

# **What is Financial Regulation Trying to Achieve?**

## ***The Mainstream Answer and A Hayekian Critique***

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### **Introduction**

This article considers the objectives of legislators when regulating financial markets. According to regulators, financial legislation has both different and interrelated goals. In short, they are as follows: 1) remedy and, if possible, prevent so called 'market failures'; 2) manage systemic risk of contagion when 'too big to fail' financial institutions threaten to go down; 3) protect consumers and/or investors.

In the next Section, I will briefly describe each of these mainstream goals from an abstract point of view. Next, I will evaluate the policies enacted under them by analyzing the extent to which regulation actually remedies market failure, mitigates systemic risk, and protects investors. Then, drawing on the work of Friedrich Hayek, I will question the legitimacy and efficacy of legislative intervention in this regard. Lastly, I will argue that what financial regulation actually

achieves is counterproductive to achieving these three goals.

### **The three goals of financial regulation**

The first goal of financial regulation that I have identified, remedying market failure, is largely seen as the most important, and also seems the most straightforward. Free markets are commonly regarded as a threat to economic stability and public welfare. If allowed to operate unrestricted, market forces are claimed to create perverse incentives that ultimately lead to disasters in the financial sector that pose an even deeper threat to the wider economy. Regulation prevents these forces from acting and serves to reduce this inherent threat posed. From the uninformed commentator to the highly skilled expert, such thinking is widely shared. The recent crisis, it is commonly argued, stands as a perfect

example of the dangers posed by unregulated financial markets.

In other words, this argument is grounded on the premise that markets are neither perfect nor self-correcting. According to this rationale, market failures exist and when markets fail, some redress is needed. Indeed, the existence of market failure is widely recognized by mainstream economics<sup>1</sup>. In general, market failures are usually identified in phenomena such as: informational asymmetries, agency problems, transaction costs, public goods, negative externalities, and imperfect competition resulting from market power (monopoly, oligopoly, barriers to entry, etc.).

Concerning specifically financial markets, failures are usually identified in the inevitable informational asymmetry between investors and institutions. This gap in information alters the principal/agent relationship between the two parties and requires inhibitive costs in order for this distance to be bridged.<sup>2</sup> The high cost that malinvestment can have on healthy unrelated investments makes this informational gap even more disturbing, especially considering the domino effect that can occur when systemic risk is involved. Due to these factors, competition can never be perfect or even close to perfect, therefore incumbent financial institutions have a substantial market power that, according to the mainstream view, has to be limited by artificially boosting competition.

The second goal, mitigating systemic risk, is linked to the above consideration. The traditional argument holds that there exist certain institutions which are 'too big to fail.'<sup>3</sup> In other words, they play such an important role in financial markets that their collapse would seriously put the entire financial system at risk, even to the point of complete collapse. The effects of such a collapse would be devastating. Widespread savings would be dramatically lost,<sup>4</sup> likely causing panic, desperation, and potential riots. As such, according to the rationale, this risk must be mitigated by either preventing financial institutions from becoming 'too big to fail' or, if they already are, preventing them from actually going bankrupt.<sup>5</sup>

Determining the 'right' dimensions of financial undertakings, and at what point they become 'too big to fail,' is a difficult undertaking. However, policymakers do maintain that such a critical dimension exists, beyond which the representative parties affected include more than just the financial institution and its shareholders or lenders. At this point, instead of a simple private relationship, the general public interest is also seen to be at stake because of the exposed risk society shares with the welfare of the large financial institution. Regulation, it is argued, is thus warranted because society, as a more comprehensive stakeholder, must be able to have its own say.

Finally, the third goal, protect consumers and investors, is also connected to the former two. Here, it is important to distinguish between, on the one hand, consumers of financial services and products that can be more precisely defined as investors and, on the other hand, actual consumers of banking and financial services. The latter are typically people who deposit their money into banks.

Here, the concern is that investors, due to informational asymmetry, may make poor investment choices, therefore safeguards ought to be instituted in order to protect them from harming themselves. As for depositors, informational asymmetry may lead individuals to unknowingly deposit their life savings into an aggressively leveraged bank, thus putting their financial health at severe risk.<sup>6</sup> Of course, if the financial institution is 'too big to fail,' the possible consequences of its failure affect a significantly larger number of people than just its investors and consumers.

### **The three goals in practice**

I will now shortly consider how these goals are translated into actual policies. In other words, let us examine the tangible methods of financial regulation.

Regulators try to remedy the existence of market failures in several ways. For example, informational

asymmetries are tackled with disclosure and informational obligations. Negative externalities are averted using more heavy-handed regulation: capital adequacy requirements, accounting rules, duty for banks to invest in highly-rated securities, separation between investment banks and commercial banks, conflict of interest regulation, rules on banker's remuneration<sup>7</sup>, market integrity provisions, etc. Finally, the threat of market power is dealt with using competition law, on which I will not go into details here<sup>8</sup>.

More broadly, these measures are usually categorized under the two general labels of prudential standards and conduct of business standards, meaning that they aim to prevent market failures either by imposing precautionary restrictions, or by dictating specific rules of good conduct for running a financial business<sup>9</sup>.

Concerning the 'too big to fail' rationale, the existence of financial behemoths is generally used to justify the existence of central banks. Here, the line of reasoning is that since there are institutions that we simply cannot afford to let go down, it is essential for there to be some 'lender of last resort' that can safeguard these institutions when in trouble. Furthermore, an entity of this kind must be a state agency so that the public interest is adequately protected when avoiding a systemically dangerous collapse: the central bank will indeed lend to the financial

institution under stress all the money it needs to recover.

As for the goal of consumer protection, this aim is pursued in different ways. Indirectly, all the measures mentioned above can also be justified with the need to protect consumers, from disclosure obligations to conflict of interest rules, from capital requirements to market integrity standards, and so forth. Since market failures and bank failures severely harm consumers, all measures aimed at preventing such failures are also measures protecting consumers.

However, there is one specific measure that is directly aimed at safeguarding consumer interests: public deposit insurance. In other words, if financial regulation fails and guiltless depositors see their savings vanish, governments usually guarantee their deposits up to a certain limited amount.

### **A Hayekian critique of the three main goals**

So far, I have tried to summarize what appears to be the general consensus among regulators, experts, and laymen. I will now consider an alternative view of financial regulation in order to obtain a wider and more comprehensive understanding of the issue.

Friedrich von Hayek stands a prominent critic of financial regulation.

His writings offer clear insights on the legitimacy and desirability of regulation, in general, which I believe can be fruitfully applied to regulation in the specific field of financial markets.

First and foremost, Hayek views economic knowledge as fundamentally dispersed and incomplete. Therefore, no one individual possesses perfect knowledge or the ability to foresee the future. Considering the unavoidable complexity of the financial community and the wider economy, Hayek maintains it is impossible for any centralized body to comprehend this complexity to the extent necessary for widespread planning<sup>10</sup>.

Rather, the best mechanism for coordinating economic knowledge is the market mechanism itself—a continuous process of discovery in which innumerable fragments of tacit knowledge are pieced together by individuals, serving to spontaneously order and enhance everybody else's knowledge. This process is not perfect. In fact, it cannot be by its own assumptions. Since no one can possibly attain perfect knowledge, mistakes are bound to happen. Trial and error and the subsequent learning opportunities this provides for other agents allows the market, over time, to learn from mistakes and spontaneously adjust quicker and more efficiently than a central authority could ever coordinate or plan for.<sup>11</sup>

So how does all of this relate to financial regulation? Due to the

'knowledge problem,' regulators are simply neither able to collect nor understand the widely dispersed information needed to adequately oversee and control financial markets. In fact, when regulators do intervene, this often distorts market signals serving to create and worsen the very problems they are designed to fix. These problems are then used to justify additional regulation, and so on. But piling up new legislation on existing legislation only exacerbates its downsides (the current crisis is arguably a perfect example of the disasters created by distorted incentive induced by regulation). Therefore, we need to rely on something different: individual freedom and its oft-forgotten but necessary companion, individual responsibility.

I will now reassess the three goals of financial regulation in light of this critique. Hayek's position on market failures is complex and would require a self-standing analysis. Let it suffice here to say that, on principle, he does not exclude either their existence or significance. Markets are not perfect, yet they continuously evolve in order to correct their mistakes and to respond to new needs. This self-correcting mechanism, Hayek maintains, is far better suited to correct failures than any government action designed in this regard. Indeed, the ability for markets to assimilate near infinite amounts of ever-changing and dispersed information through individual interaction far surpasses the

competence of any risk analysis model used by legislators.

Also, an important caveat we can draw from Hayek's work is that it is always necessary to clearly attribute responsibilities, and distinguish what failures the market is to blame for and what failures the government bears responsibility for. Indeed, if we look deep enough, we will often find that what *prima facie* appears to be a market failure is, in fact, rooted in some distorted incentive created by state intervention.

This leads to the 'too big to fail' problem. Admitting that some institutions cannot be allowed to fail means that they will not have to bear the consequences of their actions, regardless of the multitude or size of the risks they take. This allows the said institutions to skirt their obligation of responsibility. When banks know that the government will bail them out if in trouble, they are incentivized to take excessive risks. This is the most typical example of moral hazard highlighted within much commentary on the recent crisis. By regulating under the justification of preventing the collapse of 'too big to fail' banks, policymakers give these institutions implicit license to leverage their assets beyond what they would ever normally consider. Not only this, it incentivizes them to do so because of the distinct opportunity for high value short-term gain within financial transactions.

Finally, moving to the issue of consumer protection, deposit

guarantee is another typical example of government-created moral hazard that encourages depositors to seek high interest rates that are very often associated with higher risks. Such perverse incentives only serve to bolster the risky practices of the banks they do business with by creating a higher demand for risky financial instruments.

### **Conclusion: what is financial regulation trying to achieve?**

To conclude, I have identified the most commonly accepted rationales for financial regulation and offered a Hayekian critique of each. If we accept Hayek's premise that knowledge is fundamentally dispersed and imperfectly held by individually subjective perspectives, we must consider the implications this has for the feasibility and desirability of financial regulation. That is to say we can no longer trust a centralized body to appropriately model the specific

requirements necessary for optimal financial growth, and instead we need to allow the responsibility bearing threat of a free market system to incentivize financial institutions to self-regulate their actions.

If we decide to follow Hayek till the end, then, the answer to the question of what financial regulation is trying to achieve becomes very different than the three goals I originally provided: remedying market failures, dealing with 'too big to fail' institutions, and protecting consumers/investors. In short, a Hayekian response would point out that, in most instances, financial regulation, while admittedly *trying* to achieve these three goals, in reality turns out to achieve very different outcomes: exacerbate failures that markets already correct for, safeguard institutions that should not be safeguarded (if we do away with government-induced moral hazard), and perversely incentivize consumers and investors alike.

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## **Notes**

<sup>1</sup>This topic is covered by an occasional paper of the UK Financial Services Authority, that also deals with some of the other rationales (Llewellyn 1999).

<sup>2</sup> It should be noted that this information can also be regarded as a public good and something which the government is obligated to provide.

<sup>3</sup>The topic of 'too big to fail' financial institutions has become a favorite in the recent crisis: see, among other, Stem and Feldman [2004] 2009.

<sup>4</sup>From this point of view, this second objective can be looked at as a form of negative externality, because bankruptcy of an x-institution seriously affects the value of unrelated assets, whose owners have no defense against the negative 'systemic' effects of the x-institution's collapse.

<sup>5</sup> This rationale was critically analyzed, with specific reference to banks, by Hoggarth Jackson Erlend 2005.

<sup>6</sup> On this issue, see Benston 2000.

<sup>7</sup> This covers the very hot topic during the recent crisis of bankers' bonuses.

<sup>8</sup> Paragraph 13 of Llewellyn 1999, *supra* note 1, addresses specifically the subject of *Regulation and Competition*.

<sup>9</sup> See Chapter 1 (*The rationale for regulation*) of Goodhart Hartmann Llewellyn Rojas-Suárez Weisbrod 1998.

<sup>10</sup> See especially Hayek 1937 and Hayek 1945.

<sup>11</sup> This idea is expressed for example in Hayek 1948.



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