A failure of public financial sector governance

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As the Financial Crisis Inquiry Commission begins looking at the causes of the recent financial crisis, we need to consider that crisis is a failure of governance. Lucian Bebchuk from Harvard Law School has written extensively on the failure of private sector governance: boards that failed to make informed judgments or control the risks incurred by their institutions, self-serving management that lost control over reckless risk taking and compensation systems that invited speculation by traders. Although Sheila Bair, chair of the Federal Deposit Insurance Corporation (FDIC), has openly expressed her discontent with the governance of the banks and the FDIC is considering tying premiums to compensation, we are likely to witness the largest bonus season the industry has ever seen.

Given the scale and severity of the crisis, we have heard very little about the failure of public financial sector governance. When the Queen visited the London School of Economics in November 2008, she quite rightly asked, "Why had nobody noticed that the credit crunch was on its way?" Why didn't the public authorities entrusted *as guardians of financial sector stability and our savings* see the crisis coming and respond quickly to diffuse or at least mitigate the damage?

The Queen's question has two subquestions. First, why did nobody anticipate the crisis? And second, why did nobody respond in a timely and decisive manner once the crisis became evident. During the 1997-99 Asian financial crisis national and global policy makers failed on both counts. Considering that many current policy makers gained first-hand experience during that crisis and also have studied the Great Depression, why in this crisis was there a failure of collective action and a repeat of disaster myopia?

The British Academy offered one explanation in its reply to the Queen in July 2009: no one individual or institution at the national and global level had any individual or institutional incentives to take decisive action. There was collective-action paralysis, since the compartmentalisation of information and accountability meant that, in the end, no one was accountable. Since no one individual or institution had complete system-wide information, no one individual or institution was to blame. Thus bankers can believe that the crisis was an act of God and that pushing moral hazard pays: benefits go to individuals, failed banks get rescued, the blame goes to God and the costs are paid by the public purse.

Clearly public financial sector governance failed to prevent moral hazard from escalating, even though the rationale for public sector oversight of the financial sector and market transparency is to deal with principal-agent problems and reduce information asymmetry. One of the arguments against giving more power to the existing national and global institutions is that they failed to anticipate the crisis and were slow to act once it began to unfold.

We cannot prevent future crisis if we do not confront openly the structural failures of public financial sector governance. It is too glib to say that this is a once-in-a-lifetime crisis when the

frequency and scale of crises and losses have escalated in recent history. What are the possible explanations for this failure of public financial sector governance?

We will skip over some of the explanations, such as the one offered by Simon Johnson, Richard Posner and others that the regulatory community is captured intellectually or otherwise by the financial revolution. We believe that there are other explanations related to asymmetric incentives and information.

- The first and most credible explanation is Keynes's view that there are asymmetric incentives in being conventionally wrong rather than unconventionally right. "A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way along with his fellows, so that no one can really blame him." Keynes's view that there is safety in collective action, even if it is wrong, applies to regulators and policy makers as much as to bankers.

- The second explanation is the flawed nature of compartmentalised regulation, so that each department in charge of one part of the financial sector (at the national or global level) cannot see the total picture or recognise the systemic risks. Respect for each other's turf creates loopholes that are exploited by regulatory arbitrage and information asymmetry, inviting eventual failure. Disaster myopia is inherent in compartmentalised regulatory structures.

- The third explanation is that even if one person or council of wise men has been established to be fully accountable for systemic stability, what standard or rule should be used to judge whether there are bubbles and what action should be taken? This is the argument that in a rule-based society we must establish credible and measurable standards and rules to enable action to be taken in a transparent and accountable manner.[1] While this line of thinking is rational and defensible, a crisis is, by definition is difficult to define, and, more often than not, the argument that there is insufficient evidence or theory to measure a crisis is a defence for inaction.

- A fourth explanation is the self-preservation and career management of bureaucrats. It does not pay for a regulator to be in front and raise an alarm.[2] The short-term promises of profit and prosperity of an emerging bubble are such that the financial and business community as well as the media and legislators are almost always against Cassandras and regulators taking preemptive action. An enduring truth about financial regulation is that, given the discretion to do so, financial regulators will elect the easy path. In good times, it is almost impossible for bank regulators to be "tough" because the political economy pushes for lax monetary, fiscal and regulatory policy. Moreover, if the examiner calls for caution too early, he or she is "proven wrong," again and again, until he or she loses her job. In bad times that follow good times, the pressure builds on the regulators to offer forbearance and accept overly optimistic valuations.

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[1] Jaime Caruana, general manager, Bank for International Settlements, proposed recently that the approach should rely as far as possible on rules rather than discretion (*The International Policy Response to Financial Crises*, by Jaime Caruana).

[2] Discretion and financial regulation.

- The fifth explanation is the existence of asymmetric incentives, described above. Since massive information asymmetry is inherent in complex financial markets, society has to give independent central bankers and financial regulators latitude to make tough judgment calls. Central banking and regulation remains an art, which is why it is not a game for those who seek popularity.

- The sixth explanation is that national public policies can no longer be independent of global collective-action problems. Global imbalances are inherent in global markets, and even if some national authorities may have the courage to act, in the collegial, club nature of international financial settings decisions are made by consensus. We should not assume that domestic or geo-politics will play no part in the outcome of deliberations at international forums such as the Financial Stability Board. The current Westphalian structure of global governance, without binding accords, tends to avoid taking tough decisions since there is no global fiscal mechanism to deal with their consequences.

We are driven to the conclusion of Hyman Minsky that conventional wisdom and the "trend is your friend" invariably lead to complacency[3]: "Stability leads to instability." The cycle between greed and fear will be such that even if regulatory standards are toughened and independent systemic stability councils are put in place, fading memories of disasters will cause the public and policy makers alike to relax their vigilance, leading to the next crisis.

The flawed public financial sector governance incentives that led to the present crisis have not been addressed in the prospective reform agenda. This article is intended to stimulate thinking and discussion about *what can be done.*

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[3] *Nudge: Improving Decisions about Health, Wealth, and Happiness,* by Richard Thaler and Cass Sunstein, offers the best ideas from behavioral economics, concluding that human beings prefer the status quo and favor procrastination or making no decision.