Commentary

We Need Smarter Regulation, Not More

Christian Leuz 02.09.09, 12:40 PM ET

The ongoing financial crisis poses two issues. One is how to clean up the current mess and the second is how to reform the system once the crisis is over.

In regards to the second issue, which in the long run is probably the more important one, calls for a new and tighter regulation are becoming stronger by the day. While there is a legitimate case for more consistent regulation and oversight, such as to reduce regulatory arbitrage, it is less obvious that we really need more or tighter regulation.

Financial regulation imposes significant costs on the economy. For instance, excessive regulation can stifle financial innovation, reduce the flow of credit to worthy firms and consumers, and impede economic growth. Moreover, regulation is not needed to the same degree at all times. In fact, current calls for regulation come at the same time that market discipline is back in full force and more regulatory scrutiny could exacerbate the downturn.

Thus, what we need to prevent future crises is a more dynamic approach to regulation and oversight--one that is strong precisely when market forces become weak.

Much of the time, market solutions that address information problems, moral hazard and other frictions in markets work reasonably well. Underwriters, rating agencies, financial analysts and auditors all perform important roles in the financial system and serve us well, otherwise the service fees these institutions have generated for decades would be hard to explain.

Yet these institutions are clearly not perfect, as the most recent crisis shows. They suffer from incentive problems and conflicts of interest, too, which is why we often turn to regulation and oversight. However, the key to getting regulation right is not just understanding why and how markets fail, but also focusing on when they tend to fail.

Here is where we can learn from prior boom periods. During the dot-com bubble and the recent credit expansion, market institutions that normally acted as a corrective force were giving in to the frenzy instead. Why? During speculative bubbles, there is a point at which sophisticated players lose the incentive to correct a trend away from fundamentals and instead benefit from going along with it.

Their actions become--as economists say--"strategic complements" to those who are fueling the trend (and who are often less sophisticated). For instance, the dot-com bubble eventually reached a point where day-trading retail investors became a dominant force, creating incentives for venture capitalists, underwriters and fund managers to jump on the bandwagon, hoping to hop off before the bubble burst.

During the recent credit expansion, homeowners seeking mortgages to flip homes, as well as Fannie and Freddie with their affordable housing mandate and ensuing interest in securitized sub-prime mortgages, seem to have been the equivalent of the less-sophisticated, day-trading retail investor feeding the dot-com bubble.

Once these forces were large enough, they gave incentives to each element in the chain--from the mortgage originator to the investment bank--to participate in and contribute to the bubble.

When the gatekeepers and sophisticated players jump on the bandwagon, it is time for regulators to increase oversight and start asking tougher questions. Creating such dynamic oversight would reduce the costs to firms and the economy during normal times when market forces are reasonably strong.
Thus, rather than placing a heavy regulatory burden on firms and banks at all times, we need to think of actions we would like regulators to take only if and when market forces begin to weaken, like more stringent disclosure to the public.

Another example is information to the regulators about financial instruments or products that could facilitate regulatory arbitrage (e.g., off-balance sheet securitizations). Producing, disseminating and verifying information is costly, and disclosures can cause competitive harm and proprietary costs. Thus, there are limits to what we should impose on financial institutions, rating agencies and firms in general.

Moreover, the benefits of disclosures are likely to differ over time. Too much disclosure during good times, when corrective market forces are strong, may lead investors to stop paying attention to this information.

Thus, it seems sensible for regulators to ask firms for more details on their practices, or compel additional disclosures, when we are possibly in times of irrational exuberance. At that point, the regulator should reverse the burden of proof and shift it to those who are promoting the transactions and benefiting from them. Surely, if the transactions are as good as they seem, people should be able to explain them and additional scrutiny would do little harm.

There are two main obstacles to increased dynamic oversight. First, it is difficult to say when we are in a bubble and when expectations have become unrealistic. Thus, the key to my proposal is to determine when more oversight is due and when it should be relaxed again.

While it is challenging to define precise triggers ex ante, we might be able to determine them in principle. Markets do provide tell tales. These are obvious in hindsight, but there are elements that prior crises have in common, despite the frequent claim that every crisis is different.

Crisis are often preceded by major innovations, e.g., the emergence of railroads, computers, the Internet, securitizations, credit default swaps; or by major changes in the environment, e.g., financial liberalizations, expansions of global trade as in the 1920s and before the Asian crisis.

Major changes and innovations often provide a "rationale" for the sophisticated players to go along and an argument as to why "this time is different." These changes also fuel the expectations of the unsophisticated, along with very substantial run-ups in asset prices--another common feature.

In addition, pre-crisis periods are often characterized by exponential growth in trading or transaction volume in the respective market or asset. Again, using such market-based tell tales will not be perfect. This is precisely why regulatory actions should be geared first toward oversight, i.e., questioning the relevant business practices and promoting transparency, rather than banning the transactions themselves.

Even though the markets' tell tales are imperfect, they could be used to empower the regulator, which brings me to the second major obstacle to dynamic oversight: political opposition during the time of expansion.

People will argue that the regulator is stepping in at the wrong time and that the regulator's additional requirements will destroy growth in the area that is taking off. We have heard these arguments many times, only to discover later that trees do not grow to the sky.

Thus, a cooling effect in these times is not necessarily bad and, in the end, this strategy should be more efficient than permanent restrictions or oversight. But it is a serious question whether the regulator will have the clout to actually compel the information, disclosures or actions that seem appropriate during times of exuberance.

For more on this topic, see:
Lawrence White on Federal Regulation
Harvey Rowen on Wall Street Regulation
Liz Moyer On Regulators And Madoff

One approach would be to write very specific, almost mechanical, triggers into law, giving the regulator little discretion. However, such triggers based on past crises are likely to be poorly defined and exacerbate the problem of false positives.

An alternative and likely better strategy is to describe such triggers in more abstract terms to give the regulator a clear mandate of when they are expected to increase scrutiny. I am confident that regulators who were concerned about market trends during the dot-com boom or the credit expansion would have known where to look and which practices to scrutinize. The bigger issue, again, is to get them to actually do it.

Thus, in addition to a clear mandate to step in when market forces weaken, we need to improve the independence and accountability of the regulator--both are crucial for dynamic oversight to work.
The current crisis clearly suggests that we should reconsider extant regulation and oversight. However, as regulation can have substantial costs, it seems worthwhile to think about how we can make our regulatory framework more dynamic to match the dynamic nature of our capital markets.

*Christian Leuz is the Joseph Sondheimer Professor of International Economics, Finance and Accounting at the University of Chicago Booth School of Business and a co-director at its Initiative on Global Markets.*