

MORAL HAZARD IN THE
POLICY RESPONSE TO THE
2008 FINANCIAL MARKET MELTDOWN

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The Cato Institute is the ideal place to draw lessons from the subprime crisis. The organization's mission focuses on the interaction of public policies with free markets and limited government. Even the most ardent believer in free markets must fully understand that individual liberty implies neither the nonexistence nor the indifference of government to economic affairs. Individuals live in freedom and peace when public policies are crafted in accordance with well-established rules and implemented with an eye toward effectiveness, not expansion. In the halls of government, we need sobriety and vigilance rather than apathy or empire building.

The playing out of the subprime crisis has revealed a weakness in our public policy framework for dealing with institutional failure in financial markets that invites a continued expansion of government into areas that should be the domain of private citizens and institutions. In particular, policymakers have been unwilling to let financial institutions that made unwise decisions bear fully the negative consequences of those decisions. Procedures exist to provide liquidity to solvent but illiquid institutions, and other procedures exist to liquidate insolvent institutions. But as the subprime crisis emerged, the government failed to adhere to a consistent policy for dealing with

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troubled institutions, opening itself up to special pleading from many of these institutions at unnecessary cost to the taxpayer.

The Subprime Crisis in Brief

The most important lessons for monetary policy that we draw from the subprime crisis do not pertain to its formation. With regard to the path we took to get here, the players have changed but the game remains the same. The raw material for the subprime crisis is really no different than for other financial crises we have seen in the past. Financial crises occur when financial innovation meets excessive optimism. It is an insight that can be attributed to the late economist John Kenneth Galbraith in *A Short History of Financial Euphoria* that all financial innovation is simply another way to issue debt—specifically, a way to issue debt against the value of an asset that previously was not available to be leveraged. Securitized pools of subprime mortgages are the best, but certainly not the only, example of this financial innovation in the current crisis.

That there has been excessive optimism about asset prices in recent years is not really a matter of dispute. In fact, the formation of both the Internet bubble and the housing bubble were diagnosed in real time. The prevailing response was to find excuse after excuse to look the other way. Robert Shiller's wonderful recap of recent bubbles, *Irrational Exuberance*, takes its title from a remark by Alan Greenspan who as Federal Reserve chairman, saw the Internet bubble forming but was unwilling to use monetary policy to let the air out of it. As the Federal Reserve lowered interest rates dramatically to deal with the aftermath of the bursting of the Internet bubble, it sowed the seeds of the housing bubble, as cheap credit and new financial products enabled financial institutions to extend mortgage finance to ever riskier borrowers. This by itself would not have been enough to create the current environment. What was also needed was the willingness of large institutional investors not only to hold these assets but to use them as the basis for debt of their own. In financial markets, excessive optimism or irrational exuberance manifests as a systemic failure to assign accurate discounts to asset values for the riskiness of their future cash flows. In the regulated sector of the financial markets, this failure belongs as well to the regulators.

With the amount of leverage and optimism prevailing in the real estate market and its associated bond markets, it is not surprising that

the cascade went on for so long or shattered so violently. For those who did not see or fully appreciate the warning signs in the summer of 2007, the wake-up call was the bailout of Bear Stearns in the spring of 2008. At this point, all eyes turned to the federal government, in part to point a finger of blame but more sincerely to watch it roll out its contingency plan. And this is where the real lessons from the subprime crisis begin.

The Usual Response to Financial Crises

When confronted with the implosion of a major investment bank, the key actors in the federal government have two main options, which we could describe colloquially as “damned if they do” and “damned if they don’t.” The political bias toward the former is due to a time-inconsistency problem. Put very simply, before a crisis emerges, the right strategy for the government is to insist that it will not be available to market participants to clean up their mess if their risky investments turn out poorly. This should induce smarter risk-taking in the markets. However, once a crisis is upon us, what’s done is done, and if it is known that the government has some resources that it could bring to bear to alleviate the visible signs of that crisis, there will be enormous pressure to use them, regardless of the distributional consequences. That market participants anticipate that they will be assisted in the event of unwise decisions is the moral hazard that promotes excessive risk-taking in the next crisis.

The federal government, if it were so inclined to use them, has two main defenses against the pressure to intervene too capriciously in a crisis. The first is the Federal Reserve’s role as the lender of last resort. The Federal Reserve stands ready to provide liquidity to financial institutions that are solvent but illiquid. And the Federal Reserve has used these powers actively, beginning in the summer of 2007 and accelerating in 2008. Most visibly, the Fed funds rate was cut to 1 percent and then to essentially zero. Less visibly to audiences who do not follow its activities closely, the Federal Reserve’s balance sheet has nearly doubled from about \$1 trillion of U.S. Treasuries to \$2 trillion of assets, of which only about a third is U.S. Treasuries. The remainder consists of assets pledged by all manner of financial institutions desperately seeking liquidity (see Fisher 2008).

If an aggressive Federal Reserve distinguishing between illiquid and insolvent financial institutions is the first defense, the second is

the bankruptcy code to deal with insolvent institutions. All versions of bankruptcy follow the same general pattern—equity holders see their claims wiped out, management is replaced, and creditors take control of the firm in an orderly manner. I emphasize orderly rather than expeditiously. The great virtue of debt—that it does not require active monitoring of every last dollar of near-term cash flows as long as interest payments are made and the principal will be returned—becomes its great vice when unprepared creditors assume control. In the case of institutions whose assets are primarily financial rather than physical, bankruptcy often just takes the form of a liquidation.

If the process is orderly, then it will eventually work itself out in an equitable manner. But part of the political bias toward the “damned if you do” strategy is that it presumes to yield results more quickly than following the established procedure. That it does so by changing the distributional consequences outside of the contractual relationships established in the free market seems to be acceptable collateral damage in the name of “doing something.” But that is the most important source of moral hazard in the government’s response to the crisis to date.

The Policy Response to the Subprime Crisis

The federal government is not an innocent bystander in this process. It has recognized the special role of the financial sector in facilitating economic activity and insured some of it, specifically, deposit-taking institutions operating in the retail sector. The main purpose of that insurance is to boost the confidence of depositors to prevent a run on a solvent bank. What is insured is heavily if imperfectly regulated. What is not insured is much less heavily regulated. The government’s role as insurer and regulator of much of the financial system has been used to argue that the government can protect one of its institutions—the FDIC, for example—by circumventing the two safeguards of an active Fed and an adherence to the established bankruptcy procedures. Others have argued that the government must go beyond these safeguards to prevent the negative consequences of the implosion of highly leveraged financial institutions from spilling over into the nonfinancial economy.

These arguments are terribly misguided. If a financial institution, whether regulated or not, is solvent but illiquid, then the Federal Reserve can provide liquidity as needed for it to continue its opera-

tions. The more problematic cases are the institutions that cannot be clearly identified as solvent. The government has suggested two ways of shoring up their balance sheets through its Troubled Asset Relief Program (TARP): buying their distressed assets directly and providing equity infusions via preferred shares with low dividend rates and few other restrictions. It is true that if the government overpays or undercharges by a sufficient amount, then it will reduce the FDIC's exposure, since the institution is no longer insolvent. But how is this better than just letting the FDIC come in during a liquidation on an as-needed basis? A dollar spent paying off an FDIC claim goes entirely to that claim. A dollar spent propping up the institution as a whole gets split up among the insured depositors as well as the uninsured creditors and even the equity holders.

One response to this line of reasoning is that the purpose of the government's intervention prior to bankruptcy or liquidation is to enable the troubled financial institutions to lend money to borrowers with good projects that will help grow the economy. This is the classic case of debt overhang, developed by Myers (1977), in which the presence of risky debt prevents equity holders from raising new capital to finance safe investments because a disproportionate share of the returns to new investments go to the debt holders rather than those who provided incremental financing. In theory, the two interventions by the government as part of the TARP can address the debt overhang problem. Purchasing the distressed assets for cash makes a bank's existing debt less risky and thus less likely to absorb incremental returns to new investments. Equity infusions via preferred shares provide incremental capital but demand repayment with less seniority than existing debt holders.

But the presence of debt overhang does not change the basic argument against intervention prior to bankruptcy or liquidation. Any dollar spent restoring the balance sheet of a distressed bank to give it the capacity to make new loans would be more effectively put to use simply augmenting the balance sheet of a bank subject to the same regulations but without the debt overhang. The distressed bank cannot use all of the dollars; some of them go to reduce the risk and thereby augment the value of the risky debt. It was not surprising that the banks receiving equity infusions in the early fall of 2008 were less eager to lend than policymakers had desired (see Loven 2008). But the idea of using the Treasury to add resources to clearly solvent

banks would be dismissed out of hand—it accomplishes the same objective as having the Fed reduce the Fed funds rate, which it has aggressively done.

The same story has played out with the financial bailouts of non-insured entities, like AIG. The government originally provided a loan of \$85 billion in mid-September to keep AIG out of bankruptcy. It quickly needed more loans, and within 6 weeks had used over \$90 billion to pay off its bad debts. This is simply a way for the government to treat AIG's creditors and customers at least as well as if they were insured depositors, but without them having paid insurance premiums prior to the crisis (see Leonnig 2008). The main justification offered for these loans, which show very little promise of being repaid, is that a failure of AIG “would have brought down several other major investment banks whose fortunes were tied to AIG.” This prospect does not change the basic argument, so the same logic applies here. These other investment banks were not federally insured. Propping up AIG on their behalf is simply a transfer from taxpayers to AIG's creditors or its creditors' creditors.

What justification is there for such a transfer? As Anna Schwartz pointed out in a recent interview in the *Wall Street Journal*, there is a difference between saving the banking system and saving particular banks (see Carney 2008). That difference becomes clear as taxpayer funds are allocated based on “who had the biggest relationship with a poorly managed financial institution” rather than “who has the best prospects of making money for the taxpayers.”

Two theoretical justifications come to mind. First, liquidations involve payments to third parties like attorneys that reduce the resources available to the financial institutions and their creditors. If there are going to be a number of similar institutions facing the same problem, then a government standard for working out their problems may economize on costs borne by the relevant parties. This may be a good description of the government's rationale for its bailout of Fannie Mae and Freddie Mac. Many financial institutions, including those in the insured sector, were creditors and customers. And in the case of these government sponsored entities (GSEs), the taxpayers were implicitly on the hook due to the government's inability or unwillingness to make clear to investors that it would not honor these entities' debts. Beyond the GSEs, this theory strains credulity, as the sums involved in the bailouts seem to be much larger than the third-

party cost of even widespread bankruptcies. Estimates of the cost of the bailout of financial firms approached \$1 trillion by November 2008, with some critics arguing for a much higher number (see Gomstyn 2008).

Second, it may be argued that widespread liquidations will undermine confidence in the financial markets, leading investors to withdraw their funds, further compounding the problems of undercapitalized institutions. Some investors would undoubtedly be spooked by large financial institutions being taken over by the FDIC. But how concerned would they be if they also saw the insured depositors getting the full value of their deposits back? And highly publicized bank failures are not the only thing that spooks investors. Consider the spectacle of government entities like the Treasury and the Federal Reserve scrambling to figure out the right response to each successive financial institution's collapse. Bear Stearns is bailed out. Lehman Brothers is not. Some banks are liquidated. Other banks get capital infusions or the opportunity to sell their troubled assets to the Treasury. The true lack of confidence is on the part of the policymakers in the procedures in place to deal with the crisis as it emerged. The unevenness and capriciousness of the government's response introduced unnecessary uncertainty into the process. And the possibility of government assistance inhibits financial institutions from working out their own affairs, delaying the final resolution of the problem and further undermining confidence in financial markets. Again, that is the source of moral hazard that we have seen very clearly in the response to this financial market meltdown.

If policymakers in the federal government feel compelled to follow the "damned if they do" strategy, they could best serve the public by following a few simple guidelines. First, don't get in line behind other creditors. There is no reason for the taxpayer to contribute riskless funds in exchange for a position senior only to that of common stock. If the objective is to enable banks to lend new funds rather than to bail out the bank's noninsured creditors, then this can be accomplished with less risk to the taxpayer with senior debt rather than preferred equity. Creditors who complain that their seniority has been eroded can take their chances in liquidation instead. Second, drive a hard bargain with the equity holders. The terms of the equity infusions available under the TARP provide capital at very generous rates. Consider that in late September, Warren Buffet provided

preferred equity capital to Goldman Sachs—one of the least distressed investment banks—with a higher dividend rate than the government is demanding of any institution participating in the TARP (Bary 2008). Buffet also received in-the-money warrants from Goldman Sachs. Third, don't intervene too soon. The presence of a government lifeline reduces the incentive for stakeholders to work out their problems for themselves. Acting as if the institution's failure will hurt the rest of the economy more than it will the institution is a sure-fire way to use more of the taxpayers funds than are necessary.

The Profligate versus the Prudent

I would like to close by describing the broadest level at which the ex post transfer of resources to uninsured risk-takers impacts the economy. Though their stories seldom make the news, there were borrowers who could have qualified for a new home or a larger home with a subprime mortgage but not a conventional mortgage who chose not to buy the home. There were banks that lost market share to mortgage originators because their lending standards precluded them from extending credit in such a risky manner. There were investors that were willing to forego the additional yield on subprime-backed securities because the opaqueness of their design made them too risky a proposition. There were consumers who lived within their means and tried to save some money for the future, refusing to max out their credit cards or their home equity lines of credit to boost their consumption even further above their income. These were the participants in financial markets who behave prudently.

How have these prudent actors fared in the policy response to the subprime crisis? Banks that first lost market share to reckless lenders are now seeing the government injecting capital into the balance sheets of these same reckless lenders. Their net interest spreads are also being narrowed as the Fed lowers interest rates down close to zero to prop up the value of troubled assets across the economy. Households that delayed a home purchase because the prices were too high now see any number of proposals designed to prop up housing prices, keeping them out of reach and in the possession of the speculators and the profligate. Investors that stayed out of subprime-backed pools now see government programs designed to prop up the value of those pools for those who invested less wisely. Households who did not treat their housing equity like an ATM and faced higher

prices for everyday goods and services in competition with those who did now see programs to forgive the debt being proposed. They also face negative real rates of return on their savings. And every entity now showing positive profits or higher income as a result of their prudence must also shoulder the burden of funding the trillion-dollar bailout proposals.

When the government has intervened, it has done so on behalf of the profligate at the expense of the prudent. The inevitable result is that it breeds more profligacy and less prudence in financial markets in the future. The government always has a choice in how it intervenes. From the standpoint of preventing the next crisis, it is better to let an insolvent institution fail and use the government's funds to assist those individuals or institutions damaged by that failure than to use the government's funds to reward the behavior that caused the insolvency in the first place.

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