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Fewer Rules are Better Rules

By Dalibor Rohac, Policy Analyst at the Center for Global Liberty and Prosperity at Cato Institute .

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The town of Poynton in Cheshire, England, some 11 miles outside of Manchester, is known for little else than its annual agricultural show and its museum of historical engines. However, in 2010, the commuter town of some 14 thousand inhabitants embarked on an ambitious urban regeneration project.

The plan included the transformation of the town's busiest junction into a 'shared space' – a concept developed by Dutch traffic engineer Hans Monderman and applied in several communities in continental Europe, most famously in Bohmte in Germany. A 'shared space' involves eliminating the boundaries between vehicle traffic and pedestrians, typically by removing features such as curbs, road surface markings, traffic signs and traffic lights. As a result, drivers, cyclists and pedestrians exercise more care and accidents become rare and less catastrophic.

In Poynton, the results were impressive. What used to be an unpleasant and dangerous intersection, segregating the town into two disjoint areas, has become a livable, peaceful and accommodating place. Because Poynton is a on a busy road connecting Manchester with Stoke-on-Trent, the volume of traffic is much higher than in places that experimented with shared spaces before. Yet, following the change, both traffic accidents and traffic queues have been reduced, resulting in more fluent and safer traffic.

The outcome would not have been surprising to Monderman, who once said about the philosophy underlying shared spaces that:

"[t]he greater the number of prescriptions, the more people's sense of personal responsibility dwindles."

Needless to say, libertarians might be receptive to such arguments. But there is a deeper point there, going beyond Poynton or urban design. When facing complex social situations, humans use a combination of exercising care and following pre-existing rules, which may be results of legislation, precedent or proverbial wisdom.

Note that there is a trade-off between the two. In traffic, following rules relieves you of some of the burden of having to monitor other drivers, cyclists and pedestrians. It enables one to adopt what Paul Seabright, an economist at the University of Toulouse, coined 'tunnel vision', limiting the knowledge and attention needed to successfully operate in complex environments.

However, 'tunnel vision' creates risks in situations that are not foreseen by the rules one is following. Even if one follows traffic rules flawlessly, one may end up in traffic accidents – perhaps even fatal ones.

The trade-off between following rules and exercising care extends to other areas of social and economic life. The financial industry is one of the most heavily regulated sectors of the economy. It is difficult to imagine how large financial institutions would systematically get away with ignoring or violating rules - such as the ones on capital adequacy.

Yet, banks do go bust – even if they follow the rules and even if they had previously performed well on official 'stress tests'. Could it be that, in finance just as in traffic, the reliance on explicit rules is a substitute for exercising care? If that is effectively the case, then it is a plausible that the reliance on explicit rules has crowded out the exercise of care below the optimal level. After all, there is evidence that financial institutions that did exercise care prior to the 2008 crisis – eg by steering away from financial instruments that they did not fully understand – weathered the crisis relatively well.

If it is indeed the case that more care and fewer rules are desirable in the financial industry, how can we make such change happen? In car traffic, avoiding accidents is in everyone's best interest. By creating a 'shared space', the potential for collisions grows, paradoxically incentivizing everyone to exercise more care. Alas, the same principle does not translate easily into financial world, because – as we have seen both in Europe and in the United States – financial institutions are able to impose their losses on the rest of the society.

Although the notion of "too big to fail" is not going anywhere anytime soon, there may be some space for encouraging the exercise of care and prudential judgment, instead of simple reliance on explicit rules. The recent example of Cyprus, where large creditors were forced to bear the losses of bank restructuring, sets a hopeful precedent for the future.

If private involvement in resolving bank failures is reintroduced – limiting the ability of banks to impose their losses on others – higher levels of care are could be incentivised by returning to a system in which financial institutions can set their own levels of capital, based on their own assessment of risk – similar to the situation prior to the rise of prudential regulation. When things go wrong, instead of having recourse to public funds, banks and their uninsured creditors should be urged to resolve their troubles locally.

The Baltics are a case in point. During the crisis, in Latvia, the share of bad loans increased from just 2.1 per cent in June 2008 to 14.5 per cent in September 2009. In response, the government partially recapitalised the banks. But, more importantly, Latvia – alongside with other Baltic governments – changed the tax code to encourage write-offs of non-performing loans and other mechanisms for decentralised resolution of bad debt.

A by-product of the 'shared space' in Poynton is that people have started to be nicer to each other, because they are forced to engage in personal interaction. Suddenly, drivers and pedestrians make eye contact, and there are waves of thanks and other small acts politeness that one did not see previously at the heavily regulated junction. Conversely, it might not be a stretch to imagine that improve the reviled reputation of bankers one will have to address their 'tunnel vision' and the heavy regulatory oversight of the industry.