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Hillary Should Let Big Banks Go Bust

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Presidential hopeful Hillary Clinton recently penned an op-ed in The New York Times titled "How I'd Rein in Wall Street." The lengthy article includes 14 proposed reforms intended to "rein in major financial institutions," improve regulator independence and hold executives "more accountable."

According to Mrs. Clinton, the 2,300 pages of Dodd-Frank are not enough and we need "new rules…and more accountability that go well beyond Dodd-Frank."

But none of Mrs. Clinton's new rules—from imposing a "risk fee" on banks with more than $50 billion in assets to authorizing the federal government to "break up any financial institution that is too large and risky to be managed effectively"—addresses the real problem.

The real problem is that financial institutions have not internalized the risks they create. The promise of a government backstop in the form of another bailout still exists, and the FDIC remains poised to insure deposits.

The political reaction to the 2008-2009 recession, which has taken the form of writing ever more rules for banks to follow, has been understandable if not wise. Recessions hurt, and it's a natural reaction to try to stop painful events from reoccurring. Dodd-Frank and proposals such as Mrs. Clinton's seek to defang the financial sector, making it clunky and less frightening.

Under Mrs. Clinton's plan, broker-dealers would be weighted down with increased leverage and liquidity requirements, large banks would carry a risk fee and high frequency traders would counterbalance their speed with a new tax. These proposals would sit on top of the increased regulation already provided by Dodd-Frank. The problem, the theory goes, is that we have a runaway financial sector that needs a sure horsewoman to call, "Whoa!"

But the theory is flawed. The problem is not where the banks were headed, but the guarantee bringing up the rear.

To a certain extent, Mrs. Clinton recognizes this. The driving force behind her proposal is resentment toward banks that "make speculative gambles with taxpayer-backed deposits." This

resentment is justified. To the extent that any institution—whether it be a financial institution or an auto manufacturer—takes a risk, it should bear the consequences.

I agree wholeheartedly with Mrs. Clinton on that point. And the best way to prevent banks from gambling with taxpayer money is to stop giving them taxpayer money.

Under the current model, financial institutions are backstopped by an implicit guarantee (or, in the case of FDIC insured deposits, a very explicit guarantee). This backstop creates moral hazard that prevents the banks from properly assessing risk and from calibrating their strategy to align with this assessment. It would, in fact, be irrational for the banks to limit certain risk if they are likely to be bailed out.

There is therefore a mismatch between the risk financial institutions are likely to take on and the risk that taxpayers, as their guarantors, would want them to take. To fix the mismatch, we have regulation: an implicit guarantee provides an incentive for banks to do X, but the banks are then yanked back from X by regulatory hurdles.

What a clunky system. And then there's the fact that regulation, because it must apply to all actors within a certain industry, cannot be calibrated to the particular needs of any one institution nor can it shift swiftly when the environment changes. A financial sector hamstrung by regulation is unlikely to be nimble enough to meet changes in the marketplace and to exploit opportunities for innovation.

While the recession itself was painful, even more agonizing has been the sluggishness of the recovery. Clunkiness does not promote resiliency nor does it lead to vibrant growth.

Preventing another Great Recession does not require 2,300 pages of new legislation or a list of 14 new proposals. It requires simply the discipline to let companies feel the sting of their own bad choices, and to let them learn from, and internalize the harms from their own mistakes.

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