Joint Committee of Inquiry into the Banking Crisis
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STATEMENT ON BANKING AND BANKING REGULATION*

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Thank you, Mr. Chairman, for inviting me here to testify today. I want to congratulate you and your Committee for continuing the battle against regulatory capture and too-big-to-fail (TBTF) policies in the face of a worldwide industry effort to tell us that these problems don't exist or will be solved by current regulatory initiatives.

Financial markets resemble roads that are used simultaneously by individuals and businesses. The purpose of these roads is to allow ordinary citizens and corporations to create and divide wealth. Banking is regulated for the same reason that traffic is regulated: to coordinate potentially chaotic activity and to make all drivers behave more safely.

Banking crises occur because banks routinely abuse the financial rules of the road, without suffering meaningful personal penalties. During good times, supervisors ignore the banks' new and dangerous risky financial behavior. Then, in times of deep trouble, supervisors extend the safety net to promote the needs of distressed institutions and their creditors (even foreign ones) over the welfare of ordinary citizens. If systems for supervising traffic flows were as distorted, elitist, and slow to respond as those for supervising banks in Europe and the US, ordinary citizens would be afraid to venture out of their homes.

The policy implications of this cyclical pattern cannot be dismissed on the grounds that banks are stronger today. When and as the national economy gets stronger; most banks get

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stronger, too. The problem is that, in good times and in bad, regulatory and banking cultures continue to encourage their country's largest banks to take on too high a risk of ruin (i.e., too much tail risk). Existing financial accounting systems fail to identify and record the economic value these incentives transfer from taxpayers to stockholders.

Whether and how we can stop the cyclical process of subsidy buildup and extraction is the central problem your committee needs to address. It is also the central problem of my research career. As my work has progressed, I have come to understand better and better how thoroughly behavioral norms that foster deception and abuse of the public trust are imbedded in banks' and regulators' organizational cultures.

As I will describe, the central problem is simple: safety nets encourage unhealthy relationships between banks and their regulators and distort the incentives of both groups. I see two straightforward and interlinked solutions. First, regulators must explicitly measure and manage the cost of safety net guarantees. Second, regulators should impose a series of graduated penalties on individuals that violate important rules of the road. These two solutions would help force TBTF banks to internalize the costs of safety net guarantees, and would greatly lessen incentive distortions that corrupt the culture of regulation in the US and Europe.

<u>Narrower Lessons from which this Inference Flows</u>

1. *Safety nets can and often do cause financial fragility*. Safety-net subsidies to undersupervised forms of risk taking by financial institutions create strong and enduring incentives for managers to search out proudly --and exploit aggressively-- hard-to-monitor ways of putting institutional survival and taxpayer funds at risk. Hence, although financial safety nets exist ostensibly to lessen the potential for massive losses by the public from widespread

institutional failure, they are used and abused by savvy banks and other financial managers to extract subsidies in ways that are hard to see and hard to stop. The need to limit the size of the subsidies extracted and the distortions that unbridled profit maximization might cause becomes an additional justification for regulating financial firms.

To make subsidy extraction a source of disdain, regulators and supervisors must strip out from reported profit flows the embedded value of the taxpayer credit support a bank receives. Much of this value comes from anticipated government delays in recognizing and resolving insolvencies. Extending accounting principles to highlight this information that can help regulators and auditors to focus more successfully on the extent to which market extensions and financial innovations serve to reduce the effectiveness of prudential policies. Governments must make sure both that regulators and auditors explicitly monitor loss-shifting activity and that regulators routinely adapt and refocus their policy tools to keep them cogent. Despite the lip service paid to calculating the costs and benefits of regulatory policies, few regulatory agencies estimate or explain how a particular financial reform and the avoidance activity it is bound to generate are apt to affect taxpayer exposure to loss through the safety net.

Governments must not turn a blind eye either to regulatory capture or to the anti-egalitarian distributional effects and anger at government that bailouts engender. Although analysts agree that regulators should control systemic risk, most definitions of systemic risk leave out the role that regulatory officials' propensity to assist rather than to resolve deeply insolvent institutions plays in generating it. Policymakers' support of creative forms of risk-taking and their proclivity for absorbing losses in crisis situations encourages the leadership of opportunistic firms to foster and exploit longstanding incentive conflicts within the supervisory sector. To restore faith in the diligence, competence, and integrity of officials responsible for managing national safety nets, governments need to rework executive training programs, information systems, and incentives in both the regulatory and financial sectors. The goal of my testimony is to suggest how --by defining and sanctioning theft by safety net as a felony-- governments can better align incentives of private risk managers, accountants, credit-rating firms, and government supervisors with those of ordinary citizens.

2. *Safety-net managers have conflicted incentives*. Within and across countries, government safety-net managers compete with one another for budgetary resources and employment opportunities. They see themselves as winning this competition when they expand the client base for their particular supervisory and regulatory services. Far from having purely altruistic motives, both in the private and the public sectors, managers have identifiable private interests. Because top government officials have to be reappointed by each new administration, they are effectively short-timers. This keeps them interested in ensuring opportunities for their own re-employment in future governments or through the "revolving door" into the sectors they regulate. In Ireland and elsewhere, this interest expresses itself in policies that tend to favor industry interests at the expense of ordinary citizens and, as a *quid pro quo*, enlist lobbying support for legislative initiatives that enhance an agency's prestige, budget, and jurisdiction in the short run.

3. *These dangerous incentive conflicts could be reduced if safety-net subsidies were measured conscientiously and compensation schemes paid managers in better ways*. It is no accident that proposals for transparent performance accounting at **government and private watchdog agencies** are resisted not only by financial industry lobbyists, but by top regulatory officials as well. Officials find it convenient to be able to blame their inability to foresee the emergence of crisis pressures and respond to them in timely fashion to a lack of appropriate

information and authority. They often go on to twist this excuse into a plea for additional regulatory powers and budgetary resources.

4. *Thanks to regulatory capture, implicit and explicit government guarantees have become part of the* ***equity funding structure*** *of too-big-to-fail (TBTF) banking organizations and deserve to be recognized as equity claims both in company law and in financial accounting*. For firms whose insolvency cannot be established and resolved in timely fashion, financial safety nets turn taxpayers into disadvantaged suppliers of loss-absorbing equity funding. For years, taxpayers' position in TBTF firms has been exploited with impunity by managers and shareholders. To provide protections parallel to those that explicit shareholders enjoy, legislation is needed to clarify that managers of TBTF firms owe enforceable fiduciary duties of loyalty, competence, and care to taxpayers and to criminalize aggressive and willful efforts to transfer value from taxpayers to shareholders and managers. Characterizing bailout support as owners' equity leads us to look at taxpayer positions in TBTF institutions as a portfolio of trust funds. This way of thinking casts regulators as trustees and opens up the possibility of installing carefully recruited teams of private parties to serve as co-trustees. The establishment of such trusteeships would lead officials to judge regulatory performance in terms of its effects on the value of taxpayer equity positions and risk exposures. It would also require regulators and protected institutions to re-work their information and incentive systems to support this effort. This re-working would entail estimating the value of the explicit and implicit safety net benefits every TBTF firm receives and perhaps requiring systemically important institutions and financial utilities to issue extended-liability securities or put options to generate data on market values that could improve the accuracy of these estimates.

5. *Incentive conflicts lead TBTF firms' creditors and internal and external supervisors to short-cut and outsource due diligence*. I believe that G-20 and Basel III strategies of reform do not adequately acknowledge these conflicts or the patterns of "deferential regulation"[1] they sustain. To lessen these conflicts, governments need to rethink the informational obligations that insured financial institutions and their regulators owe to taxpayers *as de facto equity investors* and to change the way that information on industry balance sheets and risk exposures is reported, verified, and used by supervisors. Without reforms in the practical duties imposed on industry and government 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 who are smart enough to cash out or hedge their share of safety-net benefits before the next crisis ensues.

6. *TBTF guarantees are more than a form of bond insurance on outstanding bonds.* The coverage of TBTF guarantees are richer than insurance on outstanding bonds because, as long as regulators forbear from resolving its insolvency, a truly TBTF firm can extract further guarantees by issuing endless amounts of additional debt in both domestic and foreign markets.

Every guarantee contract has two components. The first allows the guaranteed party to *put* responsibility for covering losses that exceed the value of the assets of the bank holding company to the guarantor. The guarantor is conceived as writing the put. But the put is not the whole contract. No guarantor wants to expose itself to unlimited losses on a put option.

For this reason, all guarantee contracts incorporate a stop-loss provision that gives the guarantor a *call* on the assets of the firm. Ordinarily, the stop-loss kicks in just as insolvency is

[1] To the best of my knowledge, the term was first used by former Chairman of the US House Banking Committee, James Leach (2011).

approached or breached. The risk exposure a guarantor assumes from simultaneously writing a put and holding a call is the economic equivalent of an explicit equity position.

Efforts to exercise the government's call are termed prompt corrective action. In the US and Europe, we did not see much prompt *corrective* action for TBTF institutions during the Great Financial Crisis of 2008. The policy actions we did see have helped the world's TBTF banks to become bigger and more politically powerful than ever.

Why and How Safety-Net Guarantees Lower and Distort the Funding Cost of TBTF Firms

A firm's funding cost is the cost of servicing its funding mix. In good times and in bad, being too big to fail simultaneously lowers the cost of a firm's debt and the cost of its equity. This is because too-big-to-fail guarantees lower the risk that flows through to owners of both classes of securities. Guarantees chop off bondholders' and stockholders' losses at a specified point and direct the flow of further losses to taxpayers.

This means that, period by period, the incremental reduction in interest payments on outstanding bonds, deposits and repurchase agreements is only part of the subsidy that the stockholders enjoy. The additional part is the increase in stock prices that comes from having investors discount the firm's current and future cash flows at an artificially low rate of return on equity.

Limitless guarantees shift the risk of the deepest possible losses away from creditors and stockholders. It is as if large banks' profit flow moves through a pipeline with a Y junction in it. Once a TBTF institution becomes effectively insolvent (i.e., unable to cover its debts from its own resources), a switch is thrown that channels further losses to taxpayers until and unless the firm manages to recover its solvency again.

Deeply insolvent banks are what I term zombie institutions. They can only operate because they are backed by the black magic of government implicit guarantees. The most important part of zombification is a passive policy of regulatory forbearance, which allows institutions that are insolvent to continue to roll over -- and even to expand-- their debt.

By definition, the government's right to take over a firm's assets will never be exercised in a financial institution that is truly too big to fail. Nonexercise means that the government has effectively ceded the value of its loss-stopping rights to the too-big-to-fail stockholders. The value that forbearance gives away must not be ignored.

I include in my testimony a picture, Figure 1, that graphs the behavior of AIG's stock prices before, during and after the 2008 crisis. The only time AIG's stock price approached zero –and it did so twice—was when the notion of a US government takeover was seriously under discussion so that the probability of stockholders' continued rescue was falling. As soon as this course of action was tabled, the stock price surged again because TBTF policies gave the stop-loss back to AIG's stockholders. I am sure that the stock prices of zombie banks in Ireland exhibit similar patterns.

Also, it is inappropriate for authorities to think of a TBTF --or systemically important--financial institution as a binary condition; that is, it is wrong to say that an institution either is TBTF or it is not. TBTF forbearance does not start or stop cold at a particular size. A government's willingness to rescue different firms lies on a continuum and is influenced by several variables. In particular, a firm's access to political elites grows with its interconnectedness, geographic footprint, and the number of employees and creditors that can be persuaded to contribute on its behalf to reelection campaigns. The influence of each of these variables is intensified by the government-subsidized consolidation occurring among the world's biggest banking organizations. Here in Ireland, banking appears well on its way to becoming a duopoly (see Gurdiev, Larkin, and Lucey, 2014) with a fearsome ability to pervert and abuse the rules of your financial roads.

Figure 2 presents estimates that Armen Hovakimian, Luc Laeven and I have prepared to track on a *per-annum* basis the value of the average quarterly dividend that US taxpayers ought to have been paid by large banking firms during 1974-2010. We can see the cyclical pattern in the value of safety-net support that we have been talking about. But by looking across the cycles, we can also discern the effects of cumulative learning about how to benefit from safety-net guarantees and of growing exploitation of the value of these guarantees by these firms' managers. With each successive recession, more benefit is extracted by too-big-to-fail institutions. These patterns ought to be observable in the Irish scene as well. I fear that far greater and more-dangerous benefit flows will emerge in the next crisis.

How to Think About Guarantees

I urge your Committee not to fall into the trap of thinking of bailout expenditures as either loans or insurance. It is important that you understand the difference between guarantees, insurance, and loan contracts and in the duties they impose on the contract's counterparties.

An insurance company does not double and redouble the coverage of drivers it knows to be as reckless as TBTF firms proved themselves to be during the last economic boom.

Similarly, lifelines provided to an underwater firm cannot be thought of as low-interest loans. Loans are simply not available to firms that are in zombie condition.

The ability to extract implicit guarantees on new debt and the hugely below-market terms conveyed in bailout programs mean the repayment of funds that were actually advanced –i.e., *just* the funds that were actually advanced—does not show that a bailout program is a good deal for taxpayers.

I believe that the politicians who have made that claim in the US are embarrassing everyone in government. They are causing the public, whose members at least understand that they are being victimized, to lose confidence in economic policymakers.

Sooner or later, something must be done to sanction the reckless pursuit of TBTF subsidies. The type of sanctions I would propose are described in the last part of my statement. I maintain that society must recognize that the deliberate exploitation of too-big-to-fail guarantees is a form of criminal theft and develop ways to punish both individuals who engage in it directly and higher corporate officials who can be shown to have encouraged it.

Need for Individual and Not Just Corporate Sanctions

Legal systems must make it crystal clear that recklessly pursuing tail risk is not only an ethical violation of duties owed to taxpayers, but a form of theft from what we can think of as a taxpayer trust fund. Rules of the financial game must acknowledge that it is wrong for individual managers to adopt risk-management strategies that willfully conceal and abuse taxpayers' equity stake. These behaviors deserve to be sanctioned explicitly by both corporate and criminal law and not excused by insurance law as inevitable moral hazard.

I believe the way we frame problems is critically important in policy making. When we think of bailout support as if it were a loan, if recipients pay it back, it becomes a good loan. When we think of it as insurance, we presume that actuaries are able to figure out the risks and that the government officials should be able to use actuarial data to price and control taxpayer exposure to moral hazard.

I have stressed that, as the net value of two options, the risks incurred in backstopping TBTF firms cannot be calculated and priced in the straightforward way that the risks of bond or insurance contracts can. I have tried also to convince you to re-conceptualize bailout support as loss-absorbing equity funding provided to a zombie firm when no one else will advance it a nickel.

Regulatory capture has infiltrated the legislative and bureaucratic systems that are supposed to limit risk-taking and sewn crippling loopholes into the rules of the financial game and the ways in which they are enforced. The way that capital requirements are defined and enforced makes this tool an especially striking example of how regulatory schemes tend to lose effectiveness over time.

In recklessly risking their firms survival to gain subsidies from shifting tail risks to taxpayers, managers create needless costs and dangers for other users of financial roadways. Supervisors have let society down in two ways: by not setting up the equivalent of radar systems and helicopter surveillance to track excessive speed and aggressive driving and by not developing a penalty structure that promises to punish unruly behavior in a meaningful and timely fashion. Regulation and supervision must establish effective disincentives that can dissuade banks that are tempted to drive at perilous speeds and to engage in dangerous maneuvers. To improve driving habits more than marginally and temporarily, miscreants must be identified and risk shifting must be rendered personally unprofitable for them.

The analogy 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 historically in traffic courts. In the US, we already have administrative procedures for adjudicating regulatory findings whose jurisdictions parallel those of traffic courts. Different states embrace different penalty structures, but most combine fines for minor violations, a point system which hikes the penalty for repeated or more-serious violations, and procedures for transferring particularly consequential cases (such as vehicular homicide or extreme drunken driving) to ordinary criminal and civil courts.

No matter what regulators finally do with capital requirements, if they do not set up sanctions that punish individuals for acts of willful or complicit safety-net theft, we are going to get even similar wrong doings in the future.

Between 2008 and late 2013, fines levied for bad behavior on the ten largest US and European banking firms amount to roughly 157 billion pounds sterling (Bryant and McCormick, 2014). I believe that genuine reform would require authorities to prosecute publicly individuals in banking organizations whenever they have compelling evidence of costly forms of common-law fraud. I believe there is great value in documenting the violations and prosecuting egregious violators in open court. Information discovered about regulatory behavior in a stockholder suit challenging procedures followed in the federal bailout of AIG underscores how having to defend their actions makes individual managers and individual regulators more accountable (Morgenson, 2014). Settling violations of banking law by large fines negotiated out of court shames the firm, but tends to conceal embarrassing details of regulatory and ethical failure whose revelation promises to deter individuals from engaging in similar behaviors in the future. Information revealed in the discovery process could also help us to understand just how much miscreant managers might benefit when the burdens of the corporate fines and admissions they negotiate serve principally to punish shareholders instead of sanctioning named individuals.

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FIGURE 1

AIG Stock Never Became Valueless

FIGURE 2

Mean Annualized Value of Safety Net Benefits Per Dollar of Liabilities, 1974-2010

This figure reports quarterly average values of Hovakimian-Kane-Laeven annualized estimates of fair percentage return to taxpayers for safety-net risk, using Merton model and assuming dividend 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 from the Compustat database for U.S. banks and daily stock returns are from CRSP.