

MARKET DISCIPLINE BEATS REGULATORY DISCIPLINE

John A. Allison

I am going to talk from a different perspective because I am the only person who actually ran a bank that's been speaking today, and from that context I can tell you with absolute certainty that market discipline beats regulatory discipline. In fact, I will argue that regulatory discipline will always fail to reduce volatility and will slow economic growth. These observations are based on my understanding of public choice theory and particularly on 40 years of concrete experience in the banking business.

One observation in my 40-year career at BB&T: I don't know a single time when federal regulators—primarily the FDIC—actually identified a significant bank failure in advance. Regulators are always the last ones to the party after everybody in the market (the other bankers) know something is going on. Thus, in that context, regulators have a 100 percent failure rate. Indeed, in my experience, whenever they get involved with a bank that is struggling, they always make it worse—because they don't know how to run a bank.

An interesting reflection from public choice theory, reinforced consistently throughout my career, is that regulators regulate for the “regulatory good.” They like to talk about the “public good,” and sometimes the public good and the regulatory good may align. But they don't manage for the public good; they consistently manage for the regulatory good.

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John A. Allison is President and CEO of the Cato Institute. He was formerly Chairman and CEO of BB&T. This article is drawn from his remarks at the Cato Institute's 31st Annual Monetary Conference, November 14, 2013.

Managing for the Regulatory Good

In good times, regulators basically don't regulate banks for safety and soundness. If things are going smoothly in the economy, bank examiners might see something that bothers them in a bank. But if they start raising red flags, bankers have plenty of political contacts and the examiners are going to have a career advancement problem. They can't prove their point because they are guessing what's going to happen in more difficult times. Hence, regulators basically do not regulate from a safety and soundness perspective during good times.

For example, BB&T took over a failed \$25 billion bank (Colonial) with FDIC assistance. Earlier, we consciously decided not to acquire Colonial without FDIC assistance because *we knew it was going to fail*. How did we know? First, it was acquiring bad banks. If you make many acquisitions of bad banks, you end up with a bad bank. Second, in competing with Colonial, we observed they would take "hog shares of high-risk credits" that we wouldn't touch. Third, the CEO was a command-and-control type who could have run a \$2 billion bank but couldn't possibly develop the talent to run a large bank. So BB&T would not acquire Colonial without FDIC assistance. We knew the bank was insolvent. We saw that from the outside. But the regulators missed it, despite having much more inside information.

In addition, regulators are politically driven. Those at the top of the regulatory organizations are political appointees. You don't get to be head of the FDIC without having some political contacts. You don't get to be head of the Federal Reserve without having political contacts. Hence, you have people who come from a political perspective, and regulations change a lot depending on who is at the top. Regulators are driven by what's happening in the current political environment; there is no rule of law.

Regulations under Clinton, Bush, and Obama

President Bill Clinton's big issue was "fair lending." The regulators paid almost no attention to safety and soundness, which worked because the economy was doing well.

Under President George W. Bush, the focus was almost exclusively on the Patriot Act. One of the great myths is that banks were

deregulated under Bush. Yet, three major new laws were passed under his administration: the Privacy Act, Sarbanes-Oxley, and the Patriot Act. There was a massive increase in regulations in the Bush era—the most until the current administration. Banks were not deregulated as the myth goes, they were misregulated. In fact, one of the great myths is that the cause of the 2008–09 financial crisis was a combination of banking deregulation and greed on Wall Street.

There has always been plenty of greed on Wall Street. However, there is not one shred of evidence there was any more greed than usual leading up to the financial crisis. In fact, the financial crisis was caused by a combination of mistakes made by the Federal Reserve and government housing policy. In the early 2000s, we had a housing bubble that had started in 1993. Based on personal income, which determines the ability of a borrower to repay a loan, housing prices were 10 to 15 percent too high in the early 2000s. As the housing market was getting ready for a minor correction, Alan Greenspan engineered negative real interest rates, further inflating the housing bubble, and we ended up with a 30–35 percent correction in the housing market. Of course, the excesses were strongly aided by Freddie Mac and Fannie Mae. Plenty of banks made major mistakes and should have been allowed to fail. However, those mistakes were highly incentivized by government policy. So the recent financial crisis wasn't caused by deregulation or greed, it was caused by bad government policy.

Under President Obama, we have a truly unique phenomenon: an administration that likes *all* regulations. The problem is you can't comply with every regulation because there are just too many. Indeed, the Privacy Act and the Patriot Act are in conflict with each other, which gives regulators a lot of leverage.

The Curse of Overregulation

In addition to regulators being too good in the good times, they are too bad in the bad times. Regulators are blamed for the problems, and therefore grossly overreact. Often the regulatory agencies “retire” their senior people during the good times to cut costs and hire inexperienced young staffers as a crisis unfolds. These people have never made or collected a loan, and have never been in the banking business, but all at once they are experts on banking.

We saw this in spades during the Great Recession. In fact, the recession was much deeper because of the excessive, overregulatory reactions in the lending business. This was a really bizarre phenomenon.

The administration would not let banks foreclose on homeowners, even though they were two years past due on their home mortgage. Yet the administration viewed residential builders as bad people, because they are in business. So the banking regulators unnecessarily put about 90 percent of local residential builders in growth markets out of business. Many of these people had been in business for years. Some of them should have failed, but a lot of them did not need to fail. They were driven out of business by regulators who had no expertise in what they were doing and were just taking signals from the top. BB&T went through the economic corrections of the early 1980s and early 1990s when there was the same type of regulatory overreaction, but the recent overreaction was far more severe.

In the Great Recession, regulators experienced their biggest failure because they spurred an unnecessary panic. The United States needed an economic correction, but not a panic. Much of the damage to the economy came from the Panic of 2008, not from the economic correction. Regulators created a panic because they suspended the rule of law. There was no predictability, no policy, and no plan. During the corrections of the early 1980s and '90s, for all the foibles, at least banks knew what the rules of the game were. This time, there were no rules of the game. Regulators saved Bear Stearns, which everyone in the market knew could not possibly be a systemic risk. After regulators saved Bear Stearns, the market assumed they would save all large firms. But then they let Lehman fail. The regulators let Wachovia fail and tried to sell it to Citigroup, which everyone in the market knew was weaker than Wachovia. In late September 2008, regulators paid the uninsured depositors of Washington Mutual in full, which had not been done in the past. The Washington Mutual bondholders suffered far greater losses than anticipated due to this decision, which then caused the capital markets for banks to collapse.

When the rule of law fails, panic sets in, and that's exactly what happened. Unlike free markets, in which individuals are responsible and have an incentive to correct mistakes, panics almost

always involve some kind of government interference in the adjustment process.

The Failure of Mathematical Modeling

On a related point, there has been a massive failure of mathematical modeling (see Dowd et al. 2011, Dowd and Hutchinson 2013). The Fed's models failed, and all the large financial institutions that failed were experts at mathematical models. We were told by regulators multiple times that BB&T ought to have models like Wachovia, Citigroup, and Bank of America, all of which had major problems during the correction. Mathematical modeling was forced on the banks and then the banks lulled themselves to sleep believing their models were properly assessing risk, which justified taking excessive risk. What is really ironic is that the Federal Reserve is now forcing all large financial institutions to manage by mathematical models, which will ultimately create significant risk in the financial system. Modeling can be used as a background tool for managing risk, but overreliance on models leads to dangerous decisions.

One of the major problems is that mathematical risk models always assume normal distributions, which have small tails—because if they had “fat” tails no one would pay any attention to the models. Of course, what happens is the tails (the unexpected, extraordinary events) are always bigger than predicted by a normal distribution, and tails are the only events that matter. However, the biggest issue is that mathematical models delude managers into believing they are managing risk and they become overconfident. This overconfidence creates a massive incentive to take too much risk because your models indicate you can manage the risk. Of course, in the long term, if managers take on too much risk, they eventually will pay the price.

The Fed now is forcing all large financial institutions to use the same mathematical models, which means all banks are going to make the same mistakes. This same type of approach led to excessive risk taking in the subprime lending business. The concentration of risk created by regulatory mathematical modeling significantly increases the overall financial system's risk.

Another example of the danger of regulation in modeling relates to use of mathematical modeling for small-business loan decisions. Small-business lending is part art and part science. The practical

effect of mathematical modeling in the case of small-business lending is that small-business creation is at an all-time low. It is not that existing small businesses can't get loans. Rather, it is that the entrepreneurs who come in with venture capital ideas—some of which may be very successful based on the judgment of the loan officer—may not meet the lending standards under mathematical modeling. In my banking career, I made a lot of loans to small businesses, some of which were extraordinarily successful and created thousands of jobs. Today, if I were a small-business lender, I couldn't make those loans because they would not meet the mathematical standards forced on bankers by regulators. These models cannot grasp the importance of an innovative idea or the commitment of an entrepreneur to get the job done. Practically speaking, small-business lending standards are the tightest in many years.

Unintended Consequences of Regulation

Under the new consumer compliance provision of Dodd-Frank, the so-called qualified lending standards are very loose. In fact, the standards are below subprime, which makes the progressives happy. However, the paperwork is extraordinarily complex. Indeed, if the banks make a mistake on the paperwork, the borrower does not have to pay the loan and the bank is fined. Consequently, banks are no longer going to make consumer real estate loans in their branches, which will make it more costly and more difficult for even qualified borrowers to get loans.

Another unintended consequence of overregulation is the negative impact of Dodd-Frank on economic growth. Regulators cannot know what risks banks ought to take. Regulators don't have special insights; only markets can discipline banks to make rational lending decisions. Banks need to experiment with different risk parameters and let markets guide them. Forcing everybody to take the same risks and adopt the same standards radically reduces economic growth. I would argue Dodd-Frank and its implementation by the Federal Reserve have had a bigger negative impact on economic growth than Obamacare.

It is ironic to have the Fed printing money willy-nilly and then have regulators making it hard for banks to make loans to small businesses, which are the engine of job creation in the United States.

The Free-Market Solution

What is the solution? My solution is pretty radical and is outlined in my recent book (Allison 2012). First, I would get rid of government deposit insurance. Bert Ely (1994) has developed a concept that would work for the privatization of deposit insurance for small depositors, which is the proper role for deposit insurance. Second, I would get rid of the Federal Reserve because the volatility in the economy is primarily caused by the Fed. Sound money matters. When the Fed is radically changing the money supply, distorting interest rates, and overregulating the financial sector, it makes rational economic calculation difficult. Markets do form bubbles, but the Fed makes them worse.

We need a private, free-banking system based on a market standard such as gold. If the United States had continued with the classical gold standard instead of having instituted a government money monopoly in 1913, we would have learned through experimentation, as all markets do, and would have a radically better financial system and higher economic growth today.

In the absence of ending the Fed, the United States should raise capital standards for banks to 15 to 20 percent of assets. Prior to the Fed, banks maintained a 20 percent capital ratio. In the recent crisis, banks with strong capital positions practically never failed. We should raise capital standards, but it is even more important to eliminate burdensome regulations—including Dodd-Frank, the Community Reinvestment Act, and Truth in Lending. About 25 percent of a bank's personnel cost relates to regulations. Banks cannot pay the regulatory costs and have high capital standards. That's why Dodd-Frank cannot work. Regulators want banks to raise their capital standards while simultaneously complying with a vast array of costly new regulations. Ironically, this is killing community banks. Bureaucrats are forcing consolidation in the banking industry—because even though in theory small banks are immune to many regulations, in practice regulators are not going to let a small bank do what big banks cannot do.

I would raise capital standards and let markets discipline banks. Those reforms—not more regulation—would reduce volatility, incentivize rational risk-taking, and thereby create better economic growth. Free markets work; why wouldn't they work in the banking business?

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