Regulation Usually Fails

By Allan H. Meltzer

President-elect Obama offers increased financial regulation as a priority for the new administration. He appeals to the lack of regulation to explain the ongoing financial mess, but neither Mr. Obama nor his many assistants document the connection between alleged lack of regulation and financial failures. There isn't one. The massive losses imposed by the Madoff scandal is evidence that regulation does not prevent fraud. The regulator in this case was the Securities and Exchange Commission.

This is not a lonely example. Unfortunately it is the norm. The Federal Reserve for years has followed a policy of avoiding banking failures, especially failures by large banks. In 1991 Congress recognized this problem by passing the Federal Deposit Insurance Corporation Improvement Act (FDICIA). The Act intended to prevent the Federal Reserve from lending to insolvent banks as their losses increased. The Fed's policy increased the FDIC's losses. During the Latin American debt crisis of the 1980s, the Fed worked with the IMF to avoid recognizing the losses to New York banks. It did nothing to end the crisis. The Fed and the Treasury prevented Continental Illinois Bank from failing, and it did the same for Long-Term Capital. These are but a few examples of a long-standing policy.

At one of the annual Kansas City Federal Reserve Bank conferences, Alan Greenspan explained that the Fed could not prevent speculative bubbles. Its task was to clean up afterward. Only President Gary Stern urged a change in policy that would discourage excessive risk taking. That was not the message bankers and the credit markets received. They interpreted regulatory policy as a "Greenspan put". They believed that if they took on more risk, the Fed would keep them from failing.

The Fed may not have intended to offer a put, but the market could read the long history of preventing failures. Adding to the problem was the absence of any statement of lender-of-last-resort policy in the Fed's 95 year history. Markets had to judge what might happen by looking at the record. It encouraged them to think that failure was unlikely if they increased leverage to increase profits.

The Fed and the Treasury responded to recent failures by heightening uncertainty at an uncertain time. It followed the forced the acquisition of Bear Stearns by allowing Lehman Brothers to fail. Any sensible portfolio manager would conclude that no one could guess what would happen next. Instead of calming fears, inconsistent actions greatly increased them. Managers ran to cash assets and remained there.

Improper regulation, not its absence, is one main reason for the current crisis. Fed officials and administrators don't want to believe that capitalism without failure is like religion without sin. It doesn't work. And increased supervision, super regulators and all the rest will not make it work. That's a prominent unpleasant lesson of the current crisis.

It's not the only lesson about regulation. In my History of the Federal Reserve, I found that most regulators ignore the incentives they foster. I wrote that the first law of regulation is: Lawyers and bureaucrats write regulations. Markets learn to circumvent the costly ones. The Basel Accords tried to promote safety by requiring banks to hold more reserves if they acquired more risky assets. This ignored incentives. The banks followed the first law of regulation. They put the risky assets in structured investment portfolios that were not on their balance sheet. We went from a system that was not well monitored to one that was not monitored at all. The world and the regulators learned where the risks went when the holders were about to fail. Bad regulation, not its absence, made the problem worse.

Unwise regulation will produce more Basel debacles. We need a clear lender-of-last-resort policy, one that governments and central banks are willing to enforce. That can be done. Great Britain successfully operated such a policy for almost one hundred years. Banks and financial firms have to change their compensation systems to separate bonuses from short-term results. Regulation cannot do that; it's a job for managements. And companies that rate risks must have the incentive to return to the quiet life that they followed when they mainly rated corporate and municipal debt. Those who package and sell securities should accept responsibility for what they buy and sell.

Closing Fannie Mae and Freddy Mac would be a major step toward a better policy. If Congress chooses to subsidize housing, it should do it on the budget. Similarly, all subsidies should be put on the budget and voted on like other spending.

Most important of all, fear of failure must be in the mind of every banker and financial manager every day. If banks are "too big to fail", they should be forced to be smaller. Institutions that lend long and borrow short will face failure whenever large, persistent changes occur in their environment. That risk cannot be avoided but risk will be better managed socially, if managers recognize that it is present. Equating social and private costs in this way will do a far better job for all of us than the best intentioned regulation.

Mr. Obama, rethink your approach. Markets work best when rules induce incentives that equate private and social costs not when government regulators impose their judgments.

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