

# Pragmatic Perspectives on Rethinking Financial Regulation

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The reevaluation and reconfiguration of financial regulation should be firmly based on four observations. First, finance is very important for human welfare and this importance extends far beyond financial crises. Second, government regulation and supervision of financial systems too frequently lead to the inefficient allocation of credit based on political cronyism and the protection of favored constituents. Third, private financial markets are subject to an array of imperfections and distortions, such that particular regulatory interventions represent the most effective means for improving the financial system. Fourth, financial systems innovate, meaning that well-functioning regulatory systems will become obsolete and even destructive unless they adapt.

Finance matters for economic growth and the distribution of income and therefore financial regulation should not focus only on eliminating crises. The operation of the financial system affects the degree to which a person's economic opportunities are determined by individual skill and initiative, or whether parental wealth, social status, and political connections largely shape economic horizons. The financial system influences who can start a business and who cannot, who can pay for education and who cannot, who can attempt to realize one's economic aspirations and who cannot. Thus, finance shapes the gap between the rich and the poor and the degree to which that gap persists across generations. Moreover, finance alters the rate of economic growth by affecting the allocation of capital. Thus, in striving to eliminate crises, regulations must avoid stymieing financial development. While economies can succeed without automobile or cell phone industries, economies cannot prosper without access to well-functioning financial systems.

Although there are justifiable calls for new regulations and newspapers are filled with examples of the failure of neo-liberalism approaches to financial regulation, a sober assessment of financial regulation should not ignore an impressive body of evidence documenting the typically pernicious role of government in overseeing financial systems. Ample experience and research suggest that governments and regulators do not act with angelic intentions in promoting the well-being of the people. Too frequently granting greater regulatory and supervisory power leads to greater corruption in lending, increased flow of credit to the politically connected, and policies that protect existing bankers and firms at the expense of competition and entrepreneurship.

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Private markets will not solve all problems. For example, it was wrong to believe that private markets alone would mitigate systemic risk problems associated with the emergence of a \$50 trillion credit default swap market. By facilitating the dissemination of accurate, transparent information about the market, regulators could have improved the functioning of this market. As a second example, in the presence of deposit insurance, explicit or implicit, it is wrong to assume that the market will limit bank risk. By creating and enforcing sound capital standards, requiring uninsured subordinated bond holders, and compelling banks to provide understandable, consolidated financial statements, regulators could have improved and empowered the oversight of banks by the private sector.

Successful financial regulation is not for the ideological purist and requires a healthy dose of epistemological modesty, as suggested by David Brooks. Put differently, it is inappropriate to argue that either 999 regulations or 1001 regulations are better than 1000. It depends on the regulations and circumstances. For much of the last decade, the ideology has been that fewer regulations are better than more, without a satisfactory understanding of the informational and contractual limitations of private markets. Now, the world is embracing government intervention. Appreciation of the frequently insidious role of politics in financial regulation should temper and shape this shift.

Fourth, a well-functioning financial system will innovate. Much of this financial innovation promotes technological advancement and entrepreneurship by giving more people access to financial services. For example, improvements in credit scoring techniques and data processing expanded the range of people with access to credit. Of course, some financial innovation is driven by regulatory avoidance, such as the explosive proliferation of collateralized debt and mortgage obligations.

Regulation must adapt to financial innovation to maintain sound incentives. For example, credit rating agencies worked well for much of the last century. However, the boom in structured products and the hiring of credit rating agencies to both create and rate those products produced powerful conflicts of interest. Credit rating agency profits and employment boomed. Regulators did not adapt. Another approach would have been to prohibit structured products, or have the government rate the instruments. This would have had different, though potentially more harmful, ramifications. A more pragmatic, market-oriented approach would have been to prohibit credit rating agencies from simultaneously creating and rating financial instruments.

The great challenge lies in creating financial regulators powerful enough to (a) reduce conflicts of interest among the providers of financial services, (b) force information transparency and accountability, (c) foster sound, market-oriented incentives, and (d) adapt to financial innovation, while obliging the regulatory authorities and government to control those powers.