

Bank Regulation. Another Way

The Volcker Rule, Basel 3. Dodd-Franck and all the rules and regulations will not help banking stability until banks are allowed to fail. As long as banks are not allowed to fail, managers will continue to be engaged in willful or ignorant risky behavior.

Too much regulation also sacrifices efficiency.

The way to ensure a balance between stability and efficiency is to regulate in a different way.

- No bailouts. Period. No lenders of last resort.
- Regulate standards of disclosure in financial reporting to ensure transparency and clarity.
- Encourage linear and not convex alignment of managers' rewards and losses to the institution's fortunes.

If a bank is too opaque, or too complex in its conduct of business and in its financial reporting, or if managers have too convex a call on its profits, investors and savers will direct funding away from them starving them of equity and debt capital, and deposits.

It is a remarkable state of the industry that savers and investors can no longer rely on bank management to act in good faith. The need for more regulation is simply a restatement of this hypothesis. If one believes that this new level of regulation is necessary, they must also accept the hypothesis.