

# THE EXPANDING FINANCIAL SAFETY NET: REFORM AS DENIAL AND COVERUP

Edward J. Kane

Boston College

# No One Expects Officials to Tell the Truth or to Accept Blame When it is Due



"Which side of your mouth will you be talking out of today, Senator?"

# JUSTIFICATIONS FOR 2007-2009 SAFETY-NET GROWTH MISFRAME ISSUES

STUBBORN EARLY MISDIAGNOSIS: Funding Problems Were Evidence of Shortage of Aggregate Liquidity

FURTHER MISDIAGNOSIS: Crisis was caused by defective risk management at “systemically important” firms (SIFs  $\approx$  TDFUs)

CONSENSUS REMEDIES: Use *tougher rules* to force SIFs to monitor and support risk exposures

- Toughen capital requirements *formula*
- Restrict executive compensation
- Redefine authority and reach of financial regulators:
  1. **Propose to monitor “systemic risk” without agreeing on an operational metric**
  2. **Create new “watchdog” agency to protect financial consumers**

# ETHICAL COUNTERDIAGNOSIS: A LAYERED BREAKDOWN OF PRIVATE MARKET DISCIPLINE AND GOVERNMENT SUPERVISION

- Risk Managers at SIFs **skillfully** extracted safety-net subsidies: regulation-induced innovation misrepresented and masked SIF **leverage and interest-rate risk**
- Safety-Net Officials did not adapt their surveillance systems dialectically to counter these moves. Lacked **INCENTIVES** to do this.
- Incentive conflicts 1) fueled the securitization bubble, 2) aggravated the crisis by preventing the haircutting of the creditors of TDFU zombie institutions, and 3) stalled resolution authority needed to FORCE *prepackaged bankruptcies of complex Financial Holding Companies.*

# FAILURE OF SURVEILLANCE

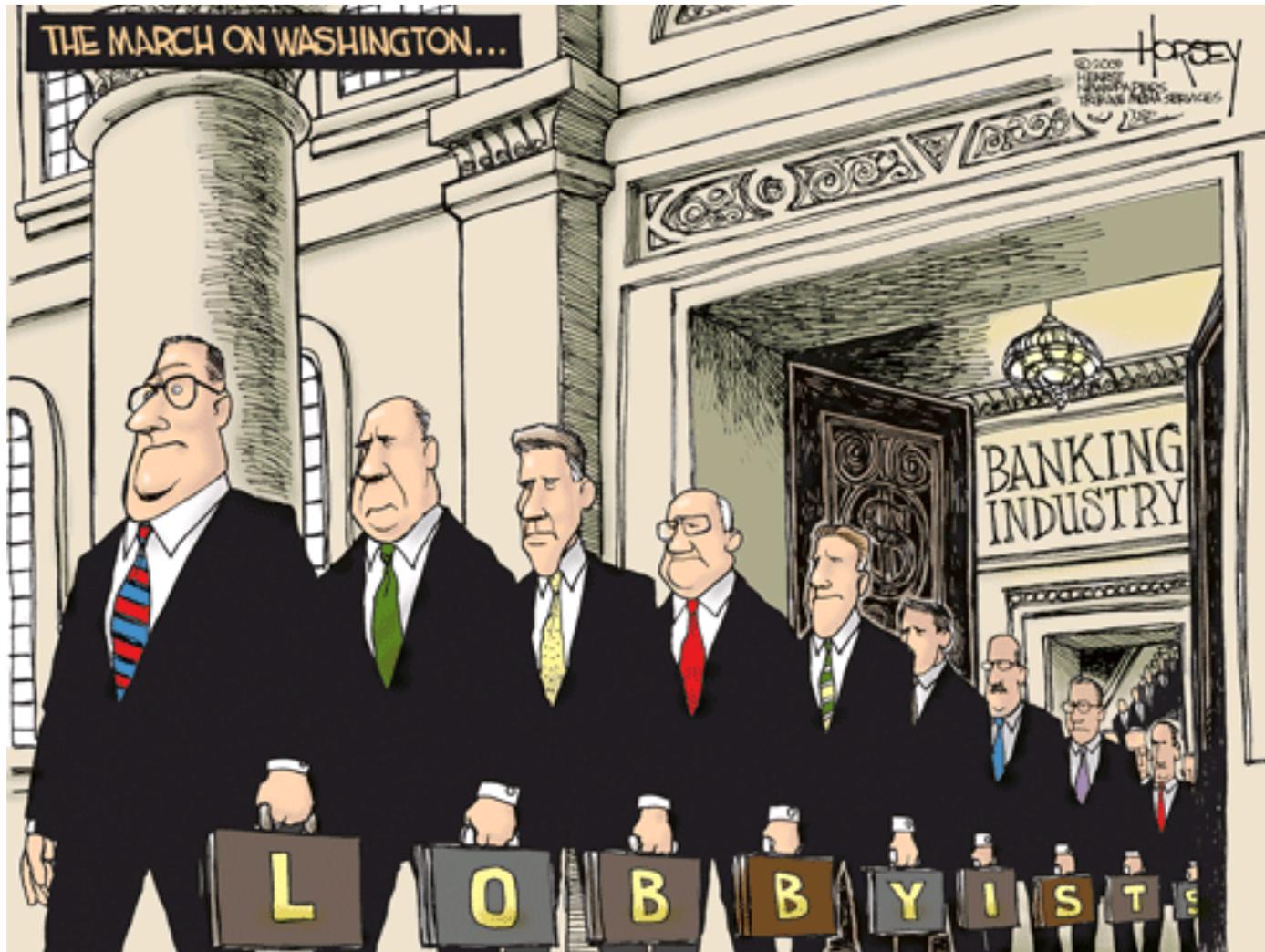


# REFRAMING THE POLICY PROBLEM: How to Incentivize and Monitor Private and Public Managers of the Safety Net So that They Do NOT Encourage Subsidies to be extracted by Firms that Actively Expand Their Risk-Taking and Political Clout in Clever Ways

Managers face Many Incentive Conflicts

- Horizons (Obsession with near-term effects)
- Multiple Principals for Top Officials
- Ethics: Lack of Accountability for Suppressing Information and for Tradeoffs made between Fairness to Taxpayers and Other Objectives (Spinning of so-called TARP successes).

# DE FACTO ACCOUNTABILITY



# DEREGULATION VS. DESUPERVISION

The effectiveness of any regulatory plan depends on the **vigilance** and **conscientiousness** of incentive-conflicted private and public supervisors and watchdogs.

Moral fiber is needed to overcome political forces that have forced officials into scary games of chicken that they have lost repeatedly in the past.

- Character vs. Reputation
- Recruiting for Expertise vs. Connections
- Inspector Generals, GAO, and Media Monitoring

# WAYS FORWARD: Goal must be to define and to enforce explicitly duties of loyalty, competence, and care that agents and principals implicitly owe one another.

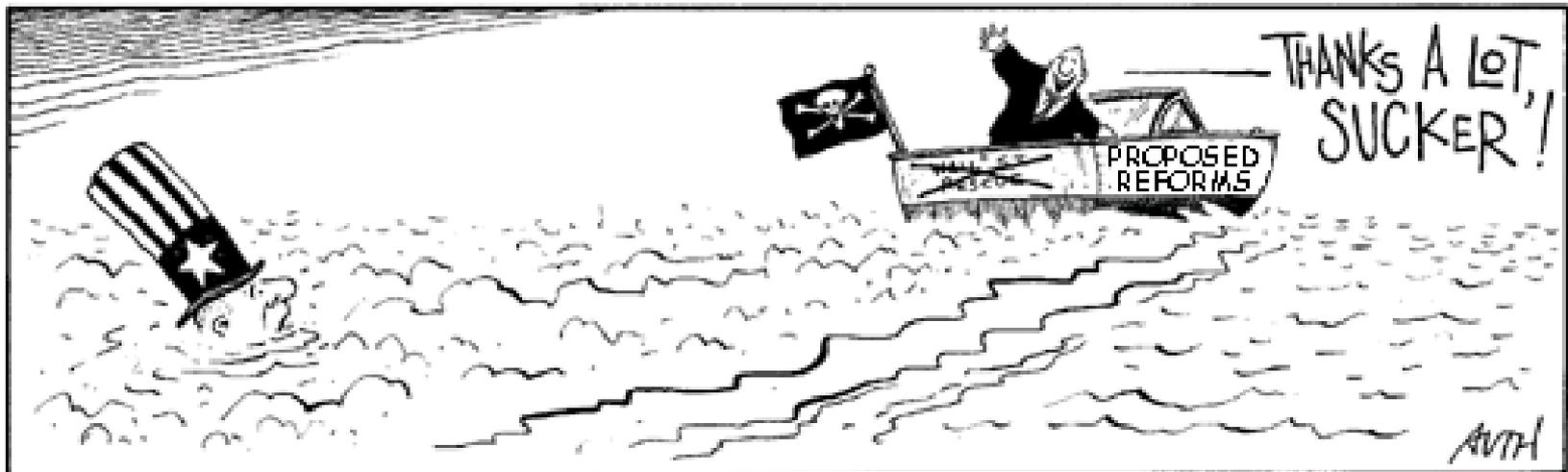
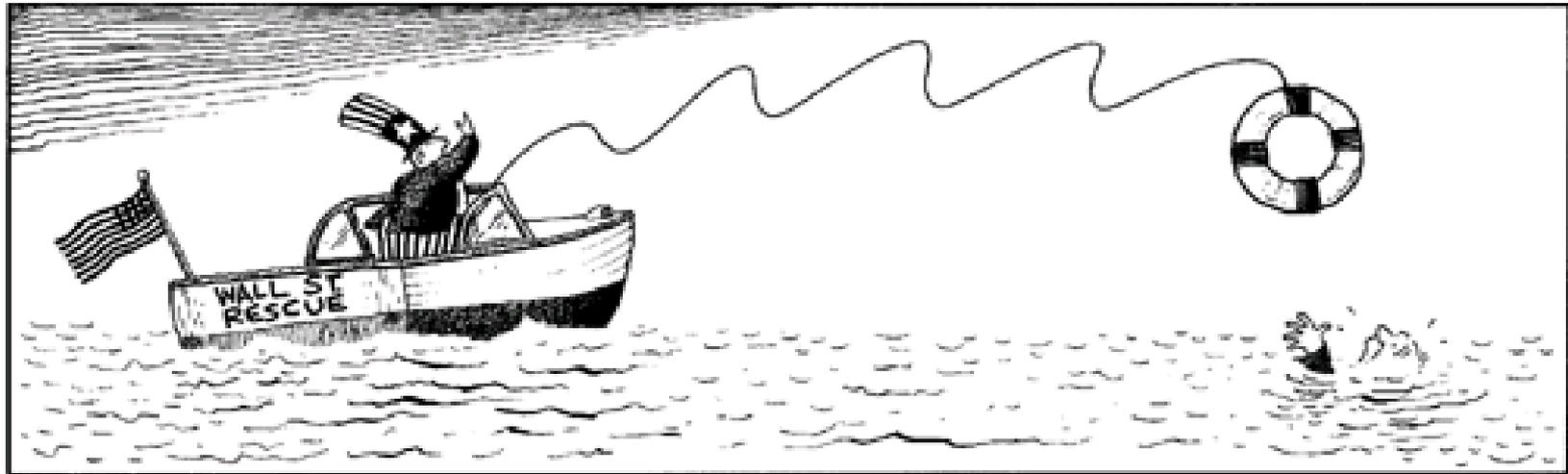
In firms and in government, Supervisors owe five common-sense duties to their principals:

1. A duty of vision: They should continually adapt their surveillance systems to counter innovative regulatee efforts to disguise their rulebreaking;
2. A duty of prompt corrective action: They should stand ready to propose new rules and discipline rulebreakers whenever a violation is observed;
3. A duty of efficient operation: They should produce their services at minimum cost;
4. A duty of conscientious representation: They should resolve conflicts fairly, plan and train for crisis, and be prepared to put the interest of the less-informed principals ahead of their own.
5. A duty of accountability: They should make themselves answerable for neglecting or botching their duties. (Issue for CROs and monoline insurers is to bond the quality of their performance in a meaningful way.)

# **It is Overly Cynical and Self-Defeating to Dismiss Incentive Reforms Out of Hand**

Toughness, Training, & Commitment to Mission  
We demand of Firefighters, Police Officers, Soldiers, Emergency-Room Attendants, and Nuclear Safety Personnel *Contrasts Badly with the Counterproductive Recruiting, Motivation, Entitlements, and Behavior Society accepts* from its Elected Politicians and the Top Regulators these pols choose to appoint (e.g., Timothy Geithner).

# HIJACKING OF THE REFORM PROCESS



9-16-09 THE PHILADELPHIA INQUIRER, UNIVERSAL PICTURES