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How to Think About Financial Regulation

In the United States, explanations of the origins of financial regulation are often as complex and contradictory as the regulation itself. US financial regulation has been depicted at times as uniquely American, reflecting the peculiar qualities of domestic law and culture,\(^1\) and at other times as derivative of the British experience;\(^2\) at times as a genuinely public-regarding effort to respond to the definitive economic event of twentieth century America, the Great Depression,\(^3\) and at other times as a private bargain that responded to nothing more than the needs of a few politically powerful interest groups;\(^4\) at times as a reflection of rational economic theory\(^5\) and at other times as an ‘incoherent barbarism’.\(^6\)

Given these contradictions, there is a strong temptation for the student of US financial regulation to ignore explanations of past regulation and to go on immediately to the pressing current question of whether and how regulation should be reformed. In fact, the inability of either policymakers or scholars to arrive at a consensus as to the original goals of financial regulation may be a good argument for deregulation. Certainly, the absence of a clear and widely shared vision of the historical purposes of regulation makes the status quo more difficult to defend.

Nevertheless, understanding how modern observers of US financial regulation choose to think about the origins of regulation is essential to understanding the cumbersome process of US financial reform. Although often presented as resting upon neutral principles, scholarly explanations of regulation actually have normative content, reflecting one’s basic beliefs about the legitimacy of financial regulation and of the reform process. Simply put, the fact that US financial experts cannot agree on a definitive explanation of regulation’s past explains...
their inability to agree on regulation’s future, and whether, in the long run, regulation matters.

With this in mind, it is useful to review the leading modern explanations of US financial regulation that have dominated the scholarly literature and have influenced to some extent the political debate over deregulation. What is striking about these explanations is how distinct they are, reflecting differing perspectives on a common set of historical events. Each tends to begin with the same defining moment in US history, the Great Depression. Although financial law in America obviously predated the 1930s (for example, the National Bank Act was adopted some six decades earlier), the laws that emerged in the 1930s and succeeding years remained the source of the most important, and the most controversial, regulation governing US financial institutions in the late twentieth century. If the Great Depression was the defining event in US financial regulatory history, however, modern explanations of financial regulation view the impact of that event on the political and regulatory process very differently, and this in turn colors their analysis of the purposes of the regulatory regime that was enacted in its wake.

There is one common element uniting prevailing explanations of financial regulation: each in its own way is highly critical of regulation. Although this might suggest that a consensus does exist in favor of deregulation, different explanations of regulation lead to entirely different conclusions as to what should be done with the existing regulatory framework. As will be described, the principal point of disagreement is whether regulation matters, a question that is raised but not fully addressed by any of the standard explanations. As this chapter will conclude, using this question as a place to begin, rather than end, scholarly analysis may offer a better way to understand both US financial regulation and current attitudes toward regulation in both the academy and the marketplace.

Three theories of regulation

Explanations of US financial regulation tend to fall into three main schools of thought that may be categorized as political, ideological and market-oriented. Recently, for reasons that will become clear, political explanations of regulation have dominated financial scholarship, particularly the works of economists and legal scholars identified with the law and economics movement. In the past, however, ideological explanations were most common, and market explanations are probably still favored by bankers and other participants in the financial markets.