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(Mis)Understanding a Banking Industry in Transition

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Under deregulation the industry became dysfunctional—but economists still won't revise their anti-regulation script.

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The U.S. financial system is, once again, in crisis. Or, more precisely, twin crises—first, huge numbers of defaults among subprime mortgage borrowers, and second, massive losses for the holders of new-fangled investments comprised of bundles of loans of varying risk, including many of those subprime mortgages.

These crises should shock the nation. Our largest, most sophisticated financial institutions have followed business practices that were certain to produce massive losses—practices so imprudent, in precisely the business task (risk management) that is supposed to be their greatest expertise, that they have created a worldwide financial crisis.

For more on the current financial crises, see Tom Palley's article on the Fed's failed paradigm, in this issue, and Larry Peterson's web-only article about the subprime/securitization panic.

Why? Because their CEOs, acting on the perverse incentives created by today's outrageous compensation systems, engaged in practices that vastly increased their corporations' risk in order to drive up reported corporate income and thereby secure enormous increases in their own individual incomes. And those perverse incentives follow them out the door: CEOs Charles Prince, at Citicorp, and Stanley O'Neal, at Merrill Lynch, had dismal track records of similar failures prior to the latest disasters, but they collected massive bonuses for their earlier failures and will receive obscene termination packages now. Pay and productivity (and integrity) have become unhinged at U.S. financial institutions.

As this goes to print, Treasury Department officials are working with large financial institutions to cover up the scale of the growing losses. This is the same U.S. Treasury that regularly prates abroad about the vital need for transparency. And a former Treasury Secretary, Robert Rubin, who failed utterly in his fiduciary duty as lead board member at Citicorp to prevent the series of recent abuses, will become Citicorp's new CEO.

To even begin to understand events in the U.S. and global banking industries, you have to look back at the seismic shifts in the industry over the past 30 to 40 years, and at the interplay between those shifts and government policy. The story that continues to unfold is one of progressively worse policies that make financial crises more common and more severe.

These policies have their boosters, though. Chief among them are neoclassical banking and finance economists, whose ideology and methodologies lead them into blatant misreadings of the realities of the industry and the causes of its failures. When the history of this crisis-ridden era in global finance is written, the economists will no doubt be given a significant share of the blame.

A New Era of Crisis

The changes in the U.S. banking industry in recent decades have been so great that a visitor from the 1950s would hardly recognize the industry. Over two decades of intense merger and acquisition activity has left a far smaller number of banks, with assets far more concentrated in the largest ones. Between 1984 and 2004, the number of banks on the FDIC's rolls fell from 14,392 to 7,511; the share of the U.S. banking industry's assets held by the ten largest banks rose from 21% in 1960 to nearly 60% in 2005. At the same time, nonbank businesses that lend, save, and invest money have proliferated, as have the products they sell: a vast array of new kinds of loans and exotic savings and investment vehicles. And the lines have blurred between all of the different players in the industry—between banks and thrifts (e.g., savings and loans), between commercial banks and investment banks. These changes were made possible by the deregulation of the industry. Bit by bit, beginning in the 1970s, the banking regulations put into place in the wake of the Great Depression were repealed, culminating in the Gramm-Leach-Bliley Act in 1999, which removed the remaining legal barriers to combining commercial banking, investment banking, and insurance under one corporate roof. The new world of combined financial services is exemplified by the deal, inked (but ostensibly illegal) before the 1999 law was passed, that merged the insurance and investment-banking giant Travelers with Citibank, at the time the nation's number-one commercial bank.

These transformational changes in domestic banking, along with the related effects of economic globalization both in the United States and abroad, have produced recurrent crises in the financial sector. Indeed, the current era has seen over 100 major banking crises, in countries around the globe. Thomas Hoenig, head of the Kansas City Federal Reserve Bank, emphasized the remarkable and disturbing facts in a meeting with fellow heads of supervision:

> *A 1996 survey by the IMF [International Monetary Fund] ... found that 73 percent [133 of 181] of their member countries had experienced significant banking problems during the preceding 15 years. Many of these problems led to substantial declines in GDP [and] serious disruptions in credit and capital markets....*

To date none of these crises has led to a global Great Depression. Only a few were larger in absolute terms than the 1980s S&L debacle in the United States. Yet many imposed a much greater relative cost, measured as a percentage of the country's GDP. Some caused severe, depression-like economic problems in the affected nation. Some produced contagion effects that caused severe crises in other nations. And acute banking crises can cause long-term harm. Japan is a rich nation and can afford a 15-year banking crisis—but the world economy cannot. The crisis cut Japan's economic growth to near-zero for a decade, in turn creating contagion effects in the many countries for whom Japan was a major trading partner or a significant source of capital investment. Tens of millions of people remain in poverty in Asia and Africa as a result.

The recurrent banking crises have come as a shock to the United States, given the dearth of bank failures over the first three decades after World War II. The first severe postwar U.S. banking crisis was stemmed from the large loans that top U.S. banks made to sovereign borrowers (i.e., nations), largely in Latin America. The banks had claimed that sovereign loans offered high returns with minimal default risk because the nation could always repay the loan by printing more money. Citibank head Walter Wriston notoriously implied that countries could not go broke. The claim was absurd. However, banking regulators took no effective action to restrain this lending.

The 1982 Mexican default led to contagion and fears of an international meltdown, but the Federal Reserve and the Bank for International Settlements (BIS) took effective action. Brazil experienced a long economic slowdown that contributed to an imminent default on its loans from major

Deposit Insurance Spreads, Despite Economists' Protests

Banking economists now overwhelmingly criticize deposit insurance. This represents a major change. The prior consensus, shared by Milton Friedman and John Kenneth Galbraith alike, praised deposit insurance for ending the periodic runs on uninsured banks that helped cause the Great Depression. Today, however, the conventional economic wisdom is that deposit insurance may stop runs, but at the expense of encouraging banks to make imprudent loans and take excessive risks. (Neoclassical economists widely view insurance as inherently creating an incentive for insured parties to act in unduly risky ways because of the safety net that insurance provides—a phenomenon termed "moral hazard.")

This claim is dubious: economists do not offer a credible mechanism whereby deposit insurance could lead to the ills they claim it causes. Deposit insurance does not protect the shareholders or the CEO—the two groups (the first, in theory; the second, in practice) that control a bank. It is the depositors who are insured. Thus, they must be the ones who are subject to moral hazard—in other words, the argument against deposit insurance must be based on the claim that it reduces the incentive of depositors to exercise "private market discipline" by pulling their money out

U.S. banks. A Brazilian default could have rendered several of our largest banks insolvent. The banks were rescued by a combination of bailouts to Brazil through the IMF and the World Bank and flawed (albeit permissible under so-called Generally Accepted Accounting Principles, or GAAP) "troubled-debt restructuring" to cover up the losses. Brazil used the bailouts to pay minimal interest on the U.S. bank loans and ultimately recovered; while several U.S. banks took serious losses, none failed.

On the heels of this crisis came the savings and loan crisis, an unprecedented debacle which saw the collapse of some 1,000 S&Ls and which cost U.S. taxpayers about $125 billion dollars—primarily the cost of repaying to depositors money that criminal S&L heads had literally stolen from their institutions.

The causes of these crises are varied. They typically occur, however, when large banks are in essence looted by their owners and managers (a phenomenon known as "control fraud") or when there are financial bubbles in which assets become massively overvalued.

Economists who conduct case studies of banking crises commonly report the existence of substantial control fraud. Looting played a prominent role in the S&L debacle. Here is the conclusion of the National Commission on Financial Institution Reform, Recovery and Enforcement (NCFIRRE):

> *The typical large failure was a stockholder-owned, state-chartered institution in Texas or California where regulation and supervision were most lax. ... The failed institution typically had experienced a change of control and was tightly held, dominated by an individual with substantial conflicts of interest. ... In the typical large failure, every accounting trick available was used to make the institution look profitable, safe, and solvent. Evidence of fraud was invariably present as was the ability of the operators to "milk" the organization through high dividends and salaries, bonuses, perks and other means. In short, the typical large failure was one in which management exploited virtually all the perverse incentives created by government policy.*

Looting has played a significant role in banking crises around the world. It became so prevalent in the states of the former Soviet Union that it inspired a new term of art, "tunneling," to describe the process of the CEO and owners converting a company's funds to their private benefit.

In addition to the national banking crises, fraud has caused spectacular failures of large banks. The Bank for Credit and Commerce International (BCCI—known informally as the "Bank for Crooks and Criminals International"), Barings Bank, and Continental Bank all stunned the public when they failed. BCCI was the largest bank in the developing world, Barings was England's oldest bank, and Continental was America's third

of a bank they believe is being poorly run or looted. But there is no credible evidence that depositors are capable of either discerning frauds or avoiding runs on healthy banks based on false rumors. Indeed, studies have shown that even private-sector financial experts who specialize in evaluating the health of banks cannot do so effectively.

Proponents of the view that deposit insurance causes banking failures display an unrecognized logical inconsistency. Their proposed reform is to rely on private market discipline to prevent management from looting the bank or lending imprudently in a bubble. But, if we assume hypothetically that private market discipline is effective against CEOs who would be so inclined, then it should normally be effective despite the presence of deposit insurance. Deposit insurance does not remove private market discipline where the bank is owned by shareholders (unless the CEO owns all the stock) or where the bank issues uninsured subordinated debt. Yet during the S&L crisis, control fraud (the looting of an institution by its own managers or owners) was most common in S&Ls owned in stock form, with the largest losses overwhelmingly among stock S&Ls. In these cases deposit insurance did not preclude private market discipline; market discipline was simply inadequate to prevent control fraud. Some opponents of deposit insurance proclaim the S&L debacle to be their primary example—a flat misreading of the facts.

The empirical evidence economists use to support their critique of deposit insurance is inconsistent. Moreover, even where the adoption of deposit insurance is correlated with a rise in bank failures, the causal relationship may be just the opposite of what economists claim. Nations with early signs of an impending banking crisis may adopt deposit insurance to reduce the risks of runs. Developing nations tend to adopt deposit insurance in conjunction with privatization—which itself often prompts a banking crisis. More broadly, in part because of the fall of the Soviet Union and the rise of the neoliberal "Washington Consensus," the number of nations adopting deposit insurance increased sharply in the last two decades. Banking crises have indeed been far more common over this same period—precisely because these radical transitions have been occurring in nations with weak institutions, too few regulators with too little experience, patterns of bank ownership that maximize conflicts of interest, and substantial largest bank. Each one collapsed with minimal public warning.

And, of course, more recently control fraud played a role in a number of spectacular business failures outside of the banking industry including Enron, WorldCom, and Tyco. This fact makes it obvious that the conventional economic wisdom, which blames this era's wave of bank failures and banking crises on regulation and deposit insurance (which are specific to the banking industry) is just wrong. Despite this, mainstream economists persist in their diagnosis, rarely scrutinizing the deregulation and privatization that many observers believe in fact triggered these crises.

...They First Make Proud

Economists have dominated the creation of public policies to prevent banking crises. Their track record has been abysmal. They designed and implemented the disastrous deregulation that produced the U.S. S&L debacle, they praised Japan's and East Asia's banking structures just before they collapsed, and they designed the IMF's crisis intervention strategy that intensified losses and human misery. They also designed and praised privatization programs in many transition economies that led to banking crises; they planned (and in some cases profited from) the catastrophic failure of "shock therapy" in Russia. The irony is that when financial experts were most confident in their consensus, they erred the most grievously. As Mark Twain remarked: "It's not the things you don't know that cause disasters; it's the things you do know, but aren't true."

This record of failure is disappointing and has caused great human suffering. Remarkably, the economists' hubris is unaffected by it. They are now engaged in a war against deposit insurance and regulation. At this juncture, they are losing that war, but they are persevering in their effort to reclaim their domination over banking policy.

corruption.

In addition, empirical studies rely on subjective coding of different countries' deposit insurance policies, often done by economists who oppose deposit insurance. In countries with no formal deposit insurance, implicit government guarantees for banks are common. There are good theoretical and historical reasons to argue that such implicit guarantees—common in crony capitalism and kleptocracies—create greater moral hazard than explicit deposit insurance does because they can be structured to bail out a bank's shareholders and CEO as well as its creditors (as was done in Chile). But there is no way to code accurately for whether there was an implicit guarantee (or whether bank CEOs believed there was an implicit guarantee) in a particular country at a particular time.

Despite these weaknesses in both evidence and analysis, World Bank economists draw firm conclusions, opposing the adoption of deposit insurance in any nation and clearly hoping for its elimination. But the world has rejected their advice. By 2006, 95 countries had deposit insurance, over four times the number in 1983. Moreover, economists' suggestions on how to "improve" deposit insurance (require banks to issue subordinated debt, charge variable rates for deposit insurance, or require private insurance of accounts) are rarely adopted and have proven unsuccessful in practice.

Neoclassical banking economists are failing in this arena for three reasons. First, they neither study nor understand fraud mechanisms and the institutions that are essential to limit fraud and corruption. Second, they are shackled by an ideology that presumes that unfettered markets always produce the best outcomes and that government intervention is always bad. For instance, in their writings many of the World Bank's banking economists display a passionate contempt for democratic government and banking regulators. Third, they are mono-disciplinary. They rarely cite (and no doubt rarely examine) the literature in other relevant fields such as political science, sociology, and white-collar criminology.

Indeed, although it should be central to their study of crisis prevention, they rarely even cite the work of economist and 2001 Nobel Prize winner George Akerlof. Based on their study of the S&L crisis, which found that looting was a major cause of total S&L losses, Akerlof and Paul Romer developed an economic model of the looting control fraud.

Looters use accounting fraud to make a company appear extraordinarily profitable. Consider the S&L crisis. The worst S&L control frauds were the ones reporting the highest profitability. Moreover, the control frauds were routinely able to get a Big 8 audit firm to give them "clean" GAAP (or Generally Accepted Accounting Principles, the official standard of review in the U.S. accounting industry) opinions for false financial statements.

Economists, in turn, relied on reported accounting profits and share prices (which rose along with reported profits) to determine whether a given S&L was well run. But relying on reported accounting earnings or stock prices must lead to perverse results when a wave of looting control frauds is expanding. Thanks to their fraudulent accounting, whatever strategies control frauds follow will look profitable, and hence praiseworthy. In the S&Ls, this led economists to praise (1) domination by an owner/CEO; (2) extremely rapid growth; (3) changes of control; and (4) large investments in acquisition, development, and contruction (ADC) loans and direct investments. Lo and behold, these factors turned out to characterize the worst failures. In other words, standard econometrics techniques led economists to praise that which was fraudulent and fatal. The error was so great that they identified the worst S&L in the nation as the best.

Worse, economists persist in the same error. During the recent expansion of the even larger wave of looting control frauds such as Enron, economists touted (1) conflicts of interest at the top audit firms (which they euphemistically restyled as "synergies"); (2) using a top-tier auditor; (3) rapid growth; and (4) granting the CEO greater stock options as positive factors that were leading to increased profits and higher share prices. It was only after the looters began to collapse that variables like these reversed their sign (from a positive to a negative correlation) and displayed their true relationship to business failure. Economists are doomed to repeat these mistakes until they adopt statistical techniques that cannot be gamed by accounting fraud.

The Economists' War Against Banking Regulation

In keeping with their skewed analysis of the recent wave of bank failures and banking crises, banking economists, including those at the World Bank and the IMF, have been waging a war against banking regulation. It is a curious assault that rests on implicit and false dichotomies between market and regulation and between types of regulation.

The World Bank economists recognize that regulation is vital to mandate accurate disclosure of corporate financial information and aid private market enforcement, but appear to believe that regulatory strength is unnecessary to induce banks to provide accurate information. That view is illogical and incorrect. Obtaining accurate information about banks is the heart of banking examination. Regulators use their powers primarily to pry out accurate information from the fraudulent; control frauds do not cooperate voluntarily.

Economists' rationale for opposing strong banking regulators typically rests on public choice theory, which holds that the actors in political systems act to maximize their own self-interest. This analysis paints politicians as corrupt and regulators as "captured" by the industries they are supposed to be regulating. World Bank economist Thorsten Beck and his colleagues summed up this view in 2003 and 2006 working papers:

> *Politicians may induce banks to divert the flow of credit to politically connected firms, or powerful banks may "capture" politicians and induce official supervisors to act in the best interest of banks ....*

Government solutions to overcome market failures ... have been proven wrong in Bangladesh as across the developed and developing world. ... Indeed, powerful regulators are worse than futile—they are corrupt and harmful.

Again, this analysis is nonsensical. If banks can dominate politicians and strong regulators, they can certainly dominate the design of the disclosure standards they face. In that case, pursuant to the economists' own logic, the

Offshore Banks

One particularly dark side of globalization is the rise of new offshore banks. While Switzerland now has reasonably workable procedures for tracking the funds of kleptocrats and drug traffickers, several small nations have adopted extreme forms of bank secrecy designed to cater to the needs of criminals and tax evaders. Corporations often incorporate in a tax haven because of the extremely low tax rates. In the late 1990s, the Organisation for Economic Cooperation and Development, an organization of the world's industrialized countries, created an initiative to try to curtail these abuses. Conservative think tanks sought to kill the OECD plan and convinced President Bush to block its implementation as one of his earliest actions. The administration reduced its opposition to the OECD initiative after the 9/11 attacks, when it became clear that terrorists used the offshore banks as their preferred means to banks will submit, and politicians beholden to them will permit, deceptive financial reports that grossly overstate banks' value. (This has, in fact, been done in many cases.) Accounting fraud, in turn, renders markets deeply inefficient and causes private market discipline to become perverse. The looters report record profits. Credit is supposed to flow to the most profitable banks. So private markets aid the CEOs looting their banks by providing them with the funds to expand rapidly. Again, the failure to understand bank accounting fraud mechanisms, which have been well explained by Akerlof and Romer, leads to a deeply flawed analysis. (In lieu of Akerlof and Romer, the anti-regulation economists frequently cite work sponsored by Michael Milken's institute. Milken was the notorious junk-bond king and looter who caused large losses during the S&L crisis by recruiting and funding several of the worst control frauds, such as Charles Keating. Today, Milken's institute blames the S&L debacle on regulation and seeks to rehabilitate his reputation.

move funds.

This overarching logical error, their hostility to democracy, and their view of public officials as inevitably rapacious leads economists to a claim that only private parties should exert discipline against banks. The view has a number of problems. First, it is overstated. Regulators in some nations do resist political pressure. In the S&L crisis, many regulators did their job despite intense political pressure and saved over a trillion dollars in the process. On the other hand: if, over time, people are taught to believe that it is normal and rational for public officials to be rapacious, this can become a self-fulfilling prophecy as those who aim to enrich themselves sign on to become officials. Moreover, the argument proves too much. If the banks (or politicians) are powerful enough to act illegitimately through regulators, they are powerful enough to act illegitimately without regulators to achieve the same result. The argument is also based on a fundamental misunderstanding of control frauds. It is not the "powerful banks" Beck and his coauthors refer to that put pressure on regulators or politicians—it is the CEOs or their agents who do. They do not coerce regulators "to act in the best interest of banks." They coerce them in an attempt to act to help the CEO loot the bank.

In fact, the evidence shows that private parties are more subject to capture than public officials. Looting control frauds are routinely able to get top-tier audit firms to give their blessing to massive accounting fraud. The ratings agencies do no better against control fraud. Our most prestigious law firms have helped CEOs loot and destroy their clients. Private deposit insurance funds for thrifts used to exist in many states. None do now. The Maryland, Ohio, and Utah funds were each destroyed by the very first thrift that collapsed in their state thanks to control fraud. No private insurer made more than a feeble effort to exercise discipline. Instead, they acted as boosters for the CEOs who looted and destroyed their own thrifts and brought down the insurance funds with them.

Finally, the empirical studies on banking regulation rely on coding of data by economists who typically oppose regulation, rendering the results unreliable. The risks of subjective bias are acute. There is no objective measure of "strong" regulation, or capture, or "rent seeking behavior." We know that economists have claimed that the Bank Board under Chairman Edwin Gray was captured during the S&L crisis. Not so. In fact, private experts were routinely captured by the S&L control frauds. Plus, the studies focus on formal supervisory power, yet informal banking supervision is widespread and often a regulator's most effective tool. Overall, empirical studies find that better quality regulation (again, to be fair, a subjective concept) reduces banking losses.

International Convergence

They Just Never Learn

Today's financial crisis offers a superb example of how their methods lead mainstream economists to endorse both private practices and public policies that are perverse. The current crisis exemplifies a variant of accounting control frauds—one in which the CEO and top managers "skim" rather than loot the company—and demonstrates the unrecognized economic costs of obscenely high CEO pay. The incentives created by typical CEO compensation packages in the financial services industry produce bad investment decisions, decisions that increase the CEO's ability to skim, but that expose the financial institution to losses and the nation and world to recurrent financial crises.

Consider the plight of the honest chief financial officer (CFO) in the modern financial world. His counterparts at rival firms are earning record returns by investing in subprime mortgages. Economists trumpet studies showing that banks' income is boosted by practices he questions, including:

- Making more subprime mortgages
- Making more of the worst

Despite the flawed logic and lack of empirical support for their views, conventional banking economists, including those at the World Bank, continue to voice opposition to the creation of strong supervisory agencies. For now, however, their call has been rejected.

In the 1980s, the U.S. government reacted to Japan's emergence as the new (apparent) dominant financial power by claiming that Japan gained an unfair advantage because its banks were permitted to operate with lower capital reserves. If all other factors are held constant, a bank held to a lower capital reserve requirement can grow more quickly, lend more cheaply, and finance greater economic growth. Complaining that the playing field was not level, the United States insisted on an international agreement to set minimum bank capital standards. The U.S. effort succeeded in 1988, when the largest industrial nations adopted the Basel Accord. More recently, the accord was revised and expanded ("Basel II") to include more closely calibrated minimum capital requirements as well as a supervisory strategy of "prompt corrective action" against banks that fail to meet the capital requirements and a strategy to make private market discipline more effective by requiring banks to disclose more information.

The Basel Accord was a major step towards greater international uniformity of banking regulation ("convergence") among developed nations. The expansion of the European Union is another major force for convergence, as candidate nations must adopt modern banking laws and regulatory structures meeting the EU's minimum standards.

Banks are also subject to an increasing number of international treaties designed to restrict money laundering and bribery. There are, however, very few enforcement actions or prosecutions, so enforcement does not appear to be effective at this time. In addition, offshore banks remain an enormous loophole limiting the effectiveness of convergence. New banking crises have diminished substantially in nations complying with the Basel accords.

Of course, it is too early to judge whether the Basel process is responsible for this success. However, we do have cross-country evidence showing that weak regulation leads to recurrent waves of control fraud. Tests of Basel's effectiveness by one of the World Bank economists find positive relationships between stronger regulation and bank health. (These tests employed a methodology that posed less risk of subjective bias by the economists conducting the studies, but they remain inherently subjective.)

The economists' frustration, however, is understandable. They are skilled research scientists for whom econometric studies are the epitome of proof. Contrary case studies are mere "anecdotal evidence" that are fully encompassed within their data and, therefore, require no refutation. Moreover, their worldview is shaped by public choice theory. They view banking regulators as corrupt, "rent seeking" parasites who merely pretend to virtue. Alternatively, in their "capture" model, regulators are cowards who roll over to aid the control frauds. They have not been banking

mortgages such as "Ninja" loans (no verification of income, job or assets), also known as "liars' loans"

- Making subprime loans at particularly high interest rates—which draws in the riskiest borrowers because only the worst credit risks and frauds will apply
- Making loans as quickly as possible
- Growing as quickly as possible
- Reducing internal controls against fraud
- Making loans in cities known to be "hot spots" for mortgage fraud
- Qualifying borrowers by offering "teaser" interest rates that will soon increase substantially
- Making loans in areas with rapidly inflation housing bubbles
- Purchasing and holding in portfolio high-yield CDOs (collateralized debt obligations, the investment instruments backed by bundles of mortgages and other loans, often of high risk)
- Keeping minimal reserves against losses

When a housing bubble is expanding, these practices dramatically increase fees and other noninterest income, minimize expenses, and produce relatively few losses. (Losses remain low as long as house prices are rising because borrowers who get in trouble can sell their house for more than they owe or else refinance based on its market value.) Note that this pretty income picture requires accounting and securities fraud, though: reserving properly for the future losses inherent in subjecting the financial institution to this vastly increased default risk would remove the fictional accounting gain.

The combination of dramatically increased revenue, moderately reduced expenses, and minimal loss means that financial institutions that invest heavily in subprime mortgages and CDOs must report record profits while the bubble is hyperinflating.

So what is our honest CFO to do? If she does not follow the pack, her company will report substantially lower income. Its stock price will fall relative to its rivals. The CEO's and CFO's compensation and wealth will fall sharply as raises disappear, bonuses decline, and the value of their shares and stock regulators, so they are uncontaminated and can see the truth as the empirical data reveal it to them.

Regulators, however, dominate much of the Basel process. They view the economists' disdain as an inaccurate and insulting caricature that indicates their ignorance of the real-world banking business. Regulators tend to believe in their experiences, which overwhelmingly teach that control frauds exploit regulatory weaknesses and that normally honest, sober bankers act like frat boys on spring break during financial bubbles. Imprudent lending is the norm in bubbles. Regulators have seen many econometric "proofs" of propositions they know to be false from experience. Some of them have a reasonably sophisticated understanding of the illusion of precision in empirical work and the many opportunities for subjective coding to lead even the best scholars into error. To date, the regulators have staved off the economists' war against banking regulation, and even the World Bank's economists have had to concede that the initial results of the Basel process are extremely positive.

options falls. The CFO may be fired.

The upshot is that modern compensation systems and the short-term perspective of investors and senior managers all result in perverse incentives to make grossly imprudent investments in those assets experiencing the worst bubbles. This creates a destructive cycle in which large numbers of financial institutions follow the same dysfunctional strategy, which in turn extends and inflates the bubble and produces even more accounting control frauds.

Basel II does have a worrying component. It encourages the large banks to value their assets (which implicitly means evaluating their risk) using their own proprietary models. It is easy for these models to be designed so as to dramatically overstate asset values. The problem is compounded by the nature of proprietary models: they are secret, complex, and (perhaps) subject to frequent adjustment. That makes them a nightmare to try to regulate. And in what is essentially a form of control fraud, modern compensation systems, especially in the United States, create powerful incentives for top managers to overstate banks' asset values in order to puff up their own pay packages. Such abuse is so common that instead of "mark to market," the usual term for bringing the valuation of an asset into line with its market price, the process is often known to insiders as "mark to myth."

In the United States, the word "deregulation" still has a positive ring for many despite the disastrous results of this country's experiment in loosening the reins on the banking industry. So perhaps it is ironic that it was the United States that instigated an international effort to develop convergent banking regulations worldwide. International convergence is moving forward, and for now the pace of new financial crises has slowed. The Basel process is indeed leveling the playing field among financial services companies around the world. But what kind of field will emerge? Does the Basel process offer any hope of reshaping the new world of banking into one that better meets consumer needs and better serves the broader public interest? If the banking economists, with their ideological commitment to oppose any regulation, are kept at bay, then at least we may find out.

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