Government Intervention Counterproductive; Economic Crisis calls for New Thinking on Managing Risk, Stimulating Economies – New Report

On the eve of a meeting of government officials from the G20 group of leading economies, a new report published by a global group of think-tanks argues that the attempts by governments to intervene in the financial crisis has been counterproductive and calls for clearer thinking on how to manage the risks inherent in the financial system.[1]

The report, written by Bill Stacey and Julian Morris, notes that the financial crisis was created in part by well meaning market interventions intended to enable low-income US households to own homes, and in part by discriminatory regulations against certain classes of asset that resulted in 'regulatory arbitrage', whereby financial institutions created off-balance sheet structures in order to generate synthetic credit.

These factors drove lending to impecunious borrowers in the US, fuelling a housing boom. The subsequent bust has led to the collapse in value of the off-balance sheet structures. Because those structures had been used to underpin loans, their collapse has caused banks to stop lending to one another.

Sequential attempts by governments around the world to intervene in the markets and bolster lending have been largely counterproductive – they have pre-empted private market solutions and in many cases generated further moral hazard, contributing to further erosion of trust and weakening of incentives to lend. As a result, what started as a financial crisis is turning into a full-scale economic catastrophe.

There is currently talk of creating stronger and more global regulatory structures. This would be a disaster on several counts. First, as the report notes, several smaller countries have suffered less in the crisis – seemingly because of different regulatory regumes. If there had been only one global rule and it had been the wrong one, everybody would have suffered equally and we would have less knowledge as to why – and what to do. When governments compete with one another, they have stronger incentives to identify solutions rather than placate vested interests.

Second, stronger regulation is almost certainly the opposite of what is needed. The danger of creating further incentives for counterproductive regulatory arbitrage is large. The report concludes that from a regulatory perspective, the better solution would be to create governance structures based on simple, clear rules that do not discriminate in favour of or against any particular class of asset.

The report cautions against any direct intervention by government. It notes that "Governments are terrible at allocating resources and their attempts to boost our economies will almost certainly backfire. Economic growth is the result of entrepreneurs identifying and filling niches by developing better products and production processes, thereby boosting production and productivity. In contrast, when

[1] How Not to Solve a Crisis, by Bill Stacey and Julian Morris, WEB ADDRESS HERE

governments throw money at the economy, they divert resources away from their most efficient and effective uses, undermining innovation and growth."

Finally, the report concludes that "The best way to stimulate the economies of the world would be to reduce the number of overbearing taxes and regulations that currently inhibit the development and delivery of all manner of products and services."

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How Not to Solve a Crisis

Bill Stacey and Julian Morris

On 7 February 2007, HSBC issued an unprecedented profit warning based on higher provisions for sub-prime lending originated in 2005-2006. That was arguably the first sign of an impending financial crisis. By the end of the 2007, around 210 mortgage specialists had failed, including Northern Rock, one of Britain's biggest mortgage lenders. Since August 2007, money markets have experienced serious problems as a result of the winding up of financial structures built largely on mortgage related securities, as well as dislocations in other asset backed securities markets and large associated losses.

As the crisis accelerated in September 2008, governments around the world responded with massive interventions. Far from rectifying the situation, however, this series of ad-hoc policy decisions has successively undermined confidence in most of the key markets that underpin the global financial system, turning a financial crisis into a looming economic catastrophe. This weekend, representatives of the G20 group of countries are meeting in Washington to discuss the crisis. There is a grave danger that their actions will further exacerbate the problem.

This briefing seeks to outline the underlying causes of the financial crisis, assess the impact of attempts by governments to resolve the crisis, and offer suggestions as to where policymakers should best focus their efforts if they are to prevent the crisis from leading to a severe recession.

The Causes of the Crisis

From 2000 onwards, and especially in and after 2005, huge amounts of money were loaned as mortgages to people in the US with poor credit records. These loans were then purchased and repackaged in traditional mortgage backed securities (MBS), as "collateralized debt obligations" (CDOs) and other structured investment vehicles (SIVs), many of which were given inappropriately high credit ratings. When US house prices began to fall, loan default rates increased, funding dried up and these leveraged structured finance vehicles turned sour. But with no transparent market for the off balance sheet SIVs, financial institutions did not know what exposures each other held and, fearing the worst, stopped lending to one another.

But why were so many such loans made? In part the cause was simply excessive quantities of money in the system chasing loans of ever decreasing quality. Monetary policy contributed, arguably not only in
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the US. On successive occasions between 1998 and 2003, in response to financial shocks, the US Federal Reserve reduced its funds rate to exceptionally low levels and held it there for extended periods. However, most of the bad loans were made in 2005, 2006 and early 2007, whereas the Fed Funds rate had been rising since mid- 2004. Moreover, narrow money did not grow exceptionally fast during the period. So, why was there still so much money chasing low quality home loans in 06 and 07? An important contributor is Asia and oil producing countries, which saw a massive build up of central bank dollar reserves that needed to be invested.

We believe four other factors were crucial:

First, sharply divergent capital rules for banks, security companies and special purpose vehicles (SPV) led to 'regulatory arbitrage'. Specifically, by purchasing asset-backed securities through an SPV, banks were able to minimize capital requirements on their balance sheets and thereby increase their return on equity, performing better within capital adequacy rules. Ironically, the new Basle 2 requirements would have reduced this regulatory arbitrage for some of the largest banks, and may have contributed to the rapid wind up of these structures.

Second, US government sponsored entities, Freddie Mac and Fannie Mae, were required to buy up, securitise, and resell hundreds of billions of dollars of mortgages, with an increasing proportion coming from people on low incomes. Meanwhile, the mortgage companies originating these loans were prohibited, under the Community Reinvestment Act, from discriminating against applicants on the basis of the location of a property (ostensibly this was motivated by the laudible aim of preventing racial discrimination but the consequences were far broader and though unintended they were entirely foreseeable).

Third, the existence of Federal Deposit insurance and other explicit and implicit government guarantees led to the mispricing of counterparty risk. Under the presumption that certain companies (such as major insurers) would not be allowed to fail, banks and other financial companies bought credit default swaps (CDSs), thereby insuring themselves against the failure of less privileged companies. Moreover, these CDSs, created opportunities to create synthetic credit structures, again purchased through SPVs, that added substantially to leverage in the financial system.

Fourth, governments granted privileged roles to certain ratings agencies, leading to over-reliance on those agencies in determining the risk of ABS, CDOs and other SIVs. Meanwhile, unbeknown to many purchasers of these assets, the ratings agencies consulted closely with issuers to create the desired ratings. Indeed, we now know that a AAA rating in structured finance does not mean the same default risk as in corporate debt, that serious errors were made in some ratings models and that liquidity and counterparty risks embedded within these structures were under estimated.

The Jingle Mail and the Initial Response

The easy credit led to a dramatic rise house prices in many parts of the US, which further fuelled demand, as borrowers sought to 'flip' properties and lenders, assuming that prices would continue to rise, offered 100% loan to valuation ratio (LVR) mortgages. With lax underwriting standards, borrower fraud increased sharply. Then, in 2007, prices began to falter. And as they fell, some borrowers with 100% LVR mortgages, whose homes or investment properties were worth less than the nominal value of the mortgage, decided it was time to do the 'jingle mail' – handing the keys back to the mortgage originator and walking away.

Suddenly, vast swathes of allegedly 'triple A' CDO tranches, which actually comprised a mix of mortgage debt of varying quality, looked less than healthy. It soon become apparent that the assets upon which banks had been lending to one another were of questionable value. The result: lending to SIV's and then between banks dried up.

Among the first victims of this dessicated credit market was Northern Rock (NR), one of Britain's top 5 mortgage lenders, which had moved into subprime lending in 2006, through a deal with Lehman Brothers. It was more reliant than any European bank on securitization markets. In August 2007, Northern Rock found that it simply could not borrow in short-term credit markets. Initially, the Bank of England attempted to broker a sale of NR. Several banks were apparently interested in the business but Britain's financial regulator, the Financial Services Authority, compelled the Bank of England to open up the bidding. Apparently, senior officials at the FSA thought that EU rules intended to protect shareholders required a public auction.

Unsurprisingly, as soon as the proposed sale became public, tens of thousands of savers queued round the block to withdraw their money. This run on the bank scared off any potential bidders and shortly thereafter, NR was taken into public ownership. This set a precedent not only in the UK but globally that banks considered 'too big to fail' would be bailed out by governments.

The NR fiasco also illustrates that such crises can be prevented – if those skilled in interpreting and responding to market signals are permitted to do their jobs without government interference. Had the directors of NR been permitted to conduct a private sale of the bank, its assets might have been transferred in an orderly fashion to a larger bank able to benefit from its substantial order book and willing to take on its riskier subprime assets.

Unfortunately, when Bear Stearns began to stumble in the spring of 2008 under the weight of its mortgage heavy business model, the US government quickly stepped in and brokered a bailout, transferring the bank lock, stock and subprime barrel to JP Morgan – along with a multibillion dollar injection of cash and guarantees. The precedent was ominous – as the non-partisan Congressional Research Service noted at the time:

> [I]f financial institutions can receive some of the benefits of Fed protection, perhaps because they are "too big to fail," should they also be subject to the costs that member banks bear in terms of safety and soundness regulations, imposed to limit the moral hazard that inevitably results from Fed and FDIC (Federal Deposit Insurance Corporation) protections? If so, should the "too big to fail" label be made explicit so that regulators can better manage systemic risks?

Had governments not intervened by bailing out banks and other companies, there is no doubt that there would have been serious consequences for many financial companies, including likely several major bankruptcies. However, it is difficult to imagine that the problems would have been anything like as severe – or potentially lingering – as the crisis that now threatens the entire World economy.

Unfortunately, the bailout of Bear Stearns did create an expectation that some institutions were simply too important to fail. This reduced the pressure on some companies to raise new capital. It also delayed recognition of counterparty risk issues.

As property markets continued to deteriorate through the year, fixed income markets progressively priced higher risks. On September the 8th Freddie Mac and Fannie Mae were placed under "conservatorship". The biggest non sovereign fixed income issuers in the world were now subject to the massive uncertainty of ill defined rules that saw some residual equity left for shareholders, effectively wiped out value for preference share holders who would have dividends suspended, but preserved the position of senior debt holders. The confusion in debt markets triggered a "flight to quality" of pure sovereign risk.

The Lehmans bankruptcy followed on 15 September, after talks with a few parties about a buyout failed. Early talks apparently failed because management held out for a higher price. Later talks failed because the government refused the guarantees sought by potential purchasers. The consequences of failure were large, with unsettled trades and frozen collateral disrupting markets everywhere. The Bear precedent had led many market participants to believe that Lehman would not be allowed to fail. Markets quickly priced the swing in policy, leaving all securities companies vulnerable.

The popular view among market participants is that Lehman should not have been allowed to fail. Yet if Bear had not earlier been rescued, Lehman would likely earlier have raised funds, counterparties would have more quickly protected themselves from risks and underlying problems would have been recognized sooner.

From Creative Destruction to Wanton Destruction

Then, on September 16th, just as markets were beginning to price the risk that banks and other finance companies might fail, AIG was rescued. Lines of credit were offered in exchange for punitive interest rates and massive dilution of equity holders. The bulk of AIG's insurance business was essentially healthy. The problem was the credit default swaps (CDSs) it had written on CDOs. As the value of CDOs were written down, holders of these CDSs began to demand collateral to cover the difference between the nominal market value and the hold to maturity value. With the value of CDOs spiraling downwards, these collateral demands spiraled upwards.

Had AIG proceeded into a conventional bankruptcy, it seems highly likely that its main insurance business would have swiftly been sold off intact, with little to no impact on insured parties. Meanwhile, the contracts AIG had written on CDOs would then have to be marked to market at an appropriate discount. It is even conceivable that the previously opaque CDO and CDS market might have been subject to the illumination of open market transactions. It is difficult to avoid the conclusion that the sole reason for the 'conservatorship' of AIG was to protect the holders of the CDSs it had written – presumably in response to special pleading by those CDS holders.

From 17 September, the SEC began to target short selling, with new prohibitions on "abusive naked short selling". On Friday 19 September, this became a ban on short selling 719 financial stocks (later increased to 924 stocks). While the ban was intended to prevent speculative short selling driving down stock prices, it likely had the opposite effect. One of the primary reasons market participants sell stocks short is to hedge positions, either in that stock or in related stocks. So, perversely, the ban on short selling undermined the incentives to hold various long positions and effectively contributed to further declines in stock prices, as investors sought to liquidate both long and short positions. Related markets, such as those for convertible bonds were also drastically undermined. Moreover, the potential to use equity markets to raise capital for banks was – at least in the short-term – dramatically reduced, as investors exited the sector. Short investors are often key investors in new capital raisings as a means of closing their positions.

In spite of the evident damage done by the US ban, regulators around the world followed suit imposing bans on short-selling of financial stocks (Hong Kong was one of the few major markets to maintain its existing rules). This introduced a new wave of uncertainty for investors to manage. And to top it off, a "sweeping investigation of market manipulation" was launched by the SEC, threatening legal sanctions for investors who may have done little more than position correctly for financial sector weakness.

All this seemed to be built on a conspiracy theory that some hedge funds with short positions were building up substantial positions in illiquid CDSs written on those stocks, forcing up prices of those CDSs and signaling distress to equity markets (since a high price for a CDS implies a substantial risk of default), thereby benefiting their short positions. While in principle plausible, the price action in both markets can as readily be explained by investors seeking to protect themselves from counterparty and risk at their largest prime brokers. Market manipulation has rarely been demonstrated to have had a systematic impact on prices and it is unlikely that recent events will prove different when analysed in a more sober environment. Moreover, as noted, the action taken by regulators in an attempt to counter these alleged speculative trades almost certainly caused more damage than it prevented.

Morally Hazardous

On September 19th, the Federal Reserve initiated guarantees of money market funds, in response to a flood of money out of funds and the second order illiquidity to which this contributed. This measure had the perverse effect of discouraging investors from discriminating between money market funds and thereby rewarded less conservative managers. Overall, it drove more money out of the money markets it was intended to keep liquid, as conservative investors switched into treasury securities.

Making for a dramatic day, the US government introduced the first draft of the Troubled Asset Relief Program (TARP). TARP 1 sought congressional authority to purchase "troubled assets" from banks. The initial plan would have had one of two unintended consequences: if the government bought the troubled assets at market prices, it would have caused crippling mark to market adjustments across the market; on the other hand, paying elevated "hold to maturity" prices would be an unjustifiable use of taxpayer funds, given that such valuations would entail a fairly substantial (but difficult to quantify) premium to market proces.

The depressing reality is that a market for distressed mortgage assets had actually begun to form earlier in the month, with sales by Merrill Lynch. Indeed, several major private equity groups had set aside tens of billions of dollars specifically in order to purchase these assets. This market might plausibly have fairly quickly resolved many of the problems associated with the mortgage-backed securities that had plagued the finance industry and inhibited interbank lending. But with the prospect of the government stepping in as a buyer, this market was stopped in its tracks.

As TARP 1 was being debated by Congress, on 25 September, Washington Mutual (WaMu), one of the country's largest mortgage lenders, was taken over by the Federal Deposit Insurance Corporation (FDIC). (This happened despite the fact that its regulator, the Office of Thrift Supervision (OTS) had recently issued assurances that WaMu had adequate liquidity and capital.) WaMu's main operating assets were immediately sold on to JP Morgan. Equity holders were wiped out, while debt holders were left as residual claimants on the rump company, though they have practically no prospect of a material return. Note the seemingly arbitrary difference in treatment compared to debt holders in Freddie/Fannie and AIG. Arguably, debt holders would have been much better served by orderly liquidation, since the company clearly had positive net asset value. This adds to turmoil in debt markets.

Contrast also the 29 September treatment of Wachovia. Under FDIC guidance and financial support, a complex proposed buyout from Citigroup would preserve the position of senior debt holders. However, as shown by the subsequent ultimately successful bid from Wells Fargo, the regulators had pre-empted a superior offer and market solution that would have been better for shareholders.

TARP 2 is the congressional version of the original Treasury plan (formally the Emergency Economic Stabilization Act 2008). In its final form, TARP 2 included constraints on executive pay, foreclosure assistance provisions, higher deposit insurance and an open ended requirement for participating firms to issue warrants to the government granting equity. The equity warrant provision created substantial problems, since potential equity investors in banks had no idea what dilution they might face. It also, inevitably, undermines the potential for solutions through private capital raising.

On September 30th, the Irish government offered to guarantee all bank deposits. The following day, UK depositors began moving funds from UK to Irish banks. Governments around the world then introduced a series of "beggar thy neighbor" deposit guarantees, to prevent depositors shifting their funds into foreign banks with government guarantees. Euro-dollar markets flounder, with USD funding drying up for the large European banks with large dollar assets and no dollar deposit base. Dramatic currency moves also amplify during the month, with Iceland under particular pressure.

By early October, Iceland's banking system, already tottering as a result of exposure to subprime assets and the now-generalised liquidity problems, falls apart. On October 6, Iceland's government nationalized Glitnir. The final straw came on 7 October, when the UK government used antiterror laws against Landsbanki, in order to seize assets followed the day after with seizures from Iceland's largest bank, Kaupthing. The Icelandic payments system froze and shortly thereafter the banking system collapsed. The Icelandic government subsequently nationalized its other main banks.

On October 8th, the UK government announced plans for partial nationalization of four of the country's five main banks. Unlike Iceland, however, the banks were not forcibly nationalized; instead, they were offered some flexibility in how they would meet stiffer capital requirements.

On October 14th, the US government announced plans (this becoming the 3rd major revision of the TARP programme) to provide capital to the country's 9 largest financial institutions, regardless of their risk or need for capital. The measure would punish stronger firms, who would not have any need to participate. By harming the shareholders in those stronger, better managed firms, the measure would undermine the incentives for investors and counterparties to discriminate between financial institutions.

Debates over how to implement the various versions of TARP continued throughout October and into November. On November 11, the US government announced that it was no longer planning to purchase troubled assets directly and would instead take further direct stakes in banks.

In sum, the series of policy actions taken since September successively undermined money markets, term debt markets, equity markets and markets for distressed debt. These markets were already fragile, but private sector responses were emerging. However, these alternatives were undermined, moral hazard problems created or compounded, expectations perturbed and uncertainty increased. The "rescues" seem to show indifference to due process and existing contractual rights in favour of rapid and reactive solutions.

Already the injection of equity into banks is leading to demands for government support to an increasingly wide array of institutions, many of which have no systemic importance.

What Should be Done?

There are clearly lessons for companies in the financial sector. Managements are paid to handle risks, yet in many cases they have failed so to do. Boards need to think about how to rectify poor incentive structures and information flows to top executives. Management of highly technical product areas and counterparty risks must be improved. Growth aspirations should be managed according to organizational capabilities. Having said all that, there is no single answer as to how to best manage financial risk. What is needed is vigorous competition to drive genuine innovation rather than regulatory arbitrage.

That last point cannot be overemphasized. The danger of creating further incentives for counterproductive regulatory arbitrage is large. But the solution is not global regulation. Indeed, many regulatory problems have arisen from attempts to create more universal rules, such as Basel 2. It appears that regulators in Hong Kong, Canada and Australia have done better than those in the US or the European Union. This emphasizes the importance of encouraging rather than restricting competition in regulatory regimes. As a corollary, global regulations should be avoided.

As governments contemplate new policies to address the ongoing turmoil in financial markets, it is of utmost importance that they recognize the deficiencies in recent policy making. In particular:

- Better mechanisms are needed to manage the failure of large financial institutions, some of which may now be both too big to fail and also too big to rescue.
- Open ended guarantees to depositors and other counterparties are expensive and unsustainable in the longer term.
- The rights and hierarchy of investors across the capital structure should be clear and honoured – not subject to arbitrary alteration by government.
- Closer attention to the rights of collateral providers and custodians in the case of failures can limit systemic risks.
- Hedge fund failures have not created systemic risks in this crisis and they should not be a target of policy action.
- Ad-hoc bailouts should be avoided, since they create ever expanding demands for further intervention.
- Much more thought needs to be given to the unintended consequences of over strict capital rules, rating agency privileges and rating based limits on pension investments.

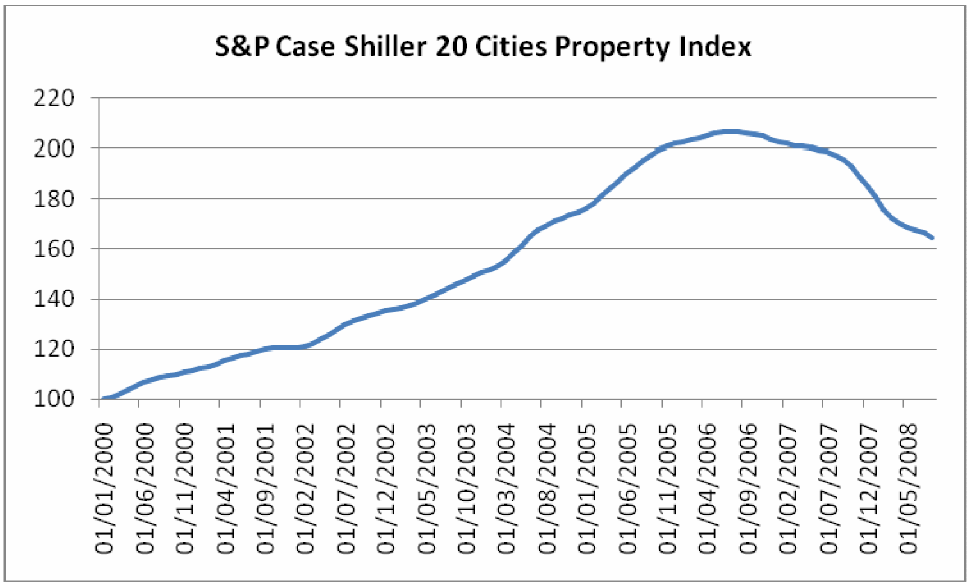
Free markets thrive on creative destruction. Irrespective of the underlying causes of the property market disruption, financial markets should have been able to manage through the crisis, despite the failure of many institutions. Mistakes by policymakers and regulators contribution substantially to the acceleration of the crisis.

We feel that it is important to emphasize that derivatives themselves are not the problem. The problem is that financial institutions have been incentivised to construct and utilise derivatives in ways that have created opacity and, ultimately, undermined trust. This, in turn, is a result of the over-regulation of other financial products and institutions generally. Attempting to extend the regulatory net into existing derivative products would likely result, some time in the future, in complex new derivatives that evade the rules – and result in further problems.

The better solution to the problems that continue to plague the financial system would be to reduce regulatory burdens that contributed to the crisis. If financial markets were governed by simple, clear rules, there would be less incentive for regulatory arbitrage and more incentive to generate innovations that create genuine benefits for people.

Finally, to the extent that fiscal measures might help solve the current problems faced now not only by financial companies but also by the majority of participants in the global economy, we caution against any direct intervention by government. Governments are terrible at allocating resources and their attempts to boost our economies will almost certainly backfire. Economic growth is the result of entrepreneurs identifying and filling niches by developing better products and production processes, thereby boosting production and productivity. In contrast, when governments throw money at the economy, they divert resources away from their most efficient and effective uses, undermining innovation and growth.

The best way to stimulate the economies of the world would be to reduce the number of overbearing taxes and regulations that currently inhibit the development and delivery of all manner of products and services.



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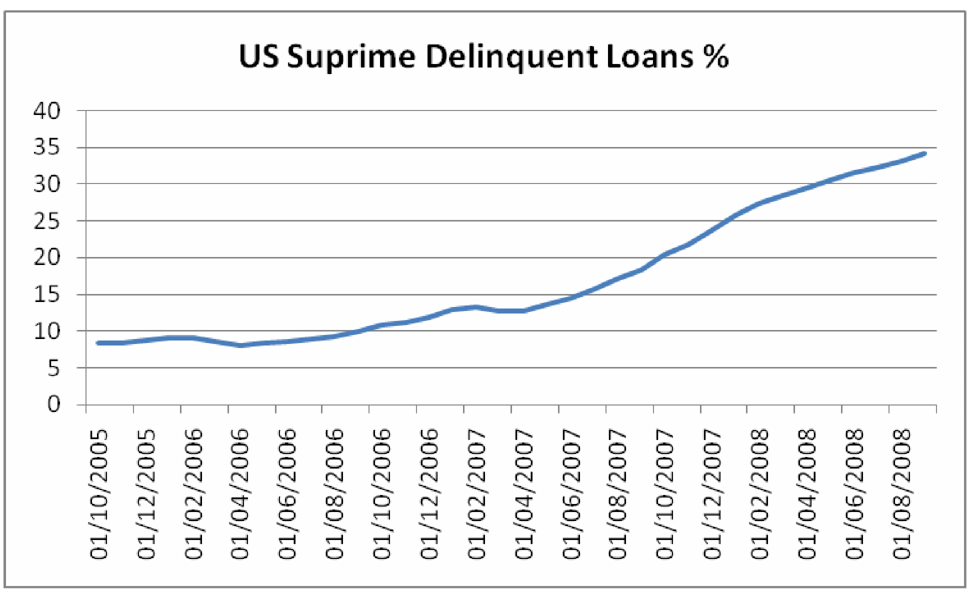

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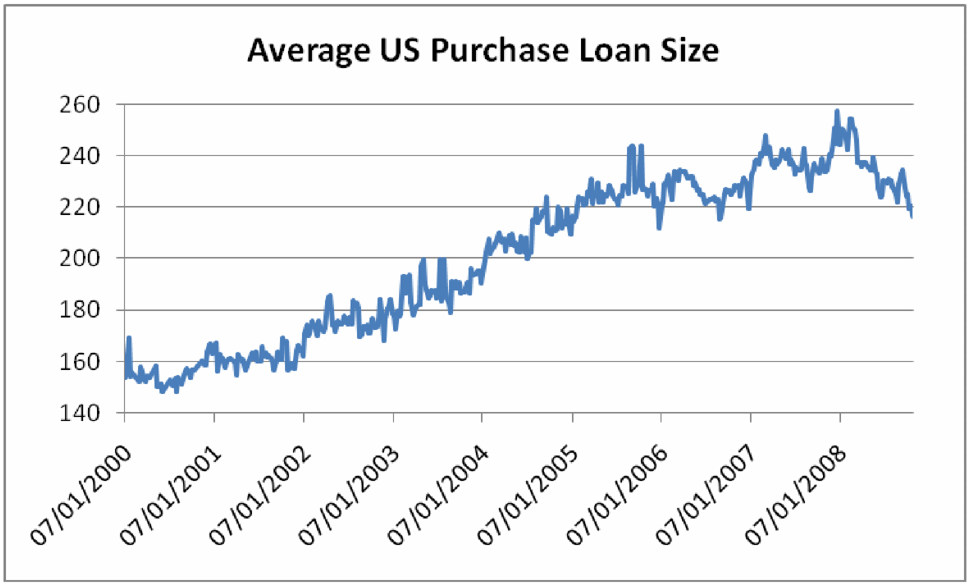

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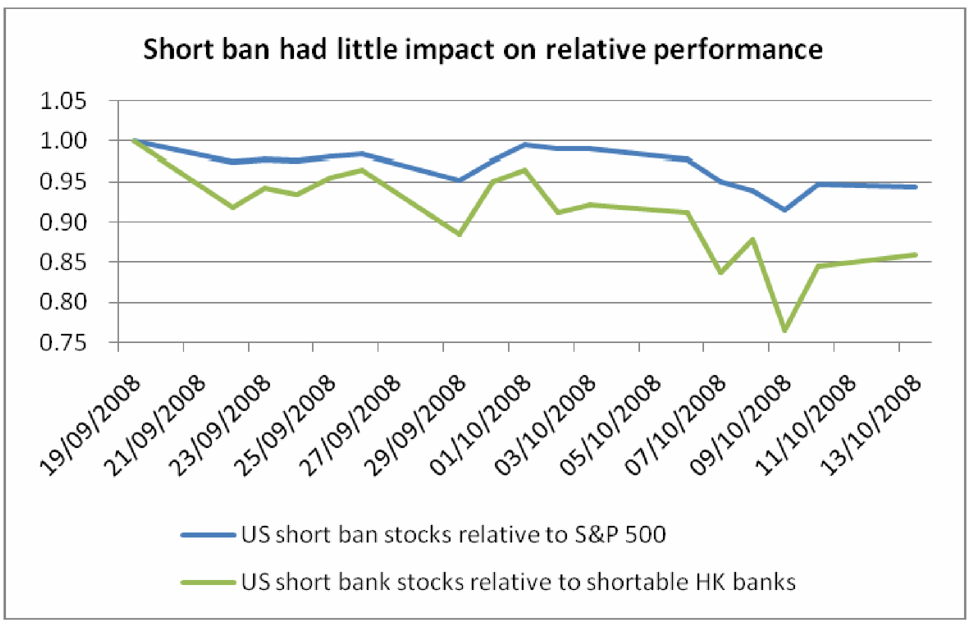

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