ETHICS VERSUS 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 creates an implicit contract that assigns taxpayers a coerced and badly structured equity stake in too-big-to-fail institutions. The entrenched managerial norm of maximizing stockholder value abuses this stake. It does so by lending an undeserved moral 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 and dividends that TBTF firms owe to taxpayers and (2) criminalizing aggressive pursuit of safety-net subsidies as a form of public endangerment.

In banking, professional standards of conduct derive less from morally defensible principles (i.e., individual ethics) than from the social cover conveyed by goal-oriented norms of evolving banking and regulatory cultures (Kane, 2016). Realistically, the world’s top bankers wrestle every day with three practical issues that squeeze out 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:”

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1 The author wishes to acknowledge financial support from the Institute for New Economic Thinking and to thank Robert Dickler (especially), Vincenzo Bavoso, Mark Carey, James Cullen, Thomas Ferguson, Gillian Garcia, Robert Johnson, Alistair Milne, Frank Partnoy, Steven Schwarz, David Skeel, Walker Todd, Haluk Unal, and an anonymous referee for helpful comments on this line of research.
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?

**Sources of Trust**

Using “should” in its dutiful sense expands the theorem-rich realm of positive economics into the less straightforward spheres of normative analysis and trust generation. I do this to emphasize that, before central banks and national deposit insurance systems were founded, banking and regulatory cultures were –like the cultures of driving and traffic enforcement today—essentially prudential in character. Prudential rules are based on norms of temperance, community spirit, and interpersonal justice and enforced in practice by a ladder of formal and informal penalties for misconduct that the citizenry deems appropriate. In such a culture, banking was a “profession,” a field in which a sense of serving others was at least as important as compensation *per se*. A banker prospered by building a reputation for making decisions that showed a due concern for other parties’ welfare.

Today, creditor trust comes less from a management team’s building a record of running a bank prudently than from government regulators repeatedly showing that they have the ability to protect the interests of bank customers, creditors, and managers even in circumstances where rent-seeking personnel managed to disable a bank’s “contracting vehicle” severely. This reworking of the foundations of creditor trust has been accompanied by increases in the average depth and geographic extent of incidents of banking crisis (Laeven and Valencia, 2012).

This paper uses the legal concepts of public endangerment and unjust enrichment — conduct that self-interestedly imposes losses on third parties—to argue that safety-net guarantees
impose on regulators and bankers fiduciary duties of loyalty, competence, and care that go beyond shareholders to the citizenry at large. To justify this claim, I take as a first principle Immanuel Kant’s imperative against using others (here, taxpayers) only as a means to an end. Applied to banking, this principle condemns as immoral the acts of public endangerment inherent in booking potentially ruinous tail risks so as to generate safety-net rents. The existence of these rents carries with it a positive “obligation for professional bankers to know and appreciate” the consequences of reckless or unjust decisions (Vanderheiden, 2016) and to use their knowledge, skill, and experience to guard against tail risks that impose bad outcomes on other parties.

In the US and Europe of today, hard-to-enforce fraud laws give megabankers a de facto right to delay asset writedowns and conceal other unfavorable information from customers and regulators alike. Megabankers understand that —as shown in Table 1— movements in their default probabilities are highly correlated. This means that, by the time evidence of any one megabank’s insolvency can no longer be suppressed, its sister institutions will be in trouble, too.

Understanding the inevitability of informational blockages transforms the supervision of financial firms operating in an insolvent condition into repeated games of chicken that megabankers expect taxpayers to lose. Regulators’ ability to rescue insolvent megabankers and their creditors ex post distorts incentives all around by relieving bank counterparties from suffering the consequences of managerial recklessness in full. These overlapping defects in megabank and regulatory cultures support patterns of risk shifting that this paper characterizes as a series of criminalizable “thefts by safety net.”

What Should Regulators Allow Megabankers to Get Away With?
It is convenient to focus on supervision 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). This reckless conduct was deemed blameworthy because it exhibited a blatant disregard for the foreseeable adverse consequences it could and eventually did visit on others.

We now know that the recklessness of many ventures were concealed from regulators by layering them through nonbank affiliates and complicated contracting structures. In the US, the Dodd-Frank Act of 2010 hopes to correct this by using federal regulators’ rule-making and supervisory authority to claw back managerial bonuses at failed banks and to force major financial firms to maintain stronger, more-transparent and more-resolvable 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 as well. UK law first outlawed endgame gambles fueled with creditors’ money 30 years ago (see Halliday and Carruthers, 1996; Brown 2010), although the focus was never on banks. For corporations generally, the Insolvency Act of 1986 defined crimes of “fraudulent” and “wrongful” insolvent trading. Directors who knew or should have known that 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 idea is that—for high-paid professional managers—a material breach should carry with it knowledge of the breach’s adverse consequences for society at large. 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 endangering behavior even in banks that were not formally declared insolvent.

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 dangerous regulatory loopholes—generated these
bubbles. Megabankers frame proposed corporate-governance reforms less as a conscientious effort by government officials to reduce both the frequency of future crises and the harm they visit on others, 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, megabank cats 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 moral 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 in some kind of task force 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’ equity 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**

Banker aggressiveness and financial crises are in part a people problem (Hagendorff, Saunders, Steffen, and Vallascas, 2016). 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 poorly skilled 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 distorts the flow of real investment toward low (even negative) expected-value, projects with long positive tails 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. Industry standards of performance have always been high, but the standards of review designed
to enforce these aspirations have been and remain overly forgiving. As a result, few individual managers have been prosecuted *ex post* for reckless behavior that took place during the precrisis bubble phase. Performance standards—such as the Dutch Bankers’ Oath of 2014—have toughened in several countries, but it remains to be seen how energetically prosecutors will pursue opportunities to fine, suspend, and/or blacklist violators.

This paper argues the unwillingness of the industry and its regulators 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. Kant’s (1785) second moral imperative makes it clear that 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 coercively through the safety net. The next section shows that not measuring, servicing, or safeguarding taxpayers’ equity position violates Kant’s 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

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2 Members of the boards of Dutch banks took the oath in 2013. In 2014, 90,000 Dutch bankers were required to take an oath: “I swear within the boundaries of the position that I hold in the banking sector:

* that I will perform my duties with integrity and care;
* that I will carefully balance all the interests involved in the enterprise, namely those of customers, shareholders, employees, and the society in which the bank operates;
* that in this balancing, I will put the interests of the customer first;
* that I will behave in accordance with the laws, regulations, and codes of conduct that apply to me;
* that I will keep the secrets entrusted to me;
* that I will make no misuse of my banking knowledge;
* that I will be open and transparent, and am aware of my responsibility to society;
* that I will endeavor to maintain and promote confidence in the banking system.

So truly help me God.”
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 the profit margins competitors could earn—spread insolvency to competing institutions. Extending accounting principles to highlight and service 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 actually be diseconomies from large-scale operation to competitors and ordinary citizens as tax and other 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 has worked to disadvantage taxpayers over a series of economic booms and busts. His model uses the methods of cultural anthropology and, perhaps for that reason, is not even mentioned in Alisina and Giuliano’s otherwise comprehensive 2015 review of the economics of culture. Schein’s 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.

Schein’s distinctions can help us to reframe compensation derived from TBTF-based safety-net abuse as a form of unjust enrichment. I believe legal systems must (and will eventually) make it clear that recklessly increasing a fully guaranteed bank’s risk of ruin is a form of theft from the equivalent of a coerced trust fund that taxpayers dedicate to covering ruinous losses at each TBTF bank. To make this clear, bank charters and enforceable rules of the banking game must be rewritten so as to encourage authorities to punish individual managers who adopt risk-management strategies that willfully conceal surges in taxpayers’ equity stake in a TBTF institution. Faithless behavior toward taxpayers deserves to be sanctioned explicitly by both corporate and criminal law and should not be dismissed routinely by insurance law as inevitable moral hazard.

Although regulators seem eager to collect corporate-level fines, the regulatory cultures of most Western countries undermine financial stability by showing a perverse reluctance to punish reckless and dishonest banking at the *individual-manager* level. In my opinion, 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 the evidence suggests 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. In this game, a good part of taxpayers’ informational disadvantage lies in regulators’ reluctance to publicize just how megabanks invest in accumulating political and economic clout and how they exercise it. This clout simultaneously supports creditors’ expectations of rescue and undermines 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 the US and other governments ought to build on the UK’s efforts to make reckless management of a TBTF bank a prosecutable crime of public endangerment, and even to oblige themselves to prosecute —rather than settle— at least the most-consequential cases.

Considered as an extension of welfare economics theory, my analysis pushes the efficient utility-possibilities frontier a step beyond the limits imposed by Pareto optimality. To accomplish this, I impose 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. A move from one Pareto point to another must always “hurt” one person while it pleases another.
But can such a move properly be called optimal if the second person B is \textit{deliberately} harmed (or even killed) solely to benefit person A?

To locate themselves on my Kant-restricted frontier, megabankers have an obligation to acknowledge and repair moral flaws in the way that regulatory and megabank cultures overlap. Currently, these flaws encourage megabankers during economic booms to expand the risk of ruin their firms face to boost their firms’ current stock price and their own stock-based compensation by devising ways of shifting \textit{de facto} responsibility for covering their firms’ worst tail risks to taxpayers and the citizenry at large. To attack these incentives directly requires changes in company law and in prosecutorial duties aimed at compelling megabankers and central-bank officials in every major country’s 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 \textit{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 excessive appetite for takeover (Kane, 2000) and a disproportionate influence on the shape of evolving banking laws and regulation. The sustained growth of very large banks and the political power necessary that fuels this growth are imposing onerous reporting burdens on small banks that have all but eliminated new entry in recent years and encouraged existing competitors to offer themselves up for sale to a larger entity.

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 immoral. 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 and taxing authority as middlemen that 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 incentives that have sustained this process.

**Incentive Conflicts Built into Central-Bank Cultures**

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 threatened 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.” The effectiveness of several of these weapons is challenged by Huertas (2015) and Kane (2016). To be effective, these weapons require a commitment on the banking side to “play fair.” In both countries, the sting that regulatory constraints convey to megabanks is being artfully delayed, lobbied down, and neutralized by innovations such as capital-relief trading activity. Given the slow pace of economic growth, the personal exposure to career damage from industry criticism makes it hard for top regulators not to tolerate some slippage in their ability to control megabank tail risk.

A Framework for Repairing the Ethical Breakdown

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.

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3 In places, this section draws specifically on Kane (2016).
I have argued that reckless pursuit of safety-net subsidies is wrongful 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 wrongful, it is potentially criminalizable. 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.\(^4\)

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.

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\(^4\) Partnoy (2007). He goes on to describe the traditional 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.”
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 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 this presumption does not hold for TBTF institutions because 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.

For this same reason, 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 pocket lasting rewards from disrespecting the rules of regulatory roads. Second, they understand that elitist supervisory and prosecutorial norms are apt to spare them from suffering a substantial personal penalty for this behavior (Eaglesham and Das, 2016).

Crimes of gross negligence and extreme recklessness provide exceptions to the need for the state to prove mens rea. 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 driving a firm to ruin, megabankers had an explicit intention to harm taxpayers or to make loans that they believed would never be repaid. Under current accounting principles, 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 hidden tail risks harms the interests of taxpayers and of workers who are encouraged to take on jobs that disappear when megabanks’ tail risks sour; and (2) that, to deserve their high pay, megabank managers ought to 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 being slow to set 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 individuals 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 \textit{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 formal declarations of insolvency, but also to increases recorded in one or more specific tail-risk measures (such as the one displayed in Figure 1) during the two or three quarters preceding and following any observable effort to bail out bank creditors.

\textbf{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 *individual* managers for acts of willful or complicit safety-net theft, we are bound to experience more and more safety-net abuse in the future. To ensure that taxpayer rights are enforced, I believe that safety-net abuse must also be defined in terms of a bright-line test for the materiality of acts of public endangerment and that regulators and prosecutors and judges 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.
TABLE 1
MOVEMENTS IN STAND-ALONE DEFAULT PROBABILITIES OF MAJOR BANKS IN THE US AND EU ARE HIGHLY CORRELATED

<table>
<thead>
<tr>
<th>Bank Pair</th>
<th>Correlation Coefficient in KRIS data</th>
</tr>
</thead>
<tbody>
<tr>
<td>BAC and C</td>
<td>.94</td>
</tr>
<tr>
<td>BAC and JPM</td>
<td>.80</td>
</tr>
<tr>
<td>BAC and GS</td>
<td>.93</td>
</tr>
<tr>
<td>BAC and MS</td>
<td>.94</td>
</tr>
<tr>
<td>BAC and DBK</td>
<td>.51</td>
</tr>
<tr>
<td>BAC and BBVA</td>
<td>.73</td>
</tr>
<tr>
<td>BAC and UBI</td>
<td>.60</td>
</tr>
<tr>
<td>BAC and CSGN</td>
<td>.71</td>
</tr>
</tbody>
</table>

Notes: The model of default probability used to generate the probabilities is Kamakura Risk Information Services version 6.0 Jarrow-Chava reduced form default probability model (abbreviated on the KRIS website as KDP-jc6). This model uses a sophisticated combination of financial ratios, stock price history, and macro-economic factors.

The version 6.0 model was estimated over the period from 1990 to 2014, and includes the insights of the recent credit crisis. Kamakura default probabilities are based on 2.2 million observations and more than 2,700 defaults.

A term structure of default over different horizons is constructed by using a related series of econometric relationships estimated on this data base. KRIS covers 35,000 firms in 61 countries, updated daily.

KRIS posted these figures on 3-17-17. The size of these correlations undermines the proposition that bail-in promises can be executed in a crisis. They tell us that, when one of these banks is in distress, the others are more apt to need help than to be able to assist them.
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.
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.


