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"When too big to fail leads to the ends justifying the means, we are all in trouble."

The scandal surrounding the manipulation of Libor raises a myriad of question about the ability of the Central Banks to regulate in an environment where there are banks that are too big to fail. Unless the issue of bank size is dealt with, regulators will be facing decisions that they should not be forced to make. Yet even if you break up the banks, the problems of questionable financial behavior will not go away.

It has become clear that regulators around the world knew and winked at the manipulation of Libor. While Treasury Secretary Tim Geithner may be taking much of the heat, current New York Federal Reserve Bank President Bill Dudley should be shouldering even more of the guilt. He was likely in position to know what was occurring before he became Bank President in early 2009 and once he assumed his position he failed to take any action to help insure that Libor was not still being manipulated.

The extent to which Mr. Dudley bears responsibility though depends upon whether he or Mr. Geithner informed Mr. Bernanke or others at the Fed that this situation was occurring. It is hard to believe that the Fed Chairman was ignorant of the Libor price manipulation. If Mr. Bernanke was aware, then the failures to act reached into the highest levels of the Federal Reserve. But it didn't stop there. The "shift the blame" contest going on between Mr. Geithner and BOE Governor King makes it clear that this was an issue covered over in Britain and probably other financial circles. Right now, of course, all these actors are, as one former Fed insider commented, *caught between a rock and a hard place. Is it better to claim ignorance and incompetence or appear to have looked the other way as fraud was being committed?* So no one is taking responsibility. What a shock.

So why would all these regulators fail to regulate? Supposedly, it was to keep the already weak banking system from becoming even weaker at a time when the world's financial system was nearing collapse. That is a logical rationalization but it also implies that the ends justified the means. But the only reason the ends justified the means is that the banks that were at risk were simply too big to fail. And that is the key lesson from this scandal: As long as financial institutions are too big to fail, regulators will continue to allow questionable activities to persist in order to keep those institutions from failing. There is no other explanation for the unwillingness of regulators in Britain, the U.S. and around the world to act. Indeed, if the manipulation occurred at a regional bank, the actions would have been swift and punitive.

While too big to fail may be the root cause of the failure to regulate, breaking up the largest banks would not stop the illegal or unethical or massively risky actions that seem to consistently give the financial sector black eyes. It may be a necessary condition for moderating the undesirable actions but it will not be sufficient. Breaking up a company doesn't remove the incentive for individuals to behave badly. While the Supreme Court may think that corporations are people, it is not imaginary "company persons" that are misbehaving, it is real people.

As long as the returns from questionable behavior remain so huge while the costs of those actions are almost nonexistent, the behavior will continue. The literature on criminal activity is clear: If, as it is in the financial sector, the probability of getting caught is low or the cost of getting caught is modest, criminal endeavors will take place. How many people went to jail as a result of the financial misdeeds that have occurred? Not very many. Add to that easy access to the booty and you can see why the scandals keep proliferating. That is hardly rocket science.

Unless personal responsibility is enforced by putting the miscreants in jail the extreme imbalance of returns over costs will ensure that nothing will change. The only other choice is to regulate the hell out of the financial sector and that makes no sense at all. So break up the banks but also enforce the laws vigorously. Otherwise, bank regulators will be forced to look the other way again and the scandals will continue unabated.