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Wrong Incentives from Financial System Fixes

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Reacting to the Spending Spree

POLICY CHANGES WE *CAN* AFFORD

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Stephen H. Haber and **F. Scott Kieff**

Few doubt the seriousness of the recent crisis afflicting the financial systems of the United States and the world. Few claim that nothing needs to be fixed. And few have missed the major debates about what types of solutions are best—often conducted at high volume, intensity, and frequency. So rather than try to add to one side or the other of the well-rehearsed arguments about each type of proposed reform, we try to refocus the analysis on some core incentives: when the basic rules of the game are changing, property rights and the rule of law are too ill-defined, creating exactly the wrong incentives for investment and economic growth. The wrong incentives created by repeated surges of bold government action pose risks that have direct, short-term impacts, which we fear have been seriously underexplored during both the end of the Bush administration and the beginning of the Obama administration. We hope that, by pointing out these risks, they can be significantly mitigated at relatively low cost.

We begin by recommending a change to the general approach: halt soon the introduction of new, bold programs. We are not saying that nothing should be done; we are saying that it is important in times like these for government to reach closure on its decisions so that it can pick one set of rules of the game and then stick to them. We then focus more narrowly on the process of structuring workouts from bad deals and recommend avoiding approaches that undermine bankruptcy. Bankruptcy allows the large group of private professionals who are experts at restructuring or winding up bad deals—consultants, financiers, lawyers, managers, and so on—to get involved. Given the magnitude of the problem of toxic assets, any solution to the current crisis will almost certainly need to involve these private actors. We then explore how particular reform proposals can be implemented without running afoul of the cautions that are the focus of our effort. In the final analysis, we applaud the Herculean efforts by so many serious thinkers in the Bush and Obama administrations and outside government who have thrown themselves into this important work in good faith and with great sacrifice. All we can hope to add to the conversation are these relatively easy-to-deploy (and important to deploy quickly) tools for mitigating some vital but underappreciated risks with proposed financial system fixes.

Reviewing Present Approaches

Four broad categories of approaches to solving the present crisis have been either tried or proposed by the administrations of both Bush and Obama, as well as by other countries facing similar problems today and in the past:

1. Let the markets and courts work it out, using institutions such as foreclosure and bankruptcy directly or as a backdrop.
2. Have the government take over the banks and nationalize them, taking control rights as well as cash flow rights. The government then cleans the balance sheets by selling off toxic assets, and re-privatizes the banks.
3. Have the government recapitalize the banks by injecting cash

in exchange for preferred shares that have cash flow rights but not formal control rights.

4. Have the government buy up the toxic assets in a special bank or institution created for that purpose, leaving control rights and cash flow rights in the hands of shareholders.

Most government rescue programs, including the one announced in March by Treasury Secretary Geithner are hybrids of at least two of these four broad strategies. While each strategy has advantages and disadvantages, the second and fourth require the government to act directly on markets as a buyer, seller, or manager of assets or firms. Strategies two, three, and four also have an indirect effect on markets in that the government is changing the underlying rules of the game by changing various laws, regulations, or norms of practice. Which solution societies arrive at depends on their political institutions. In the U.S. case, the problem facing political decision makers is as follows:

If they let the markets and courts work it out, in time banks and other financial intermediaries will foreclose on properties and those foreclosed properties will be sold on markets. The problem is that this solution involves a lot of pain for two groups: bank shareholders (who have to write down their capital) and voters (who have to sit by while they are either forced out of their houses or watch the market value of their homes plummet). Another risk is that a change in the underlying psychology of consumers will develop a logic all its own, resulting in a long-term recession much like the one Japan suffered in the 1990s. This solution is therefore not politically acceptable—at least not to a government that wants to get elected again.

The political dangers in having the government nationalize the banks (strategy two) are several. First, the government can be accused of socialism. Second, it is not clear that the government actually has the statutory authority to nationalize banks or that it can develop enough political support to make a fundamental change in that statutory authority. Third, if the plan winds up costing taxpayers trillions of dollars, the government will be the only one to blame.

For option three, the buying of preferred shares, there await two horns of a dilemma. On the one side lies the appearance that the government has simply given away too much money while failing to take control away from those seen as having contributed to the underlying problem. On the other sides lies the reality that the government actually is taking a great deal of control, which is one reason some banks have tried desperately to return the money they received through the TARP program created by former Treasury Secretary Paulson. Although the preferred stock may not convey control rights as a formal matter, the ability to grant or withhold future cash injections conveys a great deal of control. Control also is wielded by the ongoing threat of shut down or other unfavorable action in response to regulatory reviews like the stress tests, or by the ongoing threat that any member of a bank's leadership or rank and file can be publicly called to the carpet regarding their compensation package.

There is also a political and economic danger to solution four, the government buying the toxic assets via an institution especially created for that purpose. The basic problem is that the government will inevitably pay more for the assets than their market value, for at least two reasons. First, the owners of the assets (the banks) know the quality of the assets better than the government. Second, the government will have an incentive to pay a price as close to that demanded by the bankers because, to the degree that the government pays less than the book value, it will require the banks to write down capital, in turn leaving the banks undercapitalized when the process is done. This may mean, in turn, that the government would have to undertake yet another rescue plan: to recapitalize the banks by buying more shares.

Treasury Secretary Paulson's solution was number four, which was politically viable for only three days. Treasury Secretary Geithner's plan is a combination of solutions one and four, but the government has already deployed solution three via the TARP program. The end result is a curious hybrid. The government tries to bring private market actors into the solution by giving investors the opportunity to buy toxic assets. At the same time, most of the financing for these transactions comes from the government, via an equity match from the Treasury and via a loan from the FDIC. Private actors bear some risk because they must put up part of the capital and must service a loan from the government to cover much of the rest, but they have the option of walking away from bad assets because the loans are nonrecourse (they are collateralized only by the assets being purchased). The government has also, however, taken preferred stock ownership stakes in the banks, via the TARP program.

In short, there are a lot of moving parts to the government's approach. Not only can they work at cross purposes to one another, but the high degree of ambiguity about whether the next government action will target any particular margin creates a huge disincentive among market actors to invest in any particular direction.

A related concern with this hybrid set of strategies is that they are so inherently burdened by the huge risks of the government paying either too much or too little that they lead to the government implementing its goals through a protracted series of moves. As discussed more fully below, we think that whatever benefits may come from getting the approach exactly right through careful titration are eclipsed by the risks of multiple rounds of bold actions.

The bottom line is that at least two key unintended consequences follow when market actors come to expect that the government will continue to change the institutions in an open-ended way. The first is that the belief the government will step in again in the future encourages moral hazard: private actors may take too much risk, expecting to be bailed out in a future round of government action. The second is that the belief the government will step in later may discourage private market actors from acting now, considering it prudent to wait until the government provides an even more attractive program.

We think it can be fine for the government to focus on approaches that facilitate coordination among private actors as the direct, first-order effect, so long as it avoids approaches that will require further qualitative shifts of the type that would cause overall uncertainty about what the rules of the game will be. Although the uncertainty created by successive deployment of bold moves may technically be a second-order effect in that it is indirect, it is far too big to be ignored.

The Importance of Final Moves to Stimulating Regrowth

Showing their determination to address the present crisis, President Obama, Treasury Secretary Geithner, and Federal Reserve Chairman Bernanke have each proclaimed on several occasions, including as recently as early March, that they will take whatever steps are needed to help resolve the economic crisis. The message is in part constructive in providing a calming effect on anxious people in their roles as both citizens and market actors. But the message also is in part destructive, especially against a backdrop of several months of bold moves, going back to Paulson's original plan of direct government purchase of toxic assets in that it strongly suggests that each round of moves is not the last.

This is a serious problem because when market actors think that further significant changes are coming, they find it difficult to engage in the commercial activity our economy needs for recovery. A great deal of wealth still exists throughout the economy, in the form of labor, money, tangible assets such as factories, equipment, inventory, and real estate, and intangible assets such as securities, commercial paper, skills, and intellectual property. Further economic activity requires that these wealth components be put to work: that they be exchanged with one another through new commercial activity. But many of those assets are waiting on the sidelines. Many others are tied down in existing transactions that are not doing well at the moment; but in order for them to be redeployed, their deals must be unwound.

In normal times, deals are routinely made and modified to meet the changing needs of the private actors involved in them, who are remarkably adept at integrating new information and preferences into deals when they can predict what the basic rules of the game are likely to be. But bold government actions—and the expectation of more such actions in the future—are game-changing events. Some of these changes are the direct consequence of new laws and regulations; others are a bit more subtle. When the government spends vast sums of money on emergency programs, it has a huge impact in the short run on relative costs for taking particular risks and opportunities and, in the slightly longer run, on expectations about tax rates, inflation, and the scope of government in the future. The problem is that private actors have a difficult time taking the actions we need now when they think the rules of the game—the laws, regulations, and contracting environment—are likely to change in big ways. Such a paralysis affects those holding assets that are ready to be deployed as well as those who own assets tied up in bad deals.

Consider those who are holding assets that are ready to be deployed. When facing the possibility of significant changes in tax rates, enforceability of contracts, and available subsidies that the government is presently employing and considering, every market actor risks feeling like a patsy for diving into deals too soon to successfully operate under the new rules. It might seem that the government could employ the normal tools that private actors use in deals to mitigate the anxieties of those among their counterparties who are early movers, such as committing to what deal-makers call "most favored nation clauses," and the like. When a seller uses a clause like this in a contract with a first buyer, the seller is constraining herself not to contract with any other buyer at a lower price without also giving the first buyer that same low price. But the government can't make such commitments about its present emergency financial actions for at least three reasons. First, it would be difficult to figure out what commensurabilities, if any, exist across the various programs on offer, which means it would be almost impossible to determine whether everyone were being given the same or a different deal. Second, even if the exchange rates among such programs were determined, each program would then have to be as expensive as the others, making their aggregate cost enormous. Third, it is not clear that any market actor would bank heavily on a government commitment to equal treatment, especially against the backdrop of rapidly changing behavior. After witnessing Lehman Bros. not receiving the same bailout as AIG, one would expect treatment to vary, not to hold constant.

A somewhat different set of problems faces those presently in bad deals that must get unwound. Ironically, the expectation of changes to the rules of the game causes strategic paralysis in any party who thinks she or he is suffering particular economic trauma from her present deal. In normal times, those involved in bad deals have strong reasons to cut their losses and get out. But as new bailouts, tax breaks, insurance, and other tools designed to mitigate financial trauma are rolled out, those facing such trauma have large incentives to stay in, hoping that if the mere passage of time won't bring a particular fix their way, then further trauma might.

Although all of the above argue that government leaders should wrap up their actions sooner rather than later, we recognize that there are important reasons for not doing so too soon. In some cases, leaders may have wanted more internal vetting; in others they may have wanted to test the applications of their actions; and in others they may have figured that beginning with low amounts would avoid overpayments. We are not trying to fault our leaders for taking such concerns seriously.

What we are trying to emphasize here is that political leaders must not overlook, especially now, after several rounds of action, that the benefits generated from those actions must be weighed against the too often underexplored costs of having the market think our leaders are likely to act further. Our leadership must bake into their thinking the importance of credibly committing themselves to stop making further game-changing moves and then signal that to the market so as to induce private actors to move much faster in unwinding their bad deals and in forging new ones.

Imprudently Tolling the Death of Bankruptcy

The problems of bad deals are particularly acute during difficult times like these. A great number of ongoing deals have turned out badly, as they either contributed to the downturn or were a result of it. Despite ongoing debates about the direction of causation, assigning blame may be less important to the economy as a whole than the need to simply ensure that the resources tied up in these deals are quickly put to higher and better uses. In addition, the problems of bad deals will not go away. When new ventures are launched, especially in such times of uncharted conditions, a great number will fail, and the rules of the game must be structured so as not to leave those assets sidelined and unable to contribute to economic recovery.

Now, and for the foreseeable future, our society has a particularly acute need for dealing well with failure. Professionals who are highly trained, experienced, and skilled, who are particularly adept at swooping into a failing or failed enterprise to turn things around or at least wind things up most productively would do just the trick. Specialized legal rules and organizations would provide the essential frameworks. The fortunate news is that our society has done a great job in building both the professionals themselves as well as the legal system associated with bankruptcy practice. The unfortunate news is that so many of the present approaches to emergency action may be tolling their death knell.

Like the members of any profession, those involved in turnaround and windup are good at what they do. Their practice has evolved over decades, supported by robust and diverse intellectual and academic foundations and honed by richly competitive practice.

In contrast, politicians are not experts at dealing productively with business failures. Yet many of the government actions taken to steer failing ventures away from bankruptcy have crowded out the experts our society has created to deal with such issues. Those experts make their living by acting within and against the backdrop of the bankruptcy system and thus have no reason to throw themselves into the mix when matters are being handled directly by the government (nor do they have the power to act through these governmental avenues). Some may be tempted to help, either out of altruism or in hopes of earning a share of the value they contribute to the rescue—such as taking salaries of a dollar a year with the right to a bonus if they are able to turn a profit. But they may ultimately be dissuaded by the real risk they face of being demonized by the base populism some in government and the media have recently directed toward some of those not involved in the private sector's failed decisions of the past who were asked to help save at least the non-failed components of business to prevent the public from having to take on even more risk.

At the same time, it makes little sense to favor the incumbents in the failed businesses over those who specialize in turnaround and windup. In some cases the incumbents have been poor custodians of the enterprise, leading to its failure; in some cases some aspect of the relationships among the incumbents—contractual or otherwise—was just not working well enough to prevent the business from failing. In other cases, there is no blame, but the incumbents' ability to add value to their enterprises will be much greater when their enterprise is functioning rather than failing because their skill sets are oriented for functioning enterprises. In all cases the present failure situation provides strong reasons to favor including those who are expert at the business of dealing productively with business failure.

Not only do present emergency actions risk crowding out the experts who deal most productively with business failure, but the fact that government has provided alternatives to bankruptcy significantly undermines the viability of the entire bankruptcy system. Although, like any legal system, our system of bankruptcy laws and courts is hugely imperfect, it has evolved significantly over the past century so as to be highly adept at facilitating the smooth, deliberate, and fair process of maintaining and distributing value. The vitality of our bankruptcy system facilitates entry into risky enterprises by facilitating exit, and in turn facilitates re-entry as assets are re-deployed. Bankruptcy provides all those who invest in an enterprise—labor, management, shareholders, secured creditors, general unsecured creditors, and so on—with a set of rules under which they can expect to operate when the business gets reorganized or wound up.

Extensive debates over many years have developed in the bankruptcy system a range of methods for addressing the myriad concerns facing the many constituencies. Yet no categorically new concern or constituency has been brought forth to support the present emergency alternatives to bankruptcy. This precedent means that in the future almost any argument may be used to justify such a striking derogation from established bankruptcy practice—whatever it may be at that time. In future iterations of failure (and even in its impending arrival), all savvy players should expect that, if the political will can be mustered, they may experience (by their own design or otherwise) a set of rules governing their reorganization or windup that are totally different from those of whatever bankruptcy system is then in effect. Today's examples of such justifications for veering from established rules include those businesses said to be "too big to fail" because of the ways in which they are networked with the rest of our economy and those that impact consumers who are too small to fail because they don't have enough overall wealth. Because most companies in a well-functioning economy do business with many other companies as well as with a large number of consumer purchasers, investors, borrowers, or lenders (either directly or indirectly), the precedent being set by the emergency actions makes most businesses into credible candidates for treatment outside bankruptcy in the future.

In fact, the government's decision to bail out Bear Stearns left many at Lehman, who expected similar treatment, to stand on the sidelines too long as bankruptcy neared. By the time these private actors realized Lehman would be left to go bankrupt, it was too late for them to implement many of the steps they could have taken to mitigate the resulting mayhem. (Despite getting off on the wrong foot, the Lehman bankruptcy managed to move quickly once begun, with Barclays able to buy up the failed firm's brokerage assets within the first week after the filing.)

Although the bankruptcy system, like all legal systems, can benefit from ongoing debate and evolution, it would be unwise to simply kill it off absent thoughtful discussion and good reason. Our leaders must exercise restraint when taking actions that will crowd out those who are adept at swooping into a failing or failed enterprise to turn things around or at least wind things up productively. When taking such steps they must also credibly delineate why ordinary bankruptcy rules are not being applied in a way that leaves ample room for our bankruptcy system to continue to operate with credibility in the future.

Applications to Some Current Proposals

The central political problem faced by the Obama administration is that it doesn't want to overpay or to be the only one to blame if things go badly. Thus, it needs prominent partners from the private financial sector, who, however, have every reason not to participate. Why get into a partnership with someone who has mixed goals? The business of the private actors in our financial system is to make money by paying as low a price as possible for the assets in question and then reselling those assets at a higher price. The government (under administrations of either political stripe) is not out to make money, meaning its goals are hugely complicated and subject to change. In fact, the government has an incentive to overpay (as discussed above) because it wants to avoid leaving the banks undercapitalized and thus having to launch yet another program to purchase bank shares.

So how can the government gain political participation? It needs to get important groups in the private sector with large blocks of both political and economic power to decide to act in a coordinated fashion. And it needs to do so with enough self restraint that the fundamental rules of the game won't continue to change. We think this is all possible by focusing on mechanisms others have suggested for directly working through the core economic problems underlying the present crisis.

The most central economic problem of the current crisis is the large number of mortgages facing foreclosure that are held by ordinary citizens stretched too thin to adequately address their existing mortgage payments, especially in the face of declining home values. Estimates put the total number of such mortgages in the millions, covering a total amount of bad debt in the trillions of dollars. The prospect of carrying out so many foreclosures seems practically daunting and socially devastating. The people who own those homes face crushing challenges on the most human level. The financial entities that hold the mortgage notes and the many complex derivative instruments based on these notes appear to be carrying such huge losses on their books that they are unable to attract the new infusions of investment they need to enable them to contribute to the flows of financial credit the economy needs.

Not all these bad mortgages are of equal toxicity; many could be carried if a productive arrangement could be worked out. The uncertainty over sorting these out, however, is a significant factor driving down overall book values of banks.

Getting all these bad mortgages quickly and productively restructured or settled out involves a massive coordination problem, requiring participation by workout experts, mortgage holders, debtors, and owners of the derivative instruments. Clear rules that let all interested parties know that they must deal with one another and on what terms are the best way to get the needed collective action started and continued. Although the existing legal system, including contract law, property law, and bankruptcy law, provides an adequate framework, for reasons explored above, the chance that many of these rules will change freezes actors in place or encourages them to perhaps take steps that might help themselves but decrease the size of the overall pie. This means that the ongoing uncertainty associated with future commitments to act boldly is itself a factor contributing to the ongoing problem.

Furthermore, even immediately implementing some of the proposed reforms could be almost as risky. Consider for example the proposal to allow individual bankruptcy judges more leeway to cram down on the finance community on a case by case basis a lower amount than is due under existing loan contracts. First, putting these millions of cases through full-blown litigation is unlikely to increase the coordination speed. Second, for reasons explored above, such bold changes in bankruptcy law leave those who need to make new investments uncertain of the rules under which their deals will be judged. Third, it presumes that judges will be best able to figure out which mortgages can be productively carried by their debtors, even after restructuring, and which ones can still lead to serious failures.

In contrast, the ranks of professionals who are adept at turning things around or unwinding things can help, quickly and effectively, leveraging the private information held by the debtors, creditors, and others who are involved in each deal. If additional work is needed to bring all parties together quickly, then a proposal other than new power for bankruptcy judges might be in order. As suggested by Charlie Calomiris, the government could commit to bearing a percentage—perhaps 30 percent—of all write-downs reached by private agreement between the affected parties within a specified period of time, say six months. During the 1999 implementation in Mexico of the "Punto Final" (Final Point) program, private-sector actors came together quickly to take advantage of just such a joint subsidy approach. That joint subsidy approach would not only facilitate the needed coordination, but would also subsidize both the suffering home owners and the cash-strapped banks. At the same time, it would avoid both crowding out the professionals and scaring off those needed to invest in the reworked deals.

Conclusion

We recognize that many interesting ideas for short-term fixes to our present financial crisis have been offered. Not having endeavored to provide a thorough account of everything that has been written or tried on this important issue, we offer instead a single overarching point with a few practical implications that we fear have been largely overlooked during both the end of the Bush administration and the beginning of the Obama administration. Our hope is that pointing them out will help; once noticed they can be significantly mitigated at a low cost relative to the other approaches on offer. At bottom, we think it important for the government to very soon pick one set of institutions, and then stick to whatever it selects; for we fear that the costs of the uncertainties caused by ongoing change outweigh whatever benefits may come from tinkering further. Along the way, we pointed out one particular risk raised by present approaches, which is crowding out the many professionals in our private sector—consultants, financiers, lawyers, managers, and so on—who are expert at stepping into failed businesses and reworking or winding up affairs in a way that will redeploy assets toward more productive uses. Another risk is eliminating through the backdoor, and probably by accident, the ability for our well-established rules of bankruptcy to form the backdrop against which ongoing investments can be made. Although the bankruptcy system is far from perfect and discussions for improvement are encouraged, tolling the death of bankruptcy at a time when new investments are most needed is not the best approach.