

# Chapter 1

## Why Regulate?

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Finance is part of the information industry. If the right borrowers and investors could find each other easily enough, we would not need banks. Until this happens, we need banks to allocate investment and savings across time and space and to package savings and investments in a way that facilitates transactions. This is a critical function. Financial markets help economies to grow by mobilising savings so that consumption can be higher in the future as a result of investments made today. Financial markets help global growth by sending savings from countries with little room for further investment, to countries with more room than current savings can satisfy.

We regulate finance over and above the way we regulate other industries because finance exhibits market failures that can have devastating consequences. When financial markets malfunction seriously, the real economy takes a nosedive. This financial crisis was triggered by problems in the U.S. subprime mortgage market, but it led to German GDP shrinking by 6 percent in the first quarter of 2009 and the biggest drop in global trade since the 1930s.

During the boom there were more than a few who warned that the bigger the boom the bigger the fall would be. Regulators generally responded that it may be easier to manage the crisis if and when it comes than try to prick a bubble whose dimensions were uncertain. The scale and chaos of this crash have expunged that notion for now. Recessions that follow financial crashes tend to be severe, long and painful. The crashes themselves are hard to manage. In the crash, policymakers are surrounded by the fog of war. Every banker claims that if their bank is not saved the entire financial system will fall apart – and some are right. In crises information about what is going on is scarce, rumours are plentiful and tax payers are angry. Crashes are best avoided or dampened, rather than managed.

During the recent boom the zeitgeist was to see the benefits of markets everywhere; today some of the same commentators can only see the costs of markets. In our view, there are two principal drivers of market failures in finance that require regulation: asymmetrical information and social externalities. There are other failures too. Principal-agent problems abound, but these are not so unique to finance and the principles we may use to address them are more readily found in other industries.

## Reflections of an Academic Practitioner

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I come to the Warwick Commission as both an academic financial economist and as a financial market practitioner. Reflecting on this experience, it seems to me that there are at least four key issues that will drive the policy and research agenda in the coming years.



First, of course, there are questions about the appropriate regulation of financial markets.

Since the early 1980s there has been an international trend towards deregulation. Moreover, some of the regulations introduced – such as ‘mark-to-market’ accounting – actually exacerbated rather than ameliorated the crisis. Designing appropriate regulation is no easy task. Regulation of any kind tends to have distorting effects on incentives. Financial markets are also remarkably adept at circumventing regulation. But where the ‘first-best’ solution – freely functioning markets – fails, the ‘second-best’ alternative of appropriate regulation becomes inevitable.

Second, there are important questions to be answered about the design of monetary policy. At least one factor that fuelled the housing bubble – in the U.K., the U.S. and elsewhere – was the very low level of interest rates. There seemed to be a consensus among economists on both sides of the Atlantic that asset markets, including the housing market, could be left to their own devices and that interest rate policy should be directed solely at controlling price inflation, not asset price inflation. Additionally, it was understood that monetary policy could be used as the single main instrument of government macroeconomic policy. Inflation targeting, however, needs to be supplemented by some form of regulation specifically aimed at calming asset markets when they become overheated.

Third, a remarkable feature of the crisis in ‘subprime’ mortgages that triggered the global financial crisis in the summer of 2007 was that it appeared to take the world by surprise. While subprime markets featured on the radar screens of the Bank of England, the International Monetary Fund (IMF) and the Bank for International Settlements, no alarm bells were sounded. This is itself somewhat alarming since, following similar surprise at the Asian financial crisis of barely a decade ago, there has been a substantial amount of research on ‘surveillance’ and ‘early warning indicators’ of financial crises, both at policy institutions such as the IMF and the Financial Stability Forum and in academia. Perhaps this is because of an inherent nonlinearity in the world. If the world is unpredictable we need to learn to expect the unexpected. If it is not, then we need to develop more refined early warning systems.

Fourth, it has become clear to me that an interdisciplinary approach to the study of financial markets is the only way forward. Throughout much of the last three years, there has been a clear disconnect between the ‘economic fundamentals’ – what economic and financial models would predict should be the main drivers of financial markets – and actual financial market behaviour, as market participants were gripped by jitters, herding behaviour and a loss of confidence that often appeared to be related more to psychology and uncertainty than economic fundamentals. Similarly, the international financial structure is built within a political, sociological and geographical framework that governs its behaviour – the financial deregulation of the past two decades, for example, had its roots in political ideology. It is clearly time for a unified social science approach to the problems of the financial system.

A key asymmetry is between the sellers of financial products and the buyers. Markets work relatively well when there are repeat purchases; it is easy to identify the quality of the product and easy to switch from a poor

quality product. The market for apples in the local fruit marketplace is the example of a market that is likely to function well. In finance, buyers purchase a small number of products – a mortgage, life-insurance, a pension – each of which may have life-changing impact. The buyers only discover if it is a bad product long after the original transaction has occurred, when it will be hard if not impossible to do anything about it.

Thus, an important function of financial regulation is to balance the interests of unsophisticated consumers of financial products and their sophisticated sellers. This consumer protection focus of regulation is usually carried out through rules on how products are sold, who can sell them and, sometimes, what can be sold. Part of the process of consumer protection involves making a distinction between vulnerable consumers and professional investors who are deemed to be less vulnerable. Professional investors dominate the over the counter wholesale markets in bespoke financial products where trade size and turnover are large. Individual consumers dominate the retail exchange-traded markets where trade sizes are smaller and more transparent. This distinction is being reconsidered today given how bewildered some professional investors turned out to be and the way the wholesale markets froze in the crisis.

Another key reason why financial regulation is necessary is the presence of social externalities. A social externality occurs when the overall consequence of an activity is not captured by the private interests of those involved in the activity. The classic social externality is pollution from a factory. The shareholders of a sugar factory and the foreign buyers of sugar do not face the costs of the air pollution around the factory and consequently they are likely to raise production above levels that would be socially optimal if the interests of all were considered. The classic Pigouvian response to a social externality is to 'internalise' it through taxes. The sugar mill pays a tax scaled by the amount of pollution it produces, encouraging it to invest in pollution reduction. Faced with this pollution tax, the factory output may fall to a more socially optimum level or the

revenues from the taxes may be used to provide compensation to those who suffer from the pollution.

One of the unique aspects of finance is that banks lend to banks. Bank A may borrow from Bank B to lend one of its customers a loan to buy a car from a customer of Bank B. Shoe shops do not lend to shoe shops. Consequently the failure of one shoe shop is good for the others, but the failure of one bank can undermine other banks. A bank run may be a result of the interconnectedness of the banks involved, or a result of panic by consumers that the bank that has failed looks like their own bank and that their own bank, therefore, may be the next to fail. A single bank failure could lead to a collapse of the financial system.

The costs of a failure of the financial system are far in excess of the costs to the shareholders of the bank that failed. This is a social externality. Left to their own devices, the shareholders in a bank will underinvest in the bank's safety from a systemic perspective. The regulatory response to this social externality is to provide government insurance for depositors and, in order to avoid moral hazard behaviour of these insured banks, to require them to hold greater capital than they would otherwise wish to hold. This response has not addressed interconnectedness directly; instead, it has sought to secure each individual element in the system. We argue that this neglects the endogenous risks that arise as a result of the collective behaviour of banks.