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# Ethics vs. Ethos in US and UK Megabanking

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## Abstract

Company law in the US and UK fails to acknowledge that authorities' propensity to rescue giant banks from the consequences of insolvency assigns taxpayers a coerced and badly structured *equity* stake in too-big-to-fail institutions. The entrenched managerial norm of maximizing stockholder value lends a misplaced legitimacy to efforts by TBTF managers to take on dangerous levels of tail risk because their bank's deep downside is effectively eliminated by the prospect of unlimited taxpayer support. Conventional tools of prudential regulation constrain but do not *de-legitimate* this behavior. To accomplish that end, this paper calls for: (1) a formal recognition of the fiduciary duties that TBTF firms owe to taxpayers and (2) criminalizing aggressive pursuit of safety-net subsidies as "theft by safety net."

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In banking, professional standards of conduct derive less from fundamental moral principles (i.e., individual ethics) than from the pragmatic character of slowly evolving norms of banking and regulatory cultures (Kane, 2016). Realistically, the world's top bankers wrestle every day with three practical issues that leave little or no room for high-minded concepts of right and wrong:

1. What is profitable for our firm to do?
2. What will our regulators let us get away with?
3. How can we defend and expand these profit-making opportunities?

This paper argues that each of these questions can be improved by replacing the first verb by the word "should:"

1. What *should* our firm do?
2. What *should* our regulators let us get away with?
3. How *should* we defend and expand our profit-making opportunities?

Using "should" in its dutiful sense moves us from the theorem-rich realm of positive economics to the mushy sphere of normative analysis. My justification for doing this is to improve our understanding of why financial crises have become increasingly deep and widespread during the last 50 years. The gentlest way to express the explanation I put forward is to say that, especially at megabanks, bank managers have been allowed to violate repeatedly two duties they owe the citizenry at large. The first comes from the Kantian imperative against using others (here, taxpayers) only as a means. The second is to use their knowledge, skill, and experience to fulfill what Vanderheiden (2016) would call their "obligation to know" and to guard against the consequences of reckless actions. Finally, regulators' propensity to rescue insolvent megabankers and their creditors has lessened their incentive to perform these duties by

relieving them from suffering the consequences of their recklessness in full. These overlapping defects in megabank and regulatory culture support patterns of risk taking that this paper characterizes as a series of criminalizable "thefts by safety net."

What Should Regulators Allow Megabanks to Get Away With?

It is convenient to take up the second question first and to begin our inquiry by identifying similarities and differences in how US and UK regulators initially and subsequently responded to the most recent crisis. In the US and Europe today, prudential regulators have blamed the Great Financial Crisis on the reckless pursuit of profit opportunities at the world's leading banks (Binham, 2015). In the US, the Dodd-Frank Act of 2010 hopes to correct this by using federal regulators' rule-making and supervisory authority to clawback managerial bonuses at failed banks and to force financial firms to maintain stronger and more-robust balance sheets.

But in the UK, concerns about banker recklessness led Parliament and the Financial Conduct Authority (FCA) to move simultaneously in a normative direction. UK law first outlawed endgame gambles fueled with creditors' money 30 years ago (see Halliday and Carruthers, 1996; Brown 2010), although the focus was not then on banks. For corporations generally, the Insolvency Act of 1986 defined a crime called "insolvent trading." Directors who know their zombie firm is insolvent and add to the debts of their company anyway can be made personally liable for company debts and disqualified from serving as a director of other UK corporations for a number of years. The purpose of the law is to encourage directors to enter into a creditor-liquidator agreement that would prioritize the interests of creditors and the creditors' guarantors.

The Financial Services (Banking Reform) Act of 2013 similarly defined a new criminal offense, that of reckless misconduct leading to the insolvency of a bank, and set a relaxed burden of proof for this crime that would have required senior bankers to prove that they took every reasonable step to prevent regulatory breaches in their areas of responsibility. Although the relaxed burden of proof was shelved before it could take effect, members of the Senior Management Regime at a bank that has been declared insolvent can still be found guilty of this offense *if* regulators can prove that the defendant was responsible for a material breach of FCA rules. The penalty for the crime is a substantial fine and up to 7 years in prison.

At the same time, the FCA started a thorough review (since abandoned) of post-crisis changes in banking culture, pay, and practices, looking to impose a more socially responsible ethos on bankers. Presumably, the new ethos would have improved corporate governance in banks by expanding the roles of officers in charge of risk management and regulatory compliance and subjecting them to stiff penalties for unruly behavior.

In both countries, megabank lobbyists pushed back with self-serving narratives that characterized post-crisis rule making as over-regulation and claimed considerable social value for minor changes in corporate governance and risk management practices that the industry has seen fit to adopt on its own (e.g., Waxman, 2016). The industry narrative characterizes government efforts to improve post-crisis standards of banking conduct –not in ethical terms—but as vindictive "bank bashing." Everyone agrees that the bursting of twin bubbles in housing prices and securitization activity triggered sharp declines in asset prices that resulted in the Great Financial Crisis. But in the industry narrative, supervisory weaknesses exploited by a few bad apples–not an industrywide exploitation of ethically abusive regulatory loopholes—generated these bubbles. Megabankers see proposed corporate-governance reforms less as a conscientious

effort by government officials to reduce both the frequency of future crises and the harm they exact, and more as a weaselly attempt to exculpate the government sector from blame that it deserves for not perceiving in timely fashion a pre-crisis breakdown in its efforts to contain potentially ruinous forms of risk-taking, especially in innovative mortgages, securitization structures and various derivatives markets.

This recap of postcrisis reform and industry resistance suggests that modern bankers and regulators are locked in a cat-and-mouse game in which they use their very different resources in an unequal struggle to bend the opponent to their will. In this game, megabanks do not want to eat the mouse. They want to get subsidies to tail risk that the underpowered mouse is *supposed* to be guarding.

The intensity of this struggle leaves both sides not merely uninterested in ethical principles, but as a form of "motivated ignorance," unable to acknowledge that government safety nets have turned taxpayers into unfairly compensated equity investors of last resort. Despite the reckless way that many bank managers conducted themselves in the previous boom, as the dust from the crisis has settled, industry lobbyists have bullied political leaders in both countries into letting the industry set the dialectic's next round of ethical codes and approved practices more or less by and for itself.

To protect future taxpayers, this paper argues that government officials and megabank managers each have an obligation to understand how safety net guarantees and gaps in supervision have been abused in the past and to guard against future abuse. This means that they "should" work together to craft interlocking moral standards for both sectors. But current corporate law and its outmoded embrace of stockholder primacy gives neither side an incentive to do this. Nor does it offer an adequate conceptual platform for reframing these standards. This

paper explains that in too-big-to-fail institutions, stockholders and taxpayers have morally equivalent equity claims on current and future earnings. To establish the incentives and platforms needed to balance these claims, company law must be amended to recognize that the safety net makes taxpayers equity investors of last resort. The last part of the paper sketches a framework for establishing enforceable fiduciary obligations from bank managers to taxpayers whose express purpose would be to see that taxpayers' stake is safeguarded from abuse by measuring it appropriately, servicing it fairly, and treating faithless behavior by individual megabankers as a serious crime.

Importance of The Dunning-Kruger Effect

Financial crises are in part a people problem. Far from being paragons of virtue, megabank managers often display vindictive personalities, difficulty in grasping their particular limitations, and a fascination with getting very, very rich (Flood, 2016; Ho, 2009). Confidence in the banking industry's ability to deal with issues of conduct and practices in a self-regulatory manner strikes me as a glaring instance of the Dunning-Kruger effect (Dunning, Johnson, Ehrlinger and Kruger, 2003). The D-K effect is a cognitive bias that leads unskilled persons to believe that their ability and job performance are dramatically better than they are. Dunning and Kruger hypothesized and (with various co-researchers) have confirmed that, for a given skill, poorly performing people will fail to recognize their own lack of skill, fail to recognize the extent of their inadequacy, and fail to recognize genuine skill in others. To assess how good we are at something requires exactly the same skills as it does to be good at something in the first place. The D-K effect implies that bankers and regulators whose careers have prospered in

cultures shaped by predatory politics lack both the skills and the motivation needed to recognize and root out injustice.

It is hard to change the norms of any culture, particularly one that continues to make its leaders rich (Schein, 2010). Related research (Ehrlinger, Johnson, Banner, Dunning, and Kruger, 2008) shows that poor performers in any endeavor tend not to learn from feedback that clearly suggests a need to improve. For example, even in the wake of the Great Financial Crisis, government macroeconomists (e.g., Fischer, 2016) still espouse a myopic view of the variables on which crisis-management policies should focus. Their models neglect the longer-term impact that creditor bailouts aimed at averting runs and meltdowns and macroeconomic policies aimed at current rates of inflation and unemployment have: (1) on the fairness of distributions of income and wealth and (2) on longer-term financial stability. This neglect is odd (and seemingly culpable) since it is well-known that reinforcing go-for-broke financial behavior reduces the productivity of real investment and that the marginal propensity to spend out of income and wealth is apt to be much higher for low-income and middle-income families than for the ultra-high-income households that benefit directly from creditor bailouts. So at least to this extent, bailout policies that indiscriminately load future tax burdens on ordinary citizens: (1) reduce employment and aggregate demand, and (2) promote the reckless pursuit of safety-net subsidies in ways that lessen the social value and sustainability of post-crisis economic growth.

The D-K effect implies that, however skilled they may be in generating profits, megabankers instinctively over-rate the quality of their personal and corporate ethical standards. But the industry's unwillingness to face up to the logical flaw in their insistence that stockholder value may properly serve as the touchstone for ethical behavior at too-big-to-fail firms amounts to a violation of top managers' "duty to understand" the consequences of actions that risk the

ruination of their firm. The maximization of stockholder value is an ethically abusive goal for a megabanking institution (Kane, 2016). This goal is abusive because it lets managers write contracts that reward them for booking dangerous tail risks that they fund with guarantees extracted from taxpayers forcibly through the safety net. The next section shows that not measuring, servicing, or safeguarding taxpayers' equity position violates common-sense ethical principles.

At megabanks, efforts to defend the stockholder-primacy hypothesis ignore an obvious fact: *Anticipatable credit support is available to any firm –large or small-- that authorities find hard to fail and unwind when and as it approaches insolvency.* Central-bank incentives to rescue the creditors of zombie megabanks in particular force taxpayers to supply loss-absorbing equity capital to these firms on concessionary terms at times when no one else will give them any credit at all. Authorities' propensity to rescue megabanks assigns taxpayers a coerced and badly structured equity stake in their operations. From a moral perspective, this stake deserves to be measured and serviced every bit as carefully as the stake that explicit shareholders enjoy. Figure 1 shows that representative estimates of the dividends due on this stake increase in recessions, fall back in booms, and have been increasing on average over time.

Managers can hide losses and tail risks with impunity as long as they understand how to exploit an evolving set of professionally certified accounting loopholes. Like a Las Vegas magician, managers and accountants expect directors and stockholders to admire their skillful use of smoke and mirrors to make losses and loss exposures invisible to the naked eye.

To stop the secular expansion of safety-net subsidies, society needs to make profits based on subsidy extraction a source of professional disdain, rather than admiration. This will not

happen until and unless regulators and supervisors strip out from reported profit flows the embedded value of the taxpayer credit support a megabank receives.

Safety-net subsidies are rooted in regulatory norms that delay the recognition and resolution of *de facto* insolvencies. Delays in loss detection and regulatory intervention intensified the Great Financial Crisis by enabling insolvent zombie institutions (such as Countrywide Financial) to adopt aggressive endgame strategies that—by squeezing industry profit margins—spread insolvency to competing institutions. Extending accounting principles to highlight taxpayers' stake can force regulators and auditors to focus specifically on whether and to what extent particular market extensions and financial innovations reduce the effectiveness of prudential policies.

What Should Regulators and Megabankers Do?

My answer to this question is based on an apolitical theory of the fiduciary duties that, in principle, managers of difficult-to- resolve banks owe taxpayers as implicit shareholders in their firms. Regulators and megabankers should in principle work together to give taxpayers a fair return on the equity funding they supply. The follow-on policy problem is to insist that the executive cultures of the post-crisis banking and financial-regulation sectors of the US and UK explicitly incorporate and enforce duties of loyalty, competence, and care that as a matter of principle they already owe to taxpayers. This section seeks to establish a moral basis for recognizing the existence of these duties.

The core problem of ethical theory is to distinguish motives and conduct that are morally right from motives and conduct that are morally wrong or dicey. Immanuel Kant (1724-1804) based his common-sense ethical theory on the existence of what he described as "categorical

imperatives." These are universal principles that determine abstract duties that everyone logically owes to others. Dutiful action is to be contrasted with conduct that is aimed rationally at achieving some self-serving end. Kant's second imperative states that one should act so that one treats oneself and others as ends in themselves and never only as a means to an end (Kant, 1993, 1785). On this criterion, no professional or bureaucratic code of ethics can be morally right if it tolerates using other citizens merely as means to achieve the self-serving end of maximizing stockholder value.

The key is to see that the confident expectation that creditor bailouts will emerge when a megabank falls into distress lets the managers and boards of megabanks treat other citizens as means rather than ends. The firmness of creditors' expectations of rescue makes creditors pay insufficient attention to risks in booms and helps zombie firms to force central bankers into unwinnable games of chicken when and if these risks sour. This process allows predatory megabanks to shift what may be diseconomies from large-scale operation to competitors and ordinary citizens as tax burdens generated by forcing them to live with a heightened frequency and depth of financial crises.

Doing good may be good business, but it is hard to prove that by looking at the behavior of the world's biggest and most successful banks. Figure 2 shows that 10 world-class firms paid fines for specific regulatory breaches during 2009-2015 that totaled $150 billion. Over $60 billion of this amount was for lying to clients either in reporting or in describing the quality of loan securitizations in particular. Many of these breaches (e.g., for mis-selling personal protection insurance and various derivative instruments) harmed customers directly and fooled outsider shareholders into thinking the bankers involved were doing a great job. Buried inside

these figures are fines for perpetrating frauds engineered to conceal for years the increasingly perilous economic condition of Greece and Enron (see, e.g., Abdel-khalik (2016).

Edgar Schein's model of organizational culture (2010) can help us to understand how central-bank incentive conflict works to disadvantage taxpayers over a sequence of economic booms and busts. His model of organizational culture has three components: (1) espoused goals and strategies for achieving them; (2) artifacts: buildings, staffs, equipment, various processes the organization uses, and other observable features of its operation; and (3) deeply imbedded behavioral norms and shared assumptions ("beliefs") about how to behave in different circumstances. These unspoken and resilient norms and assumptions (what the French call *le non dit*) often conflict with espoused goals.

Lawyers and economists need to re-think the problem of safety-net abuse. Legal systems must make it clear that recklessly increasing a megabank's risk of ruin is a form of theft from the equivalent of a trust fund that taxpayers have dedicated to covering ruinous losses at each TBTF bank. The wording of bank charters and enforceable rules of the financial game must make it wrong for individual managers to adopt risk-management strategies that willfully conceal and misappropriate taxpayers' equity stake in megabanks. Such faithless behavior deserves to be sanctioned explicitly by both corporate and criminal law and should never have been excused by insurance law as inevitable moral hazard.

Although regulators seem eager to collect corporate-level fines, the regulatory cultures of most Western countries show a perverse reluctance to punish reckless and dishonest banking at the *individual* level. This leniency traces to unacknowledged norms of mercy and helpfulness for "good people caught in bad situations" (see Eisinger, 2016). These norms conflict sharply with regulators' espoused mission and values, but are deeply imbedded in central-bank cultures,

as modeled in Figure 3. Among other prescriptions, central-bank norms celebrate not rocking the boat, regarding big banks as *clients* to be helped (especially in competing with foreign firms) and, even if proven otherwise, to attribute solvency problems to bad luck, bad judgment, and persons doing "one bad thing," rather than to endless games of hide-and-seek and chicken that megabankers have been putting over on them for years.

From a game-theory perspective, how particular policy strategies work in practice is co-determined by the *rules* officials promulgate and by regulatees' ability to find and exploit circumventive *loopholes* in the enforcement of these rules. Kane (1988) depicts this process as a Regulatory Dialectic. Part of the process is that regulators are reluctant to publicize just how megabank investments in accumulating the political and economic clout necessary to sustain rescue expectations undermine officials' ability to force megabanks to behave more prudently. Although they are outcoached, outgunned, and almost always playing from behind, regulators soldier on. In the postcrisis era, soldiering on entails writing loophole-riddled rules that ask megabanks in good faith: (1) to formulate viable windup plans; (2) to accept evolving disclosure obligations, stress tests, and compensation controls; (3) and to strengthen balance-sheet liquidity and capital positions. My concern is that megabankers have shown again and again that rules of this kind can only temporarily *constrain* the pursuit of destructive tail risks. To make long-lasting progress, I firmly believe that governments need to make recklessness management of a TBTF bank a prosecutable crime and oblige themselves to prosecute at least the most-consequential cases.

As an extension of welfare economics theory, my analysis seeks to push the efficient utility-possibilities frontier a step beyond the limits imposed by Pareto optimality. To accomplish this, I introduce Kantian ethical principles as an additional constraint on the shape of

this frontier. These principles focus on discrediting what one does *to* rather than *for* others. To locate themselves on my ethically restricted frontier, megabankers have an obligation to acknowledge and repair moral flaws in the way that agency and megabank cultures overlap. Currently, these flaws encourage megabankers to deliberately risk the ruin of their firms during economic booms to boost their firms' current stock price and their own stock-based compensation by shifting future responsibility for covering their firms' worst tail risks to taxpayers and the citizenry at large. To lessen these incentives requires changes in company law and in prosecutorial duties aimed at compelling megabankers and central-bank officials in both countries' financial and government sectors to treat taxpayers more fairly.

## How Should Megabankers Defend and Expand Their Profit-Making Activity?

Despite the widespread suspicion that megabanks have become too large and complex to manage efficiently, in the aftermath of the crisis, megabanks have been allowed to increase their market power substantially. For the US, the increase in market power is indicated graphically in Figure 4 using the Hirschman-Herfindahl Index.

Arguably, megabanks owe this development to an ability to corrupt the politics of the regulatory system to impose disproportionate paperwork burdens on smaller competitors. In the absence of safety-net subsidies to tail risks, many of the tasks megabanks perform through subsidiaries could be accomplished as well (or perhaps even better) by more loosely affiliated firms, able to co-ordinate their behavior across a series of external information networks and trading platforms. But because the reliability of its access to safety-net subsidies grows with the political clout that a bank can generate by increasing its size, complexity and geographic footprint, megabanks have an appetite for takeovers and a huge competitive advantage over

smaller competitors. The apparent profitability of very large banks and the political power necessary to sustain this advantage are squeezing small-bank profit margins and facilitating their absorption over time into larger entities.

Kant's second moral imperative tells us that using the political and regulatory system to promote one's welfare at the expense of competitors and ordinary citizens is per se unethical. The harm suffered by ordinary citizens through the safety net depends on the same kind of coercion that we see in a protection racket. Force is used or threatened by employing the central bank as a middleman to scare the citizenry into transferring resources through the safety net from the central bank to megabank perpetrators. The Great Recession that has followed the Great Financial crisis shows that the level of harm has become high enough that citizens have a right to expect megabankers and regulators to make a sincere effort to understand and repair the ethical flaws that have sustained this process.

## Uncovering Ethical Flaws in Central-Bank Culture

It's important to understand what's gone wrong at central banks. The problem is not that prudential regulators do not *want* to protect society from the consequences of reckless risk-taking, capital shortages, and loss concealment at megabanks. The problem is that they also have other important fish to fry.

Various memoirs [e.g., Arthur Burns' diaries (compiled in Ferrell, 2010) and Bernanke (2015)] indicate that central bankers see themselves as an unfairly scapegoated team of heroes who in difficult times are assigned a series of overambitious goals by cynical politicians. In advanced countries, performance norms for crisis management embody long-held assumptions about how regulators might best deal with a distressed banking sector. First, a *market-calming*

*norm* says that it is okay to mischaracterize the nature of a hopelessly insolvent zombie firm's distress as a liquidity problem to forestall a run or system meltdown. Then, to minimize spillover effects, central bankers also claim a duty to rescue the creditors of troubled banks *as fully as possible*.

But Kant makes clear that any and all duties of rescue are inferior to the moral imperative of *not harming* other citizens. To respect this imperative, central bankers must not use the window of relief that emergency guarantees provide to delay or avoid the cleanup and allocation of losses that economic recovery requires (Kane and Klingebiel, 2004).

I find it instructive to contrast central-bank efforts to rescue managers, creditors, and stockholders of zombie institutions with the way firefighters approach their jobs. Both professions prioritize a duty of rescue, but providing funding support to an insolvent bank without resolving its insolvency amounts to abandoning prematurely the metaphorical "fire" that has burnt through its assets. Providing credit support to a zombie firm allows the ashes of its insolvency to fester and encourages arsonist managers to fan the flames by loading up on new forms of tail risks. On average, the lack of sustainability in the real investments the zombie-bank borrowers are encouraged to pursue is bound to slow macroeconomic recovery (Kane, 1989).

Regulators, politicians and the financial industry enjoy a great deal of cover because the precise depth of a zombie firm's insolvency cannot be determined quickly. They operate in a regime of secrecy that –to protect confidential information and to limit the possibility of runs and meltdowns—makes it hard for outsiders (even well-trained bank examiners) to observe adverse information promptly. But to isolate the worst cases, authorities need only establish that assets equivalent to those a distressed firm holds have lost a great deal of market value.

Post-crisis reformers pride themselves on equipping US and UK central bankers with weapons of "enhanced prudential regulation." But in both countries, the sting that these weapons convey is being artfully delayed, lobbied down, and neutralized by innovations such as capital-relief trading activity. The slow pace of economic growth and personal exposure to career damage from industry criticism lead top regulators to tolerate this subtle, but unwelcome slippage in their ability to control megabank leverage.

## A Framework for Repairing the Ethical Breakdown[2]

Financial safety nets *coerce* taxpayers into becoming disadvantaged suppliers of loss-absorbing equity funding. The risk exposure a guarantor assumes comes from simultaneously holding the short position in a put on a bank's losses and a long position in a call on the bank's assets. This is the functional equivalent of an explicit equity position.

Characterizing bailout support as owners' equity transforms taxpayer positions in TBTF institutions into a portfolio of trust funds. This way of thinking casts bankers and regulators as trustees and opens up the possibility of installing carefully recruited teams of independent parties to serve as co-trustees. The formal establishment of such trusteeships would lead officials to judge regulatory performance in terms of its effects on the value of taxpayer equity positions and exposures to ruin. It would also require regulators *and* protected institutions to re-work their norms, information systems, and incentive frameworks to support this effort.

I have argued that reckless pursuit of safety-net subsidies is ethically abusive because it entails the coercive exploitation of other citizens. This exploitation is accomplished by suppressing outside access to adverse information and by manipulating the incentives of top regulators and their staff. Because reckless banking is abusive, it is potentially criminalizable.

[2] In places, this section draws specifically on Kane (2016).

The last step in my argument is to note that the level of harm others have suffered from reckless megabanking creates a *prima facie* case for outlawing it and prescribing appropriate punishments for its perpetrators. My policy recommendations reduce to the following *haiku*:

When governments bail
a bank that deserves to fail,
someone warrants jail.

However, neither British nor American company law currently allows an arrest warrant to be issued for safety-net abuse *per se*. The traditional approach to fiduciary duty has two central components: (1) non-shareholder participants in the capital structure may be expected to obtain their legal protections through contract, not through the operation of corporate law; but (2) duties can shift from shareholders to bondholders in an undefined "vicinity" of insolvency.[3]

Partnoy (2007) shows that complications that stock options and hybrid securities introduce into that capital structure of modern firms demand a radical rethinking of the assignment of corporate fiduciary duties, and not just in the vicinity of insolvency. The idea is that innovative instruments provide different ways of investing in a firm and the contract-law metanorm of good faith precludes deliberately privileging one group of investors over another.

In the US, statutory company law is left to the states, which means principally Delaware and New York. Lynn Stout (2012) and Vincenzo Bavoso (2015) show respectively that neither US nor UK law offers any *statutory* authority for making profit maximization the primary management norm. This lack of statutory authority and legislators' reluctance to re-think basic corporate-law principles suggest that issues related to management's evolving duties to other

[3] Partnoy (2007). He goes on to describe the rationale for stockholder primacy in the following way: "it is the shareholders who have the claim on the residual value of the enterprise, that is, what's left after all definite obligations are satisfied. Accordingly, the argument goes, managers have an affirmative open-ended duty to increase this residual value, rather than the wealth of some other group. Managers should maximize share value subject to the constraint that the corporation must meet all its legal obligations to others who are related to or affected by it."

stakeholders in TBTF firms are likely to be settled in the courts. The traditional justification for stockholder primacy in common law is the presumption that stockholders are the residual risk bearers in the corporation. But in TBTF institutions, implicit safety-net guarantees assign the worst parts of residual risk to taxpayers.

As judges come to understand this, the common law may be expected to change of its own accord. Stock-based compensation in TBTF firms permits managers and stockholders to conspire against taxpayers, whether or not individual managers can be shown to understand and intend this. Looking favorably on incentive contracts designed to align the interests of managers and stockholders in megabanks against taxpayers is inconsistent with the principle of equal treatment under the law.

Still, the burdens of proof embodied in the US business-judgment rule make no sense for TBTF firms and must also change. Banking crises and customer abuse occur for two reasons. First, bankers can reap immediate rewards from abusing the financial rules of the road. Second, they understand that elitist supervisory and prosecutorial norms are apt to spare them from suffering a substantial personal penalty for this behavior.

Judges do not give reckless drivers a pass if prosecutors cannot show that the accused fully understood the dangers of violating the rules of the road or had a willful intention to cause an accident. It is wrong-headed for fraud laws to require evidence that, in recklessly driving a firm to ruin, megabankers had an explicit intention to harm taxpayers or to make loans that they believed would never be repaid. Profit maximization at TBTF firms violates the norm of fairness on which all law is based and courts should recognize this. The critical points are: (1) that the reckless pursuit of tail risk harms the interests of taxpayers and misallocated workers; and (2)

that, to deserve their high pay, megabank managers should understand the principles of risk management and risk transfer well enough to know that.

Whether they are complicit or merely deferential, banking supervisors have let society down in two ways: (1) by not setting up the equivalent of state-of-the-art red-light cameras, radar systems, and helicopter surveillance to track excessive speed and aggressive driving and (2) by not developing a resolution scheme and penalty structure that can punish unruly behavior in a meaningful and timely fashion.

Goodhart and Segoviano (2015) study the effects of triggering a ladder of increasingly stringent penalties on distressed banks, in the form of increased oversight and various limitations on dividends and executive bonuses. As a metric for distress, these authors develop operational methods for estimating a bank's probability of distress. But effective regulation and supervision must also establish disincentives strong enough to dissuade individual bankers whose mindset might otherwise tempt them to drive at perilous speeds and to undertake dangerous maneuvers for personal gain. To improve megabank driving habits more than marginally and temporarily, miscreants must fear that they will be caught and punished firmly enough to make risk shifting and customer abuse seem *personally* unprofitable for them.

The correspondence between regulating banks and regulating vehicular traffic suggests that, country by country, the penalty structure and burdens of proof in cases of safety-net theft could be designed to parallel those used to prove speeding and driving under the influence in traffic courts. Most governments combine: (1) fines for minor violations, (2) a point system which hikes the penalty for repeated or more-serious violations, and (3) procedures for transferring particularly consequential cases (such as vehicular homicide or extreme drunken driving) to ordinary criminal and civil courts. In the US, we already have administrative

procedures for enforcing regulatory findings in hearings that resemble those of traffic courts. What we need (but don't have) is bright-line rules for triggering arrests and prosecution any time that safety-net abuse rises to the level of highway robbery. It is important to link individual penalties, not as in the UK only to recorded insolvencies, but also to increases recorded in a specific tail-risk measure (such as the one displayed in Figure 1) during the two or three quarters preceding and following any material intervention that served to rescue bank creditors.

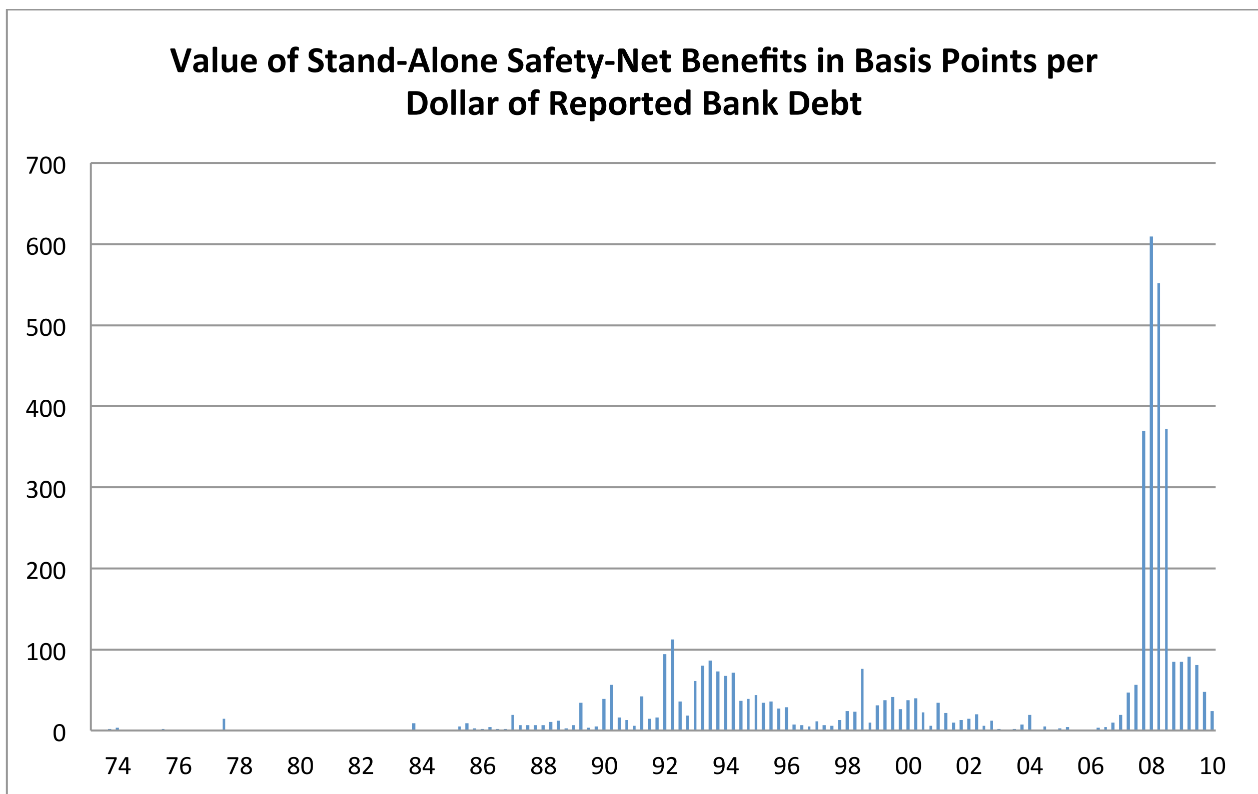
## Summary

Characterizing taxpayer bailout support as a form of coerced equity investment leads us to interpret taxpayers' positions in megabanks as a portfolio of trust funds. Although it is only part of the solution, rewriting each country's corporate code to require bankers to measure and service the value that they extract from these trust funds would be a good start. But no matter how regulators write such a rule and how they might repack their tangible toolbox of stress tests, living wills, compensation controls, and capital and liquidity requirements, if they do not also set up ways to punish *individuals* for acts of willful or complicit safety-net theft, we are bound to experience more and more safety-net abuse in the future. To assure that taxpayer rights are enforced, I believe that safety-net abuse must also be defined as a bright-line form of criminal theft and regulators and prosecutors must be obliged to impose a ladder of graduated penalties on *individuals* who can be shown to have authorized or engaged in reckless tail-risk maneuvers.

**FIGURE 1**

**AN ESTIMATE OF THE MEAN ANNUALIZED VALUE OF SAFETY-NET BENEFITS PER DOLLAR OF LIABILITIES AT US BANKS, 1974-2010**

This figure reports quarterly averages of Hovakimian-Kane-Laeven annualized estimates of fair percentage dividend due taxpayers for absorbing safety-net risk, using the well-known Merton model (1977) and assuming dividends continue to be paid. Averages are computed across a sample of U.S. bank holding companies over the 1974-2010 period and reported per-dollar of debt quarter by quarter in basis points. Financial statement data are taken from the Compustat database for U.S. banks and daily stock returns are taken from CRSP.




Source: Hovakimian, Kane, and Laeven, 2012. The surge in mean safety-net benefits during the 2008-2009 crisis and their eventual decline in the post-crisis period appears in virtually all studies attempting to measure these benefits, irrespective of the way the subsidization process is modeled.

**FIGURE 2**

Note: The particular banking organizations covered by Corlytics' work are Barclays, Bank of America, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JPMorgan, Morgan Stanley, and UBS.

**FIGURE 3**
**MY MODEL OF BELIEFS AND SHARED ASSUMPTIONS IN THE PRUDENTIAL REGULATORY CULTURE FACING US MEGABANKS**

1. Focus

    - Prudential regulation seeks to protect society from the consequences of dangerous risk-taking, capital shortages, and loss concealment at megabanks.

    - US Megabanks are in a competitive war with foreign megabanks and prudential regulators must be careful not to handicap them in these battles. This implies a duty to be helpful.

    - The financial industry needs a disclosure regime that makes it hard for outsiders to observe adverse information in a timely manner.

2. Self-Image: An embattled and often-scapegoated team of heroes that has been assigned contradictory goals.

    - Organization and management is inherently hierarchical. Dissent may be expressed, but is seldom welcomed.

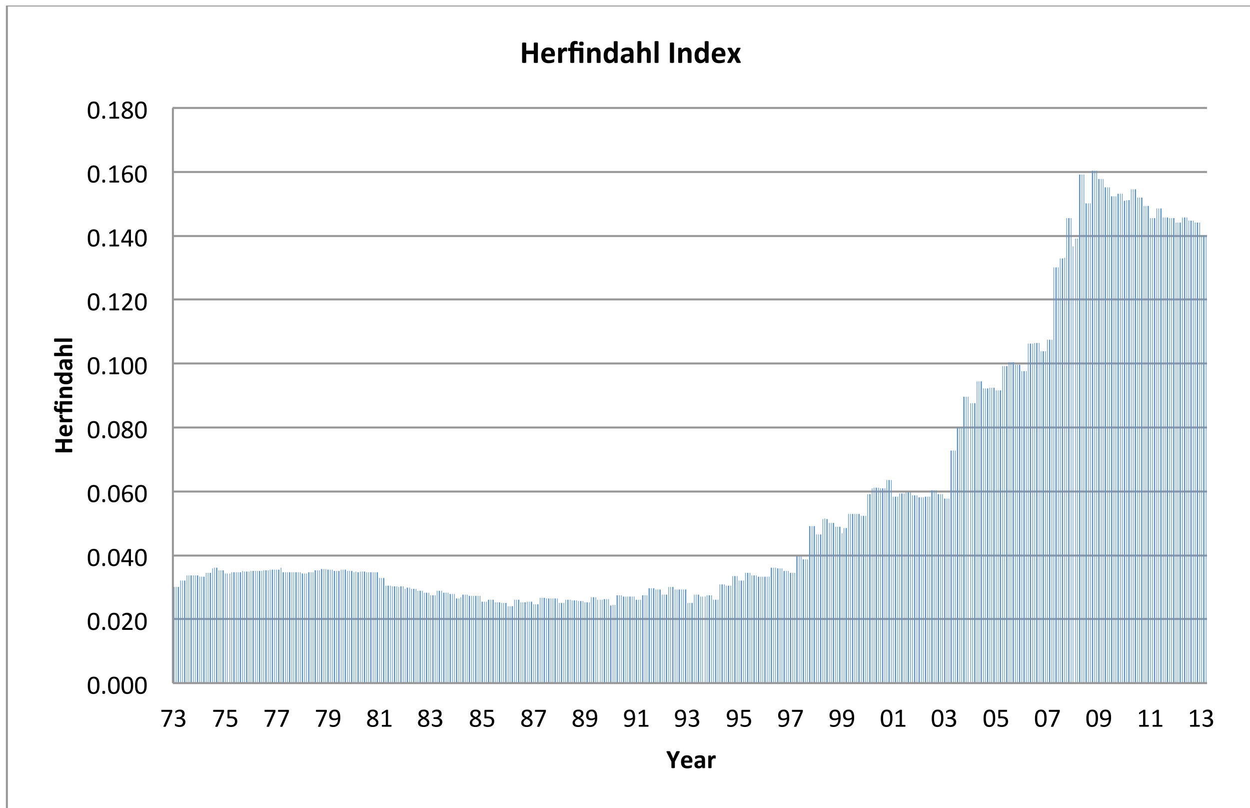
    - The extent to which staff members rise in the hierarchy depends on their ability to perceive and conform to a series of behavioral norms. In the text, these norms are described as:
        - Mercantilist norms of clientele service and protection
        - Mercy and benefit-of-the-doubt norms that dictate sympathy, help and lenient discipline for distressed client firms and then top managers.
        - Loss-concealment norms that demand that regulators must not only hold adverse client information confidential, but misrepresent this information when this is thought to promote the common good.
        - Performance standards that honor executives for not rocking the boat and sometimes for "solving" immaterial problems of their own invention.
        - Blame-avoidance norms that urge staff members to protect the professional reputations of team leaders by not admitting mistakes even to themselves.

    - Respected veteran employees who are uncomfortable with some or all of these norms may be allowed to try in subtle ways to reshape the conscience of the enterprise.

Source: Adapted from Kane (2016).

**FIGURE 4**
**HERFINDAHL INDEX FOR THE BANKING SECTOR, 1974-2013**

This figure shows the Herfindahl index for the distribution of banking assets in the US banking sector during the period 1974-2013. The Herfindahl index is computed quarter by quarter across a sample of U.S. bank holding companies over the 1974-2013. Data on total bank assets for individual bank holding companies are taken from the Compustat database for U.S. banks.




Source: Hovakimian, Kane, and Laeven, 2015.

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