Allison, John A. *The Financial Crisis and the Free Market Cure*. New York: McGraw-Hill, 2012.

John A. Allison, who recently retired as CEO of Branch Banking and Trust Company (BB&T) to head the Cato Institute, has written a book that challenges the most common narrative of the financial crisis. That narrative holds that deregulation turned loose the forces of greed in finance, leading to the crisis. In Allison's view, it was misregulation, not deregulation, that caused the crisis. At a deeper level, Allison believes that collective efforts at financial regulation are doomed to fail, and that free markets are the only solution.

Believers in free markets will find this book bracing. Believers in the conventional narrative will find it unacceptable. Anyone who is open-minded or conflicted about the topic probably will find it disappointing. That is, I do not think that Allison anticipates well enough objections and counter-arguments to offer a case that would persuade anyone who does not already agree with his general outlook.

In my view, banking and financial intermediation pose a difficult problem. The challenge is that it is difficult to distinguish a prudent, competent banker, who is managing money responsibly, from a banker who is incompetent or a banker who takes risks irresponsibly, expecting to profit if things go well while expecting others to bear most of the loss if things go poorly. In good times, good bankers and bad bankers may be indistinguishable. Only under stress does it become clear which is which.

How to address this problem? The decentralized, libertarian approach is to leave it to individual savers and investors to try sorting out the good bankers from the bad ones. Eventually, the bad bankers will suffer, and so will their customers. In a Darwinian contest, eventually the good bankers will be more likely to survive.

The more conventional approach is to collectivize the risk in banking and to centralize the problem of distinguishing good banks from bad banks. In the United States, government agencies, such as the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC), insulate individual savers from the risks that their banks take. These agencies hire experts to evaluate and regulate banks, under the presumption that these experts will be better than ordinary individuals at sifting through banks, keeping out bad bankers, and ensuring the prudence and competence of those who manage financial intermediaries.

Allison is very good at criticizing the conventional approach. However, his description of the libertarian approach does not confront the obvious challenges involved. In particular, if ordinary individuals must bear the risks of failure to distinguish good bankers from bad bankers, are they not likely to place very little trust in financial intermediaries? Does this not imply

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a greatly diminished financial sector, reducing overall investment and growth in society?

If left to themselves, ordinary individuals will want experts to help them find the best banks in which to deposit funds. Experts can enhance their credibility by offering guarantees. Thus, consumers will be attracted to schemes that insure against loss. In other words, consumers will seek out the same sorts of services that government provides with bank regulation and deposit insurance. Perhaps these services will be provided effectively by market institutions. However, Allison fails to offer convincing evidence that this is the case. If there is a successful example of a modern industrialized country with a libertarian financial system, I am not aware of it. This fact does not prove that the libertarian approach is unworkable, but it puts a burden on Allison to go into greater depth to explain what he thinks would emerge to address these problems.

Although Allison's defense of a libertarian financial system is weak, his attack on the conventional approach is powerful. His indictment is fourfold.

> (1) The government officials who are assigned to play the role of experts lack the required competence. This is not merely a problem of particular individuals. It is an inherent systemic flaw.
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> (2) The collectivization of risk encourages bad risk-taking. Even prudent bankers have their judgment distorted by the misleading signals that are sent when regulators create a false sense of security.
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> (3) The collectivization of financial risk punishes prudent bankers. It enables imprudent bankers to capture market share, and ultimately prudent bankers pay the price through bailouts and regulatory burdens.
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> (4) The collectivization of risk pushes politics into the forefront. Bank executives who are skilled at navigating the political process out-compete those who are more skilled at managing risk.

On the first point, Allison indicts government officials for exacerbating the housing boom and the subsequent bust. I think that his argument is well taken.

One reason for financial cycles is that optimism is procyclical. That is, when the economy is doing well, people become more and more confident and take less prudent risks. Those who favor regulation assume implicitly that experts will resist the general mood. As 1950's Federal Reserve Chairman William McChesney Martin puts it, the Federal Reserve's job is to "take away the punch bowl just when the party is getting good."[1]

[1] William McChesney Martin, "Address before the New York Group of the Investment

Allison demonstrates that regulators in practice are procyclical. He shows that all of the practices that came to be viewed as dangerous and inappropriate after 2008 were promoted by regulators prior to 2008. These included sub-prime mortgage lending, mortgage securitization, disintermediation (now referred to as "shadow banking"), the role of bond-rating agencies, and high financial leverage (meaning that intermediaries relied too much on borrowed funds and too little on their own capital).

For example, on the rating agencies, many commentators have pointed out that with bond sellers paying for ratings, the agencies have more incentive to please the customer by issuing a high rating than to warn the buyer by issuing a low rating. The rating agencies fall under the jurisdiction of the Securities and Exchange Commission (SEC). Allison writes:

> When John Moody founded his now-famous firm in 1909, he charged bond investors for the research and ratings. Tragically, in the early 1970s, the SEC, seeking to expand market access to ratings, forced Moody's and the other rating firms to fundamentally change. . . . Under the new method, the agencies were paid by issuers—bond sellers, not bond buyers. The SEC was influenced by union and government pension plans that did not want to pay the cost of the ratings. (pp. 83-84)

An example of regulation that turned out to be procyclical was fair-value accounting, also known as mark-to-market accounting. With mark-to-market accounting, a bank must calculate asset values based on the most current market prices for similar securities. When asset values are rising, mark-to-market accounting strengthens the (apparent) capital position of banks, enabling them to lend more aggressively. When asset values are falling, this goes into reverse. In 2008, the reverse was very rapid, because there was a liquidity panic and assets were being sold below their fundamental values, which made the downward part of the cycle especially vicious.

What Allison fails to point out, however, is that mark-to-market accounting, while suffering from the defect of being procyclical, was not introduced arbitrarily. Regulators changed to mark-to-market in the aftermath of the Savings and Loan crisis of the 1970s and 1980s. During that crisis, thrifts were using historical-cost accounting. This means that they carried mortgage assets at book values that were far above market values. This in turn allowed these savings and loan banks to fend off government takeover even though they were insolvent. The result was more bad risk-taking by these institutions and a higher cost for taxpayers to pay off depositors.

Thus, while mark-to-market accounting has problems, there is no alternative that is necessarily better. Allison himself decries specific

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Bankers Association of America," October 19, 1955, accessed online at: http://fraser.stlouisfed.org/docs/historical/martin/martin55_1019.pdf.

accounting rules, and instead champions principles-based accounting. Indeed, each bank has its own unique set of operational challenges, so that no set of rules is going to fit all cases. If all banks were committed to the principle of accurate reporting, then principles-based accounting ought to lead to better results. However, a skeptic could argue that rule-based accounting, while imperfect, at least has the virtue of making comparisons across banks more straightforward. Also, one may question the leeway that principles-based accounting might give to someone whose principles are not especially strong.

The second problem with collectivization of risk is that it creates an economy-wide moral hazard. Allison points out that between 1980 and 2008, the consequences of bad risk-taking were constantly mitigated by government action. In some cases, firms were bailed out. In other cases, the monetary spigot was loosened when problems threatened. As a result, financial executives were taught that caution only served to sacrifice profits. Why worry about the possibility of falling home prices, if you think that the Federal Reserve can and will prevent such an event from happening?

The third problem with collectivization of risk is that it redistributes pain from the imprudent to the prudent. When the government bails out a home buyer who speculates on ever-rising home prices, it does so using tax revenue collected from those who refrained from such speculation. When the government keeps alive a bank that otherwise would have failed, it does so using deposit insurance fees collected from banks that sacrificed short-term profits during the boom for the sake of long-term safety. When the government imposes new regulations in the wake of a catastrophe, the burden on these regulations falls more on the many firms that behaved well than on the few firms that were irresponsible.

Allison is particularly effective at describing regulation in practice as irrational and arbitrary. He writes that "during good economic times, the examiners will say that this regulation or that regulation is not important. However, when times get tough, they will suddenly clamp down on a standard that was not important six months before" (p. 139). With his experience at BB&T, Allison is able to back up his complaints about regulation with numerous real-life examples. This is the one aspect of the book that I can recommend to people who do not already have a free-market perspective. Too often, people carry in their heads an idealized picture of regulation, in which the regulators have an Olympian detachment and wisdom. The day-to-day practice is much uglier and much less often described.

The final flaw with collectivization is that it pushes politics to the forefront. This is particularly problematic in the case of housing finance, where small, subtle regulatory changes cause major structural shifts in the market. Allison spells out one particular example, concerning the accounting treatment of "mortgage servicing rights," an arcane and seemingly obscure aspect of mortgage lending (pp. 110-14). Intense lobbying by Freddie Mac, Fannie Mae, and their Wall Street allies resulted in treatment that was unfavorable to traditional mortgage lenders and favorable to mortgage securitization.

Had Allison wished, he could have chosen many other examples. The big boom in mortgage securitization was kicked off by the creation of the real estate mortgage investment conduit (REMIC), which depended on a special tax treatment. The political battle over the REMIC and other laws and regulations pertaining to mortgage securities has been well documented in *Liar's Poker*, by Michael Lewis, and *All the Devils Are Here*, by Bethany McLean and Joe Nocera.[2]

Allison's fourfold criticism of regulation in practice generally hits the mark. Those who believe in regulatory solutions to the fundamental problem of finance are doomed to disappointment. On the other hand, the "free market cure" that Allison proposes will not be persuasive to anyone not already so inclined. He recommends abolishing the Federal Reserve Board and the FDIC altogether, while the conventional approach is to try to "fix" the regulatory system, and above all to "strengthen" it.

My own view is that the problem of finance is nearly intractable. A modern economy needs a way to channel savings from people into risky projects that they cannot evaluate directly. This requires financial intermediation. Financial intermediation, in turn, can be undermined by incompetence and moral hazard. We would like experts to intervene in the process in order to sift out the incompetent and the irresponsible, but there is no generally reliable way to ensure that this happens.

When it comes to the financial crisis of 2008, the conventional view seriously under-estimates the extent to which collectivization of financial risk was the cause of the problem and seriously over-estimates the extent to which strengthening this collectivization represents a long-term solution. I am in complete accord with Allison on that score. However, I do not share his view that there is a free market "cure." At best, there are movements in the direction of the free market that would reduce the costs of regulation without increasing the risks of another meltdown. However, such changes will not be made as long as the conventional history of the crisis—which treats it as resulting from the loss of will to regulate—holds sway. And I do not believe that, in the end, Allison's book will have much of an impact on converting those who hold the conventional view.

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[2] Michael Lewis, *Liar's Poker: Rising through the Wreckage on Wall Street* (New York: W. W. Norton & Company, 1989); Bethany McLean and Joe Nocera, *All the Devils Are Here: The Hidden History of the Financial Crisis* (New York: Portfolio/Penguin, 2010).