Financial Crises: The Interaction of Ethical and Collective Action Issues?

John C. Pattison

Having worked for many years in the financial sector in government, banking and academia I am grateful that I have **not** missed the best crisis on record. 1961 and 1982 were great for fine wine, 1929 and 2008 for fine crises. In both cases these vintages will be savoured, analyzed and discussed for time to come. Both give headaches. 1961 and 1982 apparently promote romance while allegedly 2008 promotes divorce.

All financial crises are ugly, and are unfair in the damage they do. This unfairness is profound, often random in its effects and affects individuals through unemployment, loss of investments, and pension income to give but a few examples. The unfairness spreads in terms of increased tax burdens, reduced capacity of governments to pay for social services and to invest in the economy.

History and Crises

There was nothing new in this crisis. Re-reading John Kenneth Galbraith's ***The Great Crash*** by changing some of the words, for example from investment trusts to collateralized debt obligations, transparency to transparency, leverage to well, leverage the story is the same only the names have been changed to protect the guilty.

This is my first ethical point.

Not only was there nothing new in the crisis except for a larger scale and more complex markets and instruments, but the financial literature had studied many of these issues and their complexity. So how is it possible in the presence of such detailed knowledge to allow such a crisis to happen? Would a doctor display a similar disregard for symptoms or medical knowledge?

This thought troubles me. I will return to it below.

Just to recapitulate quickly, this crisis was caused by:

(a) The build-up of financial imbalances between countries and across sectors

(b) The failure of monetary authorities in major countries to respond to these imbalances

(c) Weaknesses in regulation

(d) Moral hazard, which is always an issue but became worse after the decision to provide for a resolution of the problems of Long Term capital Management

(e) Failure of financial institutions to manage risk, and at the higher levels to exercise due diligence and oversight.

(f) The interconnections of global markets and the immediate correlation of markets as investors sold, hedged, bailed out of anything financial.

Aside from these factors, things worked well.

Ethics and Financial Markets

Ethics is about moral principles which the *Oxford English Dictionary* says are concerned with the principles of right and wrong.

To start with, the crisis has shown that what goes wrong in financial institutions is often simply bad judgment, poor decisions, flawed execution, ill considered strategies, insufficient internal controls and their integrity, inadequate management supervision, wrong risk modeling, poor data, a lack of detailed market knowledge, perverse incentives, dominant business leaders trumping sound risk management, understaffing key roles, badly managed or ill-considered mergers and so forth.

Ethics as they relate to financial institutions are most often discussed in terms of securities regulation. In banking markets the emphasis of much of regulation is on safety and soundness – that your money will be there when the deposit matures. There is an ethical issue if people lose their funds from financial failures. So a test is the consistency between regulation and protecting depositors.

But this is not the way the system works.

Safety and soundness is not an assured target either for governments or institutions. At the official level it is traded off against efficiency, profitability, competition with other financial centres, job creation and innovation. It is this tradeoff that is difficult and where supervisors often do not have the tools to fine tune their choices.

A second fundamental issue is that the global financial network and global trading accumulate risks that can create instability for otherwise well managed institutions. People forget this: **Total** financial risks are greater than the sum of the individual parts.

Fundamental Theme: Collective Action Problems

Ethics is about ***individual*** behavior and choices and so is banking, but the problems are ***collective***.

This is a fundamental issue that is often present but rarely acknowledged. Many of the perceived regulatory or risk issues are “collective action problems” that is they <u>cannot</u> be solved by individuals or financial firms doing the right thing. Don’t get me wrong, doing the right thing is **necessary** but it is **not sufficient**, that is the point. So individuals may act appropriately within their terms of reference but not act collectively in the public good. That undermines a focus on individual ethical decisions. This is the core issue that overlaps with ethical issues: to repeat, doing the right thing is necessary but not sufficient.

Consider a few examples of collective action issues.

The Finance Minister's recent decision on mortgage restrictions is a classic example. No individual bank could have put in place adequate restrictions on its own. They would have lost customers to other banks; its employees and branches would have suffered. Eventually a larger financial problem may have surfaced but by then it would have been too late.

Controlling remuneration is another example. Yes good governance would be nice to have, but we are already seeing firms luring traders with promises of better bonuses that are incompatible with evolving norms that relate bonuses to longer term behavior. Some banks are saying that if they do the right thing on remuneration they will lose employees and earnings. But if a few do this they will undermine the collective safety for the industry. Clearly only collective action will help.

In the United States we saw that during the crisis investments in banks by the US government were compulsory on all of the largest banks, even the safe ones. The reason was that it would have been increasingly hazardous in the crisis to have two classes of banks, or perhaps three, the good, the bad and the ugly. During the depth of the crisis you needed collective action or risk fragmenting an already endangered system.

Finally let me return to the earlier issue about predicting crises. Crises are difficult to predict but the preconditions are not. Excessive leverage has always been deadly, as have imbedded flaws in widely used financial instruments. In the 30s they were investment trusts today they are structured products. But this too is a collective action issue. No one bank can withdraw from its markets or customers when things get risky, although they can become more and more prudent. This is why a former Governor of the US Federal Reserve said that it is the job of the central bank to take away the punch bowl when the party gets interesting. There is also a **signaling issue** on the part of the central bank, Finance Minister and chief regulator.

These points demonstrate a **fundamental ethical** issue. Financial network risks cannot be entirely solved by individuals. Thus it is not possible to consider financial problems without looking for collective rather than single bank solutions. I will come back to this point.

Recipes for Crises

Ethics and crises are about **behavior**. There are many ingredients for such a crisis. It is only reasonable to suspect that these will reoccur. We should ask ourselves if they also reflect moral or ethical principles.

Consider some of these.

Failure to Understand the System

Both bankers and government officials failed to recognize the interdependencies across countries and markets. Also potential problems with structured products and securitization had been only partially

understood. In fact most would have said that in the event of a financial crisis, a shortage of funding or liquidity banks would simply securitize assets rather than fund them.

No one at the domestic or international level competently surveyed systemic risks, although the Bank for International Settlements came closer than others. Governments are looking to correct this with international surveillance of systemic risks. Good luck.

Assuming Banks can Manage Risks without Regulation

There is an emerging strongly held view that preventing crises is a collective action challenge, not one of simply making individual banks safer. Banks cannot manage their own risks without significant regulation, that is, their own governance processes executed in each firm will ***still*** fail to deliver stability. Once again these individual steps are **necessary** but **not sufficient**. I can recommend an excellent article by Andrew Haldane of the Bank of England on some of these points (Andrew Haldane, "Why Banks Failed the Stress Test", London: Bank of England, 13 February 2009.)

(a) Financial institutions have what Haldane calls disaster myopia. Firms consistently understate the probability of adverse outcomes. Often these risks are out of their own hands so the only thing to do is to withdraw from a market which is difficult to do.

(b) In the past bankers with a fine sensitivity to risk were unlikely to rise within any firm, or be valued by their peers. The world has changed but human behavior may revert back to the norm.

(c) A large amount of risk comes from the financial network, not just your own decisions, good and bad. Your counterparties, those with whom you deal, for example Lehman Brothers may create huge amounts of risk for the system and yet an individual firm will not be able to see this. This is an unstable situation. In good times you don't know if those with whom you deal are in fact incredibly risky because of their own risks or the risks of their major counterparties. In bad times institutions will cease to deal at all for fear of what may be going on in their counterparties. The system locks up as it did in this crisis. AIG is an example. Once again this is a collective action issue.

(d) Human behavior leads to taking more risks in good times, leading to an unsustainable boom, and to pulling back in bad times leading to a recession. The longer the good times the lower the subjective probability of bad things happening. This is basic human behavior, flawed but that is how many human's behave.

(e) Regulation and accounting rules exacerbate bank behavior over the cycle.

(f) The tyranny of good times: there is a history of banks which attempted to avoid risks being pulled into them (if the good times persisted for a few years). This is sometimes described in manners that are very unfair to **lemmings**.

Thus, left to their own devices, history suggests banks will inevitably take on too much risk as the cycle peaks.

Errors of Financial Logic

Many bankers made serious errors of Banking 101. These have been covered very well by the literature on the crisis but suffice it to say that funding $75 billion or more overnight, every night as happened in the US investment banking business is not a safe and sound practice. Nor is using short term, often overnight financing for portfolios of long term illiquid, hard to value property loans consistent with the business or regulatory model.

Bank risk management was not only flawed but governance, internal reporting and oversight, internal audit and various checks and balances did not work in many cases. Work is ongoing on several fronts to deal with this, including the work of the Institute for International Finance that a number of Canadian bankers are involved with.

Serious Errors of Judgment

Central bankers and other governmental authorities made serious errors in the decade (or more) leading up to the crisis.

The issues around financial bubbles were recognized by the authorities in the United States and dismissed. Worse the Greenspan “put” meant that monetary policy was subjugated to ensuring that financial markets prospered. No greater sign warned me of risks to come than the Greenspan put.

The Federal Reserve Board lowered interest rates **13 times** between May 2000 and June 2003 taking interest rates to one percent without an economic crisis. The lower cost of borrowing led to dramatic increases in **leverage** and the low interest rates caused investors to seek yield in risky and unconventional places.

It is unethical to do the wrong thing? Not if it is not within your experience and knowledge. Also many of these were group decisions. But it strikes me as no longer tolerable for major imbalances and systemic risks to the safety of global society to not lead to steps to eliminate such risks. It would be beyond the scope of this talk to get into the details, especially on a full stomach. Clearly there is a role for institutional change to fix the problem. I am not optimistic that committees at the IMF and the Financial Stability Board will suffice.

But this is nothing new in the history of central banking. You are referred to a wonderful book *Lords of Finance The Bankers Who Broke the World,* by Liaquat Ahamad for a description of the central bank governors of the United States, United Kingdom, France and Germany and their errors leading up to the Great Depression. (As an aside I believe we are well served in Canada both by OSFI and the Bank of Canada.)

Getting Better

Making the system better is all about human behaviour. The technology of regulation and supervision can make financial crashes, like car crashes survivable. But is the current debate about safe driving, or, the airbags or ambulance services? In fact we need all of them.

Governments and regulators face stark choices (a) how to modify financial behavior, (b) how to improve the management of banks and markets, (c) how to wield the blunt, inaccurate toolkit of regulators and d) how to revive to shut failing institutions.

In some areas of regulation, such as capital regulation, the assumption is made, **wrongly**, that regulation can be achieved by formulae based upon historical data and the application of mathematics by intelligent people with good personal hygiene. I do not deny that regulation will use formulae, data and mathematics. These may be **necessary**, but that is not the same as **sufficient**. Moreover rule based systems lead to arbitraging and gaming the system.

Thus there is no alternative but to have hands on supervision with careful attention to emerging risks. The supervisor needs a great deal of courage to resist the calls that will come to move with the times. In fact the industry has criticized the major tools that were needed in the crisis and had hoped to water them down: capital, liquidity and leverage to name three.

But note this is where countries such as Canada and Australia have a comparative advantage. This type of supervision is almost impossible to do well in the United States with 8000 banks plus savings and loans and other competing institutions. Even in the United Kingdom the FSA had thousands of institutions to oversee. So there is a temptation to make bigger blunt tools and not consider the behaviour and strategies of the regulated firms in stressful times.

So far Australia and Canada have escaped the worst of the crisis because our financial systems have a small number of critically important participants. **But hold on**. In **Iceland** and **Ireland** this worked against them.

What is critical is the balance of power. In Canada, contrary to popular belief, the banks win few battles with governments. Bankers petitioned government to have the leverage ratio removed and the government said no: many times. Yet if something was critical and well based I believe there is a good chance that both the governments and the banks would do the right thing, although this might be painful to watch. In both Canada and Australia supervisors denied large bank mergers. In Australia they increased the capital requirement on mortgages above the internationally accepted norms. Canada implemented a leverage ratio where others didn't. So smaller countries have greater scope to manage risks better than where a regulator has to deal with hundreds or thousands of institutions.

Regulation is a game.

The rules of the game differ from country to country. In Canada we have a tradition of **moral suasion**, regulators talking with industry participants and expecting them to obey since they have ways of making them do so. In Canada we have a small number of banks and the Minister of Finance can get them in one room and have a confidential discussion. While many may disagree with this method I believe this is a better way than the alternatives to manage systemic risk if both sides are honest and show their cards. Certainly rule based systems without a strong regulatory dialogue lead to arbitrage and undermining of regulation. In most countries financial institutions spend money on good lawyers to find

ways to do indirectly what is often not permitted directly. Securitization and some types of off balance sheet transactions arbitraged the capital rules and everybody knew that.

So politics is important, critically so! The risk to any system is a weak government, one captured by the industry or a populist government that used the financial system to promote political ends. Regulation and supervision do not work the same in any two countries. In many, regulation is a dangerous game, notably the United States. Politics no doubt created the mortgage problem in the United States through actions and inactions at both the federal and state levels. So while we have much for which to be grateful in Canada we also need to know what to avoid.

Chairman Greenspan said in his memoirs "In today's world, I fail to see how adding more government regulation can help." [*The Age of Turbulence,* The Penguin Press, page 490] In other words, the game, while getting more complex and risky needs fewer rules.

Within the past month the *Financial Times* reported "Several aids from both parties involved in reform negotiations told the *Financial Times* that republicans are opposing a plan to impose tougher capital and liquidity requirements on companies that pose a risk to the financial system." ("Senators oppose 'systemic risk' curbs", 16 February, 2010, page 4)

Conclusion

I have five conclusions.

There are many competing proposals for financial reform: most have some merit. Because there are so many they may either compete and ultimately come to little, or worse overlap and become counterproductive to the economy.

Second, because of the collective action issues it is unethical to deny that significant regulatory change is necessary. But there are deniers, and more specifically while acknowledging change, those that want to avoid significant change. This is more a US issue than a Canadian one.

Third, game theory suggests that a cooperative rather than a conflicting solution is not only desirable but necessary. Reread the **Prisoner's Dilemma** for a reference: the prisoners desperately need to talk or they will both make the wrong decision which is technically correct based on their information. Read bankers and governments for the two prisoners.

The question for institutions – both governments and industry – is to find an institutional framework where these complex issues can be resolved in a manner in which the motives of all sides are transparent. I believe this is an ethical issue: specifically, failing to act in good faith when it is called for. Governments may also lack the perseverance to resolve complex issues. Canada is well positioned on these issues although improvements are possible.

Third, I mentioned earlier that governments must manage a trade-off between safety and soundness competing with efficiency, competition between financial centres that are differently regulated and innovation. I also mentioned that this trade-off does change from year to year. For example complex

structured products disturbed this mix. It is **not** a question of balance. The public interest is bigger than allowing a few to benefit from complex products at the expense of the many. Regulators and supervisors must recognize they are constantly managing tradeoffs not absolutes. When trading off unquantifiable risks the goal should be to minimize them. Perhaps this trade-off should be recognized and a Parliamentary Committee regularly review how the tradeoff is assessed. Everyone could benefit by such transparency.

Finally, Canada can be, and perhaps must choose to be different as international rules are often set by large countries with different agendas. It would be wrong simply to accept a set of rules because they are internationally agreed if they are a compromise, risky or based on different factors than our local legal or financial system. To return to the analogy to the Prisoners' Dilemma having discussions in third countries in the presence of your competing financial partners is not likely to resolve domestic issues.

The game is afoot. I have tried to argue that in this game are many ethical or related decisions that must be considered by financial institutions, governments, regulators and central banks. These involve the process of getting to a better financial world as a collective action solution to support individual institutions and prevent them from becoming victims of the global financial network. Once again these problems are worse outside of Canada but we know from this crisis that – unless you want to be North Korea – you cannot easily create a financial system as a safe island from the rest of the world.

Thank you for your interest in this topic.

Background Points for Reference

Appendix A

Rules of the Game

(a) All games must have rules that are accepted and adhered to

(b) Governments can change the rules;;

(c) Regulation is a positive sum game played by financial firms and the official sector;

(d) Industry has more cards than the regulator because they own the cards. This is not being critical it is simply the nature of the game;

(e) Industry believes regulation is a negative sum game, and thus finds ways to arbitrage or thwart regulation.

(f) Regulatory arbitrage is not an aberration but is part of the game;

(g) The official sector plays the game with fewer cards and with less valuable chips to bet on the outcome.

(h) The players may merge their cards and be too big to lose.

Appendix B

Misreading the literature.

First, a large number of banks - of all sizes, not just the biggest - got into trouble through ill advised mergers or acquisitions. Yet the economic literature struggles, and fails, to find economies of scale beyond a certain point, nor does it find large benefits from many mergers. While rejected by the industry this point has strong backing. Probably the contrary view is based on the fact that large banks can take bigger risks, lose more and are subject to bail outs as opposed to smaller banks that are too small to save. (In the interests of full disclosure I confess that I have changed my mind on this point.)

There are good mergers, particularly where markets are fragmented, inefficient and where risk management, technology and other activities cannot otherwise be improved by small institutions. There are some examples of these in the United States.

Second, market participants argue that a large amount of trading resources is needed for price discovery leading to efficient markets. Yet while informationally efficient markets are desirable, it is not clear that anywhere near the current level of trading is necessary for this. Moreover it is hard to believe that markets discover prices accurately using these massive resources. If you disagree consider the prices of oil and most other commodities in the past 2 years.

Thus regulation, such as capital rules, that provide a disincentive to the excessive dedication of resources to trading ***by insured financial institutions*** do make sense.

Appendix C

Why regulation is difficult:

1. Financial behaviour is unstable, follows trends, momentum and small amounts of new information can overturn the direction of the underlying economy.

2. Correlations that everyone relies upon for diversification to reduce risk are notoriously unstable leading to an ***accumulation*** of risks rather than a reduction in risks in a crisis.

3. Regulation only covers the regulated. There is a long history of companies avoiding regulation; arbitraging regulation to profit from it; or driving activity to legal entities, jurisdictions or products that are not regulated. This is often called the boundary issue.

4. There is no great quantity of the right kinds of risk, default and loss data over long periods; but worse participants reject long term data when it is available as being irrelevant. This is called heteroscedasticity – older error terms are allegedly less relevant to today. After all the world has changed.