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Arguments for and against Regulation

2.1 Introduction

In this chapter we present arguments for and against regulation in general and financial regulation in particular. Arguments for regulation may come in response to arguments against deregulation, and vice versa. This is why arguments for and against regulation are lumped together rather than separated, and this is why there may be some overlapping in the arguments. We reach the conclusion that corruption is (or should be) the main justification for financial regulation and that it is related to other justifications for regulation. For example, it is argued that corruption and greed can cause financial instability, which is typically considered to be the main objective of financial regulation.

Due to rampant corruption in the finance industry, investors must be protected from predators, the likes of Bernie Madoff who swindled his clients out of billions of dollars. Another form of corruption, which we came across in Chapter 1, is regulatory capture which occurs when a regulatory agency is established for the purpose of combating corruption (among other reasons), but ends up as the subject of corruption when it gets captured. Capture involves the corruption of regulators and facilitates the corruption of the regulated firms. Snyder (2010) presents examples of “how insanely corrupt the U.S. financial system has become”. He writes:

If you ask most Americans, they will agree that the financial system is corrupt. It is generally assumed that just like most politicians, most big bankers are corrupt by nature. But the truth is that the vast majority of Americans have no idea just how corrupt the U.S. financial system has become. The corruption on Wall Street has become

so deep and so vast that it is hard to even find the words to describe it. It seems that the major financial players will try just about anything these days – as long as they think they can get away with it. But in the process they are contributing to the destruction of the greatest economic machine that the planet has ever seen.

Corruption is linked to moral hazard, a term that is frequently used in the finance literature. K. Dowd (2009a) describes moral hazard as a situation where one party is responsible for the interests of another, but has an incentive to put their own interests first. As examples, Dowd refers to situations where someone sells a financial product (such as a mortgage) to a person while knowing it is not in their (the buyer's) interest. Another example is a business executive paying themselves a big bonus in return for managing shareholders' funds. The same executive may take risks that the shareholders have to bear. Corruption hurts ordinary people and makes a minority well off. We will come back to the issue of corruption as a justification for financial regulation later on.

2.2 Avoiding Corporate Failure

The underlying argument is that enterprises should not be allowed to fail as corporate failure causes recessions and panics. This is indeed a weak argument for regulation because it sounds like the notorious pretext of too-big-to-fail (TBTF), whereby money is transferred from taxpayers to failed businesses, particularly financial institutions. Bailing out financial institutions on the basis of the TBTF doctrine is a big problem, not in the least because it is so expensive that it imposes a heavy financial burden on future generations. It is also immoral. Regulation aiming to protect failed or badly-run firms is bad regulation, and arguing for regulation on the basis of the TBTF pretext is exactly what the opponents of regulation want to hear. We will elaborate on this point in Chapter 10.

2.3 Creature of the State

The creature of the state argument for regulation, made prominent by Ralph Nader and others, holds that business activity should be regulated because companies are chartered by the government. According to this view, government charters create firms, hence the government should regulate the behaviour of its "dependents", the firms. In response to this argument, Hessen (1979) suggests that firms do not

have to be created by the government and that they are created only when the government is mercantilist. The alternative, the argument goes, is that in the kind of community that sees the individual as a sovereign being, business enterprises can and do arise through individual initiative, which is “merely an extension of the idea of freedom of association, in this case for purposes of making people economically prosperous”. Machan (1988) argues that if the creature of the state argument is a matter of historical accident, the moral case for regulation based on the firm’s dependent status disappears. While firms are chartered by governments, that is merely a recording system—it does not signify creation.

Van Eeghen (2005) presents a critique of the private right to free incorporation from a classical liberal or libertarian point of view. He argues that the incorporation of private business firms driven by the profit motive should be allowed only when public interest is served within the public domain, which is largely confined to the management and infrastructural improvement of public land. He suggests that while incorporated business firms operating in the public domain may be subjected to a degree of state control and intervention, non-incorporated firms operating outside the public domain should be free from control and intervention as long as there are no involuntary spillover effects. Kinsella (2005) argues that van Eeghen’s argument is “beside the point”. The divergence of views on this issue is an integral part of the debate between free marketeers and their opponents.

2.4 Market Failure

Free marketeers believe that free markets enable people to do the best that can be done, encourage maximum efficiency, foster responsible conduct, and encourage the production of goods and services desired by members of the community. Opponents of the free-market doctrine contend that free markets often fail to achieve maximum efficiency by wasting resources. For example, free competition among utilities results in wasteful duplication when different companies put up the same infrastructure side by side. Therefore, it is important for the government to restrict competition, thereby correcting market failure. Opponents of regulation respond to these arguments by suggesting that the question of whether establishing monopolies in public utilities secures efficiency in the long run and at what expense. For example, a strike is particularly crippling in the case of a public utility, implying that to prevent inefficiency, strikes must be prohibited, thus infringing on the freedom

of workers to withhold their services. This means that the remedy of market failure comes at the expense of a serious loss of freedom.

Another kind of market failure is that markets tend to misjudge what is important from a societal point of view. Typically, markets do not respond to the needs for medical care, libraries, safety measures at work, health provisions, fairness in employment and commerce, and so on. Therefore, governments should take regulatory measures to remedy market failure—these include (among others) safety standards, health codes and minimum wage laws. While the opponents of regulation accept the proposition that markets may fail to produce important (but commercially infeasible) goods and services, they argue that government actions embody their own hazards. Hence, the argument put forward by free marketeers that a free market encourages the production of goods and services desired by the members of the community may be valid only for commercial output, which does not include goods and services like clean air, safety and fairness. Surely, most of us (members of the community) aspire to clean air, safety and fairness. As for the argument that a free market fosters responsible conduct, it is more intuitive to think that the opposite is true. It is doubtful if the likes of Bernie Madoff go extinct in a free market.

Free marketeers believe that political (government) failure is worse than market failure for the following reasons (among others): (i) bad laws are widespread; (ii) it is difficult to remedy undesirable consequences; (iii) once established, bureaucracies are virtually impossible to undo; and (iv) regulators cannot be sued, which means that their errors are not open to legal remedy. Moosa and Ramiah (2014a) accept the validity of these arguments against regulation, suggesting that the “red-tape” typically associated with regulation is not conducive to robust economic activity and that there is nothing worse than government bureaucrats flexing their muscles on individuals and businesses in the name of “public good”. However, they add, this does not justify the stance of the true believers, the free marketeers who think that any regulation (even a small dose) is a welfare-reducing obstruction of the working of a free market that should be avoided or dismantled if it is already in place. In reality, regulation imposes costs while producing benefits and unintended consequences. Cars kill hundreds of thousands of individuals each year but no one in their right mind would argue that we should abandon the use of cars. The right thing to do is to regulate the use of cars (for example, by imposing heavy penalties on drink-driving) to minimise the loss of life and limb as a result of car accidents.

2.5 The Protection of Rights

Another justification for the regulation of business is the belief that the government is meant to protect people's rights, those rights that cannot be protected in a free market. For example, employees are entitled (as a matter of right) to safety protection, social security, health protection, fair wages and so on. Consumers are exposed to the risk of potential health problems inherent in the goods and services they purchase. Under a free market, for example, any wage is a fair wage as long as it balances the supply of and demand for labour (free marketeers hate minimum wage legislation). In a free market, if you cannot pay for an operation, you are left to die. In a free market, if you lose two fingers in an accident, the surgeon will only put back one of them if you cannot pay for both. However, since the consumer is always king, you can choose the finger to be fixed (this is an actual incident documented in Michael Moore's *Sicko*). In a free market, producers do not take into account externalities, which may include health hazards.

In response to the argument that government regulation of business defends individual rights, Machan (1988) suggests that the doctrine of human rights invoked by defenders of government regulation is very bloated. Machan (1981) and Regan (1983) argue that many values are mistakenly regarded by their adherents as something they have a right to and that protecting these "rights" violates actual individual rights. These claims sound "humanitarian" and "democratic", but should we for the sake of these arguments give up regulation so that unscrupulous entrepreneurs feel free to engage in harmful activities for the sake of profit? Consider the following (real-life) scandals that impinge on human welfare: (i) fake medicines; (ii) beef infected with the mad-cow virus; (iii) food products containing horse meat but labelled "beef"; (iv) fake aircraft parts; (v) bread made of a mixture of flour and sawdust; (vi) faulty building materials and less-than-adequate construction standards; and (vii) compromising safety standards in dealing with hazardous chemicals. Are we supposed to allow transactions involving these hazards in the name of commercial freedom? In a civilised society, people should have the right to be protected against hazards such as infected beef and sawdust-infused bread.

2.6 Efficiency

Opponents of regulation argue that the absence of regulation encourages efficiency in the sense that inefficient enterprises go bankrupt and go out of business. There are indeed examples to support this

proposition, but these examples invariably pertain to bad regulation. Take, for example, the regulation (particularly the prohibition) of short selling. This practice provides an external governance mechanism, in the sense that it was short sellers who uncovered earnings manipulation and other accounting irregularities at firms such as Enron, Lehman Brothers and WorldCom, which eventually collapsed. The prevention of short selling keeps poorly-run firms in business only through fraudulent means. The same argument applies to regulation based on the doctrine of TBTF, whereby badly-run firms are kept in business by government bail-out.

However, the prohibition of short selling and the bailing out of firms deemed TBTF are two examples of bad regulation. There is no reason why regulation always implies that regulators would strive to salvage failing financial institutions. On the contrary, good regulation is or should be preventive, reducing the incidence of failure. Take, for example, the New Deal wave of regulation in the midst of the Great Depression. That wave of regulation kept the US financial system stable for more than 50 years—that stability came to an end with the savings and loans crisis of the 1980s, following the wholesale deregulatory measures introduced by Ronald Reagan (Moosa, 2010). It was also Reagan who initiated the first multi-billion dollar bail-out of a TBTF bank, Continental Illinois. In this case at least, deregulation (rather than regulation) is associated with the failure of financial institutions and the desire to keep them alive.

2.7 Impeding Innovation

It is claimed that deregulation facilitates progress and innovation—for example, how much more progress would be made in stem cell research without regulation? There are, however, arguments as to why regulation is not inconsistent with innovation, particularly in the field of environmental regulation. The Porter hypothesis can be interpreted to mean that environmental regulation may provide some firms with “early mover” advantages by creating an incentive to come up with products that will be in demand in the future (Porter, 1991). It has also been suggested that the imposition of strict environmental regulation induces innovation that gives domestic firms lasting comparative advantage (for example, Gardiner, 1994). Barbera and McConnell (1990) found that lower production costs in the non-ferrous metals industry were brought about by environmental regulation that led to the introduction of new, low-polluting and efficient production practices. By forcing a re-examination of products and processes, regulation may induce

an overall increase in the resources devoted to research, which would enhance competitiveness. Environmental regulation is not incompatible with innovation and efficiency.

In the case of financial regulation, impeding and containing financial innovation may be the right thing to do. It is the so-called “financial innovation” and “financial engineering”, coupled with objections to the regulation of OTC derivatives, that have led to the explosive growth of financial markets and eventually the global financial crisis. Instead of producing tools for risk management, financial engineers have been producing tools enabling more risk exposure, tools that can hardly be understood by anyone. Why on earth do we need options on futures, futures on options, options on options, futures on options on futures, options on futures on options, and so on and so forth? Why do we need the so-called exotic options? And what has been the contribution to human welfare of those “innovators” who invented synthetic CDOs and CDO squared? It is not only that these “inventions” serve no purpose whatsoever (apart from the generation of revenue for the inventors and their bosses)—they are actually the financial equivalent of weapons of mass destruction. Creating obstacles through regulation to impede this kind of “innovation” is actually the right thing to do.

Stiglitz (2010) is very critical of financial innovation as he argues that “much of the innovation of the financial system has been designed to circumvent accounting standards designed to ensure the transparency of the financial system, regulations designed to ensure the stability and fairness of the financial system, and laws that try to make sure that all citizens pay their fair share of taxes”. As a matter of fact, Stiglitz points out that the finance industry has actually resisted welfare-enhancing innovations such as inflation-indexed bonds. Typically, these kinds of instrument are held by would-be pensioners until maturity, which financiers do not like because they want more trading and hence more fees. “Wall Streeters”, according to Stiglitz, also opposed another innovation, GDP-indexed bonds, which would have helped Argentina manage its international debt in a better way. Stiglitz holds the view that “a better-regulated financial system would actually be more innovative in ways that mattered”.

2.8 The Cost of Compliance

An argument against regulation is that it makes firms less efficient because they have to bear the cost of compliance. To start with, we should never think about regulation in terms of costs only—we should

think in terms of costs and benefits. The opponents of environmental regulation argue that compliance costs add to the cost of production and make firms less competitive and less productive. For the proponents, environmental regulation may have a positive effect on productivity by producing benefits that make the net cost of compliance lower than the observed gross cost. Porter and van der Linde (1995) argue against the view that environmental regulation raises the costs of production and erodes productivity. They describe this view as “static” because everything except regulation is held constant. While they agree with the proposition that regulation raises the costs of production if technology, products, processes and customer needs were all fixed, they cast doubt on its validity in “the real world of dynamic competition, not in the static world of much economic theory”. Firms regularly find innovative solutions to pressures of all sorts arising from the activities and actions of competitors, customers and regulators.

As for financial regulation, the cost of compliance with bad regulation is indeed a burden, which banks pass on to their customers. For example, is Basel 2 (or Basel 3) worthwhile in terms of costs and benefits? We should not talk about the Basel accords as providing better ways of measuring regulatory capital and incentives for better risk management practices (if any) without asking about the costs, financial and otherwise, of being Basel-compliant. Banks have been spending huge amounts of money on, and allocating resources to, efforts aimed at achieving the objective of being Basel-compliant. Is this spending worthwhile, in the sense that it will produce some positive outcome in terms of risk reduction or reduction in the likelihood of a financial crisis? While holding capital against risk is a useful “shock absorber” and allocating resources to the improvement of risk management techniques is justifiable, what may not be effective, in terms of costs and benefits, is the millions of dollars spent on the development of internal risk models for regulatory and compliance purposes. But good regulation pays off—we should not worry about the cost of compliance only because it reduces the bonuses of the CEOs of financial institutions.

2.9 Circumvention of Regulation

Another argument against regulation is that there will always be a way around the rules anyway, so why bother? That is true, particularly in the case of bad regulation. Under Basel 1 banks were required to hold capital against credit risk only, so they reacted by securitising their debt, which subsequently became a factor that led to the advent of the global

financial crisis. The solution is not to give up regulation but to improve and adapt it. The argument that we should give up regulation because there are ways around it sounds like the argument that serial killers get better and better in evading punishment, therefore they should be given a free hand. The same argument applies to human and drug traffickers—criminals in general get better with time and know how to use technology to accomplish their objectives. The right thing to do is to not provide a free-market environment where criminals can operate efficiently.

2.10 Ineffectiveness

The last argument against regulation is that no amount of regulation will stop people losing money and businesses going bankrupt, unless we turn to communism. But regulation should not be about losing money in a broad sense. If people lose money by taking excessive risk it is up to them, but they should not expect to be compensated. We should not close down stock markets only because some people lose money in stock trading. The fact that businesses go bankrupt is an integral part of capitalism. Again, the fact that businesses going into risky ventures or those that are badly managed go bankrupt does not mean that we move to communism (where government-owned firms may also go bankrupt). Regulation is about costs and benefits and about striking a balance. What is important is to provide a level playing field for market participants and prevent corruption and white-collar crime.

2.11 Corruption as a Justification for Financial Regulation

Financial regulation can be justified in terms of the objective of maintaining financial stability. If corruption is a cause of financial crises, then corruption provides solid justification for financial regulation. Corruption is perceived as a cause of the global financial crisis. One of the conclusions of the Financial Crisis Inquiry Commission (FCIC) is that “there was a systemic breakdown in accountability and ethics” (FCIC, 2011). This is what the Commission had to say:

We witnessed an erosion of standards of responsibility and ethics that exacerbated the financial crisis. This was not universal, but these breaches stretched from the ground level to the corporate suites. They resulted not only in significant financial consequences but also

in damage to the trust of investors, businesses, and the public in the financial system.

The subprime crisis of 2007 is also perceived to have been caused by corruption. K. Dowd (2009a) views this crisis as a scandal and a “giant Ponzi scheme”, which was enabled by the “financial innovation” of securitisation. Derivatives were used extensively to rip off unsuspected and naive customers. This is what Das (2006) says about the rip-off:

Dealers began seeking new ways to improve profitability and started marketing structured products directly to retail customers, the widows and orphans of legend... Structured product marketers set out into suburbs and strip malls. The logic was compelling—you had less sophisticated clients, the margins would be richer. In short, you could rip them off blind.

In the good old days, before the advent of securitisation, a bank would grant a mortgage with a view to holding it on its books to maturity. If the mortgage holder defaulted, the bank would make a loss—this provided an incentive for the bank to be selective with respect to who is granted a mortgage. Under those conditions subprime borrowers had no chance of obtaining a loan. That was “boring banking”, but that was exactly what the people who entrusted their money to bankers wanted. The advent of financial innovation changed all of that as banks were enabled to originate a mortgage with a view of selling it to an investment bank for securitisation. In this case the bank does not care whether or not the holder of the mortgage defaults, which puts the bank in a position where it is happy to grant a mortgage to any borrower. This means that the mortgage operation is conducted by the bank without any concern about risk (the risk of default). This is how Hutchinson (2008) describes the situation:

Even the doziest mortgage broker can originate subprime mortgages for even the least creditworthy borrowers. The fact that the borrowers are incapable of making payments on the mortgage will magically be priced into the mortgage by the securitization process, which will bundle the mortgage with other mortgages originated by a similarly lax process and sell the lot to an unsuspecting German Landesbank attracted by the high initial yield. Everyone will make fees on the deal, everyone will be happy.

This giant Ponzi scheme, as K. Dowd (2009a) calls it, was maintained only for as long as house prices continued to rise. We know the rest of the story. It is ironic, therefore, that regulators seem to be welcoming the resurgence of securitisation, as we will find out in Chapter 4.

During the subprime crisis, fraud took the form of undermining the underwriting standards by fraudulent means, and this is why Stiglitz (2010) describes the “wheelings and dealings of the mortgage industry” as “the great scam of the early twenty-first century”. First-person evidence of mortgage-related fraud is also supplied by Richard Bitner, who was a subprime lender for five years during the heyday of subprime lending (Bitner, 2008). He sold his share of his mortgage business in 2005 when he noticed a marked deterioration in the quality of the loans. As he was leaving the subprime lending business he noticed that about 70 per cent of mortgage applications contained some misrepresentation. In his book, Bitner describes the deceptive tactics brokers used to get loans approved and the methods used by brokers and mortgage banks to subvert conventional underwriting criteria. On 2 November 2008, a *New York Times* reporter, Gretchen Morgenson, told the story of a senior underwriter who at the height of the bubble was pressured to approve loans that she felt were obviously flawed, and in some cases fraudulent. Levin (2010) observes that two “prolific and highly praised underwriters” were found by an internal audit to have violated underwriting standards and that they “had an extremely high incidence of confirmed fraud”. Finally, an audit performed by Fitch on a sample of subprime loans revealed fraud in the overwhelming majority, including 16 per cent where identity fraud was indicated (L. Francis, 2010).

The same can be said of the savings and loan crisis. In his book, *The Best Way to Rob a Bank is to Own One*, William Black describes in detail the complex network of collusion between bankers, regulators and legislators that brought about the savings and loan (S&L) crisis of the 1980s (Black, 2005). Black obtained an insider’s knowledge of many details not generally known because he was a lawyer working for the Federal Home Loan Bank Board during the presidency of the big deregulator, Ronald Reagan. The fraud was enabled by accounting conventions whose fraud friendly rules helped hide the true extent of the collapse for a long period. The episode involves a Ponzi scheme that was in operation as bad banks were allowed to buy other banks, using phantom capital, which affected the S&L industry. Ironically, it was a Reagan appointee and a deregulation advocate, Edwin Gray, who ultimately revealed and stopped the fraud. Gray was an enthusiastic deregulator until he saw

the consequences in the form of Ponzi schemes, real estate bubbles and derelict construction projects. Black believes that Gray's re-regulation agenda averted a national real estate bubble and saved the taxpayer an enormous amount of money. He explains why the conventional wisdom about the S&L crisis is fallacious and prevented people from learning lessons that might have prevented the global financial crisis, and he shows why private market discipline does not prevent widespread fraud of this type.

Black (2005) argues that, without the regulatory response, and despite the interference that tempered the response, the systemic risk generated by the fraud would have spread through the economy and a global debacle similar to the global financial crisis might have materialised. Black's real message is clear: in the aftermath of the S&L crisis, he thought regulators had learned a lesson and would vigorously enforce anti-fraud regulation. But crises with similar causes occurred subsequently. He suggests that regulators failed in their responsibility to protect the public from fraud. Calavita et al. (1997) compare the actions of the principals involved in the S&L crisis to organised crime. They also argue that fraud was a significant factor in the S&L crisis and that it was probably involved in the majority of institutions that went bankrupt. L. Francis (2010) argues that the S&L crisis provided a model of the use of bank loans for fraud. In 2010, William Black gave an interview to The Real News Network, providing his perspective on the global financial crisis, which he sees as being eerily similar to previous collapses. In that interview, he explained how the crisis resulted from fraudulent schemes orchestrated by top people on Wall Street, with the simple aim of enriching themselves.

Black (2005) makes the interesting remark that "one of the great advantages that white-collar criminals have over blue-collar criminals is the ability to use top lawyers even before criminal investigations begin". Despite the prosecution of some of the most high-profile operators of insolvent S&Ls, Calavita et al. (1997) express concern that revisionist economics has de-emphasised the role of fraud, instead blaming the economic environment, poor regulation and poor (but not intentionally fraudulent) management. They provide statistics to support their claim that fraud was a major, if not the major, factor in the S&L crisis, concluding that "corrupting government by influencing the legislative and regulatory process was an integral part of the fraud". Both Calavita et al. (1997) and Black (2005) warn that failure to regulate against fraud creates an environment that is conducive to the materialisation of fraud.

2.12 The Greed Game

Greed triggers corruption, leading to financial instability. Peston (2008) describes as a “greed game” the arrangement between the partners of equity and hedge funds and their clients. This situation is what K. Dowd (2009a) calls “subsidized risk-taking: heads I win, tails you lose”. A typical arrangement between the partners and their clients involves a compensation scheme whereby the partners would receive 20 per cent of the gains (plus a 2 per cent annual management charge). Any losses, however, will be borne by the clients and by them alone. This is a clear case of moral hazard that leads to excessive risk taking and significant leverage. If the market is booming and the fund generates \$500 million in gains, the partners will receive \$110 million, including \$10 million in management fees. But if there was a loss of \$500 million—well, the partners lose nothing. Peston (2008) writes the following:

Structured finance was revolutionary financial technology for transforming poor quality loans into high quality investments. There was an epidemic of Nelsonian Eye Syndrome on Wall Street and London. And bankers, private equity partners and hedge-fund partners acknowledge—or at least some do—that the cause was good, old-fashioned greed induced by a turbocharged remuneration system that promised riches in return for minimal personal risk.

Clients accept this kind of rip-off when they see a good track record, and a good track record can be obtained with excessive leverage in a bull market. What makes things even worse, according to K. Dowd (2009a), is that “this absence of any deferred compensation gives fund managers an incentive to focus only on the period to the next bonus”. In the case of a loss, the attitude of the fund managers is as follows: “the bad news is that we have lost a lot of money; the good news is that it is not our money”. Dowd argues that the absence of deferred remuneration institutionalises short-termism and undermines the incentive to take a more responsible longer-term view. Wolf (2008) describes this situation by suggesting that no other industry but finance “has a comparable talent for privatising gains and socialising losses”. Dowd describes this kind of corruption as follows:

Instead of “creating value”, as we were repeatedly assured, the practices of financial engineering (including structured finance and alternative risk transfer), huge leverage, aggressive accounting and

dodgy credit rating have enabled their practitioners to extract value on a massive scale—while being unconstrained by risk management, corporate governance, and financial regulation.

The “talent” argument is typically used as a justification for ripping off clients and shareholders. One talented practitioner was Bernie Madoff, who ended up taking not only the agreed-upon fees and bonuses but the whole lot, while the clients lost the whole lot. Taleb (2009) makes an interesting remark: “do not let someone making an incentive bonus manage a nuclear plant—or your financial risk”, because “odds are he would cut every corner on safety to show profits while claiming to be conservative”.

Because of the corruption involved in the money “mismanagement” business, Partnoy (2010) recommends the return to 50 years ago when 97 per cent of individual investors invested in the stock market directly without going through mutual funds and what have you. He argues that investors are better off with a passive approach, such as investing in an index, because returns are not obtained by trading too much and by trying to pick stocks. Investing in an index is a simple buy and hold of a diversified portfolio. He also argues that mutual funds have proven disastrous for investors, simply because mutual fund managers trade too much or try to pick stocks. Even funds that are advertised as index funds are actively managed funds in disguise. According to Partnoy (2010), “the vast majority of actively traded mutual funds have underperformed market indexes, because of their high costs and relatively low comparative advantage”. Taleb (2009) shares the sentiment, as he argues that “citizens should not depend on financial assets or fallible ‘expert’ advice for their retirement” and that “economic life should be definancialised”. He further argues that we should learn not to use markets as storehouses of value because they do not harbour the certainties that normal citizens require” and that “citizens should experience anxiety about their own businesses (which they control), not their investments (which they do not control)”.

2.13 Concluding Remarks

Why is corruption rampant in the finance industry? Partnoy (2010) provides an answer to this question by suggesting that it is the absence of fear of punishment. For example, regulators were tipped off to the fraud committed by Bernie Madoff, but nothing happened for a long time, either because regulators did not understand the tip or because they

did not have the political will to bring a case. People are deterred from engaging in criminal activity either because they believe it is immoral or because the expected punishment, if caught, exceeds the expected benefits. Partnoy makes it clear that “in financial markets, the question of whether an action is morally wrong is typically irrelevant; the relevant consideration is profit”. For example, Partnoy suggests that “if the gains from cooking the books is substantial, and the probability of punishment is zero, the rational strategy is to cook, cook, cook”. What is important is the probability of punishment, not what the punishment is. In 2002, the US Congress doubled the maximum prison sentence for financial fraud, but that made no dent whatsoever in criminal behaviour in the finance industry. Partnoy makes the interesting remark that “legislators might as well have added the death penalty, given the low probability of conviction for complex financial fraud”.

A stronger case can be put forward by taking corruption, rather than anything else, as a justification for financial regulation. As long as corruption and white-collar crime are present, regulation is needed. Arguing otherwise is like advocating the abolition of the police force and giving murderers and rapists a free hand in the name of free market and the invisible hand.