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HOW AND WHY CENTRAL-BANK CULTURE PERSISTENTLY ABUSES TAXPAYER INTERESTS

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SUMMARY

- My talk is built around the idea that financial regulation is a cat-and-mouse game.
- It employs the predominant model of executive culture developed by Schein and Kluckhohn in the field of **cultural anthropology**, in contrast to *the business organization models* that other economists use.
- I use 6 cartoons to illustrate how **ethical effects** in executive cultures feed and intensify modern crises
- My explanation focuses on norms in megabanking and government executive cultures that **squeeze out** moral concepts of right and wrong and support waves of what I call "theft by safety net."

What is a Model?

- A model is a deliberately simplified logical system that defines a set of variables and analyzes their interaction. Does not have to be “Mathey.”
- Conceptual distinctions underlie the definitions of variables. In evaluating policy, the more insightful the model’s distinctions, the more useful the model.

How to Model a Corporation's or Agency's "Character" or "Culture?"

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

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

CONFLICT **Between Mission and** Unspoken Norms

Mission: Prudential regulators want to **protect** society from the consequences of dangerous risk-taking, capital shortages, and loss concealment at megabanks. However, they face three strong "buts."

- **But #1**: Megabanks are at war with foreign megabanks. Pols caution prudential regulators not to handicap clients in these battles. Staff-members see a **duty to be helpful**.
- **But #2**: Regulators, politicians, and the industry want a **disclosure regime** that—to limit the possibility of runs and meltdowns-- makes it hard for outsiders (even regulators) to observe **adverse information** in a timely manner.
- **But #3**: Top regulators are short-timers whose future job opportunities can be hurt by industry criticism.

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

[The cat doesn't want to eat the mouse. It wants "subsidies to tail risk" symbolized by the cream.]

EXECUTIVE CULTURES OF PROFIT MAXIMIZATION (at banks) AND BLAME AVOIDANCE (in government) INTERACT WITH LITTLE ROLE FOR MORALITY PER SE

Realistically, Megabank executives wrestle every day with three issues:

1. What is profitable for our firm to do?
2. What will the culture-driven supervisory activity of our regulators let us get away with*?
3. How can we defend and expand these profit-making opportunities?

*Legality is as close to right and wrong as executive cultures get.

Is Legality a Strong Moral Justification?

Apartheid was legal.

The Holocaust was legal.

Slavery was legal.

Colonialism was legal.

Legality is a matter of power, not a proof of morality.

It is Instinctive to Manage Accounting Measures of Performance Rather than Culture and Character

- Ethically challenged subsidy-seeking (or blame-avoiding) organizations go through **cycles of scandal, coverup, and denial** that start and end in the same place:
- Stage 1: What are you talking about? Our staff are **good people** doing great things.
- Stage 2: Maybe we have **a few problems**, but we cover these up because it would damage our reputation if we admitted them to outsiders.
- Stage 3: Coverup breaks down.
- Stage 4: At last, our critics have moved on. Now we can **go back to doing great things** = Stage 1 of next scandal.

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

- Organization and management is inherently **hierarchical,** with great **power distances** as we move away from the agency head.
- Carefully phrased **dissent** may be expressed from time to time, but there is little tolerance of outright disagreement: leads to "GROUPTHINK"
- Short time horizon: Central banks perennially focus on achieving demonstrable **short-term** results. Are attracted to policies that they know can have bad long-term effects.

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

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

My working hypothesis is that these 2 norms undermine stability, but this rescue mentality is part of the **nonpublic** character of central-bank regulatory cultures around the world.

No matter how much the **weapons** of prudential regulation are "enhanced" after a crisis or bail-in powers expanded, until these **anti-egalitarian norms** are confronted and modified, megabanks and their creditors will **foster weaknesses in transparency** and data quality that let them play successive games of hide-and-seek with regulators during booms and **chicken** in the following bust. **[It is irrational to reinforce behavior without expecting to see it again and dangerous to presume that next time will be different.]**

PRETENSE AND UNEQUAL POWER ARE PART OF THE GAME

Reforms are re-equipping Central Bankers with a quiver of sticks they call "enhanced prudential regulation." Regulators refuse during precrisis and postcrisis periods to admit that the prospect of **living wills, stress tests** and capital and liquidity **constraints** cannot exert long-lasting discipline on the cat-quick megabanks that roam their countries. In most countries these reforms are being artfully and insidiously **delayed**, **lobbied down, and neutralized (e.g., by capital-relief trading activity).**

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

(Several of these megabankers may actually eat themselves to death)

Where does the trough of subsidies come from?

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

1) In crises, the **souring of megabank tail risks** push central banks into **unwinnable games of chicken**.
2) Why Regulators chicken out: (1)they fear having a **meltdown** on their watch, (2)giant firms are economically, politically, and administratively **difficult to unwind,** and (3)they don't want to slam any **revolving doors.**

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

Cultural Norms are resilient because they are communicated by seeing what behaviors lead to advancement. Rising in any hierarchy depends on their ability to perceive and conform to a series of **behavioral norms** drilled into newbies. My paper identifies 6 behavioral norms for central bankers:

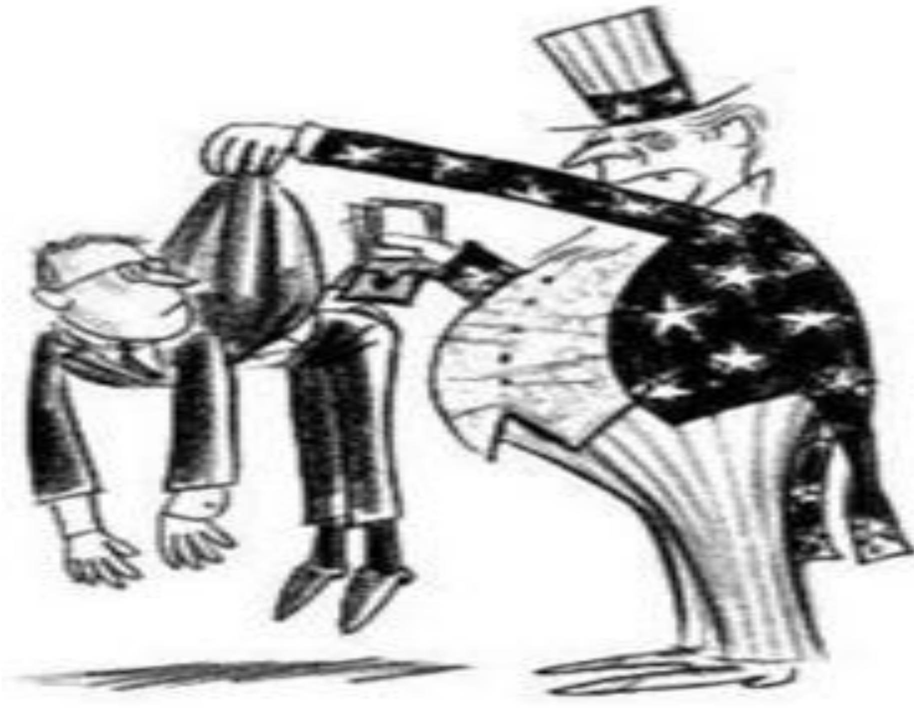
1. **Mercantilist** norms of partiality and clientele service to protect clients' **earning power.**
2. **Mercy** and **benefit-of-the-doubt** norms that dictate sympathy, help, and lenient discipline for **distressed** client firms and their creditors at virtually all times.
3. **Loss-concealment** norms that—due to an ingrained fear of runs and meltdowns-- demand that regulators must not only hold adverse client information confidential, but **misrepresent** this information when this is thought to promote the short-term common good.
4. Reluctance to Prosecute High-Ranking Bankers for Reckless Behavior

[5. Performance standards that honor employees for not rocking the boat

6. **Blame-avoidance** norms that urge staff members to protect the professional reputations of team leaders by **not admitting agency mistakes** even to themselves.]

THE SAFETY NET IS A CRIMINALIZABLE RACKET

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



PART OF THE DECEPTION IS TO CALL BAILOUTS “LOANS” AND “INSURANCE PAYMENTS” RATHER THAN LOSS-ABSORBING EQUITY FUNDING

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

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

POLICY RECOMMENDATIONS

- Fairness is the Nominal Goal of all Law. I employ Kant's common-sense **concept of fairness** to establish that megabanks & central banks abuse taxpayers. Taxpayers are used as **coerced suppliers of equity funding** for TBTF firms. Governments have a duty to **acknowledge** that and to make company law explicitly **recognize** and **protect** taxpayer interests in crisis-management policy.
- Tail risk like speed is **measurable**, albeit imperfectly. The reckless pursuit of tail risk by megabankers resembles reckless driving. The harm this business model visits on the citizenry implies the need for laws—fiduciary law—by which to change incentives by identifying and penalizing **extreme recklessness** and prosecuting: (1) managers who intentionally or at least knowingly pursue this kind of racketeering(e.g., "fraudulent trading" in the UK) and (2)regulators who willfully tolerate this behavior.
- To create a reasonable burden of proof and an obligation to prosecute, the new laws should include **presumptive tests** for megabank recklessness that parallel those we see in laws that punish reckless driving and driving under the influence.
- The structure of individual punishments should parallel those used in enforcing traffic laws: a point and fine system that reflects the severity of particular violations, penalizes repeat violators, and, in extreme cases, could pass the case on to the criminal courts.

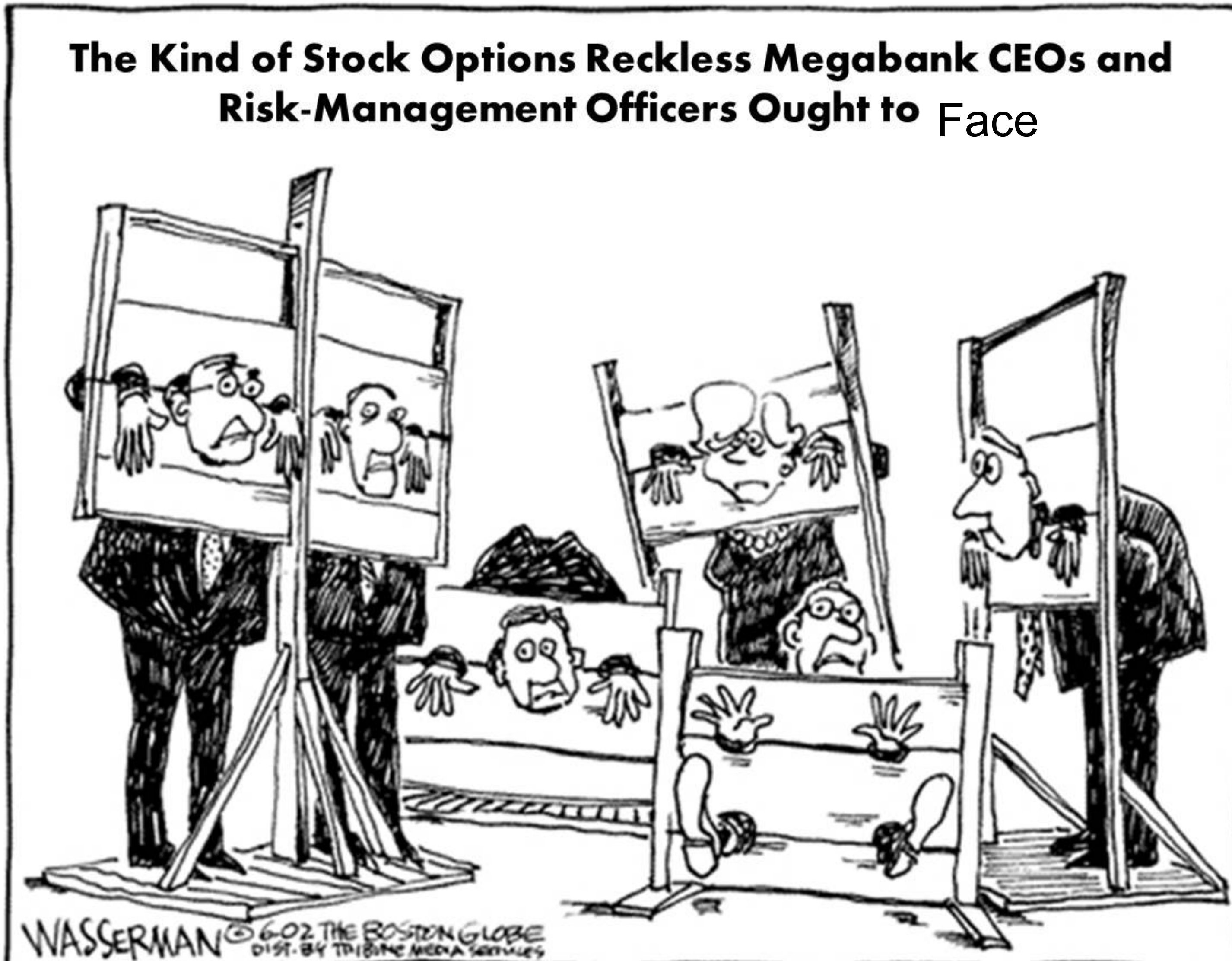
Unspoken side of Regulatory Contract: Why don't Pols and Regulators Discipline Reckless Megabankers to Protect Taxpayers? Another Unfair Part of the Game is that Megabank Cats Can **Hide** their Moves But can **Observe** and Even **Constrain** Every Move their Mousy Regulators Make and Return to Them a Carefully Metered Bit of Subsidy-Based Cheese.

Major Takeaways

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

BURDEN OF PROOF ISSUES

- Alternate standards of knowledge in case and criminal law: What one knew or should have known about dangers being visited on third parties.
- In prosecuting impaired or reckless driving, the "should have known" standard is ruthlessly applied, especially when accidents occur. In recklessly or negligently expanding tail risk, I would argue that individual bank managers from CROs on up should be sanctioned to some degree when negligence or recklessness can be shown to have resulted in failure or huge bailout expense.
- Outcome-based **bright-line *primafacie* standards** for recklessness, negligence, and bailout expense need to be established.


The Kind of Stock Options Reckless Megabank CEOs and Risk-Management Officers Ought to Face
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POST-CRISIS GAME OF BLAME DISTRIBUTION

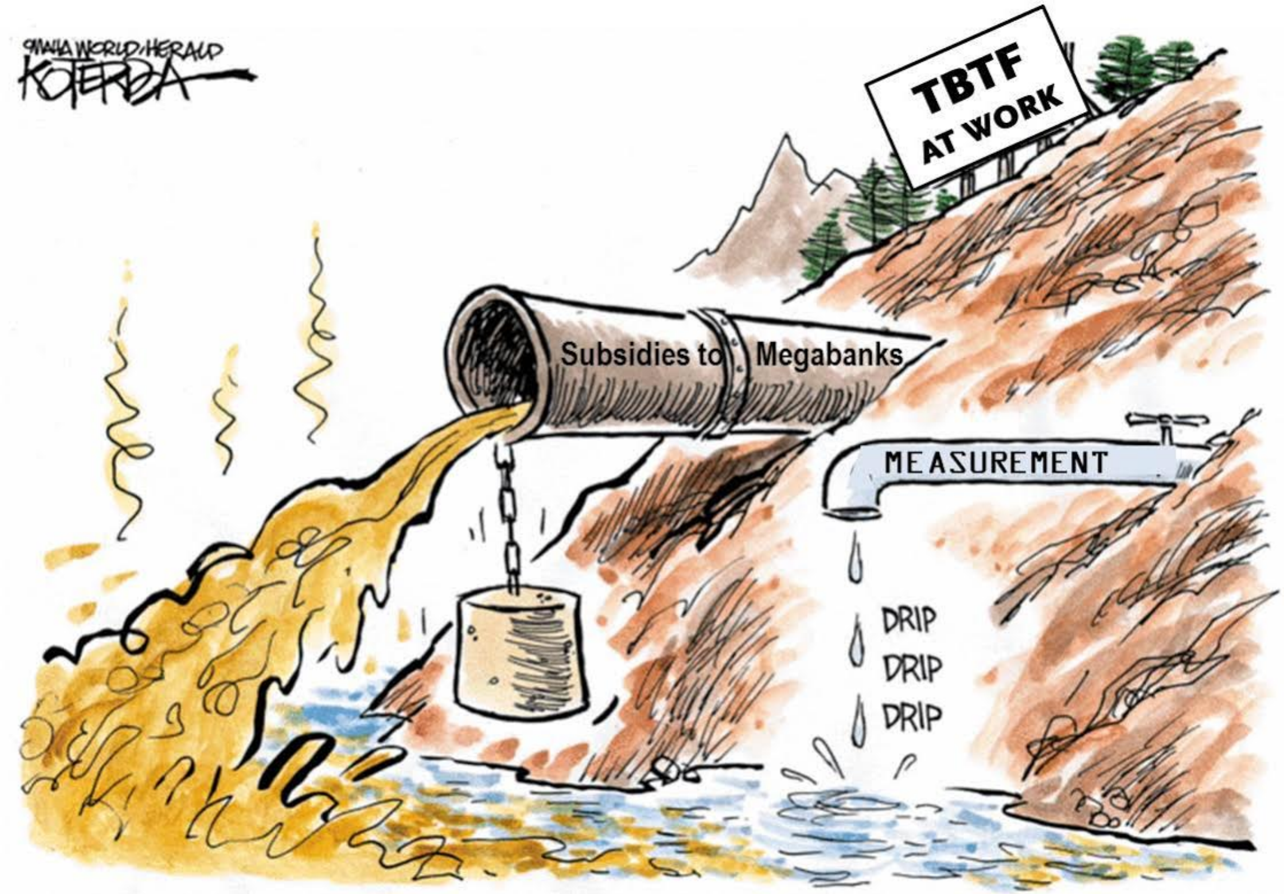
- In the US and UK, central-bank officials are increasingly blaming the Great Financial Crisis on **Ethical Weaknesses** in the Executive Culture of Megabanks. But they need to acknowledge the centrality of: (1) their agency's **own culture** and (2) what is a fixable difficulty of **proving** the occurrence of reckless behavior **beyond a shadow of a doubt**.
- To underscore the pretense, we need to look into the interacting **organizational cultures** and understand that megabankers' predation is **sustained and intensified** by **payoffs** they can gain from **gaming** weaknesses in executive subcultures and penalties at:

(1) central banks & prudential regulatory agencies;

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

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

UNDERSTATED MEASUREMENTS OF SUBSIDY FLOW



UK Law Makes a Good Start

- For corporations generally, The Insolvency Act of 1986 defines a crime called "**insolvent trading**." Directors who know 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 agreements that prioritize the interests of the creditors and the creditors' **guarantors**.
- The Financial Services (Banking Reform) Act of 2013 created a new criminal offense of **reckless misconduct leading to the insolvency of a bank** and **a burden of proof** that would have required senior bankers to **prove that they took every reasonable step to prevent regulatory breaches in their areas of responsibility**. Guilty parties were to be subject to unlimited fines and up to 7 years in prison.

Lobbying and Regulatory Culture Resist Establishment of Easy-to-Prove Burdens

- The toughened **burden of proof** that the UK's December 2013 law sought to establish was scheduled to apply to banking firms beginning in March, 2016.
- My cat-and-mouse model of regulatory and bank cultures **predicts** that regulators would **prefer not to enforce** anything like the letter of this law.
- Indeed, on Oct. 18, 2015, the newly elected Conservative government introduced a "statutory duty of responsibility" for *all financial-services firms designed* to **supersede** both the law's burden of proof **and** its sharp **focus on acts that lead to insolvency**. The new burden of proof turns on a general requirement for **authorities to show** that an individual failed to take steps that were reasonable for a person in his position to take to prevent a rules oriented "**regulatory breach**" (as opposed to an outcome oriented **insolvency**).