Thursday, March 8, 2012

The Cost of Consumer Financial Protection

Recently, I met with several accomplished compliance professionals for lunch. There was considerable discussion about the continuing growth of the regulatory frameworks, the bureaucracies to maintain them, and economic burden on financial institutions. *

One individual expressed the importance of financial protection of the consumer, while recognizing that such protection causes incremental compliance requirements; another individual agreed that such protection was needed, but worried that the costs to provide that protection would ultimately be borne by the consumer through increased pricing.

In a way, these views reflect an ethical dilemma, and I would like to explore this seeming conundrum and offer a resolution.

IN THIS ARTICLE

An Unfettered Market

There is no political economy that we know of, since the dawn of recorded history, in which an unfettered market has existed.

Theories abound about how such a market might function. Whether we term such markets as "unfettered" or use the more emotionally appealing word "free," these markets are nonetheless only theories, howsoever popular in the public mind, and have virtually no extrapolation into economic reality. Better to call such theoretical legerdemain "utopian markets" and leave them to their rightful place in speculative philosophy and treatises on metaphysics.

Of course, utopias are attractive and always will be, even if we instinctively know that their viability is inherently unsupported by human experience and their imagined structure is ultimately dissolved in the unsentimental crucible of human history.

Pricing

All markets are a remunerative way of exchanging information, which we call goods and services. Pricing is that information means by which markets communicate value relative to goods and services. And pricing is communicated through the conveyance of planning.

Markets contain an element of planning - some in extreme, others much less so. The plan, or the framework, is often in control of market participants by virtue of the very act of pricing. It is not possible to remove pricing from a market. Even a market predicated on bartering utilizes the "quid pro quo" as its informational pricing signal.

Framework

In the absence of a framework there is no market. It is not the framework that encourages commerce; rather, it is the commerce itself that encourages the formation of the framework. Innovative commerce often bleeds through and beyond an old framework, thus creating the need for a new framework.

And there is often reactionary resistance to the new framework. Those market participants who are paying attention to the informational signals of a new market are already finding ways and means to act in the new framework, while those whose commerce has not kept pace with innovation tend to resist the change mightily, hopelessly trying to preserve what they have by "fighting the tape."

Regulations

Over the years I have found that the word "regulations" has become a euphemism for all manner of mischief perpetrated by politicians and market participants. Notice I differentiate the two: while some politicians may be market participants, most market participants are not politicians. Yet politicians spend quite a bit of their time crafting regulations! The mischief takes the form of viewing regulations as not only coercive (which they are) but also

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capricious (which they are not).

Both the politicians and the market participants rail on and on between and amongst each other about the coercion and the capriciousness of regulations, yet none of them ever really defines what actually is an efficient regulation. That is because, often, neither side has any idea how best to define such a thing.

But I'll define an "efficient regulation" right here and now:

An efficient regulation is the means by which the framework is preserved. Nothing more.

An inefficient regulation is the means by which the framework is destroyed. QED.

Protecting the Consumer

The consumer and the provider of goods and services in a market are economic equals. These actors are not two sides of the same coin. They comprise the market itself! The consumer's impact on regulation is what economists call "endogenous;" that is, acting in the aggregate, consumers influence a regulatory framework by accentuating certain preferences, such as encouraging diversity and innovation.

And providers of goods and services influence regulations by discouraging monopoly, reducing inefficiencies, constraining the inappropriate acquisition of ownership and irreversible wealth accumulation, and so forth.

Protecting the consumer is really just another way of protecting the provider.

But it comes at a cost to both of them.

"Remember that credit is money."
Benjamin Franklin

We can agree or disagree about which regulations are efficient or inefficient, but there is no disagreement that all regulations cost money to enforce. How may we derive a cost value for an orderly market? There are no market dictates for this cost, no rule of thumb, no standardized metrics, and not even a credible idea of how much is too much!

We can argue against the bloated regulatory bureaucracies and their insufferable proclivity to turn out innumerable regulations. But we cannot legitimately argue against the need to police and maintain a regulatory framework. New regulations do bring with them the specter of new and increased overhead to implement them.

Ethical Dilemma

Here's the question, then: if the consumer is to be protected from bad providers, thereby preserving the integrity of the market, and good providers want consumer protection and also the chance to compete for the consumer's business, thereby preserving the market framework itself, shouldn't the consumer expect to pay more for such protection and shouldn't the provider be able to pass on the cost for that protection through the pricing?

In my view, the resolution to this dilemma is as clear as it is a necessity: so long as consumer financial protection regulation affects all providers equally within a market context, it is entirely endemic to actual commerce to pass on the cost to the consumer to provide such protection.

Yes, pricing may, and often does, increase to cover the provider's cost of implementing new regulations, but the market is preserved, and both the consumer and the provider have benefited by an orderly market.

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