How Is Jamie Dimon Like a Smoker on an Airplane?

Ed Kane, a professor of finance at Boston College and grantee at the Institute for New Economic Thinking, studies the dangerous risk-taking of giant banks. He sees the cultures of Wall Street and regulators coming together to turn taxpayers into victims of theft and great harm. Like extreme drunk drivers before MADD or smokers on airplanes prior to the 1980s ban, megabankers currently get away with endangering others with little fear of repercussions. Kane discusses how changes in corporate law and culture must make it legally and socially unacceptable for bankers to blow their toxic fumes at the rest of us.

Lynn Parramore: Let’s start out talking about the relationship between taxpayers, regulators and banks. How did it become so unhealthy, particularly when banks run into trouble?

Ed Kane: I think of this as a cultural problem. Organizations create a culture through some kind of mission statement, a series of buildings and staffs and procedures to promote that mission, and shared assumptions and norms about how to behave in difficult circumstances.

Financial crises are very difficult circumstances. In a crisis, the cultures of regulation and Wall Street intersect in a way that's very unhealthy for taxpayers. We get a coerced game of chicken. The world's biggest banks are aiming at the regulators and taxpayers, and the regulators want to avoid a collision. Regulators can either take over these insolvent zombies, and that's really a mess. Or they can give the zombies money and let them keep going in the hope that they'll somehow heal themselves.

The distorted culture tells the regulators to pick the second option. The regulators, the policy makers, and the central banks all around the world share the assumption that they have to rescue this industry. It's as if they jumped in their ambulances and headed straight toward every big and troubled institutions in every country. This is the cultural norm -- the industry expects rescue. Taxpayers have been forced to provide a massively valuable guarantee for giant banks. It's a very unjust situation.

LP: Why can't regulators see what's happening before a crisis sets in and take preventive measures?

EK: Regulators see themselves in an impossible situation when they get to a crisis. The failure occurs in not understanding the risks as they build up in good times, or what appear to be good times, before things go badly. The risks aren't easy to see and bankers make them deliberately so. An environment of concealment is deeply engrained in the culture of regulators and giant firms. Much of what the banks do is kept confidential on the grounds that clients are entitled to some degree of confidentiality, and that puts the regulators at a disadvantage. They can never get all the information they need or pass all of what they do get up the chain of command to the top authorities at the central bank to properly assess what's going on.
LP: We hear that giant banks like Goldman Sachs and Citigroup are raking in *megaprofits* in 2015, blowing past the expectations of analysts. How did taxpayers pay for those banks to make huge profits? Do we get anything in return?

EK: As taxpayers, you and I are contributing to bank profits because we are forced to act as investors. You might call us equity investors of last resort. This situation reverses the usual process of stockholders or shareholders investing in a firm.

In a normal situation, equity holders have a limited liability but an unlimited possibility for gain. But when it comes to giant banks, our stake as taxpayers kicks in in just the opposite way. The guarantees that we've supplied to these firms against failure are an implicit taxpayer liability. Their value to us is negative at best. Our guarantees are the same kind of loss-absorbing equity support that shareholders ordinarily supply, but we do not get dividends as taxpayers. Banks don't pay us anything back. What we get is whatever contributions the guarantees add to the economy over and above what the megabanks take from us. There's no reason to believe that that's a fair bargain.

On the other hand, the extent of our liability is limitless if authorities do not keep the bank risk-taking in check. By that I mean if they do not recognize the ways in which managers take risks that can ruin the firm, and if they don't punish the managers who exploit taxpayers by taking such ruinous risks.

LP: Banks have built their business models around this idea that taxpayers are coerced into providing them with a safety net. How does this profitable guarantee they get from us impact bank stock prices?

EK: Basically, the banks have a nice little deal you might think of as a special kind of put-option. If you own a stock and you think it's going to go down, a put contract gives you the right to sell at a specified price for a particular time. The put-option lets you benefit from a decrease in the price, which limits losses on your stock holding.

Let's say things are going very badly at a particular big bank. There is effectively little shareholder support left. At this point, the put-option starts to kick in and further losses can be loaded onto taxpayers. The regulatory authorities who represent us are supposed to stop our losses -- and they could do this by taking control of the assets of the firm. That is where the term "too-big-to-fail" comes in. Authorities are afraid for economic, political and administrative reasons to take over these firms. So that gives large banks a chance to keep gambling additional funds until they find something that pays off. If the banks really can't be closed -- if authorities really can't take them over and can't wipe out the shareholders -- then this back-up always has value, and it gets priced into the banks' stocks.

You can see this value most clearly when a firm like AIG is absolutely on the ropes and its stock is heading toward zero but never gets to zero. Once authorities turn around and say, we’re not going to take over AIG, we're going to let them keep gambling and try to get well that way, then you see the stock surge. That's how the value gets in. The central bank resembles a restaurant
franchise guy who says to a sandwich shop manager, we will always supply the funds you need to expand, no matter how badly you screw up.

**LP: How can taxpayers get the law on our side?**

EK: First, people like you and I need to get the big picture across. What I'm saying is that the taxpayers are really disadvantaged minority stockholders but not recognized as such in the law. That's unjust. The law has a concept called "equitable interest." If you can be harmed by the behavior of, say, managers of a firm (in principle, anyone who invests can be harmed), then you should have an equitable interest and you should get a fair dividend for the funds you're supplying and the risk you're taking.

If the law would recognize that taxpayers actually do have an equity position in these banks, then this would create ethical obligations directly from the management to taxpayers. Instead of stealing money from the taxpayers by forcing us to come up with the funds they need when they're in great distress and getting regulators to back off in the game of chicken, they would owe us duties of competence, loyalty and care. Bank managers would not have such strong incentives to steal money from taxpayers through the safety net.

**LP: That's pretty blunt. Are you saying that banks have built a business model based on theft?**

EK: What the too-big-to-fail banks are currently doing meets the everyday definition of theft -- it's a forceful taking of resources. But of course, the stealing happens in a complex way and it's not easy to see. It's not quite as simple as observing the hold-up man pointing a gun at someone.

The remedy is to establish in law that these megabank managers owe fiduciary duties directly to taxpayers. The way it is now, managers defend their actions by claiming that they have a formal duty to maximize value for shareholders. But if they are too-big-to-fail, that norm actually entails a duty to steal value from taxpayers. That is the absolute logical consequence of affirming maximizing shareholder value as the main duty of bank managers.

We have to change corporate law. The basic idea is to change the oaths of office of central bank officials to establish that they are trustees for the portfolio of megabank guarantees that represents the equity interest of the taxpayers. Regulators should have responsibility for measuring and collecting returns that are owed to taxpayers. Economists can calculate those amounts through mathematical and statistical methods. Lobbyists, of course, will complain that this would be unreliable, but it's really not difficult to get a decent estimate. The taxpayer position is already embedded in the stock prices of megabanks, and when those positions are getting bigger -- that tells you that regulatory failure is almost certainly underway.

**LP: Given the power of banks in our political system, how can we change laws and regulatory culture that allow the banks to rob us repeatedly? Where must the pressure come from?**
EK: I don't know. The fundamental issue is fair play. Wanting everyone to play fair is what we might call a "meta-norm" of our national culture. There are other ways than those I've suggested for attacking the problems in the financial sector. Some talk about breaking up the big banks or limiting how big one organization can get. Reformers have tried to promote fair play by placing restraints on campaign finance, but that hasn't gone very well.

I think the way norms are changed is very subtle. You have to have people who feel very strongly and are willing to invest a lot of resources in the process. I can think of two norms that have changed drastically over my lifetime. One is drinking and driving -- extreme drunk driving used to be very common and even thought of as a joke. Then Mothers Against Drunk Driving worked slowly but surely over decades, and now drunk driving has no defenders. Similarly, smoking, which used to be seen as cool, is now viewed as a slow form of suicide. A smoker on an airplane used to insist on his or her rights to pollute the air and harm the lungs of fellow passengers. The damage they did to others was not something they thought much about. Today smokers have to beg for a place to smoke.

LP: So Jamie Dimon is like a smoker on a plane, getting away with the slow destruction of the health of his fellow passengers?

EK: Yes. Taxpayers and ordinary citizens are the non-smoking passengers. Smokers selfishly pursued their own pleasure without facing up to the harm they were visiting on others. The rules offering a no-smoking section resemble the ineffective capital requirements that the industry lobbyists persuade regulators to adopt.

The wealth of ordinary taxpayers is being damaged by the smoke from megabanks' reckless portfolio strategies, but ordinary citizens and ineffectual regulators cannot see the damage until it has become massive enough to cause another game of chicken -- another giant crisis. To see the damage in time, we have to recognize that the safety net assigns taxpayers a disadvantaged equity stake in institutions that are too-big-to-fail. Like smokers on airplanes, bank managers fail to see that they owe fiduciary duties and dividends to taxpayers. To underscore this, we have to change the information system to surface regular estimates of taxpayers' stake in megabanks. Just like the airplane smoking ban, in which it took mountains of medical evidence to gradually change societal norms and industry practices, it's going to take a lot of work and educating the public to change this culture.

We really have to treat bankers who steal from the taxpayers as pariahs. We have to recognize that they are no different from a robber on the street, except they dress better! We have to regard them with contempt and they have to feel guilty about what they're doing. Right now they think of taxpayers as suckers and they don't feel guilty at all about the suffering they cause.

There is a lot of unorganized anger towards the banking industry around the world. Ordinary citizens have suffered from inappropriate risk-taking that happened during the boom before that 2007-2009 crisis. They are angry and they have a foggy idea that somehow the bankers did this. So it's a matter of an honest effort by the press and by academics to clarify this picture for the public and focus their anger properly. If it isn't refocused and this game keeps being played for a generation or two, then I think society will begin to see a lot of civil unrest. Before then, I hope
bankers will see that they are behaving like the class of nobles before the French Revolution. It is dangerous to take repeated advantage of the rest of the population. If the world's megabankers want to keep what they have, they're going to have to share it a little better.