PREPARED STATEMENT OF PAUL G. MAHONEY

Chairman Duffy, Vice Chairman Fitzpatrick, Ranking Member Green, and members of the committee, I appreciate the opportunity to speak with you about the connection between financial crises and regulatory reforms, a topic I on which I have written at length.

Effective and cost-efficient regulation is essential to the health of financial markets. Unfortunately, the way in which major financial reforms are prepared and enacted works strongly against effective and efficient regulation. Instead, it tends to produce excessively costly regulation that curtails competition and thereby harms investors. While my academic focus is on securities regulation, the same lessons can be applied to the broader financial reforms contained in the Dodd-Frank Act.

Major securities reforms always follow a stock market crash, which accounts for their counterproductive features. Elected officials and regulators are highly motivated to avoid blame for financial downturns that occur on their watch. The easiest way to do so is to claim that the crash was caused by the misbehavior of market participants and that more regulation will solve the problem. Incumbent officials will strongly resist the alternative argument that prior regulations had unintended and adverse consequences, which would put them in line for criticism.

The strategy is effective in part because of the statistical phenomenon of mean reversion, which tells us that because extreme events are rare, one extreme event is not likely to be followed by another. Thus new regulations adopted after a stock market crash will typically not be followed by another stock market crash and therefore will always appear to make things better no matter what their content. This creates a built-in bias toward over-regulation.

The tendency for regulatory proponents to describe the problem as a simple, binary question of “less” or “more” regulation also creates a built-in bias toward regulation that benefits leading firms in the regulated industry at the expense of the public. In the wake of a stock market decline, proponents of new regulation use phrases like “get tough,” “crack down,” and “hold accountable” that make it sound like regulation is a form of punishment for broker-dealers, banks, or other relevant industries. If so, the only question is how much punishment (in the form of regulation) to apply. But of course this is not accurate; regulation is a set of rules of the road that encourage some business practices and make others illegal or more costly.

Counterintuitively, speaking of regulation as a form of punishment makes it easier for the industry to get what it wants. Regulated firms can publicly hang their heads in shame and "accept" the new regulations while working behind the scenes to shape the rules to make them more costly to new entrants and less politically-connected firms. Under the guise of "best practices," leading firms seek to enshrine their own practices in law at the expense of their competitors. The largest and best-connected firms systematically win.

The Dodd-Frank Act fits this description. It followed a stock market crash that was connected to a broader financial crisis. There are reasonably strong arguments to be made that bad policy contributed to the financial crisis. From 2002 to 2006, monetary policy was looser than a simple Taylor rule would have recommended. Federal housing policies encouraged mortgage lending to borrowers with limited ability to repay in the event of an economic slowdown. And the tendency for the government to step in and protect certain creditors of large insolvent financial institutions from loss under the guise of avoiding systemic effects created enormous moral hazard.

To emphasize the last point, the phenomenon of government-assisted resolution of large and interconnected financial firms that are "too big to fail" seems likely to have contributed to the build-up of risk within the largest financial institutions prior to the subprime crisis. Proponents of the deregulatory theory of the financial crisis point to the fact that banks and other financial institutions grossly underestimated their potential losses from falling house prices because they believed the losses would be uncorrelated across geographical areas and types of borrowers, whereas the phenomena of securitization and credit default swaps helped create highly correlated losses. In short, the financial system created risk rather than mitigating it.

The counterargument is that this buildup of risk was a rational reaction to the "too big to fail" phenomenon. The implicit government guarantee creates a strong incentive for risk to become concentrated in too big to fail institutions. The problem is not just, as many commentators note, that it creates an incentive for big banks to get bigger. It also creates an incentive for the big banks to take risks off the hands of institutions that are not too big to fail.

Shareholders and managers may be willing to take large risks in pursuit of large returns. But short-term creditors and counterparties constrain risk-taking in a well-functioning market. Short-term creditors are typically not obligated to continue funding the debtor after their current loans mature and can refuse to roll over these loans if they believe the debtor has taken on too much risk. Similarly, depending on the contractual terms, counterparties may be able to demand collateral if the debtor's risk profile changes. But these constraints work imperfectly, if at all, with too big to fail banks because short-term creditors and counterparties assume that in the event of failure the bank will be acquired or recapitalized in a way that protects their interests. The typical government-assisted resolution of large financial institutions, which often occurs through a purchase and assumption transaction, protects short-term creditors and counterparties against loss or delay in accessing funds. Once a financial institution appears too big to fail, therefore, there is no need for short-term creditors to monitor it on an ongoing basis.

This fact creates substantial scope for small financial institutions to transfer risks, such as the risk that a bond will decline in value if housing prices fall, to a too big to fail bank. In effect, taxpayers subsidize that transaction, making it attractive to both parties and creating excessive transfers. In the run-up to the financial crisis, the risk of large losses on CDOs and credit default swaps was highly concentrated in several too big to fail institutions. Indeed, one can see the rise of securitization and credit default swaps not as mindless gambling facilitated by lax regulation, but as a purposive and rational attempt to maximize the private benefits of the implicit government guarantee.

In my opinion, this is the best explanation for the severe market reaction to the Lehman bankruptcy. Prior to the bankruptcy announcement, short-term creditors of the largest financial institutions believed there was an unwritten rule that no large and interconnected financial institution would be permitted to go through a regular bankruptcy process (which could delay repayment of short-term credit). Instead, the government would broker, and help finance if necessary, a purchase and assumption or similar transaction. Lehman's bankruptcy filing shattered this belief and woke the short-term creditors of all the too big to fail banks from their slumber, causing them to reduce their exposures and thereby causing immediate liquidity problems at the other too big to fail commercial and investment banks.

But the Dodd-Frank Act's proponents did not, by and large, attach any significant blame for the crisis to the unintended consequences of government attempts to avoid a recession, expand credit to low-income households, and avoid systemic risks. Instead, they chose to argue that the most heavily-regulated markets in the history of capitalism were in fact under-regulated. They did so by focusing on over-the-counter derivatives, which were less regulated than exchange-traded and centrally-cleared derivatives, and on the so-called "shadow banking" system consisting of financial intermediaries that extended credit and often relied on short-term financing but were not regulated as banks.

Choosing to see the origins of the financial crisis in the less-well-lit corners into which regulation had not penetrated deeply rather than in the unintended consequences of prior government policies and actions has important practical consequences. Dodd-Frank doubles down on the notion that large and interconnected financial institutions must be protected from so-called "disorderly" failure, which should lull short-term creditors back to sleep after their brief awakening. The statute puts great faith in the notion that systemic risks can be objectively identified and that the Financial Stability Oversight Council, dominated by bank regulators, will identify those risks and regulate systemically important financial institutions so as to reduce the potential costs they could impose on the rest of the financial system. Finally, it subjects non-bank financial institutions to regulation by the Federal Reserve, which in practice could mean they will be regulated like banks.[1]

A likely competitive consequence of these decisions is that there will be fewer and larger banks in the United States. After the acute phase of the financial crisis but before enactment of Dodd-Frank, Professor Joseph Stiglitz said, in testimony before the Joint Economic Committee, "There is no good case for making the smaller, competitive, community-oriented institutions take the brunt of the down-sizing, as opposed to the bloated, ungovernable, and predatory institutions that were at the center of the crisis."[2] But that is exactly what Dodd-Frank does, by layering on costly new regulations that the large banks can afford but smaller ones cannot. Since Dodd-Frank's enactment, the rate of bank failures has remained high by historical norms, but all of the failures have been of smaller banks, with only a handful having assets in excess of a billion dollars.

The competitive landscape will be altered even more fundamentally if the Federal Reserve imposes bank-like regulation on all large financial intermediaries as it sometimes seems inclined to do. Insurance companies, broker-dealers, private equity funds, and institutional asset managers serve a different purpose than commercial banks and their balance sheets do not look the same as that of a commercial bank. If regulated like banks they will be unable to continue

[1] For simplicity, I refer to "bank" regulation as an umbrella term that includes the Federal Reserve Board's oversight of bank holding companies as well as the functional regulation of commercial banks.
[2] "Too Big to Fail or Too Big to Save?: Examining the Systemic Threats of Large Financial Institutions", Hearing before the Joint Economic Committee, 111th Cong., 1st Sess., April 21, 2009, at 53, 54 (prepared statement of Dr. Joseph E. Stiglitz).

under their existing business models. Instead, they will become banks or be acquired by banks. And the U.S. financial system could then become like the system that Europe is slowly abandoning, in which a handful of large universal banks dominated financial intermediation, bundling commercial and investment banking and asset management. All of this would be very good news for the largest U.S. banks and for the regulatory agencies that oversee them, both of which would become more powerful. But there is no reason to think it would be better for investors, depositors, and taxpayers. And it is exactly the opposite of the model that many Dodd-Frank proponents, including Professor Stiglitz, say they favor, which is a model of smaller, more focused banks. But bank regulators and the Congressional committees that oversee them have a vested interest in expanding bank regulation to more and more financial institutions.

Policy makers' and regulated industries' use of a financial crisis to serve private goals that are not congruent with the public interest is not a new phenomenon. Indeed, we can see the same dynamics at work in prior major securities reforms, including the Sarbanes-Oxley Act and the New Deal financial reforms. Indeed, we can even see the same pattern in England as far back as the bursting of the South Sea Bubble in 1720 and the run on the Bank of England in 1696.

Consider the first of the New Deal financial reforms, the Securities Act of 1933. It has been almost universally hailed as the quintessential example of "good" regulation, but largely because lawyers, economists, and historians have paid insufficient attention to how markets operated before the Securities Act. We lawyers typically describe the Securities Act as a "full disclosure" statute and speak as if public offerings prior to 1933 were made with no disclosure at all. This is simply incorrect. In fact, the Securities Act brought about only modest changes in disclosure practices, a point on which I will elaborate below.

In fact, the statute was in many respects a secrecy statute. As initially enacted, it prohibited any disclosure about a pending offering prior to the filing of a registration statement and any sales efforts before the effective date of that registration statement. While traditionally spoken of as mere technical details of the "full disclosure" apparatus, these features had important consequences that played directly into the hands of the leading investment banks.

During the 1920s, the top investment banks saw their preferred way of doing business undermined and their market share diminished. Prior to that time, the leading investment banks, such as J.P. Morgan & Co. and Kuhn, Loeb & Co., were exclusively wholesalers. They bought newly-issued securities from companies and distributed them through retail broker-dealers. The managing underwriter exercised tight control to prevent competition among those broker-dealers, restricting where, to whom, and at what prices they could sell.

During the 1920s, these syndication practices came under attack by new entrants such as the National City Company that competed for business on the basis of more rapid distribution. They encouraged broker-dealers to fight for business by turning a blind eye to price-cutting or poaching another broker's customers. They also created their own retail distribution networks to help them sell even faster. The result was dramatic—the new entrants took substantial business away from the three leading wholesale houses and by 1928 had displaced them as the top underwriters.

The Great Crash and the Great Depression had a silver lining from the perspective of investment banking's old guard. President Franklin Roosevelt and the Congressional supporters of securities reforms argued that the Great Crash was the result of fraud by investment bankers and stock exchange members and that the Crash was itself the principal cause of the Great Depression. The evidence points strongly against both claims. But they opened the door for all parties to get what they wanted—Roosevelt became President on the strength of his pledge to clean up the financial markets, Congress avoided blame, and the leading investment banks took their ritual punishment during Congressional hearings but simultaneously helped craft the statutes out of the public eye.

The Securities Act reversed the top investment banks' decline by slowing down the offering process and re-establishing firm managing underwriter control over it. Making it illegal to sell a security prior to an "effective date" that could not occur without the managing underwriter's acquiescence guaranteed that retail brokers could not take orders before the managing underwriter gave the OK. The suppression of information prior to registration statement filing ensured that retail brokers were as much in the dark as their customers until the managing underwriter was ready to begin the sales campaign. Any violation of the syndicate agreement described in the statutory prospectus subjected the issuer and syndicate members to potential liability for making a misleading statement. The cumulative effect of these provisions was to resuscitate a firm separation between the wholesale and retail phases of an offering, which had become blurred in the 1920s. This was precisely what the leading investment banks wanted.

The statute accordingly revived the fortunes of the old investment banking aristocracy. They re-established their dominance of the underwriting market while the upstart firms that had taken market share during the 1920s lost business and in some cases disappeared altogether. The result was a loss of competition in the investment banking industry. By my estimate, the Securities Act increased the aggregate market share of the top five investment banks by 12%. And the domination of underwriting by a handful of investment banks became a structural feature of the U.S. securities market.

Major reforms enacted in the aftermath of a financial crisis do not work. What does work? Successful securities law reforms are incremental—that is, they do not try to do too much at one time. They also draw on established legal concepts and terminology, which makes it easier for regulated entities to understand their obligations and for courts to resolve disputes.

The Securities Act again provides an excellent example. I pointed out above that the statute brought about only modest changes to disclosure practices. But these modest changes were the most useful thing in the statute. Prior to the Securities Act, sellers of securities made narrative and financial disclosures about the company's business. But they did not always give investors adequate information about conflicts of interest to which the sellers might be subject.

One obvious issue was underwriting fees and discounts. Investors want to know whether their brokers are recommending investments that generate unusually high fees for the broker. They can determine this in the case of public offerings if the prospectus discloses all commissions and discounts to underwriters and selling group members and all reallowances to broker-dealers. Another conflict arises when corporate insiders are important suppliers or customers of the issuing company, which poses the danger that their dealings with the company will be on less favorable terms to the company than it could receive from independent third parties. Again, disclosure of material contracts and other insider interests reveals these problems.

The lack of conflict of interest disclosures was a problem in both England and the United States from the late nineteenth to the early twentieth centuries. In England, courts fashioned disclosure obligations as a matter of fiduciary duty, but Parliament decided to codify these duties in the Companies Act 1900 and then again in the Companies Act 1929. The United States followed a similar pattern. Investors who thought they had been disadvantaged by conflicts of interest sued under state contract, corporate, or tort law and courts tried to formulate appropriate disclosure standards. This was a messier process than in England because the resulting standards could vary from one state to another. In the Securities Act, Congress followed the English precedent and relied on the Companies Act 1929 as a model. The Securities Act required disclosure of underwriters' and dealers' compensation and insiders' ownership and contractual interests in the company.

Those provisions of the Securities Act were a model of how securities law should be made. Congress took up an issue that had been percolating in state courts and built on the principles that courts and the English Parliament had already established. It was, in short, an incremental reform that used existing legal concepts. The anti-fraud and civil liability provisions of the Securities Act are similar. State law gave a remedy of rescission to a buyer who was defrauded in the sale of a good or service, but jurisdictional and conflicts of law issues along with the basic administrative difficulty of hiring lawyers and maintaining actions in distant places made these remedies less effective than they should have been for purchasers of securities. Congress responded by providing a federal anti-fraud rule and a federal cause of action for misleading statements. One can quibble with Congress's decision to shift various burdens of proof from the buyer to the seller in the Securities Act's civil liability provision, but anyone familiar with contract and fraud law would readily understand the contours of the cause of action.

Congress in 1933 could have stopped there and the Securities Act would have been the most successful regulatory statute in the history of financial markets. But the Securities Act's drafters believed that they needed to do more. So they added detailed micromanagement of the conduct of public offerings. Those provisions took what would have been a clear win for investors and made it arguably a net loss by curtailing competition among investment banks and driving newer, more innovative investment banks out of the market to the benefit of their old, established rivals who won out in the legislative process.

Looking at Dodd-Frank in the same way, we can note that careful observers of the financial markets had been concerned about rising levels of leverage in financial firms for many years before the crisis. A simple and useful reform would have been to rethink capital requirements for commercial banks and their holding companies and to impose appropriate capital requirements on investment banks and other financial intermediaries.

A more ambitious statute could have provided a separate chapter of the bankruptcy code for financial services companies that would have been more tailored to their typical capital structures but still followed the fundamental principle of bankruptcy law that pre-bankruptcy entitlements (such as the contractual right of one creditor to priority over another) are strictly respected. Congress could then have limited the authority of the Federal Reserve and Treasury to engage in ad-hoc resolution of failing financial firms. Both of these reforms would have fit the paradigm of incremental improvements that build on existing legal principles.

Dodd-Frank is nothing like what I've described. It creates multiple new regulatory bodies and confers on them broad discretion untethered to recognized legal concepts. How can a court meaningfully determine whether the Financial Stability Oversight Council has overreached in concluding that a particular non-bank financial firm should be subject to regulation by the Federal Reserve? The standard the FSOC is supposed to apply is whether the firm's activities "could pose a threat to the financial stability of the United States." This has no objectively determinable meaning and so must in practice mean whatever the FSOC wants. The statute also creates a new "orderly liquidation authority" under which the Federal Deposit Insurance Corporation may be appointed receiver of a non-bank systemically important financial institution. The FDIC's mission is to minimize systemic effects rather than to make sure pre-bankruptcy entitlements are protected.

In short, Dodd-Frank is designed in significant part to enhance the regulatory reach of bank regulators. Inevitably, that will mean increasing the size, market share, and political clout of the largest banks. Congress can do better than this and should aim to do so in the future.