Stanford Faculty Discuss Credit Crisis and Bailout Options

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STANFORD GRADUATE SCHOOL OF BUSINESS —The financial, securities, and world markets were reeling in late September with the historic news of a proposed $700 billion federal bailout of the U.S. financial sector via a massive purchase of troubled mortgage-related assets. That earthshaking news came on the heels of the government's rapid takeover of mortgage giants Fannie Mae and Freddie Mac, its $85 billion bailout of American International Group, the collapse of Lehman Brothers investment bank, and the subsuming of Merrill Lynch into Bank of America.

To help put the crisis in perspective, the Stanford Graduate School of Business convened a panel of eight experts from the Schools of Business, Law, and Humanities and Sciences on the issue on Thursday evening, Sept. 25. The discussion ran the gamut from how the United States got into this mess, to how this crisis fits in with past credit crises, to the proper role of regulation, to the advantages, and many disadvantages, of the bailout plan just underway in Washington, D.C., and to whether the financial sector is really sufficiently "different" than the rest of the economy to warrant a $700 billion rescue, courtesy of the American taxpayer. ***Here is a summary of the discussion, which is available in full as a video.***

How We Got Here

The origins of the current crisis are a classic tale of corporate-finance 101 not being followed, said Finance Professor Peter DeMarzo. "It's almost like a syllabus from one of [Professor Jim Van Horne's] corporate finance courses," he said. "It begins with agency problems—incentive misalignment on the part of mortgage issuers who, as we know, didn't have incentive to worry about the quality of loans they were issuing. And then leverage on Wall Street amplifying that shock," he said, noting that 20 times leverage was not uncommon.

And the introduction of credit default swaps that require sellers to pay up in the case of defaults that were deemed remote but are now widespread, has exacerbated the problem. So have the deep layers of complex derivative products written against the underlying mortgage loans.

"If you want to take a lot of risk it's really easy with derivatives, and you can get into a lot of trouble very quickly, which is what a lot of financial institutions did," said Finance Professor Darrell Duffie.

"Where the daisy chain ends, nobody knows," said Van Horne. The bailout is not being discussed to save the country just from a credit crisis, but also from a liquidity crisis, where financial institutions have virtually no place to turn for funding to bolster their dismal balance sheets, some panelists explained.

"I think this started as a credit problem, related to mis-ratings of a lot of structured products, and a lack of full understanding of the nature of the inherent risk" in the underlying mortgages, said Finance Professor Ken Singleton. But now, "it's very much evolved to a liquidity crisis ... a type

of funding crisis. It's very difficult for a lot of institutions to get funding," especially given the fact that many banks are arguably technically insolvent if current values were slapped on the assets in their balance sheets.

That dire capital position of banks "has brought to a virtual halt interbank lending" and helps explain the problems in the money-market sector, he said. "The first step one has to think about in getting out of this liquidity and credit crisis is how do we recapitalize the banking sector? And at what level do we need to recapitalize it to undo this freeze as its come to be called in the markets, to bring about greater funding liquidity in the system."

Indeed, this time the market impact has been swift and almost without precedent, panelists said. It has caused "previously unthinkable financial market dislocations," said DeMarzo. "We've seen the collapse essentially of the short-term credit markets in a variety of settings. We've seen zero—and for a few hours negative—interest rates on Treasuries. So, negative interest rates—meaning investors paying the government to keep their money safe because they are not sure where else to put it." "Pretty dramatic stuff. Feels for many like we are looking into the abyss," he said.

What the Government Could Do

Several panelists described alternative proposals or offered their own, very different ideas for solving the problem.

Insuring, not bailing

Singleton noted that conservative Republicans on Sept. 25 were broaching a solution that would act more like a government insurance policy against the most toxic of the assets held by financial institutions.

The notion "is to change the value of the toxic assets themselves," he said. The Republican alternative is "essentially an insurance policy" that would "raise the value of the toxic assets effectively on the balance sheets of these institutions without having to buy them off the books, and therefore effectively raise capital" for the firms. "One could think about loan-like recapitalizations of these institutions as well," he said.

Forcing banks to bear the bailout burden

Finance Professor Jonathan Berk said he's spent the better part of his week writing letters to leaders to stress that the financial institutions—not the U.S. taxpayer—must ultimately bear the financial cost of the bailout, as the price of the risk they took, and to discourage repeat irresponsibility.

He said he could design a hypothetical proposal that would achieve three aims that should be paramount now: "One, it has to stabilize markets. Two, it must not occur at taxpayer expense, and three, it must not set up incentives so that in the future, people will take more risk," and the crisis recurs. "The current proposal doesn't satisfy these," he said.

Instead, the government could buy mortgage-backed securities from the hard-hit banks at the securities' face value—as an example, $100, even if their current market price is 30 cents. It would do so with the aim of selling them again when the markets have stabilized. But, the government would also "get a guarantee from sellers that they will make up any loss the government has on the sale of the securities," perhaps in the form of a tax giving the government "number-one priority debt claim on any of these firms," he said. That way, "the people who are being bailed out would fund the bailout."

Another idea that could be considered, Berk said, would be to find some way to force investment banks to once again bear the full brunt of liability for their traders' actions. One possible way to do that: force investment banks to go back to being partnerships. "When Goldman Sachs was a partnership, the partners had unlimited liability. So you can imagine how carefully they monitored their traders."

Accounting changes

Business School Dean Robert Joss, a former Treasury official and former vice chairman of Wells Fargo Bank, noted that the banking sector might argue for suspending the current accounting methods for how the mortgage assets are valued, to ease the impact of limited liquidity.

Banks might argue that "you would save the taxpayers a lot of money by suspending mark-to-market accounting and going to some other kind of intrinsic value accounting based on cash flows, not an arbitrary number that people can make up." He said. "Let people value them just like they've valued other loans in times of stress."

Combining that approach with a limitation on short selling of stocks, which has created a "vicious downward cycle," and the government could "save your firepower for when we see just where the institutional problems are" and "get some confidence back into the system."

Increased transparency

One major problem with the current situation is that so many holders of mortgage-related securities got disconnected to the actual risk of the mortgages underlying them.

One proposal is to improve transparency, said Duffie. That way, "no matter how this daisy chain goes, it will always be possible for you to drill down through the daisy chain to the very bottom where you know who the borrower is, and how much they owe, and you can figure out how it's related to all the other borrowings."

Cut off the fat tail

Law Professor Joseph Grundfest said a more politically appealing solution might be for the government to buy the underlying mortgages by offering to pay, for example, 50 percent of face value for them. That way, any mortgage worth less will be sold to the government, and " we then know with precision how much the bailout is going to cost the government." It has the added advantage of removing the accounting uncertainty for holders of mortgages that might decline to

50 percent or less of face value, because they could always be sold to the government for 50 percent. In accounting lingo, "we cut off the fat tail," he said. "In effect the government is agreeing to write a put option," he added.

As for the mortgages bought by the government, politicians will like being able to say "we can renegotiate the length of the loans, we can renegotiate the interest payments, that way we are not throwing my constituents out on the street."

A new kind of rating agency?

Grundfest said that he's currently at work on a research project to create a new form of rating agency that is not funded by the institutions whose products are being rated. He likened the current rating system to "the people who own the restaurants paying the restaurant reviewers to issue reviews," he said. "It's only a question of time before you get a bad meal."

His project envisions BOCRAs—buyer-owned and controlled rating agencies. Under that scenario, the financial institutions which are required by regulators to buy rated securities would pay for the ratings, including setting up the incentive structure of the raters. "If it turns out the BOCRAs do a bad job with the ratings, then the buyside has only itself to blame," he said.

How Does This Crisis Compare to Past Ones?

The current crisis is both similar and vastly different from past credit-related crises such as those involving leveraged buyouts, commercial real estate, or third-world debt, the panelists said.

Van Horne noted that in U.S. economic history, there have been 16 credit crises, all marked by speculative excesses of varying kinds. They were all followed by a peak in bankruptcy filings, he said, and sometimes "a collapse in commodity prices."

The current crisis is not the most severe the country has endured, but might be the most severe since World War II, "with the possible exception of 1974 and '75," he said. However, "the government intervention in the markets is the greatest since the 1930s, it seems clear."

Each involved speculative excesses and an inattentiveness to eroding underlying debt quality. Each involved Wall Street compounding such bad bets with steep leverage. And once they passed, each new crisis' participants had forgotten the economic lessons of the ones before.

This crisis is distinguished by its reach into the widespread market and the fact that residential real estate is so central to the problem.

"All previous crises were contained to institutions," said Joss, whereby participants could sit down, work out their accounting, and reach a solution. Not this one.

"This is a situation where credit has been securitized, marketized, distributed—very difficult for the authorities to get their arms around the size, the shape, the magnitude of the problem."

In past crises, it took a little over two years "to purge the system of the speculative excesses and get back really to a solid financial footing," Van Horne said. "We are now in the first year of this purge."

Should There Be a Bailout at All?

For many panelists, the current crisis raises fundamental questions about the role of market regulation and government intervention.

Is the financial sector special?

Economics Professor Monika Piazzesi said there is an ongoing debate among macroeconomists as to whether the financial sector should be considered more vital to the U.S. economy than other sectors—whether it deserves government bailout or whether it should be permitted to suffer through a cyclical business decline and emerge in a revamped state on its own, without government intervention.

"The vast majority of macroeconomists work with models where the financial sector is just like any other sector," said Piazzesi. "There is only a small group of macroeconomists that think that the financial sector is special, and they have been importing ideas from corporate finance, in fact, to standard models of macro."

But it's an important subgroup, she noted, and includes one key proponent: Federal Reserve Chairman Ben Bernancke.

Proponents of this view say that "the financial sector is the valve through which liquidity to producers and consumers flow," noted Duffie. "If you want to improve the life of Americans according to this hypothesis, then we have to start by making this valve unclogged."

Berk said the possibility that the bailout isn't necessary may never be explored due to fear of another depression.

"It might be that we don't need a bailout, but it's not clear whether we could ever find out," he said. "The specter of the Great Depression is such an unpleasant event, that I think most people's view is we don't want to find out if we don't need this bailout. We'd rather just do the bailout, and not suffer the consequences."

Should the industry be far more regulated?

It could be argued that special treatment of the financial sector warrants special oversight, Piazzesi said. "If they are special and we want to bail them out, then they should be regulated, and deregulation in the 1980s was probably a bad idea—we should regulate them more."

Moreover, "if these firms expect to share their losses with the taxpayer, there should be an insurance premium that these firms pay ... and ideally the premium should depend on the amount of risk that these companies are taking."

While Van Horne said he favors regulation of both financial institutions and the derivatives market, others said that shouldn't be necessary.

In principle, said Duffie, "you shouldn't need to shut down derivatives, they actually make the market work more efficiently because they do make it easier to transfer risk." But all market participants need to be far more careful in the risk management and regulation of such products because "it is so easy to concentrate a lot of risk in a very small toxic instrument like a credit derivative."

Berk added that trying to directly regulate the crafters of these financial products is wrongheaded. "You're trying to regulate the smartest people in the economy," he said. "Investment bankers are paid the most because they are very, very smart. If you come up with a regulation, they are going to be smart enough to get around that regulation."

Pros and Cons of the Bailout Package

At the time of the panel discussion, the government was considering a $700 billion purchase of mortgage assets as a way to reassure international financial institutions that billions of dollars of such assets, whose value had been thrown into question, had a solvent buyer. Congressional democrats were pushing for curbs on executive compensation for financial company executives who stood to benefit, and many were gravely concerned about the vast powers being sought by the Treasury Department to determine the price and conditions under which the assets would be purchased. Others wanted relief for homeowners or for the American taxpayers footing the bill for the massive bailout.

Singleton called the Treasury's proposal "a rather indirect way of recapitalizing the banking system," which he said is the real crux of the problem. "If you mark to fire sale prices the assets that are on the balance sheet now, a large portion of the financial sector is insolvent. The proposal that is on the table is essentially to buy at a higher price, and I'm actually not quite so concerned about whether we are making a fair price for them. The question is how much do we want to pay above the [fire sale prices] to inject capital into the system?" he said.

"Surely there is a more direct way to address the problem," he said. One way would be to invest in the banking sector, essentially offsetting the "liquidity discount" now in the market. He said government should get an equity stake in that case "on the part of the American taxpayers" and not "give away that liquidity discount."

Others said the Treasury had not explained how it would price the assets it would buy, and that continued turmoil in the housing market complicated the picture.

"One of the most troubling aspects to the bailout in my judgment is the lack of a precise pricing mechanism," said Van Horne. "The Treasury purposefully has talked about reverse auctions but has not specified what will be involved, and is asking for more or less blanket authority.