It Takes a Village to Maintain a Dangerous Financial System

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Abstract: I discuss the motivations and actions (or inaction) of individuals in the financial system, governments, central banks, academia and the media that collectively contribute to the persistence of a dangerous and distorted financial system and inadequate, poorly designed regulations. Reassurances that regulators are doing their best to protect the public are false. The underlying problem is a powerful mix of distorted incentives, ignorance, confusion, and lack of accountability. *Willful blindness* seems to play a role in flawed claims by the system's enablers that obscure reality and muddle the policy debate.

1. Introduction

"If it takes a village to raise a child, it takes a village to abuse a child."[1]

The financial system is meant to facilitate efficient allocation of resources and help people and businesses fund, invest, save and manage risks. This system is rife with conflicts of interests. Reckless practices, if uncontrolled by market forces and effective rules, can cause great harm. Most of the time, however, the harm from excessive risk in banking is invisible and the culprits remain unaccountable. They rarely violate the law.

In this chapter I focus on the excessive use of debt in banking that creates unnecessary fragility and distortions. The Great Financial Crisis of 2007-2009 exposed the ineffectiveness of the relevant regulations in place at the time. Yet even now and despite the crisis, the rules

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[1] This chilling statement is made by a lawyer who represented many victims of sexual abuse by Catholic priests in Boston in the 2015 movie "Spotlight." Child abuse persisted because abusive priests were re-assigned, victims were silent or agreed not speak publicly about the abuse, and others collaborated to keep the problem hidden from authorities and the public for years. Pervasive child abuse had been covered up in many other locations as well.

remain inadequate and flawed. Policymakers who repeatedly fail to protect the public are not accountable partly because false claims obscure reality, create confusion and muddle the debate.

It is useful to contrast safety in banking and in aviation. Tens of thousands of airplanes take off, fly and land daily, often simultaneously within small geographical area. Yet, crashes are remarkably rare. It takes many collaborating individuals, from engineers and assembly workers to mechanics, airline and airport employees, air controllers, and regulators, to achieve and maintain such safety levels. In banking, instead, there are strong incentives to take excessive risk; banks effectively compete to endanger. The victims are dispersed and are either unaware of the endangerment, misled into believing that the risk is unavoidable or that reducing it would entail significant cost, or they are powerless to bring about meaningful change. Most of those who collectively control the system benefit from its fragility or choose to avoid challenging the system, effectively becoming enablers.

Society's interest in aviation safety is aligned with the incentives of those involved in maintaining it. Crashed planes and dead passengers are visible to the public and easy to understand. Airplane manufacturers and airlines stand to suffer losses from compromising safety. Radars, flight recorders and other technologies uncover the exact cause of most plane crashes, and those responsible face consequences. Screening procedures try to prevent terrorist attacks. The fear of being directly responsible for deaths prevents individuals involved in maintaining safe aviation from failing to do their part.

In banking, the public interest in safety conflicts with the incentives of people within the industry. Protecting the public requires effective regulations because market forces fail to do so. Without effective regulations, dangerous conduct is enabled and perversely rewarded. Because the harm is difficult to connect to specific policy failures and individuals, it persists. Even if a crisis occurs, the enablers of the system can promote narratives that divert attention from their own responsibility and from the fact that much more can be done at little if any social cost to make the system safer and healthier. The narrative that crises are largely unpreventable shifts attention to emergency preparedness and away from better rules to reduce the frequency of emergencies in the first place.

Compromising safety when accountability is diffuse is not unique to finance. In a recent example, General Motors failed to recall cars with faulty ignition that could cause fatal accidents. Many employees knew about the problem, yet failed to act to prevent the harm. The

corporate culture promoted silence, obfuscation and unaccountability, and there were strong incentives to cut costs and sacrifice safety (see Valokas 2014 for an extensive analysis).

Harm and endangerment might be denied and obscured for extended periods of time. Tobacco companies denied the addictiveness of nicotine and the harm from cigarettes for decades (see e.g. Nestle 2015 and Oreskes and Conway 2010). The U.S. National Football League spent years denying the harm from concussions (see Fainaru-Wada and Fairaru 2013 on the "league of denial"). Companies selling children's products sometime endanger lives by compromising safety and obscuring known problems even after dangerous products are recalled (Felcher 2001). In some cases, overwhelming evidence eventually exposes the truth, as happened for cigarettes.

Governments have the role of creating and enforcing rules for the safety of roads, buildings, water, air, foods, medicines, etc. When governments fail in this role, the results can be devastating. One example is the preventable nuclear disaster in Japan in 2011. Despite a report that exposed the deep regulatory capture at the root of the disaster, little has changed since (see Ferguson and Janson 2013 and Green 2015). In 2014, the U.S. Department of Veterans Affairs was rocked with a scandal involving phony wait times that delayed access to treatment and benefits to many eligible veterans. It has struggled with accountability issues since (Boyer 2016). In a recent scandal in the U.S., lead-contaminated water flowed for months into the town of Flint, Michigan, causing serious and long-lasting health problems for many. State officials had ignored and failed to respond to repeated complaints. Michigan law shields decision-makers from public scrutiny, making it difficult to hold individuals responsible for the harm accountable (Clark 2016).

Designing appropriate rules requires professional expertise. Experts, however, may provide biased or flawed advice. Sometimes experts are paid by interested parties to help tilt the rules in specific ways. Even supposedly neutral academics and other experts may provide poor policy guidance. For example, medical research about drugs and medical devices can get corrupted when pharmaceutical companies are involved in funding research or employ researchers or policymakers. In one case involving a spinal fusion product, researchers paid by the manufacturer suppressed serious side effects (Meier 2012). In another, members of the Food and Drug Administration (FDA) in U.S. had direct ties with manufacturers that created conflicts of interest (Lenzer and Epstein 2012).

Flawed claims may resonate with politicians, the media, and the public (see Oreskes and Conway 2010 and the 2014 movie "Merchants of Doubt" and Nestle 2015). In finance, research based on inappropriate assumptions is used to support bad policy without proper scrutiny. Seeing the flaws is often difficult for non-experts. The issues appear complex, the jargon is confusing and the technical details are intimidating.

Many aspects of the financial system in developed economies are unjust because they allow powerful, better informed people to benefit at the expense of people who are less informed and less powerful. The injustice can be described from a number of perspectives. First, the system contributes to distortions in the distribution of income and wealth, as some of those who benefit from it are among the most privileged members of society, while those who are harmed include the poorest. Second, by allowing the privatization of profits and the socialization of losses, the financial system distorts basic notions of responsibility and liability. Financial crises affect employment and the economic well-being of many segments of society, but those who benefit most from this system and who enable it tend to suffer the least harm. The persistence of this unjust system illustrates how democracies sometimes fail to serve the interest of the majority of their citizens.

In the next section, I explain briefly the key issues related to capital regulations. I proceed in Section 3 to describe the actions and motivations of those who enable the failure of the regulation. Section 4 illustrates how ignorance, confusion and willful blindness contribute to the situation and how flawed narratives obscure the issues and muddle the debate. I conclude in Section 5 with reflection on what might bring about positive change.

2. Other People's Money

> "Traders risk the bank's capital.... If they win they get a share of the winning. If they lose, then the bank picks up the losses.... the money at risk is not their own, it's all OPM --- other people's money.... Traders can always play the systemic risk trump card. It is the ultimate in capitalism --- the privatization of gains, the socialization of losses.... Traders are given every incentives to take risk and generate short-term profits."[2]

[2] Das 2010, 151, in describing the system of incentives for derivatives traders who risk the bank's capital and are able to benefit on the upside and share downside with the bank shareholders, or with the public by playing the "systemic risk trump card."

Business corporations use money from investors in exchange for financial claims such as debt or shares of equity. Outside banking, it is rare for healthy corporations, without any regulations, to fund more than 70 percent of their assets by borrowing, even though corporate tax codes typically favor debt over equity funding.[3] (Specific ratios depend on how assets and debts are measured.) Profits are a popular source of unborrowed funding, and some highly successful corporations, such as Google or Apple, borrow little.

Heavy borrowing increases the likelihood of costly bankruptcy and creates conflicts of interest that distort decisions when managers and shareholders act in their own interests even if assets get depleted and lenders or others are harmed. Once debt is in place, borrowing can become addictive and excessive as the borrower-lender conflict intensifies. To protect their interests, lenders may charge high interest and attach costly and restrictive loan conditions. As a result, heavy borrowing becomes unattractive for most corporations (see Admati et al. 2013, 2015 and Admati and Hellwig 2013a and 2015).

In banking, heavy borrowing is less burdensome than elsewhere, because banks' lenders (such as depositors) are unusually passive and do not impose harsh terms even if banks take significant risk that endangers their ability to pay their debts. Depositors trust that the government (or a deposit insurance fund) will pay them if the bank cannot. Lenders who can seize some of the banks' assets ahead of depositors also feel safe lending to banks under attractive terms.

Since many financial institutions are exposed to similar risks and interact extensively with one another, the financial system can become fragile and prone to crises when institutions are funded almost exclusively with debt. Fears of contagion or "systemic risk" lead governments and central banks to offer supports and bailouts that prevent the default of banks and other institutions. Whereas supports and bailouts prevent default, banks are often allowed to persist in an unhealthy state of distress and possible insolvency for extended periods of time, which distorts their decisions and makes them inefficient or dysfunctional (Admati and Hellwig 2013a, chap. 3, 11). Bailouts and supports help institutions to pay their debt in full, often to counterparties within the financial system itself, as happened with insurance company AIG.

[3] This preference of debt over equity is highly distortive and has little if any economic justification, particularly for corporations (e.g., Fleischer 2011). Subsidizing debt is particularly perverse in banking, but harmful more generally (Hirshleifer and Teoh 2009 and Economist 2016).

Explicit and implicit guarantees, combined with tax subsidies of debt, exacerbate and feed banks' already strong addiction to debt. Shareholders and managers avoid the unpleasant consequences of bankruptcy. Without effective regulations, the public perversely subsidizes and rewards excessive borrowing and risk in banking and suffers the harm of the resulting fragile and unhealthy system (Admati and Hellwig, 2013a, chap. 4-6, 9, and Admati et al., 2015, Section 6). An analogy would be subsidizing trucks to drive at reckless speed even as slower driving would cause fewer accidents and be more efficient for the engine, or subsidizing chemical companies to pollute when they have an equally costly clean alternative. Even if some of these subsidies lower the price of chemical products or allow cheaper deliveries, the public pays for the subsidies (thus for any such "benefits") while also suffering the collateral harm of the accidents or pollution.

Excessive fragility and inadequate safety rules have always affected banking. As governments created central banks and deposit insurance and thus allowed banks more privileged access to debt funding, equity levels declined consistently (Hoenig 2016). The problem has gotten more severe in recent decades. Financial innovations such as securitization and derivatives, which can be used to manage risk, have enabled financial firms to take more risk while hiding this fact within the increasingly complex and opaque global system. As privileged access to funding and opportunities to hide risk expanded, regulations and disclosure rules failed to keep up and counter the distorted incentives. These developments, and the risk culture that has evolved in banking since the 1980s, are discussed in, for example, Admati and Hellwig 2013a, Das 2010, Dunbar 2011, Fraser 2015, Hill and Painter 2015, Lewis 1980, 2010, Luyendijk 2015, and Partnoy 2009, 2010.

Institutions considered too big to fail are particularly dangerous because they have an incentive to, and can, become inefficiently large, complex and opaque. It seems to have become difficult or nearly impossible to manage and regulate them effectively (Admati 2014, Admati and Hellwig 2013a, chap. 8-9 and 13; Kay 2015; Norris 2013; and Jenkins 2015a, 2015b).[4] Alistair Darling, the British chancellor of the exchequer during the Great Financial Crisis, says in his memoir: "[The top management in banks both here and in the US] didn't understand what they were doing, the risks they were taking on, or, often, the products they were selling

[4] See also the chapters by Reiff and Cullen respectively in this volume on the problems of legal enforcement in the financial industry.

… [they] failed to understand – or even ask – what was apparently making them so much profit and what were the risks" (quoted in Luyendijk 2015, 154-155).

Small banks also need effective regulations. They too can become inefficient, dangerous, and dysfunctional at the same time, thus harming the economy or needing bailouts. Examples include the Savings and Loans crisis in the US in the 1980s, banks in Japan in the 1990s, and, more recently, in Spain and Italy (Admati and Hellwig 2013a and Treanor 2016).

Contrary to claims by many, the reformed capital regulations are overly complex, dangerously inadequate and poorly designed. They are not based on a proper analysis of the costs and benefits of different approaches and fail to reflect key lessons from the crisis and the true relevant tradeoffs (Admati et al 2013, Admati and Hellwig 2013a, 2015).[5] International minimum standards allow banks to fund as little as 3 percent of their assets by equity, and the details of how this ratio is determined are subject to lobbying and debate. The measures of financial health used by regulators are unreliable and can lull regulators and the public into a false sense of safety, just as happened prior to the Crisis. They still count on problematic accounting rules, credit ratings, and complex "risk weights" that give the pretense of science while in fact being distortive, political, and counterproductive.[6] Banks are allowed, indeed encouraged, to persist in a permanent state of excessive, inefficient and dangerous level of indebtedness.

Many banks failed or needed bailouts during the Great Financial Crisis from investments that regulators had viewed as perfectly safe. In response to the design of the regulations, banks had incentives to "innovate" in ways that exacerbated the fragility and complexity of the system. The recent Greek debt crisis is partly the result of bad capital regulations. European banks made excessive loans to the Greek government prior to 2010 using only debt funding. Regulators also still count debt-like securities as "loss absorbing" even though equity provides much more reliable loss absorption at no higher cost to society. Derivatives markets continue to add fragility to the system despite recognition and some attempts at better regulation.[7]

[5] For materials on these issues, see website entitled "excessive leverage and risk in banking" https://www.gsb.stanford.edu/faculty-research/excessive-leverage.

[6] On accounting issues see Partnoy and Eisinger 2013. On models, see Behn et al. 2014, Dowd 2015, and Rajan et al. 2015. Risk weights tend to be biased in favor of governments and against traditional business lending (Admati and Hellwig 2013a, chap 11).

[7] Much of the effort to regulate derivatives has focused on forcing at least some of the trade into central clearing houses. However, it is still unclear whether this effort has significantly reduced the overall risk from derivatives; see, e.g., Persaud 2015

Admati and Hellwig 2013a, chap. 11 provides specific recommendations for improving capital regulations, including steps that can be taken immediately. Our proposals and similar calls by others have led to more discussion of the issues, but the actual impact has been rather small. Society is made to tolerate an inefficient and dangerous system because policy-makers contribute to and fail to counter distorted incentives and ability to endanger.

The main beneficiaries from this situation are managers and executives in banks and other financial institutions, who have access to cheap funding and enjoy magnified profits and bonuses during prosperous periods, often while suffering little on the downside (Admati and Hellwig 2013a, chap. 8-10 and Kay 2015, Admati 2015. Admati 2012, Bhagat 2016 and Bhagat and Bolton 2014). Auditors, credit rating agencies, law firms, consultants and lobbyists are offered many profitable opportunities from overly complex rules.

Those who manage other people's money in institutions such as pension funds and mutual funds also tend to benefit on the upside and have little to lose if they take risk for which their investors or clients are not properly compensated. These institutions may not be run fully in the interests of the small investors whose money they invest (Bogle 2005 and Jung and Dobbin 2012), and may prefer to collaborate with banks; indeed, they may be partly owned or sponsored by banking institutions. Other enabler, as discussed later, benefit from the current rules or have reasons to avoid challenging the status quo.

The main losers from this system are taxpayers and the broader public. Those lured into borrowing too much in a credit boom face harsh consequences when boom turns to bust, and the economy is harmed by an unstable financial system that does not allocate resources efficiently (Taylor 2015). The harm, however, is diffused and difficult to connect to actions or inaction by specific individuals, and it persists because of a powerful mix of distorted incentives and pervasive confusion.

3. Many Enablers

> "Banks are still the most powerful lobby on Capitol Hill; and they frankly own the place."[8]

It takes many collaborating individuals, each responding to their own incentives and roles, to enable a dangerous financial system. Who are the enablers and what are their motivations?

[8] The quote is from an interview of Senator Richard Durbin; see Durbin 2009. Note that it was made shortly after the financial crisis.

As we discuss in this section, enablers work within many organizations, including auditors and rating agencies, lobbying and consulting firms, regulatory and government bodies, central banks, academia, and the media.

The enablers have reasons to defend the system and the regulations and to avoid challenging the financial industry and each other. Their actions, or failures to act, endanger and harm the public even as some of them are charged with protecting the public and most claim and are believed to act in the public interest. Some enablers are confused or misinformed, but as discussed later, the confusion is often willful.

Most companies and organizations employ an auditor, and many regulations require credit ratings from one of very few approved agencies. Four audit firms and three rating agencies are the main providers of these certification services. Regulators and some investors treat auditors and rating agencies as if they were neutral watchdogs interested in producing the best information, but these are in fact profit-seeking companies with little if any accountability to the public, and whose interests are not fully aligned with the public interest. Their consulting business may involve advising regulated institutions about compliance. They also count the regulatory bodies themselves as clients for audits and even consulting.[9] These private watchdogs benefit if they collaborate with rather than challenge their clients. As a result, the information they produce can be distorted and misleading.

Accounting rules and risk models used in regulations allow significant discretion. Exposing fraud in disclosures or flaws in models can be costly for individuals throughout the financial system or within watchdogs and regulatory bodies. Whistleblowers are often ignored or fired, and they are likely to lose career opportunities.[10]

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[9] Shah 2015 focuses on distorted incentives in auditing and their work with banks and regulators. Consistent accounts are included in Das 2010 and Luyendijk 2015. Partnoy (2009, 406) says: "regulators gave lots of power to private watchdogs or gatekeepers such as accounting firms, rating agencies, law firms even as their record in assessing and reporting risk has been abysmal. The gatekeepers benefit dramatically and can make more money biasing their reports, hiding risk in footnotes." He also describes how accounting rules for derivatives hide enormous risk. Admati and Hellwig 2013a, chap 6 discusses the risks lurking around the "fortress balance sheet" of JPMorgan Chase. Partnoy and Eisinger 2013 analyze the opaque disclosures of Wells Fargo Bank. Kerr 2011 discusses banks' ability to manipulate regulatory measures. Ramanna 2015 describes the politics of accounting standards setting. On rating agencies, see also White 2010, Morgenson 2016 and Chapter 11 (de Bruin, this volume).

[10] On whistleblowers, see Kenny 2014, Sawyer et al. 2010, Shah 2015, and Cohan 2013. Legal protections for whistleblowers vary across nationality and are sometimes quite poor.

Laws and regulations are written by politicians and regulators within national borders. Because financial markets are highly connected across borders, international bodies attempt to coordinate the rules and set minimal standards, leaving details and implementation to each jurisdiction.[11] In these international bodies, far from the public gaze, politicians and regulators often champion "their" institutions even if their citizens are endangered and harmed.[12]

Regulatory dysfunction is often associated with the notion of "regulatory capture." One cause of capture is the "revolving doors" where the same people rotate their roles within institutions in the financial system, politics and regulations, and other organizations, including the media. Connaughton (2012, loc. 459), who worked in policy and as a lobbyist, describes Washington DC as

> a place where the door between the public sector and the private sector revolves every day. A lawyer at the SEC or Justice Department leaves to take a position at a Washington Law firm; a Wall Street executive takes a position at the Treasury Department. The former will soon be defending the Wall Street executives his old colleagues are investigating; the latter will soon be preventing (or delaying or diluting) any government policy that Wall Street doesn't like.

Government officials and staff routinely proceed to take positions in the financial sector, lobbying or consulting firms, or think tanks sponsored by companies. Government positions are often filled by people currently in the financial sector.[13]

Revolving doors contribute to excessive complexity of regulation, because complexity provides an advantage—and creates job opportunities—to those familiar with the details of the rules. Complexity also opens more ways to obscure the flaws of the regulations from the public

[11] Examples include the Basel Committee on Banking Supervision https://www.bis.org/bcbs/ and the Financial Stability Board http://www.fsb.org/.

[12] For description of some of the dynamics in the Basel Committee, see Bair 2012. Admati and Hellwig 2013a, chap. 12 discuss the politics of banking and especially the flawed arguments about global competitiveness and national champions. Mattli and Woods 2009 discuss the global politics of regulation.

[13] Ironically, Alister Darling, who served in the UK government during the Great Financial Crisis and was quoted earlier saying that top management in banks failed to understand or ask about risks, has recently joined the board of one of the largest banks, following his boss Gordon Brown into a career in banking (Parker and McLanahan 2015). This problem is pervasive in many countries. See Admati and Hellwig 2013a, chapt. 12.

and create the pretense of action even if the regulations are ineffective.[14] Revolving doors do not ensure, as is sometimes claimed, that people who stay in policy throughout their careers are effective regulators; they might well be at a disadvantage relative to people in the industry. The best regulators are sometimes the few who have worked in the industry and have no plans to return.

Politicians write laws, and they appoint and monitor top regulators. A safe banking system is often not politicians' top priority. Politicians may want banks to provide funding to particular industries and constituents or to help in political campaigns even if these actions put citizens and the economy at excessive risk.[15]

Implicit guarantees, for which the industry does not pay and which are ultimately funded by taxpayers, are particularly attractive for politicians as an invisible form of subsidy. Such guarantees do not appear on budgets and they create the illusion of costing no money. By the time the cost of the guarantees is incurred, politicians may already be reelected or retired. Such subsidies can be extremely distortive and wasteful, and eventually very costly for citizens. Excessively subsidized sectors of the economy can get bloated and inefficient. Blanket guarantees to large banking institutions are particularly dangerous because banks have significant discretion as to how they use the subsidized funding, and guarantees are an effective license for recklessness, even lawlessness (Admati 2014). Politicians are rarely held accountable for the harmful effect of implicit guarantees combined with poor regulations.

Capture takes many subtle forms in the context of financial regulations. Social connections, shared experiences, and lack of expertise can make policymakers inclined to accept claims made by financial experts even when the claims are false or misleading. Situations in which policymakers' worldview is strongly affected by those they interact with have been referred to as "cognitive capture" (Johnson and Kwak 2010), "cultural capture"

[14] On complexity of regulations, capture and revolving doors see Lucca et al. 2014 and McCarty 2013. On excessive complexity in capital regulations see Admati 2016a, Admati and Hellwig, 2013a, chapter 11, Bair 2012, Haldane 2012, Hoenig 2013 and Behn et al. 2014.

[15] Calomiris and Haber 2015 argue that banking is based on political bargains. Admati and Hellwig 2011, 2013a, chapter 12 discuss some of the politics of banking. Lessig 2012 and Teachout 2014 focus on money and politics in the U.S.

(Kwak 2013), “social capture” (Davidoff 2010) and “deep capture” (Baxter 2011). Prins 2014 documents the ties between presidents and top bankers.[16]

Regulators and politicians are subject to significant lobbying from interested parties as they set and implement the rules (see e.g. McGrance and Hilsenbarth 2012). Lobbying played a role in reckless lending practices that were key to the Great Financial Crisis of 2007–2009 (Igan et al. 2011, Vukovic 2011). Between 1999 and 2012, regulators in the US were less likely to initiate enforcement actions against lobbying banks (Lambert 2015), and lobbies are also involved in drafting laws (Connaughton 2012, Drutman 2015, Lipton and Portes 2013, Mufson and Hamburger 2014). In one case, part of the U.S. financial reform law passed in 2010 was reversed in 2014 as part of a budget law, with the active participation of bank lobbyists in writing the law (Eichelberger 2014). Advisory committees to regulators are often stacked with industry participants (Dayen 2016,Eisinger 2012b).

Economists and other experts become apologists for the status quo and enablers of ineffective policies when they fail to point out problems or, worse, when they provide “scientific” support that contributes to and obscures or justifies flawed rules. Some experts are employed by industry groups or sponsored organizations paid to produce specific research. Drutman (2015, loc. 942) describes how the saturation of the “intellectual environment” with claims made by experts, sometimes with PhDs, can affect policy. Even if it becomes clear later that claims made in a policy debate are false, those who had put forward the claims rarely suffer negative consequences.[17]

Research conducted within government and regulatory bodies can be tainted, especially if key individuals are affected by lobbying or political pressure. Staff economists or other experts are often expected to produce research to support pre-set policies.[18] Bureaucratic approval processes scrutinizes staff research before it becomes public. As a result, approved research

[16] See also Taub 2014, Omarova 2012 and Wilmarth 2013 on the politics of financial regulations in the U.S.

[17] Admati et al. 2013, 53f., describe an example in which flawed claims affected policy regarding an accounting rule change that was first delayed by lobbying, and after the rule was eventually changed, the threats made in the earlier lobby were shown to be wrong. Tetlock 2005 points to the lack of accountability for experts.

[18] A recent paper produced by Bank of England economists, challenged in Admati 2016a and Vickers 2016, appears to be an example.

tends to promote the "official" narratives, while research whose conclusions would contradict the preferred policy may be suppressed, possibly by the researchers themselves.[19]

Even experts considered neutral, such as academic economists, are not immune to the forces of capture (Zingales 2013, 2015). Their incentives may be colored by the desire for job or consulting opportunities, positions on advisory or corporate or policy boards, prestige, sponsorship of research or conferences, data, and research collaborations. Challenging people within the financial system or other enablers is inconvenient or costly.

The peer-review process in journals and in promotion decisions can also lead researchers to be strategic in how they cite and describe research by others. The content of conferences is often affected by sponsors, thus becoming naturally biased toward speakers and research that would not be critical of sponsors' actions. Enablers can thus control their engagement and avoid being challenged.

The 2010 movie *Inside Job* illustrated financial ties academics may have with industry (see also Carrick-Haggenbarth and Epstein 2012 and Rampell 2011). Subtle forms of cognitive capture are also relevant. It is easier and more convenient for academics and other experts to find ways to collaborate with the many other enablers and to express themselves vaguely rather than directly contradict the viewpoints favored by policymakers. When issues appear technical and confusing, claims by people considered "big shots" may resonate or even sound profound to many who do not see their flaws. [20] Making claims that serve the interest of powerful people can pay off, and with enough caveats there is little if any downside risk.

Research might also be colored by ideological and other biases. Economists can engage in "cherry-picking" data and assumptions, thus effectively "reverse engineering" results

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[19] Luyendijk 2015 discusses the codes of silence throughout the financial sector in London, including among regulators. Of course, it is difficult to assess the extent of this problem with any precision because research that is not published is usually unobservable.

[20] An example is the claim that banks "produce debt" like car companies produce cars (see Admati and Hellwig (2013a, chapter 10, 2013b, 2015, claims 5-6), which form the basis for the "liquidity narrative" discussed later. Another example is the claim that fragile debt helps banks "discipline" their managers (see Admati et al 2013, section 5, Admati and Hellwig 2013b, and Pfleiderer 2014). As explained in Admati and Hellwig 2013b, these theories give contradictory roles and motives to deposits. Models in banking literature that ignore conflicts of interest and where risk arises from uncontrollable liquidity shocks tend to promote guarantees. With guarantees in place, however, lenders cannot be assumed to collect costly information and monitor managers, as assumed critically in the "debt discipline" theories. See also note 36.

supporting a desired conclusion. Models in banking have created or promoted myths and narratives that have helped enable and maintain the dangerous system and its inadequate regulation. An analogy would be providing a "scientific explanation" for why people smoke cigarettes by a model that assumes smoking is beneficial to health and ignores the addictiveness and harm of cigarettes. Tobacco companies would obviously want to promote such "research" and policy-makers may cite it in justifying policies that are more tolerant of smoking.

Writing clever mathematical models and elaborate empirical studies is valued and rewarded within economics. The desire to motivate and present research as relevant for the real world and for policy can blind researchers to the possibility that the model's conclusion may depend critically on implausible or false assumptions and thus be inadequate for such applications. Just as a bridge built on faulty assumptions may be prone to collapse, the use of inadequate models in banking regulations can support reckless practices and dangerous and flawed laws and regulations.

In cases like the addiction and health risks of cigarette smoking, overwhelming evidence may eventually expose reality and overcome industry denials. In banking, flawed and unsupported narratives and myths, sometimes dressed in impenetrable mathematics and technical details, are maintained and taken as the basis of flawed empirical analyses.

Some models in banking, for example, assume that risk is out of anybody's control, stemming entirely from "liquidity shocks" or sudden panics. Such models ignore and deny risks that are the result of conflicts of interests and inadequate regulations, where people with more information, power and control benefit while harming others with less information, power and control. Other models assume that depositors collect information and monitor bankers' behavior, ignoring the dampening effect of deposit insurance on depositor monitoring incentives, and the possibility that shareholders might do the same and have more incentives to do so. The possibility that banks might increase their reliance on equity is often ignored entirely. Some theoretical models assume, inappropriately, that banks are owned entirely by their managers. Yet others assume that equity funding is scarce and "expensive" for banks even as banks can use their profits as a source of equity and generally have access to the same investors that provide equity to other viable companies. In fact, as discussed earlier, banks have as little equity as they do because the people who control them prefer this situation and because failed markets and regulations allow them get away with it.

Pfleiderer 2014 provides an insightful discussion of the potential misuse of models in finance and economics Using specific examples from banking and elsewhere he argues forcefully that having a particular model does not necessarily mean we understand anything useful about the economy. Admati et al. 2013, 2015, Admati and Hellwig 2013a, 2013b, 2015, Admati 2016a, b, Kay 2015, Vickers 2016 also challenge models and studies related to banking that make inappropriate assumptions and ignore important parts of reality and basic economic forces. Flawed research and narratives help enablers justify their actions and avoid accountability.

Central banks play a critical role in the financial system and in the economy, and this role has expanded dramatically during and since the Great Financial Crisis. They are often involved in designing and implementing regulations and among their key roles is providing "liquidity supports" to banks and sometimes to other financial institutions so as to prevent defaults. Institutions that have access to such supports are able to borrow more easily than they would otherwise. By providing excessive supports, central banks enable weak, even insolvent "zombie" institutions that are dysfunctional and do not help the economy, to persist for extended periods of time. Among the benefits of ensuring that banks are safer and less opaque is that they would be less likely to run into liquidity problems. Because central bank supports are loans, the supports do not reduce indebtedness; if central banks lend at below-market rates, the loans provide hidden subsidies to commercial banks and other firms.

Whereas they are meant to be independent, central banks are subject to political pressure (e.g. Conti-Brown 2016 and Nyborg 2016). Their decisions regarding whether and under what terms to provide support are often made with little if any scrutiny. The supports can obscure not only banks' weakness but also the failure of regulators (sometimes within the central bank itself) to intervene early and reduce the likelihood of banks needing supports. Excessive interventions by central banks distort markets, and dysfunctional banks interfere with other central bank objectives (Gambacorta and Shin 2016). These issues are often ignored.

Although financial instability and excessive subsidies to the financial sector distort the broader economy, few business leaders speak up on financial regulations. Some may be unfamiliar with the issues, believe that regulatory reform is not working, or are inclined to view regulations as bad in themselves. Business leaders may also prefer to avoid challenging financial firms or policymakers whose collaboration may be useful.

Some nonprofit groups, as well as a few politicians, regulators and others try to provide counterweight to the banking industry and enablers of poorly designed regulations (see, e.g., Lowrey 2012), but they are unable to match the enormous resources, power and collective influence of the industry and its enablers. The details of the regulations are complex, and it takes significant expertise to evaluate the rules and to respond properly to the many claims that are made. Getting access to policymakers and having an impact on their decisions is challenging.

Democratic governments should ultimately be accountable to citizens. Policy failures can persist, however, if citizens are unaware of the problem, confused about the issues, or powerless to bring about change. Enablers often come from across the political spectrum, leaving citizens few if any choices of effective advocates. Financial regulation is often not a salient topic in political campaigns. Even when there is anger about the financial system (as is the case currently in the U.S.), some key issues are not well understood.

The media can play an important role in informing and educating the public and improving accountability. For example, media has exposed corporate fraud (Dyck et al., 2010), the effect of money on politics (Grim and Blumenthal 2015), how the Fed ignored calls to avoid allowing bank dividends (Eisinger 2012a) and central bank actions that would otherwise remain secret.[21]

News and commentary, however, may get distorted. Most media companies are for-profit businesses. In an extreme example, a newspaper avoided covering a story to protect advertising revenue (Osborne 2015). The interests of media owners, and even their lenders, may also affect coverage (Zingales 2016). Investigative reporting has declined because it can be expensive and adversarial (Starkman 2014).

Most of the time, the impact of private interests on news media is subtle. The same forces that cause cognitive and other forms of capture also operate here. One important factor in news media is reporters' need for access to sources of news and stories, which brings them in frequent contact with those they cover (see e.g. Luyendijk 2015, chap 9). Publishing negative reports, or asking challenging questions, can interfere with access to stories or interviews. "Balanced" reporting may involve quoting false or misleading statements from industry or enablers (e.g. Oreskes and Conway 2010 and Admati and Hellwig 2013a, 2015, note 3).

[21] Ivry et al. (2011) is the result of Bloomberg News fighting in court to obtain detailed information about supports given by the Federal Reserve to hundreds of institutions in 2007-2009. Lawmakers were not fully aware of these supports as they debated financial reform.

Editorial decisions about topics, content, and prominence of news and commentary can have important impact on public perception and policy. Those who make such decisions face implicit and explicit pressures from individuals and organizations keen to have favorable coverage and prevent unfavorable coverage, and who seek to use the media to promote their image and views. People and institutions with significant power, status, and name recognition tend to be more successful in impacting media. Utterances by "important" individuals are reported as news, and these individuals are interviewed and quoted frequently with little if any scrutiny. Power and status also enables easier access to opinion pages where desired narratives can be promoted.

If the news media gives more access and coverage to the industry and its enablers, and if it echoes rather than challenges flawed claims and fails to clarify issues in investigative reporting or commentary, it helps maintain or exacerbate confusion and diffuse accountability. Sometimes reporters or commentators accept claims made by people considered experts because examining the claims' validity requires expertise that reporters lack. When media is used to explain the issues properly, it can elevate the discussion and help the public.[22]

Media coverage obviously responds to news, evolving voices of important individuals, and political development. For example, in the UK John Vickers, who headed an Independent Commission on Banking in 2011, made news in early 2016 in a series of op-eds and interviews, claiming that the Bank of England is too lenient in its equity requirements for the largest banks (Vickers 2016). Reporting on these developments, Chu 2016 explained the issues. Financial regulations and the excessive political influence of the financial sector are discussed in debates and the media in the 2016 US election (at least in the Democratic party primaries). New voices generate debate on too-big-to-fail banks (Applebaum 2016) and on "financialization" (Foroohar 2016, Emba 2016).

By contrast, there is virtually no public understanding in Europe of the role of poor banking regulation in encouraging banks in Germany, France, Switzerland, and elsewhere to make excessive and reckless loans to the Greek government over the previous decade by assuming that such loans are perfectly safe and requiring no equity funding to make them. Losses from the excessive lending to Greece will be mostly borne by citizens across Europe, while the banks who had made the loans were effectively bailed out before transferring them to official sector bodies and the ECB (Steil and Walker 2015). The media has not helped bring the role of flawed

[22] See e.g., media mentioned in http://bankersnewclothes.com/media/ .

and dangerous banking regulation to the public's attention. The industry and policymakers have been able to keep it obscure, thus escaping accountability and preventing or delaying improvements.

4. Spin and Narratives

> "The few who understand the system will either be so interested in its profits or be so dependent upon its favors that there will be no opposition from that class, while the great body of people, mentally incapable of comprehending the tremendous advantage that capital derives from the system, will bear its burdens without complaint, and perhaps without even suspecting that the system is inimical to their interests."[23]

The distorted incentives and power of those who control the financial system do not fully explain the failure of financial regulations. Confusion and misunderstandings interact with distorted incentives and play an important role. Miller and Rosenfeld 2010 argue that the Great Financial Crisis was caused by "intellectual hazard," which they define as "the tendency of behavioral biases to interfere with accurate thought and analysis within complex organization, thus interfering with the acquisition, analysis, communication, and implementation of information both within an organization and between an organization and external parties" (ibid., 808; see also Fligstein et al. 2014). The discussion in the previous section illustrated some of the narratives enablers use to justify their actions. The financial system is dangerous and ineffectively regulated largely because the industry and the many enablers get away with their "spin" on reality and on specific issues.

Powerful people are not immune to confusion and to putting trust in people who may be conflicted or misinformed. Anecdotal evidence and discussions with many insiders suggest that "blind spots" about key issues related to banking and finance are pervasive. People are reluctant to question the assumptions behind convenient narratives and to engage with alternative and less convenient ones. They often display "motivated reasoning" (Kahan 2016) and variations

[23] The text is attributed to a letter from the Rothschild Brothers of London to associates in New York in 1863. The Rothschilds were a major banking family in the 18th and 19th centuries. There is some dispute about whether the text is genuine or properly dated, but many people familiar with the current system find the content applicable and relevant today.

of Upton Sinclair's famous quip: "it is difficult to get a man to understand something when his salary depends upon his not understanding it!"[24]

Willful blindness (Heffernan 2012, Grossman and van der Weele 2016) is especially pronounced in finance because the harm from excessive risk is abstract and the victims are dispersed and "statistical" (Small and Lowenstein 2003). Enablers can more easily maintain narratives that minimize or deny harm when this harm remains obscured. What people *want* to know becomes at least as important as what they actually know. Codes of silence evolve from collective blindness and an implicit agreement to maintain the silence. We may lie to ourselves and live in hope.[25]

Many false and misleading claims about the health and safety of the financial system, the effectiveness of regulations and the costs and benefits of different approaches are made by people within the financial system and its enablers. These flawed claims obfuscate reality and create the confusion that allows a bad system to persist.

A frequently made statement is that the system is safer today specifically because there is now *x*% (e.g. three times) more "capital" in banking relative to pre-crisis period. Such statements avoid the question whether "safer" means "safe enough" and divert attention from the persistent flaws of the regulations or anyone's responsibility for these flaws. The statements ignore the fact that the actual amounts of equity had been, and still are, dangerously and unjustifiably close to zero, which also means that a multiple of the previous miniscule levels does not make for a large number. The claims divert attention from the serious measurement issues mentioned in the previous sections that still cause "regulatory capital ratios" to provide false reassurances. An analogy would be extolling the reduction of speed limit for loaded trucks in residential area from 100 miles per hour to 95 miles per hour without discussing why reckless speed is tolerated and while ignoring the police's difficulty in measuring the speed.[26]

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[24] The quote is from *I, Candidate for Governor: And How I Got Licked* (1935). In a Tedx Stanford talk on May 7, 2014, I created three variations on this sentence that are relevant to this essay (available at https://www.youtube.com/watch?v=s_I4vx7gHPQ).

[25] Grossman and van der Weele 2016 quote the line "living is easy with eyes closed" from the 1967 song "Strawberry Fields Forever." Das 2010, chapter 2, speaks of "the lies that we like to believe." He describes the derivatives sell-side trading floor as a place where lying is pervasive and clients "lie mainly to themselves" (55).

[26] Admati 2015, for example, was written in response to Ben Bernanke's 2015 book *The Courage to Act,* which extols the actions by the Federal Reserve once the crisis broke into the open and since, while

Misleading jargon obscures the issues and excludes many from the discussion. Lanchester (2014, 6) writes that when hearing the economists speak, "it's easy to think that somebody is trying to con you... [or] trying to put up a smoke screen" and expresses the "strong feeling that a lot of the terms ... were deliberately obscure and confusing." The jargon can also muddle the debate by suggesting false trade-offs.

For example, an insidious and pervasive confusion concerns simply the meaning of the word "capital" in banking. Attaching verbs like "hold" or "set aside" to the word "capital" (which is used in a uniquely different way in banking than elsewhere), and comparing capital to "a rainy day fund" suggest to most people that capital is idle cash reserves and that capital regulations prevent banks from making loans, both of which are patently false.[27]

Enablers maintain the confusion inadvertently if they do not actually understand the jargon. Books and media reports routinely contain false explanations. The confusion is entrenched because those who are confused may not realize it and therefore maintain and spread it further. Remarkably, regulators and economists who know better use the same misleading language and often fail to correct false statements and to clarify the issues.

The problem goes much beyond jargon and the meaning of words. A bestselling textbook, written by an academic economist who served in high-level policy positions, includes fallacious statements contradicting material in introductory finance courses.[28] As already mentioned, basic economic forces are often denied and ignored in banking, and models in which risk is assumed to be unpreventable imply that regulations are futile or costly. Financial crises are portrayed as akin to natural disasters, for which emergency supports are the main tool. In fact, as discussed earlier, effective regulations can do much at little social cost to dramatically reduce the incidence and cost of crises and to correct other distortions.

Industry lobbies and policymakers try to address anger about bailouts by assuring the public that it will be possible for even the largest global institutions to fail without needing bailouts.

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minimizing the extent of the regulatory failure prior to the crisis and overstating the progress of regulatory reform after the crisis.

[27] See Admati et al. 2013, Section 3.1, Admati and Hellwig 2013a, chapters 1, 6; 2015, Claims 1-2.

[28] The author is Fredric Mishkin from Columbia University, who has served in high-level positions within the Federal Reserve. Admati et al. 2013, Section 3 and Admati and Hellwig 2013a, chapters 7-8 explain the issues in detail.

The focus on making failures palatable diverts attention from doing much more to counter distorted incentives, which would also act to *prevent* failures and crises.

The "failure" of one or many banks financial institutions entails large collateral harm, as seen in many crises over the years, whoever bears their direct losses. The economy would be disrupted much prior to the actual point of failure, as was seen in 2007-2008 (Admati and Hellwig 2013a, chapter 5). It is therefore best to focus on prevention, particularly if it can be done while also correcting other distortions. Trying to make failure palatable is akin to preparing ambulances while tolerating and subsidizing trucks to drive at reckless speed (Admati and Hellwig 2013a, chapters 5, 6, 9; Admati 2014). We do not tolerate reckless driving that endangers lives even if "the industry" pays for the ambulances.

Bankers and some enablers of the system often warn that tough regulations will have "unintended consequences" such as restricting credit and growth. In fact, healthier and safer banks can make loans more consistently and with fewer distortions, and credit suffers when banks have too little equity. The claim also presumes that all lending is good for the economy when excessive credit is typically a precursor to bust and crises. Ironically, such claims are made even as banks seek, and are allowed to deplete their equity by making payouts to shareholders that they could have used to make loans.[29]

Another common warning of "unintended consequences" is that tough regulations will "shift activities to the shadow banking system." This claim perversely uses the failure of previous regulations that led the financial system to become extremely complex as an argument against highly beneficial steps.[30] The Great Financial Crisis was in fact an "unintended consequence" of failed regulations that had allowed the massive buildup and hiding of risk in a complex and opaque system. Those who warn about the shadow banking system rarely go on to propose how to tackle the challenge of effective regulation. The warnings appear designed to scare and maintain the status quo.

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[29] See Admati et al. 2013, Admati and Hellwig 2013a, 2015, Hoenig 2016 and Gambacorta and Shin 2016. Paul Volcker, former chair of the Federal Reserve, referred to such warnings as "bullshit" (Connaughton 2012, loc. 2290). Jenkins 2011, written by a former banking industry insider who became a regulator, describes the lobbying as "intellectually dishonest" and laments that bankers' lobbying strategy "explo31its misunderstanding and fear. "

[30] See Admati and Hellwig 2013a, chap. 13; 2015, Claim 28 and Admati 2016a, b, regarding "flawed excuses."

Admati and Hellwig 2013a is entitled *The Bankers' New Clothes* in reference to the famous story of *The Emperor's New Clothes* by Hans Christian Andersen, where people, including the emperor, his ministers, and observers did not admit that they do not see the emperor's fictional clothes for fear of being exposed as stupid or incompetent.[31] Just as the emperor kept marching, the parade of flawed claims about capital regulations continues. Statements suggesting that "much is being done," "challenges remain," and "we may need to do more in the future" allow enablers to present banks' health and the quality and effectiveness of the regulatory effort in better light than appropriate while vaguely leaving open the possibility of more action at some later point.

In 2013 we started, and periodically update, a list of the flawed claims made just on the issue of capital regulations, with brief explanations of what is wrong with them. The latest version includes 31 distinct claims (Admati and Hellwig 2015) and more are likely to be added. Clearing the fog created by flawed claims is critical for improving policy and the system.

5. Is Change Possible?

> "Collective moral disengagement at the social system level requires a network of participants vindicating their harmful practices."[32]

Good people can do harm and feel good about themselves, especially when many reinforce one another and remain unaccountable, and when the harm is diffuse, abstract, and invisible (Bandura 2015). Spreading flawed claims that cannot be definitively contradicted, as lobbyists and enablers often do, is no crime. Distorted incentives, ignorance, and confusion combine for a powerful mix. How might those strong forces be overcome?

First, the public must not be lulled into a false sense of safety and accept flawed narratives. Anger is useful but it must be properly focused. For example, the recent movie *The Big Short* (based on Lewis 2010) has left many viewers scared and angry. That anger was most often focused on unpunished fraud, but the problem is much deeper. Much of what the book and movie describe was legal and the reformed rules still tolerate many of the same practices. Lewis

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[31] Many experiences motivated the book and advocacy efforts; some are described in the preface of the hardcover and paperback, available at http://bankersnewclothes.com/excerpts/. The book website links to other materials. See further comments in Section 5.

[32] Bandura 2015, 100.

2016 writes: "*The Big Short* is just a movie, but it's also an invitation, to a huge popular audience, to have a smart and interesting discussion about the place of money and finance in all our lives." Having a smart discussion is difficult when the discussion is muddled by misinformation and confusion.

Some of those who understand that current regulations are ineffective focus on symptoms and overlook steps that can produce huge benefits at small cost. For example, the excessive size of too-big-to-fail institutions is enabled by their privileged access to subsidized debt funding, which creates enormous harm and distortions. These distortions can be addressed at little cost, and the likelihood of failure would also be reduced, if these institutions were forced to rely much more on equity and thus reduce their dependence on subsidized debt funding.

Complex regulations can create the pretense of tough action while their flaws remain obscured.[33] The confusing spin and narratives make it difficult to distinguish effective from wasteful regulations.

A deeper issue is that although the economy suffers repeatedly from the consequences of excessive borrowing by individuals, corporations, and sometimes governments, many policies encourage and subsidize the use of debt. Senseless tax subsidies of mortgage and corporate borrowing, which are particularly harmful in banking, create large distortions and instability and prolong recessions when credit boom turns to bust (Economist 2016, Mian and Sufi 2014, Taylor 2015).

Luyendijk 2015 describes his increasing horror as he realized, while interviewing many individuals in the financial sector in London, how distorted the incentives are and how extensive is moral disengagement of those involved. In the last chapter, entitled "The Empty Cockpit," he shares his hesitation about publishing the book. "What's the point of leaving one's readers in powerless fear and outrage?" he asks, but then concludes that publishing the book is valuable because "ignorance, denial or apathy is simply not an option when it comes to a problem of this magnitude and urgency" (261).

As discussed in this chapter, those at the controls of the financial system do not have strong incentives to protect the public; instead they stand to benefit from actions that contribute or

[33] For example, the requirement in the US that the largest institutions prepare "living wills" is extremely costly, yet it has produced little if any benefits so far (Admati 2014). Regulatory "stress tests" do not capture the complex interconnections through the system, yet are used provide false reassurances and allow too-big-to-fail institutions to deplete their equity by making payouts to shareholders. (Admati and Hellwig 2013a, chap. 11, Dowd 2015, and Cetina, et al. 2016).

tolerate harm and endangerment. Making the financial system safer would require better rules as well as better monitoring of the system, akin to radars in aviation. Yet disclosures in banking remains poor and systems to track financial transactions and contracts have been slow to develop.[34] The main obstacle is not the technical difficulty of controlling risk in banking, but rather the lack of *political will* to do so.

I have been intensely involved in the debate about banking regulation since 2008, first through discussions with colleagues and academic writing, and, starting in 2010, engaging with a broader set of people. The impetus for this deeper involvement came from individuals within regulatory bodies who alerted me that flawed claims are having an important impact on policy and urged me to speak up and help clarify the issues. Many of the references in this chapter reflect efforts to alert policy-makers and the public to the remaining danger and distortions in the financial system and to propose ways to address them.

Over the last eight years I have had numerous private discussions and public encounters with people from within the industry and various enabler categories discussed in this chapter (see also Admati and Hellwig 2013a, prefaces). Some of these engagements have been perfunctory or superficial and seem to have had little impact, but many people have welcomed discussion, engaged genuinely, and provided opportunities for more engagement, even as some of them have maintained their preferred narrative in public.[35]

Luyendijk 2015 classifies the moral attitudes of the people he met within the financial system and describes his reaction to these attitudes. One type he finds ethically most disturbing he calls "cold fish." Cold fish believe anything that is legal is perfectly fine to do. In our economy, responding to incentives without breaking the law is considered the foundation of growth and innovation. This chapter has examined why laws and regulations tolerate and reward unnecessary harm and endangerment in banking and who is responsible.

What I have found surprising, dismaying, and alarming are the behaviors, and in some cases the hypocrisy, of people in charge of protecting the public or who present themselves as acting on behalf of the public, yet who evasively avoid genuine engagement on issues critically related

[34] For example, there has been some effort to create legal entity identifiers (see https://financialresearch.gov/data/legal-entity-identifier/) but such systems do not appear to be a priority. Similarly cross-border resolution, a problem known and discussed for decades and essential for addressing global and systemic institutions, is also still intractable, see Admati 2014. Derivatives trading also remains poorly disclosed, as discussed in note 7.

[35] This chapter reflects my observations and insights from individuals I have engaged with, as well as direct comments on the text from individuals I cannot acknowledge by name.

to public safety, who refuse to question their assumptions, and who persist in failing to protect the public and in making flawed claims that help enable harm and endangerment.

There are well-intentioned people in government and elsewhere, including within the financial system itself, who would want to act to promote the public interest, but are often prevented or deterred from doing so by political constraints, institutional policies, and more subtle forms of discouragement. In a system dominated by powerful industry players and supported by powerful enablers, the need to promote institutional objective puts many people in conflict with the public interest. Regulators and financial practitioners may put their careers, status, and prestige at risk if they challenge certain narratives.

Tenured academics, who have the most expertise, job security, and academic freedom to express themselves and to engage in policy without being conflicted, are in a unique position to bring about positive change. Yet, some academics are important enablers of the badly regulated and dangerous financial system. By such behavior as making false statements in textbooks, creating models and narratives with assumptions that distort reality in critical ways, misusing or tolerating the misuse of research to propose or support bad policy, or making vague and misleading claims whose flaws, often subtle, can be difficult to detect, these economists exacerbate confusion, muddle the debate, and harm instead of promote the public interest. Someone with sufficient background to understand the academic literature, who has been employed by major financial institutions, quipped recently when discussing some statements by academic economists: "with such friends, who needs lobbyists?" [36]

This chapter focused on capital regulation that, if designed and implemented properly, can correct many distortions and protect the public at little social cost and, when successful, can lessen the need for costlier and less effective regulations. Even if this "policy bargain" is improved, however, distorted incentives to commit fraud and to endanger would still be a problem. More radical changes in the structure, compensation practices and culture of the industry and of regulatory bodies may be essential.[37]

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[36] A 35-year veteran from banking asked me after reading the first version of Admati et al 2013 in 2010 why we spent so much space debunking the idea that "debt disciplines managers" and added "Is this some academic thing?" Admati and Hellwig 2013b, which includes material omitted from Admati and Hellwig 2013a for being esoteric, provides a more accessible discussion of this academic myth. See also note 20.

[37] For example, Hill and Painter 2015, Bhagat 2016 and Kay 2015 propose changes in the way bankers are compensated to create more personal liability. Kane 2012 and Barth et al 2012 discusses ways to address regulatory capture. Omarova 2012 advocates inserting public interest directly into the regulatory process to create "tripartism" where policy-makers collaborate with the industry and the

Ultimately, in a functioning democracy political change comes from public pressure, which requires better awareness and understanding. Education is extremely important, so that people become savvier in their own interactions with the financial system, and so they come to see past the fog of confusion.

Entrenched and powerful systems resist change, but a just society must not tolerate a situation in which critically important systems like the financial system are run against the interests of the vast majority. More people must become aware of the problem and understand what is wrong. Then they must demand that policymakers do better. Change is possible, but it will take a village to repair a financial system.

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public interest is forgotten. King 2016 proposes radical changes in the relations between private banks and central banks. McMillan 2014 outlines a radical plan for the "end of banking" that relies on strong solvency conditions imposed and enforced on all firms to prevent the use of debt to invest in financial assets.

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