

*Government and Markets: a Call for Sensible Solutions to the
Financial Crisis*

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Listening to the news about recent economic indicators I have this eerie feeling that the economy's ship is headed for the coastal rocks and that the lighthouse, I should say the Whitehouse, is not projecting its light beam in the right direction for the ship to receive advanced warning and change course. The latest news is another historic rise in the unemployment level and more troubles with major banks and corporations... What to do?

Listening to the republicans' rhetoric the way to salvation is less government spending, more tax breaks, and the remnants of laissez-faire. Corporations and private interest know best and can self-discipline or be disciplined by the market. In October 2008, Alan Greenspan testified in front of the U.S. House Oversight Committee and publicly admitted that he may have been wrong about not regulating more tightly the subprime mortgage market at the time, and that his belief in self-regulating business was shaken. Whether one agrees with the old or the new Greenspan, and not doubting Greenspan's personal integrity, this was a fine and refreshing moment of intellectual honesty.

In hindsight, for me the culminating irony of this current crisis was the appointment of Henry Paulson a Wall-Street golden boy as Treasury secretary during the Bush years. I have noticed that these days you cannot mention the phrase *conflict of interest* about someone's actions when that someone is open about their ideology and their old corporate connections no matter how contradictory the ideology is to the mission. The operating principle seems to be that transparency removes suspicion. No need to put on a sheep's clothing. Conflict of interest becomes an issue *only* when someone gives the appearance of not being forthright. Hooray for the strong ideologues whose business connections are clear, who make *public* decisions based on these ideologies and rip personal benefits once their stint as public servants is over!

A team of decision-makers whose mental make-up is geared towards a *hands-off* government, may not have been best equipped to come-up with a *government-based* solution to the crisis: that is, how to *responsibly* use public money? The true allegiance to old corporate friends and the shared ideology to side with one's own kind IS a conflict of interest! We all know what happened with the initial \$700 billion bailout plan proposed by Paulson and *non-opposed* by star economist Ben Bernanke. Bernanke's field of expertise is monetary economics; especially with an emphasis on near zero interest rates economies and the monetary policies of the Great Depression of the 1930s. Who was better qualified to understand the current financial crisis? But academic common sense can be an oxymoron. As of February 2009, TARP had led to an initial 160 billion dollars unaccounted for. At least, I can do some simple math: \$20 billion received by Bank of America to acquire Merrill Lynch, and \$3.6 billion paid in bonuses to Merrill Lynch top execs.... Recall that current Goldman CEO Lloyd Blankfein was also the only Wall Street executive invited in to work with Paulson on the original rescue package, and that Paulson used to be the head of Goldman. Of course, the Democrats are also to blame squarely for not showing more backbone and going along with bad to worse decisions, and knowingly so. The Obama administration, and Clinton's before that, has its share of Wall-Street golden boys.

Capitalism and Competition

One of the central tenets of Capitalism is that self-interest leads to community interest. A famous quote by Adam Smith (1776) is: "*It is not from the benevolence of the butcher, the brewer, or the baker, that we can expect our dinner, but from their regard to their own interest.*" Goods and services enjoyed by consumers are not the product of an altruistic motive but a selfish motive by producers. To succeed in a capitalistic society, businesses must fulfill a consumer need or want. The Darwinian evolutionary process then goes on to root out useless and bad products and these businesses do not survive. The failed entrepreneurs do not have to fade into the sunset, but they can learn from their mistakes and take another shot at success. In a Georgia State University survey of 1,900 U.S. inventors having filed patents between 2001 and 2003, only about 53% were attempting commercialization; roughly the same percentage as in the 1950s. Some

experts estimate that only about 5% of the total pool of inventions will turn out to be commercially viable. Making it as an entrepreneur/inventor is tough!

On the other hand, we know all too well that pure competition is hard to sustain in a capitalistic society. Paradoxically, the aim of most for-profit businesses is to *monopolize* trade. Corporations grow by taking market shares from competitors, by acquiring other companies by developing patentable products and/or controlling key resources. Of course, to have an incentive to innovate, an invention should be protected from copycats. But once they reach a certain size, barriers to entry become too high and new competitors are excluded from the market. The case of Microsoft is telling. Through the process of creating an operating system that became an industry standard, Microsoft has been able to “monopolize” the PC industry and the internet browser market. Some even argue that it has slowed down the adoption of better alternative technologies.... But we may never know...

In other words, the process of corporate growth is a process of creation, attrition and pursuit of domination. The companies making up the Dow Jones 30 represent 20% of the entire stock market capitalization and have been around in the index on average for more than 29 years. They dominate their industry and have done so for a long time. Recently a few of them are in danger of being dropped from the index, namely Bank of America and GM, due to the precipitating events of the financial crisis. General Electric is also experiencing its worst crisis ever.

The Austrian economist Joseph Schumpeter argued in 1942 that the process of creative destruction is the engine of capitalism. He meant that new technologies eventually displace old ones and that the business cycle is a cleansing mechanism to weed out cost-bloated corporations. This is all fine as long as the successful corporations of yesteryears do not seek to impede the creative impetus of the market, and do not succeed in altering the rules of the capitalistic game in their favor by the *exercise of political pressure*.

In sports, competition is widely regarded as beneficial and praised for its entertainment value and I would even say “uplifting” qualities. Some teams dominate for few years, but while there are barriers to entry, National Football League rules permit lower ranked teams to build talent and to fairly compete against the winning teams.

During the new players draft season, teams are ranked in inverse order based on the previous season's record, with the team having the worst record picking first, and the second-worst picking second, and so on. This allows for equal opportunity, talent renewal and innovation in the defense vs. offense strategies. Legions of fans are rewarded in turn in many different cities around the country and local businesses linked to the game benefit as well. Wealth is shared and talent is not monopolized or excluded. While it has happened in the past that some teams have tried to rig the game in their favor, this generally has been short-lived and detrimental to the sport.

Market Solutions and Free Market Ideology

As Adam Smith pointed out more than two centuries ago unbridled greed can lead to unraveling of the social fabric and markets. The inclinations for some businessmen to accumulate wealth while adding little corresponding value to the real economy can be a problem. I want to contrast how a culture of market *solutions* is different from a “free market *ideology*”. Free market ideology is rhetoric often used by lobbyists to justify less industry regulation and to alter the rules of the market in their business’s favor. When large corporations or concentrated industries lobby the government to keep the market “free” they rather mean: “keep our market *power* intact”.

On the other hand, market *solutions* come from the creative impulse of businessmen and women. These are the doers who understand that there are opportunities in the market place, even in *regulated* markets, as most of them are. Of course you can’t *do* solutions without believing in market forces.

Some opportunities may be glaringly obvious, others may yet be unknown. Known opportunities cannot necessarily be rushed into the market place either by the government’s will before the market is ripe for it. It is often said that “necessity is the mother of invention”. Market prices usually provide the correct signal for timely technological innovations, as in the case of many innovations like the CD player, digital cameras and the first wave of Japanese fuel efficient cars in the 1980s.

This signal may be distorted or absent as in the case of non-marketed goods like car exhaust pollution, and other greenhouse gases. Ideally, there *should be* market solutions for all these issues as well as for the financial institutions failures we are seeing today,

because these solutions rely on human ingenuity and creativity. Of course, tax incentives and U.S. government funded research are another impetus for kick starting innovations. At its finest hour, the U.S. economy has produced the majority of all the key innovations and products that brought modern comfort in the last century, based on that noblest of human creative power: the electric light bulb, automobile mass production, plastics, computers and the internet.

What is Government Good For?

This brings us to the role of the Government. The government is a man-made institution. There is nothing intrinsically wrong with us having a government. I am puzzled when I hear people saying things like: “When I was born into this world, I never agreed to have a government limiting my freedom”, or “I never trusted the government”. I never “agreed” that gravitation should prevent me from flying, but there it is: a fact of life. I can still work within the constraints of this law and indeed fly in an airplane. There have never been any instances of human societies without some form of government. No matter how much people complain about it, it is *up to us* to shape our government. We tend to forget that our government is created in *our own image!* People in government are our relatives, friends and neighbors (especially if you live in Washington DC).

However, it is true that a government should be an instrument of and for the people. It is an institution that is meant to help a nation’s people and is not supposed to bring the nation down. In the view of the Swiss 18th century philosopher Rousseau, the government’s role is to provide a mechanism for enacting and enforcing the laws chosen by what he calls the “general will” and not by factional interests. In sum, the Government is a final arbiter that must act for the common good. It is not supposed to become self-interested or to parasite the economy. In Milton Friedman’s view the government’s role must be limited to just about military defense and the provision of some public goods. But local schools and roads should be privatized. If one accepts the premise that a byproduct of capitalism is a strong tendency towards monopolization, I believe that a fundamental role of government is to establish and maintain *fair-game* rules for the market. For example, we have antitrust legislations, which outlaw some extreme anti-competitive behaviors. Friedman himself was against government granted monopolies

(the U.S. post-office for example). Rules are what make the game of football interesting because as a viewer I know that both teams are given an equal chance to win. Most people eventually lose interest in a game that is rigged.

But, what happens when a corporation or group of corporations become so large that their economic power translate into *political* power? An extreme case is when such corporations are “*too big to fail*”: either they occupy one of the key links in the economic chain and/or their stakeholders become bargaining chips. This is essentially lobbying on steroids. I remember growing up in the 1970s in France when the mining and steel industries were essentially rescued by the State, because of the threat of massive unemployment and social unrest in the north of France.

The word “nationalization” is getting a bad rap these days. France did that for its automobile industry (Renault) in the 1940s and its steel industry in the 1970s. Many banks were also nationalized in the 1970s and 1980s. The State became the 51% shareholder after having pumped millions of Francs in these companies. Some CEOs were directly appointed by the government to head these companies. Often they did not have the prior business background, but were graduates of the cream of French engineering and prep schools and thus perceived as being great leaders and administrators.

The desire to prolong the life of a business beyond its economic viability does not make much sense in the long-term. But it may make some sense as a way of providing temporary relief. My recollection while living there is that people did not complain about these subsidies. To a certain extent, part of the French social(ist) contract was that tax-payers were willing to partake with their taxes to avoid the pain of seeing their peers going without jobs, at least for a while. It is estimated that the cost of keeping these obsolete jobs going was about four times their true market value. Eventually these industries were privatized in the mid-1980s.

These companies and industries did get a chance to modernize, and maintain the standards of living for their workers. Could they compete on the international stage? No. Were they able to bring their cost down as much as they could have in a free market? Probably not. Was injecting subsidies postponing an inevitable death? It certainly did look like it at the time. Should the workers have been laid-off and retrained? Possibly

yes. Should the tax payers have subsidized inferior products? The answer is probably not. However, today Renault is allied with Nissan and has become the 5th largest car manufacturer in the world. Maybe it could have happened sooner.

Now of course, the counterpoint to the argument of artificially sustaining flailing businesses as well as other welfare programs is that taxes are strangling viable businesses and the entrepreneurial spirit, giving way to an unemployment rate around 9 to 10% in France ever since I can remember. Many French entrepreneurs have moved to the UK, where they can develop their franchises, while keeping their French social safety net. But enough about France.

Markets, Cry Babies and Bad Parenting

A strange thing has happened in corporate America since the 1970s. Many managers of these corporations have acted mostly in *their* self-interest, which is not necessarily the best interest of the corporations' owners or other stakeholders. Harvard's Michel Jensen originated this famous argument in the mid 1970s. He called it the agency problem of managerial behavior or "Moral Hazard". Combining this with the "too big to fail" aspect of the crisis, leads to a deadly combination. I call it the "cry baby" syndrome. It goes something like that: your 5-year old daughter is throwing herself on the floor in the toy store because she wants you to buy her the latest Hanna Montana doll. She is crying really hard, you are rapidly becoming embarrassed, and perceive that the other adults in the store want the "crazy act" to stop. You concede and buy the doll. What is lesson learned by your kid? If I make a fuss big enough, I can get what I want.

Now fast forward 11 years later when she wants you to buy her a new car and gives you emotional aggravation if you do not comply. What check mechanisms did you put in place along the way to reduce this "blackmail" behavior? Are you getting anything back in return? Is your family living more happily by accepting this type of behavior? Is your daughter acting in the best interest of her family?

What strikes me about the negotiated rescue bank packages, at least by contrast with the automobile industry, is that there was apparently no discussion by CEOs of what the financial institutions would be doing to correct their mistakes and bounce back in the future. It was all about throwing (quiet) tantrums to get what the CEOs wanted and

running for the exits with the loot. Just like in my “kid” example, the government did not do its job to put in place check mechanism to reduce the incentives for these CEOs to act like “cry-babies”.

A modern definition of economics is that it is the “science of incentives”. It investigates how to design incentives for generating the desired outcome. Incentives do not “force” anyone to do anything against their will. Of course, it is clear that “great” incentives are those that fundamentally align with the noblest aspirations of man. The invisible hand of markets is an example of a great mechanism for providing business incentives. We are unfortunately still searching for the perfect incentive method to compensate executives.

Economists are keen in pointing out the perverse effects of actions that originate from the *best of intentions*, because incentives may not properly align with these intentions. While often not politically correct, it is invaluable to find out how incentives are structured when they lead to the wrong outcome, so we can readjust them. Of course, assuming that Treasury and Fed people had the best intentions for solving the crisis does not mean that they put the best incentives in place.

There is no market setting the price tag for “too big to fail”. People at the Treasury department and the Fed certainly have the wherewithal to understand that there is an economic cost for too big to fail and that there is also an economic *benefit* for corporations to be covered by what essentially amounts to a government insurance program free of charge. And we, the tax payers, are subsidizing these insurances. Shouldn’t these industries bear some of the cost of getting this ultimate insurance against failure? Possibly.

Cry babies will always demand more and will not want to be accountable for their actions *after* you give them what they want unconditionally. The key is in specifying what you want to them in a contract before delivery. Failure to abide by the terms of the contract should have severe retributions. It takes effort as a parent to really understand the reasons behind an excessive behavior and taking the corrective steps. So to should the Fed and Treasury go down and dirty to really find out what the extent of the problem is and then package the right incentive contracts with the nation’s best interest at heart; i.e. figuring out the best possible gains for the nation. Please don’t misunderstand: should the

government act in a paternalistic way toward ill-behaved corporations? No, I don't mean to say that. However, taxpayers should really not be treated as the financial institutions' *sugar-daddy*.

The market does not rub it into your face when you fail; it just puts you out of business. When CEOs come to the government for *last resort* help because they do *not accept* the market consequences, they should swallow their ego and the medicine.

Credit Derivatives and the Collapse of AIG

The original trigger for the current crisis was the large losses sustained by financial institutions in their investments in so-called "toxic" assets. Among these assets are Collateralized Mortgage Obligations (CMOs), which are pools of mortgages packaged together and sold to investors as securities. These securities were losing value because the underlying subprime mortgages were experiencing high default rates after the real estate market popped in 2007. More importantly the true risk of these securities was misrepresented.

Unfortunately, the domino effect carried over to other asset classes called Credit Default Swaps (CDSs), which are essentially unregulated insurance contracts between two parties, designed to insure against an event that may be related to these two parties or not. Collateralized Mortgage Obligations and Credit Default Swaps, are both examples of credit derivatives. These are financial instruments whose value depends on what happens to another (underlying) asset.

For example, a \$100 million CDS may be offered by a hedge fund and sold to Corporation X to insure against GM's defaulting on its corporate debt. The hedge fund receives an insurance premium from the corporation and pays the insurance policy (\$100 million) to Corporation X if GM defaults. Sort of a perk of using CDSs is that the hedge fund does not need to post any collateral; that is, it does not have to have in its possession a portion of the necessary \$100 million, which it should in a regulated market. Note that while there is a legitimate reason to use CDSs when Corporation X happens to be GM, it becomes a side bet on the health of GM if the corporation is not directly connected to GM. Most of the CDS activity on the market before the crisis was geared towards side-bets.

In September 2008, about \$60 trillion worth of CDS contracts constituted “potential debt” for the financial sector which recorded these transactions **off**-balance sheet! This debt would be triggered if the “bad event” occurred. In that case, that mostly meant third parties defaulting on their debt such as mortgage pools. In September 2008, the total liabilities shown in the aggregated balance sheet of the financial sector was roughly \$25 trillion (including commercial banking, property and casualty and life insurances companies, and excluding pension funds, mutual funds etc.). If one estimates at \$30 trillion the effective liabilities resulting from CDSs, excluding companies on both sides of the market, this means that these credit default swaps were effectively *doubling* the size of the financial sector liabilities.

AIG’s collapse is the largest in American history. AIG was offering a huge amount of these “unregulated insurances” or CDSs. It was severely under-collateralized and thus highly leveraged. At some point AIG was carrying up to \$50 billion of CDSs written in 2005 to insure mortgage obligations, which were still AAA rated at the time. One of the interesting aspects of AIG’s collapse is that the reason it went under is not because the mortgages it insured were not performing well in terms of making payments. Rather, the reason is that these mortgage pools were suddenly viewed as more risky by rating agencies, which in turn provoked a downgrade of AIG’s rating. The company found itself in the position of having to post more collateral than it had, to make sure that it could pay these insurances. These increased collateral calls are what did AIG in.

Up to date the government has committed \$170 billion in financial aid to AIG. In November 2008, an off-balance sheet vehicle was created by the Federal Reserve Bank of New York to purchase \$46.1 billion of AIG’s toxic collateralized debt obligations (CDOs), which also included CDSs. Many of the CDSs were bought back from AIGs counterparties at par by the government, while they were worth cents on a dollar. Of course, many of outstanding CDSs contracts have since been unwound, and some of these contracts were offset by taking positions on both sides of the market.

My analogy of the majority of CDS transactions that were side-bets is gambling. Imagine that a few major financial institutions in the US had taken out line of credits from Casinos to gamble and lost. Imagine that this debt constitutes 50% of their total liabilities, which is now due. Each institution is running around trying to collect enough

cash to pay back gambling debt, forcing some of their clients who are contributors to real GDP to sell-off assets and shrink or close. It certainly would appear ludicrous that the economy would be brought down to its knees by gambling debt, which has no relation to the real economy.

Three Simple Proposals

I am suggesting three simple solutions to help with the current crisis. These are not intended to be the keys to resolve this entire crisis. But at least, I believe they can make a difference.

The New “Philadelphia Experiment”

From May to September 1787 a group of 55 of the brightest collection of minds of that time gathered together and confined themselves to a meeting room in Philadelphia to hammer out what has become one of the highest and noblest declarations of human potential: the American Constitution. This is such time of emergency and high potential. My first proposal calls upon the government to offer what it does best; *a public good*.

Proposal #1: The Federal Government should immediately convene a 4-weeks long convention of the 100 best academic and business minds in the country who are experts in Financial Economics, to put their mind and energy at work for solving this crisis. The convention would be similar to the structure of the framing of the American constitution in Philadelphia. There would be several taskforces with finance industry professionals and representatives and academics. At the end of four weeks each taskforce would render a report about the best solutions that they can come-up with. The solutions would be proposed with the utmost scientific objectivity and with full disclosure of any ideological bias and give a sense of how each solution would show up on the political radar. These must be solutions that work for the best interest of the nation. The reports should be presented to congress and legislation should be drafted in the following month to adjust and rectify ongoing policies as see fit.

As a declaration of intent: we would be happy to host such event here in Albany NY, with funding provided by the Federal government and the Finance industry. I am calling on New York Senator Charles Schumer to help us make this event a reality.

How to Help Homeowners, Mortgage Banks and Restart the Real Estate market

One of the key issues regarding the current solutions to the crisis is the perception of fairness or injustice associated with some of these policies or industry practices, which in this environment add to the mistrust and uncertainty. An example of this is the current plan called “The Home Affordable Refinance Program” just being initiated by the Treasury. Here, I propose to introduce a *new* product into the marketplace.

Proposal #2: A new type of mortgage: the *Upside Shared Equity Mortgage (USEM)*. Sheila Bair chairwoman of the FDIC was correct in stating that homeowners must be helped. Foreclosures are costly for banks and for families who are dislocated. Dr. Bair’s proposal and the Treasury new plan to essentially renegotiate the loans are only partially viable. It is true that many honest people got in over their heads because of bad counseling. But speculators knowingly got into houses that they could not afford based on an interest-only loan or an adjustable rate mortgage, with the idea of reselling these houses before the interest rate reset. These people gambled and lost. They should not get a clean bill of health. This undermines the trust in the rescue package, and the willingness of banks to lend again.

I propose that mortgage banks offer a new product I call *Upside Shared Equity Mortgages (USEM)*. These mortgages would be renegotiated at lower interest rate based on the initial mortgage principal. However, the bank would put a clause in this new contract that it (the bank) is entitled to getting a set percentage of the capital gains when the family sells the house or transfers the property to another owner. Bequests would be treated the same way. To avoid manipulations, the bank would for example specify that in the event of a sale the amount owed to the bank cannot be smaller than say 20% of the capital gains computed based on the most current tax assessment of the property. If the tax assessment is too stale, banks could mandate that three market value assessments be made by independent assessors. Banks can certainly model the likelihood and risk

associated with obtaining capital gains and how this translates into a reduction of the mortgage interest rate. They may take some losses but not as much as under the current Treasury plan, and speculators would be more penalized.

How to halt the Domino Effect of Toxic Assets Bringing Down the Real Economy

Proposal #3: First of all, any money provided by the tax payers for bailing out institutions should NOT be allocated to side-bets “naked” CDSs. “Naked” CDSs are transactions in which none of the parties have a direct stake in the underlying insured debt. The Fed and Treasury should work in concert with the financial industry and declare a *one-time moratorium on all “naked” CDSs side-bets*. Insurers must pay all the premiums back to the insured, but no policy payment occurs even though the bad eventuality may have been triggered. The key point here is that bankruptcies caused by these side-bets have a dire chance to bring down the *whole* of the *real* economy, and they should not be allowed to do that. While some hedge funds will cry foul, all these side bets are based on funny money. Financial institutions should write-off these side bets CDSs and bank regulators should allow for temporary changes in the conditions that lead to declaring financial institutions’ insolvency based on the revised equity and assets and capital reserve ratios. Institutions that were heavily involved (90% or more of the value of assets in CDSs prior to the crisis) in these side-bets should be allowed to fail and should not be rescued by the government.

Many other proposals can be made, especially for reestablishing confidence in the financial system. What is the new regulatory environment going to look like? We need to avoid the same excesses in terms of misrepresentation of the true risk of CDOs, and we need address the lack of collateral and regulation in CDS transactions, as well as off-balance sheets transactions, which aim at hiding true risk. Solutions along these lines are already being circulated in the information sphere. I’m optimistic that there will be a concerted movement to find the best pool of ideas. Even if the ones in this essay do not make the cut, I was compelled to try.

Albany, NY, March 6, 2009.