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STILLING THE PENDULUM: REGULATORY, SUPERVISORY, AND STRUCTURAL APPROACHES

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Financial regulation is often described as a swinging pendulum.¹ A crisis occurs, and some number of years are spent crafting reforms to prevent another crisis from striking. Unfortunately, all too aware of the enormous costs of the recent disruption,² policymakers go too far,

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1. See, e.g., Edward D. Herlihy & Richard K. Kim, *It's Time for the Pendulum to Swing Back*, HARV. LAW SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 17, 2017), <https://corpgov.law.harvard.edu/2017/02/17/its-time-for-the-pendulum-to-swing-back/> [<https://perma.cc/9MCD-KGBB>]; Lawrence Summers, *The Pendulum Swings Towards Regulation*, FIN. TIMES (Oct. 26, 2008), <https://www.ft.com/content/d775399a-a38e-11dd-942c-000077b07658> [<https://perma.cc/EKD5-5XQZ>].

2. Financial crises are among the most damaging macroeconomic shocks, triggering nearly all of the most severe recessions in American history. Economists estimate that the 2008 meltdown, for example, wiped out between \$6 and \$14 trillion in economic output. Tyler Atkinson et al., *How Bad Was It? The Costs and Consequences of the 2007–09 Financial Crisis*, 20 FED. RES. BANK OF DALLAS STAFF PAPERS 1, 2 (2013) (estimates in 2012 dollars). To put this in perspective, the inflation-adjusted profits of the banking industry from 1934 to 2008 sum to less than \$2.5 trillion. In other words, even if the industry forfeited everything it netted since the Great Depression, it could not afford to make the public whole for the recent meltdown. See FDIC, *Commercial Banks - Historical Statistics on Banking*, <https://www5.fdic.gov/hsob/HSOBRpt.asp> [<https://perma.cc/PS6C-PYVW>] (last visited Aug. 7, 2017) (inflation adjusted using 2012 dollars and the GDP deflator).

stifling salutary financial activity and slowing economic growth. As memories fade, policymakers become increasingly focused on the costs of regulation. Stability is taken for granted, and restrictions are loosened. Markets stay stable and retrenchment continues. Regrettably, however, policymakers err again, and to our collective shock and horror, another crisis hits and the cycle repeats.

If this model were accurate, we should all stop trying to reform the financial system and devote ourselves to minimizing the harms of the intermittent calamities.³ But it's not.⁴ Panics are not inevitable market phenomena.⁵ They are man-made, a by-product of the multi-faceted legal regime enabling complex financial activity to occur over time. This regime includes laws governing property, contracts, and incorporation, as well as laws conferring upon certain entities the right to issue deposits, laws restricting the activities of these entities (banks), and laws providing assurances to others that the government will stand behind them (e.g., as the lender of last resort).

When this regime is designed well, panics are sparse or nonexistent. For example, Canada has never had a banking panic, despite its extensive economic and financial ties to the United States, which has had many. New Zealand, Australia, Singapore, and Hong Kong enjoyed financial stability throughout the 2008 crisis, the Asian Financial Crisis, and the market turmoil of the 1980s.⁶ Even the United States experienced financial stability at one point in its history: for fifty years following the Great Depression, a stretch known as the Quiet Period.

To the extent that the pendulum theory fits the data, then (e.g., in the case of the United States, between 1809 and 1933 and between 1985 and 2008), it is likely because the various post-crisis legal adjustments made during those years either (a) failed to correct the underlying problems responsible for financial crises or (b) were politically unstable.

3. See, e.g., HAL S. SCOTT, *CONNECTEDNESS AND CONTAGION: PROTECTING THE FINANCIAL SYSTEM FROM PANICS* (2016).

4. See generally CHARLES W. CALOMIRIS & STEPHEN H. HABER, *FRAGILE BY DESIGN: THE POLITICAL ORIGINS OF BANKING CRISES AND SCARCE CREDIT* (2014); MORGAN RICKS, *THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION* (2016).

5. The pendulum metaphor suggests that panics are an inevitable feature of market economies. The logic parallels that of business-cycle theories associated with the Austrian School and Ludwig von Mises, which portray downturns and panics as unavoidable "liquidations" that come after the "excesses" that accompany periods of significant economic growth. As Lionel Robbins explained this line of thought: "To prevent the depression the only effective method is to prevent the boom." RICKS, *supra* note 4, at 123–30; LIONEL ROBBINS, *THE GREAT DEPRESSION* (1935).

6. See CALOMIRIS & HABER, *supra* note 4, at 454–55. Note that these countries all have highly efficient banking sectors that provide plentiful credit to their economies.

As we reflect on the significant ways in which our legal regime has changed over the last eight years,⁷ we should ask ourselves whether, and to what extent, the recent adjustments are similarly flawed. In other words, how vulnerable is financial reform to pendulumitis? To answer this question, I suggest we differentiate between three types of approaches to fostering financial stability, each of which may vary in durability: (1) regulatory approaches, which rely on agency lawmaking (whether through informal guidance or notice-and-comment rule writing);⁸ (2) supervisory approaches, which allow administrative agencies to exercise discretionary authority;⁹ and (3) structural approaches, which define the overall shape of an industry typically through legislation.¹⁰

For several decades, policymakers have viewed structural approaches as second- or third-best solutions, largely due to the initial market disruptions that accompany them and the attendant private (and public) costs of retaining them. In the 1990s, officials like Alan Greenspan at the Federal Reserve oversaw a shift away from relatively crude laws limiting competition and conglomeration, arguing that breaking down these barriers would enhance financial system resiliency.¹¹ In their place, Greenspan and others developed narrowly tailored regulatory rules and more limited supervisory programs, which they thought would ensure sufficient shareholder skin in the game while minimizing the spillover costs and unintended consequences of government “intervention.”¹² Market participants, these policymakers believed, would reward well-capitalized banks with higher P/E multiples and bankers would police their own risk taking using

7. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010); BASEL COMM. ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS (2011).

8. *See, e.g.*, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018 (Oct. 11, 2013) (codified at 12 C.F.R. §§ 3, 5, 6, 165, 167, 208, 217, and 225).

9. *See, e.g.*, 12 U.S.C. § 1818 (2012) (empowering supervisors to address “unsafe or unsound” banking practices).

10. *See, e.g., id.* § 1843 (“Interests in nonbanking organizations”).

11. *See, e.g.*, Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Banking in the 21st Century, Remarks Before the 27th Annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago (May 2, 1991) (transcript available at <https://www.scribd.com/document/189525108/Greenspan-19910502> [<https://perma.cc/ENU7-C5UK>]).

12. Greenspan fought to prevent derivatives regulation, for example, believing that the Basel rules were sufficient to solidify the banking system.

innovative value-at-risk models.¹³ They were wrong: unregulated derivative markets spread risk throughout the system, substantial gaps in the rules allowed excessive leverage to build up at the biggest banks, and underregulated investment banks and other shadow banks issued trillions of dollars in deposit-like instruments, which prompted a system-wide run in 2008.

Though the post-crisis legal regime takes much better account of the significant public costs of financial system failure, it continues to rely predominantly on regulatory and supervisory approaches.¹⁴ As Federal Reserve Board Governor Dan Tarullo put it recently, the system's new rules are so numerous as to leave banks and supervisors "overwhelmed"—which is, "in effect, the price of the largest banks not being subject to a direct structural solution"¹⁵ On the whole, the new rules target a proximate cause of panics—excessive risk taking by financial firms—and attempt to constrain it. But this approach to crisis prevention is highly susceptible to swings over time. Consider four reasons why:

1. Regulatory Arbitrage: Regulatory and supervisory approaches (generally) do not change the underlying incentives that make risk taking highly profitable, forcing regulators into a challenging game of cat and mouse with market participants who seek to avoid new constraints.¹⁶
2. Industry Pressure: Though the political branches support stricter regulation and supervision following a crisis, regulatory and supervisory measures do not (on their own) alter the underlying political economy of financial law, which pits a diffuse, heterogeneous majority against a concentrated, motivated minority—a classic

13. Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Bank Supervision, Regulation, and Risk, Remarks Before the Annual Convention of the American Bankers Association (Oct. 5, 1996) (transcript available at <https://www.federalreserve.gov/boarddocs/speeches/1996/19961005.htm> [<https://perma.cc/6DEC-YGEK>]).

14. Dodd-Frank required agencies to promulgate 390 new rules. See, e.g., *Dodd-Frank Progress Report*, DAVIS POLK (July 19, 2016), <https://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/> [<https://perma.cc/4T69-EMN3>].

15. Daniel K. Tarullo, Departing Thoughts, Speech at the Woodrow Wilson School, Princeton University (Apr. 4, 2017) (transcript available at <https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm> [<https://perma.cc/CKG7-NVN9>]).

16. See Tom Braithwaite, *Banks Turn to Financial Alchemy in Search for Capital*, FIN. TIMES (Oct. 24, 2011), <https://www.ft.com/content/50a674b8-fe41-11e0-a1eb-00144feabdc0> [<https://perma.cc/B2JP-WNG9>] (quoting the CEO of JPMorgan Chase saying he would "manage the hell out of [risk-weighted assets]" to meet higher capital requirements).

problem in public choice theory.¹⁷ As a result, agencies are generally subject to considerable industry pressure to ease supervision, enforcement, and regulatory restrictions on risk taking.

3. Bias Toward Inaction: Whereas repealing legislation requires coordinated action by the President, the Senate, and the House of Representatives, regulation and supervision atrophy through inaction alone. Rules must be enforced and updated to prevent arbitrage and obsolescence.¹⁸
4. Opposition to Technocratic Government: Regulation and supervision alienate certain political constituencies that tend to oppose technocratic government (the current administration, for example, seems highly skeptical of independent agencies and of regulatory complexity).¹⁹ Thus, groups that might otherwise share the objectives of regulators or supervisors may resist their approach.

Sustaining a strict regulatory/supervisory regime, therefore, requires constant vigilance, and for these reasons, vigilance may recede over time.

If it does, policymakers should consider other solutions. In particular, these should be reforms that are (a) relatively easy to enforce, (b) less susceptible to arbitrage, (c) minimally costly, and (d) more politically durable. Perhaps the most widely discussed structural

17. See Jonathan Macey, *The Political Science of Regulating Bank Risk*, 49 OHIO ST. L.J. 1277 (1989); Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983).

18. In his 1795 report to Congress, Alexander Hamilton wrote:

To *undo*, which is to *act*, and in such a case to *act with violence*, requires more enterprise and vigor, and presupposes greater energy, or a stronger impulse, than *not to do* It often happens, that a majority of [votes] could not be had . . . to undo or reverse a thing once done, which there would not be a majority of [votes] to do. This reasoning acquires tenfold force when applied to a complex government like ours . . . which must concur to give it motion; as, in our constitution, the House of Representatives, the Senate, and the President.

ALEXANDER HAMILTON, REPORTS OF THE SECRETARY OF THE TREASURY OF THE UNITED STATES 179 (1828). Of course, enforcement and effective supervision require precisely the sort of action Hamilton argues is hard to foster: “Many men, merely from easiness of temper or want of active fortitude, will suffer evil to take place which they neither desire nor would themselves commit.” *Id.*

19. See, e.g., Reducing Regulation and Controlling Regulatory Costs, Exec. Order No. 13,771 (Jan. 30, 2017) (requiring covered agencies to identify two existing regulations to repeal for each proposed regulation); Bourree Lam, *Trump’s Promises to Corporate Leaders: Lower Taxes and Fewer Regulations*, THE ATLANTIC (Jan. 23, 2017), <https://www.theatlantic.com/business/archive/2017/01/trump-corporate-tax-cut/514148/> [<https://perma.cc/WSK9-6HAA>] (quoting President Trump: “I think we can cut regulation by 75 percent, maybe more”).

reform is twenty-first century Glass-Steagall. Increasing evidence, however, suggests that crises are caused not by risk taking per se, but by runs on short-term debt liabilities. Separating commercial and investment banks would not, on its own, address the significant threats to financial stability posed by nonbanks issuing money-like claims in the wholesale funding market. In fact, it could make those problems worse. Therefore, other proposals—to rearchitect monetary system design, prohibit unauthorized banking, expand shareholder liability, impose broader portfolio constraints, or correct management incentives—should also be considered.²⁰ Further study is needed to assess these various options, examine the lessons learned from other countries, and design reforms that will still the pendulum and durably align the activities of banks with the interests of the public.

20. See, e.g., CLAIRE A. HILL & RICHARD W. PAINTER, BETTER BANKERS, BETTER BANKS: PROMOTING GOOD BUSINESS THROUGH CONTRACTUAL COMMITMENT (2015); RICKS, *supra* note 4; Jonathan Macey, *Regulating What We Don't Understand: Bureaucratic Incentives and the Law of Systemic Risk* (2016) (working paper) (arguing for multiple-liability shareholding at large banks).