The Link Between Systemic Risk and One-Size-Fits-All Regulation

By Daniel Mitchell – June 21, 2013

After the financial crisis, the consensus among government officials was that we needed more regulation.

This irked me in two ways.

1. I don't want more costly red tape in America, particularly when the evidence is quite strong that the crisis was caused by government intervention. Needless to say, the politicians ignored my advice and imposed the costly Dodd-Frank bailout bill.

2. I'm even more worried about global regulations that force all nations to adopt the same policy. The one-size-fits-all approach of regulatory harmonization is akin to an investment strategy of putting all your retirement money into one stock.

I talked about this issue in Slovakia, as a conference that was part of the Free Market Road Show. The first part of my presentation was a brief description of cost-benefit analysis. I think that's an important issue, and you can click here is you want more info about that topic.

But today I want to focus on the second part of my presentation, which begins at about the 3:40 mark. Simply stated, there are big downsides to putting all your eggs in one regulatory basket.

The strongest example for my position is what happened with the "Basel" banking rules. International regulators were the ones who pressured financial institutions to invest in both mortgage-backed securities and government bonds.

Those harmonized regulatory policies didn't end well.

Sam Bowman makes a similar point in today's UK-based *City AM*.
Financial regulations like the Basel capital accords, designed to make banks act more prudentially, did the opposite – incentivising banks to load up on government-backed mortgage debt and, particularly in Europe, government bonds. Unlike mistakes made by individual firms, these were compounded across the entire global financial system.

The final sentence of that excerpt is key. Regulatory harmonization can result in mistakes that are "compounded across the entire global financial system."

And let's not forget that global regulation also would be a vehicle for more red tape since politicians wouldn't have to worry about economic activity migratingto jurisdictions with more sensible policies – just as tax harmonization is a vehicle for higher taxes.

P.S. For a more learned and first-hand explanation of how regulatory harmonization can create systemic risk, check out this column by a former member of the Securities and Exchange Commission.

P.P.S. Politicians seem incapable of learning from their mistakes. The Obama Administration is trying to reinflate the housing bubble, which was a major reason for the last financial crisis. This Chuck Asay cartoon neatly shows why this is misguided.

P.P.S. Don't forget that financial regulation is just one small piece of the overall red tape burden.