Causes of the Crisis: Conflicts, Compensation, and Reputation

Edward J. Kane
James F. Cleary Professor in Finance
Boston College
THREE FOUNDATIONAL HYPOTHESES:

1. Financial crises are **inevitable**. This implies that every country’s financial sector passes through a repetitive three-stage sequence consisting of a pre-crisis bubble, an actual crisis, and a post-crisis period of healthy recovery.

2. Crises arise **dialectically** from path-dependent collisions of efforts by regulators & especially SUPERVISORS to control leverage and interest-rate risk-taking with contrary efforts by regulated financial institutions to expand these risks in nontransparent ways and to shift responsibility for them onto national safety nets.

3. Micro prudential supervision (which focuses on the risks of **individual institutions and contracts**) needs to be supplemented by **macro** prudential supervision that measures and responds to hypothetical **externalities and correlations** in the operations of particular institutions and markets.
“FINANCIAL-ENGINEERING BUBBLE” WAS AN IMPROVISATIONAL CONTINUATION OF THE CREDIT-ALLOCATION MODEL DRIVING THE SIMPLER S&L MESS
TO ILLUSTRATE THE “MESS” OF 2007-2008, THE CARTOON NEEDS MORE DESKS.

1. Fed and FHLBs HELPED Treasury in the role of Uncle Sam.

2. Hit-and-run lenders opened desks alongside the banks (State-Chartered Nonbank Mortgage “Brokers”: e.g., New Century Financial)

3. A new layer of desks developed between the lenders and the government supervisors. The occupants of these additional desks are “FINANCIAL ENGINEERS” who claimed as a group to have the magical powers to turn very RISKY mortgage loans into RISKLESS BONDS:

   A. ACCOUNTING PROFESSION & APPRAISERS
   B. INVESTMENT BANKERS & DERIVATIVES DEALERS
   C. CROS: CREDIT RATING ORGANIZATIONS
   D. STATISTICAL MODELBUILDERS
   E. MONOLINE CREDIT INSURERS
   F. FINANCIAL SERVICERS
   G. GSEs and TRUSTEED INVESTORS

- Client
- Deal-Maker
- Credit Risk Mgt. Group
  - Counterparty evaluation
  - Credit limits
  - Concentration risk mgt.
- Credit Pricing
- The Credit Market
- Risk Transfer
- Credit Portfolio
- Government Supervision (including Basel)
- SAFETY NET
- CRO Supervision
Defects in Private & Government Supervisors’ Duty of Accountability:

The US needs to Reform the Incentive Structure of supervisors, not the Structure of Regulation

- In practice, institutional arrangements do not hold CROs and other supervisors strongly accountable for minimizing the costs and adverse redistributional effects they engender in resolving incentive conflicts.
- In principle, supervisors should bond themselves to disclose enough information about their decisionmaking to allow outsiders to hold them accountable for neglecting or abusing their responsibilities.
- To obtain a quid pro quo for being made to support homeownership, financial-institution managers expect mortgage loans to be supervised with a lighter hand, and expect to be subsidized in times of banking turmoil.
Dialectics of Bubble and Crisis

**THESIS:** UNSUSTAINABLE POLICY MIX
- Low interest rates fueled the Loss-Causing Credit-Allocation Scheme ("politically sabotaged loans") vs. Consequent Desupervision of Risk and Rising Costs of Providing Loans and Guarantees to Loss-Making Institutions

**ANTITHESIS:** MARKET FORCES TEST GOVERNMENTS’ ABILITY TO MANAGE THE EXPANDING COSTS OF NATIONAL SAFETY NETS
- In a Banking Crisis, Market Tests consist of Silent Runs (Symptomized in 2007-08 by a Generalized Flight to Both Quality and Simplicity)
- The probability of further tests and a deepening crisis grows the longer authorities play “coverup”, **create new uncertainties**, and delay action designed to contain the damage and instead help zombie institutions to stay in play

**SYNTHESIS:** MEANINGFUL REFORM OCCURS WHEN AUTHORITIES CAN NO LONGER QUELL MARKET DOUBTS ABOUT THEIR ABILITY TO SUSTAIN THE CONTRADICTORY POLICY MIX OF SUBSIDIZING AND LIMITING LEVERAGE
- Credit-allocation scheme unravels
- Costs of sustaining decapitalized institutions become manifest
- Regulatory/Supervisory System is Reorganized in a Plausible way
Coming out of this crisis, the central policy issue concerns how to ask regulators and supervisors to measure their performance as safety-net managers and how to make them embrace five duties that they owe taxpayers:

1. **Vision** (surveillance systems for regulation-induced innovations)
2. **Prompt Corrective Action**
3. **Efficient Operation**
4. **Conscientious Representation**
5. **Accountability for Violating the first 4 duties.**
TO FIX THINGS PROPERLY, AUTHORITIES MUST FACE AND ANSWER ONE QUESTION CORRECTLY: WHY AND HOW DID SECURITIZATION BECOME INCENTIVE-INCOMPATIBLE?

ANS. BY MARRYING REGULATORS’ AND INVESTORS’ BLIND TRUST IN REPUTATIONAL BONDING OF KEY FIRMS TO GYPSY ETHICS OF THEIR EMPLOYEES: OUTSIDERS CLOSED THEIR EYES TO THE VOLUME-BASED COMPENSATION SCHEMES THAT REINFORCED THE SHORT-CUTTING AND OUTSOURCING OF DUE DILIGENCE IN SYNTHETIC CREDIT TRANSFERS
A FINANCIAL CRISIS RESEMBLES A BATTLEFIELD:
How to contain further loss of life & limb?

• Cries From Wounded Institutions (lobbying)

• Under-Resourced Medics face hostile fire and have **limited tools** with which to do the triage needed to contain the damage

• The legal equivalent of **Transportation facilities** is needed to move potential survivors to deposit insurers whose staffs are trained and experienced in restructuring
Every Crisis Has two Interacting Dimensions

1. The Economic Dimension Turns on Losses and Continuing Loss Exposures that wounded Financial Institutions and others want to shift to Taxpayers: crisis reflects uncertainty about the size of the losses and who will bear them.

2. Political Dimension should reduce these uncertainties, to establish confidence in policymakers, and to persuade the public that the program of loss-shifting undertaken is efficient and the beneficiaries deserving.

3. Crisis ends when taxpayer loss absorption has finally been capped and political blame for the debacle has been plausibly (if inaccurately) assigned.
MISFRAMING INSOLVENCY CONCERNS AS A MARKET LIQUIDITY PROBLEM AGGRAVATED THE UNCERTAINTIES DRIVING THE CRISIS

• Highly Levered & Short-funded Institutions and Investment Schemes Lose Value Whenever a default spread, liquidity premium, or inflation premium increases

• True Economic Net Worth Must Be Recognized to be an Interval Estimate

• Near-insolvency is only slightly different from Complete Insolvency: The more of the Interval estimate that falls into negative territory, the harder it becomes to roll over debt.
STUDIES OF 129 POST-1977 CRISES SHOW THAT COSTS OF SAFETY-NET SUPPORT DEPEND ON SEQUENCING

IDEAL SEQUENCE is:
1. Triage: forensics/relicensing to contain the damage.
2. Restructuring of Industry
3. Aftermath: Explicitly Financing the Losses & terminating government support
In 2008, emergency capital and liquidity support was not accompanied by careful battlefield diagnosis of problem size or a prioritized queuing for conclusive treatment.

- Medics cannot afford to give resources to those that yell the loudest. Loans and guarantees to insolvent firms are costly and ineffective unless managed explicitly as equity investments.

- Regulators will eventually have to use forensic accounting at troubled institutions to estimate asset values and allow restructurers to fashion lasting methods for restoring salvageable institutions’ profitability and reputation. The ultimate task is to identify, clean up, and consolidate the portfolios of insolvent firms and to see that the capital positions of the reconstituted firms is adequately patched up by definitive financial surgery.
Why Did Fed and Treasury Begin so Badly?

LOBBYING PRESSURE AND TIMING IN ELECTORAL CYCLE AFFECT THE LENGTH OF REGULATORS’ POLICY HORIZON. **In 1933:** fighting the Great Depression at the beginning of a 12-year term means **calming** fear: “The only thing we have to fear is fear itself.” (Franklin D. Roosevelt, 1933)

**Now:** At end of his term, George Bush foolishly intensified crisis pressure and undermined political accountability by deliberately scaring the citizenry while having no realistic plan for fixing things: “Without immediate action by Congress, America could slip into financial panic and a distressing scenario would unfold.” (Sept. 24, 2008 TV address). Knocked business and consumer confidence for a loop.

[EESA passed on October 3, no injection of funds until Oct. 29. First $125B went to giant and hard-lobbying institutions: “Never Give a Sucker an Even Break.”]
ROLE OF INFLUENCE: 2008 BAILOUT SUBSIDIES MERELY ROB PETER TO PAY PAUL
Numerous **Complementary** Actions Could Strengthen the Odds of Intervening in Better Ways in the Future

1. **Improve Public-Service Contracting:** Reshape Incentives to confront regulation-induced innovation to offset pressures from the industry (e.g., by deferred compensation and by requiring agencies to report fully on nonpublic interactions with Congress)

2. **Extend Liability for Financial-Institution Stockholders** (esp. for owner-operated banks in low-transparency and low-deterrency environments)

3. **Disaster Planning:** require managers to prepare, update, and file with supervisors a standby **plan** for handling their firm’s possible bankruptcy (i.e., a workable **unwinding plan**) every year.

4. **Extend Liability for Institutional creditors** (establish automatic writedowns for designated liability positions in failures)
Increase **Monitoring and Loss-Control Responsibilities for competent private parties** (requires transparency and deterreny for chosen risk-bearers)

a. Clawbacks in compensation received by top financial and regulatory officials  
b. Public-Private D&O Insurance Partnerships  
c. Expand Opportunities for promptly haircutting Subordinated Debt  
d. Develop a scheme for moving OTC derivative contracts to a transparent clearinghouse structure when and as their volume grows  
e. Devise Credit default swaps written on bailout expenditures (more transparency)
LONG-RUN GOVERNMENT REFORMS

REWORK CONTRACTS WITH GOVERNMENT SUPERVISORS AND ADJUST THEIR INFORMATIONAL RESPONSIBILITIES

1. For the market to track Safety-Net subsidies they must be estimated both by beneficiary institutions and by politically accountable supervisory officials (≠ only the Fed)

2. Crisis Preparedness: Establish, publicize, and regularly test a benchmark market-mimicking plan for crisis management

3. No government regulation (including Basel II) should rely on CRO ratings: this tempts CROs to over-rate complicated securitizations

4. Deferred Compensation: A way to force top SEC and bank regulators to take responsibility for supervising the safety-net implications of off-balance sheet activity by financial firms
PRIVATE-SECTOR REFORMS

1. Effective **Contractual Clawbacks for default** must be incorporated into contracts of employees and Firms at all stages of securitization.

2. To rebuild their Brands, CROs must disclose the information they rely on, bond themselves against negligent construction of models & data samples, and should report not just an instrument’s rating, but also its downward volatility.

3. Securitizers should report monthly balance sheets and income statements for underlying asset pools.