the cards. But reregulation could have unintended consequences, bolstering the power of well-organized interest groups, reducing access to capital, and undermining America's competitive position. It is easy to fall into bad regulation during crisis situations, and it is hard to dig out.

With Wall Street still reeling from the mortgage meltdown, the Federal Reserve now seemingly committed to rescuing big investment banks "too complex to fail," and the U.S. Treasury proposing a top-to-bottom reorganization of financial regulation, pieties about the virtues of unfettered markets now seem hollow. Tighter oversight of financial markets—reversing a trend that began in the 1970s with the end of fixed commissions on the U.S. stock exchanges—is thus almost certainly in the cards.[1]

A little perspective, however, is in order. Reregulation could have unintended consequences, such as bolstering the power of well-organized interest groups, reducing access to capital, and undermining America's competitive position in the huge and growing global market for financial services. Hence the wisdom in pausing to remember both how easy it is to fall into bad regulation—and how hard it is to dig out.

The Regulatory Rush of the 1930s

In the 1930s the implosion of the commercial banking system and the subsequent economic depression led to a slew of remedial initiatives by Washington. Some of them helped to set the stage for recovery—think bank deposit insurance and disclosure requirements for securities issuers. But much of the regulation was premised on the hoary idea that low prices were the cause rather than the effect of the economic collapse and that the solution was the cartelization of industries with the goal of reducing output.

The broadest initiative based on that idea—the National Industrial Recovery Act, which had been championed by big businesses, led by General Electric—was ruled unconstitutional in 1935. But others survived long after their faults were obvious because they benefited the incumbent interests. Agricultural price supports, underpinned by government storage programs and incentives to reduce acreage under cultivation, survived largely intact until the Nixon administration. Trucking and airline regulation, which set prices based on petitioners' estimates of costs and assigned carriers to each route in order to prevent "destructive" competition, were not repealed until the late 1970s.

Today's Rush

Politicians and regulators are now under great pressure to take names and enact reforms. Will this new rush create mistakes comparable to those of the 1930s?

Probably the clearest exposition of what went wrong was offered in March by the President's

Robert W. Hahn is a senior fellow at AEI and the executive director of the AEI Center for Regulatory and Markets Studies. Peter Passell is a senior fellow at the Milken Institute. A version of this paper appeared in the *Economists' Voice* in July 2008.

Working Group on Financial Markets (PWG), the two-decades-old committee representing the Treasury, the Fed, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. The PWG diagnosed the origins of the mortgage market bust in the conflicts of interest between what economists call the "principals" (investors and home buyers) and their "agents" (mortgage brokers, securities brokers, and credit analysts). Principals relied on agents to evaluate the risks on their behalf. But the agents, whose income largely depended on the number of deals they put together, had powerful incentives to understate risk.[2] No wonder then that principals ranging from the owners of Bear Stearns stock to first-generation immigrants in California with "teaser rate" mortgages they cannot refinance were left holding the bag.

In other licensed industries—everything from hair stylists to auto mechanics in many states—regulators rely heavily on the advice of incumbents, who have much to gain from keeping competitors out.

All that makes sense; the tricky part is figuring out what to do about it. The PWG is inclined to connect the dots in the simplest way possible: if the agents are inherently compromised, straitjacket their ability to act in their own interests. In some cases that would mean no more than beefing up disclosure requirements and making it harder for mortgage brokers to lead unsophisticated home buyers astray. But other regulations have the potential to raise agents' costs sharply, reduce competition, and, arguably, unnecessarily pare moderate-income families' ability to borrow money and institutional investors' flexibility to manage their portfolios.

Some red flags here should be plain to all. For example, the group wants to license mortgage brokers, but who will set the hurdles that applicants must jump? In other licensed industries—everything from hair stylists to auto mechanics in many states—regulators rely heavily on the advice of incumbents, who have much to gain from keeping competitors out.

Or consider the recommendation that regulators require lenders to adjust their capital cushions to reflect their risks in falling markets. The task of measuring such risks in a world in which every major lender depends on every other major lender to honor financial contracts is truly daunting. And one must wonder whether more regulation would drive lenders from high-risk credit on which cutting-edge businesses depend.

Principles for Regulation

We suggest evaluating reform proposals according to the following principles:

Focus on Systemic Damage. The most easily justifiable rationale for intervention is the potential for damage to those not directly involved—for example, people who lose their savings in bank runs when credit markets freeze. The Bear Stearns case confirms that public confidence is important far beyond the U.S. commercial banks that long defined the boundaries of the payments system. Today, dozens (arguably hundreds) of other large financial intermediaries are so closely tied to the payments system—through counterparty arrangements in financial derivatives—that their failure would raise confidence questions in credit markets worldwide.

Beware Fighting the Last War. It is now clear that agents in the housing finance markets had powerful incentives to underestimate risks to be borne by others, but hindsight can be misleading in planning for the next crisis. Take, for example, the credit rating agencies' shameless inclination to bless mortgage-backed securities issued by their largest customers. Will not markets correct the problem themselves, as once-burned investors treat ratings pronouncements more skeptically? Might regulation of credit raters do more harm than good by undermining investors' incentives to do their homework?

Emphasize Transparency. Housing finance markets failed because agents failed to give investors the information they needed, while home buyers and investors in mortgages did not try very hard to get it. One would expect that this problem will largely be self-correcting, but since transparency will always be a key to efficiency in financial markets—and the sorts of information needed change rapidly as complex markets evolve—there seems much to gain and little to lose in requiring agents to provide information in forms most useful to those who bear the risks.

Public Money Should Come with Strings Attached. If the government is going to stand ready to help other firms like Bear Stearns in a pinch, the beneficiaries

should pay a price. Ideally, users of funds should internalize the costs by paying credit insurance premiums the way businesses pay insurance premiums for protection against fire or flood loss.

The case for doing something to prevent the next financial market meltdown is compelling. What that "something" should be, though, is not. Washington quite correctly moved quickly to shore up confidence in markets and to minimize collateral damage. Yet history suggests that tackling an ambitious agenda for reform in the midst of a financial crisis is an invitation to bad regulation—regulation in which costs exceed the benefits and that serves the interests of politically connected insiders rather than those of the public.

Notes

1. Department of the Treasury, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure* (Washington, DC: Department of the Treasury, March 2008), available at www.treas.gov/press/releases/reports/Blueprint.pdf (accessed August 15, 2008).

2. President's Working Group on Financial Markets, *Policy Statement on Financial Market Developments* (Washington, DC: Department of the Treasury, March 2008), available at www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf (accessed August 15, 2008).

Also by the AEI Center for Regulatory and Markets Studies:

Reg-Markets Center Policy Matters 08-08

Disclosure Is the Best Kind of Credit Regulation

By Richard H. Thaler and Cass R. Sunstein, August 2008

The Federal Reserve Board recently issued proposed amendments to Regulation Z, which governs Truth in Lending. According to the Fed, the amendments "are intended to improve the effectiveness of the disclosures consumers receive in connection with credit card accounts and other revolving credit plans by ensuring that information is provided in a timely manner and in a form that is readily understandable."

Read more at www.reg-markets.org/policy/page.php?id=311.

2008-43 #23406