Panel on Post-Crisis Financial Reform in the US and Europe
80th Meeting of the International Atlantic Economic Society
Boston, MA
October 10, 2015

REORIENTING THE PREDATORY EXECUTIVE CULTURES OF CENTRAL BANKERS AND MEGABANKERS

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Let me start with two potential examination questions that you or I might pose to ourselves or others:

<u>Question No. 1</u>

Taken together, the Dodd-Frank Act, Basel III, and G-20 Initiatives focus on symptoms of the Great Financial Crisis rather than on its causes.

____ True

____ False

____ Uncertain

Question No. 2

It wasn't just _____ that caused the financial crisis. It was _____.

Six Candidate Answers:

a. Deregulation: i.e., Bad (=Poor or Self-serving) Regulators
b. Megabanker Pursuit of Safety-Net Subsidies
c. Government Corruption and Incompetence: i.e., Bad politicians and lobbyists
d. Bad Systems of Housing Finance
e. Bad Accounting (especially for bank profits and capital)
f. Bad Incentives all around

SUMMARY

- My talk is built around the idea that financial regulation is a cat-and-mouse game.
- It employs the predominant model of executive culture developed by Schein and Kluckhohn in the field of cultural anthropology.
- I use 5 cartoons to illustrate how defects in executive cultures feed and intensify modern crises
- My explanation focuses on the process by which regulators and managers develop and transmit operative organizational values that substitute inappropriately for truly moral concepts of right and wrong and support waves of what I call "theft by safety net."

POLICY RECOMMENDATIONS

- My key point is that taxpayers are coerced suppliers of equity funding to TBTF firms and company law should explicitly recognize and protect their interest.
- Tail risk like speed is measurable, albeit imperfectly. The reckless pursuit of tail risk by megabankers resembles reckless driving. The harm this business model visits on the citizenry implies the need for laws—fiduciary civil law—by which to change incentives by identifying and penalizing extreme recklessness and prosecuting: (1) managers who intentionally and knowingly pursue this kind of racketeering and (2)regulators who willfully tolerate this behavior.
- To create a reasonable burden of proof, the new laws should include presumptive tests for megabank recklessness that parallel those we see in laws that punish drug-dealing, reckless driving, and driving under the influence.
- The structure of individual punishments should parallel those used in enforcing traffic laws: a point and fine system that reflects the severity of particular violation, penalizes repeat violators, and, in extreme cases, could pass the case on to the criminal courts.

Regulation is a Cat-and-Mouse Game of "Get the Subsidy": But Megabanks are the Stronger & More-Adaptive Players

EXECUTIVE CULTURES OF PROFIT MAXIMIZATION(at banks) AND BLAME AVOIDANCE(in government) SIDESTEP MORAL CONCEPTS OF RIGHT AND WRONG

Realistically, SIFI (i.e., Megabank) executives wrestle every day with three issues:

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?

PRETENSE AND UNEQUAL POWER ARE PART OF THE GAME

Like the “mouse” in the cartoon, regulators refuse during precrisis periods to admit that a wagging finger(i.e., the prospect of living wills and capital and liquidity **constraints**) cannot exert much discipline on the cat-quick megabanks that roam their countries. Reforms are re-equipping Central Bankers with sticks they call “enhanced prudential regulation.” But these reforms are being artfully and insidiously **delayed**, **lobbied down, and neutralized (e.g., by capital-relief trading activity).**

In the meantime, giant US and European institutions use opaque swap contracts, partnerships, and subsidiary firms to bury risk exposures in hard-to-see places that let them lap up safety-net subsidies in ways that make them bigger and more politically powerful than ever.


Kipper Williams
Megabanks
BANK
BASEL III
BEST BEFORE 2019

Where does the trough of subsidies come from?

From **Zero-haircut policies** of insolvency resolution that incentivize tail risk and coerce unlimited implicit guarantees from taxpayers for mega-institutions because:

1) In crises, the souring of megabank tail risks push central banks into **unwinnable games of chicken**.
2) Why Regulators chicken out: (1)giant firms are economically, politically, and administratively difficult to **unwind** and (2)they fear a slamming of revolving doors**.**

(Regulators ethically justify Implicit guarantees to themselves by **claiming** a duty of rescue, but Kant makes it clear that this duty is *imperfect* and inferior to a *perfect duty (i.e., a moral imperative)* of **not harming other citizens**. Do burly passengers have the right to push 50 weaker refugees off an overloaded boat?) Creditors of giant firms expect to be paid off without *haircuts* come hell or high water and this unshakable belief generates export subsidies for mega-firms from financial-center countries like the US and UK.

THE SIDE GAME OF BLAME DISTRIBUTION

- In the US, Fed officials have increasingly come to blame the Great Financial Crisis on **Ethical Weaknesses** in the Executive Culture of Megabanks. But it is dishonest to act as if (1)their agency's **own culture** and (2)the very mutable difficulty of **proving** the crime of safety-net abuse **beyond a shadow of a doubt** are not central to the problem.
- To underscore the pretense, we need to grasp the idea of an **organizational culture** and understand that megabankers' ethical weaknesses are **sustained and intensified** by **payoffs** they can gain from **gaming** weaknesses in executive subcultures and penalties at:

  (1)central banks & prudential regulatory agencies;

  (2) avoidance and advocacy intermediaries like Sullivan & Cromwell and the Promontory Group in the US.

All players treat taxpayers as an underfed herd of animals that they can milk day in and day out.

It is Instinctive to Manage Reputation Rather than Character

- Ethically challenged organizations go through **cycles of denial** that start and end in the same place:
- Stage 1: What are you talking about? Our staff are **good people** doing great things.
- Stage 2: Maybe we have **a few problems**, but we would damage our reputation if we admitted them to outsiders
- Stage 3: Our attorneys think we have finally **done enough** to get outsiders off our back
- Stage 4: At last, our critics are satisfied. Now we can **go back to doing great things.**

What is Meant by a Corporation's or Agency's "Character" or "Culture?"

Edgar Schein's **model of organizational culture** has three components:

1. **espoused** goals and strategies for achieving them;
2. **artifacts**: processes the organization uses and other observable features of its operation; and
3. **deeply imbedded behavioral norms** and **shared assumptions** about how to behave in different circumstances. These unspoken and resilient norms and assumptions (*le non dit*) often conflict with espoused goals.

Focus of Regulatory Norms

- Prudential regulators want to **protect** society from the consequences of dangerous risk-taking, capital shortages, and loss concealment at megabanks. However, they face two "buts."
- **But** Megabanks are in a non-shooting war with foreign megabanks. Pols caution prudential regulators not to handicap clients in these battles. Staff-members see a duty to be **helpful**.
- Another "**But**:" Regulators and the industry want a **disclosure regime** that—to limit the possibility of runs and meltdowns-- makes it hard for outsiders (even regulators) to observe **adverse information** in a timely manner.

Central Bank Self-Image : Central bankers see themselves as a **noble** and unfairly **scapegoated** team of heroes who have been assigned overambitious goals by cynical politicians.

- Organization and management is inherently **hierarchical,** with great **power distances** as we move away from the agency head.
- Carefully phrased **dissent** may be expressed from time to time, but there is little tolerance of outright disagreement and central banks perennially focus on achieving demonstrable **short-term** results.

The extent to which staff members rise in the hierarchy depends on their ability to perceive and conform to a series of **behavioral norms** drilled into newbies. My paper identifies 5 norms:

1. **Mercantilist** norms of partiality and clientele service to protect clients' **earning power**
2. **Mercy** and **benefit-of-the-doubt** norms that dictate sympathy, help, and lenient discipline for **distressed** client firms and their creditors.
3. **Loss-concealment** norms that—due to an ingrained fear of runs and meltdowns-- demand that regulators must not only hold adverse client information confidential, but **misrepresent** this information when this is thought to promote the short-term common good.
4. **Performance standards** that honor employees for not rocking the boat
5. **Blame-avoidance** norms that urge staff members to protect the professional reputations of team leaders by **not admitting agency mistakes** even to themselves.

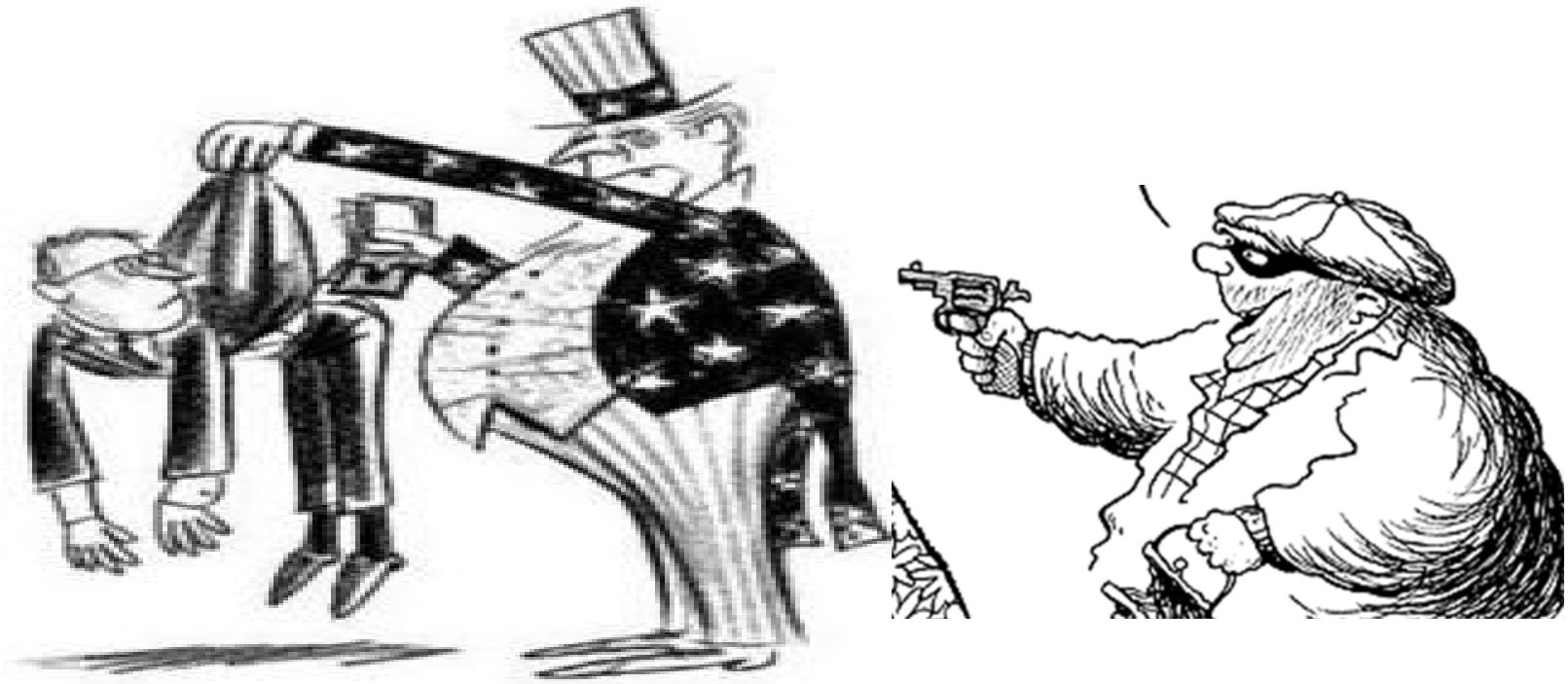
Performance norms for Crisis management illustrate long-held assumptions about how regulators in advanced countries prefer to deal with **megabank distress**:

- A **Market-Calming norm** that says it is okay to ***mischaracterize*** the character of a firm's distress to prevent or stop a run or meltdown, and
- A **Preference** for **completely** rescuing the **creditors** of institutions that are difficult to unwind or sell off.

My working hypothesis is that my 5 norms are part of the **nonpublic** character of bank regulatory cultures around the world. No matter how much the **weapons** of prudential regulation may be "enhanced" after a crisis, until these **anti-egalitarian norms** are confronted and modified, megabanks and their creditors will prepare themselves to play another expensive round of **chicke**n with regulators in the next crisis. **It is irrational to reinforce behavior without expecting to see it again and dangerous to presume that next time will be different.**

THE SAFETY NET IS A CRIMINALIZABLE RACKET

To Rebalance Incentives in Government and Industry, Legislatures Should Re-characterize **Artful** Exploitation of the Safety Net **Not** as inevitable "moral hazard," but as an **Outlawable Form of Theft**. TBTF or SIFI Firm's Funding Structure Contains A **Coercive** Taxpayer Put (a Coco) from Expected Crisis-Management Policy) that Makes Taxpayers Into *De Facto* Minority Equity Investors



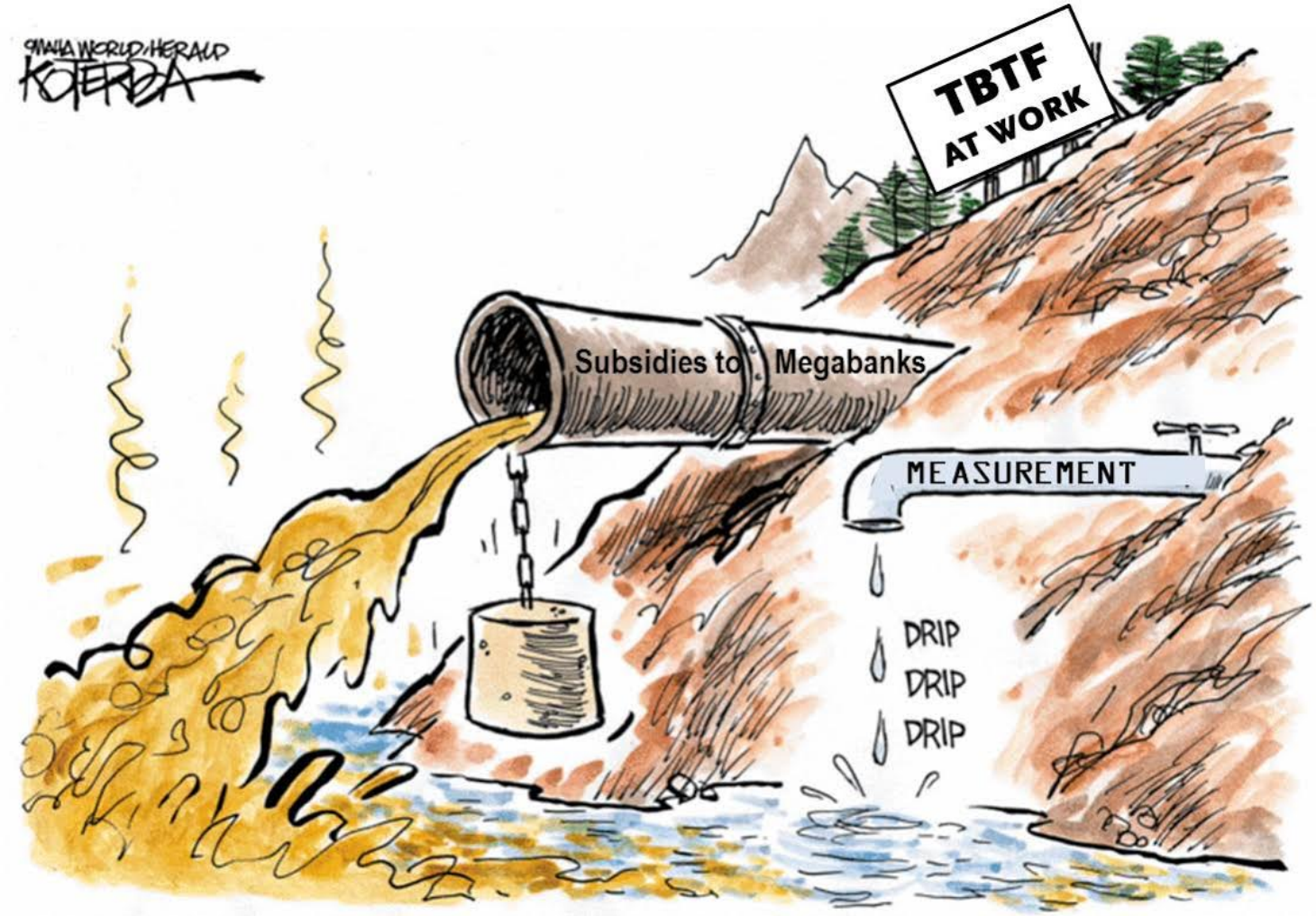
PART OF THE DECEPTIVE SIDE GAME IS TO CALL BAILOUTS "LOANS" AND "INSURANCE PAYMENTS" RATHER THAN LOSS-ABSORBING EQUITY FUNDING

TAXPAYERS' EQUITY POSITION IS INFERIOR TO THAT OF ORDINARY SHAREHOLDERS IN 5 WAYS:

- Taxpayers cannot trade their Positions Away.
- Downside liability is not contractually limited, but upside gain is.
- Taxpayer Positions are poorly compensated and carry no Procedural or Disclosure Safeguards.
- Taxpayer positions are not recognized legally as an "equitable interest." This means DFU firms may exploit them without fear of lawsuits.
- Managers can and do abuse taxpayers by **Blocking or Delaying** Recovery and Resolution.

Painting leaders of the Fed, B of E and ECB as Heroes reinforces future regulators' rescue propensity

- Because central-bank norms stubbornly resist change and operate below the public's radar, most efforts to strengthen the **observable tools** of prudential regulation end up **misleading** and **victimizing** the public. Authorities in the US continue to mis*characterize* the costs that ordinary citizens and competitors are experiencing from keeping zombie banking institutions in play.


OMAHA WORLD-HERALD
KOTERBA
TBTF
AT WORK
Subsidies to Megabanks
MEASUREMENT
DRIP
DRIP
DRIP

Major Takeaways

1. The **artifacts** of a culture may change quickly, but the **norms** of a culture resist change fiercely. (The observed default risk premia for megabanks and Greece evidence creditors' belief in central-bank rescue incentives.)
2. Recognizing taxpayers' implicit equity stake implies that individual regulators, directors, and senior management owe: (1) **fiduciary duties** toward *taxpayers* and (2) a **fair dividend** on the value of taxpayers' stake.
3. Violating these fiduciary duties entails an **abuse of trust** that today is overly hard-to- prove (e.g., promoting deceptive accounting so as to permit rampaging zombies to exist). Resulting Wealth transfers are thefts that deserve to be made **easily punishable** by civil penalties(i.e., fiduciary civil law).
4. Corporate-level fines do not challenge the anti-egalitarian norms. But **prosecuting and even jailing bad-apple executives and regulators** could create the kind of shock that cultural research says is necessary to challenge longstanding norms and replace them with values that can better **align incentives with ethics** in the financial services industry.
5. To transform a **predatory culture** into a prudential culture requires **institutionalizing individual-- not corporate-- accountability and responsibility** both at the bank and central-bank levels**.**

The Unfairness of the game is that Megabank Cats Can **Hide** their Moves But are Allowed to **Observe** and Even to **Constrain** Every Move their Mousy Regulators Make

Worries Existing Cultures Need to Address

1. Whether attempts to expand guarantees another notch to counter runs by **uninsured parties** during the **next crisis** might lead megabanks and their shadowy partners and counterparties in particular countries to bite off more than their citizenry will swallow?
2. Whether international organizations, the ECB, and the Fed can or will continue to stave off sovereign defaults by **patching** the **credibility** of countries (particularly in Southern part of the Eurozone) where expanded guarantees can easily outstrip a country's tax and debt capacity?