

THE FETTERS OF FALSE RESPONSIBILITY: Why Bank Regulators Propagate Moral Hazard

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History, literature, and clinical files abound with examples of a false sense of responsibility.

Let's look at two of them, beginning with a troubling episode from the Bible. In the book of *Judges*, the Israelite leader Jephthah vows that if he defeats the enemy, he will sacrifice "whatever comes out of the doors of my house to meet me when I return." After routing the enemy, Jephthah comes home and sees . . . his daughter—his only child. "Alas, my daughter!" he exclaims. "You have brought me very low; you have become the source of great trouble to me. For . . . I cannot take back my vow." And he doesn't.^{1[1]} Apart from his rash vow, Jephthah would not have thought he had any ground for killing his daughter. But he regards performing his vow as more important than his daughter's life—and as a higher duty than abstaining from murder.

The novel *Bridge Over the River Kwai*^{2[2]} offers another poignant example of a false sense of responsibility. It tells of British prisoners of war forced to build a railway bridge to help the Japanese invade India. A British colonel refuses to let his officers do manual labor, and consequently endures weeks of beatings and privation. Meanwhile, the bridge stands doomed by swampy soil, an inept Japanese engineer, and devious sabotage by the British soldier-laborers.

^{1[1]}*Judges* 11:29-40.

^{2[2]}PIERRE BOULLE, *THE BRIDGE OVER THE RIVER KWAI* (Xan Fielding trans., Time Books 1964).

All that changes when the Japanese relent and exempt the British officers from manual labor. The British colonel takes charge of the project and sets about building a properly designed bridge on suitable ground. In his mind, “the bridge, which the Japanese have thus far botched, ceases to be something that they need in order to fight the war more effectively. It becomes a symbol of their inferiority and an opportunity to demonstrate the skill and dauntless spirit of his empire-building breed.”³[3] He pushes his men hard and takes pride in completing the bridge on schedule. The bridge so obsesses him that when British special forces prepare to blow it up, he warns the Japanese and even murders a member of the special forces team. As the sole survivor of that team notes, the colonel “had a highly developed sense of duty and admired a job well done.”⁴[4] This misdirected sense of duty played a key role in his treason.

A sense of responsibility can be noble. But as these examples remind us, we should take care to feel responsible for the *right* things. We should, as best we can, avoid acting on a misguided, misplaced sense of responsibility.

A false sense of responsibility rarely manifests itself as dramatically as in these cases of treason or human sacrifice. More often, it is subtle and insidious. It may have all the high-mindedness felt by that British colonel but lack an obvious red flag like building a bridge for one’s enemy. The potential for error becomes even greater when sincere disputes exist about the subject in question.

Such disputes permeate the debate over government intervention to maintain stability in the financial system. By intervening to maintain stability, the government can impair market discipline, exacerbate the cycle of boom and bust, and end up promoting instability. Striking the right balance between market discipline and financial stability is hard.

But for bank regulators the deck is stacked in significant ways. Regulators face perverse incentives to overextend the safety net. Moreover, many regulators continue—to a distressingly large degree—to hold overly broad notions of systemic risk. Both types of factors—or fetters, if you will—encourage excessive intervention. They invest intervention with a potentially unwarranted aura of responsibility that can, all too easily, provide intellectual and emotional cover for succumbing to expediency.

I will begin by examining the tension between maintaining financial stability and maintaining market discipline—a tension that helps frame regulators’ decisions whether to intervene. I will then look more specifically at factors encouraging regulators to intervene.

Moral Hazard and Financial Stability

³[3]*Id.* xii (editors’ preface).

⁴[4]*Id.* at 227.

Banks are vulnerable to the ups and downs of the economic cycle, and particularly vulnerable to speculative booms and busts. Their liabilities are more liquid than their assets, and they must redeem deposits at par if they plan to stay in business. If widespread depositor panic forced banks into wholesale asset-dumping, the result could be a vicious spiral destabilizing the financial system and harming the real economy.

To help maintain financial stability, the FDIC insures deposits and the Federal Reserve stands ready to act as a lender of last resort. Yet these and other government interventions in the name of financial stability carry their own costs, their own risks. By impairing market discipline, they can let banks take greater risks without having to face a correspondingly increased cost of funds. The result can be excessive risk-taking—and the potential for accentuating both speculative mania and the ensuing hardships of adjustment.

In my view, such an impairment of market discipline figured significantly in the U.S. thrift debacle of the 1980s. The old system of deposit insurance and thrift regulation inadvertently encouraged thrift institutions' owners and managers to act in ways that harmed the deposit insurance fund. Owners and managers faced "moral hazard"—the tendency for protections like insurance to encourage the persons insured to take greater risks than they otherwise would. All thrift institutions paid premiums at exactly the same rate, meaning that safe institutions subsidized risky institutions. Moreover, deposit insurance impaired market discipline, permitting weak institutions to remain open and compete aggressively with healthy institutions. Weak institutions tended to pay higher-than-average rates to attract deposits, and also tended to channel the proceeds into riskier-than-average investments. This behavior represented a rational response to the incentives created by the combination of flat-rate deposit insurance, limited liability, and low capital: if the risk-taking paid off, the institutions' owners kept the profits and their managers kept their jobs; if it failed, the insurance fund bore the loss.

But this behavior harmed healthy institutions. It squeezed net interest margins both by increasing the cost of funds and by decreasing interest rates on loans. It undermined credit standards by making credit more freely available to marginal borrowers. Too much money chased too few bankable loans, and lenders received inadequate compensation for credit risk. The erosion of credit standards increased loan losses and depository institution failures. The failures depleted the insurance fund, necessitating higher premiums that further undercut healthy institutions' profitability.

What, then, should public policy seek to do in the face of such patterns? We want to maintain adequate stability. Yet by intervening to promote stability, we can impair market discipline, exacerbate the cycle of boom and bust, and end up promoting instability.

So we face a paradox: To maintain long-term financial stability, we must be willing to tolerate some short-term financial instability. To avoid fueling speculative excess, we need to preserve the credibility of the adjustment process—and the corresponding incentives to refrain from overextending oneself.

One can liken the adjustment process in an economy to fire in a forest. In the short run, both are destructive. But consider the alternative. If you suppress all fires in a forest, year after year and decade after decade, you actually make the forest more susceptible to a major conflagration. Vegetation grows unnaturally dense. Dead wood accumulates. And the forest becomes more vulnerable to drought, insects, and disease—and to devastating wildfires that burn longer and more intensely than those that would otherwise have occurred. Similarly, if we go too far in shielding banks (and others) from the consequences of their own excesses, we will render the ultimate adjustment needlessly costly, painful, and destructive.

Thus, in the thrift debacle, the federal safety net played the role of Smokey the Bear, suppressing market discipline just as Smokey suppressed fires. Just as the forest grew unnaturally dense, depository institutions suffered from persistent overcapacity—with too many dollars chasing too few good lending opportunities. Dead wood accumulated in the form of poorly managed and economically insolvent institutions. By weakening market discipline and by letting policymakers postpone the day of reckoning, the safety net let problems grow worse and increased the ultimate cost of resolving them.

The FDIC Improvement Act of 1991 sought to curtail the practice of treating large banks as “too big to fail” by constraining regulators’ discretion, notably by generally requiring the FDIC to adopt the resolution method least costly to the deposit insurance fund and by limiting Federal Reserve discount window lending to capital-deficient depository institutions.^{5[5]} But regulators, particularly the Federal Reserve, still retain considerable leeway for intervention—as demonstrated last year by the informally organized rescue of Long-Term Capital Management, Inc.

Why Regulators Incline Toward Excessive Intervention

So regulators, in deciding whether to shield financial institutions from market discipline in the interest of financial stability, must strike a difficult balance. Several factors tend to tilt the decision toward intervention.

Regulators face perverse incentives to intervene. Intervention confers immediate, readily identifiable benefits. By contrast, the costs of intervention (such as increased moral hazard and potential for future instability) are long-term, diffuse, and less obvious. But regulators can leave that problem for another day and another regulator.

Regulators risk criticism whether or not they intervene, as Americans tend to resent government-connected bailouts. But on balance, a regulator runs a greater risk of destroying his or her reputation by letting market discipline take its course. After all, who wants blame for tanking the stock market and triggering a recession? Hindsight bias will operate pitilessly in any event, but whereas an unwarranted intervention may singe one’s career, a seemingly culpable failure to intervene could incinerate it. In *The Bridge*

^{5[5]}12 U.S. Code §§ 347b, 1823(c)(4).

Over the River Kwai, the surviving member of the British special forces team traced the colonel's obsession with bridge-building to his fondness for action: "This . . . worship of action, to which our . . . typists subscribe as much as our great generals!"⁶[6]

Other factors reinforce regulators' incentives to act. "Regulatory capture"—the tendency for regulators to identify with the market participants they oversee—may tempt regulators to become local heroes (of sorts) by intervening. So may unrealistic political expectations holding regulators responsible for delivering short-term stability without regard for its long-term cost.

Even as regulators face perverse incentives, many regulators continue to hold (and many opinion leaders remain influenced by) flawed and overly broad ideas of systemic risk—ideas that encourage and seemingly legitimate excessive intervention. This approach includes vague, expansive notions of systemic risk. It suggests that the potential for irrational contagion occurs not infrequently, and that market discipline can easily spiral out of control, impairing financial stability and macroeconomic prosperity. One might call this the paradigm of 1933—the banking equivalent of forest fires as understood during the era of Smoky the Bear. Generations of bank regulators grew up with this paradigm, and for decades it drew little rigorous scrutiny. More recently, however, scholars have cast grave doubt on the approach—both in theory and as applied in cases like the FDIC's 1984 rescue of Continental Illinois National Bank. Several of those scholars are with us here today, and I look forward to hearing from them. For present purposes, the key point is that expansive notions of systemic risk still hold sway among many bank regulators, and provide a congenial intellectual justification for activist intervention.

Conclusion

In seeking to maintain financial stability, regulation can impair market discipline, exacerbate the cycle of boom and bust, and inadvertently end up promoting instability. To maintain long-term stability, we need to tolerate some short-term instability. This paradox poses difficult challenges for regulators. Moreover, regulators face perverse incentives to intervene, and many regulators hold to hazy, expansive notions of systemic risk that reinforce a predisposition toward intervening. In assessing proposed intervention, we should strive for a sober, clear-eyed view of the asserted need for, and the likely effect of, intervening. We should take care not to act on a *false* sense of responsibility, however beguiling its garb.

⁶[6]Boulle, *supra* note 2, at 227-28.