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Regulation without Reason: The Group of Thirty Report

By Peter J. Wallison

For months, the media have been predicting that a strong new regulatory flux would emerge from the financial crisis. Now, with a new report by the dirigiste *wing of the Group of Thirty (G30), we know what the future could look like. A good summary is that bank-like regulation would be spread beyond the banking industry. But there's a problem: banks have been tightly regulated for years, both in the United States and Europe, and of all the institutions hurt by the financial crisis, they are in the most trouble. How do the bankers, academics, and financial policymakers who make up the G30 deal with this? They don't. In the wake of this report, the principal question that Congress, the Obama administration, and the American people should ask is why regulation should be extended to most of the major players in the financial system when it has been a consistent failure for banks.*

Just before the inauguration of President Barack Obama, a subcommittee of the G30, a private organization of international financial experts, published a report setting out a series of recommendations for regulatory reform in the wake of the financial crisis.[1] Because the head of the subcommittee was Paul Volcker, an adviser to President Obama, the *Washington Post* immediately suggested that its recommendations were a forerunner to what the Obama administration would propose, calling it "the first hint of the kind of changes to the financial system President-elect Barack Obama might push for in the coming weeks and months."[2] We should all hope that greater thought and imagination goes into the Obama administration's proposals on financial regulation, whatever they may be.

The report is unusual in that it consists almost entirely of background discussion and recommendations, without any underlying analysis or justification for its proposals. The idea that far-reaching recommendations can be made without any analytical support—based, apparently, solely on the credentials of the authors—is disconcerting. And the recommendations are indeed far-reaching. Among them:

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- Special regulation of "systemically important banking institutions"
- "A framework for national-level consolidated prudential regulation and supervision over large internationally active insurance companies"
- Reorganization of money market funds as "special purpose banks" if they offer transaction features
- Special prudential regulation of "systemically significant" private pools of capital (such as hedge funds and private equity)
- A special legal regime that would provide regulators with "authority to require early warning, prompt corrective actions, and orderly closings of regulated banking organizations, and other systemically significant regulated financial institutions"

These are recommendations that could profoundly reshape the U.S. financial system—and not for the better.

The Elephant in the Room: The Failure of Bank Regulation

The weakness of the banking industry—the most heavily regulated part of the financial system—is the central and most obvious problem in the current financial crisis. This is not a new development. The current regulatory regime for commercial banks and savings and loans (S&Ls) was substantially tightened after the S&L debacle in the late 1980s, in which the S&L industry collapsed and 1,600 commercial banks also failed. This gave rise to the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which significantly increased the powers of bank and S&L regulators. FDICIA was adopted to make sure, as is always said, "this won't happen again." Yet, only a few weeks ago, the federal government had to commit several hundred billion dollars for a guarantee of Citigroup's assets, despite the fact that examiners from the Office of the Comptroller of the Currency (OCC) have been inside the bank full-time for years, supervising the operations of this giant institution under the broad powers granted by FDICIA to bank supervisors.

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Ordinarily, confronted with this dismal narrative, anyone recommending more regulation—covering yet more of the financial system—would at least feel the need to explain why the new regulation would be different and better than before. To be sure, there is an effort to advance "improvements" in prudential regulation and supervision, but these are weak and pedestrian. There are also some vague recommendations for reducing regulation's obvious procyclicality, but for the most part, these are superficial and unimaginative. Fundamentally, the report seems to reflect a judgment that the financial crisis makes the need for new and broader regulation self-evident. In reality, however, the opposite is true; the financial crisis shows that regulation is no better than market discipline at preventing the failure of financial institutions and that even in the dire circumstances of the current crisis, systemic risk—the only justification for extending regulation beyond banks—has not appeared.

Apart from its multinational approach, the report's recommendations for improving regulation and supervision have all been around the track in ages past: "Countries should reevaluate their regulatory structures with a view to eliminating unnecessary overlaps and gaps in coverage" (there were no "gaps" in coverage, however, in the OCC's unsuccessful supervision of Citi); countries should "reaffirm the insulation of national regulatory authorities from political and market pressures" (it is doubtful that this means freedom from congressional oversight, but if not, it has no meaning at all); the central bank should have supervisory responsibility over systemically significant firms (the Federal Reserve has had such authority over the holding companies of all the major U.S. banks since the 1970s, to no apparent effect); and there should be more international cooperation and coordination (the Basel Committee on Banking Supervision, consisting of the bank regulators of all the developed countries, has also been operating without notable success since the 1970s).

The recommendations for how supervisors are supposed to deal with procyclicality are somewhat more insightful. There is a recommendation for increasing bank capital requirements in periods of exuberance and a recommendation for greater risk disclosures, but no discussion of how procyclicality might have contributed to the failure of bank regulation in the current crisis or in the past. There is veiled criticism of Basel II's new model-based approach to credit risk ("Benchmarks for being well capitalized should be raised, given the demonstrable limitations of even the most advanced tools for estimating firmwide risk."), and there is an important gesture toward changing the focus of fair value accounting so that it more closely aligns with an institution's intermediary role ("[T]he accounting principles and approaches applicable to regulated financial institutions whose primary purpose is to intermediate credit and liquidity risk need to be better aligned with the firm's business model. A pure mark-to-market accounting model is generally preferred for trading activities and most elements of market risk."). The balance of the recommendations, however, is uninspiring. For example: "conducting periodic reviews of a firm's potential vulnerability to risk arising from credit concentrations, excessive maturity mismatches, excessive leverage, or undue reliance on asset market liquidity" (If this has not been part of regular bank supervision, it is unclear what the regulators have been doing.); "international capital standards should be enhanced" (The Basel Committee spent the last ten years trying to develop an enhanced international capital standard for banks, which went into effect just before the collapse.); and "supervisory guidance for liquidity standards should be based on a more refined analysis of a firm's capacity to maintain ample liquidity under stress conditions" (According to the chairman of the Securities and Exchange Commission [SEC], two days before its rescue, Bear Stearns had $12 billion in liquid securities;[3] how would "refinements" have addressed this?). In other words, there are few new ideas underlying the G30's move to impose more and broader regulation on the financial system—just the same old impulse for more regulation when the regulation already in place has failed once again.

The Deficiencies of Financial Regulation—and When It Is Needed

Even if regulation had been successful in the past, there would be many reasons not to impose it more widely—none of which can be found in the report:

- The very existence of regulation—especially safety-and-soundness regulation, with which the report primarily deals—creates moral hazard and reduces market discipline. Market participants believe that if the government is looking over the shoulder of the regulated industry, it is able to control risk-taking, and lenders are thus less wary that regulated entities are assuming unusual or excessive risks.

- Regulation creates anticompetitive economies of scale. The costs of regulation are more easily borne by large companies than by small ones. Moreover, large companies have the ability to influence regulators to adopt regulations that favor their operations over those of smaller competitors, particularly when regulations add costs that smaller companies cannot bear.

- Regulation impairs innovation. Regulatory approvals necessary for new products or services delay implementation, give competitors an opportunity to imitate, and add costs to the process of developing new ways of doing business or new services.

- Regulation adds costs to consumer products. These costs are frequently not worth the additional amount that consumers are required to pay.

- Safety-and-soundness regulation in particular preserves weak managements and outdated business models, imposing long-term costs on society.

These deficiencies—together with its regular failure as a protection for the taxpayers or the economy—suggest that regulation should be a last resort, employed only when absolutely required. There are several circumstances that may meet this standard:

- When a company or an industry has the backing—implicit or explicit—of the government. Explicit backing exists, for example, with commercial banks. Implicit backing existed when Fannie Mae and Freddie Mac were allowed to continue operating with government charters and other benefits that signaled to the market that they would never be allowed to fail. In these cases, the wariness of creditors is impaired, and market discipline is reduced, allowing more risk-taking than would normally occur. Because of its adverse effect on competition and its tendency to create taxpayer liabilities, government backing—explicit or implicit—should be avoided. But where it occurs, regulation is the only option.

- When the failure of a particular company or financial institution will have systemic effects by weakening or causing defaults by its counterparties, depositors, or creditors. As discussed below, there are elements here of self-fulfilling prophecy. If we designate companies as "systemically significant," we will certainly make them so. The designation itself reduces or eliminates market discipline and enables them to grow faster than their competitors. In normal markets, it is very difficult for companies without government backing to become systemically significant, and currently, the only companies that can be so considered are already regulated as banks. As discussed below, a

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designation as "systemically significant" operates as government backing.

- When there is a significant asymmetry of knowledge between a supplier of services and its customers. Personal insurance lines—such as homeowners, auto, or life—are frequently cited as examples of this. The complex contracts required for this service are beyond the ability of most consumers to understand. State or federal regulation is necessary in this case for consumer protection. The same may be true of mortgage loans. It may well be that some homebuyers do not understand the commitments they are making when they sign up for mortgages with low teaser rates and high resets. In these cases, regulation may be required to assure that the risks are made known to them in clear and simple language. Regulation of this kind does not necessarily involve safety and soundness.

- When there is a market failure of another kind, such as a harmful pharmaceutical product that could be sold to consumers before the dangers are known.

One of the deficiencies of the report is that it does not appear to recognize that a decision to regulate more fully involves a weighing of any of these considerations. It nods in this direction with the statement that "care must be taken *not* to extend the reach of regulations too far or too deeply," but it never explains why the broader safety-and-soundness regulation it recommends is not extending regulation "too far or too deeply" or why it is necessary. There is no suggestion that regulation has any costs or deficiencies or that it has failed in specific instances, nor is there an argument that despite these deficiencies and failures, regulation is necessary in certain cases. Without this kind of policy analysis, it is difficult to see why extending regulation beyond commercial banks, S&Ls, and government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac—all of which have some form of government backing that diminishes the effect of market discipline—would be productive or useful. As noted above, experience with regulation shows that it impairs competition and innovation, raises consumer and social costs, and interferes with the market discipline that holds risk-taking in check.

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Is There Any Policy Basis for Extending Regulation?

Since the advent of the financial crisis, many observers have argued that it resulted from excessive trust in the ability of markets to regulate themselves. Occasionally, these critiques go so far as to claim that this has been the prevailing theory of the last thirty years and has thus been proven wrong. The fact that some unregulated or largely unregulated institutions have failed during the financial crisis is cited as evidence that there is a need for greater government oversight of the financial system. This formulation misstates the history of financial regulation, ignores the fact that the most regulated institutions in the economy—commercial banks—are in the most financial trouble, and fails to explain why it is necessary for the federal government and taxpayers to prevent the failure of any company (or failures within any industry) that is currently not regulated.

In reality, there has been no "theory" during the last three decades that private markets and private financial institutions could largely be trusted to regulate themselves. The adoption of FDICIA in 1991 proves that the contrary is actually true. The theory that has prevailed over the last three decades is the same one that has governed U.S. government policy on financial regulation for the last two hundred years—that there is no sound policy reason for the federal government to regulate or protect the safety and soundness of any financial institution for which it has not assumed financial responsibility. The idea that the federal government has in some sense withdrawn its regulation of financial institutions over the last thirty years—or that a different theory about financial regulation prevailed in the past—is entirely fallacious. Yet, by proposing regulation that goes beyond the traditional role of the federal government, the report does not seem to recognize that it is breaking new policy ground or that there is any need to justify such an expansion of government control and responsibility.

With the limited exception of the five largest investment banks, federally backed commercial banks, S&Ls,

and GSEs are the only financial institutions that have ever been regulated for safety and soundness at the federal level. In 2004, in response to a demand by the European Union (EU) that securities firms operating in the EU have a consolidated home-country safety-and-soundness regulator, the SEC assumed this role for the five largest investment banks then doing business in the EU. This proved disastrous, as all five took advantage of the moral hazard thus created to overleverage themselves.

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Assuming, however, that we treat the investment banks as unregulated, there has been only one total failure among these institutions—Lehman Brothers—while four others have either been rescued (Bear Stearns and Merrill Lynch) or sought shelter with the Fed by becoming bank holding companies (Morgan Stanley and Goldman Sachs). It may well be that all these institutions would have ultimately failed, but this result must be compared with the failures of the many heavily regulated banks and S&Ls that have failed thus far, and particularly with the multibillion dollar rescue of at least one bank—Citibank—that was overseen continuously for years by the OCC. The argument that the failure of unregulated financial institutions was the result of their lack of regulation is clearly unsustainable; it completely ignores the fact that many more fully regulated entities have suffered the same fate. If regulation does not produce a better result than nonregulation, there is no reason to impose it.

Why might the government want to regulate the safety and soundness or—more specifically—the leverage of financial institutions for which it has no financial responsibility? Although they are painful when they occur, the failures of companies are a good thing from the standpoint of the overall health and productivity of the economy. Bad managements or bad business models are eliminated from the market, making room for good managements and better business models. The losses by investors and creditors make them cautious about their investments and loans in the future, enhancing market discipline. Why would the government want to prevent these salutary results? Among the reasons for regulation cited above, the only one that seems plausible as a basis for safety-and-soundness regulation is the government's interest in preventing systemic risk—that is, the possibility that the failure of one institution, through contagion, would cause other failures throughout the economy.

This, however, has never happened. There is no example in all of U.S. history in which the failure of an unregulated financial entity—securities firm, hedge fund, insurance company, finance company, or private equity fund—caused a systemic breakdown. In 1990, for example, when the investment bank Drexel Burnham failed, there was no systemic result. Occasionally, the example of the hedge fund Long-Term Capital Management (LTCM) is cited. What we know of that event is that the Fed—fearful that a systemic event would ensue if LTCM failed—convened a number of large LTCM lenders and suggested that they rescue the fund, which they did. We do not know what would have happened if they had not, and many scholars believe that the Fed overreacted.[4] In any event, LTCM never failed, and there was no systemic event. In order to maintain that there is now a policy basis for regulating firms and industries that have not previously been regulated, there must be a demonstrated change in market conditions. There is simply no evidence of this—no evidentiary basis whatsoever for arguing that the financial market is any different today than it has always been or that the failure of an unregulated entity today would have a systemic effect on the economy as a whole. Since the beginning of the financial crisis, many hedge funds have suffered major losses and have closed their doors, but in no case has the failure of a hedge fund had a systemic effect. The same thing is true of insurance companies. The G30's recommendation for hedge fund or insurance company regulation is thus without empirical justification. If, in the current panicky market, hedge fund failures have not brought down other financial institutions, what justification can there be for regulating their safety and soundness or their activities in the future, when market conditions will have returned to normal?

Reports in the media that the financial markets are now more "interconnected" are also not evidence of any change in market structure. Financial markets have always been interconnected; that is how they perform their primary function of moving money from places where it is not useful to places where it is. Financial institutions are called "intermediaries" because they are interconnected, and nothing about the financial markets today makes them more interconnected than they were before. It is true that money moves faster in the electronic markets we have today and that this makes it possible for investors and counterparties to move their funds more quickly from institutions that they regard as troubled, but this is not an indication that the markets are more *interconnected*.

This is demonstrated by the failure of Lehman Brothers. At the time Lehman failed, there was a strong reaction of panic in the financial markets. Banks stopped lending to one another, and the credit markets froze. We are still living with the results of that event. However, Lehman's inability to meet its obligations did not result in the "contagion" that is the hallmark of systemic risk. No bank or any other Lehman counterparty seems to have been injured in any major respect by Lehman's failure, although of course losses occurred. The market freeze was caused not by these relatively minor losses but by a recognition on the part of banks and other financial institutions that their counterparties could be weak and neither they nor their counterparties would be bailed out by the government. Knowing that they would have to close if they could not meet depositor or investor demands for cash, their hoarding of cash after Lehman's failure was wholly rational. Although there were media reports that AIG had to be rescued shortly after Lehman's failure because it had been exposed excessively to Lehman through credit default swaps (CDSs), these were inaccurate. When all of the CDSs on Lehman were settled about a month later, AIG's exposure turned out to be only $6.2 million. Moreover, although Lehman was one of the largest players in the CDS market, all its CDS obligations were settled without incident, and all the CDSs written on Lehman itself were settled for a cash exchange of only $5.2 billion among hundreds of counterparties. There is no indication that any financial institution became troubled or failed because of the failure of Lehman, and hence no systemic risk arose out of the failure of one of the largest dealers in the CDS market.[5] This casts considerable doubt on the notion that CDSs have made the market more "interconnected" or that they somehow increased aggregate market risks.

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Reasons for Financial Regulation

The G30 report seems to rely on two ideas as the basis for the extension of regulation beyond institutions that have some form of government backing: that regulation will produce more "transparency" for stakeholders in financial institutions and that systemic risk in the future can only be prevented if a government agency is empowered to identify "systemically significant" financial institutions and regulate them accordingly.

Transparency. Transparency is important in fostering market discipline, and one of the goals of regulation—where regulation is required because of government backing—should be to develop metrics or indicators of risk-taking that will better inform creditors and counterparties about the risks that financial institutions have assumed.[6] Is the same requirement necessary for unregulated entities? No; transparency for its own sake, while an attractive ideal, is not worth the costs and deficiencies of regulation unless there is a sound policy rationale for regulation. That policy basis for transparency exists in securities regulation, in which disclosure is required for companies and others that seek investments from the general public. Here, there is a genuine asymmetry of knowledge: managements of companies know far more about their companies than ordinary retail investors. Beyond disclosure to investors, is there a reason for insisting on transparency elsewhere? The G30 report describes the market for CDSs as one for which regulation of some kind is necessary to assure transparency. The CDS market, like the foreign exchange and the interest-rate swap markets, is a dealer market; trades occur over the counter and are not visible until reported. The interest-rate swap market has been functioning for twenty-five years without serious mishap, and the foreign exchange market much longer, also without serious breakdowns. Would it be useful to disrupt these markets in order to achieve transparency? The fact that the CDS market is functioning well, even at a time when many other markets—many of them more transparent—are virtually shut down, suggests that transparency is not necessary to serve the needs of those who participate in this market. This does not mean that improvements in the infrastructure of the CDS market are unnecessary, but these can be achieved by the participants in the market without government involvement. If there were a genuine concern about systemic risk arising out of transactions in the CDS market, that might put a different cast on the question, but since the Lehman bankruptcy, it has been very difficult to argue that the CDS market is a source of systemic risk.

The quality and tone of the G30 report is captured well in its discussion of CDSs. After noting that efforts are underway to "address infrastructure weaknesses," the report states: "For most of the past 30 years, the markets developed in something of a regulatory vacuum, being regarded legally as neither securities nor futures contracts. Innovations were widespread and the markets grew explosively, suggesting that, beyond serving a valuable risk transfer function, a large speculative element has emerged." Note the circular logic. The CDS market should be regulated because it has not been regulated. No reason is given for why "speculation" among sophisticated consenting adults should be curbed by regulation.

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"Systemically Significant" Institutions. The final question, then, is whether—as proposed in the G30 report—a government agency should be empowered to identify "systemically significant" institutions and regulate them specially. The basis for this proposal appears to be a desire for stability and a fear of systemic risk. It is important to note, however, that there is no evidence that the failure of an institution that is currently unregulated poses any kind of threat to the financial system. As noted above, no hedge funds, for example, have needed a rescue by the government. And although many have closed their doors, none of these closures has created a systemic event.

Moreover, the suggestion that a government agency should be empowered to designate systemically significant institutions and regulate them more fully than others is a particularly troubling idea for industries—such as hedge funds, insurance companies, securities firms, and private equity groups—for which the G30 report suggests that safety-and-soundness regulation is necessary to avoid systemic risk. The recommendation seems to ignore the obvious consequences of such a policy. Even assuming that it is possible to identify systemically significant institutions in advance of their failure—which itself is difficult to believe—what would such a designation mean? Clearly, the institutions involved would not be allowed to fail—that is the reason they are being designated as systemically significant. And if these institutions are not going to be allowed to fail, they will have substantial competitive advantages over institutions that are not so designated. They will have easier access to capital and loans and will grow faster. Other, presumably smaller, competitors seeking the same advantages will consolidate in order to be considered within the category of the select few that will not be allowed to fail. In other words, designating institutions as systemically significant will have essentially the same result as creating a new crop of GSEs like Fannie Mae and Freddie Mac. But this new category would be open-ended, so virtually any company could join by proving to the designating agency that its failure could be a threat to the system. The effect on our competitive system would be dire.

Far from making the financial system more stable, the designation of certain companies or financial institutions as systemically significant would have the effect of increasing the number of failures. In his famous book *Manias, Panics, and Crashes*, Charles Kindleberger recognizes this problem:

> When asset prices tumble sharply, the surge in the demand for liquidity may drive many individuals and firms into bankruptcy, and the sale of assets in these distressed circumstances may induce further declines in asset prices. At such times a lender of last resort can provide financial stability or attenuate financial instability. The dilemma is that if investors knew in advance that government support would be forthcoming under generous dispensation when asset prices fall sharply, markets might break down somewhat more frequently because investors will be less cautious in their purchases of assets and of securities.[7]

It is not possible to cure moral hazard by injecting more of it into the economy. Systemic risk is context-specific. As noted above, when Drexel Burnham failed in 1990, the markets were stable and functioning normally. There was very little reaction and no systemic problems that arose because of this failure. However, in 2008, when there was doubt about the solvency and stability of most of the world's major financial institutions, the failure of Lehman produced a significant effect, even though there is no evidence that Lehman's failure to meet its obligations resulted in any contagion to or substantial adverse effects on any other financial institution. For this reason, it is impossible to know in advance when the failure of a particular institution will have a systemic effect and when it will not. The effect of a failure will depend on the nature of its relationships with other institutions and on the financial condition of those institutions at some future time. For these reasons, the decision of the systemic regulator or designating agency will be wholly arbitrary, although of course erring on the side of caution so as to increase its bureaucratic reach.

The Lehman example also seems to demonstrate that even when a major institution fails at a time of profound market panic, the actual systemic risks are minimal or nonexistent. Other institutions come to fear runs by their depositors and counterparties and hoard cash for that reason, but they do not suffer life-threatening losses as a result of the failure. Nor is it possible to argue that regulation is necessary in order to prevent the failure of systemically significant institutions; if there were ever a systemically significant institution, it was Citibank, and of course the government had to step in to rescue it despite the fact that the bank was heavily and continuously regulated. So even if it were possible to identify systemically significant institutions, and even if we were willing to bear the competitive and moral hazard consequences of designating these institutions as too big to fail, we would still not be able to avert their failure through regulation.

Sometimes it is argued that the government has created so much moral hazard by rescuing some financial institutions during the current crisis that we now have no choice but to regulate systemically significant firms. However, even if the firms rescued during the financial crisis are seen by some in the future as too big to fail—or an indication that others will be so considered in the future—that is still not a good reason for removing all doubt by declaring any firm to be systemically significant and thus too big to fail. Any uncertainty about what the government will actually do, especially when the market is functioning normally, will preserve some element of market discipline. The appropriate policy response in the future is to adopt procedural restrictions on the government's use of its rescue authority so that some question remains about whether the government will exercise this option when the market is in a more normal condition. This was done in FDICIA, which requires the secretary of the treasury to consult with the president before the FDIC is permitted to bail out a large failing institution. In addition, of course, if financial institutions are allowed to fail, that would go some way toward restoring market discipline. Allowing Lehman to fail would have had this effect, but it was premature. There was still too much fear in the market. Finally, it would make sense to adopt policies that will limit the growth of institutions that might be considered too big to fail, including added capital charges for growth beyond a certain size. A policy of this kind might induce large companies to reduce their size in order to avoid the capital penalty involved. In the end, it is important to recall that—with the exception of AIG and GMAC—virtually all the institutions that have received assistance from the government are within the banking sector, which is already heavily regulated. These rescues do not provide a rationale for extending regulation to areas of the economy that are currently not regulated for safety and soundness, especially if regulation will create within these industries preferred players that will be considered too big to fail.

Conclusion

The G30 report falls far short of a reasonable prescription for the future. Without acknowledging and explaining the failure of bank regulation—or at least proposing new methods of regulation that overcome the deficiencies of the current regulatory system—the report cannot really be taken seriously as a public policy document.

Unfortunately, that does not mean that many in Congress, and maybe many in the Obama administration, will not use the credentials of the report's authors as a basis for adopting its recommendations. The report, however, discourages this until

> [t]he financial crisis . . . fully run[s] its course. Financial markets and institutions have yet to reengage in a healthy process of risk intermediation. Real economies around the world are experiencing sharp contraction, which is likely to lead to additional credit defaults. Governments and central banks are stretching to their limits with programs to stabilize both financial systems and real economies.
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> *Initiatives to address these immediate challenges must take precedence over even the most pressing agendas for financial regulatory reform*. Moreover, until the full costs of the current crisis are known—including the financial costs from its economic fallout—there will not be clarity on the extent of needed reforms and a sensible timetable for implementing them and for rolling back of greatly extended safety nets.

This is sound advice. But if members of Congress and the administration decide to go forward with regulatory reforms, they should consider why it is that bank regulation has been such a consistent failure and what that says about extending similar regulation to other sectors of the financial system. The lodestar in any such inquiry should be economic growth, not government growth.

Notes

1. See Working Group on Financial Reform, *Financial Reform: A Framework for Financial Stability* (Washington, DC: Group of Thirty, January 15, 2009), available at www.group30.org/pubs/recommendations.pdf (accessed January 21, 2009).

2. Anthony Faiola, "Obama Adviser Presents Plan to Alter Global Financial System," *Washington Post*, January 15, 2009.

3. Christopher Cox (address, Security Traders Twelfth Annual Washington Conference, Washington, DC, May 7, 2008), available at www.sec.gov/news/speech/2008/spch050708cc.htm (accessed January 27, 2009).

4. Shadow Financial Regulatory Committee, "The Issues Posed by the Near-Collapse of Long-Term Capital Management," September 28, 1998, available at www.aei.org/docLib/20051114_ShadowStatement151.pdf.

5. As an aside, credit default swap (CDSs) are no different from loans. If a company writes protection on a loan, as AIG did, what it has done is not essentially different from making the loan itself. The widely bruited concerns about CDSs are unfounded. There is no evidence that they create any more risks than lending itself. See Peter J. Wallison, "Everything You Wanted to Know about Credit Default Swaps—but Were Never Told," *Financial Services Outlook* (December 2008), available at www.aei.org/publication29158.

6. Shadow Financial Regulatory Committee, "An Open Letter to President-Elect Obama," December 8, 2008, available at www.aei.org/docLib/20081208_StatementNo.264.pdf.

7. Charles Kindleberger and Robert Alibar, *Manias, Panics, and Crashes: A History of Financial Crises*, 5th ed. (Hoboken, NJ: Wiley, 2005), 14.