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Bailouts: An Affront to the Market and to Democracy

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The bailout regime in which we find ourselves is an affront to the market and an affront to democracy. Along with many citizens, I am angry, frustrated and worried.

Bailouts of major financial firms were judgment calls and not obvious mistakes at the time. What is incomprehensible a full year after the Bear Stearns bailout is that there is still no plan for the future. Now, all large banks are backstopped by the federal government, and it seems likely that should any other large financial firm run into trouble it too would receive federal support. Everyone agrees that the bailout regime cannot be allowed to persist, and yet federal authorities seem not to have a clue as to what our financial course is or should be.

Our nation is facing affronts to the very foundations of our economy and our democracy, which is why the bailout regime must end. I will discuss these affronts and offer a reform proposal for the long run; reform must rely on fundamental changes in the incentives under which financial firms operate. Once the new financial structure is clear, the federal government will have to create a bridge from the current debacle to the long-run structure.

You may not like my reform proposal; I challenge you to improve upon it. Thinking through reform options will help in assessing whatever proposals are eventually put on the table.

An Affront to the Market

A fundamental feature of market allocation of capital is that the allocation depends on assessments of risks and returns. Market assessments, as we know, can be dramatically wrong. The current financial crisis is a consequence of a serious under-pricing of risk of subprime mortgages and securities of various sorts issued against that paper. This experience is hardly

unique in monetary history; although we did not know it at the time, ten years ago we were in the late stages of the dot-com boom, which shortly thereafter turned into a bust.

These manias led to excessive allocation of capital to the dot-com companies and to housing. There was physical waste of resources, in thousands of miles of excess fiber-optic cable and thousands of houses and condominiums that should never have been built. These capital investments had a much lower rate of return than anticipated, which meant that financial instruments issued to finance the capital fell in value far below par. The mortgage boom not only left us with too much housing but also with insolvent households that had extracted equity from their properties and used the funds for consumption.

Manias of this sort have occurred for hundreds of years. But we must not forget that they are called manias only when they collapse. We have also experienced hundreds of years of investment booms that turned out well overall, though with many failures along the way; examples are railroads in the 19th Century and automobiles in the 1920s. Even the dot-com boom turned out well in some respects, such as the widespread use of the Internet for transactions of all sorts today and firms such as Amazon and eBay that have survived and prospered.

Market processes, above all in the United States, serve to allocate additional capital to the successes and withdraw capital from the failures. Markets make mistakes, but also correct their mistakes. Economies organized on non-market principles also make mistakes, but have a much weaker record of correcting mistakes. Soviet-style economies failed in part because they would not shut down failed enterprises.

Bailouts are an affront to the market because they keep failed firms afloat and because they distort market risk assessments. Today, creditors' risk assessment for any large bank is based entirely on whether the federal government will, in extremis, bail out a troubled big bank.

Creditors of big banks—who, after all, provide roughly 90 percent of a bank's capital—have reason to believe, though not with absolute certainty, that their claims are safe. The efficiency of a big bank is essentially irrelevant to those who provide debt capital. Providers of equity capital, on the other hand, are at considerable risk. The government might decide at any time to take over a bank and wipe out equity. However, the risk assessment is not primarily about a bank's quality of management and soundness of its assets but about government policy. Clearly, government policy is grossly distorting capital market decisions.

Moral hazard is a serious issue today and frequently discussed. The hazard is that managements of banks too big to fail will take excessive risk and that the market will allocate too much capital to these firms. Banks below the top 10 or 20 are at a disadvantage, relative to the big banks, in raising debt capital. Should a smaller bank fail, creditors not protected under current programs may lose some fraction of their claims.

We cannot live with this situation. After the recovery begins, questions about the health of large banks will be with us for many years, and perhaps decades, unless the government acts decisively to change the situation. Market participants will be asking questions such as these: Just how large must a bank be to be too big to fail? What happens if a bank almost large enough, but not quite, is allowed to fail? Will concern spread to other almost large enough banks? And what about the politics of the situation—given that the government bailed out Citigroup and AIG, is it *fair* to let Bank X fail?

There will be no answer to these and other questions, and no lasting stability in the markets, until the federal government acts decisively to end all bailouts and all presumption that bailouts might occur. No government official has explained how we are to establish this new world. All I have heard is a plea for more regulation, with no discussion at all of the substance of

new regulation. What exactly are regulators with new powers going to do? We are in a terrible situation right now, lurching from crisis to crisis with no direction as to where we are going.

An Affront to Democracy

Our current bailout world is an affront to democracy. There is much anger in our society. People who were responsible in their use of debt, many of whom are struggling to stay current on their obligations, will eventually be taxed to cover losses incurred by irresponsible borrowers and lenders. We know that many executives of financial firms, despite huge losses, have larger fortunes remaining than most of us can ever dream of enjoying. Taxpayers in general will pay for losses incurred by the insolvent, or nearly insolvent, firms these executives left behind.

In the United States, most people understand that economic success should be rewarded. What people cannot understand is how we can allow a system to persist in which success is rewarded and losses are socialized. The federal government may spend several trillion dollars bailing out financial firms and households. Each trillion is more than \$3,000 per capita. It is an affront to our democracy that responsible citizens are being asked—no, required through taxes—to shoulder losses of this magnitude. Our government is not treating us equally.

We are told that we must pay, because the economic consequences of not paying would be even worse. And I think we do have to pay—I am not a bomb thrower who says we should just let the big banks go down. Nevertheless, we have a right to expect of our leadership a plan that will guarantee that we will never be stuck in this situation again. Most unfortunately, Washington is silent on a reform plan and I see little effort to craft a plan. I fear that Washington does not have a clue as to what reforms to put in place.

A Reform Plan

I have already noted that those who call for tighter regulation offer no specifics. Are we to believe that all we need do is hire more and smarter regulators? Regulators did fail to understand the risks from subprime mortgages; so also did rating agencies and investors, including investors in the most sophisticated firms in the world.

We need to think about reform in a different way. Instead of more regulators with more power, we need to change the incentives under which firms operate. Our financial firms got into trouble because they had too much leverage and too much of their debt was short term. They were also subject to too little market discipline. These issues can be addressed by changing the incentives under which firms operate.

Firms borrow because they believe that debt capital is cheaper than equity capital. That is certainly the case under the U.S. corporate tax system, because interest is a deductible expense in calculating income subject to tax, whereas dividends are not deductible. Moreover, most bank liabilities are short term. A run on a bank occurs when creditors refuse to roll over their maturing claims on a bank.

Four problems must be addressed. First, many financial firms have too little capital relative to the risks they run. Second, banks need longer maturity capital that cannot run. Third, we need to rely more on market discipline to deny funds to banks deemed risky. Fourth, when a bank needs to be restructured, it would be best for the bank rather than the federal government to manage the restructuring.

Here is a straightforward fix to address excessive leverage: Over a period of years, phase out the deductibility of interest on business and personal tax returns. A quick look at 2005 data, the latest available in the IRS Statistics of Income, indicates that, for the corporate sector as a

whole, eliminating the deductibility of interest would roughly double corporate income subject to tax. Cutting the corporate tax rate in half would leave revenues from the corporate tax system roughly unchanged. Given the current and prospective situation, the corporate profits tax would have to be cut further for revenue neutrality, perhaps to 10 percent.

We should not, however, try to force the adjustment all at once. Instead, we could phase out the deductibility of interest on all tax returns over the next ten years. Next year, 90 percent of interest would be deductible; the following year 80 percent would be deductible and so forth until interest is no longer deductible at all. The same reform would apply to all business entities; partnerships, for example, should not be able to deduct interest when corporations cannot.

With this simple change, the federal government would encourage businesses to become less leveraged and households as well. We have learned that leverage not only makes individual firms more vulnerable to failure but also makes the economy less stable. We use the tax law all the time to promote socially desirable behavior; the change I propose would reduce the risk of failure of large firms—especially large financial firms—and thereby promises to reduce the collateral damage inflicted by such failures.

A second lesson of our current financial crisis—not a new lesson but an old one—is that financial firms can collapse suddenly, in part because too much of their debt has very short maturities. An idea favored by economists for many years is to require that banks maintain a substantial block of subordinated, long-term debt in their capital structure.

Here is a specific proposal. Every bank, including savings institutions and investment banks, must issue subordinated debt equal to 10 percent of its total liabilities. The debt would consist of 10-year notes, uncollateralized, and subordinated to all other debt obligations of the bank. With 10-year notes equal to 10 percent of the bank's total liabilities, the bank would have

to refinance one-tenth of its sub debt every year, equal to 1 percent of its total liabilities. The subordinated debt would be in addition to existing requirements for equity capital.

The subordinated debt proposal has several important advantages. We have seen that banks do not have an adequate cushion against losses under current capital requirements. If taxpayers are to be expected to stand behind our giant banks, taxpayers deserve a larger cushion against bank mistakes. More importantly, because banks would have to go to the market every year to sell new sub debt, banks would have to convince the market that they are safe. A bank that found it too expensive to sell new sub debt would have to shrink by 10 percent. Restructuring a bank at a rate of 10 percent per year is perfectly feasible, and the restructuring would be managed by the bank and not by the government.

These two reforms—phasing out the deductibility of interest on business tax returns and requiring banks to maintain subordinated debt in their capital structure—would change the incentives under which firms operate. Firms would be more stable individually and the economy would be more stable.

These are not radical proposals. They rely on market incentives and avoid intrusive and ultimately ineffective government regulation. If we are unwilling to approach the issue of financial stability from the perspective of getting the incentives right, then we will not enjoy financial stability as a long-run matter. We will continue to experience, from time to time, bouts of instability and bailout affronts to the market and to democracy.

A Bridge from Here to There

A vexing issue is how to get out from under the current bailout regime. One widely discussed approach—the idea behind the original TARP legislation—was for the government to

take the bad assets off the banks' balance sheet. This approach has failed, because it does not help banks if the government pays what the bad assets are really worth and is a taxpayer gift to banks if the government pays too much. If the government buys the bad assets, the government has to manage them or sell them, raising further issues. Most importantly, taking the bad assets out of banks does nothing to get us out from under the moral hazard problem.

Back up for a moment and consider two simple premises. First, under current conditions the government cannot let a large bank fail. There are two reasons. First, there is so much doubt about bank solvency that if one big bank goes down the market will immediately distrust certain other big banks, and will move funds away from them. This is the process economists call "contagion." Runs on multiple big banks today are a recipe for chaos. The second reason is that banks are interconnected—if one bank goes down other banks with claims on the failed bank will suffer losses that might be enough to yield insolvency.

These considerations mean, like it or not, that taxpayers are on the hook for whatever gap may exist between the value of a big bank's assets and its liabilities. Creditors, covering all the claims on the liability side of the balance sheet except for common and preferred equity, will not be allowed to lose a nickel, at least not before the financial situation has clearly stabilized. Any effort to resolve an insolvent bank by having creditors share in the losses runs the risk of a run on other banks. Attempting to minimize taxpayer losses by such provisions as making the government's preferred stock senior to other claims is beside the point—the federal government is committed to paying all creditor claims at 100 cents on the dollar. As I have emphasized, this situation is not viable in the long run. However, that is where we are today and we must face up to that fact in designing an approach to getting us out of our financial mess.

If a bank is insolvent—and I have no idea whether any large bank is—then the issue is what to do. The government is rightly resisting the idea of taking over, or nationalizing, a large bank. These are huge, complicated enterprises. My second premise is that the federal government does not have the managerial resources to run a large bank. And once the government took over a large bank, all the incentives would be wrong. Management, constrained by limits on executive compensation and other rules, would have an incentive to flee to other firms. There would be no shareholder interests to protect and motivate sound management decisions.

To recap, the federal government is committed to supporting every large bank, so that no creditor will lose a nickel. And, it makes no sense for the government to take over a large bank and to restructure or dismantle it, because the government does not have the managerial resources to do so. It appears that we are well and securely stuck in a bad place.

Here is my proposal: The federal government should restructure its existing support for banks and add new funds as necessary, to buy 10-year subordinated debt from the banks, equal to 10 percent of each bank's total liabilities. The subordinated debt would have a ladder of 10 maturities. The first would mature in two years, the next in three years, and so forth out to the final block of sub debt maturing in 11 years. To the extent that a bank already has subordinated debt outstanding, the government would coordinate its maturities with those of the existing sub debt. The government's subordinated debt would be senior to the bank's existing sub debt.

Each bank would know that starting two years from now it would have to sell new sub debt every year to the market to pay down the maturing government-held debt. If the bank could not raise the funds, it would have to shrink by selling assets or letting assets mature to provide the funds to repay the maturing debt held by the government. Banks not currently receiving federal assistance would also have to sell sub debt, perhaps starting in five years. Under this

proposal, the government would have a clear schedule for withdrawing special assistance and forcing banks to stand on their own. The markets need the certainty of when and how the government is going to end this sorry chapter in U.S. financial history. Vague plans for regulatory reform will not provide the clarity the markets need and taxpayers deserve.

You may object that the federal government cannot afford to put more funds into banks. But that decision has already been made—creditors will not be allowed to lose a nickel at this time. What I am proposing is that the government structure its support in a way that has a clear end game.

This proposal provides a bridge to a future with a much more stable banking system. It leaves the toxic assets in the banks, where they can be managed most effectively. It leaves the banks with the incentive to perform, or shrink if performance falls short. The proposal would end most of the uncertainty about the government's support for the financial system.

Some will object to this proposal on the ground that banks must increase their lending to get us out of the recession. My answer is that the banking system may need to expand its lending but not any particular bank or banks. The market needs the certainty of a sensible design to extract ourselves from the bailout world we are in, and a bridge to a stable financial system ahead. Without that promise, we will continue to lurch from one crisis to another.

Concluding Comment

This Fair Isaac conference is not a public policy seminar. I have offered a plan to demonstrate that there is a way out of the financial mess we are in and a way to a more stable future. If you do not see the federal government offering some sort of plan in the near future—a plan that relies on changing the incentives under which financial firms operate--then I believe

that you should not expect a more stable future. We may muddle along, and things will look better once the recession hits bottom. Nevertheless, without fundamental reform that moves us decisively away from the risk of further bailouts the financial system will not be stable. Whenever a solvency issue arises, so also will debate over a possible bailout. A bailout world is an unstable world.

I have been talking from a macroeconomic perspective, but the same issue arises in judging the creditworthiness of individual households, which is where Fair Isaac excels. How can credit-scoring technology take into account the probability that a household will be eligible for federal funds to relieve distress? How will credit scoring take into account the action of a bankruptcy judge in recasting a mortgage? Federal programs today are not only changing risk assessment for the obligations of banks but also for the obligations of individual households.

It is often said that markets hate uncertainty, but that is not the right way to put the issue. Markets are superb, most of the time, in dealing with unavoidable uncertainty. Success, though, requires stable rules of the game. We face a situation now in which changes in federal policy, in some cases driven by politics and not sound policy considerations, interfere with market efforts to assess and manage risk. That is why it is essential that we find a way, and quickly, out of the bailout regime we are now in.