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House of Finance

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Protocol – Session 4
Eastern Medicine for Western Finance:
Rethinking Financial Regulation

Speaker: Kathryn Judge
Discussant: Gérard Hertig

Kathryn Judge is a Professor at Columbia Law School. She is a member of the Financial Research Advisory Council of the Office of Financial Research and an editor of the Journal of Financial Regulation. Her research focuses on financial regulation, regulatory architecture, central banking, crisis governance, and financial innovation. Prior to joining Columbia, Professor Judge clerked for Judge Richard Posner of the Seventh Circuit and Justice Stephen Breyer of the U.S. Supreme Court.

Gérard Hertig, Professor of Law at ETH Zurich from October 1995 to January 2018, currently at Singapore-ETH Centre (SEC). Previously Professor of Administrative Law at the University of Geneva Law School and Director of its Centre d'Etudes Juridiques Européennes (1987-1995).

Protocol of Session 4, Friday 7 June (17.00 p.m. – 18.00 p.m.)

In this session, a joint paper by Kathryn Judge and with Dan Awrey “Eastern Medicine for Western Finance: Rethinking Financial Regulation” is presented by [Kathryn Judge](#). The presenter starts with an overview on finance today, its dynamism, complexity and unknowns—and contrasts that with the processes through which finance is regulated. She then uses case studies to illustrate some of the problems that flow from the tension between how finance is regulated and the nature of finance. She concludes with a vision, and some concrete proposals, about how we might improve the situation. She sees “Eastern,” or holistic, approaches to regulation as an important complement to existing western-style regulation.

In more detail: Three characteristics of finance are presented: 1.) dynamism: regulatory arbitrage, innovation, and the tendency for stability to breed changes in risk taking are among factors ensuring that the financial system is constantly changing 2.) Complexity. This pervades institutions, like banks, financial products, like mortgage-backed securities pre-crisis and collateralized loan obligations today, and the broader system that connects firms, products, and markets. The shadow banking system in 2008 is an example. 3.) Unknowns: The financial system has crossed a threshold of complexity where the system is evolving faster than regulators and regulations can keep pace. According to the presenter these dynamics matter. They can impede market discipline, firm governance, and supervision. They can exacerbate fragility and delay and impede crisis response and create challenges for how we regulate finance.

In a next step, the presenter elaborates on the process of financial regulation: International Financial Regulation (e.g., Basel Accords); Statutes (bicameral approval and presentment; committees and other vetogates); Rulemaking (notice and comment; cost-benefit analyses); Supervision. Furthermore, the presenter elaborates on the rulemaking process with an example. She explained that after years of discussion, the SEC suggested changes to money market mutual fund regulation in 2013 to address problems revealed during the financial crisis. The presenter elaborates on the sharp increase in Government MMMF after legal changes, and that much of this was enabled by growth and increased liquidity risk being borne by the Federal Home Loan Bank System. This is an outcome no one seemed to have predicted. The resulting question is: can we do better? What might eastern medicine entail? The mindset of eastern medicine: The system is so complex and dynamic, there is always much that remains unknown. One way to operationalize: Decennial commissions that assess what is working, what is not, and why? What are the unintended consequences?

In the second part, the discussant Gérard Hertig provides comments. The basic claim of the paper is that there is a *fundamental mismatch* between finance and financial regulation.

While it may affect financial regulation predictability and stability, it remains unclear whether the mismatch increases legal uncertainty.

In particular, regulatory competition, changes in circumstances and diversity of preferences among bureaucrats could be a much *more likely source of legal uncertainty*. This is not necessarily a 'bad' thing: as a rule, regulation is more likely to change because of market adjustments than because of political pressure.

More generally, the extent and effect of *regulatory complexity* remains to be established; here, one would have to collect data before making any policy recommendation. It is true that regulatory changes may increase uncertainty. However, it is unclear whether having an additional unknown makes any difference from a practical perspective. And even if this happens to be the case, negative effects can generally be addressed via *ex post* regulation.

When it comes to *decennial commissions* that assess what is working, one would have to decide between a stop & go approach (with a new commission set-up every decade) and an ongoing approach (with a commission working over a decade). Moreover, critical components such as commission decision-making powers and composition (established players, outsiders, powerful chair) would have to be decided upon *ex ante*. Finally, one would have to tackle not only the usual 'human' issues (regulatory capture, one-size-fit-all) but also emerging issues such as the role of new technologies (design, artificial intelligence decision-making).

After all, the presenter responds: She agrees with commenter that not all complexity is bad, and not all arbitrage is necessarily bad. The point is to recognize that these are fundamental to finance and hence need to be better accommodated in the processes through which we regulate. She will seek to clarify that in future drafts. She also engages on relationship between complexity and regulation. She agrees that some complexity is a byproduct of regulation. However, there are different types of complexity; and de-regulation may also contribute to complexity. De-regulation as it was operationalized in the United States allowed banking organizations to incrementally engage in more activities, but in ways that exacerbated the complexity of their organizational forms. Finally, an open discussion takes place. Discussed topics include: i.) how does holistic approach account for different evolution of different financial systems; ii) institutionalize processes and mechanism to account for the incompleteness of legal rules and regulations; iii) would sunset-provisions be preferred? iv) Regulation has to adapt to current changes (internet...); how should it change? v) Started 30 years earlier (in 1970s banking sector was very complex); then great moderation. Response of the presenter: in quantitative terms (size of Basel codes etc.), there has never been a period of simplification. Re-response of the commentator: Basel I aimed at simplifying; vi) holistic approach would also require to see how supervisory action can be improved. vii) How holistic is holistic?