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How Not to Conduct a Bailout

By Mauro F. Guillen
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This much we know from our short experience with this crisis: The fashion in which the bailout of the U.S. financial system is being organized and implemented is not the best to calm the markets, recycle toxic securities, help homeowners, protect taxpayers, and get the financial systems on its feet again. The mumbled fashion in which the bailout is being presently implemented is unlikely to address the key issues undermining the functioning of the U.S. financial system.

Any bailout has to address the three fundamental root problems: moral hazards, information asymmetries, and conflicts of interest. Too many a Wall Street executive and trader came to assume that financial profits accrued to them while losses were ultimately the responsibility of the taxpayer. During the last decade or so, rampant moral hazard of this kind invited both lenders and investors to risk too much, leveraging themselves to maximize returns. Naturally, borrowers enthusiastically participated in the ensuing credit orgy. The series of piecemeal liquidity injections that the Fed and other central banks around the world have set into motion since the summer of last year have only aggravated moral hazards by conveying the ill-conceived and utterly counterproductive message that they would do “whatever it takes” to calm the markets. Then came the nationalizations of IndyMac, Freddie Mac, Fannie Mae, and insurance giant AIG, whose bailout program has just been reengineered and expanded. Meanwhile, government help and guidance were offered to Bank of America, Citigroup, and JP Morgan so that they would take over Countrywide, Bear Stearns, Merrill Lynch, and Washington Mutual. Now the new administration is considering a de facto nationalization of the largest banks.

The financial and homeownersbailouts potentially pave the road for more consumers and homeowners to default, and financial institutions to collapse. The bailout was originally conceived as an open-ended commitment by the government to assume ownership of debt and securitized loans gone bad, a plan that would exacerbate rather than curtail moral hazard. Without appropriate safeguards and direct government intervention, any of these plans are likely to increase moral hazards. Moreover, the various bailout programs invite other industries to cry foul with Congress, as the Big Three and the airlines have already done. At this pace, the entire U.S. economy may be asking for a bailout before spring starts.

Information asymmetries of various kinds are a second crucial factor in the crisis, and the implementation of the bailout should address them as well. This problem has several aspects to it. It is about time that Congress and regulators focused their attention not on the excesses of executive compensation, but on management’s uncontested ownership of information about the internal machinations that go on at corporations and financial institutions. More transparency is needed if we are to have a solid and efficient financial system. As of last year, the financial system generated about 40 percent of all corporate profits in the United States, up from no more than twenty percent during the 1980s. It is important to note that financial services and insurance account for barely eight percent of U.S. GDP. If our financial system truly were as transparent and efficient as other parts of the economy, it would not be possible to generate such mammoth profits; most of them would be competed away, as introductory economics textbooks predict.

The proposed bailout is likely to increase information asymmetries because it privileges acquirers with connections. Treasury and the Fed have orchestrated takeovers of troubled financial institutions, typically over secret weekend meetings, and landed them in the hands of Bank of America and JP Morgan. Meanwhile, the large Japanese bank Mitsubishi UFJ has taken a twenty-percent stake in Morgan Stanley, and Nomura has bought Lehman’s Asian, European, and Middle Eastern divisions. For his part, Warren Buffet, perhaps the savviest living investor, has acquired multi-billion dollar stakes in Goldman Sachs and GE. What information do these players possess that the rest of us do not? We would be much better off with officials who make decisions in daylight, and with highly-paid and transparent managers than with poorly motivated ones who continue to be opaque about what goes on inside their banks and companies. Let’s focus on the real problem, i.e. transparency, and motivate managers to perform. Limits on executive compensation may be popular, but do not even begin to address the issue of information asymmetries.

The third fundamental cause of the crisis is conflict of interest, an issue that became prominent a few years ago with the end of the dot-com bubble and the series of high-profile corporate scandals and bankruptcies. For several years now Wall Street and the financial system at large have operated in a cozy environment in which investment bankers, traders, auditors, raters, and other players have exchanged favors at the expense of investors and, ultimately, taxpayers. In the most blatant instance, one division of a financial company would sell securities to retail customers while another collected advisory fees from the issuers of the securities. The bailouts are likely to intensify conflicts of interest because Treasury lacks the resources to ensure that the money is spent wisely and in ways that address the underlying causes of the crisis.

The way in which the bailout of the financial services industry is being implemented will likely compound the moral hazards, information asymmetries, and conflicts of interest that brought us the present crisis in the first place. Rushing to action with an unpersuasive plan short on details and long on promises could be a recipe for disaster. The failure to debate the various options calmly and thoroughly is striking, especially in a situation in which more than half of the population is invested in the stock market, a fact that like no other sets this crisis apart from the Great Depression. Appointed technocrats like Ben Bernanke and elective officials must keep in mind that democracy is messy by definition, and that no financial crisis has ever been resolved without some sort of a political compromise among the affected parties. The fragmentation of government action is not helping either, with Treasury, the Fed, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the White House, and Congress not always proceeding in unison. Shotgun deals negotiated under cover of darkness do not promote transparency and openness. As a result, shareholders, homeowners, and taxpayers could end up shortchanged. This bailout might eventually cost ten or even twenty percent of GDP, just as the Japanese, Korean, Turkish or Chilean banking crises of years past. It won't be because we underestimated the problem, but because we went about solving it in the wrong way. The new administration will need to reexamine every aspect of the bailout in order to ensure that it curtails moral hazards, information asymmetries, and conflicts of interest.

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