Law, Bubbles, and Financial Regulation

Financial regulation can fail when it is needed the most. The dynamics of asset price bubbles weaken financial regulation just as financial markets begin to overheat and the risk of crisis spikes. At the same time, the failure of financial regulations adds further fuel to a bubble.

This book examines the interaction of bubbles and financial regulation through over three centuries of history of financial crises. This perspective reveals that law is crucial to the story of bubbles and that the legal history of the current global crisis has many forerunners.

The book explores the ways in which bubbles lead to the failure of financial regulation by outlining five dynamics, which it collectively labels the "Regulatory Instability Hypothesis." These five dynamics include:

The regulatory stimulus cycle. As bubbles form and markets boom, policymakers face increasing pressure to provide regulatory stimulus for financial markets. Policymakers provide this stimulus not only by deregulating financial markets and repealing statutes and regulations, but also by lowering enforcement, providing exemptions to legal rules, and choosing not to apply legal rules to new contexts. In many cases, governments intervene in markets by providing legal preferences, monopolies, and other subsidies to select market participants.

Compliance rot. Bubbles undermine the compliance by market participants with antifraud and other financial rules.

Regulatory arbitrage frenzies. Bubbles foster increased gamesmanship of financial regulations by market participants. Bubbles sharpen the creativity of these parties and their appetite for legal risk.

Procyclical regulation. Certain regulations exacerbate boom and bust cycles in financial markets, without policymakers changing legal rules or market participants varying their level of compliance.

Promoting of investment herding. Other legal rules encourage investors and financial institutions to engage in dangerous herding into particular investments.

These five dynamics become most dangerous when they undermine financial regulations that govern financial institution leverage and the supply of credit. The feedback between law and markets fuels bubbles, camouflages mistakes in pricing risk, and leaves financial institutions and markets vulnerable to a crash.

The current global crisis provided a master class in these five dynamics, as they midwifed the growth of a shadow banking system and shadow banking bubble. The shadow banking bubble, in turn, promoted more regulatory stimulus, compliance rot, regulatory arbitrage frenzies, and investment herding.

The book concludes by outlining approaches to make financial regulation more resilient to these dynamics that undermine law.

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