Written By
Frank A. Wolak
Department of Economics, Stanford University

How Should Financial Markets Be Regulated?

How does the United States continue to create wealth and economic growth at a significantly faster rate than other industrialized countries? In terms of capital raised, why are more than 40 of the top-50 private-equity firms globally US firms?

Efficient and relatively unfettered capital markets in the US are crucial to explaining these outcomes. US capital markets are extremely good at taking risky bets that typically do not pay off; but when they do, an Amazon, Apple, Google or Facebook is created. Moreover, US firms have been at the forefront of creating and encouraging the widespread use of many of the financial instruments that are now an essential component of modern business-risk management practices.

These factors imply that a fixed amount of investment capital can produce significantly more economic activity in the hands of US financial firms because of the greater freedom they have to leverage this capital.

Despite these successes, there are increasing calls for expanding the scope of government regulation of the US financial sector. This stems from the belief that greater regulation can prevent financial crises such as the one that occurred in 2008, without reducing the likelihood or magnitude of the economic boom that preceded it. However, many of the changes proposed by advocates of increased regulatory intervention are unlikely to achieve the desired effect.

Instead, many of the current and proposed regulations significantly limit the likelihood and magnitude of an economic boom, while only slightly reducing the probability of a future financial crisis. A major flaw in the design of these regulations is the implicit belief that a financial regulator knows better than a market participant how best to manage a complex business risk or what is a prudent investment. However, there are many historical examples of financial instruments that were initially deemed imprudent and purely speculative but are now part of accepted business practices. These same financial instruments are also a major contributing factor to how US financial firms are able to achieve the economic outcomes described above.

Let me be clear—I am not recommending the elimination of all regulation in the financial sector. I am only suggesting that it focus on the traditional problem that regulation is designed to address: consumer protection. The major motivation for economic regulation is to protect consumers in markets where competitive forces are weak, so that competition alone cannot be relied upon to protect consumers from excessive prices or low-quality products. The primary driver for health and safety regulation is to protect consumers in those instances in which informational asymmetries between firms and consumers can have long-lasting adverse consequences.

> “The major motivation for economic regulation is to protect consumers in markets where competitive forces are weak.”

Financial-sector regulation should therefore focus on the major points of access between consumers and the financial sector, such as retail-banking services, home and automobile financing, and retirement income and estate planning. Other aspects of the financial-sector regulatory oversight should recognize that most financial-market interactions are between sophisticated and well-informed players that understand, or at least should understand, the risks involved.

The rationale for consumer protection in the financial sector is very similar to the motivation for building codes in the housing sector. Determining the appropriate materials and methods to use to construct a house is an extremely complex task. At best, a household is likely to engage in this task once or twice in a lifetime. Consequently, having an impartial regulatory process to set minimum standards for materials and methods of construction significantly lowers the transactions costs a household faces in building a new house.

Household members are also likely to take out home mortgages only a few times in their lives. Retirement planning is clearly a once-in-a-lifetime activity. Consequently, there is scope for a regulatory process that ensures the household does not take excessive mortgage or retirement-savings risks. The Federal Deposit Insurance Corporation's (FDIC's) guarantee of a household's bank deposits against the failure of its bank is another example of consumer-protection regulation against the collateral damage of a bank that is poorly managed.

The Consumer Financial Protection Bureau's Consumer Complaint Database—which allows consumers to submit complaints about their dealings with banks and financial firms over mortgages, credit cards, debt collection and other issues—is another example of consumer-protection regulation. This database has the potential to provide valuable feedback to banks and financial firms on their customer service as well as information to consumers about the quality of service that these firms provide. One current shortcoming of this database is that it only covers complaints made to financial institutions with more than $10 billion in assets, so it misses the vast majority of depository institutions.

With these consumer protections in place, the financial-sector regulatory process should limit its interventions into the day-to-day operational and risk-management activities of financial firms. These firms should be permitted to trade sophisticated financial instruments among themselves and with sophisticated market participants. Prohibitions on financial firms taking positions in physical commodities or financial derivatives based on physical commodity prices should also be eliminated.

Although it is possible that some of these sophisticated players could incur large losses or even be forced to exit the industry, a regulatory process focused on consumer protection will ensure that the economic harm caused by the failure of a financial player will be limited to the greatest extent possible to other financial players. Moreover, the bankruptcy and exit of market participants that fail to adapt to changing consumer demand is all part of the dynamics of an industry that is serving the interests of consumers. The regulatory process for large firms should focus on facilitating the orderly exit, with minimal harm to consumers, of large firms that persistently make losses, rather than attempt to prop up their failing business models.

This form of regulatory oversight will allow financial players the freedom to take risks that both parties to the exchange find acceptable and that both understand, and develop new financial products to hedge the increasingly

> “The potential economy-wide benefits to limited regulatory intervention into the operations of large financial market participants are likely to exceed the costs, as long as consumers are protected against the unintended consequences of these transactions.”

complex set of business risks that modern firms face. The regulatory process would focus on protecting consumers from unintended economic harm from their dealings with the financial sector.

This does not mean that the regulatory process should protect consumers from all economic harm. If consumers invest in risky assets with high expected rates of return, they cannot be protected against financial losses. Similar to the warnings on cigarettes against the health risks of smoking, consumers investing in risky financial assets should be warned that they may lose some or all of their money from doing so.

To summarize my main point: The potential economy-wide benefits to limited regulatory intervention into the operations of large financial market participants are likely to exceed the costs, as long as consumers are protected against the unintended consequences of these transactions. Consequently, the financial-sector regulatory process should focus on achieving the primary goal of regulation in other industries—protecting consumers from economic harm. This is accomplished by ensuring that households do not become accidental collateral damage through the actions of large financial players and that they are adequately informed of the financial implications of any risky-investment decisions they might make.

Although it is unreasonable to expect that a financial-sector regulator knows best how to manage a complex business risk or design a new hedging instrument, it does seem reasonable to expect that a financial-sector regulator can provide standardized protection and guidance to consumers on retail-banking activities, home and automobile loans, and retirement and estate planning. Consequently, requiring financial firms to manage the full economic consequences of their actions while protecting consumers from the unintended consequences of the activities of the financial firms is the best approach to financial-sector regulation. «

© Depositphotos/Frank-Peters