The Washington Times
www.washingtontimes.com

Financial Regulatory Limitations

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Published April 23, 2008

Do you think we need more regulations for banks and other financial institutions, as many politicians and others have recently urged?

Before you answer this question, you may wish to consider the following. There are now literally hundreds of regulators of financial institutions. The federal government has many agencies involved in regulating financial institutions, including the Federal Reserve, the Treasury Department, the Securities and Exchange Commission, the Commodity Futures Trading Commission, etc. Every state has an agency that oversees the state-charted banks, and another agency that oversees the insurance companies that operate in the state.

Every country and political entity in the world has one or more financial industry regulator. International organizations, such as the International Monetary Fund, the Financial Action Task Force, and the Bank for International Settlements in Basel, Switzerland, all have some financial regulatory authority.

Financial institutions increasingly operate on a global basis, and thus a large financial company, such as Citibank, which operates in many states and countries and sells not only banking services, but insurance and securities products, is quite literally regulated in whole or part by hundreds of different public authorities.

The world's public financial regulatory authorities collectively have well more than 1,000 full-time and part-time directors (including yours truly) and literally hundreds of thousands of employees — and yet things still go terribly wrong.

In the United States, banks have been regulated at the state level for more than 200 years and at the federal level since 1863. Still, financial panics continued to occur, and banks continued to fail, causing Congress to create the Federal Reserve System in 1913.

Before creation of the Federal Reserve, the dollar was not subject to sustained inflation (there were periods of inflation and deflation) but the wholesale price index in 1913 was roughly the same as it had been in 1793. Ninety-five years after the creation of the Fed, the dollar is worth about one-twentieth of what it

was worth in 1913, despite the fact that the Fed was supposed to provide stable money.

The greatest periods of bank failures occurred during the Depression of the 1930s after the creation of the Fed, and then again in the late 1980s and early 1990s when 1,600 banks and one-third of all the savings and loans (S&Ls) failed.

The evidence clearly shows that abrupt, unanticipated and incompetent changes in monetary and regulatory policy by central bankers and other financial regulators have caused far more financial instability and financial institutions' failures than have unsavory or illegal practices by managers of these institutions.

Leaders of some financial institutions have obviously been more adept at anticipating market and regulatory changes than others. Markets punish those companies whose leaders were less astute, but it is not proper to attempt to criminalize well-intentioned mistakes, particularly those caused by failures to anticipate actions of public officials.

Regulation can and often does add more systemic risk to the system because people believe the regulators will see problems and act upon them before the market does, giving an illusion of greater safety and stability than actually exists.

Those of us who exercise some regulatory functions are on average no smarter, wiser, or knowledgeable than the other participants in the financial markets. Regulators can ensure competent auditors prepare timely financial statements and that certain standards, such as reasonable capital adequacy ratios and fraud prevention policies, are adhered to. But regulators are not equipped to, nor should they attempt to, micromanage the companies they oversee. And regulators should be sure that regulations meet solid cost-benefit standards and do not discourage innovation in order to avoid killing the golden goose.

It is usually easy, after the fact, to understand why institutions fail, but it may be more useful to understand why some succeed for very long periods of time. Switzerland has a number of very old banks (a couple going back more than 250 years) being managed by successive generations of the same family.

Under Swiss law, these "private banks" are partnerships, with one or more partners having unlimited liability. Most people are much more prudent with their own money than with other peoples' money, and because these Swiss bankers have all of their own money at risk (as well as their family reputation), they tend to be very careful and prudent. These banks have not to date had the same recent problems of many of the very large global banks, including two of Swiss origin, which are corporations whose stock is held by the public (this is not to imply all financial institutions should be unlimited liability partnerships).

There are definite limits to what financial regulators can achieve, and their mistakes are often even more damaging to the financial system than incompetence and dishonesty are by individual players.

Neither individuals nor business people should have exaggerated faith in government financial regulators or private ratings' organizations, many of which have made major mistakes. Prudent people should diversify their financial holdings and relationships among several institutions. One should pay attention to whether the incentives for the managers of the institutions are closely allied with the long-run interests of the stockholders — with the emphasis on long run, because that also usually means the interests of the customers.

Regulation is not a panacea. It can be constructive or destructive. The goal should not be more regulation, but simplified, more cost-effective, and nonduplicative domestic and international regulation.

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