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Make Failure Tolerable

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These are tough times for the U.S. economy and for many others around the world. Tense moments in the last half of 2008 produced unprecedented actions that, according to recently published detailed accounts, were taken without the benefit of reflective strategy, on a case-by-case basis, and in an environment of panic. The result, especially in the United States, has been massive bailouts of faltering organizations with consequent commitment of huge amounts of taxpayer dollars and heavy involvement of the federal government through ownership in customarily private sector activities: selecting boards of directors and chief executives, regulating pay, and otherwise influencing corporate behavior. The American people are clearly upset about these bailouts. In the view of many, the people who created the problem should pay a penalty instead of being bailed out by the taxpayers. Who would disagree with that sentiment?

Difficult times are still with us and clearly lie ahead. Unemployment is high, the Fed has unleashed every trick in its bag (and even some that no one realized were in its bag) to stimulate the economy, government spending seems out of control, tax rates are rising with the clear prospect of more to come and with their well-documented disincentive effects, and protectionist actions are all too evident. Remember, the 1930s were characterized by the heavy tax of virulent protectionism and an increase in the top marginal income tax rate from 25 percent in 1932 to 80 percent by 1936.

WHAT TO DO?

The way to proceed is to set a strategy designed to produce growth based on the vigor of the private sector with inflation under control. One essential pillar of that strategy must deal with the current bailout mentality. The right question is, How do we make failure tolerable? If clear and credible measures can be put into place that convince everybody that failure will be allowed, then the expectations of bailouts will recede and perhaps even disappear. We would also get rid of the risk-inducing behavior that even implicit government guarantees bring about. "Heads, I win; tails, you lose" will always lead to excessive risk. And we would get rid of the unfair competitive advantage given to the "too big to fail" group by the implicit government guarantee behind their borrowing and other activities. At the same time, by being clear about what will happen and that failure can occur without risk to the system, we avoid the creation of a panic environment.

Here are a few ideas that can help make failure tolerable.

1. The first is to make a careful assessment of just what systemic risk means and how it comes about. In recent times, the words "systemic risk" have taken on the impact of a yell of "Fire!" in a crowded theater. Careful analysis is essential. My own experience with labor disputes thought to be national emergencies and a few other so-called failure situations tells me that the problem can be overestimated or can be reasonably contained. So, what are the size dimensions of the problem? Remember, markets can handle lots of size. What are the kinds of interconnections that cause trouble? Are certain kinds of activities so risky that they need to be reined in somehow? To what degree does excessive leverage create problems? Can capital requirements be structured in such a way that any risk is borne in important ways by the person deciding to take the risk? Are some activities too risky to permit financial organizations to use them for their own accounts?

2. How might intervention deal directly with the issues posed by a failure rather than by using a bailout to prevent the failure in the first place? Such action depends on the earlier analysis of what creates the risk. Then these questions arise: How can these risks be dealt with directly? What can be learned from other areas, such as the handling of major labor disputes, about how to handle systemic risk?

3. The phrase "too big to fail" implies some sort of restriction on size that would place an unnatural limit on reach and capacity. Actually, the difficulties of managing very large, disparate, and complex organizations tend to limit size. Competitors tend to cut them down. That is the

history of conglomerates in the United States. Nevertheless, financial institutions present special problems because, by their nature, their activities can affect large sectors of the economy.

4. So, an escalating schedule could be required of necessary capital ratios geared to size and matched with escalating limits on leverage. The presumption here is that size happens because it brings advantages. Since size implies a certain risk to society, some additional costs would also be appropriate. Therefore, increased capital and leverage requirements are justified. Alternatively, or simultaneously, well-defined and compelling specific capital ratios and leverage limits could be related to the riskiness of the activity undertaken.

5. Understood and transparently used methods of delinking parts of large organizations could be developed so that if one goes haywire, the others can remain in business. Are you old enough to remember Christmas tree lights from long ago? When one light failed, they all went out. And the longer the string, the harder it was to find the guilty bulb and therefore the more time-consuming was the remedial action. Derivatives and securitization, so to speak, made the vulnerable string of lights even longer, increasing vulnerability and making the system more difficult to fix. The Christmas-tree-lights problem caused manufacturers to come up with a delinking system so that, these days, when one light goes out, the others stay on. If the manufacturers of Christmas tree lights are smart enough to do this, why shouldn't we be smart enough to work out delinking arrangements in the financial and corporate spheres? Obviously, limited-recourse suborganizations would have to be clearly advertised as such, so that those who play with whatever fire exists will know they could get burned.

6. Then there are organizations that grow because they are heavily subsidized. This is a deliberate process designed by government to encourage some form of activity such as homeownership. The widespread American instinct that homeownership is a good thing, that owners take care of their properties better than renters, and that people prefer to live in a nest they have created according to their own style of life are great virtues and arguably deserve some subsidy. The question is how to structure the subsidy. Tax deductions for interest payments on mortgages are one model. They are widely used and present no problem of abuse. The gross misfortunes generated by Fannie and Freddie, with their guarantees that represent large and somewhat invisible exposure, suggest that this broad approach is the wrong one. Keep the subsidy focused on the individual who has some real skin in the game, and cause lenders to keep at least some reasonable amount of their skin in the game.

7. Bankruptcy proceedings need to be examined carefully. Are different processes needed for different kinds of organizations? Do we need a system especially adapted to the financial services industry? To what degree do problems arise from slowness of application? If quicker resolution would be helpful, can some greater degree of automaticity or presumption be built into these processes? Of course, the key part of a bankruptcy reorganization proceeding is that the organization continues to function while the proceedings take place. This fact deals automatically with some of the risk factors. And the proceedings take place within an understood rule of law.

8. There has been considerable discussion of the contribution to the problem by certain financial instruments.

Warren Buffett says derivatives are weapons of financial mass destruction. Securitization has been identified by many as a cause of problems because this process separates the originator of a risk from the consequences. And while risk may be spread, risk is also obscured in this process. Should something be done about these instruments? And what about other risky activities such as taking positions in private equity, hedge funds, or other trading activities? Should organizations like banks, with their access to credit from the Fed, be prohibited from trading in these kinds of presumed assets? Or, if they or other financial organizations do trade in such assets, they do so in the form of a mutual fund and not on their own account. Such a requirement would remove the risk from the financial organization. The holders of the mutual funds would bear the risks and would be entitled to the gains.

9. Recent problems got their start from a Fed-induced long period of exceptionally easy credit and a government-produced push for homeownership on terms (no down payment, no questions asked) that together produced excessive risk taking and mortgage originations. Can we expect government to act in a way consistent with prudent practice in the private sector, most especially the financial services industry?

I am attracted to Andrew Crockett's standards in his "Reforming the Global Financial Architecture":

> There are four key prerequisites of an acceptable . . . regime . . . that permits the orderly winding down of a failing institution: (i) imposing losses on stakeholders that are predictable and consistent with

> avoidance of moral hazard; (ii) avoiding unnecessary damage to "innocent bystanders," especially when that would provoke a loss of confidence in otherwise sound financial institutions; (iii) minimizing taxpayer costs; and (iv) sharing equitably across affected countries any residual fiscal burden.[1]

This conference is designed to help answer the kinds of questions I've listed earlier. The mission must be set out with clarity and urgency. The financial system is the central problem. The goal must be to remove the word *bailout* from our vocabulary. With that accomplished, one needed pillar for the strategy of growth without inflation will be in place.

NOTE

1. Andrew Crockett, "Reforming the Global Financial Architecture," speech presented at Asia and the Global Financial Crisis Conference, Santa Barbara, CA, October 18–20, 2009.