Putting bankers in jail cannot prevent mistakes [1]

Written by **Sam Bowman** [2] | Wednesday 19 June 2013

The Parliamentary Commission on Banking Standards has published its report on how to make bankers act less irresponsibly [3]. Among other things, it recommends making bankers criminally liable for reckless professional conduct. ?Too many bankers?, it says [4], ?especially at the most senior levels, have operated in an environment with insufficient personal responsibility?.

The assumption here is that bankers acted recklessly because they were insulated from the negative consequences of their actions. I don?t know if that?s true. During the 2008 crisis, plenty of executives at failing financial institutions made the same mistakes that their firms made. AIG?s former CEO kept much of his net worth in AIG stock, most of which he lost [5]. The CEO of Lehman Bros lost $1bn. Citigroup?s Sanford Weill lost $500m. Between them, Bear Stearns? executives lost billions.

There are many other examples like these. If bankers had known that they were acting recklessly in business, they would not have done the same thing with their personal holdings. That so many executives' *personal* losses were so great suggests that they did not realise what they were doing. Their bad business moves were errors, not calculatedly reckless decisions.

Indeed, Jeffrey Friedman has shown that the real error was on the part of regulators [6]. Financial regulations such as the Basel capital accords that were designed to make banks act more prudentially in fact did the opposite, incentivizing banks to load up on government-backed mortgage debt and, particularly in Europe, government bonds. And, unlike mistakes made by individual firms, these mistakes were compounded across the entire global financial system.

Making the punishment for failure harsher will only improve behaviour if the people affected *already know* that they?re doing wrong. If they?re simply mistaken ? as I would imagine you?d have to be to lose billions of dollars of your own net worth ? regulations like this will not have the effect we want them to.

But what about the ones who really did know what they?re doing? We used to have a mechanism for punishing reckless business practices ? it was called bankruptcy. In banking, at least, this seems to have been abandoned in favour of unlimited bailouts. If we had let bad banks go bankrupt, as Iceland did, we might not be in such a bad situation today.

Throwing a few scapegoats in jail to satisfy an anti-banker mob ignores that the crisis was largely about regulators' and bankers' error. It is no replacement for letting bad firms go bust and punishing them the old-fashioned way.

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