



Punish the Bankers

Political correctness invariably overwhelms economic sensibility. You can find evidence for this on both sides of the political spectrum. When “market views” dominated, regulation of all sorts of financial transactions was out of vogue. The SEC barely moved on a wide variety of abuses that have been uncovered as the financial tide waned. Regulation of the mortgage industry was bad form in the hey day of the financial boom as anyone who was not already in the grave could get a mortgage and the broker would fill in the blanks. Finally, derivatives and the regulation thereof have been on the minds of many financial seers, but it took the collapse of AIG and the disclosures of billions of dollars of credit default swaps written essentially with no equity at the base of the pile to accelerate the call for exchange based derivatives. Nothing is free, so there are consequences to moving to an exchange.

If derivatives trade on an exchange, they have to have some sort of standardization, and one loses some ability to adapt the “trade” to individual circumstances. That means that the exchange based derivative will have some “basis” risk with regard to any particular asset or liability the investor wishes to hedge. It makes hedging more difficult and more costly, with the social benefit of lower default risk. Of course, standardization of derivatives and required “margin” takes a lot of the profit out of the deal. This presumably weakens incentives to innovate by various financial institutions. All this may avoid risk, but at what ultimate cost?

Henry Simons, writing in the 1930’s, articulated a “no risk” position regarding the banking industry. He wanted 100% reserves for all deposits. No Leverage! To hear some of the comments of Congressional critics it often seems that is precisely what they want, even if they are unaware of the implications of their statements. Maybe that is what they actually want. Be careful what you wish. Congressional critics often regress to the mean when they leave the Congress and enter the business world where leveraging equity has always been enticing. Few entrepreneurs willingly give up the search for leverage since leverage allows “more bang for the buck.” It is always a question of balancing risk versus return.

Only when the boat is swamped by waves of political correctness that emerge from a vast financial storm do we think about throwing leverage under the bus. Factually, of course, it is not precisely leverage that is the issue. It is more the assets which are leveraged and how you account for the value of those assets.

There are many sides to this interminable debate. One could have a financial system that is quite leveraged but indulges in only “guaranteed” outcomes, such as being long government bonds, for example. Of course, that requires a monetary regime where the short term borrowing cost is kept below the nominal yield on longer term government bonds. It also requires we don’t force the “bank” to mark to market because of any disturbance in the yield curve. Yield curve inversion and mark to market accounting on long bonds will make the bank earnings tip over due to mere accounting convention. And, here, there is no necessary leverage. Asset quality and a judicial determination of risk is always the issue, not leverage.

Of course, if the Government is your partner and can always bail out your illiquidity, then marking to market is not informative and may actually spook your accountants. If we look at the increasing scope of financial bailouts, we may conclude we are coming to that. Certainly, there are many out there who think that the “public is duped” by giving it market information and others who believe that not all market prices are “right.” Sometimes one thinks as one listens to arguments for dumping mark to market conventions that ignorance is bliss and that markets cannot read through an accounting fiction. In fact, we know from the early skeptics of this housing boom that some did and profited immensely by doing so. Of course, some who saw through the financial statements of leading banks were punished in the public domain for being short, even when they were right!



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The Government will now be a preferred partner in at least nine major banks in the U.S. It achieved the ultimate in political correctness by homogenizing the risk of individual banks, by forcing each of the nine to sup at the trough of the bailout. With this reform we put the same lipstick on all the pigs. No adverse selection allowed. It is the ultimate group punishment. All major bankers were judged equally guilty and forced into accepting a Government infusion via preferred, non-voting shares. Why? In this way, no invidious comparisons can arise. It is a truly democratic infusion!

All banks, however, didn't come to the infusion party on the same footing, and they are certainly not equal today. Some inevitably are "better" than others because of better management, better policy and better strategy. Each, however, will be tarred by the same politically correct brush. Some will argue that a democratic firing squad is better than an elitist one. Who knows? Attached to "bailout," comes (as yet unstated) controls on executive compensation. Equality and Placation ride supreme.

Our financial collapse came after a period of wildly inflated rewards for top level bankers of every stripe. Since highly levered banking institutions could generate larger and larger profits by further levering of their balance sheets, our financial sector came to look like a set of inverted pyramids. Each new layer of leverage was piled upon the same (or an even smaller) equity base. Earnings rose along with leverage. As earnings rose, pay and benefits for the bankers rose. The incentives were all on the side of the bankers with the biggest risk appetites. Boards were quiescent and often were rewarded with stock options as well. All of the usual suspects appeared once again at this corporate misgovernance fiesta: accountants, rating agencies, other capital market participants such as other bankers and analysts. Disorganized crime all over again.

Everything went along swimmingly until the ever-narrowing equity base got shaved by mark to market accounting and a drastic escalation in mortgage default rates. Some of the assets, particularly asset backed securities, started losing value as more and more mortgages defaulted. As it were, the foot at the base of the financial pyramid got incomparably smaller even while earnings grew and compensation grew a pace.

Some of the reported earnings increases were tainted by a refusal of some financial companies to write down impaired assets. Too much compensation was tied to the earnings growth rate. That takes us into the promised land of political correctness---correcting the executive compensation system.

It is hard to argue that much of the outlandish compensation earned by financial executives in the past decade was based on truly solid earnings growth. Boards were accomplices to the crime. Some of it may even have been the result of outright fraud. For many financial companies, one could deduce an inverse correlation between balance sheet quality and compensation growth. The more leveraged the balance sheet, the higher the executive compensation.

Cynics will argue that such is the nature of capitalism and the only answer is regulation. In the throws of this financial crisis, those wishing to tar an entire industry for the sins of a comparative few will win hands down. It has been an age of plenty: Plenty of compensation; plenty of earnings growth (in spite of plenty of growing balance sheet weakness) and finally, without doubt, plenty of additional leverage. Their answer: punish, punish, punish. Roosevelt said as much in 1933.

"Primarily, this is because the rulers of the exchange of mankind's goods have failed through their own stubbornness and their own incompetence, have admitted their failures and abdicated. Practices of the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and minds of men.

True, they have tried, but their efforts have been cast in the pattern of an outworn tradition. Faced by failure of credit, they have proposed only the lending of more money.



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Stripped of the lure of profit by which to induce our people to follow their false leadership, they have resorted to exhortations, pleading tearfully for restored conditions. They know only the rules of a generation of self-seekers.

They have no vision, and when there is no vision the people perish.

The money changers have fled their high seats in the temple of our civilization. We may now restore that temple to the ancient truths." (FDR First Inaugural, March 4, 1933).

The last weeks of the Presidential campaign have seen the invocation of Roosevelt's earlier lines of that speech.

"So first of all let me assert my firm belief that the only thing we have to fear. . . is fear itself. . . nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance.

We have a crisis of confidence and a history of government intervention to cure such a social malaise. Sadly, only a few will remember that the Great Depression did not end until WWII overwhelmed it, despite massive government interference. It took nearly a decade and the greatest war in our history to get the job done.

It is now impossible to stop this punishment bus. It has far too much momentum. The issue that few are willing to ask at this point is whether by such politically correct methods, we will make our credit mechanisms much less responsive to opportunity, much less adaptable to change and much more sodden and uncreative. The critics will argue: "Its about time," because we have been robbed. A longer view of history suggests that without a creative, risk oriented financial system, growth will slow...permanently. We wasted a decade in the 1930s with many policies that neither restored employment nor growth nor solid financial institutions. The policies hung over innovation and change well into the late 1970s and early 1980s. Bad as our credit markets are now, we can easily make the situation worse. And we will, because political correctness now demands it.