Financial Regulation and Externalities: Efficiency *vs* Politics

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Fundamentally, financial regulation aims at facilitating access to finance.
From an efficiency perspective, this means that entrepreneurs as well as consumers should get financing at competitive rates. However, the rewards of financial regulation are not necessarily equally distributed, an externality that is likely to favor some financial intermediaries or industrial firms over others. Financial crisis regulation tackles externalities more directly. In particular, prudential regulation generally targets those firms that are most likely to be a source of systemic risk – The aim being to impose the internalization of externalities.
However, efficiency is not the sole driver of financial regulation. Lawmakers and enforcement agents may favor specific interest groups or take into account fairness considerations. This kind of intervention is likely to produce externalities by having an impact on the production and distribution of goods and services. In particular, regulatory interventions to facilitate access to finance in specific industries is likely to distort competition within or across industries.

Purposes of Financial Regulation

Technically, financial regulation aims at improving the functioning of the financial system (Armour *et al.,* 2016). More fundamentally, the objective is to facilitate access to finance.

From an efficiency perspective, this means that entrepreneurs as well as consumers should get financing at competitive rates. In the real world, however, regulatory and transaction costs often result in market rates being above competitive rates.

Regulatory bodies generally do not mind, given that efficiency not being the sole (or even the dominant) driver of financial regulation. In fact, lawmakers and enforcement agents also take into account the preferences of interest groups as well as fairness considerations.

Adding fairness and political to efficiency considerations is likely to have an impact on financing costs. Moreover, it will affect the distribution of the costs and benefits of financial regulation, both in normal and in financial crises times.

In normal times, financial market participants may be diversely affected by financial regulation, leading to externalities among them. Financial crisis regulation is likely to more directly deal with externalities, given the risk of spillover from the financial world to the real economy.

Efficiency – Driven Financial Regulation and Externalities

Efficiency-driven financial regulation aims at improving the functioning of financial systems by regulating financial intermediaries and markets via capital and other prudential requirements, disclosure obligations and rules of conduct.

The costs and benefits of these requirements are not equally distributed. To begin with, they may prove more demanding for some market participants (a negative externality), and more useful for others (a positive externality). Similarly, some investors may end-up better protected than others.

Financial disclosure requirements provide a good example, as their impact varies across industries and among firms. Hence, Admati and Pfleiderer (1998) show that some firms must be better than others at internalizing their disclosure's social value. Conversely, disclosure by one firm is likely to benefit other firms, for example, when it improves their stock market value. There is empirical evidence to back-up theory. Hence, a study covering 26 European countries shows that subjecting firms to financial-statement audit imposes a net fixed cost and may deter entry by smaller firms (Breuer, 2018).

Netting requirements have similar effects. Briukhova, D'Errico and Battiston (2019) show that mandates

to centrally clear derivatives may diversely affect counterparties, thus leading to externalities among members. They provide evidence that netting is beneficial for relatively high-quality counterparties, but that counterparties with low creditworthiness are better off from accumulating larger gross positions.

What is true for transparency and transactional requirements is also true for financial stability requirements. Stein (2012) points out that monetary policy can constrain the short-term issuance of issuance of short-term debt by financial intermediaries, thus making the financial system less vulnerable to financial crises.

The latter being the prototypical producer of externalities, it is not surprising that financial crisis regulation tackles externalities more directly. In the eight years following 2008 credit crisis, various international organization significantly reinforced the regulatory architecture. To begin with, they increased capital buffers, introduced new liquidity requirements and putt caps on leverage. In addition, global systemically important financial institutions are now subject to higher loss absorbency requirements, more intensive supervision, and resolution planning. This set of reforms resulted in externalities similar to those produced by the requirements discussed above, but obviously with more wide-ranging effects.

These developments have generated less radical, but still significant proposals aiming at constraining the externalities generated by the failure of large firms. A far-reaching example is provided by de la Torre and Ize (2009) proposing to equally apply prudential regulation equally to all regulated intermediaries, so as to insure the internalization of externalities. A more modest, governance-oriented example is provided by Listokin and Mun (2018) proposing to significantly alter the voting rights and fiduciary duties in firms that are both failing and a source of systemic risk.

Socially – Driven Financial Regulation and Externalities

Efficiency is not the sole driver of financial regulation. Lawmakers and enforcement agents may favor specific interest groups or take into account fairness and cultural considerations.

Fairness has become a significant regulatory goal post credit crisis. For example, the US Consumer Financial Protection Bureau has explicitly stated that the aim of its bank supervision program is to ensure that markets for consumer financial products and services are not only transparent and competitive, but also fair (Burniston, 2012).

The same is true for culture. For example, significant efforts were made post credit crisis to improve corporate culture (Group of 30, 2015). These effort turned out to be profitable in that they restored trust (Group of 30, 2018).

On the other hand, there is also evidence of inefficient socially-driven financial regulation. For example, it is well-established that regulatory interventions aiming at facilitating access to finance in select industries may distort competition within or across industries (Heremans and Pacces, 2012).

The latter kind of externalities is obviously a source of concern, especially in a post credit crisis. In fact, a recent study covering 15 major jurisdictions points toward a significant increase in the influence of politicians in the banking area (Gadinis, 2013). In particular, it is worth noting that nowadays politicians' powers are not limited to emergencies (as used to be the case), but now extend to financial institutions' regular operations.

However, political intervention may prove less costly if one assumes that, going forward, the financial system must also serve the broader economy, society and the environment. In such an environment, regulatory objectives may have to go beyond market efficiency or a narrow concept of consumer detriment. In other words, one would have to consider a wider social purpose as an asset to be nurtured rather than an anomaly to be treated with caution (Finance Innovation Lab, 2018).

In fact, there is evidence of major regulatory bodies precisely following such an approach. For example, the UK's Financial Conduct Authority has clearly stated that its aim is to add public value, defined as the collective value it can contribute to society by improving how financial markets operate (FCA, 2017). Similarly, the US Securities and Exchange Commission aims at protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation (SEC, 2013).

While these approaches insure for more "real world oriented" interventions, they are also likely to produce a more diverse set of externalities. While efficiency has never been the sole goal of financial regulation and financial regulators, the advent of the *Law & Finance* movement had somewhat put 'social' considerations on the back-burner, the pendulum has somewhat swung back towards the latter post credit crisis.

Determining whether this new orientation will be welfare enhancing remains to be seen. However, given the complexity of financial systems, it is unlikely that the externality map as described above will significantly change.

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