



THE BENEFITS OF PLAYING WELL

Vincent Reinhart*

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*Vincent Reinhart is a Resident Scholar at The American Enterprise Institute (AEI) and a former Director of Monetary Affairs at the Federal Reserve Board. Adam Paul provided excellent help in preparing these remarks. The views represented in this presentation are his own and not necessarily shared by others at the AEI.

I appreciate the opportunity to participate in this panel to learn lessons from the ongoing financial crisis. By my count, the participants who came before amassed 15 lessons, which is a little disquieting. That so few people can come up with so many lessons immediately leads to the conclusion that matters are complicated. Despite differences among panelists, an agreed-upon lesson at this banking conference is that bankers are not as bad as some people might think.

For me, the good news for our session on learning lessons is that failure teaches as much, if not more, than success. And events over the last year and a half have given ample opportunity to better ourselves. In that regard, the situation reminded me of a reflection of David Halberstram in the introduction of the 20th anniversary edition of the *Best and Brightest*. Halberstram wrote that “The failure of a major policy is ..., if nothing else, a marvelous lever with which to open a debate.”¹ We are now at the stage where the debate is about to be opened.

The ellipsis in the quote from *The Best and the Brightest* referred to the United States’ performance in Vietnam. In my remarks, I will talk about a failure of equivalent scale and scope in crisis management and regulation of financial institutions. This assessment is bipartisan. In 2008, policy-making was inconsistent, adding uncertainty in an uncertain environment. This magnified the reaction in financial markets to the initiating economic shock that we built too many houses. Inefficient policies wasted government resources, and the reputation of some key institutions was damaged.

Two-thousand-and-nine is different. We now have cynical policy-making that recognizes that public opinion is such that the government cannot get the explicit authorization to spend resources to aid financial market repair. Rather than attempt to change that opinion, officials are working the back channels of policy. This involves delaying the recognition of bank losses and designing a rescue package on the principle of minimizing the footprint on the budget. To keep the scale of the package politically acceptable, officials intend to rely on off-balance sheet entities (the Federal Reserve and the FDIC), contingent guarantees, and leverage by attracting private sector money. There is a cost: you don’t get closure, you don’t get clarity; and you probably make the ultimate resolution more expensive.

My presentation has three parts. I will address policy interventions and why they have significant cost. Next, I will explain why bailouts occur and reveal the irony that the source of policymakers’ fears is of their own making. Lastly, I will outline why understanding that mechanism is important for framing new legislation and regulation. Do not, however, think that I will end on a hopeful note. The odds are high that the Administration, Congress, and financial agencies will fail to address the problem directly and will ratchet up restraints on the financial sector excessively and indiscriminately.

I have four rules for bailouts, mostly learned from the varied experience of emerging market economies. Rule number one: don’t do them. The possibility of government intervention has consequences for the private sector, the government, and the political process. What about the private sector? It lessens pressure on management to raise capital and address balance sheet problems and it lessens counterparty discipline. The most instructive example occurred the week after the Federal Reserve lent to Bear Stearns, doing something for the first time in 60 years, and

created the primary dealer credit facility to extend its safety net to major investment banks. Lehman Brothers issued a structured note, in which it rolled together the bits and pieces of complicated products it had on its cutting room floor to create a new security. The only evident economic purpose of that new security was that it was structured so it would be eligible for collateral for the Federal Reserve's discount window.² If you ever want proof that investment bankers have a sense of irony, consider that those securities were called freedom notes. This highlights the wisdom of the line in the Kris Kristofferson song, "Me and Bobby McGee," made famous by Janis Joplin, "Freedom's just another word for nothing left to lose."³ Rather than address the problematic assets on its balance sheet, Lehman rolled them together and embedded them even deeper into its corporate structure.

Bailouts open agencies to political pressures. Why did you do them in one case and not the other? Is this a new lever of policies? Is this an area where Congress should be involved?

Bailouts confuse the public about policy intent and eliminate forever the possibility that a government agency could be an honest broker. As much as you might have been troubled by the acts of the Federal Reserve Bank in New York in 1998 with regard to Long-Term Capital Management (LTCM), at least it could get 17 investment bankers in the room and say, "What are you going to do to solve the problem?"⁴ For the next LTCM, those 17 investment bankers will immediately ask, "How much will the government pony up first?"

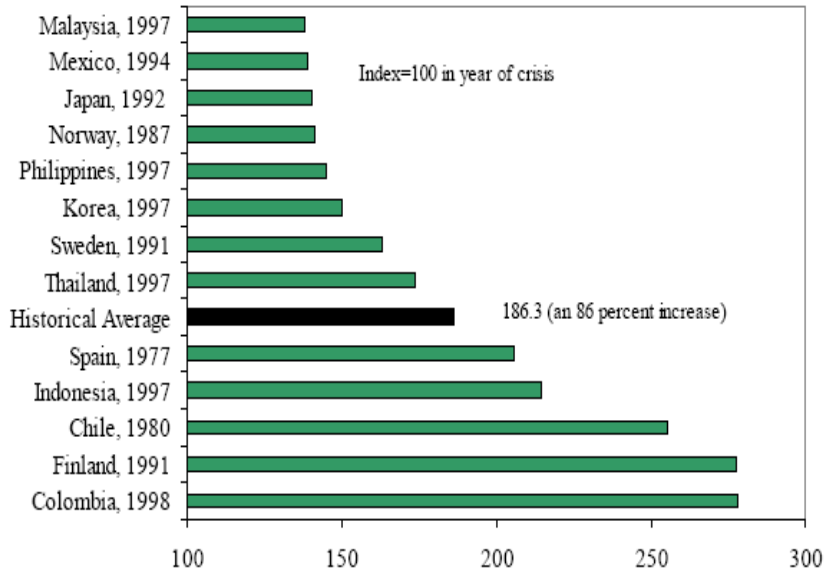
Lastly, the political process tilts the playing field toward intervention generally. Intervention opens the path to the slippery question, "Given that the government has helped financial firms, don't you think it should help X?" In the last year, the set of X got a lot bigger. Recent decisions also legitimize increased supervision and regulation for a wide portion of financial activity because if those entities need the help of the government, they need the supervision of the government.

My rule two: if you break rule one, please be consistent. Otherwise, uncertain actions add uncertainty to an uncertain environment. Policy interventions by the Federal Reserve and the Treasury in 2008 were ambiguous as to the scale and scope of the protection offered. In the weekend in which Washington Mutual and Wachovia were resolved, there were haircuts at WaMu and none at Wachovia, even though the two appeared to face similar problems. Why? It depended on who picked up the phone first—which entity led the resolution effort. In the weekend that the GSEs were resolved, it was decided to wipe out preferred shareholders. That was the same week that Lehman was trying to raise funds through a preferred share issue.

Officials created an uncertain perimeter of government intervention. Inconsistent government action opens up incentives for speculators to test the fences. Consider what would happen if you picked the right firm and shorted its equity and used the proceeds to buy its debt. When the government came in and wiped out the shares and protected the debt fully, you would profit handsomely. So, the fear of contagion, the need to resolve institutions because there was a concern about debt contagion, produced speculative attacks on firms. There is always a weakest antelope in the herd. So, every weekend that Secretary Paulson worked late in 2008, there was a new problem facing him on Monday morning.

Rule three is that if you break rule two, be prepared to spend a lot. Figure 1 is drawn from a forthcoming book by my wife Carmen Reinhart and Ken Rogoff.⁵

Figure 1
Public Debt Three Years from a Financial Crisis



Source: Reinhart and Rogoff

The book looks at, among other things, all the financial crisis of the twentieth century. And three years after a financial crisis, on average, the level of public debt is 86 percent higher. That is a very big number, but not out of the bounds put forth in the Congressional Budget Office's debt projections.

Why is the nation on a track to spend so much? The fundamental problem is that its residents built too many houses. The recognition of that excess supply was sure to push home prices down. However, the effect spilled over to other financial markets because the mortgages on those houses were transformed into collateral for securities. Markets magnified losses on those securities. Those losses have blown holes in the balance sheets of financial firms at the center of our global trading. The presumption that the government will act leads investors to delay capital investments. The more that the private sector has been discouraged from providing capital, the more that the government is going to have to fill the hole.

Last is rule four: whatever you do, do not add to uncertainty and worsen confidence. Why? Simply put, a poorly performing economy does not support any business model. High public officials made statements in the fall about the need to pass the Troubled Asset Recovery Program (TARP) and to justify the takeover of the American International Group that added to uncertainty and damaged confidence. As Figure 2 shows, the Institute for Supply Management's PMI composite index just fell off the table as confidence disappeared like a fist when you open your hand.

Figure 2
PMI Composite Index (Manufacturing)

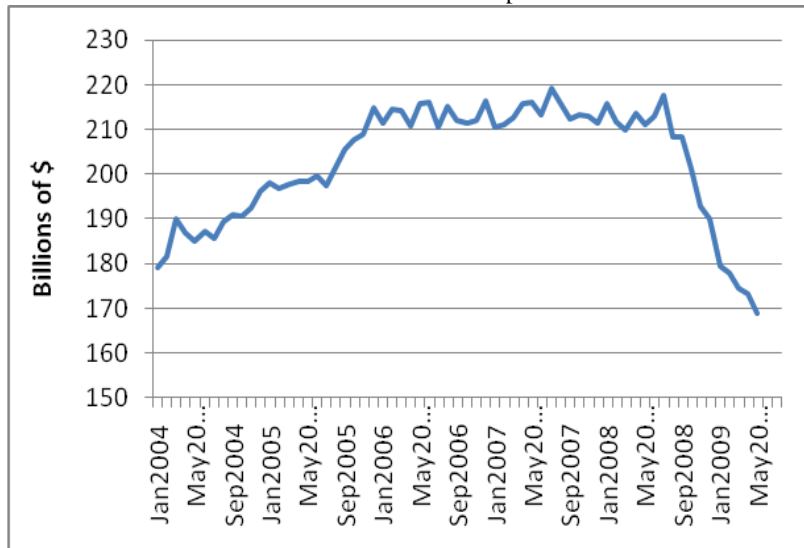


Source: Institute for Supply Management

Note: A PMI reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent that it is generally declining

The household sector also headed for the hills when officials told them that the financial market threat meter was flashing orange and on watch to go to red. As Figure 3 shows, new orders for durable goods cratered.

Figure 3
US Durable Goods Shipments



Source: US Census Bureau, Manufacturing, Mining, and Construction Statistics

The collapse in business and household confidence owed to an inherent problem in the brinkmanship of bailouts. What you have to do to justify a package to Congress is exactly not what you want households and businesses to think about in their spending decisions. Political salesmanship does not align well with economic stewardship.

This seems like a compelling list that should warn away the official sector. Yet, bailouts have been a feature of the policy landscape. The revealed concern of officialdom is that some institutions are too complex to fail. One obvious argument is that policymakers fear spillovers from the failure of complicated firms. We *had* to intervene in the case Bear Stearns, the story runs, because it had many counterparty relationships. Back in 1998, the same story held that a flurry of failures would follow if LTCM went into bankruptcy because it had very large gross positions, even though its net positions were considerably smaller.

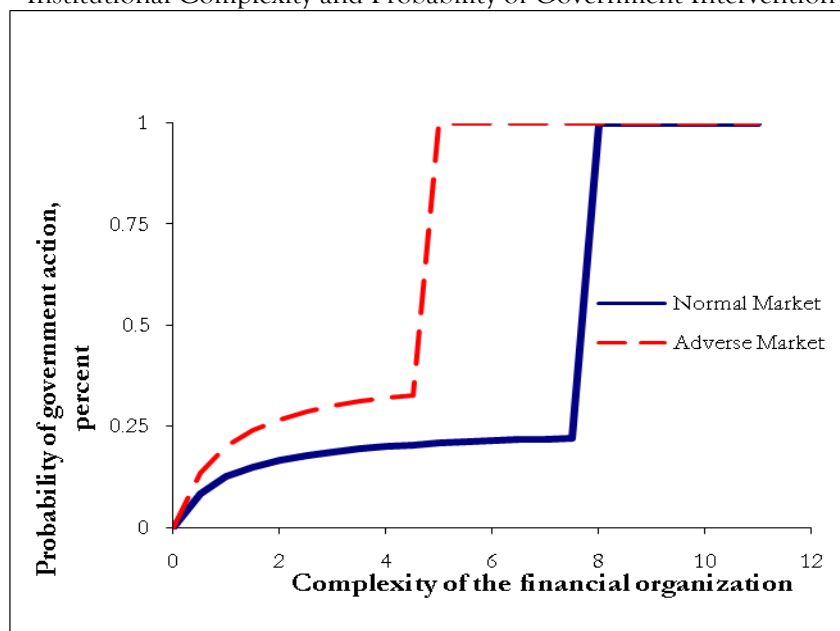
The fear is fueled, in part, by the tyranny of event studies. The cost of not doing something is evident immediately in financial markets and, therefore, translated into headlines. We know what happened when the Treasury decided not to aid Lehman; we could read it in the Dow Jones Industrial Average. We do not know the cost associated with acting for AIG a few days later because it was not registered exclusively in that 24-hour window. In fact, we are still paying the cost, a cost related, in part, to a complete unwillingness of our Congress to deal like grownups with the resources that need to be allocated to help financial markets.

Some argue that intervention is associated with the self-interest of officials. Personally, I do not believe for a moment that officials are captured by Wall Street by the lure of post-employment fortunes. But there can be the appearance of capture, reflected in articles that count off the number of people who once worked at Goldman Sachs who happened to wind up to be Secretary of the Treasury or some other high Treasury official or those that troll through phone records to recount the contacts of Federal Reserve Bank presidents.

At the root, intervention is endemic because officials worry about the complexity of institutions and the knock-on effects on markets if a complex organization were to fail.

We can envision this interaction at the cost of some simplification as done in Figure 4.

Figure 4
Institutional Complexity and Probability of Government Intervention



Source: Author

I assume that the importance of one firm in the web of finance can be expressed by a summary index of a firm's complexity (as measured on the horizontal axis). In normal times, the more complex an organization is, the greater is the probability of government action (measured along the vertical axis). At a certain level of complexity, you hit the wall, and government intervention is assured, seen as the leveling of the blue line at the value one. Firms like AIG, Bear Stearns, or the government sponsored enterprises are just too complicated for policy-makers to be willing to let fail, even in normal times. In adverse times when markets are stressed, that willingness to test the resilience of markets by letting a complicated firm fail, as shown by the red dashed line, sags even more. The whole probability structure shifts up.

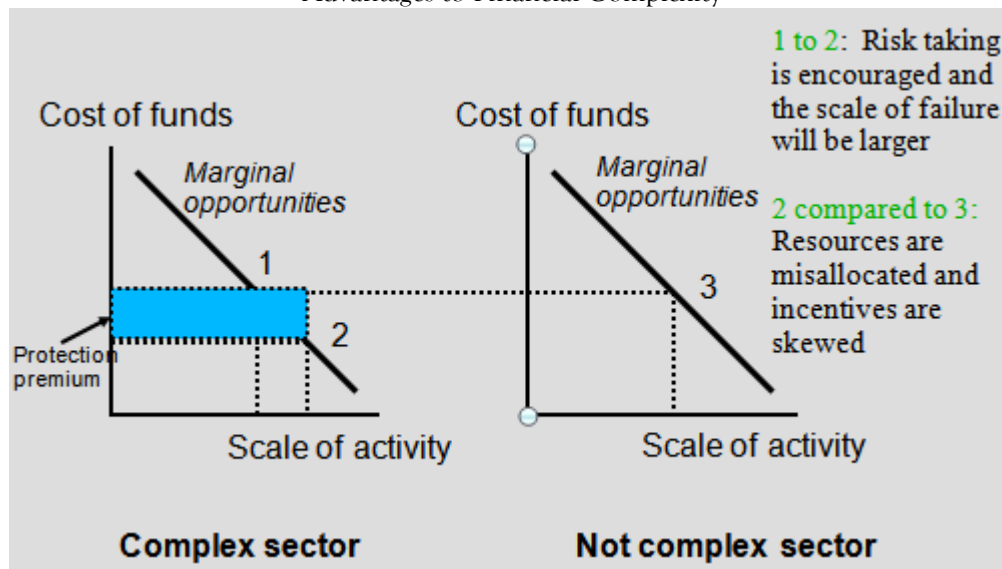
When I say complexity, by the way, I do not mean size alone. Complexity is imperfectly related to size. Size can be proxied reasonably well by the assets of individual institutions. The complexity of firms varies a good bit across the asset size. An institution like Bank of America (at least before the acquisition of Merrill Lynch) was not as complex as it was big. Retail banking is retail banking, and bricks and mortar do not necessarily bring along a systemic threat. In contrast, a market fixture like Bank of New York, which is one of the two wholesale providers of clearing services for government securities, is so interconnected in the payments system that a regulator would nod his or her head and say, "That one is complex. That one is critical to our infrastructure."

In such a world, there are some firms that are too complicated to fail, and there are other firms that are not complicated enough to protect. That means the complicated firms have a certain protection premium. They get preferred funding because their counterparties recognize

that the government will ultimately bail out them out. This preferential status is not solely in terms of cost. They also access preferred lines of credit, because the ultimate counterparty is going to be the government.

The consequences of this funding advantage can be discussed with reference to the two panels of Figure 5.

Figure 5
Advantages to Financial Complexity



Source: Author

Firms in the “too complicated to fail” sector, the left panel, face a cost of funds lower than those that are not too complicated, the right panel. If both sets of firms face identical and diminishing opportunities to use those funds, as in the downward-sloping marginal product schedules, the complicated firms will use more funds. This leads to an aggregate “protection premium” represented by the shaded rectangle in the figure—which is the funding differential multiplied by scale.

The premium skews incentives. Comparing panel (1) to (2), there is an encouragement to risk taking so as to get more complicated. Firms spend resources to keep their special status, including by going slow on industry initiatives that limit risk and by weaving systemically important activities into its structure. Management’s goal is to make the firm so complicated that there is no way a systemically important function could be lifted out at a time of stress without killing it. Self-interest also calls for resisting regulation that would make closure easier. Along the way, a firm’s balance sheet gets more intricate and its instruments more complicated to take advantage of regulatory arbitrage.

That is to be expected: When there is money on the table, private sector resources will be spent to try to get it. This rent seeking implies that resources will be used up to capture the protection premium, potentially to its entirety.⁶

The more complicated the structure becomes to take advantage of what the government has put on the table, the harder it is to understand the firm's operations, both from outside and from within. There are three fundamental problems associated with this difficulty in monitoring effort in a complicated firm.

First, supervisors are at a decided disadvantage in understanding risk taking and compliance for a firm that might involve dozens of jurisdictions, hundreds of legal entities, and thousands of contractual relationships. Individual instruments offered by such an institution might have been tailored to a small slice of its clientele to take advantage of tax and accounting rules. Its balance sheet might be especially malleable to advances in finance and legal interpretations. And the same risks might be booked in different ways across affiliates, let alone across different institutions, with evident consequences for capital requirements. Indeed, the reliance of self-regulation inherent in the Basel II supervisory agreement can be seen as an official admission of defeat: a large complex financial institution cannot be understood from outside.

But if an institution is so difficult to understand from the outside, how can we expect market discipline to be effective? The second cost of complexity is that the outside discipline of credit counterparties and equity owners is blunted.⁷ Creditors see the firm as a black box and are more likely to look to the firm's reputation or a stamp from a rating agency rather than the underlying collateral provided by the financial contract. Equity owners are more likely to defer to senior management, opening the way to compensation abuses and a twisting of incentives to emphasize short-term gains. In this regard, it is probably not an accident that financial firms tend not to be targets for hostile takeovers—their balance sheets are black boxes to the outside.

Third, the problems in understanding the workings of a complicated firm are not limited to those on the outside. A complicated firm is also difficult to manage. Employers will find it more difficult to monitor employees, especially when staff on the ground have highly specialized expertise in finance, law, and accounting. These problems in monitoring are described in a variety of ways in the economics literature of the principal-agent problem, but the most evocative in this context is that employees who are difficult to monitor “shirk” in the performance of their duties.⁸ The financial market amplification of the real economic shock of the housing downturn importantly owed to manifestations of this shirking, including failures of suitability in matching borrowers to the appropriate lending agreement. Employees in complicated firms cannot necessarily be expected to look to the long-term interests of where they work.

Note the irony. A firm's effort to take advantage of government induced distortions by becoming more complicated and by making its instruments more complex lessens the owner's ability to monitor management and management's ability to monitor workers. Market discipline breaks down.

Also note the circularity. Policy-makers' concern about complicated firms puts money on the table, the protection premium. That induces firms to be more complicated. It worsens internal monitoring, the principal-agent problem, making the financial system more vulnerable to abuses and less resilient. This raises the odds of strain, therefore, justifying policy-makers' concerns about complicated firms. The problem is in part of our own making. The way forward is not to add

another layer of supervision, as in some proposals to create a financial stability supervisor. Another layer of supervision requires somebody on the top strata to read the reports regulators generate about the firms they supervise in the lower strata. Neither is the solution to create a college of supervisors, in which those same supervisors rather than reporting to one, get together every once in awhile to chat about the health of the financial system. And the solution is not to create a special resolution authority for too complicated to fail institutions. No doubt, improving our resolution authority is very important, but those proposals accept the inherent inefficiencies and gaps in the current system, leaving the fundamental incentive for complexity and the resulting rent seeking and shirking on the table.

My preferred solution is to follow the example of Ole Kirk Christiansen, who was the carpenter that invented LEGOs. The genius of LEGOs is that a complicated apparatus is actually built of resilient and well-defined modules. In that spirit, the whole of a financial holding company can be made of parts that can be disconnected and reassembled. LEGO, by the way, is a contraction of the Danish word for “playing well”.

In a modular solution, any part of a firm that is systematically important can be protected in bankruptcy with haircuts. Over time, industry infrastructure can be developed to limit the perimeter of what is actually systematically important. But in the event of a crisis, the modules that are not systematically important can be left to the market to resolve. Playing well essentially involves reducing the number of corporate charters and agencies, enforcing a strong consolidation of balance sheets. This may involve giving up efficiencies of scale and scope, but it is worth that to bend back the curve relating scale and complexity.

Playing well would also facilitate international cooperation, because a foreign host country can supervise a subsidiary module. Anil Kashyap was talking about this in his presentation earlier, but it is also an undercurrent in the Turner Review from the FSA.⁹ Allowing the host to monitor subsidiary modules of foreign firms may have prevented the spread of Icelandic default risk.

Playing well should have the goal of making prepackaged bankruptcy a viable option for any large financial entity. That is also a proposal by Garry Stern and Ron Feldman in their book on *Too Big to Fail*.¹⁰ Part of the supervisory process should be a discussion in which the management of a firm periodically convinces the supervisor that the firm could be taken apart and sold.

Playing well should also increase discipline on management, because hostile takeovers are more likely when entities can be carved up. That is another irony. The last thirty years of creating rules and laws to make hostile takeovers harder has also lessened internal discipline and made complexity a viable option. It should also improve monitoring in the firm. And it should work overall to improve economic efficiency.

Now, I have no illusions. Playing well would be costly and take time to implement. It would be resisted by industry, because it takes money off the table, because it puts more pressure on management, and it will lower the return on equity and finance in the future. But every other proposal on the Congress’s radar will raise the cost of finance too, with more burden and

increased regulatory oversight. Change is coming. It would be nice, at least, to get some efficiency gains.

To conclude, playing well is only my aspiration. It is not my prediction. Following this episode of heightened government intervention, more and burdensome regulation is almost a certainty, which is going to make the job of attracting capital and restoring confidence harder. Ask yourself, who is going to supervise large complex financial institutions in two years? How much capital are they going to have to hold? What lines of business can they do and can not do? Are there going to be executive compensation limits? What injunctions will be placed on dividend policies?

No one can answer those five questions at this juncture. And if those questions are unanswerable, why should anybody put private capital in the industry? I also fear that capital, once infused by the government, will be slow to exit the private sector. As this is a Federal Reserve conference, I would like to conclude by noting that the Federal Reserve, in particular, will be overburdened and subject to political pressures that may change its current structures and powers and call its inflation resolve into question.

¹ David Halberstram, *The Best and the Brightest* (20th Anniversary Edition), Ballantine Books, NY, p. xiii.

² A description of this process can be found in Jody Shenn and Pierre Paulden, “Buyout CLOs May Be Used for Fed Loans, Analysts Say,” April 9, 2008, Bloomberg, at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aiPSunxgo5w4>.

³ The lyrics of the song, rights owned by Combine Music, can be found at <http://www.metrolyrics.com/me-and-bobby-mcgee-lyrics-kris-kristofferson.html>.

⁴ This is described in Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, Random House, NY, 2000.

⁵ Carmen M. Reinhart and Kenneth F. Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, Princeton NJ, 2009.

⁶ “Rent seeking” is the concept made famous by Anne Krueger, “The Political Economy of the Rent-Seeking Society,” *The American Economic Review*, Vol. 64, No. 3 (June 1974), pp. 291-303.

⁷ Thus, the useful discipline described in Eugene Fama, “Agency Problems and the Theory of the Firm,” *Journal of Political Economy*, Vol. 88 (April 1980), pp. 288-307, is lost.

⁸ As in Guillermo A. Calvo and Stanislaw Wellisz, “Supervision, Loss of Control, and the Optimum Size of the Firm,” *Journal of Political Economy*, Vol. 86, No. 5 (October, 1978), pp. 943-952.

⁹ “The Turner Review: A regulatory response to the global banking crisis,” Financial Services Authority, March 2009, available at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

¹⁰ Gary Stern and Ron Feldman, *Too Big to Fail: The Hazards of Bank Bailouts*, Brookings Institution Press, Washington, DC, 2004.

