The Panic of 2008
Managerial Capitalism in Crisis

aka
Hunter Economics
In a Global Financial Setting

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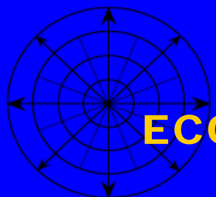
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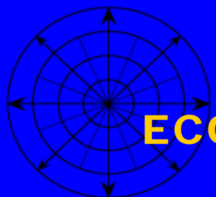
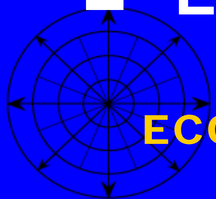
Knowing where you've been helps in determining where you are going

The Panic of 2008 had rich antecedents



“Eat What You Kill”

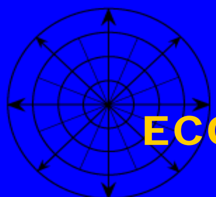
- “**Pay for performance**” incentive compensation systems, unconstrained by a suitable corporate culture and adequate monitoring by “professional” gatekeepers, has led to
  - Extreme focus on (short run) earnings management
  - Earnings manufacture (accounting fraud)
  - Capital market collusion by fee based capital market participants such as rating agencies, commercial and investment banks, auditors, outside counsels that can obscure the true financial circumstances of a public company (“Getting what you pay for”)
- “**Eat what you kill**” -- a recipe for financial fraud



Lessons of Enron

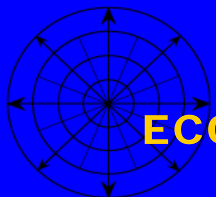
Corporate Misgovernance and our Credit System

- **Corporate Misgovernance--**a micro issue—in banking and credit system becomes a source of systemic risk
- **Enron fathered "Sarbox"** which focused regulatory concern on financial statement reliability but totally ignored the crucial issue of risk management and its supervision
- **The responsibility** Corporate Monitors must include "owning" the problems they monitor which means they must be made be made liable **for failure to exercise that responsibility**



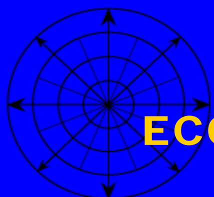
Macro Financial Failure

- **Individual corporate failures** can become a macro events when the failures involve our credit system to a significant degree
- **Basle I and II** incentivized moving risk into the "shadow banking system," without adequate provision of risk management and risk supervision. A flawed process for determining Capital Adequacy.
  - **Capital Adequacy based on VAR determined risk weighting**
  - **Pushing assets off bank balance sheets does not reduce systemic risk**
- **The premise of VAR** as a metric for determining capital adequacy is faulted. VAR never takes into account "risks" never before encountered!
- In a Panic, capital is always inadequate! If Capital were adequate, there would be no Panic!



Systemic Lapses

- **Credit risk:** will be regulated by market participants because in their own self interest. Reliance on reputation will be an adequate restraint on risk taking (Greenspan)
- **Hunters:** paid on basis of absolute returns, unadjusted for risk creates incentives for levered bets with shareholder's and taxpayers picking up the tab for the losses
- **Bubbles:** can't be treated (Greenspan)
- **Bubble Consequences** can be treated by Monetary Policy
- **A Lesson of 2008:** The size and source of the Bubble counts:
  - Was the real lesson of Lehman that Bear Stearns and AIG should not have been bailed out?
  - Should Central Banks' LOLR efforts be limited?



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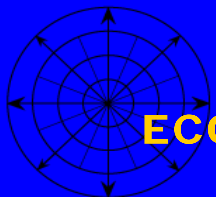
US Regulatory Approach Failures

- **Regulation through the rear view mirror**
  - treats the last problem seen
  - focuses on preventing specific outcomes
  - ignores incentives to capital market participants
- **Regulation through the front window**
  - correctly determine what went wrong
  - identify participant incentives
  - be mindful that all regulations create new incentives
  - be careful what you wish for!



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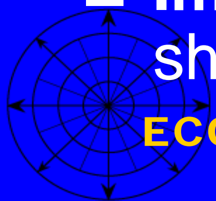
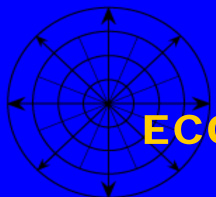
Agency Problem Anomaly

- **Corporate Governance:** was seen as an "agency problem" that was solved by "how you pay," not "what you pay?"
- **The Anomaly**: Some of the biggest individual losers in recent financial collapses were the executives who were paid in their own stock.
- **Payment in stock:** doesn't necessarily produce the actions of a "prudent investor."
- **Managerial shortcoming:** Why didn't the managers pay more attention to risk management since their own fortunes were at stake?
- **Possible Answer**: Horizontal mobility?
- **Implication :** If Managers don't pay attention to risk, who should?



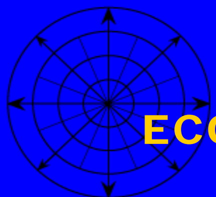
Improving Corporate Governance 1

- **The Board must monitor risk.** Each board should have a “Risk Committee” and independent sources of information on risk taking.
- **Risk Committee** members must include professional risk management experts
- **Penalties for failure and rewards for success** at the Board level. Board Members need to be made personally responsible.
- **The Rule of Business Judgment** must be amended
- **Similar treatment for all other Gatekeepers.**



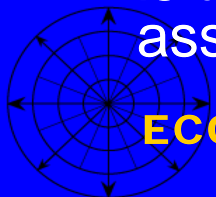
Improving Corporate Governance 2

- **In a world of hunters, can’t solely rely on corporate reputational risk** as an adequate deterrent (Greenspan’s faulty analysis pivoted on reputation)
- **Hunters can move horizontally:** not particularly concerned with corporate ladder and personal “vertical” failure risk. Hunters can move on.
- **The Board has “survival responsibilities”** that must be recognized, and rewarded or penalized accordingly. That is the true “care” and “duty” obligation of a Board Member in global setting



Corporate Misgovernance and Systemic Risk

- **Corporate Governance reforms work at the micro level** but the Panic of 2008 shows Corporate Misgovernance can create systemic risk i
- **Reduce probability that Micro Risks create Systemic Risks** by making the Board responsible in a "responsible way"
- **Central Bank Lender of Last Resort obligations** can convert micro corporate failures into a Moral Hazard dilemma
- **Panic of 2008 made the taxpayer the Risk Taker of Last Resort**
- **Markets could price in these macro risk**, but Central Banking with its LOLR function, implies that some risks will be 'bailed out' because of the political fear of systemic upsets, making market pricing difficult
- **The Corporate Governance analogue for Central Banking** is to place restraints that limit the extent of LOLR bailouts and associated "taxpayer risk"



Panic of 2008--financial "Catch 22"

- **Yossarian asks Milo Minderbinder** how he can buy eggs for 7 cents and sell them for 5 cents? Milo answers, "because everyone has a share."
- **The Panic of 2008 was a financial Catch 22**…remember what Catch 22 was…You could be exempt from flying if you were mentally disabled. If you said there was too much risk in combat flying, you couldn't be mentally disabled because you saw the situation correctly.
- **Taking on more risk was justified** by the argument that your competitors would do so if you didn't!
- **Under present arrangements, Moral Hazard is endorsed by the doctrine of "too big too fail."** If you want to avoid systemic failure, then failure at the micro level has to be allowed…this is exactly the reverse of current policy.
- **We have behaved like the post French Revolution Bourbons.** "Learned nothing and forgot nothing." (Talleyrand). Enron produced the Lessons…but we didn't learn them!