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On the Wrongfulness of Bank Contributions to Financial Crises

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1. Introduction

Financial crises are severely harmful events. The Global Financial Crisis of 2008 (GFC) demonstrated this forcefully: 35 million people lost their jobs, 19.1 million of which were citizens of developing nations (ILO 2009); 84 million people have been pushed below the extreme poverty benchmark of a daily income of \$1.25 (World Bank 2010); more than one-quarter million excess cancer-related deaths resulted from the aftermath of the GFC (Maruthappu et al. 2016).

Private commercial and investment banks have often been identified as one of the main culprits of the GFC. Much of the philosophical literature agrees: The core of the problem were greedy, overly risk-friendly bankers who were part of a morally corrupt culture in banking (see for example de Bruin 2015; Graafland and van de Ven 2011; Moore 2012; Sison and Ferrero 2019). However, is it exclusively "greedy bankers," as Tooze (2018, 26) put it, who committed wrongdoing? This question is of particular importance, because the problem we identify to be at the center of past financial crises will have an impact on how we attempt to mitigate future financial crises. Greedy bankers require a different response than, for example, merely increasing capital requirements for banks, as suggested by experts in finance and economics (Admati et al. 2010).

In this chapter, I investigate what precisely makes it wrong for banks to contribute to financial crises in general and explore different ethical theories that try to provide an answer to this question. More specifically, I defend the view that the actions of banks which contribute to a financial crisis are wrong insofar as they collectively expose third parties to a severe risk of harm. The chapter is structured as follows. In section 2, I illustrate how banks can contribute to financial crises in reference to the best-known economic theory that explains how financial crises emerge, Hyman Minsky's Financial Instability Hypothesis (FIH). In section 3, I sketch out the general structure of collective harm cases and explain how this structure applies to the case of bank contributions to financial crises. I also argue here that we have a defeasible pro tanto reason to consider bank contributions to financial crises as wrong insofar as they expose third parties to a

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severe risk of harm. Section 4 discusses the virtue ethical perspective on individual bank contributions to financial crises. Virtue ethical theories can acknowledge that it is in some cases pro tanto wrong for banks to impose risks on third parties, but because of their insistence that only vicious conduct is wrongful, they fail to concede that even virtuous agents (including banks) can wrongfully contribute. Section 5 is dedicated to the consequentialist perspective on bank contributions. I argue that consequentialist theories can also acknowledge that bank contributions wrongfully impose risks onto third parties, but they fail to acknowledge important fairness considerations regarding risk impositions. In section 6, I demonstrate how Scanlonian contractualism can circumvent the problems of both virtue ethics and consequentialism. Section 7 concludes with a summary of the main arguments and an outlook on future research.

2. Financial Crises and Bank Contributions

In his book *Finance and the Good Society*, Robert Shiller emphasized that "finance remains an essential social institution, necessary for managing the risks that enable society to transform creative impulses into vital products and services" (Shiller 2012, xvi), while Ann Pettifor even speaks of banking as a public good (2016, 155). But the past decades have demonstrated that our financial system is periodically under threat of catastrophic failures, i.e. financial crises. Financial crises are states of affairs in which the financial system's functioning is catastrophically impaired; most centrally, the function of matching lenders with borrowers. Whether a financial crisis erupts or not is a matter of uncertainty. Economists refer to the risk of a financial crisis as Systemic Financial Risk (SFR), i.e. the risk that an endogenous or exogenous shock will unravel imbalances within the financial system which then results in significant economic losses (Smaga 2014, 1).[1] SFR builds up through the transactions of a multitude of market participants, until, if nothing is done to prevent the outcome, it culminates in a financial crisis. Banks are at the center of most financial crises.

In order to illustrate the role of banks in the emergence of a financial crisis, it pays to look a bit closer at the mechanisms by which such crises come about. For this, we require an explanatory model that tells us how individual lending operations of banks causally connect to the emergence of a financial crisis. One of the most prominent economic models of financial crises is Minsky's FIH.[2]

[1] Alternatively, one might define systemic risk not as the risk to the entire financial system, but instead as the contribution of a single individual firm to a financial crisis. See also Acharya et al. (2012).

[2] See for example Kindleberger and Aliber (2005), Brunnermaier and Oehmke (2012), Eggertson and Krugman (2012), Bhattacharya et al. (2015). Additionally, an excellent recent contribution in political economy on Minskian supercycles can be found in Gabor et al. (2020).

According to the FIH "[the] instability [of our financial system] is not due to external shocks or to the incompetence or ignorance of policy makers. Instability is due to the internal processes of our type of economy" (Minsky 2008, 11). The FIH states that an economy's financing structure is determined by the predominating financing structures of the individual firms within the economy. Minsky distinguishes three such structures: First, "hedge units," i.e. firms that are consistently able to meet their payment obligations without taking on further debt. Second, "speculative units," i.e. firms that have to roll over their debt to meet their payment commitments. Third, "Ponzi units," i.e. firms that constantly have to grow their debt in order to meet their payment commitments. The central contribution of the FIH is an explanation of how stable hedge economies transform into instable speculative and Ponzi economies.

The model begins with the boom phase of an economy, during which lenders grow less cautious about the debt structure of their borrowers, as most borrowers are hedge units. As a result, more and more firms thus enjoy a wider availability of credit (Minsky 1982, 65). But over time, debt becomes a significant production cost which diminishes profit margins, because once the demand for debt increases, so does its price: Interest rates rise (Minsky 2008, 239). Higher costs of debt diminish profits further and hence, the economy gradually is ever more characterized by the presence of speculative units and Ponzi units, which need to acquire additional credit in order to repay their old debts.

This process continues until the economy reaches an "upper turning point," i.e. a state of affairs in which production costs, financed by both internal (i.e. equity) and external (i.e. debt) sources, are greater than the value of goods produced (Minsky 2008, 239). Firms that were once hedge units are transformed into speculative and Ponzi units, which are highly sensitive to increases in interest rates. If interest rates rise, speculative and Ponzi units must find new sources of income to cover their increased costs. If they fail to do so, they might be pressured to desperately sell off their assets at only a fraction of their value. Such processes are known as "fire sales." Fire sales are one of the central transmission mechanisms by which SFR spreads through the financial system (ECB 2019). Eventually, some firms will go bankrupt due to some relatively small trigger event. As a result of increased bankruptcies, lenders refuse to offer credit as willingly, thereby provoking a sharp debt contraction, a so-called credit crunch. Many firms that survive the initial shock are likely to lose their credit lifelines over time. This is the beginning of a financial crisis.

Minsky's FIH does not stop here: Even if the current crisis can be overcome, a new boom phase might set the stage for the next crisis. But economies are not inevitably caught in a cycle of booms and busts. Appropriate policy interventions can help economies escape the grasp of instability (Minsky 2008, 324). Among these policies are, of course, also financial regulations that determine the degree to which financial institutions are permitted to contribute to the boom phase of a financial crisis. As Minsky notes: "the financial powers and practices of corporations are the starting points for policies to manage or contain instability" (Minsky 2008, 349). But unless appropriate regulations are thoroughly enforced, firms are free to contribute to the emergence of the next crisis.

On to the banks' impact on financial crises. In their highly influential book *This Time It's Different* (2009), Reinhart and Rogoff empirically confirm one of the central insights of the FIH: Financial crises are almost always precipitated by a credit expansion (Reinhart and Rogoff 2009, xxxiii). Credit expansions are driven by financial institutions of various kinds, but my focus here lies with banks.[3] Banks are most usefully characterized in terms of the functions they serve in an economy. Central to my arguments in this chapter is the banks' lending function, i.e. the provision of credit. The provision of credit is a vital source of economic growth. Credit is beneficial insofar as it allows consumers and firms to finance capital expenditures and overcome liquidity constraints, i.e. temporal difficulties in meeting one's payment obligations (Meyer 2018). But as Minsky points out, once credit becomes an essential source of funding for a firm's day-to-day operations, firms are rendered highly vulnerable to adverse changes in financial markets (Minsky 2008, 260). These credit expansions can increase an economy's growth rate for a while but can eventually lead to a financial crisis. Due to their lending function, banks are thus specifically important in their role of enabling credit expansions.

Just like their non-financial counterparts, banks are profit-maximizing firms. Banks generate profits from earning more on assets, i.e. loans and investments, than they pay for funds, i.e. their own debt (Admati and Hellwig 2013, 84). When a widespread erosion of margins of safety occurs, some banks might be incentivized to secure their profits by either increasing their net earnings per unit of assets or by increasing their net assets per unit of equity (Minsky 2008, 265).

The first option ultimately requires banks to extend riskier loans to extract higher risk premia from their bank or non-bank borrowers. A bank can demand a higher interest rate in order to compensate for excess risk. All things equal, this increases the bank's net earnings per asset (i.e. loan) and thereby their profit. Minsky specifies two types of particularly risky loans: Loans the repayment of which depends on increasing asset prices and loans the repayment of which depends on the increasing value of the underlying collateral (Minsky 2008, 261). Both kinds of loans are vulnerable to changes in financial markets and hence tend to introduce a "Ponzi-flavor" into the financial structure of an economy. In the

[3] In what follows, I will use the term "bank" somewhat loosely, as is usual in the economics jargon. What precisely institutions do that are legally declared as banks differs from jurisdiction to jurisdiction. Furthermore, with the age of financial liberalization, non-bank financial firms (for example mutual and hedge funds, commercial paper markets, and insurance companies) have moved their business activities onto the turf of banks and vice versa. Hence, the arguments I provide in this section will to some extent also apply to non-bank providers of credit.

next section, I provide an example (*Land Loan*) involving a loan the repayment of which is dependent on its underlying asset value.

The second option involves extending more, rather than riskier, loans by borrowing more. By taking on more debt (an increase in liabilities), banks are able to finance more loans and thereby generate more profits. Banks are speculative units in Minsky's sense of the term, but the more a bank's balance of debt and equity shifts toward debt, the more the bank itself becomes exposed to adverse developments in financial markets (Minsky 2008, 262).

In conclusion, the business model of banks itself creates incentives to drive credit expansions. Consequently, not all bank lending is increasing the risk of a financial crisis. But some specific kinds of loans can steer borrowers into speculative or Ponzi finance. Banks themselves can also increase their own vulnerability to changes in financial markets, for example, by borrowing excessively to fund their own lending operations. Because both methods of producing profit mentioned above increase the vulnerability of the financial system to financial crises, both constitute contributions to the risk of a financial crisis. In the next section, I explain the moral relevance of bank contributions in the context of collective harm cases.

3. Financial Crises as Collective Harm Cases

From the standpoint of moral philosophy, it is helpful to consider financial crises as collective harm cases. Collective harm cases are situations in which a group of individual agents engage in actions which collectively lead to an undesirable outcome.[4] Consider a variation of a famous example introduced by Derek Parfit for illustration:

> *The Harmless Torturers*: A victim is strapped to a table that is connected to a machine with a thousand buttons. Each button, once pressed, will imperceptibly increase the voltage of an electric shock received by the victim. A torturer is assigned to each button. Even though the victim does not perceive any pain when only few torturers press their button, once sufficiently many do so, the victim will be in unbearable pain.[5]

The example illustrates three morally relevant features of collective harm cases. First, it is obvious that the end result (the victim's suffering) is *undesirable*. Second, the undesirable result only comes about as a *combined effect* of (some, if

[4] For the sake of simplicity, I assume that even collectives such as firms qualify as agents in the relevant sense. For further discussion, see for example French (1979).

[5] For variations of the Harmless Torturer case, see Parfit (1986) and Spiekermann (2014).

not all) torturers pressing their respective buttons. Third, while the combined effect causes the victim's pain, it is unclear whether any individual torturer causally contributed to this outcome, since no button press on its own was sufficient or necessary to bring about the victim's pain (Sandberg 2011, 235).

Nonetheless, many of us will have the straightforward intuition that the torturers do not only do wrong as a collective by causing the victim severe pain, but that each individual torturer does wrong. I assume this assessment is correct: We have a reason to consider each of the individual actions as *wrongful, because each one causally contributes to a collective action that imposes significant harm onto the victim*.

Let me expand on the central concepts of this claim: First, having a reason to consider an action wrong does not entail that the action is all-things-considered wrong; we may have strong countervailing reasons. The kind of reasons I discuss throughout the course of this chapter are thus defeasible, pro tanto reasons. Second, the term "causally contribute to a collective action" serves as a placeholder here. Some contributors to the literature on collective harm cases doubt that individual actions are causally efficacious in bringing about collective harms (such as Sinnott-Armstrong 2005 and Sandberg 2011). But if there is no causal connection between individual contributions and a collective harm, it follows prima facie that there is no reason not to perform actions that only seem to, but do not actually causally contribute to a collective harm (Nefsky 2017, 2744). Solving this particular issue is not the focus of this chapter. Instead, the term "causally contribute to a collective action" stands as a placeholder for whichever account delivers the result that individual contributions do have a causal impact on the collective harm in question (such as the victim of the torturers being in pain).[6] To sum up: We have reason to consider each torturer pressing their button as wrong, because each torturer thereby *contributes to a collective action that exposes a third party to an undesirable outcome*, i.e. *the victim suffers severe physical pain*. I believe that this reasoning generalizes to other collective harm cases, including financial crises.

The analogy from *Harmless Torturers* illustrates why financial crises also constitute collective harm cases: First, financial crises tend to *cause significant risks of harm* and thereby threaten the livelihoods of those who were not participating in transactions that brought about the crisis.[7] This is doubtlessly an undesirable outcome. Second, the overall risk of a financial crisis (i.e. SFR) is the combined effect of an immense number of financial transactions. A large number

[6] The literature offers a wide variety of solutions to this problem. Due to space constraints, I refer readers to Kagan (2011), Braham and van Hees (2012), Kutz (2000), and Nefsky (2017).

[7] There is an ongoing debate on whether risk impositions constitute genuine harms (see for example Oberdiek 2017). I remain non-committal on this issue here. I merely assume that we have pro tanto reasons to consider risk impositions wrong. Readers put off by the term "collective harm cases" are hence invited to replace it with "collective risk cases."

of these transactions were the result of standard banking practices. Individual banks thus collectively contribute to the collective risk of SFR by engaging in these practices. Third, as discussed earlier, I assume each individual bank's contribution is causally efficacious in bringing about SFR. For illustration, consider the following case:

> *Land Loan*: Credit Bank (CB) is a medium-sized, domestic bank which, among other products, provides so-called land loans, i.e. loans that use land as collateral.[8] CB approves a land loan of $1 million to GTA Inc., a mid-sized automotive supplier. Because GTA Inc. is already heavily indebted, the loan contains an unduly significant default risk for CB. By providing the loan to GTA Inc., CB hence slightly increases the risk that the bank itself might not be able to meet its own payment commitments in time. This effectively constitutes a minimal increase in SFR (or, in Minsky's terminology, a minute shift toward a vulnerable Ponzi-type economy). A large number of banks approve similar loans. The combined loans destabilize the financial system sufficiently to cause a financial crisis.

Similar to each individual torturer's causal contributions to their victim's suffering, the increase in SFR produced by CB's loan approval is seemingly causally negligible in isolation. However, taken together, the collective contribution to SFR by CB and the other banks is one of the primary causes of the resulting financial crisis. CB causally contributed to a collective action that generated a significant risk of harm to third parties, just as each individual torturer contributed to the risk that the victim might suffer severe pain. If we have reason to consider the actions of each individual torturer as wrong, then we must also have reasons to consider the actions of each individual bank as wrong.

Notice that this line of reasoning adequately captures the outrage directed at the financial industry in the aftermath of the GFC: It was obvious to even the most casual observer that the GFC was caused in part by the excessive risks taken on by the financial industry (FCIC 2011, xviii). In acknowledgment of this fact, Barack Obama famously warned the financial community in 2014 that the USA would "not go back to the days of reckless behavior and unchecked excess at the heart of this crisis" (*New York Times* 2014). I believe the widespread consensus on risky financial activities should guide our moral evaluation of bank contributions to SFR. Any moral evaluation of risky activities by the financial sector should acknowledge that we have at least a defeasible, pro tanto reason to consider financial transactions that raise the risk of a financial crisis as wrong.

[8] As explained earlier, CB approves the loan in the hope that the value of the underlying collateral, the land, will increase. However, the loan is risky because the land on its own does not generate profits for GTA Inc.

However, there are also important disanalogies in *Harmless Torturers* and financial crises: First, that the degree to which each contributor increases SFR is not homogenous. All else equal, we have a stronger reason to consider larger contributions as wrong compared to smaller contributions. Second, the interests of the contributors are not homogenous either. Financial firms differ in their business models, their legal forms, the markets in which they operate etc. In this chapter, I focus exclusively on the case of bank lending, but there are other kinds of actions by which financial firms can increase SFR (developing misguided financial innovations, promoting subpar underwriting standards, etc.). Third, as has been mentioned earlier, even if there is reason to consider contributions to SFR as wrong, such reasons might be defeated. *Harmless Torturers* does not provide any such countervailing reasons. In the case of financial crises, however, one might (perhaps implausibly) argue that the benefits of excessive bank lending generally outweigh the costs of financial crises.[9]

In conclusion, I argued that financial crises can aptly be characterized as collective harm cases. The (defeasible) reason why we can consider contributions to collective harms as wrong is that they together constitute a collective action which imposes risks of severe harm onto third parties. If bank contributions to the risk of a financial crisis are structurally similar enough to the torturers' contributions in *Harmless Torturers*, they are also prima facie wrong. In the next section, I argue that a virtue ethical approach is unfortunately not fully congruent with the commonsense intuition that bank contributions are wrong because each contribution causally contributes to a collective risk imposition onto third parties.

4. Virtue Ethics

A disproportionately large number of authors in moral philosophy have discussed the role of banks in the wake of the GFC from the perspective of virtue ethics. All virtue ethical analyses point to failures of financial professionals or entire financial firms to act in accordance with a virtuous disposition.[10] Roughly, virtue ethical theories state the following:

> An action is wrong iff a virtuous agent had characteristically not performed it in the relevant circumstances. (Hursthouse 1999, 28)

Some authors argue that financial firms failed to act in accordance with conventional virtues, such as honesty, prudence and instead displayed vices such as greed

[9] Quite interestingly, this seemed to have been the consensus among mainstream economists prior to the GFC (Besley and Hennesy 2009).

[10] For simplicity, I assume here that firms can be virtuous agents, as is commonplace in some of the virtue ethical literature on the GFC, see for example de Bruin (2015).

and an irrational appetite for risk (Moore 2012; Sison and Ferrero 2019). An exception worthy of mention from this standard is de Bruin (2015), who argues more subtly that a lack of epistemic virtues, such as epistemic courage and generosity, was a driver of incompetence among financial firms and regulators. In general, virtue ethical accounts offer a compelling narrative about why banks contributed to the GFC. But virtue ethical accounts also imply that bank contributions are morally wrong precisely because they resulted from a lack of virtue. The virtue ethicist would hence argue that in *Land Loan*, CB's loan approval is wrong, insofar as the loan would not have been approved by a virtuous agent.

But despite the initial appeal, the virtue ethical analysis has drawbacks. To see this, consider again the FIH. According to the FIH, banks' involvement in credit expansions is part of their business model. Far from being vicious, this is simply standard practice. Nonetheless, contributions to SFR are pro tanto wrong, even if it is not apparent that they are indeed vicious.

The main worry is thus that if only vicious conduct can in principle qualify as wrong, the virtue ethical analysis will fail to evaluate many apparently non-vicious bank contributions as wrong. For illustration, consider two variations of *Land Loan*:

> *Land Loan 1*: Before being presented with the option to approve GTA Inc.'s loan, CB underwent significant change. Ethical counselors successfully changed the internal moral culture of the company, eliminating any traces of greed, psychopathy, incompetence etc. After long and careful deliberating on GTA Inc.'s loan, CB approves the loan with the same impact on SFR as in *Land Loan*.
>
> *Land Loan 2*: Contrary to the case in *Land Loan 1*, CB did not receive any guidance by ethical counselors and exhibits a careless, greed-driven internal firm culture. Nonetheless, CB does not approve GTA Inc.'s loan out of sheer incompetence.

The examples show that we can conceive of cases in which the presence or absence of virtuous behavior is not correlated with the imposition of a risk onto a third party. There is no apparent lack of moral virtue in *Land Loan 1* (while there is an evident lack of both moral and epistemic virtue in *Land Loan 2*). Hence, the virtue ethicist will be hard-pressed to find any virtue-related reason to consider CB's loan approval morally wrong (vice versa in *Land Loan 2*). Examples like these demonstrate that "virtuous character is not sufficient to insure right action" (Adams 2006, 6). Even virtuous banks are doing wrong if they contribute to SFR in absence of any countervailing reasons. In short, what makes the approval wrong is not that it occurs due to a lack of virtue, it is simply that the approval constitutes a contribution to a collective risk imposition.

The virtue ethicist could object that problematic cases like *Land Loan 1* are inconceivable. Following Hursthouse's account of virtue ethics (1999), a virtuous agent would characteristically not approve the loan, hence CB must have made a mistake or acted out of a lack of virtue. But neither of these options establishes that we have reason to consider CB's approval of the loan as wrong on the virtue ethical analysis.

First, the virtue ethicist might well agree that when a virtuous agent makes a mistake and brings about a bad outcome, she might not be acting out of a lack of virtue, but we have reason nonetheless to consider her action wrong. But it is unclear whether the virtue ethicist has the resources to acknowledge any wrong-making feature of such a mistake, given the fact that a mistake has been made precludes any further reference to a lack of virtues. In short, the virtue ethicist is not able to acknowledge that we have reason to consider CB's mistake as wrong.[11]

Second, the virtue ethicist might then state that the loan could have only been approved due to a lack of virtue. But this is where the virtue ethical analysis opens itself up to what Das (2003) called the "circularity objection."[12] The virtue ethical analysis states that it is wrong to approve the loan because it would be uncharacteristic for a virtuous agent to approve the loan. But why would this be uncharacteristic for a virtuous agent? The virtue ethicist cannot respond that it is uncharacteristic for an agent to approve the loan because doing so constitutes a contribution to a collective risk imposition. This response effectively admits that the virtue ethical analysis adds nothing but redundancy to the original analysis; the real evaluative force of the virtue ethical analysis then comes from an "independent concept of right action" (Das 2003, 332). But neither can the virtue ethicist respond that a virtuous person would not approve the loan because doing so would be wrong simpliciter—this response would constitute straightforwardly circular reasoning, because the virtue ethicist needs to explain (instead of simply presuming) why wrongful behavior is uncharacteristic for virtuous agents (Das 2003, 332).

To sum up, unless the virtue ethical analysis can overcome the circularity objection, we must conclude that the virtue ethicist's assessment of bank contributions will falsely state that we only have reason to consider vicious bank contributions (for example, those involving fraud, deception, and incompetence) as pro tanto wrong. Conversely, this implies that if virtuous banks contribute to SFR, we have no reason to consider their contribution wrong. As I argued earlier, we do have such reasons irrespective of vice or virtue.

5. Consequentialism

An obvious alternative candidate to evaluate bank contributions is consequentialism. Consequentialist reasoning has become a staple of real-world policy decision-making in the form of cost–benefit analysis (Hansson 2007).

[11] For discussion, see van Zyn (2009).
[12] For similar objections, see Hooker (2002) and Johnson (2003).

Consequentialism states that:

> An action is wrong iff it does not bring about better expected consequences than all available alternative courses of action. (Hayenhjelm and Wolff 2012)

Much of the economic and popular literature on the GFC with its focus on aggregate data reveals a consequentialist bias. Talk of unemployment rates, consumer debt levels etc. reflects a consequentialist perspective on what matters morally: That the aggregate sum of the costs imposed onto the victims of the GFC outweighs the benefits of its preceding credit expansion. Quite surprisingly, to the best of my knowledge, there is no strictly consequentialist philosophical literature on financial crises. In order to progress my argument, I assume here that a charitable consequentialist perspective on bank contributions to financial crises would state that such contributions are wrong if an alternative course of action was available that would have a minimal impact on SFR.[13] For illustration, consider the following example:

> *Land Loan 3*: Alongside other banks' efforts in contributing to a credit expansion, CB approves the loan to GTA Inc. The result of the credit expansion will likely be a financial crisis the costs of which by far outweigh the benefits of the credit expansion. Had sufficiently many banks not provided loans similar to the one approved by CB, the crisis would have had a far less severe impact on its victims.

The consequentialist will evaluate CB's action as wrong because it contributes to a collective action that generates significant harm for third parties—it leads to a worse outcome than could have been achieved. Thus, consequentialists need not appeal to a lack of virtues to explain why CB acted wrongly. Unfortunately, consequentialism is highly insensitive to the distribution of costs and benefits among those affected. To see this, consider the following case:

> *Land Loan 4*: If CB and sufficiently many banks approve their respective loans, the overwhelmingly likely outcome of this practice is a financial crisis in which a minority of individual third parties will suffer from extreme poverty (say half a million people), while the large majority will enjoy a long-term purchasing power increase of $1 per month (say 4 billion people). The aggregate increase in purchasing power slightly outweighs the aggregate suffering caused by extreme poverty. If CB does not approve the loan, it does not contribute to the collective action that brings about a financial crisis.

[13] I thus assume a contributory consequences account of consequentialism (Regan 1980, 13). For discussion, see Nefsky (2017) and Kagan (2011).

Improper bank lending in *Land Loan 4* thus generates minor benefits for a large part of the population but risks that a minority of the population ends up in extreme poverty. Notice that the example is not far-fetched: Many countries, including the USA, have experienced a stark rise in inequality after the GFC (Almeida 2015).

But because the aggregate benefit outweighs the aggregate costs, the consequentialist would argue that CB ought to approve the loan. Cases like *Land Loan 4* demonstrate that consequentialism does not consider bank contributions as wrong merely because they constitute a risk imposition. This is an important drawback of the consequentialist analysis: We might think that there is nothing wrong with imposing risks onto third parties insofar as they would benefit accordingly from risky practices. Consequentialism does not acknowledge this qualification. What matters is only the aggregate balance of costs and benefits. According to the consequentialist calculus, it is not wrong to expose a third party to a significant risk of harm and hand the potential benefits accompanying the risk to an entirely different party.[14] This excessive focus on aggregate effects is a principled problem in consequentialist reasoning that informed banking regulation and fiscal policy should demonstrate awareness of (Cochrane 2014). Scanlonian contractualism, which I discuss in the next section, is a response to precisely this problem.

6. Scanlonian Contractualism

Scanlonian contractualism (from here on: contractualism) has rarely been applied to financial crises, except for some notable exceptions such as James (2012) and Scharding (2019). In its standard formulation, contractualism states that:

> An action is wrong if its performance under the circumstances would be disallowed by any set of principles for the general regulation of behaviour that no one could reasonably reject. (Scanlon 1998, 153)

The gist of contractualism is that whether an action is right or wrong is best determined via fair negotiations between those affected by the action's consequences.[15] Strictly speaking, the participants in these negotiations do not evaluate each action on its own, but rather approve or reject principles which would permit

[14] For the classic formulation of the so-called separateness of persons objection against consequentialism, see Rawls (1999, 164).

[15] It should be pointed out that contractualists often acknowledge that the wrongness of an action does not depend exclusively on its (expected) consequences. See for example Kumar (2015, 37). Because I am exclusively concerned with the contributions to harmful collective actions in this chapter, I bracket this debate here.

the action to be performed.[16] The negotiations are subject to two constraints: First, each participant can only approve or disapprove of a principle on her behalf. This "Individualist Restriction" rules out the kind of aggregation that is involved in consequentialism. Contractualism hence does not allow greater aggregate benefits for a majority to outweigh the costs imposed onto a minority. Second, participants cannot reject a principle if all alternative principles would impose even greater costs onto others. This is known as the "Greater Burden Principle." For illustration, consider a variation of *Land Loan 4*:

> *Land Loan 5*: CB again faces a choice between approving GTA Inc.'s loan or not. If CB and sufficiently many other banks approve similar loans, the outcome is identical to the one in *Land Loan 4*. Bert is one of the unlucky few who stand to suffer from extreme poverty if CB and other banks approve the loan. Ernie is one of those who would gain a $1 increase in purchasing power.

If CB approves the loan, Bert has a complaint against CB's approval corresponding in strength to whatever his risk of suffering extreme poverty amounts to. But there are others who have a complaint against CB not approving the loan, such as Ernie. Both Bert and Ernie can only object to CB's approval or denial of the loan on their behalf. But because Bert stands to lose much more than Ernie stands to gain if the loan is approved, Bert's complaint against CB's approval outweighs Ernie's. Thus, Bert's complaint determines that it would be wrong for CB to approve the loan. Contractualism hence states that CB's loan approval is wrong due to the fact that it avoidably imposes a much greater burden on individuals such as Bert than on individuals such as Ernie.

Notice that contractualism circumvents the problems of both virtue ethics and consequentialism. Virtue ethical approaches will trace the source of wrongness back to a lack of virtue, but not all bank contributions are an expression of a lack of virtue. We have reason to consider bank contributions wrong in general insofar as they causally contribute to SFR, regardless of whether they additionally express a lack of virtue. Consequentialist approaches will maintain that it is not wrong to impose risks onto third parties if these risks are offset by some sufficient aggregate benefit—but this benefit need not accrue to the victims. Contractualism, however, avoids both problems: It does not stipulate a lack of virtue to arrive at the conclusion that bank contributions are pro tanto wrong and, by the Individualist Restriction, it requires offsetting benefits to accrue to those who have been exposed to the risk of suffering harm due to a financial crisis.

However, the discussion of contractualism thus far has been subject to an important simplification: The outcomes in *Land Loan 4* and *5* are not certain.

[16] To simplify the discussion, I modify the contractualist framework such that persons reject actions directly, instead of objecting to principles which permit actions when suitable.

To account for this, we need to consider risk-sensitive versions of contractualism. Contractualists put forward two mutually exclusive risk-sensitive variants of their theory, Ex Post and Ex Ante contractualism. These two variants differ in how they calculate the weight of burdens. Ex Post contractualism insists that the relevant burden to be considered is the full burden were the risk to materialize. In *Land Loan 5*, Bert's burden thus amounts to suffering from extreme poverty with certainty. Ex Ante contractualism permits discounting this burden by its probability. Hence, Bert's burden amounts to suffering extreme poverty discounted by the probability with which he would face this outcome. Only Ex Post contractualism is capable of reliably delivering the result that it is wrong to expose third parties to severe risks without offsetting the risk. To see this, consider the following case:

> *Land Loan 6*: CB again faces a choice between approving or not approving GTA Inc.'s loan. If approved, all employees of GTA Inc. will receive their wages as planned. Otherwise, their wages will be waived for three months. However, a financial crisis again looms in the not-so-distant future. If the crisis occurs, all domestic residents face a one-in-a-million chance of falling below the poverty line.

According to Ex Ante contractualism, CB ought to approve the loan, even though falling below the poverty line is a much larger burden than missing out on one's wage for three months. Ex Ante contractualism permits the loan approval because it is the discounted burden that counts, not the full burden should the crisis materialize. Missing out on one's wage for three months with certainty is hence the comparatively weightier burden. Thus, Ex Ante contractualism states that it would not be wrong to approve the loan.[17]

Ex Post contractualists will argue that this result is unintuitive. According to their view, we ought not discount uncertain burdens, since "harm is just as bad when suffered 'by accident' as when it is inflicted" (Scanlon 1998, 209). If the domestic population is sufficiently larger than one million, irrespective of how small the risk is, we know with virtual certainty that some will fall below the poverty line if a crisis were to occur as a result of excessive credit expansion.[18] The problem Ex Ante contractualism faces is hence similar to the problem faced by consequentialism: Ex Ante contractualism is far too insensitive toward the distribution of benefits and burdens that result from risky practices. In opposition to this result, Ex Post Contractualism states that widespread credit expansion

[17] For a related discussion on Ex Ante Rules, see Frick (2015, 201).

[18] This problem with Ex Ante Contractualism is well-known in the literature. See for example Frick (2015), Holm (2018), and Rüger (2018).

can be reasonably rejected, because it imposes unjustifiably severe risks onto third parties.

In this final section of the chapter, let us go back once more to *Harmless Torturers*: In this case, no individual torturer imposes harm on the margin, yet all of them together torture the victim with no apparent justification. By focusing primarily on the burden of the victim, instead of a lack of virtue exhibited by the torturers or the aggregate balance of benefits and burdens, Ex Post contractualists can explain why this is wrong: Whatever each individual torturer gains from pushing their button cannot outweigh the severe pain that the victim is suffering. Throughout this chapter, I argued that we ought to consider cases of bank contributions to financial crises through a similar lens: Whatever individual banks stand to gain from contributing to SFR cannot (at least not as a matter of principle) outweigh the severe burden faced by the worst off should a financial crisis occur.

Ex Post contractualism thus enriches our understanding of what we need to do in order to address the pro tanto wrongfulness of credit expansions driven by bank contributions: We need to offset the burden that impacts those most affected by SFR if a risk materializes, irrespective of how miniscule the risk is to each of them individually.[19] In order to render risky practices justifiable to each, the resulting balance of benefits and burdens must be acceptable to all potentially affected by the respective risks. Banks need to consider carefully how they drive hedge economies toward instability and minimize risks for themselves and others wherever possible. But this will not be enough. Some risks will persist and need to be counterbalanced with benefits provided to those most at risk. Such benefits should include not only better access to banking services, such as depository services and readily available access to affordable credit, but also well-designed social welfare programs that cushion the losses of the worst-off when the next inevitable financial crisis occurs. To put the matter in a well-known slogan, when banks contribute to financial crises, it is unjustifiable that the collectively brought about resulting distribution of SFR amounts to "privatized gains and socialized losses." The risks inherently created by our financial system must be mitigated and offset to offer protection specifically to those who stand to lose the most.

7. Conclusion

Individual banks have a role in safeguarding financial stability. Because of its potentially destructive impact, the conduct of individual banks is a legitimate

[19] Due to space constraints, I am here unable to discuss the various points of criticism launched against Ex Post Contractualism. For examples, see Ashford (2003) and Frick (2015). For responses to these criticisms, see for example Rüger (2018) and Steuwer (2021).

target of moral evaluation. Insofar as regulation has the objective of reining in morally unjustifiable conduct, it matters what features of a particular kind of conduct we conceive of as morally wrong. If bankers are "greedy," we might be more inclined to look for policies which show promise in combatting greedy dispositions. If financial crises are the result of practices that just did not result in sufficient aggregate benefits, we might be more inclined to permit more, rather than less risky practices. Conversely, if our goal is to protect those who are affected the most by financial crises, we might consider constraining the most excessively risky methods by which financial firms can generate profits and provide economic support for those who stand to suffer the most.

With this in mind, I proposed in this chapter that any moral theory aiming at evaluating bank contributions to SFR should at least in principle be capable of acknowledging that we have a pro tanto reason to consider bank contributions to financial crises as morally wrong. More explicitly, I argued that while virtue ethical and consequentialist analyses of bank contributions deliver this result, they suffer from significant drawbacks. The virtue ethical analysis suffers from a limited scope focused only on bank contributions that result from a lack of virtue, while the consequentialist analysis is insensitive to distribution and thus permits small benefits to some to offset immense costs to others. In a last section, I argued that contractualism does not suffer from these drawbacks. More specifically, the (Ex Post) contractualist view yields the most defensible evaluation of bank contributions. Future research informed by a contractualist perspective could prove invaluable in providing insight into the types of fiscal policy and banking regulations that could render the systemic risks generated by banks justifiable to all.

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