The Upside of a Downturn

by Krzysztof Ostaszewski

The financial crisis that began in 2007 and accelerated greatly in 2008 has posed a unique challenge for the regulators of financial intermediaries. The speed and severity of the events that transpired have been quite a shock to the financial and political system in the United States, and subsequently, worldwide.

This crisis has posed a unique challenge for regulators. And, it has brought to the forefront the following key question: What should regulators do with an impaired financial institution?

This crisis is the first crisis of the new financial services industry, an industry created by the Gramm-Leach-Bliley Financial Services Modernization Act of 1999, which opened up competition among banks, securities companies and insurance companies. Yet while the industry has become integrated, its regulation has remained fractioned. When banks are impaired, their problems are addressed by the Federal Reserve and FDIC, while insurance companies face state insurance regulators; exchanges are supervised by SEC and CFTC; and independent investment banks as well as hedge funds remained largely unregulated. In response to a systemic crisis, the U.S. government has worked on crafting an integrated response, and has crossed some of the boundaries between separate parts of the industry. But those boundaries had been breached by the industry itself quite some time ago.

Different regulators have had different responses to firms under their supervision becoming impaired. The FDIC has consistently pursued the strategy of taking over banks found to be too weak to continue functioning and arranging a purchase by another bank, without any interruption in services provided to customers. The Federal Reserve has offered unprecedented liquidity, expanding it to all financial institutions and even non-financial firms. State insurance regulators remained mostly uninvolved, because the only major impairment of an insurance firm, AIG, was addressed in a very unorthodox fashion by federal authorities, who, ostensibly, do not regulate insurance firms. At the same time, an unregulated investment bank, Lehman Brothers, was allowed to fail. I should add, however, that the phrase "allowed to fail" seems quite inappropriate, as there was no federal or state authority whose job it was to save Lehman Brothers.

The federal government's response to the financial and economic downturn has consisted of several phases:

1. Economic stimulus checks sent to American taxpayers in early 2008.
2. The initial "bailout" proposal: to buy currently non-performing mortgage-based assets from banks and financial institutions, touted very loudly by many in the investment industry as a "great trade," on which the government would eventually make trillions, by spending approximately $700 billion now.
3. Capital injection for banks in the form of purchase of partial ownership in banks by the federal government.
4. Assuming full control in some failed banks, notably AIG Insurance, in order to transfer their full or partial ownership to some other, better performing financial institution.

As I am writing these words, it appears quite clear that the first step was ineffective in stemming this financial storm. Also, the secretary of the treasury has just announced abandonment of the second step (known as Troubled Assets Relief Program). Only steps 3 and 4 are being implemented. They are similar, yet subtly different. They both involve a transfer of ownership of an impaired financial institution to the regulators, but step 4 causes that ownership to be transferred fully. This has significant consequences. As we know from the careful reading of the Modigliani-Miller Theorem, a change in the capital structure of a firm has no effect on the value of the firm, unless it affects the productive capacity of the firm, its tax expenses, its bankruptcy cost, or the agency cost of that capital structure. The government is attempting to lower the cost of bankruptcy by lowering its probability. But other, maybe unintended, consequences of government actions ought to be considered:

1. As the permanent income hypothesis tells us, a one-time grant of money from the government, provided in step 1, was unlikely to cause any permanent change in the behavior of all economic decision makers. Given the likely long-term damage of the crisis, economic decision makers acted wisely by ignoring stimulus checks. The government could have been even wiser by not sending the checks in the first place.
2. The question of why financial firms are so uninterested in selling their troubled assets is quite fascinating. I would venture the hypothesis that a firm known to the market as selling their troubled assets is automatically a target of negative rumors, and, in the current fragile state of the markets, that is a very uncomfortable position in which to be.
3. Providing funds for banks without any conditions on restructuring and improving their profitability creates rather wicked incentives. If the bank is reasonably stable after capital injection, but not yet strong, the best course of action is to purchase a better performing rival, and improve its own profitability with the rival's profits. The result is that a better-managed company is acquired by a company managed badly, and good managers are let go. Bad managers have their jobs saved by taxpayers. Things are even worse if the bank is really on the brink. In this situation the smartest strategy for the managers is to pay themselves large bonuses before the inevitable end happens. And the government conveniently provided the funds.

This brings us to the fourth, least pleasant, it seems, resolution of a situation of an impaired financial intermediary: the takeover by the regulators. Or is this really such an unpleasant resolution?

A financial intermediary performs two key functions in the economy:

- Uses funds obtained from clients to purchase capital assets. This activity is, effectively, equivalent to writing derivative securities. Cash flows of an intermediary's assets are used to make payments on liabilities issued to customers. Customers' deposits or insurance policies are, effectively, derivative securities created out of the firm's assets. This activity, often misrepresented as spread business, is **very** risky, very complex mathematically and virtually never taught this way in business schools.
- Processes payments for customers. This function used to be simple and mostly banking-like. It has become more complicated with the advent of private transactions that also amount to payment processing, especially swaps of all types, that are done outside of the regulated banking system.

The first function is speculative. If a firm fails at it, it loses capital, and may need to be taken over by regulators. But failure is the firm's own problem. Failure at the second function means that the firm's customers are unable to pay their bills, resulting in a systemic economic crisis. We live in a world in which those two functions are automatically combined. Yet it is the first function, the risky one, that creates the most profits, especially with an assumption of additional leverage. Failure impairs the second function, without which economic activity stops.

We do not need to sacrifice the entire government budget, and the country's economy, to save badly managed financial intermediaries. We merely need to make certain that their customers can pay their bills. If a financial intermediary fails, its managers who did not know how to manage the derivative securities portfolio they created lose their jobs. If the regulators assure continuity of payment processing functions, such failure can and should be viewed as entirely desirable and a positive outcome. When a firm fails in

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the free market system, its employees and its resources can be utilized productively by other firms, but its managers proved themselves to be incapable. Keeping them in place means that their management policies will continue and the impairment they brought about will become even bigger. The upside of the downturn is that these powerful, influential, connected and important, yet incompetent people can be removed from their positions. To quote a great insight of Ayn Rand: "There is no substitute for competence." Not even $700 billion of taxpayers' money will do.

Granted, this current crisis has its roots in an utterly irresponsible behavior of politicians who envisioned granting credit to everyone and pushed hard for it. We cannot remove or punish those politicians through economic mechanisms. The whole country is punished instead. But we must allow the return of competence in the financial industry, if we are to have one.

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