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At this writing in early October, 2008 it appears that the first phase of the financial crisis is ending and the second is about to or has begun. The phase that is ending entails flushing the worst assets created during the sub-prime lending boom out of the financial system. It has been accomplished by massive write downs and government actions of various kinds culminating with the creation of a taxpayer financed buyout fund for these assets. The phase that is beginning will be driven by the broader deterioration in bank balance sheets and income streams emanating from the ongoing decline in real estate values. This decline has already created negative equity for many prime mortgage holders. Were plain vanilla, held-to-maturity prime mortgages marked to market or to some realistic approximation thereof it is likely that significant chunks of the banking system would be or will shortly be insolvent. We should expect this underlying economic reality to roll through the banking system in 2009 and 2010. It will create more demands on the FDIC's insurance fund and, ultimately, the federal treasury.

There is little we can do now to avoid this painful unraveling, though wise policy may mitigate the pain. The policy question that will shortly move to the fore is how to avoid or contain a repeat of the kind of system meltdown we are currently embroiled in. My remarks will focus on this question, and I will sketch a modest proposal that I think would make the financial system less fragile.

A widespread view among academic economists is that we should rely more on market forces to restrain excessive risks. On this view, suppliers of funds should bear losses from risky

asset purchases. Then they will exert pressure on management to restrain risks, or they will move their funds to safer institutions. This market discipline should be supplemented by risk based deposit insurance fees or capital requirements, because insured depositors have no incentive to monitor risk. There is, I think, some intellectual merit to some of this academic orthodoxy. To some degree we are today reaping the whirlwind spawned by overriding the market signals in the cases of Continental Illinois, the era of regulatory forbearance of zombie Savings and Loans, Long Term Capital Management and most recently Bear Stearns.

On the other side, I have become less optimistic about the efficacy of balance sheet regulation or risk based insurance fees in reducing systemic risk. Such regulation creates incentives for offsetting responses that strike me as too powerful for regulators to adequately overcome. Thus, the current meltdown began when large banks were called to make good on guarantees to investors in Special Investment Vehicles (SIVs). The SIVs were a response to Basel capital requirements which effectively took the liability off the banks' books. The Basel requirements, themselves enacted in the wake of a previous crisis, arguably made the underlying problem worse, because the SIVs hid the banks' liability and thereby weakened corrective market forces. Suppliers of funds to the banks were being led to believe – by the regulatory treatment accorded the SIVs, by their AAA ratings, by the banks' silence on their residual liability – that the SIVs posed no threat.

While the kind of policy that relies on market forces, possibly complemented by regulation, to avoid excessive risk has some intellectual merit I have concluded that it is wrong. The reason for this conclusion is that such a policy has become irrelevant, so it is a waste of time to discuss it. We must contend with two facts, which have crystallized during the current crisis:

1. The Federal Reserve and the Treasury will always be in the grip of a world view that it is they alone who stand between the rest of us and the abyss.

The large participants in the markets they regulate, who often supply the leadership of these agencies, share this world view.

2. Much more importantly, these agencies have the demonstrated ability to act on this belief system without serious democratic restraint.

How else can one interpret the sudden revelation that \$29 billion of the full faith and credit of the US Treasury had been committed to the Bear Stearns transaction, or the equally sudden undebated and unvoted announcement that \$85 billion of government funds had been loaned to AIG? If there is any principle that emerges from these announcements – and non-announcements like the decision not to rescue Lehman Brothers – it seems to be that amounts at least as large as \$85 billion can be appropriated, or not, at the discretion of official Washington. Significantly greater amounts will require the assent of a Congress rushed into action by officially sanctioned fear of the consequences of delay. Exactly where the border between \$85 billion and that larger amount is remains utterly unclear.

No intelligent policy response to the current crisis can ignore these two facts. They seem entirely unalterable. The policy problem that they create is that, if left unchecked, they will lead to recurrent crises or, at least, to an ever lengthening line of potential supplicants. That prospect will likely evoke some response, either from Congress or the Agencies or from both. Most likely the response will be another round of tougher regulation: higher capital requirements, more balance sheet restrictions and the like. For reasons I have already indicated, this kind of response

is unlikely to work well in the long-run. Just as Basel led to the SIVs, so will the next round of regulation have to contend with the ingenuity unleashed by the incentives to find a way around them. The likely outcome of tougher regulation is a short-run success that is eroded over time.

Another policy approach would seek a broad realignment and redirection of the institutionalized moral hazard incentives emanating from the Washington/Wall Street world view. Proposals to attach warrants to any financial aid or to exchange the aid for preferred stock are a move in this direction. They capture some of the upside from what would otherwise be a heads-you –win, tails-I-lose kind of bet. However, such proposals are wholly ex-post. They cannot change any of the behavior that got us here. We need to think about ex-ante mechanisms, which can affect future decisions in a world where there is no realistic hope of avoiding potential future claims on government funds. Such mechanisms would, I think, have two desirable properties: they would shorten the number of claimants on the government and they would mitigate the taxpayer burden. I will sketch out a mechanism that I think has these properties. It is designed to deter the kind of behavior that leads government to ride to the world's rescue and to provide a self-funding mechanism for the rescues that do occur. I will be deliberately vague about details.

I would begin by institutionalizing government bailouts. Once we understand that they will happen, whether we like it or not or whether voted by Congress or not, we should regularize them so that they do not, as they do now, engender further panic. For example, the Federal Reserve Act institutionalizes liquidity provision by allowing eligible institutions to borrow against good collateral. I would extend this to provision of funds not secured by good collateral, without artificial distinction between liquidity and capital funding. An eligible institution should

be able to be accommodated by the Fed whether or not it is able or willing to post eligible collateral. In return for any unsecured credit, however, the institution would be required to give the Fed a convertible bond, with the following properties:

- A fixed term. Say, due in five years
- Pay interest at the treasury rate plus a hefty premium
- Senior to all other liabilities not already insured by the federal government
- Convertible to equity at the market price on the issue date if not paid back at maturity

I leave open thorny issues, like whether the funding comes at the request of the bank or the Fed itself or some other regulator. Suffice it to say that, even if we keep the current system whereby only the government can commandeer the aid, it makes sense to impose the ex-ante restriction that any aid be paid for by a convertible bond along the lines just described. This would be so if the aid comes in the form of a capital injection, a loan, a loan guarantee or any other form.

An ex-ante requirement for exchanging government assistance for the convertible bond would have several desirable properties:

- Deterrence. The conversion feature creates the prospect of dilution or transfer of control to the government. The force of this threat is enhanced by the presumably low conversion price, which is set at a time when the recipient has already experienced bad news. It is further enhanced by the penalty interest rate and the senior status of the bond. All of this should create a disincentive for management to make decisions that will raise the likelihood of requiring government assistance. Or it will create an incentive to take actions that allow the bond to be paid off before its due date.

- Reduced taxpayer exposure. Presumably the deterrence will reduce the occasions that require taxpayer exposure. Any exposure that does occur will either result either in repayment in full or the acquisition of some valuable assets that can cushion the taxpayer loss. There is currently no institutionalized mechanism whereby government assistance requires some promise of repayment. For example, the Bear Stearns loan guarantees came at no cost to the beneficiaries. The just enacted program to buy bad bank assets has no charge for the benefits it will grant. This willingness to grant benefits without cost to the beneficiaries has poor deterrence characteristics, and it leaves taxpayers exposed to all the resulting costs.

- Avoidance of capital structure distortions. The strict priority of the government's claim is an important part of this proposal. The imposition of large losses on equity holders in Bear Stearns and AIG (not to mention Fannie and Freddie) is sometimes pointed to as an offset to moral hazard. Surely the prospect of future equity wipeouts will deter excessive risk taking in the future, according to this view. This view is incorrect. My late colleague, Merton Miller, and Franco Modigliani taught us to be skeptical about artificial distinctions between equity and debt. In the aforementioned cases if your claim on a firm's assets was called "equity" you lost, but if it was called "debt" you gained. In the Washington/Wall Street world view a wipe out of equity is merely unfortunate, but any loss to debt holders threatens to push us into the abyss. This is dangerous foolishness, because it threatens to multiply the number of crises. It does so by providing an incentive for suppliers of funds to get their claims classified as debt rather than equity. This increases the financial system's leverage and its vulnerability to shocks that threaten debt values. The priority rule for the proposed convertible bond eliminates this source of instability by making it clear ex-ante that government assistance will not be biased in favor of one kind of claimant over another.

The kind of incentive mechanism I have just sketched obviously needs to be fleshed out. Perhaps it can be improved upon, or replaced by something much better. But it is important to begin discussing such mechanisms before we are engulfed by, or preferably to head off, the next crisis. There is a need to create institutional incentives for not getting rescued even if, as I think is likely, we rely heavily on tougher regulation going forward. We need a hedge against the failure of that regulation to produce more stability than similar moves have in the past. But that hedge needs to be put in place now, before the decisions that lead to the next crisis are taken.