The Fourth Panel of this International Consultation asks if ethical questions raised by the Churches help the international decision process on financial reform. The ultimate answer is obvious. Many factors contributed to the debt crisis that continues to this day: some were technical, some involved poor judgment and bounded rationality, but beyond doubt the crisis and its continuation has been in large part an absence of ethical constraints and an abundance of greed. An excellent, recent text has synthesized the breadth of disciplines involved in the study of regulation. The disciplines identified include “law, economics, political science and public policy, sociology, history, psychology, geography, anthropology, management, and social administration.”1 If virtually all of the sciences dealing with human behavior are involved in the effort to understand the strengths, weaknesses and diversity of regulation, those who study ethics and morality must have essential wisdom to share. The Catholic Church, particularly through its interdisciplinary social doctrine, should have a key role. So, yes, religious and secular institutions that focus on ethical and moral issues have an important place at the table. Catholic Social Doctrine should play a significantly important role informing policymakers with regard to the ethical dimensions of financial reforms, particularly in the globalized economic world.

That said, I would like to address some aspects of learning from the literature on regulation and apply a couple of principles from the social teachings to the issue at hand. The world of finance has become international which presents challenges that require some form of oversight and regulation. The current situation demonstrates convincingly that an unregulated financial sector can wreak havoc on the “real” economy and the people who depend on a properly operating economic order for employment and the goods they need. The consequences of excessive speculation and malfeasance by those in the financial sector, and those who regulate them, is anything but a new phenomenon, but the international scope of the problem is growing. Hence, the focus of this conference is on multinational or global regulatory solutions.

The speakers at this International Consultation, and the documents that were circulated in advance, have presented a comprehensive picture of the problem and its possible regulatory solutions. I would like to focus on a couple of issues that I believe are particularly problematic with regard to the future of regulation in the international financial sectors. The problems are not new or limited to the international arena, but the consequences have been magnified by the
global reach of banking and finance. Preventing the systemic risk that became so apparent when the sub-prime real estate bubble burst in 2008 will be a complicated task on many, many levels: institutional, structural, procedural, and political to name a few. There is no single, self-evident way to avoid the many limitations on the capacity of humans to overcome self-interest, bounded rationality and the quest for profits at any cost.

While confessing my own limited insights into the multifaceted world of finance, let me note a few issues that plague all regulatory systems, and which I believe are particularly troubling in the area of financial regulation. The financial industry is not a single entity, serving similar clients in similar ways, and the extent of that institutional complexity requires regulation at various levels and with diverse goals. We must deal in the realm of second best options because no optimal regulatory structure can resolve the problems of the financial sector nationally, much less globally. Regulation, moreover, in the world of banking and finance with their many forms and functions is ultimately about the containment of financial risk. The minimization of “systemic” risk, however, will require complex, layered and networked regulatory bodies that can respond to the distinctive nature of the various actors within the “system.” Industry and regulatory failures will occur, and it is the dilemma of contagion that we must anticipate and avoid at the systemic level. Capture is a ubiquitous challenge for regulatory organizations and the financial sector seems to be particularly prone to this problem. There is much more that can and has been said about the regulation and deregulation of the Financial Services industry, but they are beyond this short paper. After developing these issues in a bit more depth, this intervention will suggest how Catholic social doctrine can inform the debate. The principle of subsidiarity is particularly relevant as well as the need for a person-centered viewpoint. Pope Benedict’s social encyclical, Caritas in veritate, adds a principle that is likely to be extremely strange and troubling to those operating in the financial sector, perhaps not in their personal lives, but surely in their professional capacities: gratuitousness. Finally, I will suggest some regulatory structures that I believe are appropriate for the challenges of the current economic crisis and the mitigation of future episodes of “bubbles.”

COMPLEXITY

One of the most obvious challenges of regulating the financial sector of the world’s, or even national, economies is the exceedingly complex nature of the financial industry. There are banks, commercial and investment, of many sizes and with various functions. There are non-bank financial institutions which provide diverse financial services and which are subject to varying degrees of regulation. Some financial institutions provide very specialized services, e.g. the Bank of International settlements (the banks’ bank) at one extreme and micro-finance banks at the lower end of the financial transactions’ spectrum, while others provide a broad range of services. And there are innumerable regulators overseeing in various ways the activities of financial institutions. In the U.S., for example, the states and the federal government have multiple agencies regulating the financial sector. This brief description just scratches the surface
of the multiple financial institutions and related regulatory bodies operating throughout the world.

The point of this discussion of complexity is not simply to urge great care and prudential judgment-making when attempting to find ways to mitigate the most recent financial debacle, important as care and prudence are. Rather, the reason is that the multiplicity and diversity of financial institutions and the regulatory structures in place are so substantial that any quest for a single solution would strain the rationality and imagination of human beings. In economic terms, we are dealing in a world of second-best options.

SECOND-BEST OPTIONS

As suggested above, the first-best option for regulation of “the world-wide financial sector” is beyond human capacity. Anything approaching the best possible outcome would require an exquisite balancing of rules, administration and enforcement that strikes the proper equilibrium between certainty and flexibility, and do so for each sector of a very diverse segment of the economy. And there is no easy fallback to a second-best outcome. Matching the right regulatory body, structure and rules with the multiplicity of financial institutions will provide severe challenges. Moreover, the best learning regarding the regulatory policies in a field as broad and multi-faceted as the financial industry would come incrementally, particularly in the international realm. The nature of the financial services industry is too dynamic for any static regulatory regime to control efficiently. Given these circumstances, the regulatory structure will surely consist of multiple structures complementing and competing with each other. Time and experience will point us in the right direction and there are sure to be failures within the system. Hopefully, the network and layers of regulatory bodies, and the financial industry members themselves can catch and limit bubbles and other flaws before they infect the entire industry.

RISK

The global financial project is ultimately to minimize systemic risk to the world’s financial order. Much of what has been written regarding the current crisis, however, tends invariably to treat risk as a negative factor in the financial sphere. Risk, however, is an essential feature of a vibrant market. The economy grows largely through the risks taken by entrepreneurs and innovators. The magnitude of reasonable risk, however, will necessarily vary with the types of financial services and the clients they serve. Some sectors of the financial industry must, I believe, continue to be regulated in a traditional “prudential judgment” format. The managers of savings banks, credit unions and other relatively small, local financial institutions must be held to high levels of prudence, i.e. low risk, when employing or investing the deposits they receive. The current crisis after all was precipitated by commercial banks and mortgage companies extending loans to those who predictably could not repay.

We knew or should have known that the ready availability of credit to both well qualified and unqualified home buyers fed the unrealistic inflation of home prices – a “bubble.” Presumably,
the securitization of mortgages would spread the risks of default so broadly that those at the top of the financial chain who held the securities would be protected. We all know how this particular cycle ended. Massive numbers of borrowers could not pay their mortgages, defaults and foreclosures were the order of the day, and the “bottom fell out” of the real estate market. One of the largest and most prestigious investment banking houses in the United States went into bankruptcy and the insurance company that was supposed to provide protection against the failures of the securitized mortgages had to be bailed out by the U.S. government. The fact that the banking industry had become global in scope meant that the financial malady that started with the U.S. real estate industry spread throughout most of the developed world. Its effects continue to this day.

My point in rehashing the evolution of the crisis is that the extreme risk that precipitated the event should have been caught and stopped at a fairly low level in the hierarchy of financial institutions. The ability of the initial mortgage lenders to sell the paper to a buyer who would securitize the debts and sell them as securities backed by huge numbers of aggregated mortgages, which could in turn be insured by “credit default swaps” created a systemic moral hazard. Traditional prudential standards were ignored because the individuals who should have applied them to the original mortgage transactions had no particular incentive to be prudent. Those higher in the chain of financial institutions were indifferent or unaware of the risks that are now so obvious.

I began this section of my paper with the notion that the assumption of risk can be good if exercised with sound judgment and common sense. One of the distinctions between the various types of financial institutions is the level of risk they take with their own transactions and those they facilitate for others. Even the wealthiest individual and institutional investors attempt to limit their risks by diversifying and hedging, but they are taking more risk than the credit union depositor and they expect a higher return on that investment.

The attempt to establish a regulatory structure that can control systemic risk throughout the financial sector of the world’s economy faces one other major obstacle. Those who manage risk do not act blindly. They deal in calculations that provide relatively reliable information about the probabilities of various outcomes which are then balanced against the probabilities of gains. The risks assumed are informed and not reckless. The risks inherent in a diverse and complex, but highly interdependent networked industry, exacerbated by the layers of regulatory bodies, are “Knightian.” That is, they cannot be quantified and stated as probabilities. A regulatory regime based on a strategy of risk-management, therefore, will be unable to reliably measure probabilities and impose or encourage risk avoidance strategies. The next bubble will come. That said, it is still essential for regulatory bodies to use the best available methods to anticipate and avoid major disruptions in the financial industry.
The evolution of regulation, and the scholarship about it, has gone from a relatively naïve belief in the capacity of government officials to bring needed expertise to the regulation of various types of industries in the public interest. Over time, it became hard to square this benevolent notion with the reality of much regulation. The most widely accepted answer to this paradox was provided by a number of economists, most notably George Stigler. Regulated industries “capture” the regulators, either at the time of the legislative enactment or afterwards as the regulation is implemented. In Professor Stigler’s words, “as a rule regulation is acquired by the industry and is designed and operated for its benefit.”2 There are more and less cynical explanations for the phenomenon of regulatory capture, but there is little doubt that many of the problems with the regulatory state came from the undue influence of the industry being regulated. The prominence of this notion of capture, plus empirical evidence that regulation in many sectors of the regulated economy was inefficient and inflexible, ushered in the era of deregulation. During a time of deregulation generally and economic prosperity the financial services industry was able to obtain statutory and regulatory relief. Whatever good that may have achieved, it made the current crisis possible.

One of the great challenges facing those who would create a new regulatory regime to impose stricter risk management rules on the financial industry, and to deal with the too-big-to-fail phenomenon, is the entrenched power of the banking industry and its sponsors in government. Although among regulated industries in the United States the financial sector does not commit the largest amount of resources to lobbying, it is obvious that the bankers have the organizational structure and resources needed to shape regulatory policy to suit its own interests. Whether it is a crude capture through power and influence, or a more subtle ability to shape policy because only the financiers and securities dealers understand the world of high finance, the financial industry has proven itself resourceful when it comes to shaping the rules that should set limits on its practices. The men and women who run the great financial institutions are an elite club with ready access to government officials who “manage” the financial sector. The revolving door between employment at the great banking houses, e.g. Goldman Sachs, and the Treasury Department and Federal Reserve Banks in the U.S. operates smoothly. I am not suggesting blatant corruption, but, rather, a culture that is shared by an elite and wealthy coterie of like-thinking experts in the world of banking and finance. Part of the shared belief, and a contributing factor to the crisis, is the justness of compensation packages that shock the reasonable person.

There is evidence showing a cycle that the financial industry works through when regulatory restraints are imposed. Professor John Coffee describes a “regulatory sine curve” that tracks a pattern following economic crises in the financial sector. Regulatory reform in the financial industry, Coffee explains, occurs only in response to a perceived crisis. The reforms of the New Deal responded to the Great Depression. The securities and banking industries were reigned in. Coffee’s article is more focused on the crises driven reforms of the last decade. The collapses of
large companies like Enron and WorldCom, and related scandals about managerial salaries and perks, caused public concern and outrage. Congress responded with the Sarbanes-Oxley Act. More recently, and again in response to a crisis (the current crisis), Congress enacted the Dodd-Frank Act. The “sine curve” reflects an upswing in regulation to address a crisis, followed by a leveling off of the regulatory resolve, followed by an avoidance of the full impact of the regulation by repeal, partial-repeal or regulatory indifference.

Some commentators attribute the sine curve pattern reflects the fact that legislation enacted during a crisis is generally rushed through and flawed. When cooler heads prevail, the upsurge in regulatory interest wanes and the representative curve declines. Coffee relies on a seminal work by Mancur Olson, The Logic of Collective Action, to offer an alternative explanation. When the public’s interests are diverted to other issues, a smaller, well-organized, and wealthy interest group will be able to sway legislative or regulatory actors to eliminate or moderate the regulation. This is not really an application of the capture theory, but rather of a theory about collective action in the political sphere. Coffee believes this already starting to occur with respect to the Dodd-Frank Act.

The actions that have been taken to date reinforce the concern about the banking industry having significant control over government responses to major failures by the industry. Bailouts and the Fed’s monetary policies have largely restored the securities and investment banking industries to their prior status. Whether this is the result of the capture theory at work, Mancur Olson’s insights about collective action, or evidence that too-big-to-fail is at work is not relevant. It does, however, demonstrate that the sector that caused the financial crisis was the first to recover.

SOME THOUGHTS ABOUT CATHOLIC SOCIAL DOCTRINE

There are several aspects of the social doctrine that are relevant to the discussion of the current economic crisis and how it can be avoided in the future. I have already mentioned one. The financial structure operates at virtually every level of society, from the smallest rural communities to global enterprises. The principle of subsidiarity suggests that the structure of the regulatory systems overseeing this complex economic system should be adapted to controls at the lowest feasible level. Naturally, it also requires regulation at a universal level to deal with the multinational financial sector.

SUBSIDIARITY AND REGULATION

Catholic social doctrine provides guidance through the principle of subsidiarity. What I have written above about the nature of risk and its management draws an implicit distinction between local or regional commercial banking, international multi-function financial institutions, and other types of banks and shadow banks. Without attempting to identify the many various structures of the financial industry, there are independent banks and branches of larger banks, as well as credit unions and other smaller savings institutions that function primarily in local communities. They generally take deposits and extend loans, commonly for the purchase of
homes. Presumably, these local bankers know the communities which they serve, but in any case they are the first line of defense against the extension of “subprime” mortgage-backed loans. Following the Great Depression, with the many bank failures, the United States determined that the commercial and investment banking industries should be separated. Speculation by commercial bankers contributed to the collapse of so many banks. The Glass-Steagell Act\(^3\) established a wall between the two types of banks. The Gramm-Leach-Bliley Act of 1999\(^4\) repealed most of Glass-Steagell and permitted commercial banks, investment banks, insurance companies and securities firms to operate together. There is evidence, and many are convinced, that the blending of banking functions among all types of financial institutions has increased the risks that led to the crisis and also resulted in the “too-big-to-fail” phenomenon.

A bill has been introduced in the United States Senate to reestablish much of the Glass-Steagell Act\(^5\), but that will have to overcome the strong deregulatory impulse of the banking regulators and of Congress, as well as the influence of bankers. I should note that the repeal of Glass-Steagell probably did not play a major direct role in the current crises, but it does provide evidence that stronger regulatory policies could have mitigated the breadth of the current problem. Whether or not some form of Glass-Steagell is enacted in the U.S. or elsewhere, the principle of subsidiarity and the experience of the post-Glass-Steagell financial industry suggest that a fairly heavy-handed form of regulation should establish and enforce strict prudential rules on the practices of localized banking activities, with emphasis on both their lending and investing practices.

With respect to institutions which, because of their size or function, are expected to take greater risks, a “risk-management” style of regulation may be more appropriate. Experience, however, with delegating this function to the financial institutions themselves has proven disastrous. There must be some credible, independent body to oversee the risk structure of even the largest financial firms. Even if risk is ultimately unquantifiable as I wrote earlier, the type of risk that resulted in the current crisis did not require precise quantification. An attentive regulatory body, with appropriate jurisdiction should readily have seen this disaster in the making. The types of securities instruments that were created and marketed were complex and certainly beyond the analytical abilities of an average investor. The fact that the underlying assets for the instruments were unsound, or that the supposed insurer (AIG) could not cover the predictable losses, should not have surprised the industry whose job it is to manage other people’s money. Some combination of greed, hubris and bounded rationality (the human condition) caused a collapse that sound regulation could have avoided or at least mitigated.\(^6\) In short, the financial sector is one area where deregulation precipitated a crisis of global proportion.

**WEALTH TRANSFER**

Although the media coverage and political dialogue has been sensationalized, there is one element of the situation that has gotten little serious attention. The practices that led to the crisis, as well as remedial actions taken by government, at least in the United States, have resulted to
two significant transfers of wealth. The financial industry seems to have been restored to substantial profitability with support from the FED’s easy money policy. The capital making its way to the “real” economy, however, does not match the revenues and profits flowing into the financial sector. There seems to be a growing and troublesome flow of resources out of the real economy into the financial economy. The second major transfer of wealth is from the poor and middle classes into the financial sector; to put it more bluntly, from the poor to a class that is conspicuously wealthy. The crisis has left far too many people jobless and homeless, while those running the great banks and investment houses retain very substantial wealth. The economists who are convinced that regulatory capture explains most regulatory regimes may find support in this apparent shift of resources from the consumers, especially of homes, and the “productive” economy to that section of the economy charged with aggregating capital and generating wealth for the benefit of society. From the perspective of Catholic social doctrine, this raises serious concerns about distributive justice.

THE ROLE OF THE PERSON

The Church’s social doctrine is person-centered and not profit-centered. The social teachings understand the role that profits appropriately play in the world of finance and business enterprise, but it must always be dedicated ultimately to the promotion of the common good, i.e. the good of each and all persons. Business enterprises of all types must ultimately serve the needs of the human person, men and women, and not the other way around. Very little that I could find in the scholarly literature addressed directly the effects of this crisis on the many, many thousands of people throughout the world who have lost homes, jobs and pensions. In the world of finance, people seem to fall into a couple of categories: They are managers, investors, and shareholders. The ethical dilemmas seem to be centered on matters like moral hazard and agency problems. For example, how do we make managers and agents align their interests with those of the investor/shareholders? The plight of the people who were most severely hurt by the financial crisis seldom bubbles to the surface in much of the literature. I am not suggesting that there are easy solutions to this broader social problem. “Stakeholder” statutes in business organization laws do not seem to have made a great deal of difference. The Church however must continue to foster distributive justice, the centrality of the person and the common good when the world experiences an economic disaster.

CARITAS IN VERITATE

The Church has in fact addressed this very crisis shortly after it began, most notably and authoritatively in Pope Benedict’s Encyclical, Caritas in Veritate. The answer lies largely in an economic order that is informed by gratuitousness. This is a strange term to interject in a discussion about the financial sector, where profit is clearly the primary measure of success. Recognizing this dilemma, Pope Benedict called for a healthy diversity of financial institutions. Some centers of financial activities have always had a local and, sometimes, a distributional outlook. They must be promoted and protected as needed. The other challenge that Caritas in
Veritate poses is the need for “righteous” men and women to function within the financial sector. This cannot be relegated to churches alone, or to classes in professional ethics. But churches have a special role to play, as do families, in the development of men and women of integrity. And Catholic social doctrine has a major contribution to play in the development of policies that understand the nature of the secular financial dilemma without losing sight of the human dimension.

SOME SUGGESTIONS FOR REFORM:

- An international “watchdog” group is needed, but most regulation should follow the principle of subsidiarity. Regulators and bankers at every level will best be able to identify unsound practices within their own operating sphere. The “watchdogs,” auditors or a higher regulatory body can watch for problems of capture at the local level.
- Regulation at the lower levels of the financial hierarchy should impose and enforce strict prudential standards.
- Maintaining regulatory structures close to functional level of financial institutions, particularly traditional commercial banks and thrifts of various types will likely generate the qualities promoted by the Church’s social doctrine. Local bankers are likely to be more aware of the needs of their customers – even to the point of saying “no” to improvident loans – and perhaps more open to an appropriate level of gratuitousness.
- The higher the level of the financial institution in the hierarchy of finance, the more the regulatory mandate should shift from tradition “prudential” modes of regulation to most sophisticated risk-management models.
- Those problems that have been clearly identified with the current crisis, e.g. excessive leverage, improvident lending practices and the creation of new, opaque products should at every level generally be prohibited. Innovative and complex new products, however, should be permitted when they are understood by a high-level regulatory body with the needed sophistication and methods.
- Too-big-to-Fail has not been addressed in this paper, but the most obvious and often suggested answer is a sound process and body to oversee the resolution of very substantial firms.

These are obviously not a comprehensive listing of regulatory remedies for the current or future financial crises. The point of this paper is that there is no clearly right or universal regulatory answer. They are, however, themes that can help to make regulation better and accommodate to the extent possible the goals of Catholic social doctrine. The “Catholic” and secular goals coalesce at times and they clash at others. Subsidiarity, for example, can be justified under both Catholic teachings and the best learning of secular disciplines. Profit-maximization and gratuitousness, by contrast, are difficult to reconcile.
2 George Stigler, Theory of Economic Regulation, 3, quoted in Understanding Regulation, supra n. 1 at 43.
6 I should note that the human failings that brought about this crisis was not limited to the banking sector. Real estate brokers, appraisers, and naive consumers contributed as well.