The Daily Dish

No Financial Crisis = No Financial Regulation Reform?

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Yesterday NATO announced that U.S. allies will increase their defense spending this year by $12 billion. NATO Secretary General Jens Stoltenberg said the 4.3 percent increase in defense spending for 2017 will be raised by Europe's NATO allies and Canada. In 2016 the United States, Estonia, Poland, Greece, and Britain were the only NATO members who met NATO defense spending goals.

Yesterday the American Action Forum released a new analysis examining the deregulatory efforts of both President Trump and President Obama. AAF analysis finds that while there has been a spotlight on President Trump's deregulatory push, President Obama also made strides in deregulation. However, the historic amount of new regulations from the Obama Administration wiped out any deregulatory cost savings his administration had made.

Eakinomics: No Financial Crisis = No Financial Regulation Reform?

Reuters reports that Federal Reserve Chair Janet Yellen does not foresee another financial crisis as long as she lives, but not forever: "Would I say there will never, ever be another financial crisis?" Yellen said at a question-and-answer event in London. "You know probably that would be going too far but I do think we're much safer and I hope that it will not be in our lifetimes and I don't believe it will be," she said.

The catch, however, is that she believes it would "'not be a good thing' if reforms of the financial services industry since the crisis were unwound, and urged those who had helped manage the fallout at the time to be vocal in preventing such a dilution." Put bluntly, this sounds like Yellen believes touching Dodd-Frank means that you are engendering a financial crisis. That is just silly.

The Volcker Rule — precluding the use of taxpayer-insured funds for proprietary trading — is widely agreed to be one of the most costly and unworkable aspects of Dodd-Frank. At a minimum, reforms should be made to make Volcker compliance less burdensome. But upon reflection, why do we have a Volcker Rule to begin with? In what way did proprietary trading cause the financial crisis? In our extensive analysis of the financial crisis, fellow Commissioners Bill Thomas, Keith Hennessey and I identified 10 contributing factors. Proprietary trading is not among them. The Volcker Rule is a costly, burdensome unworkable response to a non-problem.

So, too, are most of the reforms to derivatives trading. Did interest rate futures, interest rate swaps, commodity futures, exchange rate hedges and the myriad other derivatives cause the crisis? No. One and only one derivative was featured in the crisis: credit default swaps issued by AIG. The problem in this instance was not the derivative itself, it was the shoddy internal risk management by AIG that ultimately got the company in (deep) trouble. Tweaking derivatives regulation is not rolling back any significant prevention of a future crisis.

Indeed, a broader point is that Dodd-Frank is essentially a banking regulation law, with some implications for other aspects of financial services. For purposes of argument, suppose that it works perfectly and banking risks are dramatically reduced. Does that mean that overall risk is lower? Not necessarily, as the underlying economic risks still exist, and their fallout likely has been shifted to some other aspect of the financial system. Policymakers will likely identify and understand that risk when it manifests itself — in the worst case during a future crisis.

The exception to this observation is that Dodd-Frank created a systemic risk regulator — the Financial Stability Oversight Council (FSOC) — that, in principle, is supposed to regulate the overall risk in the financial sector. Unfortunately, it has no definition of systemic risk, no metric to tell whether systemic risk has gone up or down, and, as a result, no real way to fulfill its mission. But, true to the history of government agencies, once the regulatory hammer has been forged, it will find a nail to pound somehow. The FSOC has dealt blows to large banks and insurers, and should be relegated to the waste bin of history before its mission further metastasizes and its harms multiply.

I certainly hope that there is no financial crisis in the foreseeable future. But I hope just as much that policymakers understand that this need not come at the price of avoiding much-needed reforms to our financial regulatory regime.