STATES, BANKS AND THE FINANCING OF THE ECONOMY: MONETARY POLICY AND REGULATORY PERSPECTIVES

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8. **Regulatory Reforms and the Independence of Central Banks and Financial Supervisors**

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8.1. **Introduction**

A multitude of factors combined to produce the subprime crisis in the US and the, still ongoing, European financial crisis. High on the list among those, particularly in the US, were the growth of an unregulated shadow banking system and regulatory forbearance. In Europe the absence of a unified regulatory system along with the existence of international systemically important financial institutions (SIFI) still complicate the handling of the banking cum fiscal crisis. It is therefore not surprising that reforms of the regulatory and supervisory systems are high on the agenda in both the US and Europe as well as worldwide.

The global financial crisis led to the realization that traditional micro-prudential regulation and supervision do not suffice and that they should be supplemented by macro-prudential regulatory authorities. This raises important questions about the institutional location of macro-prudential regulation cum supervision, the allocation of instruments, and responsibilities across those institutions and the extent of information sharing between them.

The conventional pre-crisis view was that monetary policy should aim at price stability and that financial stability could be assured largely independently by regulatory/supervisory authorities. The global financial crisis revealed that there are important interactions between the central bank (CB) monetary policy aimed at price stability and financial stability. For instance the crisis showed that low interest policy within an inflation targeting (IT) framework may reinforce a real estate bubble – increasing the severity of the downturn caused by financial instability once the bubble bursts.

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1 Paper prepared for the 30th SUERF Colloquium on “States, Banks and the Financing of the Economy”, Zurich, September 3-4, 2012. I also benefited from useful comments by Stanley Fischer.

2 A fuller discussion appears in (Cukierman 2011).

3 Although most emerging market economies were affected by the global financial crisis only indirectly the G20 put worldwide reform of financial regulation high on the agenda already at their London meeting (G20 2009).

4 Macropreudential regulation is a central element of the US post crisis regulatory reform as embodied in the Dodd-Frank Act.

5 See, for example Taylor (2009). In view of this some economists argue that, due to the interactions between aggregate monetary policy and regulation, both authorities should aim at both price and financial stability when setting their instruments (Brunnermeier & Sannikov 2012).
Both regulators and central banks need to be sufficiently independent to achieve their respective functions of financial and price stability. There consequently are obvious similarities between the role of independence for these institutions but also some differences. This paper compares and contrasts the role of independence for central banks and regulatory/ supervisory authorities, the problems they encounter and the wider issues of how those institutions should be devised, function and cooperate to achieve the dual goal of price and financial stability.

Section 8.2 describes the main challenges and pressures facing regulators. Section 8.3 then takes up the similarities between regulators and central banks and the role of independence in alleviating those pressures. Section 8.4 follows with practical recommendations designed to build up the independence of regulators. Section 8.5 discusses informational and other differences between regulators and central banks in their role as setters of aggregate monetary policy. Against the background of the recently recognized need to address systemic financial risks Section 8.6 argues that close cooperation between central banks and regulators is essential for achieving the twin objectives of price and of financial stability. The section concludes by discussing the institutional implications of this point of view. Section 8.7 discusses the tradeoff between the scopes of regulation and of financial intermediation and Section 8.8 reviews a recent proposal for regulatory reform of rating agencies in light of the experience accumulated during the global financial crisis. Section 8.9 evaluates the ongoing regulatory reforms in the US and the Eurozone in light of the growing recognition that macro-prudential regulation is essential.

8.2. MAIN CHALLENGES FACING REGULATORS AND SUPERVISORS

Regulators and supervisors have to confront a number of challenges the most important of which are: 1. Forbearance inducing regulatory capture, 2. A constant flow of financial innovations many of which are designed to evade regulation, 3. Fractionalized regulatory institutions, 4. Political pressures, and 5. International regulatory competition.

Regulatory capture: Regulatory capture occurs when regulators become, at least partly, advocates for the financial institutions they are supposed to regulate and supervise rather than being strict enforcers of rules. This leads to loose application of regulatory rules, forbearance to regulatory infractions resulting in poor application of supervision. Frequent personal moves of individuals between regulatory institutions and the private financial sector, relatively higher pay in the private sector, limited tenures, political pressures and human nature combine to encourage regulatory capture and supervisory forbearance.

Financial innovations: During the last twenty years technological progress in the high-tech industry dramatically changed the modus operandi of banks and other financial institutions. It also made it easier for them to devise financial instruments and innovations aimed at bypassing or totally evading regulation. This process is partially responsible for the fact that, at the eve of Lehman’s collapse in 2008, about half of financial assets in the US were unregulated.

Fractionalized regulatory systems: The regulatory systems of countries with major financial centers are highly fractionalized. In Europe different countries possess different regulatory systems in spite of the fact that, by the single act, there is a free flow of financial assets and banks can branch out across all the European Union (EU) countries. Obviously, given this structure, national regulators have difficulties in effectively discharging their supervisory duties. These difficulties are particularly important in the case of SIFI with many branches across national borders. Unlike Europe the US regulatory structure is not geographically fractionalized. But it is characterized by a multitude of regulatory institutions whose areas of responsibility often either overlap or leave regulatory “holes” in between.

Political pressures: Regulatory and supervisory activities usually have immediate distributional consequences for the regulated parties and/or their clients. When the supervised institutions are sufficiently large they often have political clout that can be used to exchange favors with politicians and to mobilize them in order to lighten their regulatory burdens.

A classic example is the case of the Government Sponsored Enterprises (GSE) – Fannie Mae and Freddie Mac – in the US. For many years the US congress was split about whether to create a program that would help low income people buy a first house. As a compromise Congress persuaded the GSE to loosen credit requirements to people with no credit history and low incomes. In return the GSE got an implicit bailout guarantee that was actually consummated in fall 2008 when the US government bailed out the failing GSE. Although regulators of the US mortgage market were well aware of the excessive risks that the GSE were taking they were, by and large, silenced by the political clout of Congress.

* The related issue of how monetary policy and institutions have and are likely to change as a result of the financial crisis is addressed in Cukierman (2013).

* Since the GSE account for half of the mortgage market in the US this is no small matter.

8.3. Similarities between Regulatory Authorities and Central Banks and the Role of Independence

The main similarity between central banks and regulatory authorities (RAs) is that both types of institutions are subject to pressures by interested parties. Consequently sufficiently high levels of independence from those parties are required in order to enable central banks and regulators to function efficiently. Although both types of institutions may be subject to pressures from both government and the private sector it would appear that the monetary policy dimension of central bank activity is subject mainly to pressures from government while the pressures on regulators emanate mainly from financial institutions in the private sector. However, this distinction is not entirely clear-cut since businesses may push for lower interest rates (to reduce the cost of borrowing and to raise the competitiveness of their exports) and financial institutions often weigh in on the interest rate, which they would prefer to be higher.

Both the executive and legislative branches of government tend to exert expansionary pressures on monetary policy. They do that in order to ease pressures on government’s finances by reducing the cost of government debt and to provide short term stimulus to economic activity. These motives for monetary expansion and the role of central bank independence (CBI) in addressing them in order to maintain price stability is well documented (Cukierman (1998) and others).

On the other hand less attention has been paid to regulatory avoidance tactics and pressures of financial institutions on regulators and to the importance of regulatory autonomy and determination in resisting those forces in order to protect the financial stability of the economy. Be that as it may, there is an analogy between the roles of independence with respect to the conduct of monetary policy and with respect to regulation/ supervision. In both cases sufficient autonomy is a precondition for effectively resisting pressures from the financial sector in the case of regulatory authorities and from government in the case of monetary policy.

8 Since banking regulation is often located in the central bank it is important to keep in mind that the relevant distinction here is between aggregate monetary policy and financial regulation rather than between the central bank and regulatory authorities.

Independence is particularly important when a RA or a central bank has to occasionally take unpopular steps against low probability adverse events during periods in which, due to expansion and optimism, such steps appear to most of the public as unnecessary. In the case of monetary policy this may consist of a preemptive strike against inflation (an increase in the interest rate) in spite of the fact that higher inflation is not in evidence yet. In the case of financial regulation this may involve a preemptive tightening of loan to value (LTV) ratios on mortgages in order to moderate an expanding real estate bubble before it bursts. The reluctance of regulators and central banks to act preemptively is reinforced by their uncertainty about the future.

8.4. How Can Independence of Regulators Be Build-up in Practice?

Unlike aggregate monetary policy most of the activities of regulators/supervisors are at the micro level and have visible immediate distributional consequences for the regulated parties. As a consequence the incentive of the latter to weaken the grip of regulation through various channels are likely to be strong (details on those channels are discussed in section 8.2). It is therefore important that the impartiality and independence of regulators be sufficiently well anchored to offset such strong incentives. This section proposes practical measures designed to achieve those objectives.

Given the rules on the books implementation of regulation depends to a large extent on the quality of the labor force that supervises financial institutions and applies the rules. It is therefore important to recruit competent individuals with adequate levels of integrity. To reduce the lure of the private sector regulators’ remuneration should not be below what they could have made in the private financial sector. Some of the remaining difference could be closed by cultivating a sense of mission and public duty among regulators.

It is often the case that, after the end of their tenure, high level regulators accept lucrative jobs in the private financial sector. In many cases the main value of former regulators to their new employers derives from the fact that they possess specialized knowledge and connections that facilitate regulation avoidance by the new employers. Obviously this tendency directly undermines the effectiveness of regulation. In addition it also induces regulatory forbearance on the part of the

9 Monetary policy also has distributional consequences but they are not as obvious or clearly understood as the actions of micro regulators.

10 Some of these recommendations bear obvious similarities to determinants of CBI as summarized in Table 19.1 of Cukierman (1998).

11 Kane (2013) suggests that this could be achieved by setting up high prestige academies for training financial regulators.
8.5. INFORMATIONAL AND OTHER DIFFERENCES BETWEEN CENTRAL BANKS AND REGULATORS

There are interesting informational and other differences between central banks in their monetary policy function and between financial regulators.

First, to conduct monetary policy the central bank mainly needs aggregate information and it usually has at least as good information about aggregate variables as agents in the private sector (Romer and Romer (2000)). Regulators, on the other hand, possess less information about the entities they are supposed to regulate than those entities.

Second, the distributional consequences of aggregate monetary policy are smaller and less visible than those of regulation which often has, immediate, highly focused distributional consequences. Specific examples include issues such as the setting of banks’ capital requirements, setting of loan to value ratios and the regulation of executive compensation – all of which have immediate and clear distributional consequences for the regulated parties.

Third, national regulators and supervisors are subject to international regulatory competition. This tends to soften regulatory requirements and to encourage regulatory forbearance. Although there is no directly similar interference of international monetary competition among central banks on domestic monetary policies there is evidence that home interest rates are influenced by rates set in other major countries (Cukierman, Rodriguez and Webb (1998))). This phenomenon has been highly visible since 2008 as many central banks reduced their policy rates in order to maintain competitiveness of their respective countries’ exports.

8.6. SYSTEMIC RISKS CALL FOR CLOSE COOPERATION BETWEEN CENTRAL BANKS AND REGULATORS

The global financial crisis alerted policymakers and economists to the importance of systemic risks in the creation, propagation and persistence of financial crises. This recognition raises three related questions: How to identify systemic risks early on, what types of policies should be deployed to reduce those risks and by whom? Comprehensive answers to these challenging questions are likely to be the subject of much research and debate over the upcoming years. My more modest objective in this section is to point out some lessons of the financial crisis for the desirable level of cooperation between the central bank and financial regulators in addressing systemic risks.

The crisis has shown that the actions or inactions of regulators affect systemic risks but also that aggregate monetary policy whether conventional or non-conventional affects the liquidity and solvency of regulated financial institutions. Hence the largely prevailing pre-crisis view that price stability can be assured by the central bank via some aggregate monetary policy rule like inflation targeting (IT) independently of financial stability and that the latter objective can be achieved by means of regulatory/supervisory instruments available to regulators independently of monetary policy has been discredited.

The evolving current consensus appears to be that central banks and regulators should cooperate in order to jointly attain the dual objectives of price and financial stability (Brunnermeier and Sannikov (2012)). Due to their specialized respective expertises those two institutions may continue to individually set their respective policy instruments subject, perhaps, to advance consultations and exchange of views. Furthermore, since some of the information available to the central bank is pertinent for regulatory decisions and vice-versa, information sharing between those institutions appears to be highly desirable.

This raise an important issue about whether the necessary coordination between the key financial regulators and the central bank should be done in one institution or by coordination among them in a third body. I believe that coordination outside an institution is much harder than that within an institution, creating a bias in favor of doing it in one place. The new Bank of England model – of which the key feature is that the governor is chair of all three regulatory bodies embodies this point of view. The three regulatory bodies are the Financial Policy Committee (FPC) that is located within the Bank of England, the Prudential Regulation Authority (PRA), and the Financial Conduct Authority (FCA). The FPC will be

\[12\] However this may not be true for very big economies, where diseconomies of scale in managing institutions are relatively more important.
in charge of macroprudential regulation, the PRA will be responsible for microprudential regulation and the FCA for conduct issues across the entire spectrum of financial services. The FPC will have powers of recommendations and direction vis-à-vis the other two regulatory authorities (HM Treasury, Cm 8012, (2011)).

In practice there is no cross-country uniformity with respect to the institutional location of regulation and supervision. Thus, in some countries banking supervision is within the central bank while in others it is in the Treasury or organized in the form of one or several separate authorities.\(^{13}\)

8.7. **Bubbles and the Tradeoff between the Scopes of Regulation and of Financial Intermediation**

Tighter regulation reduces the likelihood of a bubble buildup and therefore of its subsequent burst. However, it also reduces the volume of financial intermediation creating a tradeoff between more effective regulation and the volume of intermediation. An important illustration of this principle is the growth of Asset Backed Securities (ABS) and of Mortgage Backed Securities (MBS). The proliferation of ABS and of MBS substantially raised the volume of intermediation and fed the pre-crisis expansion at the cost of more opaqueness about such assets.

More generally, most expansions contain some self-reinforcing bubbly credit increases. But in most cases those bubbly elements work themselves out without a financial crisis as the economy expands. However, as optimism and intermediation through credit buildup rise the likelihood of a crisis rises as well. Consequently policymakers (regulators and central banks) face a tradeoff between allowing a boom to continue unchecked at the cost of a rising probability of a burst.

However one should not conclude from the preceding discussion that all or most financial innovations should be prohibited. Comparison of the Canadian and US experience with MBS is relevant in this context. Prior to the crisis, MBS have been widely used in both Canada and the US but financial regulation in Canada was more comprehensive and tighter than that of the US. The fact that Canada did not experience a subprime crisis supports the view that the tradeoff between the scope of regulation and of intermediation can be improved by broader and more efficient regulation than those that existed in the US prior to 2008. Prior to the crisis Canada had integrated regulation of banks, insurance companies and large investment dealers. The Canadian Office of the Superintendent of Financial Institutions (OSFI) regulated banks on a consolidated basis (retail, commercial, investment and wealth activities) worldwide. In contrast to the US Canada had a regulatory cap on leverage at an asset-to-capital ratio of 20 to 1. As a result, prior to the crisis, major Canadian banks had an asset-to-capital multiple of about 18 while for many US and European banks this ratio was 25 and 30 respectively (Lynch (2010)).

However, even within the most efficient regulatory/supervisory structure, a tradeoff between allowing relatively free intermediation and keeping the probability of a painful bubble burst low remains. This begs the question of how to evaluate ex ante the likelihood that the bubbly parts of expansions will burst into a costly recession.

Although the economic profession is currently far from possessing a well-founded answer to this important question recent work by Jorda, Schularick and Taylor (2012) on the behavior of the ratio between bank credit and GDP during 200 recessions and the preceding expansions in 14 advanced economies suggests that a stronger increase in this ratio during the boom tends to lead to a deeper subsequent downturn. Relatedly Borio and Drehmann (2009) find that, as an empirical matter, financial crises are more likely the larger are the rates of growth of the credit to GDP ratio and of real estate and financial assets prices.

Based on those findings Calomiris (2011, p. 66) argues that a simple dual threshold rule based on credit growth and either stock or real estate price increases can be used by the central bank and regulators to decide when to start to lean against a developing bubble. The work of Jorda, Schularick and Taylor (2012) also suggest that the larger is the buildup in the credit/GDP ratio during the expansionary phase of the cycle the more serious and prolonged are the recessionary effects of a potential bubble burst.

8.8. **What Kind of Regulatory Devices can Eliminate ‘Rating Inflation’ by Rating Agencies?**

The subprime crisis exposed an important conflict of interest between the public interest on one hand and securitizers and rating agencies on the other. Securitizers have an interest in embellishing the prospects of the financial assets that they package. Since rating agencies were paid by securitizers they obviously had an interest in partially catering to those incentives of their clients within limits determined by the requirement that this did not visibly affect their ex ante credibility. The problem was compounded by the fact that regulators were using the same ratings to measure the risk levels assumed by regulated financial institutions –

\(^{13}\) Details appear in Macciocchi et al. (2008).
thus adding an official stamp of respectability to the biased ratings (Cukierman (2011))\textsuperscript{14}.

Calomiris (2011) argues that the pressure to inflate ratings came from institutional investors because it reduced the amount of capital they had to maintain, increased the flexibility of their investment policy and increased their risk-adjusted profitability in the eyes of less sophisticated investors by making it appear that an AAA rated investment is earning an AA-rated return. He argues convincingly that any solution to the consequent distorted structure of incentives must make it profitable for rating agencies to issue high quality, non inflated ratings in spite of the demand for inflated ratings by institutional investors and some politicians.

To achieve this objective Calomiris proposes that all agencies wishing to qualify as Nationally Recognized Statistical Ratings Organizations (NRSROs) – the rating agencies whose ratings are used in regulation - should submit ratings that link letter grades to specific default probabilities. Once the rating is equated with a number it is possible to hold the issuing agency accountable for any discrepancy between the fraction of ex post default and the fraction predicted ex ante. To induce rating agencies to produce their best ex ante forecasts this should be accompanied by a schedule of penalties to be imposed when ratings are persistently exaggerated. The penalty could involve a temporary removal of the NRSRO license or a ‘claw back’ on fees earned. To enforce the second penalty agencies would be required to post some of their fees as a ‘bond’ to draw upon when ratings turn out to be excessively biased.

I should add to the above proposal that in order to prevent forbearance on the part of the authorities in charge of regulating the rating agencies the schedule of penalties should be established in advance and applied automatically. In extreme cases regulators could be given some discretion to waive the automatic penalty. However in such cases they should simultaneously explain why they deviate from automatic application of the penalties. In Goodhart’s words “comply or explain”.

S.9. **Concluding Reflections on Regulatory Reform and the Role of the Central Bank in the US and the Eurozone**

The global financial crisis has triggered a process of regulatory reform in most if not all areas with major financial centers. Although regulatory reform through the legislative process is more advanced in the US than in the Eurozone (EZ) doubts about its effectiveness remain. The US reform is encapsulated in the gigantic Dodd-Frank Act of July 2010 (Dodd-Frank Act). The Act creates a Financial Stability Oversight Council (FSOC) made up of 10 federal financial regulators including the Federal Reserve Board and chaired by the Treasury Secretary. The Council is charged with identifying and responding to emerging risks throughout the financial system.

The Council majority has very broad powers including setting rules for capital, leverage and liquidity management, requiring large complex financial companies to divest some of their holdings if considered to be systemically dangerous and create orderly liquidation mechanisms through living wills for such institutions. Among the ten regulators the Federal Reserve and the FDIC are assigned particular roles – the Fed to regulate a non bank financial institution if the Council believes it poses systemic risks and the FDIC to unwind SIFIs.

Critics of the Act argue that it is overly complicated, that does not adequately address regulatory forbearance and that the fact that, for some issues, corrective actions have to be approved by at least seven independent regulators may impede the prompt deployment of corrective measures when such measure are needed (Barth, Caprio and Levine (2012)). Furthermore, since it is often the case that the Act leaves many specific issues for further determination by the Council the scope for discretion leading to forbearance is wide. In view of the political clout of the US financial sector and the fact that the Council is chaired by the Secretary of the Treasury (a political figure) this concern is no small matter.

Calomiris (2011, p. 52) argues convincingly that regulatory reform should be “incentive-robust”. An incentive robust reform has to satisfy two main criteria: (i) Financial institutions should find it difficult to circumvent it via regulatory arbitrage. (ii) Supervisors, regulators and politicians should have incentives to enforce it\textsuperscript{15}. Whether the Dodd-Frank Act will live up to those criteria in practice remains to be seen.

Although various institutions like the European Stability Mechanism (ESM) are in the process of being established and there is talk of a “banking union”, regulatory reform in Europe is lagging behind that of the US\textsuperscript{16}. Regulatory reform in Europe is burdened by two main difficulties. First, in spite of initial attempts at unification, regulatory and supervisory authorities in the EZ operate at the national levels. A second, not unrelated, difficulty is that the charter of the ECB

\textsuperscript{14} The recent discovery of Barclays Bank feeding biased data into the construction of the Libor index is a vivid reminder of the fact that, in the absence of appropriate safeguards, the incentives for misreporting are quite strong.

\textsuperscript{15} Calomiris (n.c.) proposes ten specific devices to achieve such an incentive robust regulatory reform.

\textsuperscript{16} In November 2010 the European Parliament and the Council established the European Banking Authority (EBA) to monitor Europe’s biggest banks. In line with this mandate the EBA conducted stress tests but failed to predict the current Spanish debt problems. This is now catalyzing German and French support for transferring this function to the ECB.
makes it responsible for price stability in first place, while the responsibility for financial stability resides mainly with the national regulators.

Nonetheless, in spite of its lexicographically mandated focus on price stability, the ECB recently demonstrated that when push comes to shove it is willing to perform the lender of last resort (LLR) function and to inject substantial amounts of liquidity into the economy. Two recent illustration of this growing tendency are the Long Term Refinancing Operation (LTRO) that offered up to one Trillion Euros of three years loans to EZ commercial banks and the Outright Monetary Transactions (OMTs) in secondary markets for sovereign bonds in the euro area. The second programs opens the door for unlimited purchases of sovereign bonds by the ECB.

As argued in section 8.6 the informational and other synergies between regulation and aggregate monetary policy in the face of systemic risk imply that concentration of regulation as well as monetary policy within the central bank is likely to increase the efficiency of both monetary policy and regulation. An added benefit is that, since many central banks already enjoy high levels of independence, transfer of regulation/supervision into the central bank is likely to automatically raise the autonomy of those authorities.

Those general principles apply, in particular, to the ECB. Circumstances have forced it to reluctantly act as a lender of last resort and in some cases also as a market maker of first resort. Engaging in such activities without having regulatory authority in the individual countries has already distorted some of the ECB’s precautionary safeguards as national regulators in some countries allowed ECB money to be diverted toward institutions that the ECB would not have lent to directly (Bini Smaghi (2013)).

Importantly, the existence of SIFIs at the European level requires at least an EZ wide authority in charge of regulation and supervision of the financial system at the same level. The ECB is the natural institution to perform this function. Even if, due to the large varieties in institutional structures across countries within the area, detailed implementation is left to local regulators and supervisors the ECB should take the lead in devising and implementing those functions. Due to its monopoly over the creation of liquidity the ECB is also the natural candidate to act as a lender of last resort in the face of a financial crisis17.

Ex ante regulation and supervision by the ECB should be aimed at minimizing the likelihood of contagion and the associated financial panics. However in the (hopefully) few cases in which such panics materialize the ECB will have to perform the lender of last resort function. This implies that the financial stability objective in the ECB charter better be elevated to a status similar to that of the price stability objective.

REFERENCES


17 Ayadi et al. (2012) have recently found that, depending on the risk structure of their assets and liabilities, European banks can be classified into four types of business models. Based on these findings they call for the establishment of a European regulatory structure that would recognize those differences. Implementation of such a regulatory structure at the European level obviously requires a centralized European authority. Hence again the ECB is the choice institution for performing this function.
9. GAPS AND WISHFUL THINKING IN THE THEORY AND PRACTICE OF CENTRAL-BANK POLICYMAKING

Edward J. Kane

Of men who have a sense of honor, more come through alive than are slain, but from those who flee comes neither glory nor any help... Ajax in The Iliad

Roles played by fear and disinformation and authorities’ response to them are major gaps in conventional theories of crisis management. This is despite the fact that, in the midst of a crisis, the central goal of lobbyists for distressed firms and their various creditors is to magnify governmental fears as a way to secure bail-outs.

Detailed descriptions of the 2008 industry and governmental crisis-management environments painted by Bait (2012) and Sorkin (2010) depict a virtual epidemic of fear. While it is often said that fear makes cowards of us all, this is an overstatement. What fear does do is to increase the attraction of myopic actions over sounder, but immediately painful ones. In Europe and in the US, central bankers characterized themselves as wrestling in timely fashion with macroeconomic and financial forces that threatened to destroy prosperity as we know it. But arguably, in the months leading up to the crisis, authorities’ fear that tougher supervision might engender political, bureaucratic, and career punishments intensified the forces they had to deal with. Supervisory forbearances extended the lives of bubbles in housing and in shadowy forms of financial transacting and this extension aggravated the effects that the crisis-generating bursting of these bubbles had on the real economy (Kane, 2012b). The problems that authorities feared came from the capacity of affected parties to mischaracterize needed discipline as profit-destroying overregulation. Fear of embarrassment led authorities to tolerate (and even to encourage) misrepresentation of Libor rates for years on end and to neglect the buildup of risk in seemingly profitable firms such as the American International Group (AIG). The result has been a slow breakdown in the ethics of financial management and government service. Regulatory complicity in the resulting flow of safety-net subsidies is rationalized politically by the unproven and increasingly unconvincing claim that elite financial institutions are economi-

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