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Financial Regulation Reform: 16 Key Studies and Analyses

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The 1,334-page financial markets bill now pending in the Senate would implement a vast array of changes in the way banks and other financial institutions are regulated. Issues range from how best to protect consumers to how to liquidate failing firms to what rules to apply to complex financial instruments.

These issues tend to be as complex as they are critical to the future of the U.S. economy. The good news is that there is a wealth of expert analysis on the key issues. Here are 16 of the best.

Consumer Protection. The Senate bill would create a new financial consumer protection agency within the Federal Reserve with independent powers to regulate consumer finance. The financial crisis, however, had nothing to do with a lack of consumer protection. New consumer rules would instead simply reduce consumer choices while undermining regulatory efforts to ensure financial soundness.

1. How to Protect Consumers in the Financial Marketplace: An Alternate Approach

David C. John, Heritage Foundation

Backgrounder No. 2314, September 8, 2009

http://www.heritage.org/Research/Reports/2009/09/How-to-Protect-Consumers-in-the-Financial-Marketplace-An-Alternate-Approach

"The same goals supported by those who propose the creation of a new agency can be better achieved through a coordinating council of existing regulatory agencies. There is no need for a massive new agency when existing agencies could work better, faster, and at little additional cost."

2. Three Problematic Truths About the Consumer Financial Protection Agency Act of 2009

Joshua Wright and Todd Zywicki, George Mason University

George Mason Law & Economics Research Paper No. 09-48, September 14, 2009

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1474006

"[T]here is no evidence that consumer ignorance or irrationality was a substantial cause of the crisis or that the existence of a CFPA could have prevented the problems that occurred. The CFPA is likely to do more harm than good for consumers."

3. Let's Treat Borrowers Like Adults

Todd J. Zywicki, George Mason University

The Wall Street Journal, July 8, 2009

http://online.wsj.com/article/SB124701284222009065.html

"Our current problems are caused by misaligned incentives and the rational response of consumers

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and lenders to those incentives. It's not a crisis of consumer protection. A new agency premised on the erroneous belief [that] what consumers need is to be protected from themselves is likely to do more harm than good."

4. The Consumer Financial Protection Agency and the Hazards of Regulatory Restructuring

William Kovacic, Federal Trade Commission

Lombard Street, September 14, 2009

http://www.finreg21.com/lombard-street/the-consumer-financial-protection-agency-and-hazards-regulatory-restructuring

"As now conceived, the CFPA also may have the unexpected consequence of diminishing the quality of consumer protection in non-financial sectors."

Super-Regulators and Systemic Risk. The Senate bill would establish a council of existing regulators with nearly unlimited powers to regulate big financial firms in order to reduce systemic risk. Regulators, however, have consistently failed to identify systemic risks in the past or craft steps to avoid them. By identifying firms subject to such special rules, however, regulars would be creating a class of "too big to fail" institutions, and actually increase the chances of another financial meltdown.

5. Financial Systemic Risk Regulators: Congress Is Asking the Wrong Questions

David C. John, Heritage Foundation

WebMemo No. 2471, June 9, 2009

http://www.heritage.org/Research/Reports/2009/06/Financial-Systemic-Risk-Regulators-Congress-Is-Asking-the-Wrong-Questions

"[R]ecognizing that systemic risk can exist is a very different thing from knowing that it is present in a specific situation, and both are extremely different from actually knowing how to prevent it.… Even if systemic risk can be accurately identified, it is less certain that the political system will allow a regulator to act to address it.… One has only to look at Chrysler and GM's experiences for such evidence."

6. If You Liked Fannie and Freddie

Peter Wallison, American Enterprise Institute

The Wall Street Journal, March 18, 2010

http://www.aei.org/article/101799

"Designating large non-bank financial companies as too big to fail will be like creating Fannies and Freddies in every area of the economy. Their lower cost of funds—stemming from their implicit government protection—will allow them to outcompete smaller firms. Gradually, our competitive financial markets will consolidate into markets dominated by a few big firms."

7. Systemic Risk and the U.S. Financial System

Margaret Polski, George Mason University

Mercatus on Policy No. 53, May 2009

http://mercatus.org/publication/systemic-risk-and-us-financial-system

"To address systemic risk, some policymakers would prefer a more centralized regulatory authority.… [T]his is misguided. The U.S. financial system is polycentric, closely tied to local economic activity, and ever-evolving. In today's world, systemic risk cannot be effectively regulated by a centralized regulatory authority."

Resolution Authority/Bankruptcy. Government-managed wind-downs, or "resolution" of troubled financial firms, would politicize the closure process, subjecting private firms to seizure with little judicial oversight. A proposed fund to assist such resolution actions would at the same time create a "permanent TARP," ensuring bailouts for creditors of such firms. A better answer is to close down failing firms through enhanced bankruptcy procedures.

8. Using Bankruptcy and Capital Standards to Address Financial Institutions That Are "Too Big to Fail"

David C. John, Heritage Foundation

Backgrounder No. 2343, November 24, 2009

http://www.heritage.org/Research/Reports/2009/11/Using-Bankruptcy-and-Capital-Standards-to-Address-Financial-Institutions-That-Are-Too-Big-to-Fail

"The better choice would be to amend U.S. bankruptcy law to create an open, expedited bankruptcy process in which an impartial court would oversee the restructuring or closure of large and complex financial firms."

9. The Argument Against a Government Resolution Authority

Peter Wallison, American Enterprise Institute

Pew Financial Reform Project, *Briefing Paper* No. 4, August 18, 2009

http://www.pewfr.org/project_reports_detail?id=0016

"The effect will be to introduce moral hazard into the financial system, as creditors come to believe that large financial companies will be rescued; the financial system will be weakened as inferior managements and business models are saved from extinction by inappropriate government action; and the taxpayers will be required to bear needless costs."

10. Why Banks Are Not Allowed in Bankruptcy

Richard M. Hynes and Steven D. Walt, University of Virginia

Virginia Law and Economics Research Paper No. 2010-03, December 11, 2009

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1522205

"The FDIC's experience in quickly resolving failed banks is not encouraging. It gives no reason to believe that the FDIC would resolve a bank holding company much more quickly than would bankruptcy."

11. Speed Bankruptcy: A Firewall to Future Crises

Garett Jones, Ben Kwesi Klutsey, and Katelyn Christ, Mercatus Center

Mercatus Working Paper No. 10-02, January 2010

http://mercatus.org/publication/speed-bankruptcy-firewall-future-crises

"[T]here's an alternative, even in the midst of a crisis: Speed bankruptcy, the court- or regulator-appointed conversion of tradable bonds into shares of common stock. By reducing debt and increasing equity, it reduces leverage and places the firm back in the hands of people who have money at risk."

12. Bankruptcy or Bailouts?

Kenneth Ayotte, Northwestern University, and David Skeel, University of Pennsylvania

University of Pennsylvania, *Institute for Law and Economics Research Paper* No. 09-11, July 23, 2009

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1362639

"[B]ankruptcy has been surprisingly effective in most cases, and it avoids many of the distortions and taxpayer commitments required from the standard, more popular strategy of last-minute rescue lending."

Derivatives, Swaps, and Innovation. Innovative financial instruments such as credit default swaps and other derivatives have on the whole been a boon to consumers and the economy. Problems encountered with their use are being resolved through actions in the marketplace. Ill-considered regulation of these instruments would hurt consumers without making the financial markets safer.

13. Senator Dodd and Derivatives: How the Market Has Made Regulation Redundant

Dave Mason, Heritage Foundation

WebMemo No. 2850, March 31, 2010

http://www.heritage.org/Research/Reports/2010/03/Senator-Dodd-and-Derivatives-How-the-Market-Has-Made-Regulation-Redundant

"Rapid reforms in derivatives markets since 2008 have made command-and-control regulation represented by the Dodd draft redundant. Lawmakers should understand that imprudent regulations, such as top-down mandates and inflexible rules that inhibit the private market, are worse than no regulations at all."

14. Everything You Wanted to Know about Credit Default Swaps—but Were Never Told

Peter Wallison, American Enterprise Institute

AEI Online, December 2008

http://www.aei.org/outlook/29158

"Far from creating new or significant risks, CDSs [credit default swaps] simply move risks that already exist from one place to another. For this reason, they are a major advance in risk management for all financial intermediaries, and restrictions on their use will create more risk in the financial system than it will eliminate."

15. Credit Default Swaps and Regulatory Reform

Houman Shadab, New York Law School

Mercatus on Policy No. 56, August 2009

http://mercatus.org/publication/credit-default-swaps-and-regulatory-reform

"CDSs were not a fundamental cause of the crisis and in important ways even helped to reduce its impact."

16. In Defense of Much, but Not All, Financial Innovation

Robert Litan, Brookings Institution

February 17, 2010

http://www.brookings.edu/papers/2010/0217_financial_innovation_litan.aspx

"[I]t is important that the policy environment permit, if not encourage, socially beneficial financial innovation in the future. Another wrong lesson from the recent crisis would be to tighten up regulation so much that innovations of positive value cannot be introduced because regulation makes it too difficult or expensive to do so."

Too Big to Let Fail. No one wants to see another financial crisis or more bailouts. But, as shown by these and other analyses, the proposals now pending in the Senate would actually make both more—rather than less—likely. A better approach would be to allow troubled financial firms to fail—without taxpayer assistance—using bankruptcy laws under judicial supervision.

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