

# Whistle-blowing in the Stampede?

Comment on B. Frey and R. Cuenis, ‘Moral Hazard and Herd Behaviour in the Financial Crisis’

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## I. Mismatch

Public support for whistle-blowing—this is what I see as Frey’s and Cuenis’ important contribution to the debate on herd behaviour. Whistle-blowing is one of the strongest countervailing forces in a situation where everybody agrees with a wrong corporate decision and nobody dares to protest. Frey’s and Cuenis’ ambition is to strengthen the civic virtues of dissent, protest, opposition, and *Zivilcourage* against the stifling atmosphere of corporate hierarchies and against strong market pressures for rigid conformity. Their diagnosis plausibly makes prohibitive costs of non-herding responsible for the lack of publicly raised opposition in the firm and in the market, and they can successfully claim empirical support from interviews with managers. Three main factors are singled out as raising the costs of non-herding: conflicts and problems of justification, deterioration of career opportunities, and social pressure by colleagues (groupthink). Their therapy aims to reduce these costs of dissent, among other things by strengthening institutionalized diversity in decision-making organizational bodies. Corporate governance reforms, either via private ordering or via corporation law, could play a decisive role in encouraging a culture of dissent in the corporate world. In my view, these are promising strategies.

However, of what help is whistle-blowing in a stampede? The recent financial crisis unleashed collective turbulences of such violence that the suggested cost-lowering devices would remain unheard. The herding behaviour during the recent financial crisis belonged to this especially turbulent kind, as a British observer noticed: ‘[t]he fastest-spreading contagion known to humankind swept through Britain this week causing raised blood pressure, spiralling stress hormone levels and rash economic actions galore. The contagion is an outbreak of mass

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panicked anxiety'. 'Contagion'—this is the key concept in the new discipline of financial epidemiology which has been developed by economists like Claessens, Forbes, and Haldane and by sociologists like Staeheli. Finance theory conceives of contagion as a 'spread of market disturbances . . . from one country to another',<sup>1</sup> or as a 'spill-over' effect. Contagion is based upon (too) close inter-dependencies of different markets or market sectors. The measure of contagion is defined by a change in correlations: '[c]ontagion is best defined as a significant increase in cross-market linkages after a shock.'<sup>2</sup> Both the speculation boom before the crisis and the panic reaction in the midst of the crisis are attributed to processes of contagion in financial markets which made both resistant to cost-conscious incentives. When Alan Greenspan discovered that this contagion in the finance markets was irresistible even for rational institutions, it came as a shock: 'those of us who have looked to the self-interest of lending institutions to protect shareholder's equity, myself included, are in a state of shocked disbelief.'<sup>3</sup> He would never have believed that banks would act against their own interests by imitating thoughtlessly high-risk 'gambling' practices to the point of self-destruction. It brought Greenspan to the painful realization that his 'whole intellectual edifice . . . collapsed'.

My argument in a nutshell: public support for whistle-blowing alone is helpless in a situation that the new financial epidemiology describes as the rapid processes of social contagion. Since reduction of dissent costs relies only on incentives for individual action, it cannot combat two crucial dynamics in the crisis. One is the overwhelming affective dynamic—vulgo: greed and fear—under the influence of which cost arguments are silenced. The other is a genuine collective dynamic in financial herding, a maelstrom which sweeps away individual resistance. Both dynamics require considerably widening the search for public reactions—to engage in the politics of contagion.

## II. Collective Dynamics of Herd Behaviour

As is well-known, greed and fear—the affective dynamics of social contagion—greatly diminish the effects of a strategy that tries to reduce the costs of dissent. For a long time, criminological research has demonstrated that effect-related deviance cannot be prevented either by cost-raising negative sanctions or by cost-reducing positive incentives.<sup>4</sup> More recent risk analyses show that even when cost considerations do play a role, strong affective engagement changes the risk perception so drastically that cost reductions become marginalized. In any case, the regulatory resources needed to block herding behaviour via cost incentives

<sup>1</sup> S. Claessens and K. Forbes (2001) *International Financial Contagion* (Dordrecht: Kluwer, 2001) 22.

<sup>2</sup> Claessens and Forbes, n 1, 46.

<sup>3</sup> A. Greenspan, *New York Times*, 24 October 2008.

<sup>4</sup> For a devastating critique see P. -A. Albrecht, *Der Weg in die Sicherheitsgesellschaft: Auf der Suche nach staatskritischen Absolutheitsregeln* (Berlin: Berliner Wissenschaftsverlag, 2010) 153.

for individual dissent will be prohibitively high in the highly emotionalized situations of speculation booms or panic reactions in financial crises comparable to 2008.

A cost reduction strategy seems even more problematic when it comes to influencing the collective dynamics in herd behaviour in financial markets. Here, theories that try to identify a collective subject, a ‘crowd spirit’, a *conscience collective* in the Durkheimian tradition, are clearly misleading. Methodological individualism has successfully criticized such a mystification of collective entities. But for methodological individualism itself, the collective phenomenon of herd behaviour is difficult, if not impossible, to grasp. At best, methodological individualism can reconstruct herd behaviour by taking up elements of the old mass psychology and interpreting herd behaviour as the aggregation of irrational individual behaviour in a mass situation where massive stress induces individual actors to act erratically. But the sheer aggregation of individual motives cannot explain the fast-spreading contamination, be it the mechanics or the dynamics. It looks only to its effects on individuals and is not able to identify the medium of contagion itself, the channels of contamination and its inner dynamics.

The decisive step beyond this misplaced alternative is to identify the collective dimension of financial herding behaviour in a different way. Neither a simple aggregation of individual motives will do nor will the erratic movements of one trans-individual collectivity. Instead, it is the autonomous flow of financial communications itself that represents the mediality of contagion. Communication, the triad of information, signalling and understanding financial transactions, is the carrier of the contagious process on which empirical research, theory constructs, and institutional reforms should concentrate.<sup>5</sup> ‘*Contagio*’ (which means touching) does not take place in the complex motivation structure of individual actors which is then supposed to be transferred in the meeting of minds from actor to actor. Instead, the contagious spreading happens much more directly in the concentration of one financial communication—money transfers as well as financial information—to the other. Social contagion gains its enormous speed and power by deviating from the usual time-consuming mode of interaction in which two actors exchange information in a complex ego-alter-relation. Instead, decisions are based on unilateral observation and pure and rapid imitation. In situations of social contagion, ‘communication becomes an uncontrollable cascade of events’<sup>6</sup>

The overwhelming dynamic of financial contagion is fully understood once it is seen in its interaction with other components of excessive growth compulsion within financial markets. The material component is an excessive multiplication of symbols, of ever-new financial instruments. The temporal component is

<sup>5</sup> *Locus classicus*: N. Luhmann, *Social Systems* (Stanford, CA: Stanford University Press, 1995) 139–45.

<sup>6</sup> U. Stäheli, ‘Political Epidemiology and the Financial Crisis’ in P. F. Kjaer and G. Teubner (eds) *The Financial Crisis in Constitutional Perspective: The Dark Side of Functional Differentiation* (Oxford: Hart Publishing, 2011) 123–42, 140.

acceleration of financial transactions, mainly via information technologies. And the social component is contagion which is reinforcing the temporal and material components and is reinforced by them.<sup>7</sup>

This shifts the attention away from individual motives of investors to the links between financial communication flows and the institutional structures that influence these flows. Instead of analysing in depth the ‘infections’ of individual actors, the inquiry should ask how the ‘channels of contamination’ are structured and how the infection is transmitted. Of course, flows of information are always accompanied by individual motivation, but the dynamics of contagion do not take place in the reduced psychic state of greedy or angst-ridden individual investors, rather in the connectivity of financial communication chains. In short:

The epidemiological framework is not primarily interested in processes of subjectification (which would look to motivations of individuals and the influences of sanctions and incentives, G.T.), but in the control of network structures and topologies. What is in the foreground are the flows of communication and their media infrastructure, network links and the organisation of connectivity.<sup>8</sup>

### III. Financial Epidemiology

If the dynamics of contagion in speculation bubbles and panic behaviour cannot be combated by individual cost incentives alone, does this then mean *lasciate ogni speranza*? Indeed, as one observer rightly notes, it is very ‘difficult to control the spread of panic behaviour... Within the financial system, robustness is something that emerges; it cannot be engineered.’ Contagious dynamics cannot be fought directly, one must make recourse to indirect measures that restructure the channels of contamination. One needs to go beyond measures of regulation that attack the causal influence of one or another factor responsible for the crisis, as well as beyond strategies that influence individual motives of behaviour. The financial markets need changes in the connectivity of communication channels, transformations of their capillary constitution. Indirect control means ‘creating network conditions which prevent the quick spreading of contagious dynamics’. The key is what Luhmann called *Interdependenzunterbrechung*, ie interrupting too close interdependencies.<sup>9</sup>

In this vein, Haldane, one of the directors of the Bank of England and the main representative of financial epidemiology, recommends two strategies that would have the capacity to block the channels of financial contamination: (1) restructuring

<sup>7</sup> G. Teubner, ‘A Constitutional Moment? The Logics of “Hit the Bottom”’ in P. F. Kjaer and G. Teubner (eds) *The Financial Crisis in Constitutional Perspective: The Dark Side of Functional Differentiation* (Oxford: Hart Publishing, 2011) 3–42, 9. For more details, see G. Teubner, *Constitutional Fragments: Societal Constitutionalism and Globalization* (Oxford: Hart Publishing, 2012) 78–81.

<sup>8</sup> Stäheli, n 6, 138. On legal regulation of network structures, see G. Teubner, *Networks as Connected Contracts* (Oxford: Hart Publishing, 2011) chaps 4–6.

<sup>9</sup> Luhmann, n 5, 38, 476.

of financial networks and (2) de-homogenization of financial information. Both would change the ‘capillary constitution’<sup>10</sup> of the finance sector, but each would target a different contagion process. The first strategy tries to reduce contagion between primary operations, ie, in the flow of financial transactions themselves. The second strategy counteracts contagion between secondary operations, ie information, models, instruments, rumours, stories, and narratives that influence financial transactions.

As for the first strategy—restructuring of financial networks—Haldane argues that the massive deregulation of the last decades swept away banking segregation and, with it, decomposability of the financial network. The upshot was a predictable lack of network robustness in financial markets. He recommends that this massive growth of uncontrollable interdependencies should be blocked by measures similar to Glass-Steagall which should now be back on the international policy agenda. Even if it is too narrow an answer, he thinks this is asking the right question: can network structure be altered to improve network robustness which would block financial contagion?

He recommends reshaping the financial network so as to reduce the chances of future systemic collapse. He pleads for learning from experience with engineering networks through intra-system netting arrangements, which reduce the financial network’s dimensionality and complexity. And regulation should ensure appropriate control of the damaging network consequences of the failure of large, interconnected institutions. Since financial networks are asymmetrically structured insofar as they have only few central nodes and numerous peripheral nodes, financial epidemiology should realize that these central nodes are super-hubs with increased connectivity and may well become ‘super-spreaders’ of the contagion. His advice, then, is to actively seek to vaccinate the ‘super-spreaders’ to avert financial contagion.

The second strategy—de-homogenization—is even more indirect, because it restructures not the payment flows themselves, but the information channels on finance instruments and risk management. Perhaps they even represent the most ‘contagious’ dynamics’ of public perceptions and asset valuation’;<sup>11</sup> they are responsible for a dangerous homogenization of financial models across financial sectors and within them. Simultaneously the information about potential risks, auditing, and risk management became homogenized in their turn. And even regulatory measures like Basel II amplified this homogeneity. They provided a prescriptive rule-book ensuring a level playing-field. Ratings were hard-wired into regulation. These information channels in finance models and risk management opened the way for the waves of informational contagion. From this follows the

<sup>10</sup> Derrida introduces this term contrasting it to the ‘capital constitution’ of the state which is not capable of changing the inner processes of the economic and other discourses: J. Derrida, *The Other Handing: Reflections on Today’s Europe* (Bloomington: Indiana University Press, 1992) 34. For an elaboration of the concept, see G. Teubner, n 7, 83–6.

<sup>11</sup> R. M. May, S. A. Levin, and G. Sugihara, ‘Complex Systems: Ecology for Bankers’ (2008) 451 *Nature* 895.

policy recommendation to change information channels in such a way that the chance to *heterogenize finance products, risk strategies and regulation* will increase.

Again, the important thing is to change the ‘capillary constitution’ of the network. The suggestion is to introduce Central Counterparties (CCPs) which interpose themselves between every trade and transform the complex but fragile web from a highly decentralized heterarchical network into a more hierarchical network that consists of bilateral relationships with the central counterparty. This would be needed for all kinds of financial instruments, including a broad range of over-the-counter financial instruments, both cash and derivatives.

It is at this point that Frey’s and Cuenis’ cost lowering strategies and Haldane’s and Staeheli’s network restructuring strategies show a certain complementarity. Both strategies aim at legal policies that institutionalize dissent and diversity of opinion, different financial instruments, methods of risk analysis, and regulatory interventions. But only if the networks in the financial markets are restructured so that they create a sufficient amount of heterogeneity of operative and informational channels can the prohibitively high costs for individual actors be reduced to allow them to express their disagreement within the corporate hierarchies.