Making Financial Regulations Work for Society

Comments by Anat Admati

Finance and Society INET Conference

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I am thrilled to be here with Brooksley Born, one of the great heroes on financial regulation. This event culminates work of about two years. I am grateful to co-organizers Gudrun Johnsen, Signe Krogstrup, and Ceyla Pazarbasioglu, for sharing the passion, and to Rob Johnson and the folks at INET for joining us and putting such resources to make the conference come together in this amazing way. I also want to thank other sponsors, especially Stanford GSB, my professional home for more than 30 years. Finally I am grateful to the wonderful speakers, and to all of you, for engaging on the issues.

I am a Finance academic. Before the financial crisis, I did research on financial markets and contracts, most recently on corporate governance. I taught finance to future managers and entrepreneurs. Before immersing in the technical details of valuing stocks, bonds, derivatives and companies, I always told my students that the financial system is really useful for society because it helps move money across time, allocate risks, and fund productive investments.

My life changed starting end of 2008. Fortunately for me, I didn't lose my job or my house. I still do research in finance, currently on the forces that shape corporate funding decisions and how they can lead to excessive use of debt and great inefficiencies. But I am no longer in the silo I occupied and I talk to many more people both in other academic fields and outside academia. I teach a course entitled, like this conference, Finance and Society, which draws from multiple fields, including finance, economics, accounting, law, and political science. Even psychology, philosophy and sociology can bring insights.

What changed my life was seeing bad research and false or misleading claims, including from academics, affecting policy. Innocent people, powerless and often ignorant of the issues, are harmed by bad policies.

I assumed that at least academics and policymakers would welcome engagement so we can get the policy right, but I was wrong. People don't want to engage when what you say challenges their viewpoint or actions. They may ignore and evade. I've witnessed not only blind spots, but what Margaret Heffernan writes about, willful blindness.

I had to step out of my silo and question my assumptions to understand better what is going on. I urge you to do the same. You can't understand Finance and Society from any one silo.

Governance problems, when someone has control over decisions while others are impacted but don't have enough control, are everywhere. If people can benefit at the expense of others, without facing any negative consequences, they often do just that. If people find it convenient to say false or misleading things (which they might even believe to be true) without being challenged, they often do that. If people can stay silent even if they know harm is done, they often do that, especially when staying silent pays and speaking up is personally inconvenient or worse.

These issues are not unique to finance. Pursuing profits in free markets may cause people to lie, pollute, or sell unsafe products. GM knowingly sold cars with faulty ignition switch. Tobacco companies knew but denied for decades that smoking is addictive and harmful. The makers of an unsafe portable crib that was recalled after killing 3 babies failed to actively alert parents to the safety problem, and in fact tried to prevent people from finding out that the crib was unsafe, which resulted in the death of my friends' 16 months old son in 1998 and at least 18 additional babies.[1]

So in our free markets, people might carelessly play with “other people's lives,” or “other people's babies” if they can get away with it. We get relatively safe air travel in part because crashed planes are on TV for all to see, and we relate to the harm, and because accountability can typically be established. Airlines, engineers or others can't spin that the plane crashed because of an unforeseen lightening, or that it was “a perfect storm.”

The financial system is not serving society well right now, certainly not as well as it can. It is a drag on the economy. Finance is fraught with governance problems. Free markets don't solve these problems. Effective laws and regulation are essential.

[1] Linda Ginzel and Boaz Keysar created Kids in Danger, an organization devoted to children's product safety. See http://www.kidsindanger.org/

The governance problems, however, go all the way to the politics. That's why today's first panel about “other people's money” went beyond the culture of financial firms into the political issues around regulations. Improving the regulations, and sometimes the law, as well as their enforcement, is our key to a better system.

We heard this morning from Fed chair Yellen that there is recognition of the issues and progress on improving regulation. The massively complex Dodd Frank Act was signed hurriedly into US law in July 2010. Almost five years later, the debate about the law is highly political. Some say that, even if it is imperfect, every part of the law must be protected at all costs. Others want to dismantle it altogether.

There are numbing details to all these regulations, here and elsewhere. You'll hear about Basel rules, macroprudential regulations, ring fencing, etc. A short summary of the regulatory reform effort is *an unfocused, complex mess*, both in design and in implementation. Some regulations end up as wasteful charades. They provide full employment and revolving opportunities for numerous lawyers, consultants, and regulators without producing enough benefits for society to justify the costs. Some of the complaints from the industry about these regulations have merit. In this category I put living wills, stress tests, risk weights, TLACs/cocos/bailinable debt (whatever the term for today), and liquidity coverage ratio. I am also concerned that, as implemented, central clearing of derivatives does not reduce, and may even increase, the concentration of dangerous risk. In all these contexts we see the *pretense of action*, the *illusion of “science,” a false sense of safety, over-optimistic assessments of progress*, and *counterproductive distortions*.

Lost in this mess are simpler, more straightforward regulations that would counter the incentives for recklessness and bring enormous benefits to society by making the system safer and healthier, reducing unnecessary, unproductive risk that is a key source of system fragility, and the many distortions. I don't think trying to reinstate Glass Steagall should be a top priority even if it may have some merit. Another bipartisan proposal by Senators Sherrod Brown and David Vitter offers more immediate “bang for the buck” and has a better chance, if implemented properly, of helping even on its own.

Among what's most wrong with the financial system and most essential (and possible) to correct is that, even with new rules so far, there is still *too* *much opacity and hidden risk and too much reliance on debt funding*. There is no justification for this situation. Yet, an enormous amount of nonsense has tricked policymakers into tolerating it.

After six years of discussing these issues with many and writing to explain, I am very disappointed to see that so much nonsense continues to be uttered and to impact the debate. It might take another harmful crisis, or more, to make progress. What we are tricked into tolerating, even subsidizing, is the equivalent of allowing trucks full of dangerous chemicals to drive at 120 mph in residential neighborhoods (and having trouble actually measuring actual speed), which burns lots of fuel, harms the engine and risks explosions. We rush to do whatever it takes to fix the trucks should they implode, since they deliver essential fuel. We may even give the drivers, safely ejected, jobs as policemen during repairs... Lower speed limits, we are told, will “harm growth” or send deliveries to a “shadow trucking system” around the corner that, for some reason, we can't send the cops to patrol.

Making the system more transparent and dramatically reducing the reliance on debt would be hugely beneficial. All claims against this approach are nonsense, spin and flawed excuses. Among the benefits, it will improve, stabilize and correct distortions in credit markets, and reduce the incidence and intensity of boom and bust cycles and costly crises that bring prolonged recessions. It will make the governance problem of financial institutions more contained and manageable, more similar to that of other corporations. Tying back to Signe's opening remarks, it will even help central banks “transmit” their policies to the rest of the economy. A sick financial system doesn't do the job, and thus harms recovery and growth.

There are many challenges in the details of the regulations, especially around measurements issues, but the challenges can be met. Frustratingly, regulators are spending enormous resources on all these more complicated and less cost effective efforts mentioned above, and neglect the best bargains in regulation. Indeed, another bonus of taking strong actions to reduce opacity and reliance on debt would be to make these other complex measures I mentioned, LCR, TLACs, living wills, etc. less relevant, less important, and less costly.

We also make life harder for ourselves by keeping counterproductive laws that create more of a conflict between what is good for those in financial firms and what is good for the rest of society. These include, as Senator Warren mentioned, a bad tax code that perversely encourages the use of debt and punishes equity funding for corporations (and sometimes for households too). And our bankruptcy code gives special, superior status to counterparties of certain financial contracts, perversely enabling and rewarding reckless practices that harm. These laws are not in the bible or the constitution. They can be changed.

Why all this nonsense and bad policy? First, harm from finance is abstract and spread out. Connecting the harm to individual wrongdoing or recklessness is hard to establish. Courts might work for fraud, but you can't take someone to court for designing bad regulations. Second, the jargon of finance is impenetrable, and those in and around the industry, and often the regulators too, want to make it all sound really complicated, which helps them dismiss and evade. Third, everyone, especially politicians, loves credit and wants to tell financial institutions where to put their money. Most people, especially most politicians, want to stay on good terms with the rich people who run financial institutions.

Finance is about money and power. Money and power can corrupt. So unlike in the airline business, in finance it is possible for the industry, regulators and politicians, to harm and endanger, to spin narratives and cover up the harm, and to be willfully blind, without any accountability. DoJ and SEC must do their job, but they can't deal with nonsense and capture.

So the biggest challenge in regulation is political. The details hardly matter if there is no political will. Unfortunately, most politicians put other objectives ahead of having a stable and healthy financial system. Ordinary people, meanwhile, may not be aware of what is going on or get confused by the spin. Not enough people understand why regulation is essential and what type of regulation makes sense.

What can be done? Here are some concrete ideas. First, increasing the pay of regulators may reduce revolving door incentives. Second, effective regulators might be industry veterans who are not inclined to go back. Third, we must try to reduce the role of money in politics.

Of course, there are some amazing people involved in the effort for financial reform, including politicians and regulators. These people have the political will, they do engage, they do remember what it's about. A number of these role models are on the program for this conference, and there are many more in the room and elsewhere. For example, with us today is Tom Hoenig from FDIC, who is one of my heroes and should be yours.

Unfortunately there are too few of them. We must thank these individuals. Goldman Sachs CEO was wrong when he said banking is “god's work.” Creating and enforcing good financial regulation is god's work. The forces on the other side are depressingly powerful and it would be tempting to get discouraged and give up.

Those of us who are not policymakers must also do what we can to help. We must engage, question our own assumptions (and not believe what every “expert” says), applaud progress, protest setbacks, challenge the narratives and expose the nonsense.

Badly regulated financial system and counterproductive laws do great harm to society. The spin allows them to persist.

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A report on the session and related links are available here

http://www.gsb.stanford.edu/insights/anat-admati-are-banks-safe-now

Brooksley Born’s comments available at

http://ineteconomics.org/conference-session/making-financial-regulation-work-a-conversation-with-anat-admati-and-brooksley-born

Full videos of the sessions are available at

https://www.youtube.com/playlist?list=PLmtuEaMvhDZZqxX0JtrF1R-LwOgqaaKlE