Enough Already: Is Post-Crisis Financial Reform Going Too Far?

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Thank you for that warm welcome, and thank you all for being here today. It is wonderful to be back in Tokyo, and a true honor to address the American Chamber of Commerce in Japan once again. ICI has built a close relationship with the ACCJ, and I welcome the opportunity to come back to speak to you.

I'm privileged to chair the International Investment Funds Association and am here for our 30th annual meeting, hosted in Osaka by Japan's Investment Trusts Association. The members of IIFA represent funds and asset managers from six continents—we can't claim Antarctica just yet. JITA has organized an outstanding program for our meeting, and I very much look forward to visiting Osaka.

It was almost precisely 18 months ago that I last spoke to the ACCJ, and it is sobering to reflect on the course of events since then. In the United States, our political season has been in full swing. Just three weeks from Election Day, the stakes in this election are as great, across a wide array of issues, as any I have seen in my four decades in Washington.

Today I propose to focus on just one question: is the wave of financial reform launched after the great financial crisis going too far?

The *Wall Street Journal* ran a commentary a couple of weeks ago declaring that "The Regulatory Tide Recedes." I was tempted to call the author to ask what beach he was visiting. Where I stand, the tide is still rising—and that is cause for concern.

I would tend to agree instead with Nobuchika Mori, commissioner of Japan's Financial Services Agency, when he says: "the factories manufacturing new regulations are still operating at their full capacity."

And there is every sign that they will keep doing so. Just look at the presidential campaign.

Both major political parties, in their official platforms, are calling for reinstatement of the Glass-Steagall Act—the Depression-era law separating commercial banking from securities market activities. They would ignore sweeping changes in the financial system that rendered that law obsolete decades ago.

The leading candidate would go much further. She declares that "Our banking system is still too complex and too risky"—despite all of the regulations flowing out of the Dodd-Frank Act. She proposes a "risk fee" on large banks and other financial institutions, along with laws to empower regulators to break up firms that are "too large and too risky to be managed effectively." She would institute a financial transaction tax that supposedly would only affect high-frequency trading. And—of particular concern to me—she continues to claim that portions of the regulated fund industry are engaged in "shadow banking" and pose a threat to investors and the economy.

Now it’s true that platforms and campaign briefing papers don’t always get enacted into law. But they do exert a strong influence on future policy choices.

Regulators in other jurisdictions are not relenting, either. The Basel Committee, the Financial Stability Board, and the European Commission continue to pour out new rules and new ideas to constrain financial institutions. At ICI, we opened a London office just five years ago this month—and are now deeply engaged in regulatory matters all around the world. There’s no slowdown.

Clearly, this matters greatly to the fund industry, because we are in the thick of the financial markets. We are directly affected by the wave of regulation that continues to build, eight years after the great financial crisis.

Now, I readily concede that the great financial crisis spotlighted weaknesses that cried out for reform. Our financial system needed to be stronger. Much effort has been devoted to this objective, with considerable results to date, and ICI has supported that process.

But I believe the time has come to pause and take stock, because excessive or inappropriate regulation is not just a parochial concern for those in financial services. It has wider implications.

My point today—the message that I want you all to take away—is that the quest for more and more financial regulation has a direct bearing on other, more sweeping societal concerns. This is because of something new in financial regulatory thinking—a single-minded push toward the goal of financial stability. I believe this overriding goal of “stability” may put at risk other objectives—such as growth, and innovation, and opportunity—and make economic and social conditions worse, not better.

So, what is wrong with “stability,” you ask? Here, insights drawn from engineering, the sciences, and technology are instructive. In these fields—all of them concerned with highly complex systems — the concept of “stability” stands in contrast with that of “robustness.”

What’s the difference?

“Stability” is the capacity of a system to return to its original state after a shock. One author has described a stable system as one that maintains all of its features, with only small differences, “for all time.” A second scholar has described a “stable system” as one whose response to external impulses “approaches zero as time approaches infinity.”

“Robustness” is different—because it reflects the ability of a system to cope with and adapt to shocks. The concept is typically applied to complex systems subject to “multiple perturbations in multiple dimensions.” Robust systems function better than stable systems in the face of uncertainty. When Nobel laureate economists Lars Peter Hansen and Thomas J. Sargent wanted to figure out how policymakers could make better decisions even when using uncertain models, they turned to robust control theory for answers.

I will return to these concepts presently, but first let me put all this in a broader context.

ICI is a global association for mutual funds, exchange traded funds, and other funds that are closely regulated and offered to the public.

That phrase “closely regulated” is important. The funds that we represent embrace regulation as a necessary component for building trust among investors. Without that trust, we could not operate. In the US, funds have operated and prospered for more than 75 years under a comprehensive framework of laws and regulations. The success of our industry—as reflected in the $18 trillion in assets we manage for 90 million American shareholders—depends on that sound regulation.

That regulatory structure served funds well when the banking system started to come apart in the fall of 2007. Yes, money market funds, which operate under a special set of rules, faced heavy redemptions in the middle of the banking collapse. The rules governing money market funds have been reformed—not once, but twice—and those funds are now more resilient than ever.

In contrast, funds that invest in stocks and bonds rode out the financial crisis without incident. Their value of fund shares fell sharply, in line with the markets in which they invested. But they did not experience investor flight, heavy redemptions, operational disruptions, or other problems that could have exacerbated the financial crisis. In fact, it’s fair to say that regulated stock and bond funds were among the most robust segments of finance during those dark days.

And they were dark days indeed. Billions of dollars of personal wealth was destroyed. Millions of people lost their jobs and their homes.

Not surprisingly, public and political attitudes toward finance—indeed, toward capitalism and free markets themselves—shifted. French President Nicolas Sarkozy spoke for many when he called for greater government control over finance, declaring “The idea that the market is always right is a crazy idea.”

In a 2010 survey—two years after the crisis—the polling firm GlobeScan found that only 59 percent of Americans believed that the free market economy is the best economic system for the future. That's still a majority—but it was down significantly from the 80 percent who expressed faith in the market system in 2002. Even more surprising, free market capitalism got a stronger endorsement in China—where 67 percent of respondents described it as the best hope for the future—than in the United States.

If the presidential campaign in the United States this year can be taken as evidence, faith in markets has not recovered since. The rise of outsiders, populists on both the left and the right, united in their opposition to free trade, is a sign that markets have not regained the public's trust.

So we could expect a re-examination of our financial system. At ICI, we engaged actively in the response to the crisis. In the US, we testified on Capitol Hill about the need for reform. We represented our members when Congress was debating its legislative response, the Dodd-Frank Act. And we have been active participants in a global regulatory process.

The crisis peaked eight years ago, Dodd-Frank was passed six years ago—but still the wave of rulemaking has not crested.

In the past 12 months, ICI filed 111 comment letters, totaling more than 1,600 pages. That is almost one letter every other working day, as we responded to a vast array of rulemakings and other proposals from an alphabet soup of agencies, councils, boards, and other bodies in the US and around the globe.

I cannot remember a time in the 23 years since I first worked at ICI when our regulatory agenda has been more extensive, or more consequential for the future.

ICI is not alone in seeing this. The momentum for regulation is only growing—and it's clearly going too far.

Take a look at the *Federal Register*—the repository of all the regulations issued by Washington. It published 80,260 pages in 2015. That's almost at the level of 2010 and 2011, in the immediate aftermath of the crisis.

And this is not merely an American phenomenon.

Each year, Thomson Reuters surveys compliance professionals around the world. In its 2016 global survey, it found that more than two-thirds of firms expect an *increase* in the volume of information pushed out by regulators in the coming year. One-quarter of firms think the increase will be significant.

Indeed, we seem to be moving toward an economy in which, as economist Daniel Yergin has said, "if you want lifetime employment, go into compliance."

The volume of regulation is one problem. But for the financial sector, the *approach* to regulation may be just as significant—if not more so.

In the response to the crisis, "stability" was enshrined as the overriding goal of financial policy. In the US, Dodd-Frank created a Financial Stability Oversight Council, or FSOC—a body of senior US financial regulators dominated by banking agencies.

Globally, the Group of 20 nations chartered a Financial Stability Board to develop international standards that promote financial stability. Like the FSOC, the FSB consists largely of bank regulators.

"Stability" has been interpreted as a mandate to wring all sources of risk out of the financial system. In banks, stability regulation has meant higher and higher capital requirements, and more and more stress tests, all designed to ensure that banks and taxpayers are well shielded from risks.

But much of the focus of stability regulation is elsewhere—on the perceived risks of what regulators and academics like to call "shadow banking."

The very term is an epithet, intended to suggest that all institutions that perform financial intermediation are just banks by another name—and that they pose grave risks because they allegedly are unregulated and unaccountable. The term is sweeping, but it usually is meant to embrace virtually all forms of asset management, including mutual funds.

And the preferred instrument to address the risks of shadow banking is what the stability regulators call "macro-prudential regulation." In a nutshell, this means the extension of bank-style regulation to capital markets.

Arthur Schopenhauer once observed, "Everyone takes the limits of their own field of vision for the limits of the world." Bank regulators are no exception.

That is why ICI—drawing on the 75-year history of the US fund industry—has had to devote so much effort in recent years to demonstrating how very different regulated funds are from banks, and why funds do not fail the way banks do.

Yet despite all of this evidence, the stability regulators persist and the prospect remains that large segments of the capital markets may be subject to bank-type regulation.

Now, clearly this is a deep concern for the fund industry — but what does it mean to you? What is at stake?

A great deal, I would say.

The most pressing need today—in the US, in Japan, in virtually all of the world—is for greater economic growth. Political leaders have recognized this. At their Brisbane summit in 2014, the leaders of the G20 declared, “Raising global growth to deliver better living standards and quality jobs for people across the world is our highest priority.”

In the United States, growth since the financial crisis has averaged about 2 percent per year—well below the post-World War II trend of 3.5 percent. And even at that rate, America has enjoyed a stronger and steadier recovery than Europe and some other parts of the world.

Slow growth exacts a heavy toll on individuals, families, nations. *Faster* growth means *higher* incomes, *more* wealth, *more* shared prosperity.

As Stanford University economist John Cochrane recently wrote: “Looking ahead, solving almost all of America’s problems hinges on re-establishing robust economic growth. Over the next 50 years, if income could be doubled relative to 2 percent growth, the US would be able to pay for Social Security, Medicare, defense, environmental concerns, and the debt. … Doubling income per capita would help the less well-off far more than any imaginable transfer scheme.”

Unfortunately, he added, at current US growth rates, “none of those spending challenges can be addressed.”

Over-regulation is a major factor in the sluggishness of our economies. In a landmark study released last month on the competitiveness of the US economy, Michael Porter and his co-authors at the Harvard Business School asked both Harvard alumni and the public what factors were helping or hurting the US. Both groups identified “regulation” as an element of competitiveness where the United States was weak relative to other nations—and deteriorating.

The US Chamber of Commerce, in a survey released last summer, found that more than three out of four companies surveyed “believe that the regulations on the financial services sector will not help their companies’ outlook over the next three years.” As David Hirschmann, president and CEO of the Chamber’s Center for Capital Markets Competitiveness said, “financial services is the essential fuel of economic growth, and when you begin to hear the impact on their customers, it becomes clear why we need to have growth as part of our financial-regulatory agenda.”

To combat the stagnation, central banks around the world are using near-zero—or even negative—interest rates. The strategy has not succeeded, and in many ways has only compounded the damage. Pension funds—indeed, all retirement savers—have been hurt, as near-zero interest rates have depressed returns. With lower returns, workers must save more and spend less today in order to provide for retirement tomorrow. And the lower interest rates go, the more investors are tempted to “reach for yield,” taking on greater financial risks.

As the Organisation for Economic Co-operation and Development wrote last month: “Exceptionally low—and in some cases negative—interest rates are distorting financial markets and raising risks across the financial system.”

In sum—the relentless march of financial regulation calculated to achieve “stability” courts adverse economic and social consequences.

As Commissioner Mori has observed, “financial stability is not a goal in itself—it is a means to ensure sustainable growth.”

A far better goal would be a financial system that is *robust*, rather than stable. And in our capital markets, we have a model of a robust financial system.

Speaking here 18 months ago, I extolled the advantages of the capital markets—the efficiency, flexibility, and immediate feedback that they bring to economies. The United States has been blessed since its founding with flourishing capital markets, which have provided a strong competitor to the banking system. In the US, roughly half of financial intermediation takes place in the securities market—a share that has grown in recent decades.

Why do I believe that capital markets offer robustness? Because they share the key characteristics that we see in robust systems in

computer science, engineering, biology, and other areas.

Robustness is the property of being strong and healthy in constitution.

A robust system offers and promotes *diversity*. Strong and healthy capital markets, operating alongside banks, provide diverse sources of funding for businesses, households, and governments. Japan has recognized the value of this diversity, in seeking to convert risk-averse savers into risk-taking investors, and thereby spur economic expansion. Similarly, the European Union is trying to develop a Capital Markets Union to diversify and expand sources of funding for infrastructure and corporate growth.

A robust system encourages *innovation and experimentation*. We certainly see this in the fund industry, where dozens of new products—ranging from global stock funds to exchange-traded funds to target date funds to the latest alternative strategy funds—have evolved to meet changing investor needs and market conditions. Indeed, regulation of US mutual funds is designed to encourage such experimentation, permitting sponsors to obtain exemptions from regulations for new products.

And a robust system is *adaptable*. Rather than simply avoiding risks, capital market participants accept and manage risks. In our funds, investors willingly and knowingly accept the risks of their investments, based on clear disclosure and the prospect of commensurate rewards.

The characteristics of a stable system are far different. And capital markets overseen by prudential regulators with stability as the overriding goal would be far different as well.

A stable, bank-centered system would *narrow* the sources of financing. Businesses and households would be more dependent on large, highly leveraged institutions for the funding they need.

A stable, bank-centered system would *hamper* innovation—both in finance and in the broader economy. Institutions focused on "prudential" operation aren't driven to create new products to meet the needs of savers and borrowers. Banks simply don't fund start-ups and entrepreneurial ventures—the wellsprings of creativity and vigor in our economies.

And a stable, bank-centered system would be *rigid and inflexible*—because banking regulation squeezes all institutions into a one-size-fits-all mold.

In short, if banishing risk in the name of stability is the central goal for regulation of the financial system, it clearly threatens economic growth—because growth requires risk-taking.

Robust or stable? Which course should we take?

To me, the choice is obvious.

Thank you for your attention.

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