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Abstract

The success of any treatment plan depends on how completely the problems it targets have been diagnosed. The precrisis bubble in securitization can be traced to incentive conflict that allows national safety nets to subsidize leveraged risk-taking. Safety-net subsidies encouraged regulation-induced innovations that enabled firms to take hard-to-monitor risks and to make themselves politically, administratively, and economically difficult for government officials to fail and unwind.

This paper summarizes the incentive conflicts that led creditors and internal and external supervisors to short-cut and outsource due diligence. The Dodd-Frank strategy of reform does not adequately acknowledge or address these conflicts. The key step needed is to develop an effective statistical metric for measuring the ex ante value of safety-net support in the aggregate and at individual institutions. To accomplish this, government and industry need to rethink the informational obligations that insured financial institutions and their regulators owe to taxpayers as de facto investors and to change the way that information on industry balance sheets and risk exposures is reported, verified, and used. Without reforms in the practical duties imposed on industry and governmental officials and in the way these duties are enforced, financial safety nets will continue to expand and their expansion will undermine financial stability by generating large rewards for creative and aggressive risk-takers that are smart enough to cash in their share of safety-net benefits before they evaporate.

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1. Introduction

In signing the massive Dodd-Frank Wall Street Reform and Consumer Protection Act (henceforth the Dodd-Frank Act), President Barack Obama issued a seemingly straightforward prediction about the effectiveness of the Wall Street Reform section of the Act:

"The American people will never again be asked to foot the bill for Wall Street's mistakes. There will be no more taxpayer-funded bailouts. Period." (McGrane, 2010).

In 1766, Voltaire famously opined that “Men use thought only to justify their wrongdoings, and speech only to conceal their thoughts.” This is another way of saying that no one should expect private or government officials either to tell the truth or to accept blame when it is due. Riffing on this theme, comedian Steven Colbert characterizes official explanations of adverse developments as "truthy" cover stories. Officials tell us what they want the facts to be as opposed to either what the facts are or what realistic analysis can support.

When government officials misinform the public about the reasons for -- or probable effectiveness of -- one or another economic policy, they violate a duty of accountability that every public servant owes to citizens of his or her country. This is because the right to protect high officials from painful criticism that government spokespersons implicitly invoke is trumped by duties of disclosure, loyalty and care that, as agents, high officials owe to other members of society. The integrity of representative democracy turns on these duties. For this reason, governmental or media deceptiveness poses a professional and ethical challenge to conscientious newspersons and academic economists to uncover the spin and explain the deception to citizens who might be harmed by it. This paper takes up this challenge with respect to the Dodd-Frank Act. It seeks to explain that ignoring the mechanisms of regulatory capture renders the Act

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deceitful at its core. Without changes in the ethical obligations accepted by managers of regulated institutions and regulatory agencies and new limits on how both groups interact with Congress, genuine and lasting financial reform is impossible.

2. Why we cannot trust the President’s statement

One way to establish the truthiness of the President's prediction is to expose mental reservations that could in principle explain its deceptiveness. The President was careful not to include "mistakes made by Congress or by incentive-conflicted managers of federal agencies and government-sponsored enterprises (GSEs)" in his first sentence. His second sentence reassures taxpayers, but neglects lower-income categories of “American people” that are apt to be harmed by crises in different ways. Finally, the President did not clarify whether he meant to exclude indirect “taxpayer funding” such as guarantees. Whether or not he had such reservations in mind, the one-word third sentence is an indefensible rhetorical flourish that strongly suggests an intention to mislead.

The Act puts responsibility for avoiding future crises squarely on the competence and good intentions of future regulators. The presumption that regulators can succeed year after year in this task --in the face of perverse Congressional pressures and recruitment procedures-- is a wishful element that could account for the President's rosy forecast. Table 1 shows that -- at 2,319 typed pages -- the Dodd-Frank Act is orders of magnitude longer than previous financial legislation. Despite its length, the Act allows GSEs to continue their loss-making ways and offers numerous opportunities for the regulatory community to misread its authority or otherwise miss its marks. In particular, the Act encompasses lengthy phase-in periods for most of the changes it mandates and leaves to federal financial regulatory agencies the hard work of specifying and implementing crucial details of the proposed new regulatory structure. By one count, federal
regulators' incremental workload is to “complete 243 rules, largely during the next two years, along with 67 one-time reports or studies [including one on GSEs] and 22 periodic reports” (Kaper, 2010).

Although most moralists regard scapegoating and truthy “spinning” of facts as slippery slopes (Bok, 1999; Strudler, 2010), inviting listeners or readers to misinterpret shrewdly worded legislation is definitely more elegant than lying. Moreover, our legal system conditions us to accept (and even to admire) the use of clever evasions. Like producers of shoddy goods, producers of artfully framed words routinely defend themselves by blaming their victims for swallowing the bait. They can and do argue that listeners ought to realize that they are in a position of caveat emptor and act accordingly. From this captious perspective, verbal sleight of hand is acceptable because it offers its audience an opportunity to reason their way through the deception. However, the more officials use such techniques, the clearer this opportunity becomes and the smaller the percentage of a country’s population that misdirection can fool.

A Bloomberg National Poll conducted during the week before the signing suggests that Presidential and Congressional misdirection has failed to sell the public on the effectiveness of the Act’s legislative thrusts. Only 21 percent of respondents believed that the Act “will require big Wall Street Banks to make major changes in the way they do business” (Miller, 2010). In a Risk magazine survey conducted on its website about a week later (Table 2), only 12 percent of its presumably more-expert respondents thought regulators “are ready for new regulations.”

To explain the divergence in expectations between the US political establishment and ordinary citizens, we can make use of the Kübler-Ross model of how people work through the emotional pain generated by personal and societal crises (Kübler-Ross, 1969). In recent years, her model has been expanded from five to seven stages: shock, denial, anger, fruitless bargaining
for an easy way out, depression [i.e., realizing things (e.g., mortgage availability) will never be the same], examining realistic solutions, and settling on a satisfactory way to move forward. The model recognizes that people may easily become trapped in one of the passive early stages of denial, fruitless bargaining, and depression or cycle back to one of these stages in frustration when realistic solutions seem unreachable.

This paper advances the hypothesis that federal authorities are cycling between the stages of denial and superficial political bargaining, while the public is cycling between anger and depression. Although authorities refuse to admit it, Congress has ignored or undertreated what are easily perceived to be fundamental causes of the crisis: the regulation-induced "shadow" banking system (Gorton, 2010); the SEC’s lax oversight of securities, credit-rating, and investment-management firms (as exemplified by the Madoff scandal); the de facto corruption of regulatory capture (accomplished through bargaining for campaign contributions and postgovernment job opportunities); and subsidies to leveraged risk-taking offered in derivatives markets and mortgage finance. The Bloomberg and Risk Polls suggest that these undertreatments and omissions have led a large percentage of the citizenry to lose faith in the ability of the US financial and regulatory systems to confess and amend their weaknesses.

It is instructive to think of excessive financial-institution risk-taking as a life-changing disease and Congress and regulators as doctors. During the securitization and housing bubbles, regulatory and supervisory entities misdiagnosed and mishandled the buildup of systemic risk in part to transfer subsidies targeted to financial institutions, homeowners, and builders (Kane, 2009). When the bubbles burst and with the tacit approval of Congress, regulators transferred the bill for consequent financial-institution losses to taxpayers through the financial safety net without weighing the full range of out-of-pocket and implicit costs of their rescue programs.
against those of alternative programs such as prepackaged bankruptcy or temporary nationalization and without documenting differences in the way each program would distribute benefits and costs across the populace.

With respect to distributional effects of bailout policies, framers of the Act seem to hope that they can get away with verifying only the direct benefits generated by Treasury and Federal Reserve rescue schemes. But the public deserves more than this. To realign incentives going forward, someone outside of the agencies that conceived and carried out inadequate value-at-risk stress tests and extravagant bailout schemes needs to be made responsible for measuring and discussing the distribution of the net opportunity costs of the crisis. Taken together, financial-sector rescue programs and the policy of near-zero interest rates (which also help to recapitalize insolvent institutions) have inflicted substantial losses on depositors, on future taxpayers, on pension plans and on persons living on interest incomes (particularly, the aged).

It is unreasonable to believe that, without actions to realign bureaucratic incentives and reporting responsibilities, authorities either can or will adequately measure and price tail risk during future economic booms. Even though important new powers were conferred on regulators by the FDIC Improvement Act of 1991, lobbying pressure from elite sectors undermined rulemaking and oversight during the housing and securitization bubbles (see Kane, 2009). The hard-to document nature of safety-net benefits in good times and the industry's overwhelming lobbying power provide good reason to doubt --in line with the results of the Bloomberg and Risk polls-- that the financial rules US regulators are working on now will come close to meeting the aspirations that the President's signing statement sets for them.

During and after what will be an extended post-Act rulemaking process, decisionmakers will be energetically lobbied to scale back taxpayer and consumer protections to sustain
opportunities for extracting safety-net subsidies. Ex-Comptroller Eugene Ludwig offers the following nicely laundered justification for lobbyists to exercise their ability to influence agency personnel:

“A goal of effective regulation should be to foster healthy, growing and profitable companies that can continue to serve their communities. During the public comment phase, it is important that bankers make this case thoughtfully and constructively showing which regulatory approaches work and which do not” (Ludwig, 2010).

Financial-sector lobbyists' ability to influence regulatory and supervisory decisions remains strong because the legislative framework Congress has asked regulators to implement gives a free pass to the dysfunctional ethical culture of lobbying that helped both to generate the crisis and to dictate the extravagant cost of the diverse ways that the financial sector was bailed out. Framers of the Act ignored mountains of evidence that, thanks in large part to industry lobbying, incentive-conflicted officials have almost never detected and resolved widespread financial-institution insolvencies in a fair, timely, or efficient fashion.

Initial improvements the Dodd-Frank Act may engender in the administrative framework and toolkit through which regulatory authority is exercised are unlikely to hold up over time. As memory of the crisis recedes, their effectiveness is apt to be undermined. Lobbying pressure will be exerted on Congress for relief from well-targeted reforms (such as those aimed at increasing borrower downpayments on mortgage loans), while any set of rules is vulnerable to regulation-induced innovation and incentive conflicts that soften the impact of whatever enforcement procedures private watchdogs and government safety-net managers put in place. The still-to-be-treated part of the policy problem is to change Congressional priorities and to incentivize and monitor private watchdogs and private and public managers of systemic risk in ways that will lead them to contain – rather than tolerate – the subsidies to risk-taking that financial firms can extract by mixing regulation-induced innovation with well-placed political pressure.
3. Elements of denial in the Dodd-Frank Act

Congress and the President cynically assigned the task of framing the government’s response to the financial crisis to committee chairmen who had helped to create it: a Senator who was retiring under a cloud for favors received from a giant mortgage lender and a Congressman who served as a longtime cheerleader for the dangerous policy of using the housing-finance system (rather than direct grants to households) to expand homeownership.

Realistically, the success of any treatment plan depends on the accuracy of doctors' diagnosis of the particular deficiencies and imbalances that need to be remedied and on the ability of the treatments proposed to remedy the targeted disorder. The diagnosis that guided the treatments the Dodd-Frank Act prescribes is incomplete. It rightly acknowledges that the current crisis was caused by “defective” risk management during the bubble or buildup phase. But the Act presumes that important mistakes were made exclusively by private firms: those whose size and complexity spread the consequences of their aggressive risk taking too widely for the private financial system and the government’s formal safety net to handle. This view disregards governmental mistakes made in inspecting the safety net during the buildup phase and in administering the net during the crisis.

The Act’s narrow theories of blame and regulatory behavior are inadequate in four ways. First, they excuse incentive-conflicted US officials for their role in expanding the safety net during the bubble and subsequent crisis. Second, without addressing weaknesses in leadership incentives, they call upon government agencies that failed society during the buildup (such as the SEC) to devise and enforce rules tough enough to prevent renewed risk-taking by clientele firms from engendering future crisis. Third, because agencies accepted this assignment without protest, the Act positions Congress to scapegoat rulemakers by pretending that –without changes in the
way Congress asks them to do business-- the agencies ought in fact to have been able to craft
detailed treatment plans that would compel “systemically important” private firms (SIFs) to
monitor and support their risk exposures more effectively in the future. Fourth, both theories take
it for granted that the interest-rate and default risk inherent in long-term nonrecourse mortgage
instruments can continue to be efficiently and fairly financed by short-term debt protected by the
federal safety net.

The Act purports to reduce systemic risk (which officials define incompletely as the
likelihood of a cascade of contagious defaults by important private institutions) by expanding
and reallocating regulatory authority. But it leaves in place incentive conflicts that make it hard
for the regulatory establishment to solve two problems: (1) to figure out how and how much they
ought to increase capital requirements at short-funded institutions and restrict over-the-counter
derivatives trading and executive compensation at financial firms to protect society from being
billed for future rounds of financial-institution losses, and (2) to figure out how closely political
pressures will allow them to approach this ideal.

The nub of the problem is that government regulators’ conception of systemic risk
neglects the pivotal role they themselves play in generating it. Officials’ tolerance of innovative
forms of contracting that are designed to be hard to supervise (such as the shadow banking
system) and the government’s penchant for rescuing creditors and derivatives counterparties by
nationalizing losses in crisis situations are politically conditioned responses. Although the fiscal
deficits this behavior implies cannot be sustained forever, the predictability of bailout policies
encourages opportunistic financial firms simultaneously to foster and to exploit incentive
conflicts located within the various private and governmental enterprises that society expects to
identify and police complicated forms of leveraged risk-taking.
The effectiveness of any regulatory scheme depends on the vigilance and conscientiousness of professional watchdogs (such as accountants, lawyers, and credit-rating firms) and private and public risk managers. The US regulatory system broke down in the 2000s because the GSEs, OTC derivatives dealers, and other SIFs had strong incentives to try to shift risks to the taxpayer in clever ways and private and government supervisors did not adapt their surveillance systems conscientiously to curtail these incentives as needed to recognize off-balance-sheet leverage and contain burgeoning taxpayer loss exposures in a timely manner.

Zen Buddhists proclaim that truthfulness eradicates deceit. A complete diagnosis of modern financial crises must acknowledge that lobbyists for SIFs have persuaded Congress to maintain a loophole-ridden regulatory structure. Risk managers at SIFs use changes in technology to exploit the loopholes and to invite supervisory blindness and subsidy-generating mistakes by private and governmental overseers. Far from conceding any moral obligation to provide meaningful information on the value of taxpayer support they enjoy or to pay a fair price for this support, SIFs skillfully extract subsidies from the safety net. They do this by devising innovative funding strategies and corporate structures that misrepresent and conceal from outside eyes the leverage and interest-rate risk these innovations generate (Caprio, Demirgüç-Kunt, and Kane, 2010).

4. Elements of coverup

The idea of coverup embraces any action or strategy that deflects or interferes with efforts to investigate or expose an embarrassing problem situation. By its neglect of political and bureaucratic drivers of systemic risk, the Dodd-Frank package of reforms downplays the practical importance of supervisory incentive conflicts and draws attention away from the need for incentive reform.
Safety-net officials deny that Congress imposes on them a series of insuperable and deeply ingrained conflicts of interest. To understand the gravity of this problem, it is useful to liken the safety net to a consolidated government enterprise that is owned by taxpayers. The long list of managerial incentive conflicts summarized in Table 3 is alarming. Fiduciary standards applicable in the private sphere would expose managers to punitive lawsuits and extensive disclosure requirements if they tolerated such extensive conflicts with enterprise owners.

The size and intricacy of the Act provide additional misdirection. Table 4 lists what the press regarded as the major differences in the treatment plans that House and Senate conferees had to reconcile. Although the two bills covered a vast amount of ground, neither proposed to resolve -- or even to stem -- the largest source of taxpayer losses in the securitization debacle. This is the many ways in which the tax and regulatory system supports and distorts mortgage lending. The financial system would be much less fragile if maturity transformation was not subsidized in opaque and hard-to-observe ways that encourage long-term nonrecourse mortgage loans to be funded by government-guaranteed forms of short-term debt. Particularly worrisome is the prolonged crisis in foreclosures and the still-expanding $200 billion in losses imbedded in Fannie Mae and Freddie Mac. While crisis management policies have done little for underwater mortgagors, they have transformed Fannie and Freddie from government-sponsored enterprises into de facto government-owned corporations. Figure 1 shows that since the securitization bubble dissolved in 2007, Fannie and Freddie have been purchasing or guaranteeing an increasing percentage of the single-family mortgages being originated in the US. Along with agencies such as the Federal Reserve and Federal Housing Administration, these firms continue

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2 These firms’ longstanding life-in-death existence provides strong evidence that, despite the passage of the DFA, substantial political obstacles restrain the practical use of insolvency-resolution procedures. Lucas and McDonald (2009) show that taxpayers’ stake in Fannie and Freddies was substantial even before the crisis.
to nurture traditional forms of mortgage lending even though private institutions appear to have lost interest in holding the risk traditional mortgage loans generate.

5. Reframing the policy problem

Less than five months after the DFA’s enactment, the incoming Chairman of the House Financial Services Committee characterized the purpose of financial regulation in the following way: “In Washington, the view is that the banks are to be regulated and my view is that Washington and the regulators are there to serve the banks.” Although the halls and offices of Congress give daily evidence of this propensity to serve, the Act ignores the role that political clout plays in sustaining and expanding safety-net subsidies for major firms.

Major institutions become systematically important by deliberately making themselves economically, politically, and administratively ever more difficult to fail and unwind (DFU). Although the Act helps taxpayers by asking DFU firms and the FDIC to work out insolvency-resolution strategies (so-called “funeral plans”) in advance of an actual crisis, it is hard to rehearse the intense lobbying pressures regulators will face to rescue these firms when these strategies actually have to be applied. Bailout decisions arise in circumstances that loss-making DFU institutions make as stressful as they can.

The point is that DFA-generated increases in the “resolvability” of DFU firms may not rise to the threshold necessary to offset authorities’ bailout reflex. Recruitment and reappointment processes for top regulators typically generate a substantial trail of political debts. Far from emphasizing job skills (such as financial acumen, mental toughness, and loyalty to the taxpaying and voting public), high officials are screened first and foremost for connections and for their anticipated loyalty to the agenda of the President who appoints them. For example, in 2009 Transportation Secretary Ray Lahood attributed his appointment (Leibovich, 2009) not to
being seen as “that great a transportation person,” but to credentials he called “the bipartisan thing” [his roots lay in the Republican party], “the Congressional thing” [his 14 years in the House of Representatives], and “the friendship thing” [with the President’s chief of staff]. Missing from his catalogue is evidence of the moral fiber and passion for serving the interests of the nation’s citizenry that are needed to overcome the nasty political pressures that force unpracticed officials into scary games of chicken that the financial industry seems always to win.

Kane (2010a) argues that complete and authentic financial reform must include an operational definition of systemic risk and more detailed mission statements and oaths of office for regulatory personnel. Ideally, mission statements and oaths ought to espouse five duties that a conscientious supervisor ought to be willing to agree that government personnel owe to the community that employs them:

1. **A duty of vision**: Supervisors should continually adapt their surveillance systems to discover and neutralize innovative efforts by financial firms to disguise their rule breaking;

2. **A duty of prompt corrective action**: Supervisors should stand ready to propose new rules and to discipline regulatees whenever a problem is observed;

3. **A duty of efficient operation**: Supervisors should strive to produce their insurance, loss-detection, and loss-resolution services at minimum dollar cost and distributional disruption;

4. **A duty of conscientious representation**: Supervisors should be prepared to put the interests of the citizens they serve ahead of their own;

5. **A duty of accountability**: Implicit in the first four duties is an obligation for safety-net managers to embrace political accountability by bonding themselves to disclose enough information about their decision making to render themselves answerable for mishandling their responsibilities.

In principle, rulemakers and supervisors are recruited from a population of public-spirited individuals who should embrace these fiduciary duties enthusiastically. But Voltaire has also
advised us that, to assure bravery under fire, "from time to time it is necessary to kill one admiral [i.e., a fearful official] in order to encourage the others." This is his way of saying that accountability is the most important of governmental duties and that exempting any government program from outside scrutiny is a form of denial and coverup that encourages other officials to seek carveouts of their own.

The Federal Reserve has traditionally interpreted its fragile “independence” as if it were logically inconsistent with close bureaucratic accountability. Its leaders have shown a willingness to let Congress blame them after the fact for policies that prove unpopular, but they exhibit little enthusiasm for explaining how carefully they consider the differential incidence of the burdens their policies place across the populace. They have been reluctant to allow the Government Accountability Office to audit Fed accounts, even if only -- as the Act actually envisions -- to determine whether any of the creative 2007-2009 tax-transfer schemes Fed officials devised to rescue failing institutions and markets unduly favored particular firms and countries. The agency's resistance to routine third-party scrutiny of how contentious policies are made indicates a reluctance to be held accountable for distributional effects. But if identifiable subpopulations were overburdened by Fed rescue programs and this result could be traced to elements of the agency's corporate culture, taxpayers deserve to know this.

6. Informational reforms

To underscore and strengthen regulators’ duty of accountability, Kane (2010a) calls for a series of informational reforms designed to measure systemic risk on an ongoing and less conflicted basis. This program has three components: (1) expanding the types of information financial institutions generate and report; (2) separating bureaucratic responsibility for measuring
growth in the safety net from responsibility for limiting safety-net growth; and (3) improving the tools and incentives of safety-net managers.

Financial institutions could assist in the task of measuring systemic risk by issuing extended-liability stock and other securities that could help inside and outside parties to track the taxpayer's stake in their firm. This information would make the obligations that the safety net passes through to taxpayers more transparent during bubbles and administratively easier to rebalance in times of duress.

Although still at an early stage, econometric strategies for measuring safety-net subsidies exist and are rapidly expanding. Following the lead of Merton (1977, 1978), researchers have developed several promising metrics that regulators could use to assess the value of safety-net support from balance-sheet and market data. Ronn and Verma (1986), Duan, Moreau, and Sealey (1992), Hovakimian and Kane (2000), and Carbo, Kane, and Rodriguez (2009 and 2011) estimate the value of safety-net support from data on a banking organization’s stock price. These models show that the value of safety-net credit support increases dramatically as stockholder-contributed capital begins to disappear. Baker and McArthur (2009) extract estimates from a firm’s credit spread. Tarashev, Borio, and Tsatsorinis (2010) show how to quantify institutions' exposure to common risk factors. Hart and Zingales (2009) show the usefulness of data on the prices of institutions' credit default swaps. Huang, Zhou, and Zhu (2009) use stock price, credit spreads, and credit default swap data simultaneously. Eberlein and Madan (2010) combine data on equity option prices with balance sheet data on specified dates to calculate values for the taxpayer put. Finally, Robert Jarrow’s work on integrated risk management (2007) suggests how analysts might aggregate the value of the taxpayer’s puts in individual firms.
Office of Financial Research. Good policy requires good information and good incentives. As a way to improve accountability, Kane (2010a) and others (Levine, 2009; Lo, 2009) propose to separate the supervisory function of diagnosing systemic risk from that of containing it. The DFA takes a potentially important step in this direction. It establishes a multiagency Financial Stability Oversight Council (FSOC) and an Office of Financial Research (OFR) to “support” its work. The Council is chaired by the Secretary of the Treasury and composed of voting and nonvoting delegates from more than 10 supervisory agencies. Besides reporting at least annually to Congress, the OFR is asked to communicate its findings to the FSOC and its member agencies and to “support” and “assist” agencies in improving data collection.

But it is not specifically authorized or required also to report its findings or concerns directly to the public. Revealing evidence of widespread insolvency is bound to embarrass the Treasury and the leaders of most other member agencies. Officeholders’ resistance to accepting blame makes it likely that, despite the CFR’s substantial data-gathering powers and budgetary independence, the Director of the OFR will have difficulty separating CFR activities and interests from those of the FSOC’s governing agencies.

Council delegates’ first responsibility is bound to be to the bureaucratic interests of the agency that pays their salary and to its current leadership. History shows that agencies and their leaders repeatedly succumb to the temptation to use accounting trickery to understate or cover up surges in financial-sector insolvency and related supervisory problems rather than to treat them when they first occur.

As a practical matter, developing effective statistical metrics for measuring the value of safety-net support at individual institutions requires logically prior changes in industry reporting
responsibilities. Insolvency detection would have been improved as long ago as the Glass-Steagall Act if industry leaders had been willing to acknowledge and fulfill the *commonsense fiduciary obligations to taxpayers that safety-net support entails*. It is unreasonable for an industry to expect to skin taxpayers forever. Far from treating the taxpaying public as a sucker they can exploit ever more efficiently over time, financial institutions need to show some gratitude. They should be forced to recognize that the safety-net support they derive from taxpayers creates moral obligations on guaranteed institutions that perfectly conscientious legislators would long ago have made explicit.

The first obligation that legislators and safety-net beneficiaries should concede is the need to help the OFR to develop and use reliable metrics for estimating confidence intervals for the *ex ante* value of their safety-net support and to report these estimates at regular intervals to their various supervisors. To contain the temptation to understate self-reported values of safety-net benefits and overstate the value of associated regulatory burdens, the OFR should have been empowered to challenge and vet the methods used and the calculations reported by private firms for reasonableness in more or less the same ways that Internal Revenue Service personnel challenge and vet personal and corporate tax returns. This implies that that OFR and FSOC member agencies should be made accountable for recruiting, retaining, and advancing the careers of risk-management personnel that possess the skills and incentives needed to keep industry estimates honest.

Data that individual institutions report must be aggregated not only across firms, but also across supervisory agencies. To minimize incentive conflicts that might arise in staffing this aggregation function and in processing such politically sensitive information, the task of aggregating and publicizing the estimates cannot safely be located within the span of existing
regulatory agencies. It is important that it be assigned to a truly independent OFR or to a special division of the Government Accountability Office specifically charged with measuring and monitoring safety-net costs and benefits. The goal is not just to separate accountability for mismonitoring safety-net subsidies from accountability for underpolicing them. It is also to make someone specifically responsible for publicly identifying on an ongoing basis the ways in which regulation-induced innovation might be exploiting loopholes in the current structure of regulatory authority.

Period-by-period costs of supporting the safety net may be analyzed as the (negative) return generated by what is a portfolio of highly correlated positions in the various firms the net protects. As a portfolio value, the capitalized value of taxpayer costs for supporting safety-net benefits would generally be less than the sum of the benefits that accrue to individual firms. But because correlations increase in crises and asset bubbles, it may not be much less. Research on correlations shows that the effects of crisis-generating and other large common industry shocks are more highly correlated than smaller common shocks that industry capital is expected to absorb (see, e.g., Gropp and Moerman, 2003). This tendency for institutions protected by the safety net to expose themselves during economic booms to much the same sources of tail risk makes it conservative for safety-net analysts to adopt the hypothesis that correlations across firms are very close to unity.

The layering of blame for the current crisis implies that private and government sources of systemic risk should be monitored and policed jointly. Kane (2010a) proposes to divide responsibilities for collecting and processing data on safety-net benefits into at least three pieces. The first segment would task managers of financial firms with estimating and reporting to their primary regulators (on the same quarterly basis that firms publish other data) interval estimates
of the value of the safety-net benefits their firm receives. Especially for large or complicated firms, this task could be streamlined by requiring financial institutions to issue bonds that automatically convert to equity in observable circumstances and/or stock that carries an extended liability. (In fact, the Senate bill contemplated such a requirement.) The second segment would task individual regulators with examining (i.e., conscientiously challenging the accuracy of) these estimates and undertaking correlation studies that would allow them to prepare interval estimates of the aggregate value of taxpayer support accruing to the firms they supervise. The third segment would task the regulators to report and justify their estimates and aggregation procedures to a newly formed Safety Net Accountability Forecast Office (SAFO) and task the SAFO with publically reporting interval estimates of the aggregate value of safety-net subsidies for different industry sectors. A fourth segment could eventually task SAFOs in different nations with establishing arrangements for monitoring the quality of one another's work and preparing and publishing interval estimates of the value of bilateral and multilateral cross-country safety-net support.

If the analytical resources of the world’s central banks and largest institutions could be incentivized to attack these estimation problems on a massive scale, the assumptions underlying the estimates that might emerge from different methods should converge over time. However, each nation's SAFO should also recognize that, although the confidence intervals that careful statisticians need to place around the different point estimates might be presumed to narrow with experience, this result will be sabotaged by wave after wave of regulation-induced innovation. For this reason, confidence intervals may be expected to increase sharply in times of financial turmoil.
Adopting these informational reforms would make the jobs and recruitment of top regulators more their difficult. For this reason, the US and other countries would be well advised to make regulatory careers more prestigious by establishing the equivalent of a publicly funded academy (i.e., a nonmilitary West Point) for financial regulators and welcome cadets from anywhere in the world. Reinforced by appropriate changes in regulators’ oaths of office and a system of deferred compensation, such an academy would raise the prestige of regulatory service and instill a stronger and broader sense of communal duty in safety-net managers than this generation of officials has shown during the current crisis. In view of the damage financial crises can cause, it is unfortunate that regulators have not been trained and incentivized as carefully as military, police, firefighting, and nuclear-safety personnel.

7. Summary implications: The importance of addressing distributional effects

Practical politics consists of denying or ignoring salient facts. The crisis has taught the public a number of lessons, lessons that have changed the policymaking environment in ways that framers of the Act refused to acknowledge. The crisis raised public consciousness of how regulator-sanctioned moral hazard turns financial-institution losses into taxpayer debt. Crisis experience in Greece, Iceland, and Ireland demonstrates that authorities’ bailout reflex exposes ordinary citizens to great harm. The crisis has clarified that this exposure is intensified in countries with a system of subsidized mortgage finance that encourages borrowers and lenders to overleverage themselves and to accept substantial interest-rate risk. The crisis has also revealed the importance of regulation-induced innovation and underscored the hard-to-supervise nature of the “shadowy” institutions, markets, and funding instruments it generates. Finally, it has made it clear that political contributions and revolving-door postgovernment rewards corrupt the
corporate governance of regulatory institutions in two ways: by enfeebling important rules and by relaxing enforcement.

Ironically, mainstream economic models of the policymaking process do not incorporate these lessons. They too are built on a foundation of truthiness. Efforts to create a "positive economics" that is independent of any particular ethical position or normative value judgments have produced a generation of economists who prefer to think of society as if it were composed of a collection of identical agents (a criticism also made in Solow, 2010) and conceive of policymakers as perfectly forward-looking and selfless idealists. Unfortunately, the distributional effects that are generated in managing financial crises invalidate the first assumption and, together with the second assumption, this way of thinking becomes a recipe for helping elite financial institutions to use the safety net as a way to exploit poorly informed and politically impotent members of society.

To build a robust, reliable, and fair system of financial regulation, relationships between regulators and those they regulate must be revised. Good corporate governance requires that financial-institution managers and federal regulators must accept joint responsibility for identifying and disclosing taxpayers' \textit{de facto} equity stake in financial firms. Until taxpayers' stake is made observable, incentives to manage the distributional consequences of regulation-induced innovation will remain weak.

Most of the profits that the financial industry appeared to have earned in 2002-2007 have turned out in retrospect to have been income transfers extracted unwillingly and with great pain from the accounts of ordinary taxpayers and of those whose jobs disappeared in the wake of the crisis. To contain safety-net costs, safety-net beneficiaries and safety-net managers must be made to acknowledge their joint obligations to estimate and attack in timely, proactive, and
accountable ways the distributional consequences of innovative financial contracts and institutional structures.
References


FIGURE 1

GROWING GUARANTEES
Fannie Mae and Freddie Mac own or back three-quarters of new single-family mortgages in the U.S., double their share of five years ago.

<table>
<thead>
<tr>
<th>Year</th>
<th>Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>37.3%</td>
</tr>
<tr>
<td>2006</td>
<td>37.4%</td>
</tr>
<tr>
<td>2007</td>
<td>54.5%</td>
</tr>
<tr>
<td>2008</td>
<td>72.8%</td>
</tr>
<tr>
<td>2009</td>
<td>75.6%</td>
</tr>
</tbody>
</table>

Source: Federal Housing Finance Agency
<table>
<thead>
<tr>
<th>Act</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve Act (1913)</td>
<td>31 pages</td>
</tr>
<tr>
<td>The Glass-Steagall Act (1933)</td>
<td>37 pages</td>
</tr>
<tr>
<td>Interstate Banking Efficiency Act (1994)</td>
<td>61 pages</td>
</tr>
<tr>
<td>Gramm-Leach-Bliley Act (1999)</td>
<td>145 pages</td>
</tr>
<tr>
<td>Sarbanes-Oxley Act (2002)</td>
<td>66 pages</td>
</tr>
<tr>
<td>Dodd-Frank Act (2010)</td>
<td>2,319 pages</td>
</tr>
</tbody>
</table>
TABLE 2
JULY 21, 2010 RISK MAGAZINE POLL: DO YOU THINK THE WORLD’S REGULATORS ARE READY FOR NEW REGULATIONS?

Do you think that regulators around the world have the talent, resources, and expertise to correctly implement the sweeping regulatory changes being proposed, in the wake of the financial crisis?

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Yes</strong></td>
<td>12%</td>
<td>61%</td>
</tr>
<tr>
<td><strong>No</strong></td>
<td>27%</td>
<td>73%</td>
</tr>
</tbody>
</table>

They don’t now but they are building their expertise up

Source:
### TABLE 3

**SOURCES OF INCENTIVE CONFLICT BETWEEN REGULATORY OFFICIALS AND TAXPAYERS THAT ENCOURAGE WEAK ENFORCEMENT**

1. Asymmetric and Uncertain Information (Lessens Accountability by Creating Easy Alibis and Opportunities for Coverup)

2. Political Debts that must be serviced to hold onto their positions (Shortens Horizons of Agency Leaders)

3. Reputational and Budgetary Damage Generated by Industry Criticism (Creates Dysfunctional Accountability)

4. Role of Political Screening and Post-government Career Opportunities in Recruitment (Revolving Door)

5. Attraction of Passively Waiting for a Cyclical Upswing (Gambling for Resurrection)

6. Budgetary Cost of Training Staff and Administrative Difficulties of Winding Down Complex Firms

7. Political Pressure to Escape the Adverse Short-Run Effects that Reasonable Prudential Restraints Have for the Goal of Achieving Rapid Macroeconomic Growth

- **Conclusion**: A Complete Program of Reform Should Mitigate These Difficulties by Improving Public and Private Compensation Structures, Performance Measurement, Training and Recruitment Procedures, and Reporting Responsibilities.
### TABLE 4

<table>
<thead>
<tr>
<th>Provision</th>
<th>Senate</th>
<th>House</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consumer Protection Agency</strong></td>
<td>Creates a Bureau of Consumer Financial Protection, placed inside the Federal Reserve, with an independent director and budget. Its rules could be vetoed by a two-thirds vote of a council of bank regulators.</td>
<td>Creates a new Consumer Financial Protection Agency (CFPA), with an independent director and budget. The CFPA has full rule-writing authority.</td>
<td>A Consumer Financial Protection Bureau (CFPB) was placed within the Federal Reserve, with a single director.</td>
</tr>
<tr>
<td><strong>Derivatives</strong></td>
<td>Mandates exchange trading and clearing for most derivatives, with a limited end-user exemption. Forces federally insured banks to spin-off their swaps desks.</td>
<td>Mandates exchange trading and clearing for most derivatives, with wide exemptions for end-users.</td>
<td>Carveouts and Exemptions for bank OTC market making for most quantitatively important derivatives</td>
</tr>
<tr>
<td><strong>Volcker Rule</strong></td>
<td>Gives regulators discretion regarding whether to implement the Volcker rule, which is a ban on proprietary trading.</td>
<td>Does not include a proprietary trading ban.</td>
<td>Outright ban jettisoned, but limits on proprietary trading were imposed.</td>
</tr>
<tr>
<td><strong>Auto Dealer Exemption</strong></td>
<td>Did not originally include a provision exempting auto dealers from new consumer protection rules. However, the Senate voted to recommend to the conferees that such an exemption be added.</td>
<td>Includes an exemption for auto dealers from the CFPA’s rules.</td>
<td>Exemption was included.</td>
</tr>
<tr>
<td><strong>Resolution Fund</strong></td>
<td>The resolution authority for unwinding systemically risky financial institutions would be funded by an after-the-fact levy on the biggest financial firms. Any money necessary for the unwinding would be fronted by the Treasury Department.</td>
<td>Envisions a $150 billion resolution fund from the biggest financial firms, which would be tapped in order to unwind a failed institution.</td>
<td>Resolution authority was adopted, but advance funding was abandoned.</td>
</tr>
</tbody>
</table>

Numerous more-arcane differences existed between the bills, including the ways in which they address capital requirements (i.e., permissible leverage), risk-retention for securitized loans, credit-rating firms, executive compensation, preemption of state consumer protection laws (the Senate would have allowed more preemption leeway), and restrictions on interchange fees (which seems to have created more visible ex post pushback than any other single provision in the Act). In the end, many controversial issues were designated as subjects for study by the regulatory agencies.

Source for first three columns: Pat Garofalo: [Laying Out Some Key Differences Between The House And Senate Financial Reform Bills](http://wonkroom.thinkprogress.org/2010/05/21/difference-house-senate-reg/)