Regulating Financial Markets: Protecting Us from Ourselves and Others

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Any doubts that financial markets are global and that actions by one institution can bring down others have surely been dispelled by the current and still unfolding financial crisis. Any doubts that financial markets are built on confidence and trust have been dispelled as well. The crisis has brought the demise of Lehman Brothers; the U.S. government's rescue of Fannie Mae (Federal National Mortgage Association), Freddie Mac (Federal Home Loan Mortgage Corporation), and AIG (American International Group); and the disappearance of Bear Stearns, Merrill Lynch & Co., and Wachovia Corporation as independent companies. The bankruptcy of Lehman Brothers slashed the assets of the Reserve Primary Fund, the oldest money market fund, forcing the fund to "break the buck" and undermining confidence and trust in all money market funds. In early October 2008, central banks in the United States, the United Kingdom, Europe, and China reduced interest rates to bolster lending and reassure investors, but these reductions failed to halt the global slide in stock prices. According to Hilsenrath, Perry, and Reddy (2008):

> Lower interest rates reduce the cost of borrowing for banks, businesses, and households, and potentially boost confidence. . . . [But] it's far from clear whether the lower rates will make banks and other lenders, which are gripped by fear of defaults by borrowers, any more willing to lend. (p. A1)

The current financial crisis has renewed the debate about the roles of governments and markets in promoting confidence and trust and the economic gains they bring. And it has renewed the debate about the roles of governments and markets in protecting investors from themselves and from one another. Should government regulation lean toward libertarianism and allow consenting adults to buy and sell as they wish? Or should government regulation tilt toward paternalism and constrain the choices of consenting adults in order to protect them from themselves and from others and to protect the rest of us from them? Should the government protect homebuyers from the cognitive errors and emotions that lead them to sign mortgage documents before reading them because the stack of documents is too high and the emotional pull of home ownership is too strong? Steve Sanders (2007), a mortgage banker, has noted that signing mortgage documents would take a day and a half if signers actually read the documents before signing them:

> After witnessing literally thousands of signings, I will tell you that most people are so focused on getting into their new home that they have no idea what it was they just signed. (www.fhaloanpros.com/2007/10/fha-mortgage-reform-thanks-but-no-thanks-says-mba/)

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And should the government protect us—the neighbors of foolish and emotional homeowners—from the consequences of their likely defaults and foreclosures? Should the government prohibit banks from issuing mortgages it deems unsafe in the same way that the U.S. Department of Agriculture prohibits meat processors from selling meat it deems contaminated or the U.S. Food and Drug Administration prohibits pharmaceutical companies from selling drugs it deems ineffective or unsafe?

Should the government protect financial engineers from the cognitive errors that lead them to construct faulty models? In a recent newspaper article, Emanuel Derman, a former managing director of Goldman Sachs, observed, "To confuse the model with the world is to embrace a future disaster driven by the belief that humans obey mathematical rules." Leslie Rahl, president of Capital Market Risk Advisors, added, "Complexity, transparency, liquidity, and leverage have all played a huge role in this crisis, and these are things that are not generally modeled as a quantifiable risk" (Lohr 2008, p. B1). Should the government protect investors from the consequences of financial engineers' actions by, for example, regulating leverage, which magnifies the consequences of erroneous models? And should the government bail out banks and automobile companies with taxpayers' money and assume ownership stakes in them?

Government regulation constrains otherwise free markets, and direct intervention pushes us even further away from free markets. Over time, changes in regulations and interventions reveal continuing attempts by society, through its legislative process, to find the proper balance in a tug-of-war between those who pull toward free markets and those who pull toward regulated markets and direct intervention. At the extreme left are those who pull toward completely regulated markets and comprehensive paternalism, and at the extreme right are those who pull toward completely free markets and comprehensive libertarianism. But members of each group do not fully agree about how far to pull the rope. Only a few want to pull the rope all the way to the left, where most enterprises are owned by the government and regulations proscribe most transactions. And only a few want to pull the rope all the way to the right, leaving no role for government. Instead, the tug-of-war is fought mostly in the middle, where groups pull left or right but not all the way to either extreme. Those pulling toward regulations want regulations they consider helpful and effective (e.g., mandatory disclosure of information about mortgages) but not regulations they consider excessive (e.g., prohibition of some mortgages). Those pulling toward free markets want markets that are helpful and productive (e.g., a free market in derivatives) but not necessarily free markets for everything (e.g., cocaine).

Motivated by ideology or self-interest, members of each group try to enlist legislators and the general public in their cause. Historical accidents, such as stock market crashes and economic recessions, attract members to one group or the other, boosting its power and tugging the rope left or right. New self-interest groups form once new regulations are enacted, new historical accidents occur, and the tug-of-war continues. This sequence of events played out when the Securities Act of 1933, the Securities Exchange Act of 1934, and the Glass–Steagall Act of 1933 were enacted during the Great Depression; when the Gramm–Leach–Bliley Act was signed into law during the boom of 1999, thereby repealing portions of the Glass–Steagall Act; when the Sarbanes–Oxley Act of 2002 was enacted after the 2000 crash; and, most recently, when financial institutions were bailed out and their regulation was tightened in the current crisis.

This tug-of-war has been fought for centuries. In 1900, Charles R. Flint, founder of the United States Rubber Company, spoke for free markets and libertarianism and against regulated markets and paternalism: "My idea is that affairs of trade are best regulated by natural law. The careless banker has lost his reputation; the careless investor has lost his money; and the result of it is, more care will be taken" (Carosso 1970, p. 160).

Others, however, were unwilling to leave the protection of the investor to the libertarian "natural law" of the marketplace and recommended paternalistic blue-sky laws instead. From 1900 to 1910, the price of Kansas farmland more than doubled, and this new prosperity attracted investment promoters. Bateman (1973) quoted a commentator from that time:

> The state of Kansas, most wonderfully prolific and rich in farming products, had a large proportion of agriculturists not versed in ordinary business methods. The State was the happy hunting ground of promoters of fraudulent enterprises; in fact, their frauds became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. Metonymically they became known as the blue-sky merchants and the legislation intended to prevent their frauds was called Blue Sky Law. (p. 766)

Kansas enacted its blue-sky law in 1910; by 1933, every state except Nevada had a blue-sky law. Blue-sky laws generally restricted underwriting commissions and the issuance of stocks and options at favorable prices to executives and employees. They also prohibited the offering of shares to the public at prices regulators deemed excessive.

Blue-sky laws have changed a great deal during the intervening decades, the result of a tug-of-war between those who want to make them more stringent and those who want to abolish them altogether. Sosin and Fein (1987) examined the amendments that weakened Illinois' blue-sky law in 1983:

> The amendments were proposed by the nonpartisan Securities Advisory Committee to Jim Edgar, secretary of state of Illinois, to address long-standing objections of the legal and financial communities that [the blue-sky law] stifled capital formation, deterred private investment, and resulted in gross inequities in the operation of the exemption from registration most frequently used in Illinois for limited offerings. (p. 506)

Shefrin and Statman (1992, 1993) described the tug-of-war and its reflection in six types of regulations: blue-sky regulations, mandatory-disclosure regulations, margin (leverage) regulations, suitability regulations, trading halts, and insider trading regulations. In this article, I discuss the tug-of-war in the context of the current crisis. Four of the six types of regulations are especially pertinent here: margin (leverage) regulations, suitability regulations, blue-sky regulations, and mandatory-disclosure regulations.

Margin (Leverage) Regulations

The current crisis would not exist if not for leverage. There would be no housing defaults and foreclosures if homebuyers had paid for their homes in full with their own cash rather than leverage them through mortgage loans to the tune of 80, 90, or even 100 percent. The current crisis would not exist if financial institutions had not multiplied mortgage leverage in securities backed by leveraged mortgages. But the costs of regulations prohibiting leverage altogether are enormous. Few people would be able to buy homes if not for the ability to leverage their down payments through mortgage loans. The leverage debate is not about whether leverage should or should not be allowed; rather, it is about whether leverage should be allowed without limits. Much of this debate has been conducted in the context of stocks, in which leverage is discussed in the language of margins.

Margins on stocks are regulated by the Fed, and the minimum margin set by the Fed has remained at 50 percent since 1974. Margin was used for many years before the government began to regulate it, and it has always been accompanied by concern. Speculation facilitated by low margins is among the factors blamed for the panic of 1907 and the crash of 1929. In a letter to Senator Duncan Fletcher on 26 March 1934, President Franklin Roosevelt wrote:

> The people of this country are, in overwhelming majority, fully aware of the fact that unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted "boom" which has so much to do with the terrible conditions of the years following 1929. (Ellenberger and Mahar 1973, p. 2)

Limits on margin were deemed necessary to protect investors from the cognitive errors and imperfect self-control that lead them to margin-facilitated speculation. And limits on margin were also deemed necessary to protect others from systemic risk imposed by those who use leverage.

The desire to protect investors from their own cognitive errors and imperfect self-control is reflected in this excerpt from a U.S. Senate report leading up to the passage of the Securities Exchange Act of 1934:

> Margin transactions involve speculation in securities with borrowed money. . . . The ease and celerity with which such a transaction is arranged, and the absence of any scrutiny by the broker of the personal credit of the borrower, encourage the purchase of securities by persons with insufficient resources to protect their accounts in the event of a decline in the value of the securities purchased. Many thoughtful persons have taken the view that the only way to correct the evils attendant upon stock market speculation is to abolish margin trading altogether. A Federal judge furnished this committee with instances from his long experience on the bench, indicating that a large proportion of business failures, embezzlements and even suicides in recent years were directly attributable to losses incurred in speculative transactions. (Ellenberger and Mahar 1973, pp. 6–7)

The desire to protect others from systemic risk is stressed in this excerpt from a U.S. House report before the enactment of the Securities Exchange Act of 1934:

> The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry—to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry, and agriculture, were drained by far higher rates into security loans and the New York call market. Increasing margin . . . is the most direct and the most effective method of discouraging an abnormal attraction of funds into the stock market. (Ellenberger and Mahar 1973, p. 8)

Concerns about protecting others from the systemic risks of leverage and derivatives were regularly downplayed before the current crisis. In "Swaps, Derivatives, and Systemic Risk," a chapter in *Merton Miller on Derivatives*, Miller (1997) dismissed such concerns expressed in 1992 by Richard Farrant, deputy head of banking supervision at the Bank of England. Farrant argued that "different markets are being tied more closely together, greatly increasing the potential for shocks in one market to be transferred to others in ways that are not fully understood" (Miller, p. 36). Miller, however, described derivatives trades as benign—analogs of back-and-forth trades of two $25,000 cats for one $50,000 dog by bored financial traders on a slow trading day:

> There is, of course, a credit-risk element in swaps as there is with any system of forward contracts. But if one party defaults, the counterparty loses only to the extent it has been "in the money" on the deal. And even then, only if the counterparty could not net the deficiency against other deals in which it is out-of-the-money to the defaulter or against any collateral previously posted by the defaulter. It is hard not to be impressed with how effectively the swaps dealers have dealt with credit risk by creatively and ingeniously combining credit management practices from the interbank forward markets and from the clearinghouses of futures exchanges. (pp. 35–36)

Although we cannot yet quantify precisely the role of leverage and derivatives in the current crisis, we do know that Farrant's concerns about the transfer of shocks from one market to others are valid and that leverage and derivatives overwhelmed the ingenious credit management practices of institutions that seemed solid only months before they collapsed.

Leverage in stocks is limited by regulations that set the minimum margin at 50 percent, but no such limitations exist for hedge funds, investment banks, proprietary desks, or anyone who leverages through derivatives. The leverage of some financial institutions before the current crisis exceeded 95 percent, and the leverage of some homeowners approached 100 percent. The current financial crisis has shifted the tug-of-war power from those who pull toward free markets and libertarianism to those who pull toward regulated markets and paternalism. Those in the latter group are attempting to use their newfound power to extend margin regulations beyond stocks to financial institutions and homeowners in order to protect them from their own cognitive errors and imperfect self-control and protect the rest of us from them.

Suitability Regulations

"Cheat me once, shame on you; cheat me twice, shame on me." Free markets and libertarian societies are not without restraint. We prefer to stay away from not only those who have cheated us but also those who fail to nurture a reputation for honesty and fair dealing. This preference provides an incentive for honesty and fair dealing even in the absence of regulations mandating them.

Reputation can sustain trust in free markets. Jacob Schiff, an investment banker at the turn of the 20th century, attributed the growth of investment banking and the prominence of firms like his own to

> the fact that they have been more honest than those who, thirty and twenty years ago, were among the leading banking firms. Not more honest, as construed in the literal sense of the word, but honest in their respect for the moral obligation assumed toward those who entrusted their financial affairs to them, be it investing in the securities of corporate enterprises which these bankers brought before the public, or otherwise; more honest in keeping their own capital from becoming immobile, so that their credit and prestige should not be called into question during times of financial peril and uncertainty; more honest in the ways which, not taking alone into account the monetary pecuniary profit, are certain, in the long run, to determine position, credit, and prestige. (Carosso 1970, p. 49)

Alan Greenspan, the former Fed chairman, would have preferred to sustain trust with reputation, as Jacob Schiff did: "In a market system based on trust, reputation has a significant economic value." But reputation did not sustain trust. Greenspan added, "I am therefore distressed at how far we have let concerns for reputation slip in recent years" (Goodman 2008, p. A1).

Regulations can replace trust when reputation slips. Regulations can also replace trust when being cheated once does not put us on guard against being cheated twice or when even one instance of cheating is one too many, as when predatory lenders force borrowers into foreclosure or bankruptcy. Suitability regulations are such regulations. The Maloney Act of 1938 established the National Association of Securities Dealers (NASD) (now the Financial Industry Regulatory Authority [FINRA]) to formulate rules to prevent abuse in the sale of securities and to protect investors and the public interest. The NASD Rules of Fair Practice required NASD members to have reasonable grounds for believing that their recommended securities were suitable for their customers' financial situation and needs.

Suitability regulations are paternalistic. They represent a shift away from the libertarian notion that suitability is in the eye of the customer to a paternalistic notion that suitability is in the eye of the broker. Mundheim (1965) described the difference between the libertarian and the paternalistic notions of suitability:

> Imposition of any suitability doctrine has a revolutionary flavor, because it shifts the responsibility for making inappropriate investment decisions from the customer to the broker/dealer. It does so in what seems to me the correct belief that disclosure requirements and practices alone have not been wholly effective in protecting the investor—including protecting him from his own greed. (pp. 449–450)

Roach (1978) illustrated the application of suitability regulations by quoting from a U.S. SEC decision finding that a broker had violated suitability obligations:

> Whether or not customers Z and E considered a purchase of the stock . . . a suitable investment is not the test for determining the propriety of applicants' conduct in the situation before us. The test is whether [the broker] fulfilled the obligation he assumed when he undertook to counsel the customers of making only such recommendations as would be consistent with the customers' financial situation and needs. The record shows that [he] knew all the facts necessary to enable him to realize that reasonable grounds for his recommendations did not exist. (p. 1126)

Roach commented:

> Both the NASD and the Commission here suggest that suitability is an objective concept which the broker is obliged to observe regardless of a customer's wishes. . . . The NASD's statement that the customer's "own greed" may well have been their motivation reinforces the idea that the customer is not sovereign for suitability purposes. (p. 1126)

The recent experience of subprime borrowers and lenders has prompted Congressman Bradley Miller of North Carolina to introduce a bill extending suitability regulations to mortgage loans. Under that bill, lenders could be sued for providing unsuitable mortgages for the borrowing homebuyers. Preferring libertarian notions to paternalistic ones, the Mortgage Bankers Association is not happy with such attempts. Kurt Pfotenhauer, the senior vice president for government affairs and public policy at the Mortgage Bankers Association, stated, "We believe the consumer is the best one to determine the loan product that's best for their individual circumstances" (Tedeschi 2006).

The self-interest of financial professionals inclines them toward libertarianism, and perhaps their temperaments incline them in the same direction as well (see Statman 2004). We should not be surprised by the Mortgage Bankers Association's aversion to extending paternalistic suitability regulations to mortgages. Indeed, some people continue to advocate shifts away from paternalistic suitability regulations in the direction of libertarianism. Recently, Shadab (2008) argued against suitability regulations that preclude nonwealthy investors from investing in hedge funds:

> Limiting hedge funds only to the wealthy prevents financially sophisticated yet nonwealthy investors from using the funds to minimize losses and maximize the risk-adjusted returns of their investment portfolios. To more fully advance the regulatory goals of investor protection and capital formation, U.S. financial regulators should therefore enact reforms to permit retail investors to invest in hedge funds. (p. 1)

Blue Sky and Mandatory Disclosure

Suitability regulations are paternalistic and thus anathema to libertarians. Extreme libertarians would rather trade in a buyer-beware market, free of regulations, where people can buy anything they want from willing sellers, even without being assured that sellers do not lie. Indeed, this market is what Akerlof (1970) described as the market for "lemons." Prospective buyers of used cars expect sellers to lie by saying that their cars are cream puffs when, in truth, they are lemons. Buyers must beware in such markets, assume that they are buying lemons, and offer no more than lemon prices.

Less extreme libertarians would rather trade in a voluntary-disclosure market where regulations prohibit sellers from lying when they answer buyers' questions but do not compel them to answer buyers' questions or prompt buyers to ask pertinent questions. In such markets, prospective borrowers can ask mortgage brokers any question they want about fees and kickbacks, but brokers need not answer buyers' questions and surely need not tell buyers that better mortgages are available elsewhere.

Mandatory disclosure is one length of tug-of-war rope away from extreme buyer-beware libertarianism and toward paternalism. In mandatory-disclosure markets, regulations require lenders to disclose interest rates on loans even if borrowers fail to ask. Further along the rope toward paternalism are regulations that require disclosure in particular forms, such as the annual percentage rate (APR). In the days before the Truth in Lending Act of 1968, lenders could describe a loan as a "6 percent interest rate loan," whereby \$6 was deducted from every \$100 when the loan was granted and \$100 was paid in equal installments of \$8.33 during the following 12 months. Although not an outright lie, such a description was misleading. The effective interest rate of such a loan was more than double the stated 6 percent. Mandating disclosure of interest rates uniformly as the APR, the Truth in Lending Act made it easier for borrowers to compare loans.

Suitability regulations are one length of tug-of-war rope further away from libertarianism and toward paternalism, and blue-sky laws are a further length of rope closer to paternalism. The frameworks of blue-sky and mandatory-disclosure regulations competed in a tug-of-war for a foundational role in the Securities Act of 1933. Mandatory disclosure won then, but the tug-of-war continues today.

By 1933, all the states, with the exception of Nevada, had adopted blue-sky laws, but their enforcement was lax, in part because the states found that coordinating enforcement was difficult. Bills to improve the enforcement of blue-sky laws by turning them into a federal law were introduced in Congress, and Congressman Edward Dennison's 1920 bill was the most prominent among them. But Dennison's bill never reached the Senate floor. According to Seligman (1982):

> The Dennison bill would have plugged the largest loophole in the enforcement of state blue-sky laws by making it illegal for any person to use the mails or any of the facilities of interstate commerce to sell securities in any state until there had been compliance with the formalities of that state's blue-sky law. (p. 50)

In 1933, soon after President Franklin Roosevelt's inauguration, Senator Huston Thompson took the lead in crafting a new securities bill in the spirit of blue-sky laws, but others pulled away from it. Congressman Sam Rayburn cast doubt on the government's ability to exercise its paternalistic powers wisely:

> Do you believe that an administrative officer of the Government ought to be given that much power, as a general principle—to pass upon whether or not a man's business is based on sound principles? It is mighty easy when you go to write a statute, if you want to delegate absolute authority; you can write that in a very short statute; but the question that this committee has got to determine is whether or not you want to give anybody that kind of authority. (Seligman 1982, p. 56)

Seligman commented:

> Roosevelt acquiesced to Rayburn's view that the bill was too far-reaching, because the only substantive feature of the legislation he felt strongly about was the basic disclosure principle, and Rayburn persuaded him that so stringent a bill might prove unnecessarily divisive. The point is significant, because when Roosevelt agreed to bring in his third drafting team in four weeks, he was not merely seeking . . . draftsmen who could hone the technical provisions of the bill, but, rather, draftsmen who could produce a bill conservative enough to be rapidly enacted. In the interest of speed, Roosevelt was willing to compromise considerably his securities proposal. In deference to Sam Rayburn's sentiments about Thompson's bill, he did so. (pp. 56–57)

The tug-of-war between those who pull toward the paternalism of blue sky and those who pull toward the libertarianism of mandatory disclosure continues today. Pulling toward paternalism are Bar-Gill and Warren (2008), who noted that physical products (e.g., toasters, lawnmowers, meat, and pharmaceuticals) are regulated for safety. They urged the creation of a new federal regulator who would have both the authority and the incentives to prohibit unsafe mortgages and other credit products. Pulling toward libertarianism is former Senator Phil Gramm. Lipton and Labaton (2008) wrote that Gramm, described by a fellow senator as a true dyed-in-the-wool free-marketer, "led the effort to block measures curtailing deceptive or predatory lending, which was just beginning to result in a jump in home foreclosures that would undermine the financial markets" (p. A1). Speaking with Gramm, they found that he holds firm to his views today and remains unswayed by the current crisis. Standing in between are Thaler and Sunstein (2008), advocates of libertarian paternalism who reject banning credit products that some consider unsafe but who favor regulations mandating clear-format disclosures that would nudge investors toward the best credit products:

> Credit regulation raises immense challenges, and there is a serious danger that, in light of the current crisis, government regulators will overreact. The fundamental line of defense should be improving market competition, not eliminating it. And to improve competition, transparency is the place to start. As Supreme Court Justice Louis Brandeis proclaimed in 1914, "Sunlight is the best disinfectant." That statement is the best foundation for rethinking credit regulation. (p. A17)

What Should We Do?

Testifying before Congress on 23 October 2008, Alan Greenspan said, "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief" (Andrews 2008, p. B1). A housing bubble combined with subprime lending and leveraged financial instruments and institutions to bring on a crisis of a magnitude not seen since the Great Depression. Like Greenspan, we must come to grips with the crisis and reconsider the balance we should strike in the tug-of-war between libertarianism and paternalism, between markets that are completely free and markets that are severely regulated, between a government that intervenes to bail out companies and combat unemployment and a government that allows companies to fail and leaves employment to companies left standing. President George W. Bush reconsidered his free-market noninterventionist position. In the last press interview of his presidency, on 12 January 2009, Bush said:

> Now, obviously, these are very difficult economic times. . . . The question facing the president is not when the problem started, but what did you do about it when you recognized the problem? And I readily concede I chunked aside some of my free market principles when I was told by chief economic advisers that the situation we were facing could be worse than the Great Depression. So, I've told some of my friends—who've said, you know, who have taken an ideological position on this issue, you know, "Why'd you do what you did?"—I said, "Well, if you were sitting there and heard that the depression could be greater than the Great Depression, I hope you would act too," which I did.

The *Wall Street Journal* is still pulling toward libertarianism or, at a minimum, libertarian paternalism. It celebrated President Barack Obama's appointment of Cass Sunstein to the position of administrator of the Office of Information and Regulatory Affairs in the White House. As the newspaper opined in a recent editorial, "Mr. Sunstein is no conservative, far from it." But it expressed hope that Sunstein would guide the Obama administration away from cracking "down on financial innovation for no better reason than because it seems like a popular reaction to the credit crisis" ("A Regulator with Promise—Really" 2009, p. A10).

The *Wall Street Journal* is right to be wary of overreaction that would pull us too close to extreme regulation. But there is also a danger in not pulling far enough in that direction. We cannot be blind to the systemic risk that free but unwise behavior by some of us could lead to disastrous consequences for all of us. We know now that the actions of homeowners who overloaded themselves with mortgages inflicted major collateral damage, as did the actions of financial institutions that overloaded themselves with leveraged mortgage securities. As President Bush observed, the government has moved some way toward regulation and direct intervention, and I think these moves are wise.

Regulations are not all equally good, and we must choose the best among them by comparing burdens with benefits, however imprecisely. There are benefits to increasing home ownership by increasing the availability of mortgages, even to subprime borrowers. Brownstein (1999) noted that homeowners are more likely than renters to participate in their communities and that the children of homeowners tend to perform better in school than the children of renters. Moreover, increased home ownership allows minority families who have accumulated far less wealth than nonminority families to accumulate wealth and transmit it to future generations. Brownstein described the increase in African American and Latino home ownership in the 1990s as one of the hidden success stories of the Clinton administration, noting that President Clinton enforced the Community Reinvestment Act, which was designed to prevent redlining and required banks to serve their low-income communities. The roles of Fannie Mae and Freddie Mac in encouraging subprime lending by relaxing loan criteria were central to the effort to increase home ownership.

Support for the expansion of mortgage lending to low-income borrowers extended beyond Democrats. Republican Senator Gramm was persuaded to support such lending by his mother's story:

> Some people look at subprime lending and see evil. I look at subprime lending and I see the American Dream in action. . . . My mother lived it as a result of a finance company making a mortgage loan that a bank would not make. . . . What incredible exploitation. . . . As a result of that loan, at a 50 percent premium, so far as I am aware, she was the first person in her family, from Adam and Eve, ever to own her own home. (Lipton and Labaton 2008, p. A1)

But now we know that although mortgages extended to subprime borrowers can fulfill the American Dream, mortgages extended to homeowners who lack the income to support those mortgages impose nightmarish burdens on both the homeowners and the rest of us.

Regulations prohibiting mortgages with low teaser rates are burdensome for some potential homeowners and exclude others from home ownership entirely, but the benefits of such regulations likely exceed the burdens. The same is true for regulations that limit home leverage by requiring down payments of at least 20 percent. Such regulations should be accompanied by policies that equalize government benefits for homeowners and renters by reducing the disadvantage imposed on those who must rent because they cannot afford to buy. Such policies might include subsidies for renters or reductions in the tax benefits afforded to homeowners.

I would also advocate the application of suitability regulations to mortgage brokers, bankers, and other mortgage providers. Mandatory disclosure of mortgage facts, even if done in required formats that aid comprehension, is insufficient because it puts lenders and borrowers in adversarial positions. We can see the effect of these adversarial positions in all credit markets, including those for credit cards and mortgages. The Truth in Lending Act mandates disclosure of interest rates in the APR format, and there is evidence that consumers are indeed using APR numbers in comparison shopping. But APR is not the total cost of a loan, and interest payments are not the total revenue of lenders. Credit card companies circumvent the spirit of the Truth in Lending Act by imposing late fees, overlimit fees, and other fees, all of which are disclosed but not in ways that make them easy to find. Even clear disclosure of such fees is unlikely to be sufficient. Credit card applicants might be confident in their ability to pay balances in full and on time, but credit card companies know that such confidence is often misplaced and that interest and late fees can generate greater revenues than applicants anticipate.

Mortgage loans are different from credit card loans in that they are for much higher amounts and can inflict much greater damage on both borrowers and the rest of us. Suitability regulations would require that lenders not only disclose clearly all information about credit products but also guide borrowers to suitable products. The burdens of suitability regulations in the credit card market might be higher than the benefits, but the benefits of suitability regulations in the mortgage market likely exceed the burdens.

Last are the regulations that limit the leverage used by financial institutions, from hedge funds to banks. (I would have added investment banks, but investment banks are now extinct—victims of leverage.) The desire of financial institutions to maximize profits is no different from that of butchers, bakers, and candlestick makers. But the benefits that butchers, bakers, and candlestick makers bring to the rest of us are obvious, and the benefits of some products and services of financial institutions are not.

Consider a hedge fund engaged in a long–short strategy: It sells relatively expensive German bonds and buys relatively cheap Italian bonds, using a 30-to-1 leverage ratio. Hedge fund investors profit if German bonds become cheaper and Italian bonds become more expensive. Benefits also exist for us non-hedge-fund investors. The long–short actions of the fund move the prices of both bonds closer to their "correct" or "efficient" levels, providing correct "signals" to policymakers, corporations, and individuals. But are long–short actions primary in moving prices to their correct levels, or are they only secondary to the more prosaic actions of such investors as pension funds that buy the cheap bonds and shun the expensive ones? I would venture that a regulation that limits leverage does more good than harm if high leverage, such as a 30-to-1 ratio, can cause a collapse of the magnitude of that of Long-Term Capital Management, or worse. Similarly, mortgages do much good by helping homeowners, and bundled mortgages do much good by spreading risk. But I see little good and much harm in allowing financial institutions to leverage mortgages and other securities without limits.

Conclusion

In 1999, Senator Phil Gramm spearheaded the Gramm–Leach–Bliley Act, which eased regulation and repealed barriers erected by the Glass–Steagall Act of 1933 to reduce the risk of economic catastrophes by separating commercial banks from investment banks. Senator Gramm was a Republican, but support for the Gramm–Leach–Bliley Act extended beyond his party. The act was signed into law by President Clinton, a Democrat.

We should not be surprised to learn that the Gramm–Leach–Bliley Act was enacted in 1999, which was during the top end of a financial and economic boom. Financial and economic booms shift the tug-of-war power from those who pull toward paternalism and heavy regulation to those who pull toward libertarianism and free or lightly regulated markets. Now, in 2009, a year at the bottom end of a financial and economic bust, power is shifting to those who pull toward paternalism and heavy regulation.

History tells us that we tend to overreact by urging legislators and government executives to pull too far toward paternalism when we are fearful and too far toward libertarianism when we are exuberant. There is danger in pulling too far toward one end or the other, but there is also danger in not pulling far enough. The pull toward libertarianism and light regulation stoked the stock bubble of the 1990s and the real estate bubble that followed it.

Often citing U.S. Supreme Court Justice Louis Brandeis's 1914 proclamation that the sunlight of disclosure is the best disinfectant, some urge us to stop pulling toward paternalism once we have reached mandatory transparent disclosure to investors and in financial institutions and markets. But today, almost a century after Brandeis's declaration, we know that our hospitals need more than sunshine as a disinfectant and that diseases can spread rapidly even when relatively few forgo immunization. Mandatory disclosure might keep most of us economically healthy most of the time, but we need the economic equivalent of mandatory immunization to prevent the carelessness of some from infecting us all.

This article qualifies for 0.5 CE credit.

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