US Financial Regulation: A Hopeless Tangle, or Complexity for a Purpose?

by Lawrence J. White

Executive Summary

- The US financial services sector is heavily regulated.
- The regulatory structure is quite complicated, with a myriad of regulatory agencies and overlapping responsibilities.
- This structure is daunting and confusing, and it has its costs and complications.
- However, a great advantage to this complicated and duplicative system is that it gives someone with an innovative idea more than one place to turn; there is no monopoly regulator.
- Although there are periodic calls for simplifying the system, a major cost from simplification would be this reduced choice, and consequent reduced innovation.

Introduction

The US system of financial regulation has received heightened scrutiny recently, because of the financial debacle of 2007–2009. No observer can come away from that scrutiny without being overwhelmed by the complexity of financial regulation in the United States. Many are convinced that this system's complexity is somehow responsible, at least in part, for the debacle; and, in any event, they would argue that the system must be reformed and simplified.

Any enterprise that enters the US financial services industry must immediately confront this regulatory system and its complexity. The reasons for having financial regulation—and at least some of the reasons for the system's complexity—are certainly worth understanding. That there are actually strengths and advantages to that complexity should be understood as well.

Finance Is Special

Finance is special, for at least four reasons.

1. Finance is ubiquitous. Every individual, enterprise, organization, or government requires finance, even if it is self-finance, to smooth income and expenditure flows, and to provide the basis for investment. The payments system of a modern economy—cash, checks, credit and debit cards, electronic transfers—involves finance as well.
2. Finance involves an unavoidable time sequencing that creates special problems: Finance always involves an initial conveyance of funds—a loan, an investment—and then a later reversal of the flow of funds—the loan repayment (plus interest), a stream of dividends, etc.[1] Because of this time sequencing, the lender or investor has to be worried about the prospects of being repaid. But asymmetric information problems between the lender and the borrower (or between the investor and the enterprise) will adversely affect the lender's (investor's) ability to determine the prospects for repayment.
3. Many individuals have difficulties understanding finance and its complexities.
4. At least partly because of reasons 1, 2, and 3, the financial sector is heavily and extensively regulated;[2] financial regulation, too, is ubiquitous.

Categories of Regulation

Despite its ubiquity, financial regulation is not an undifferentiated mass of governmental intervention in the provision of financial services. There are a few important categories that can help in the understanding of the whys and the wherefores of financial regulation.

- Prudential regulation. This type of regulation is reserved primarily for depository institutions (i.e., commercial banks, savings institutions, and credit unions), insurance companies, and defined-benefit pension plans (i.e., those in which a company has promised a retiree a specified monthly or annual sum).[3] The goal of prudential regulation of these institutions is to maintain their solvency, so that their claimants will remain whole[4] and so that the institutions themselves can function as major providers of credit to the rest of the US economy. The important comparison between a healthy (solvent) bank and an insolvent bank, shown in Tables 1 and 2, illustrates the goal of prudential regulation: maintain banks in the condition shown in Table 1, and avoid having banks incur losses so as to arrive in the condition shown in Table 2.

Table 1. The balance sheet of a solvent (healthy) bank or thrift

Assets	Liabilities
US$100 (loans, bonds, investments)	US$92 (deposits)
	US$8 (net worth, owners' equity, capital)

Table 2. The balance sheet of an insolvent bank or thrift

Assets	Liabilities
US$80 (loans, bonds, investments)	US$92 (deposits)
	#US$12 (net worth, owners' equity, capital)

- Consumer safety regulation. This encompasses prudential regulation (as consumers often have their savings in banks, etc.) but goes substantially beyond, and includes disclosure requirements, limits on what can and cannot be sold, and licensing requirements for who can do the selling. Such requirements can apply to financial advisors, brokers, dealers, and accountants, as well as to the banks and other financial institutions.
- "Economic" regulation. This usually involves limits on prices and/or profits and/or entry or exit. Examples include usury limits (i.e., a maximum interest rate that can be charged on a loan), limitations on where a bank can establish locations, and restrictions on what kinds of products or services a bank (or other financial institution) can offer. The motives underlying "economic" regulation are usually complex, sometimes encompassing antitrust and consumer protection considerations, but sometimes also just reflecting the successful lobbying of incumbents who fear competition (but who usually "dress up" their arguments in the language of consumer protection).

The Regulatory Agencies

Here is where complexities truly do arise. The reasons for the complexities are partly rooted in the United States system of decentralized federalism, whereby the 50 states have a considerable degree of sovereignty and autonomy alongside the federal government, and partly in a patchwork of regulatory agencies (at the state and federal levels) that have been legislated into existence as new financial institutions and new problems have arisen. This complexity is illustrated by the following:

- There are five federal regulators of depository institutions, as well as one or more regulator in each of the 50 states. The states also regulate lenders and mortgage originators that are not depositories.
- There is a separate federal agency that has the responsibility for regulating Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System.
- There are two federal regulators of the securities markets and financial instruments, as well as 50 state regulators (and 50 state attorneys general, who are prepared to bring lawsuits against securities firms on behalf of their respective states' citizens).
- The regulation of insurance companies is exclusively the domain of the 50 states.
- Pension funds are regulated by two federal agencies, and, again, the 50 states also have a say.
- Consumer fraud in financial products can be the responsibility of yet another federal agency, as well as the 50 states.

There are overlapping responsibilities and jurisdictional disputes throughout this framework. For example, federal bank regulators and the 50 state bank regulators are constantly struggling for jurisdiction with respect to consumer protection issues. As another example of regulatory complexity, a commercial bank's holding company is usually regulated by the Federal Reserve, while the primary safety-and-soundness regulator for the bank itself will be the federal Office of the Comptroller of the Currency, or one of the 50 state bank regulators; but if the "bank" is a savings institution, then the regulator of its holding company will be the federal Office of Thrift Supervision (OTS), and the regulator of the savings institution itself will either be the OTS or one of the 50 state regulators. It is surely no exaggeration to claim that a diagram of these multiple agencies and their responsibilities looks considerably more complicated than a 1930s radio wiring diagram.

Is Simpler Better?

It is easy to see why this crazy-quilt pattern—and its extra costs—would provide the ammunition for periodic proposals to reorganize and simplify the architecture of the US regulatory system, even in the absence of a financial crisis. Such proposals stretch back at least to the 1970s; the most recent major proposal, "Blueprint for a Modernized Financial Regulatory Structure," emerged from the US Treasury Department in March 2008, but the Treasury initiated its efforts on this proposal a few years earlier, even before the current debacle was a specter on the horizon. The current debacle will surely give birth to many more such proposals.

But is simpler really better? Before arguing against simplification, I will concede a few obvious points: The current system is extremely complicated. The complications and duplications can delay regulatory decisions and increase costs, and a competitive regulatory "race to the bottom" is a risk.[5] If the regulatory system were being designed on a "clean sheet," with no history or legacy, it would probably not be designed with these complications and duplications.[6]

But, also, there is no credible argument that links this complexity to the current debacle. So, why might complexity and duplication actually be preferable? Fundamentally, the presence of multiple regulators is more likely to encourage innovation in the financial sector. Just as a monopoly in the private sector can be an impediment to the implementation of new ideas, so can a monopoly in regulation. For someone with a good idea—whether it's a better financial instrument, or a better way to regulate—the initial answer of "No!" by a sole regulatory agency might well mean the demise of that idea. By contrast, if there are multiple regulators, an initial "No!" to the innovator need not be a death sentence, as other regulators may have different viewpoints.

The three historical case studies illustrate this point.

Case Study 1

Exchange-Traded Financial Derivatives

In the 1970s, the introduction of exchange-traded financial derivatives happened in Chicago, on exchanges that had previously handled agricultural and minerals futures, and under the jurisdiction of the US Commodities Futures Trading Commission (CFTC). This was not a coincidence. These instruments were seen as competitive to the stocks and bonds that were traded primarily in New York, and that were under the jurisdiction of the US Securities and Exchange Commission (SEC). The latter agency was usually sympathetic to the concerns and arguments of the New York-based brokerage community. Had there been only one regulator—which surely would have been the SEC—the development and flourishing of these innovative instruments would surely have been restricted and delayed.

Case Study 2

Breaking the Grip of Regulation Q

A legacy of the 1930s that was still in full force in the late 1960s was the legal requirement that the Federal Reserve (through its “Regulation Q”) maintain ceilings on the interest rate that banks (and, starting in 1966, savings institutions) could pay on deposits. The Congressional intent was to restrict banks’ competition for deposits, which had (mistakenly) been thought to have encouraged unprofitable lending by banks, and to have contributed to the wave of bank failures in the early 1930s.

The consequences of “Reg Q” for a roughly competitive banking (and savings institution) industry was exactly what is taught in Economics 101 to freshmen: A shortage of supply (of deposits) by households and businesses, and an excess of demand, and less-efficient ways of inducing households to bring and keep their deposits in the bank—such as offering them toasters and other gifts, which began in response to Reg Q.

The breaking of this gridlock started with a different regulator: The National Credit Union Administration (NCUA), which in the early 1970s placed no restrictions on the interest rates that credit unions could pay to their depositors. This competition then put pressure on savings institutions, which lobbied their regulator (the Federal Home Loan Bank Board) for greater latitude in pricing deposits; after some exemptions were granted, greater competitive pressures were next experienced by banks, which pressured for and then received some exemptions. Finally, in the early 1980s, most of the provisions of Reg Q were repealed (although a vestige remains in the prohibition on banks and savings institutions from paying interest on business checking accounts). The competition inspired by the NCUA surely hastened the demise of this inefficient regulatory restriction.

Case Study 3

Regulatory Expertise with Respect to Interest Rate Risk

After the savings and loan debacle of the 1980s, federal regulators realized that they needed better methods of measuring and regulating the interest rate risks that were embedded in the long-lived, fixed-rate mortgages held by savings institutions and, increasingly, by commercial banks. As of the early 1990s, the US Office of Thrift Supervision (OTS), which regulated savings institutions, had far better knowledge of the problems, and better regulatory procedures for dealing with interest rate risks than did the other federal regulators of depository institutions. It took a while for the latter to catch up.

What About the Financial Debacle of 2008–2009?

It is clear that excessively lax prudential regulation of depository institutions, and of large complex financial institutions more generally (for example, investment banks, financial holding companies, Fannie Mae, and Freddie Mac), along with inadequate consumer protection regulation with respect to mortgage originations in the US, can explain much of the financial turmoil of 2008–2009. And, at the center of the turmoil were the financial innovations of a variety of mortgage derivatives that were based on subprime mortgage loans.

However, it is hard to claim that this regulatory laxity was due to the complexity of the US regulatory structure; equivalently, it is far from clear that a more unified and simplified regulatory structure would have prevented the debacle. For example, the more unified regulatory structures that exist in the United Kingdom and the rest of Western Europe have not been appreciably better at shielding their financial systems from the turmoil.

Further, the financial innovations, if used responsibly (as they were before the US housing boom turned into a bubble around 2004–2005), could have achieved the usual results of useful innovations: Better and/or more varied products at lower costs that could benefit participants, and thereby could be socially beneficial. For a complex set of reasons, which mostly involve the problems of asymmetric information involving the multi-tiered participants in the vertically disintegrated mortgage process (and even some vertically integrated participants), the innovations were abused. But, again, the complexity of the US regulatory system was not a cause or abettor of this abuse.

Conclusion

In Robert Bolt's *A Man for All Seasons*, Sir Thomas More asks his son-in-law (William Roper), "What would you do? Cut a great road through the law to get after the devil?" When Roper replies affirmatively, More responds, "Oh? And when the last law was down and the devil turned 'round on you, where would you hide, Roper, the laws all being flat?"

A monopoly regulator need not be the devil. Still, the cause of financial innovation, and even regulatory innovation, will be better served in a more diverse environment.

Financial firms are often in the forefront of lobbying for regulatory simplification, including the consolidation of duplicative agencies. If the arguments concerning innovation that are advocated here are correct, such efforts are shortsighted. The adage, "beware what you wish for, because you might get it," is surely appropriate here.

More Info

Books:

- Acharya, Viral V., and Matthew Richardson. *Restoring Financial Stability: How to Repair a Failed System*. Hoboken, NJ: Wiley, 2009.
- White, Lawrence J. "The partial deregulation of banks and other depository institutions." In Leonard W. Weiss, and Michael W. Klass (eds). *Regulatory Reform: What Actually Happened*. Boston, MA: Little, Brown, 1986: 169–204.
- White, Lawrence J. *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation*. New York: Oxford University Press, 1991.

Articles:

- Gramm, Wendy L., and Gerald D. Gray. "Scams, scoundrels, and scapegoats: A taxonomy of CEA regulation over derivative instruments." *Journal of Derivatives* 1 (Spring 1994): 6–24.
- White, Lawrence J. "Bank regulation in the US: Understanding the lessons of the 1980s and 1990s." *Japan and the World Economy* 14 (April 2002): 137–154.

Websites:

- Commodity Futures Trading Commission (US): www.cftc.gov
- Federal Deposit Insurance Corporation (US): www.fdic.gov
- Federal Reserve (US): www.federalreserve.gov
- Office of the Comptroller of the Currency (US): www.occ.treas.gov
- Securities and Exchange Commission (US): www.sec.gov

Notes

1 Insurance involves a similar time sequencing, where the initial event is the commitment to provide insurance, and the later event is the payout if/when the insured-against event occurs.

2 This is true in virtually all countries.

3 This contrasts with a defined-contribution pension plan, in which employees contribute specified sums (sometimes matched by employer contributions), which are then invested in financial instruments that are selected by the employee.

4 Deposit insurance and other forms of back-stopping are also present for these institutions and their liability claimants, to protect the claimants against insolvencies that occur despite prudential regulatory efforts. With

deposit insurance (or some other guarantee) in place, the details of prudential regulation can be considered as analogous to the rules that insurance companies establish to protect themselves.

5 A regulatory race to the bottom can occur when financial institutions seek regulators that are the most lax. The regulators compete in laxity, so as to maintain or enlarge their regulatory domains; and laxity is a problem because the regulation really is serving a worthy social purpose (rather than just protecting incumbents or otherwise distorting beneficial outcomes).

6 However, as is argued below, in an important sense the duplication of regulatory agencies is a protection against a form of regulatory failure; and complex systems are often designed with deliberate redundancies and duplication to protect against unexpected failures.

See Also

Best Practice

- How Much Independence for Supervisors in Financial Market Regulation?
- Rules versus Discretion in Supervisory Interventions in Financial Institutions
- Why Organizations Need to be Regulated—Lessons from History

Checklists

- Basel II—Its Development and Aims
- Comparative and International Financial Regulation
- The EU Regulatory Regime
- Principles of Financial Services Regulation

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