How Little We Know: The Challenges of Financial Reform

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When an airplane crashes, expert investigators probe the cause of the crash. Their analysis can lead to changes in aircraft design, flight procedures, and regulations in hopes of reducing the likelihood of a crash in the future. The growth of knowledge in the airline industry has been extremely productive. Between 1989 and 2008, there was a seven-fold reduction in the probability of a fatal crash.

There is a natural tendency for economists (and even for normal people) to presume that similar analytical techniques can be applied to financial crashes. After all, economists presumably know more than we did in the past. We have ever more data and ever more sophisticated techniques for analyzing the data. Yet there is no evidence to suggest that financial market regulation is more effective than in the past. If anything, the opposite appears to be the case.

This discouraging empirical record does not seem to hamper the unending stream of ideas for what might make our financial system more secure, based on an analysis of what went wrong this time. It is obvious, for example, that excessive leverage played a role in the vulnerability of the firms that collapsed in 2008. The natural response is to increase capital requirements.

The incentives of management on Wall Street appear to be out of line with the interests of both investors and the taxpayers, leading to suggestions for caps on executive compensation or changes in the mix between cash and other forms of compensation. As an example, the Obama Administration pay czar, Kenneth Feinberg, has limited take-home pay for executives at firms receiving government assistance and offset the reduction with increases in stock that would not be accessible for two to four years. The hope is to encourage the growth of long-term investing instead of riskier short-term bets.

Despite the spectacular failure of Fannie Mae and Freddie Mac, some economists insist that Fannie and Freddie need to be kept in place but somehow, just made safer. This optimistic advocacy—which assumes that Fannie and Freddie are like airplanes that need better landing gear—is in spite of the fact that

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between 1992 and 2008 Fannie and Freddie had their own regulator, the Office of Federal Housing Enterprises Oversight, that failed to stop the meltdown of Fannie and Freddie that has cost the U.S. taxpayer about $100 billion and counting. Somehow, this time will be different.

EMERGENT ORDER, FEEDBACK LOOPS AND UNINTENDED CONSEQUENCES

I am not so optimistic about reforming the government sponsored enterprises or the system of regulation and supervision of Wall Street. Our financial system is unlike an airplane. It is complex in a way that makes even an airplane look simple. A synthetic CDO has something of the complexity of an airplane. The financial system is much more complex. It is an emergent system, where outcomes are the result of a dynamic interaction between investors, regulators, and politicians.

Economists have a very imperfect understanding of this interaction. Because of the feedback loops between the different actors in the system, we also have a very imperfect understanding of how changing one piece of the system interacts with the rest of the system. Landing gear that is more reliable makes an airplane safer, but reducing risk or changing incentives in one part of the financial system can cause less transparent changes elsewhere that reduce stability. Recognizing the meagerness of our understanding would be a good starting place for what should be a humble approach to financial reform.

For example, advocating 'better' supervision or 'more vigorous' regulation or even something more specific such as larger capital cushions, ignores the empirical record that regulators and politicians either for venal or human reasons, seem unable to maintain these restrictions in the face of pressure from participants. Even detailed, specific plans are unlikely to succeed because of feedback loops that are present in all emergent systems.

Hayek said: "The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design." There are few better illustrations of this than the attempts to engineer a financial system that preserves the incentives to take risks while at the same time preserving prudence. We imagine we can design a better financial system. Perhaps it is time to concede that such a top-down enterprise is inherently flawed.

Economists who treat the financial system like an airplane ignore the symbiotic dance between politicians on the one hand and financial institutions on the other.

The revolving doors between Fannie Mae and government, and between Goldman Sachs and government, are only the most obvious indicators that something is wrong. A Martian impartially observing the U.S. financial system would conclude that it is run to benefit the executives and protégés of Goldman Sachs. This is not a good thing even if it is not true. If it is true, then any meaningful financial reform must start with finding ways to break that symbiosis.

Most reforms ignore that symbiosis, condemn capitalism as inherently unstable, and look for ways to artificially create the right incentives. But the government, because of that symbiosis and other political incentives, played a significant role in reducing the stability of the system and perverting the incentives that would naturally emerge. The references provide some recent work that discusses this in more detail.

THE CONSEQUENCES OF RESCUING CREDITORS OF LARGE FINANCIAL INSTITUTIONS

The rescues of the last 25 years, starting with Continental Illinois, up through the Fed-orchestrated intervention to prevent the sudden collapse of Long Term Capital Management and the implicit guarantee of Fannie and Freddie, reduced the incentive of counterparties, particularly lenders, to restrain the highly-leveraged bets that ended up wreaking so much financial havoc.

It's obvious why equity holders like debt. But why didn't debt issuers restrain risk-taking as Wall Street firms pursued riskier investments? Part of the reason is that they anticipated the possibility of government rescue, particularly as their lending made them increasingly entangled with each other.

The importance of moral hazard, described presciently in 2004 by Gary Stern and Ron Feldman, is often greeted with skepticism because of what seems to be the restraints on recklessness imposed by equity holders. After all, the skeptics point out, Jimmy Cayne, the CEO of Bear Stearns and Richard Fuld, the CEO of Lehman Brothers each lost $1 billion (yes, with a 'b') from the collapse of the value of their companies' stocks from earlier highs. Surely this limits the moral hazard problem.

But Cayne and Fuld could not access those paper profits at will. More importantly, each man is worth in the neighborhood of $500 million, wealth they accumulated through cash compensation and the occasional judicious sale of their companies' stock in advance of the crash. Yes, there was a lot of myopia and overconfidence on Wall Street. But when people spend their own money, they spend it more carefully. Cayne and Fuld doubled down with other people's money. They were more prudent with their own.

Reasonable people can debate the magnitude of the responsibility that past rescues played in the excessive risk-taking that destroyed much of Wall Street. But the subsequent rescue of Bear Stearns, Merrill, Citigroup, Fannie and Freddie and AIG have certainly set significant expectations for the future.

The solution seems simple. Rather than try to turn this dial or push that lever connected to some part of the system the optimal amount (holding everything else constant, somehow) we should let natural feedback loops emerge that encourage prudence as well as risk-taking. For these natural feedback loops to emerge, we must get rid of the doctrine of 'too big to fail' or maybe 'too connected to fail' or at least 'too connected to Goldman Sachs to fail.'

But even otherwise optimistic economists understand that this prescription is unlikely to succeed given the incentives of politicians and policymakers to avoid short-run damage in favor of meltdowns that come to pass in the long-run, where they may not be dead but are at least out of office. Yet without rescinding the implicit policy of bailing out the creditors of large financial institutions, there will be inadequate incentives to restrain excessive leverage and the imprudence that inevitably follows when people are allowed to gamble with other people's money. Attempts to repair the system from the top-down will fail. We must find ways to let bottom-up solutions emerge.

WHAT CAN BE DONE?

These observations suggest a very modest program for reform:

Don't try to re-create the old system while trying to make it 'better.' There is a natural wariness about securitization right now. That is good. Let it blossom. There is a natural

wariness about zero-down mortgages. That is good. Let it blossom.

Recognize that having every American own a home is not the American Dream but the dream of the National Association of Home Builders and the National Association of Realtors. Any government programs to increase home ownership should be funded out of current tax dollars where the costs are visible. Get rid of mandates such as the Community Reinvestment Act. Get rid of Fannie and Freddie and the implicit guarantee that turned out to be only too real.

Be aware that the Fed is certainly part of the problem and may not be part of the solution. The Fed created the artificially low interest rates that helped inflate the housing bubble. The Fed then raised interest rates too quickly with disastrous effects for the adjustable-rate mortgages encouraged by their low-interest rate policy. Monetary policy should not be left to any self-proclaimed or publicly-anointed maestro. Following an automatic money growth rule or the Taylor rule would have avoided much of the pain. Somebody needs to hold the Fed accountable for funding exuberance.

In addition, the Fed has played a major role in exacerbating the moral hazard problem. It needs to be restrained rather than empowered. It is not good for a democracy to have an agency as unaccountable as the Fed acquire even more power and use it in ad hoc ways.

Capitalism is a profit and loss system. The profits encourage risk-taking. The losses encourage prudence. These natural feedback loops have been distorted by the rescues of the past and the present. We need to take the 'crony' out of crony capitalism. That will not be easy. But economists should not make it more difficult. The near universal praise by economists for the actions of Bernanke, Paulson, and Geithner and the near universal condemnation by economists of the decision to let Lehman Brothers enter bankruptcy, greatly reduces the credibility of any promise by policymakers to act differently in the future.

Over the last 15 months, average Americans have sent hundreds of billions of dollars to some of the richest people in human history. The better the citizenry understands this reality, the better chance the political incentives will change. If people don't understand it, the political incentives are going to stay in place. Economists play an important role in how people perceive what has happened. We should stop being the enablers of such obscene transfers of wealth.

Policymakers who make creditors and lenders whole should be excoriated, condemned and called to account rather than praised and honored. Zero cents on the dollar for bankrupt bets made by lenders and creditors would be ideal but is unlikely to be a credible promise. So let's start more modestly. A ceiling of 50 cents on the dollar for creditors and lenders when the institutions they fund become insolvent is a natural place to start. Even this may be too difficult for politicians to stomach. But economists should at least preach the virtues of letting creditors lose money when they finance imprudent risk-takers.

We are what we repeatedly do. Not what we say we are. Not what we'd like to be. But what we do. What we do as a body politic is rescue rich people from the consequences of their decisions. That is bad for democracy and bad for capitalism. Until we fix that, we as citizens are playing a game of "heads—Wall Street executives win a ridiculously

enormous amount, tails—they just win a ridiculous amount, paid for by the rest of us." Until we fix that, little else matters.

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