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BACKGROUNDER

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Financial Institutions: Necessary for Prosperity

David R. Burton and Norbert J. Michel, PhD

Abstract

Financial intermediation improves economic growth and prosperity by reducing transactions costs, fostering capital formation, and promoting a more efficient allocation of capital. Current banking and securities laws are complex, counterproductive, and interfere with financial intermediation. They make the financial system less stable, reduce competition, promote industry concentration, harm investors, and slow economic growth. Therefore, financial market regulation should return to its core purpose of deterring and punishing fraud, and fostering reasonable, scaled disclosure of information that is material to investors' investment choices.

Key Points

- Financial intermediaries—such as banks, investment banks, investment companies, and venture capital firms—play a major role in economic growth and productivity.
- The current regulatory framework is a complex morass that imposes high costs on financial intermediation and distorts capital markets.
- For decades, U.S regulators have been taking an increasingly active role in managing financial firms' risk even though the approach has repeatedly failed. The paternalistic and onerous regulatory regime is economically counterproductive and protects people from financial risks that they knowingly choose to accept.
- Policymakers should reform deposit insurance and the bank resolution process to reintroduce market discipline to financial institutions. Poorly managed financial firms should be allowed to fail via a streamlined bankruptcy process.
- The proper role of government in financial markets is to deter and punish fraud, and foster reasonable, scaled disclosure of information that is material to investors.

Financial intermediaries serve a key role in the U.S. economy. They are a central reason why the U.S. economy is as productive as it is. The term *financial intermediary* includes depository institutions (such as banks[1] and credit unions[2]); insurance companies;[3] investment banks;[4] investment companies (such as mutual funds and exchange-traded funds);[5] and venture capital funds.[6] They pool individuals' funds and channel the money to others who need capital to operate. These intermediaries provide services to both groups.

Banks, for instance, effectively allow depositors to loan funds to businesses without having to investigate or monitor those companies' operations and financial health. These businesses, in turn, avoid the trouble of having to find hundreds or thousands of people willing to make loans to them. In return for providing their financial intermediation services, banks earn a profit on the difference between the interest they receive from borrowers and the interest they pay to depositors or creditors.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3108**

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

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Investment banks serve a similar function by matching investors with companies seeking equity or debt capital. Broker-dealers enable investors who wish to sell a security to find a buyer in an instant. Investment companies take the savings of millions of investors and then invest those savings in the shares of tens of thousands of companies around the world. Venture capital funds take investors' capital and seek out new, dynamic companies to finance. Insurance companies invest premiums to settle future claims, and they sell products, such as variable life insurance and annuities, that have an investment component.[7]

The process of financial intermediation, whether carried out by banks, investment banks, or another intermediary, is a vital component of economic growth.

The process of financial intermediation, whether carried out by banks, investment banks, or another intermediary, is a vital component of economic growth because it facilitates capital formation and the efficient allocation of scarce capital resources. Without financial intermediation, raising the capital necessary to launch or operate a business, or borrowing to buy or build a home, would be much more difficult and expensive. It would also be harder for capital to find its most productive use. In 2014, the finance and insurance industries generated a value of $1.3 trillion (7.2 percent of gross domestic product),[8] and employed 7 million people.[9]

A poorly functioning financial-intermediation sector results in a society with fewer goods and services, fewer employment opportunities, and lower incomes. For at least a century, the U.S. regulatory framework has been increasingly hindering the financial-intermediation process. The current regulatory regime is counterproductive because it seeks to micromanage people's financial risk, a process that inevitably substitutes regulators' judgments for those of the investing public. Financial regulation should not protect people from business or financial risk that they knowingly choose to accept. Instead, financial regulations should focus on punishing and deterring fraud, and fostering the disclosure of information that is material to investment decisions.

1. As of June 30, 2015, there were 6,348 Federal Deposit Insurance Corporation (FDIC)-insured banks in the U.S. with domestic deposits of $10.6 trillion. See Federal Deposit Insurance Corporation, "Statistics At A Glance," Second Quarter, 2015, https://www.fdic.gov/bank/statistical/stats/2015jun/industry.xls (accessed March 15, 2016).
2. As of June 30, 2015, there were 6,159 credit unions in the U.S. with insured shares and deposits of $935 billion. See National Credit Union Administration, "Industry at a Glance," June 30, 2015, http://www.ncua.gov/Legal/Documents/Reports/IAG201506.pdf (accessed March 15, 2016).
3. Life insurance companies play the largest role in financial intermediation among insurance companies. As of the end of 2013, there were 850 life insurance companies in the U.S. with about $3.8 trillion in assets. See ACLI, "U.S. Life Insurers Organizational Structure by Number of Companies," Table 1.1, and "Distribution of Life Insurer Assets by Account Type," 2013, Table 2.1, *Life Insurers Fact Book 2014*, November 3, 2014, https://www.acli.com/Tools/Industry%20Facts/Life%20Insurers%20Fact%20Book/Pages/RP14-012.aspx (accessed March 15, 2016).
4. As of the end of 2014, there were 4,068 broker-dealers and 636,707 registered representatives who were registered with the Financial Industry Regulatory Authority (FINRA). See FINRA, "Statistics," https://www.finra.org/newsroom/statistics (accessed March 15, 2016). Only some broker-dealers underwrite primary offerings (that is, the issuance of new securities). The others are involved in the secondary market (markets where investors sell previously issued securities to other investors). Registered representatives work for broker-dealers.
5. As of the end of 2014, there were 16,660 investment companies in the U.S, managing about $18 trillion in assets. See *2015 Investment Company Factbook*, "Number of Investment Companies by Type," Figure 1.13, and "Investment Company Total Net Assets by Type," Figure 1.1, Chapter 1, http://www.icifactbook.org/fb_ch1.html (accessed March 15, 2016).
6. As of the end of 2014, there were approximately 1,206 venture capital funds and 803 venture capital firms in the U.S. with approximately $157 billion under management. See *2015 National Venture Capital Association Yearbook*, "Venture Capital Under Management Summary Statistics," Figure 1.0, http://nvca.org/?ddownload=1868 (accessed March 15, 2016).
7. Insurance companies' central function in the economy is risk intermediation, but they also provide financial intermediation services.
8. Bureau of Economic Analysis, "National Income and Product Accounts, Value Added by Industry, 2014," http://www.bea.gov/iTable/iTable.cfm?ReqID=51&step=1#reqid=51&step=51&isuri=1&5114=a&5102=1 (accessed March 15, 2016).
9. Bureau of Labor Statistics, "Labor Force Statistics from the Current Population Survey, Employed Persons in Nonagricultural Industries by Sex and Class of Worker," Table 16, http://www.bls.gov/cps/cpsa2014.pdf (accessed March 15, 2016).

Overview of Capital Markets

This *Backgrounder* focuses on capital market intermediation, particularly by commercial banks (depository institutions),[10] investment banks, and broker-dealers. While commercial banks typically provide customers with loans, investment banks and broker-dealers intermediate mainly by enabling investors to develop diversified portfolios of businesses' debt and equity securities.

Commercial Banks. Historically, the core function of commercial banks has been to accept customers' deposits and provide loans to individuals and businesses. Most people view their bank as a place to store their money, but that view is not completely accurate. While banks must return their customers' deposits on demand, banks do use those deposited funds to finance business investments and consumer purchases.

For instance, an individual may open a checking account with $1,000, then regularly withdraw and add funds to the account. The bank is always obligated to make the account balance available to the customer. However, because the bank's customers, in the aggregate, always have some money on deposit, the bank can lend a portion of the money on deposit to borrowers. Banks also use these deposited funds to buy other financial instruments, such as municipal bonds, Treasury bills, and mortgage-backed securities (MBS).[11]

While different banks specialize in different types of loans, they generally all make personal, commercial, and industrial loans. Some businesses, for instance, can use commercial loans to finance their inventory and computer purchases, while other companies can use industrial loans to fund new buildings, storage facilities, or manufacturing plants. All banks face a common problem: Their demand deposit customers can ask for their money without any notice.[12] In other words, banks have to make funds available to their deposit customers on demand, even when they have used those funds to make a loan to a borrower. For this reason, banks tend to prefer making short-term loans (no longer than five years).

Investment Banks and Broker-Dealers. Investment banks[13] connect investors with companies seeking new equity or debt capital. If the company sells securities to investors, it is called a primary offering. In addition to intermediating primary offerings, broker-dealers connect investors seeking to sell previously issued securities with investors seeking to buy securities, creating a robust secondary market in securities.[14] These broker-dealer secondary-market services enable investors to receive a better price with lower transactions costs and to quickly sell their securities. Moreover, a robust secondary market makes it easier to sell new primary offerings to investors because they know they will be able to sell the purchased securities rapidly and at a reasonable price when they wish to do so.

The Current Regulatory Framework

For decades, regulators have increasingly taken on a more active role in managing financial firms' risk despite the fact that this approach has repeatedly failed. In the late 1980s, for instance, federal banking regulators introduced the complex Basel capital rules, a purported improvement over the previous capital requirements. While these rules were intended to improve the safety and soundness of the banking system, they clearly did not prevent the 2008 meltdown. In fact, the Basel rules *contrib-*

10. 12 U.S. Code §3201 defines a depository institution as "a commercial bank, a savings bank, a trust company, a savings and loan association, a building and loan association, a homestead association, a cooperative bank, an industrial bank, or a credit union." For simplicity, we interchangeably use the terms *commercial bank* and *bank* to describe the general operation of all depository institutions (those accepting some form of deposits and making loans). As of 2010, commercial banks accounted for approximately 34 percent of all assets held by the major types of financial intermediaries. Frederic S. Mishkin, *The Economics of Money, Banking, and Financial Markets*, 10th ed. (Upper Saddle River, NJ: Pearson, 2013), p. 43.
11. There are restrictions on the securities that banks can purchase. See, for example, 12 U.S. Code §24; 12 CFR 1.3: "Limitations on dealing in, underwriting, and purchase and sale of securities."
12. A similar problem exists for savings deposits (time deposits or certificates of deposit). That is, savings deposits are typically made for specific amounts of time, but they can usually be withdrawn early (subject to a penalty).
13. The securities laws generally call investment banks "underwriters."
14. These secondary transactions can be effected through exchanges, through alternative trading systems, or through a less formal market operated by broker-dealers. Companies receive capital in primary offerings but they do not receive funds from secondary market sales.

uted to the crisis because they assigned inappropriate risk weights to certain assets.[15] Federal Deposit Insurance Corporation (FDIC) data even show that U.S. commercial banks exceeded their minimum capital requirements by two to three percentage points (on average) for six years leading up to the crisis.[16]

Historically, regulators have not managed non-banking financial firms' risk-taking as extensively as they have banks' activities, but the approaches have been moving in the same direction for decades. For instance, sections 8(b) and 15(c)(3) of the 1934 Securities Exchange Act introduced a net capital rule for broker-dealers, a rule that dictated the type and amount of liquid assets that broker-dealers had to maintain.[17] The rule has been amended several times, including a major adjustment in 1975 after a series of firm failures in the late 1960s and early 1970s, and again in 2004 just prior to the 2008 financial crisis.[18]

The 2004 rule change has been blamed for allowing broker-dealers to raise their leverage, but data shows that major investment banks were more highly levered in 1998 than in 2006.[19] One problem with both sets of capital rules is that they were crafted on the assumption that regulators know exactly which level of capital these firms should use to fund their operations. At the very least, this approach—mandating legally required capital ratios—should not be viewed as superior to allowing market participants to determine which levels of capital are adequate. Empirical research does caution against relying on excessive government supervision and regulation even of bank activities, as doing so does not necessarily promote the development and stabilization of the financial system.[20]

Internationally, evidence indicates that, by cultivating large and liquid securities markets, laws that mandate disclosure and enhance enforcement through civil liability rules have a more positive impact than other forms of securities regulations.[21] Some evidence suggests that this type of disclosure and private monitoring works best even in the banking sector.[22] Regardless, there is no reason to think that regulators have superior knowledge compared to other market participants when it comes to measuring financial assets' risk.[23] In fact, regulator-assigned risk weights under the Basel rules proved

15. Norbert J. Michel and John L. Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem," Heritage Foundation *Backgrounder* No. 2905, April 23, 2014, http://www.heritage.org/research/reports/2014/04/basel-iii-capital-standards-do-not-reduce-the-too-big-to-fail-problem?ac=1.
16. Juliusz Jablecki and Mateusz Machaj, "The Regulated Meltdown of 2008," *Critical Review*, Vol. 21, Nos. 2–3 (2009), pp. 306–307. Bank capital (and reserve) frameworks have changed a great deal over time with respect to the legal arrangement, the type, and the specific amount. See Malcolm C. Alfriend, "International Risk-Based Capital Standard: History And Explanation," Richmond Federal Reserve *Economic Review* (November/December 1988), https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_review/1988/pdf/er740603.pdf (accessed March 15, 2016), and Richard S. Grossman, "Other People's Money: The Evolution of Bank Capital in the Industrialized World," Wesleyan Economics *Working Paper* No. 2006-020, April 2006, http://repec.wesleyan.edu/pdf/rgrossman/2006020_grossman.pdf (accessed March 15, 2016).
17. This rule is very different from a bank's capital rules, largely because a bank is very different from a broker-dealer. See Erik Sirri, "Remarks at the National Economists Club: Securities Markets and Regulatory Reform," April 9, 2009, https://www.sec.gov/news/speech/2009/spch040909ers.htm (accessed March 10, 2016).
18. See 17 CFR 240.15c3-1 for the current rule. For a history of the rule's development, see Nicholas Wolfson and Egon Guttman, "The Net Capital Rules for Brokers and Dealers," *Stanford Law Review*, Vol. 24, No. 4 (1972), pp. 603–643.
19. U.S. Government Accountability Office, "Financial Markets Regulation: Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and across System," GAO–09–739, July 2009, p. 41, http://www.gao.gov/new.items/d09739.pdf (accessed March 15, 2016). Also see Andrew Lo, "Reading About the Financial Crisis: A 21-Book Review," *Journal of Economic Literature*, Vol. 50, No. 1 (March 2012), pp. 151–178.
20. James R. Barth, Gerard Caprio Jr., and Ross Levine, "Bank Regulation And Supervision: What Works Best?" *Journal of Financial Intermediation*, Vol. 13 (2004), pp. 205–248.
21. Rafael La Porta, Florencio Lopez-De-Silanes, and Andrei Shleifer, "What Works in Securities Laws?" *The Journal of Finance*, Vol. LXI, No. 1 (February 2006), http://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.2006.00828.x/pdf (accessed March 15, 2016).
22. James R. Barth et al., "Do Bank Regulation, Supervision and Monitoring Enhance or Impede Bank Efficiency?" *Journal of Banking & Finance*, Vol. 37 (2013), pp. 2879–2892.
23. One valid reason for imposing regulatory capital requirements on depository institutions is that taxpayers provide deposit insurance. This issue is discussed further below.

TABLE 1

Primary Bank Regulators

Federal Regulator	Number of Institutions	Total Assets (trillions)
FDIC	4,177	$2.61
OCC	1,554	$10.55
FRB	858	$2.19
Total	6,589	$15.35

SOURCE: Federal Deposit Insurance Corporation, 2015–2019 Strategic Plan, https://www.fdic.gov/about/strategic/strategic/bankingindustry.html (accessed March 15, 2016).

incorrect and contributed to the 2008 financial crisis.[24]

Summary of Bank Regulation. Banks' activities are highly regulated by both state and federal regulators, more so than most types of businesses. These regulatory functions can be broadly grouped as follows: (1) chartering and entry restrictions, (2) regulation and supervision, and (3) examination.[25] Chartering and entry restrictions address issues such as the process that people must follow to start a new bank, as well as how existing banks can expand into new geographic markets through mergers and acquisitions. Supervision and examination authority are complementary, and they cover a much wider range of activities. Supervision involves both the initial publication of rules to implement statutory law, and less formal press releases and circulars known as "guidance."

Additionally, regulators routinely examine banks' records to ensure that they are following the rules. Sometimes these examinations are informal regulatory sessions, but regulators still use the process to implement changes. Even an increase in capital can be implemented through threatened enforcement actions during informal examinations. Banks tend to comply with regulators' informal suggestions because failure to do so can bring additional regulatory scrutiny or formal enforcement actions.[26]

In most cases, banks are supervised and examined by more than one regulator. In general, federally chartered banks are subject to supervision by the Office of the Comptroller of the Currency (OCC). State-chartered banks that are members of the Federal Reserve System are subject to oversight by both the Federal Reserve Board and by state regulators. Non-Fed-member state-chartered banks that are insured by the FDIC are regulated by the FDIC and state regulators.

Additionally, the Fed is the primary regulator of all bank holding companies, even though such holding companies are also subject to state regulations.[27] Separately, a statutory formula dictates many specific responsibilities for the various federal banking regulators. For example, the Federal Deposit Insurance Act[28] defines the "appropriate Federal banking agency" for purposes of which agency regulates which bank,[29] and determines which federal agency is responsible for approving mergers between particular banks.[30]

Depending on the banking activity, at least seven federal regulators—(1) the Federal Reserve; (2) the FDIC; (3) the Securities and Exchange Commission (SEC);[31] (4) the Commodity Futures Trading Commission (CFTC); (5) the Consumer Financial Protection Bureau (CFPB); (6) the Federal Hous-

24. Michel and Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem."

25. For an introductory overview, see Michael P. Malloy, *Principles of Bank Regulation*, 3rd ed. (New York: Thomson Reuters, 2011).

26. There is essentially no appeals process for this type of regulation. See Julie Hill, "When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations," *Washington University Law Review*, Vol. 92 (2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2494634## (accessed March 10, 2016).

27. Title VI of Dodd–Frank, Public Law No. 111–203, July 21, 2010, broadened the Fed's holding company authority. See "Title VI: New Authority for the Fed," in Hester Peirce and James Broughel, eds., *Dodd–Frank: What It Does and Why It's Flawed* (Arlington, VA: Mercatus Center at George Mason University, 2012), pp. 66–75.

28. P.L. 81–797, 12 U.S. Code §1811 et seq.

29. 12 U.S. Code §1813(q).

30. 12 U.S. Code §1828(c)(2).

31. If the bank sells investments to customers, it will also be subject to regulation by the Financial Industry Regulatory Authority (FINRA).

ing Finance Agency (FHFA); and (7) various agencies within the U.S. Treasury Department[32]—could supervise, examine, or otherwise regulate a bank. These are, of course, in addition to state regulators. These regulations have imposed enormous costs on banks, and undoubtedly contributed to the decline in the overall number of banks and the increased concentration in the banking industry.[33]

In practice, both state and federally chartered banks are subject to state laws governing the basic transactions in which they engage with their customers. For instance, state laws, most notably the Uniform Commercial Code, govern practices such as the transactions in commercial paper and promissory notes, bank deposits, funds transfers, secured transactions, and contracts.[34] Other state laws govern bank chartering, safety, and soundness; securities; insurance; real property; and mortgages.[35] However, federal law governs federally chartered banks' rights and obligations as corporate entities.

Moreover, the Truth in Lending Act (TILA)[36] is supposed to provide uniform credit standards, and the Real Estate Settlement Procedures Act (RESPA) governs real estate settlement processes throughout the U.S.[37] Banks are also subject to the Equal Credit Opportunity Act,[38] the Community Reinvestment Act,[39] and the Fair Credit Reporting Act,[40] among many other statutes. Although this dual state–federal system has existed for more than a century, the bank regulatory framework is now more federalized than ever because the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) requires that any FDIC-insured state bank not engage in any activity impermissible for national banks—and nearly all state banks are FDIC insured.[41]

In general, bank regulations are justified on the grounds that they ensure the safety and soundness of the banking system and also promote equitable access to loans. Rather than providing a detailed description of major banking regulations, the goal of this *Backgrounder* is to provide an overview of the regulatory framework. The following list provides an overview of several key regulations:

- All bank holding companies with assets of more than $50 billion are subject to heightened super-

32. Besides the OCC, the Financial Crimes Enforcement Network and the IRS impose a wide variety of information-reporting and due-diligence requirements on financial institutions. The Treasury's recent request for "Public Input on Expanding Access to Credit Through Online Marketplace Lending" shows that it is clearly contemplating greater regulation of online lenders. Department of the Treasury, "Public Input on Expanding Access to Credit Through Online Marketplace Lending," Billing Code 4810-25-P, July 17, 2015, https://www.treasury.gov/connect/blog/Documents/RFI%20Online%20Marketplace%20Lending.pdf (accessed March 15, 2016). Separately, Title I of Dodd–Frank created the Financial Stability Oversight Council (FSOC), a council that consists of the heads of many of the above-mentioned regulatory agencies, and tasked it with several broad responsibilities, such as identifying systemically important financial institutions and activities. See Norbert J. Michel, "The Financial Stability Oversight Council: Helping to Enshrine 'Too Big to Fail,'" Heritage Foundation *Backgrounder* No. 2900, April 1, 2014, http://www.heritage.org/research/reports/2014/04/the-financial-stability-oversight-council-helping-to-enshrine-too-big-to-fail.
33. For example, as of June 30, 2015, the largest four banks (of 6,357) accounted for approximately $4.7 trillion out of $10.6 trillion (44 percent) of insured deposits. See Federal Deposit Insurance Corporation, "Statistics at a Glance," Second Quarter, 2015, and US Bank Locations, "Banks Ranked by Total Deposits," data as of June 30, 2015, http://www.usbanklocations.com/bank-rank/total-deposits.html (accessed March 15, 2016). The share of deposits held by small banks has declined from 40.4 percent in 2000 to 21.7 percent in 2014. See Hester Peirce and Stephen Matteo Miller, "Small Banks by the Numbers, 2000–2014," Mercatus Center, March 17, 2015 http://mercatus.org/publication/small-banks-numbers-2000-2014 (accessed December 2, 2015). The FDIC's resolution process has also contributed to industry concentration because the FDIC promotes the acquisition of failing banks by healthy, larger banks, thus concentrating assets in a smaller number of larger banks.
34. Uniform Commercial Code, https://www.law.cornell.edu/ucc (accessed March 21, 2016). The UCC is not actually "uniform" throughout the country. Different states have enacted somewhat different versions.
35. Essentially since the nation's founding, the U.S. banking system has consisted of significant state involvement and regulation. See Howard Bodenhorn, *State Banking in Early America: A New Economic History* (Oxford University Press, 2003).
36. P.L. 90–321, 15 U.S. Code §1601 et seq., as amended. See also 12 CFR Part 226–Truth in Lending (Regulation Z).
37. P.L. 93–533, 12 U.S. Code §2601 et seq., as amended.
38. 15 U.S. Code §1691, et seq.
39. 12 U.S. Code §2901, et seq.
40. 15 U.S. Code §1681, et seq.
41. 12 U.S. Code §1831a.

vision by the Fed. These special standards apply to banks' leverage, liquidity, and capital requirements, as well as overall risk-management and resolution processes.[42]

- Federal law limits how much money a bank can lend to any one customer or to a group of related customers.[43]

- All banks are subject to the Federal Reserve's deposit reserve requirements.[44]

- The Dodd–Frank Wall Street Reform and Consumer Protection Act transferred the rulemaking authority for various consumer financial protection laws to the newly created Consumer Financial Protection Bureau (CFPB).[45]

- Banks are subject to lending limits (and other restrictions) on loans they can provide to insiders (such as officers, directors, and shareholders), as well as to affiliate institutions.[46]

- The OCC has promulgated rules that determine the minimum amount of capital required to form a bank.[47]

- The Federal Reserve is the primary regulator of all bank holding companies and, as such, regulates the "financial condition and operations, management, and intercompany relationships of the bank holding company and its subsidiaries, and related matters."[48]

- Federal banking agencies regulate banks' capital adequacy, and have discretion to define what constitutes adequate capital levels.[49] Federal regulators examine banks' capital adequacy every 12 months (every 18 months for small institutions).[50]

- The Fed's Regulation E covers rules for electronic funds transfers,[51] and Regulation C covers home-mortgage disclosure rules.[52]

- The Fed's Regulation Z (Truth in Lending) prescribes uniform rules for "computing the cost of

42. Michel, "The Financial Stability Oversight Council: Helping to Enshrine 'Too Big to Fail.'"
43. A national bank's or savings association's total outstanding loans and extensions of credit to one borrower may not exceed 15 percent of the bank's or savings association's capital and surplus, plus an additional 10 percent of the bank's or savings association's capital and surplus, if the amount that exceeds the bank's or savings association's 15 percent general limit is fully secured by readily marketable collateral, as defined in 12 CFR 32.3–Lending Limits, 12 U.S. Code §84.
44. All depository institutions, as opposed to only Fed member banks, became subject to this requirement under the Depository Institutions Deregulation and Monetary Control Act of 1980. The Fed's Regulation D: Reserve Requirements of Depository Institutions covers these requirements. See 12 CFR 204.
45. Prior to passage of Dodd–Frank, authority for some 50 rules and orders stemming from 18 consumer protection laws was divided among seven agencies. See Diane Katz, "The CFPB in Action: Consumer Bureau Harms Those It Claims to Protect," Heritage Foundation *Backgrounder* No. 2760, January 22, 2013, http://www.heritage.org/research/reports/2013/01/the-cfpb-in-action-consumer-bureau-harms-those-it-claims-to-protect.
46. 12 U.S. Code §375a(1) and 12 U.S.Code §371c(a), respectively.
47. Malloy, *Principles of Bank Regulation*, p. 278, and 12 CFR 5.20.
48. 12 U.S. Code §1844. This arrangement has been in place since the 1956 Bank Company Holding Act, and was amended by the 1999 Gramm–Leach–Bliley Act (GLBA). Under the GLBA, the Fed approves applications to become a financial holding company (FHC) only after certifying that both the holding company and all of its subsidiary depository institutions are "well-managed and well-capitalized, and…in compliance with the Community Reinvestment Act, among other requirements." See Dafna Avraham, Patricia Selvaggi, and James Vickery, "A Structural View of U.S. Bank Holding Companies," Federal Reserve Bank of New York *Economic Policy Review*, July 2012, p. 67, http://www.newyorkfed.org/research/epr/12v18n2/1207avra.pdf (accessed March 15, 2016). Also see 12 U.S. Code §1843–Interests in nonbanking organizations.
49. The 1983 International Lending Supervision Act enacted this authority. Each appropriate federal banking agency must establish minimum levels of capital for banks. See 12 U.S. Code §3907 and 12 U.S. Code § 1831o(c). The federal agencies have jointly decided to use the Basel requirements as their guidelines for what constitutes adequate capital.
50. See 12 U.S. Code §1820(d)(1)–(4).
51. 12 CFR 205.
52. 12 CFR 203.

credit, for disclosing credit terms, and for resolving errors on certain types of credit accounts."[53]

- Regulation BB "implements the Community Reinvestment Act and encourages banks to help meet the credit needs of their communities."[54]

- Banks and other financial institutions are required to comply with complex anti–money laundering laws and "know your customer" requirements primarily administered by the Treasury Department's Financial Crimes Enforcement Network.[55]

- Banks and other financial institutions are required to comply with a complex set of tax-information reporting requirements administered by the IRS.[56] The Senate is considering a treaty that would impose a wide variety of new information-reporting requirements on financial institutions to help foreign governments collect their taxes.[57]

Summary of Securities Regulation. The regulation of securities issued by companies to investors (primary offerings) and sales between investors (secondary offerings or secondary market) has become monstrously complex. The Securities Act of 1933 (as amended)[58] governs the offering of securities to the public by companies. In general, the 1933 act requires companies to register the securities they sell, and mandates disclosure of a great deal of information. It creates various exceptions. It prohibits fraud. In addition, the Trust Indenture Act of 1939 regulates the issuance of bonds and other debt securities.[59]

The Securities Exchange Act of 1934 (as amended)[60] governs secondary markets and securities firms. In general, the 1934 act governs stock exchanges, underwriters (investment banks), and broker-dealers. It requires broker-dealers and exchanges to register with the SEC. It prohibits fraud, and the SEC has exercised its authority under the act to prohibit insider trading. Investment companies such as mutual funds and closed-end funds are regulated by the Investment Company Act of 1940 (as amended),[61] and investment advisers are regulated by the Investment Advisers Act of 1940 (as amended).[62] The Sarbanes–Oxley Act of 2002[63] and the Dodd–Frank Act[64] made major changes in corporate governance and auditing rules for public companies.

These laws are enforced by the SEC, but the Treasury Department also regulates financial (including securities) markets, particularly the activities of broker-dealers.[65] Additionally, the U.S. Commodity Futures Trading Commission (CFTC), created in 1974, enforces the Commodities Exchange Act[66] and regulates commodities futures and foreign exchange.

53. 12 CFR 226.
54. 12 CFR 228.
55. 31 U.S. Code §5311, et seq.; 31 CFR Chapter X.
56. Internal Revenue Code §6041, et seq.
57. David R. Burton, "Two Little Known Tax Treaties Will Lead to Substantially More Identity Theft, Crime, Industrial Espionage, and Suppression of Political Dissidents," Heritage Foundation *Backgrounder* No. 3087, December 21, 2015, http://www.heritage.org/research/reports/2015/12/two-little-known-tax-treaties-will-lead-to-substantially-more-identity-theft-crime-industrial-espionage-and-suppression-of-political-dissidents.
58. The Securities Act of 1933, P.L. No. 73–22, 48 Stat. 74, 15 U.S. Code §77a, et seq. (as amended through P.L. No. 112–106, April 5, 2012).
59. The Trust Indenture Act of 1939, P.L. 76–253, 53 Stat. 1149 (as amended through P.L. 111–229, August 11, 2010).
60. The Securities Exchange Act of 1934, P.L. 73–291, 48 Stat. 881. 15 U.S. Code §78a, et seq. (as amended through P.L. No. 112–158, August 10, 2012).
61. Investment Company Act of 1940, P.L. 76–768 (as amended through P.L. No 112–90, January 3, 2012).
62. Investment Advisers Act of 1940, P.L. 76–768, 54 Stat. 847, 15 U.S. Code § 80b–1, et seq. (as amended through P.L. 112–90, January 3, 2012). Also, broker-dealers, investment advisers, and others that provide advice or services to retirement plans are subject to the Employee Retirement Income Security Act of 1974 (as amended), 29 U.S. Code §1001, et seq., which is primarily enforced by the Department of Labor.
63. The Sarbanes–Oxley Act of 2002, P.L. 107–204, July 30, 2002.
64. The Dodd–Frank Wall Street Reform and Consumer Protection Act, P.L. 111–203, July 21, 2010.
65. Most notably via the Financial Crimes Enforcement Network (FinCen), the Office of the Comptroller of the Currency (OCC), and the Financial Stability Oversight Council (FSOC).
66. The Commodity Exchange Act, P.L. 74–675, June 15, 1936.

The CFTC's regulatory authority can overlap with that of the SEC with respect to certain derivatives.[67] Finally, state "blue sky" laws and state regulators also regulate securities (both primary and secondary offerings) and broker-dealers. For firms seeking to raise capital or do business in more than one state, these laws add substantial costs and delays. Similarly, blue sky laws are a major impediment to small broker-dealers seeking to operate across state lines.

Essentially every sort of panic, crisis, or downturn has been met with added regulation in the name of preventing the next calamity, a goal that can never be reached.

Much of the regulation of broker-dealers has been effectively delegated to the Financial Industry Regulatory Authority (FINRA), a private not-for-profit organization.[68] Similarly, the Public Company Accounting Oversight Board (PCAOB) has been delegated regulatory authority over the auditing of public companies and broker-dealers.[69] The SEC is charged with oversight of the activities of FINRA and the PCAOB. The overall approach to securities regulation has gone well beyond the traditional focus of deterring and punishing fraud, and requiring reasonable, limited, scaled disclosure of material information by widely held firms.[70] The regulatory framework has reduced the competitiveness and effectiveness of the U.S. financial system, and it is time to move to a more market-based regulatory system where private actors—not taxpayers—absorb losses when they take unwarranted risks.

A New Approach

The process of financial intermediation, whether carried out by banks, investment banks, or another intermediary, is a vital component of economic growth because it facilitates capital formation and the efficient allocation of scarce capital resources. A great deal of evidence supports this proposition.[71] Furthermore, evidence indicates that a regulatory framework that mandates disclosure and improves enforcement through civil liability is superior to one that relies on excessive government supervision and regulation.[72]

U.S. banks have dealt with some form of risk management from regulatory agencies since the early republic. Securities market regulation was originally focused on fraud prevention and disclosure. Particularly at the state level, but increasingly at the federal level, regulations in both areas have become more concerned with active risk management. Essentially every sort of panic, crisis, or downturn has been met with added regulation in the name of preventing the next calamity, a goal that can never be reached. Worse, the new regulations often fail to address the underlying cause of the problem and typically exac-

67. Section 14.1 "Overlapping Jurisdictions after the Dodd-Frank Act," in H. David Kotz, *Financial Regulation and Compliance: How to Manage Competing and Overlapping Regulatory Oversight* (New York: Wiley, 2015), and Edward V. Murphy, "Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets," Congressional Research Service, January 30, 2015, https://www.fas.org/sgp/crs/misc/R43087.pdf (accessed March 15, 2016).

68. FINRA is a private not-for-profit organization with a budget of approximately $1 billion. It was formed by a merger in 2007 of the regulatory functions of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE). It is not a true self-regulatory organization (SRO) because industry does not control a majority of its board. It is not a true government agency, although Congress and the SEC have delegated governmental regulatory authority to it. For more information, see FINRA http://www.finra.org/ (accessed March 15, 2016).

69. For more information, see PCAOB, "Protecting Investors Through Audit Oversight," http://pcaobus.org/Pages/default.aspx (accessed March 15, 2016). Additionally, the Municipal Securities Rulemaking Board (MSRB) regulates "the municipal securities firms, banks and municipal advisors that engage in municipal securities and advisory activities." MSRB, http://www.msrb.org/ (accessed March 15, 2016).

70. Some research calls into question even the traditional approach. See Paul Mahoney, *Wasting a Crisis: Why Securities Regulation Fails* (Chicago: University of Chicago Press, 2015).

71. For a broad overview, see Ross Levine, "Finance and Growth: Theory and Evidence," in Aghion Philippe and Steven Durlauf, eds., *Handbook of Economic Growth* (North Holland, MI: Elsevier, 2005), pp. 866–934, http://faculty.haas.berkeley.edu/ross_levine/papers/forth_book_durlauf_finngrowth.pdf (accessed March 15, 2016), and Valerie R. Bencivenga and Bruce D. Smith, "Financial Intermediation and Endogenous Growth," *Review of Economic Studies*, Vol. 58, (1991), pp. 195–209.

72. La Porta, Lopez-De-Silanes, and Shleifer , "What Works in Securities Laws?" and Barth et al., "Do Bank Regulation, Supervision and Monitoring Enhance or Impede Bank Efficiency?"

erbate the situation. The 2010 Dodd–Frank Act is the latest example of this flawed approach.

Title I of Dodd–Frank creates the Financial Stability Oversight Council (FSOC) and charges these regulators with the ill-defined task of maintaining financial stability as well as identifying so-called systemically important firms (that is, companies deemed too big to fail).[73] Title II creates a government-backed resolution process for these firms,[74] Title VIII provides Federal Reserve access to a new group of financial firms identified as financial market utilities,[75] and Title XI codifies the types of emergency lending the Fed conducted during the 2008 crisis.[76] Finally, Title III extends the FDIC deposit insurance limit to $250,000.[77] This approach has reduced the competitiveness and effectiveness of the U.S. financial system, and has undermined financial intermediation and stability.

To reverse these trends, policymakers should take an entirely different approach to regulating capital markets. The main goals of a financial market reform program should be to reduce impediments to capital formation and market efficiency, to reduce unwarranted regulatory costs, to eliminate policies that socialize private investors' losses, and to protect taxpayers from bailing out failed financial firms. In both the banking and securities industries, the main goal of regulations should be to provide reasonable, scaled disclosure, enforce contracts, and deter fraud.

In many cases, the current disclosure rules have become overly burdensome and so voluminous that they obfuscate rather than inform.[78] For example, over the past 20 years, the average number of pages in annual reports devoted to footnotes and "Management's Discussion and Analysis" has quadrupled.[79] Other so-called disclosure laws have also expanded in scope. For instance, although TILA is supposed to promote uniform disclosure of credit terms to relatively unsophisticated consumers, the rules are so complex that regulators monitor banks' training programs to ensure that employees are properly trained in TILA requirements.[80]

The new framework should be grounded in the following principles:

- Private markets do a better job of allocating capital than the government.
- The government exists to protect individuals' property, to prevent fraud, and to enforce contracts. It is not a proper function of government to protect people from making poor business or investment decisions, or from bad luck.
- Government regulators do not have better investment judgment than private citizens investing their own money.
- The socialization of the risk of loss via government backing increases the willingness to take unwarranted risk, reduces rather than enhances stabil-

73. Michel, "The Financial Stability Oversight Council: Helping to Enshrine 'Too Big to Fail.'"
74. Norbert J. Michel, "House Highlights Dodd–Frank Deficiencies," The Daily Signal, July 24, 2014, http://dailysignal.com/2014/07/24/house-highlights-dodd-frank-deficiencies/, and Paul H. Kupiec and Peter J. Wallison, "Can the 'Single Point of Entry' Strategy Be Used to Recapitalize a Failing Bank?" American Enterprise Institute *Economic Working Paper* No. 2014-08, November 4, 2014, https://www.aei.org/wp-content/uploads/2014/11/SPOE-Working-paper-Nov-5.pdf (accessed March 15, 2016).
75. Norbert J. Michel, "Fixing the Dodd–Frank Derivatives Mess: Repeal Titles VII and VIII," Heritage Foundation *Backgrounder* No. 3076, November 16, 2015, http://www.heritage.org/research/reports/2015/11/fixing-the-doddfrank-derivatives-mess-repeal-titles-vii-and-viii.
76. Norbert J. Michel, "Dodd–Frank's Title XI Does Not End Federal Reserve Bailouts," Heritage Foundation *Backgrounder* No. 3060, September 29, 2015, http://www.heritage.org/research/reports/2015/09/doddfranks-title-xi-does-not-end-federal-reserve-bailouts-norbert-j-michel-phd.
77. Title III, Subtitle C, Section 335 essentially extended coverage limits that were provided to some accounts by the Federal Deposit Insurance Reform Act of 2005. See 12 U.S. Code §1821 (a)(1)(E).
78. Troy A. Paredes, "Blinded by the Light: Information Overload and Its Consequences for Securities Regulation," *Washington University Law Quarterly*, Vol. 81 (2003), pp. 417–485.
79. Ernst & Young, "Now Is the Time to Address Disclosure Overload," *To the Point* No. 2012-18, June 21, 2012, http://www.ey.com/Publication/vwLUAssets/ToThePoint_BB2367_DisclosureOverload_21June2012/$FILE/TothePoint_BB2367_DisclosureOverload_21June2012.pdf (accessed March 15, 2016).
80. Independent Community Bankers of America, "ICBA Summary of the TILA-RESPA Integrated Disclosure (TRID) Rule," October 2015, https://www.icba.org/files/ICBASites/PDFs/TILARESPAIntegratedDisclosureSummary.pdf (accessed March 15, 2016). For a broader perspective on TILA and whether it has solved the problems it was supposed to, see Ralph J. Rohner, "Truth in Lending 'Simplified': Simplified?" *N.Y.U. Law Review*, Vol. 56 (1981), pp. 999–1035.

ity, increases concentration in the financial services industry, rewards politically connected actors, and imposes an unfair burden on taxpayers.

Broadly, regulations directed at restricting investor choice and substituting regulators' investment judgment for that of investors should be discarded. To promote freedom, improve the economy, and enhance the stability of the financial system, a new regulatory framework should be adopted for both banking and securities markets.

Bank Regulation. Throughout U.S. history, banking regulations have increasingly focused on risk management conducted by regulatory agencies rather than on disclosure and fraud prevention. Yet, data show that the U.S. has had 15 banking crises since 1837, a total that ranks among the highest of developed countries.[81] Similarly, among severe economic contractions in six developed nations from 1870 to 1933, *banking* crises occurred only in the U.S.[82] More recently, the U.S. is one of only three developed countries with at least two banking crises between 1970 and 2010.[83] Furthermore, as federal interventions, such as central banking, deposit insurance, and loan guarantees, became more widespread internationally, banking crises occurred relatively more frequently.[84] Evidence also suggests that government policies have not greatly improved overall macroeconomic stability in the U.S. during the post WWII era.[85]

The *safety and soundness* regulations imposed on U.S. banks are consistently justified by citing systemic-risk concerns (financial and macroeconomic stability), as well as the necessity of protecting the FDIC insurance fund.[86] In the 1980s, regulators forced the Basel capital rules on virtually all banks, even though these rules were originally meant only for internationally active financial institutions. Banks are now dealing with the third iteration of these rules, known as Basel III.[87] Under this system, banks must maintain various capital ratios and liquidity buffers based partly on regulators' subjective risk assessments. These rules impose needlessly complex requirements. They impose lower capital requirements for assets that regulators deem safe, and higher capital requirements for assets that regulators deem riskier.[88]

Rather than forcing banks to adhere to arbitrary standards set by regulatory fiat, policymakers should introduce more market discipline into the system so that, ultimately, market participants can set their own capital rules. While allowing market participants to determine the appropriate equity levels for funding still fails to *guarantee* a stable banking system and macroeconomy, evidence clearly shows that allowing regulators to set statutory capital requirements fails as well. What's more,

81. Charles A. Calomiris and Stephen Haber, *Fragile By Design: The Political Origins of Banking Crises and Scarce Credit* (Princeton, NJ: Princeton University Press, 2014), pp. 4–7.

82. Michael Bordo, "Some Historical Evidence 1870–1933 on the Impact and International Transmission of Financial Crises," NBER *Working Paper* No. 1606, April 1985, http://www.nber.org/papers/w1606.pdf (accessed December 17, 2015).

83. Calomiris and Haber, *Fragile By Design*.

84. Charles A. Calomiris, "Banking Crises Yesterday and Today," *Financial History Review*, Vol. 17, No. 1 (2010), p. 4.

85. For instance, the average length of recessions, as well as the average time to recover from recessions, has been slightly longer in the post-WWII era than in the pre-WWI era. Although recessions were more frequent in the pre-WWI era than in the post-WWII period, this comparison omits roughly 30 years that included the Great Depression. When the entire Federal Reserve period is compared to the full pre-Fed period, the frequency of recessions has not decreased. See Norbert J. Michel, "Federal Reserve Performance: Have Business Cycles Really Been Tamed?" Heritage Foundation *Backgrounder* No. 2965, October 24, 2014, http://www.heritage.org/research/reports/2014/10/federal-reserve-performance-have-business-cycles-really-been-tamed.

86. Mark Flannery, "Supervising Bank Safety and Soundness: Some Open Issues," Federal Reserve Bank of San Francisco, "Conference on Safe and Sound Banking: Past, Present, and Future," August 17–18, 2006, http://www.frbsf.org/economic-research/files/flannery.pdf (accessed December 18, 2015). Even prior to the creation of FDIC deposit insurance, U.S. regulations never completely allowed market participants to set banks' capital levels.

87. Michel and Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem."

88. The Basel rules came under criticism in the wake of the Greek debt crisis because they allowed banks to hold no capital—via zero-risk weights—against sovereign government debt. In January 2015, the Basel Committee initiated a review of its existing treatment of sovereign debt. See Huw Jones, "Global Bank Watchdog to Review Rule on Zero-Risk Weighting for Sovereign Debt," Reuters, January 23, 2015, http://www.reuters.com/article/2015/01/23/basel-sovereign-regulations-idUSL6N0V22ZO20150123#2MI4gx2T3BydgfvQ.97 (accessed March 15, 2016).

both theory and evidence suggest that the banking system will perform better when banks' capital suppliers face more market discipline.[89]

Imposing more market discipline in the banking sector will require major changes to the FDIC bank-resolution process, the FDIC deposit-insurance scheme, and the Federal Reserve's lending authority. It is critical that banks' capital suppliers are no longer protected from loss by taxpayers. Allowing banks to fail, just as other types of businesses are allowed to fail, is integral to bringing market discipline to the financial sector.

Allowing banks to fail, just as other types of businesses are allowed to fail, is integral to bringing market discipline to the financial sector.

The fear that a bank failure could freeze a large amount of customer deposits, thus disrupting the economy, has been a main contributing factor to the existing FDIC bank-resolution process. There are, however, many market-based options used around the world that could replace the FDIC process and bring much-needed market discipline to the banking sector. New Zealand, for instance, uses an open-bank-resolution policy that freezes a portion of a failed bank's assets but allows the bank to remain open to conduct limited business in a way that minimizes economic disruptions.[90]

There is no doubt that the taxpayer-backed deposit insurance provided by the FDIC insulates banks from market discipline. To mitigate this problem, FDIC deposit insurance should be reduced, at least to the pre-Dodd–Frank limit of $100,000 per account. Even lowering the value to the pre-1980 limit of $40,000 per account would insure a level (based on 2014 data) nearly 10 times the average transaction account balance of approximately $4,000.[91] Another major improvement would be to require that banks acquire *private* deposit insurance from well-capitalized insurance company syndicates. At the very least, a private system that mutualizes deposit insurance losses—as in other countries—should be developed.[92] Research shows that countries with more government involvement in a deposit insurance system, and with higher levels of deposit insurance coverage, tend to have more bank failures and financial crises.[93]

Taxpayer backing in the current framework also comes indirectly from the Federal Reserve, which has a long history of using its emergency lending and discount-window loan policies to support failing

89. One author argues: "Although bank supervision under the National Banking System exercised a light hand and panics were frequent, depositor losses were minimal." Eugene N. White, "'To Establish a More Effective Supervision of Banking': How the Birth of the Fed Altered Bank Supervision," NBER *Working Paper* No. 16825, February 2011, http://www.nber.org/papers/w16825 (accessed March 15, 2016). Also see Jonathan Macey and Geoffrey Miller, "Double Liability of Bank Shareholders: History and Implications," *Wake Forest Law Review*, Vol. 27 (1992), pp. 31–62.

90. Reserve Bank of New Zealand, "Open Bank Resolution (OBR) Policy FAQs," http://rbnz.govt.nz/faqs/open-bank-resolution-policy-faqs (accessed March 16, 2016). The FDIC used an open-bank assistance (OBA) policy 137 times between 1950 and 1992. With reforms, OBA could be converted into a sound open-bank resolution policy. See FDIC, "Open Bank Assistance," https://www.fdic.gov/bank/historical/managing/history1-05.pdf (accessed March 15, 2016). A streamlined bankruptcy or resolution procedure for large banks, such as the one developed by the Hoover Institution's Working Group on Economic Policy, also deserves serious consideration. See Kenneth E. Scott and John B. Taylor, eds., *Bankruptcy Not Bailout: A Special Chapter 14* (Stanford, CA: Hoover Institution Press, 2012).

91. Transaction accounts include checking, savings, money market, and call accounts. See Federal Reserve Board of Governors, "Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin* Vol. 100, No. 4 (September 2014), p. 16, http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf (accessed March 15, 2016). Also see Christine M. Bradley, "A Historical Perspective on Deposit Insurance Coverage," *FDIC Banking Review*, December 2000, https://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_1.pdf (accessed March 15, 2016).

92. Switzerland and Germany, for example, have largely privatized their deposit insurance systems.

93. For an overview, see Thomas Hogan and Kristine Johnson, "Alternatives to FDIC Deposit Insurance," *Independent Review*, forthcoming, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2568767 (accessed December 18, 2015). According to the World Bank, 87 countries have explicit deposit insurance, as opposed to a system where people simply expect the government to cover deposit losses in the event of bank failures. Of these 87 countries, 21 countries had (as of 2003) some form of private co-insurance requirement as part of their deposit insurance system. See Asli Demirguc-Kunt, Baybars Karacaovali, and Luc Laeven, "Deposit Insurance Around the World: A Comprehensive Database," The World Bank, April 2005, http://siteresources.worldbank.org/INTRES/Resources/469232-1107449512766/DepositInsuranceDatabasePaper_DKL.pdf (accessed December 12, 2015).

firms.[94] This type of lending perpetuates the too-big-to-fail problem, so Congress should eliminate the Fed's ability to provide such lending, and limit the Fed to providing system-wide liquidity (instead of allocating credit to individual institutions). The Fed can expand system-wide liquidity by, for example, temporarily expanding its open-market purchases as it did during the Y2K scare and after the 9/11 terrorist attacks. Banks can then use the temporary expansion in liquid reserves to lend to each other as needed in the federal funds market, presumably only to sound banks.[95] Combined, these improvements will introduce more market discipline into financial markets with minimum economic disruption.

Securities Regulation. Current securities laws are a complex morass. They impede capital formation, disproportionately harm small and start-up businesses, and reduce innovation and economic growth. Securities laws should focus primarily on the core mission of deterring and punishing fraud, as well as requiring reasonable, limited, scaled disclosure by widely held firms.[96] That is, public firms should disclose material information required by investors to make informed investment decisions, such that larger and more widely held firms are subject to greater disclosure requirements.

The modern securities market is generally interstate in character and therefore most primary offerings, secondary markets, and broker-dealers should be subject only to the federal regulatory regime. State securities regulation should be limited to intrastate offerings and anti-fraud enforcement rather than offering registration and qualification.

The law should allow the development of robust secondary markets in the securities of smaller companies by improving existing secondary markets for small public companies, establishing a regulatory environment that enables venture exchanges, and reasonably regulating the secondary sales of private securities. Regulators should not engage in "merit review" or mandate particular portfolio choices where regulators seek to substitute their investment or business judgment for that of investors.

Countries with more government involvement in a deposit insurance system, and with higher levels of deposit insurance coverage, tend to have more bank failures and financial crises.

Conclusion

Historically, the U.S. has one of the worst financial-stability records among developed nations. Virtually every crisis period has been followed with the same response: more invasive federal regulation. This response has not improved stability, but it has made the financial sector less competitive because younger, smaller firms find it more difficult to comply with voluminous, complex regulations. Currently, more than ever before, federal oversight of U.S. capital markets relies on regulators to plan, protect, and maintain the safety of the financial system. Furthermore, the federal government now stands ready to absorb private financial firms' losses to an even greater degree than prior to the 2008 crisis.

For decades, regulators—undaunted by their past failures—have taken a more active role in managing financial firms' risk-taking. It is time to move to a more market-based regulatory system where private actors—not taxpayers—absorb losses when they take unwarranted risks, and poorly managed

94. Norbert J. Michel, "The Fed's Failure as a Lender of Last Resort: What to Do About It," Heritage Foundation *Backgrounder* No. 2943, August 20, 2014, http://www.heritage.org/research/reports/2014/08/the-feds-failure-as-a-lender-of-last-resort-what-to-do-about-it?ac=1, and Anna J. Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis *Review*, Vol. 74, No. 5 (September/October 1992), pp. 58–69.

95. The Fed can also replace its limited primary dealer system with a market-wide liquidity auction program. See Michel, "Dodd–Frank's Title XI Does Not End Federal Reserve Bailouts," and George Selgin, "L Street: Bagehotian Prescriptions for a 21st Century Money Market," *Cato Journal*, Vol. 32, No. 2 (Spring/Summer 2012), http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2012/7/v32n2-8.pdf (accessed March 15, 2016). Also see Renee Haltom and Jeffrey Lacker, "Should the Fed Do Emergency Lending?" Federal Reserve Bank of Richmond *Economic Brief* No. 14-07, July 2014, https://www.richmondfed.org/publications/research/economic_brief/2014/eb_14-07.cfm (accessed December 17, 2015).

96. Reporting companies, smaller reporting companies, Regulation A (Tier 2 and Tier 1) companies, crowdfunded companies, and private offerings to non-accredited investors should have scaled, decreasing reporting obligations.

banks are allowed to fail. Such an approach would have the added benefit of reducing the regulatory burden on smaller financial institutions, increasing their competitiveness and reducing concentration in the industry.

Securities laws should focus primarily on the core mission of deterring and punishing fraud, as well as requiring reasonable, limited, scaled disclosure by widely held firms of information material to investors' investment decisions. The modern securities market is generally interstate in character and therefore, in order to reduce barriers to small-firm capital formation, most primary offerings, secondary markets, and broker-dealers should be subject only to the federal regulatory regime. Moreover, the law should allow the development of robust secondary markets in the securities of smaller companies. Finally, regulators should not seek to substitute their investment or business judgment for that of investors.

*—**David R. Burton** is Senior Fellow in Economic Policy in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation. **Norbert J. Michel, PhD**, is a Research Fellow in Financial Regulations in the Roe Institute.*