Responding to the Financial Crisis

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Anupam Chander*: I am grateful to the Federalist Society for convening us here on a timely and crucial topic. Given that I am speaking to law students, let me begin with a story I heard when I was a law student. The story is undoubtedly apocryphal, but it's funny and instructive nonetheless. A law professor was getting married, and his bride-to-be went to get her hair done. She returns home, but unfortunately the cut has gone awry. The professor then goes to the salon and angrily demonstrates his displeasure. The police are called and they take him to jail. The story, as told, is that he gets on the phone with his law professor colleagues and asks them to bail him out. And they all admit, in seriatim, that they don't know how to do it.

My point is that it's important for lawyers to know something about bailouts. This is a subject that we often leave to business men and women, but it is imperative that we discuss this subject here, in law schools, and not just across the Hyde Park Midway at the business school. We cannot afford to rely upon the expertise at the business school alone to get us out of this mess.

What are some of the basic legal issues before us? I will identify three. First, there's the well-known principal-agent problem; that is, the people who own the assets don't share the same incentive as the people who actually run the companies, who make the decisions on a day-to-day basis. The disconnect between the incentives and interests of the principal and agent are something that we lawyers know a lot about, and we have designed common law and corporate governance structures to address this problem. In our current predicament, private bankers, people on Wall Street, people at Chicago hedge funds, etc., made the decisions, but often not as the actual proprietors of the assets with which they were dealing—yet still pocketed enormous profits on a short-term basis. So over the last handful of years you could make a million dollars on the risks undertaken yet not be the one left holding the bag when the value of Lehman Brothers dwindled to zero. Much of that compensation was in the form of options, with the hope that that stake would ameliorate the principal-agency problem, which apparently it did not do sufficiently. We lawyers are the professionals best positioned to structure long-term relationships to address the principal-agency problem.

A second important factor familiar to lawyers is the concept of moral hazard, the notion that those who are actually undertaking these activities are insured from the risks of those activities. Again, we lawyers are the ones who design structures to deal with moral hazard. How do we make sure that people don't make such foolish moves in the future? How do we internalize the risk, not externalize it to all of us?

Third, there's an international aspect to this problem, to which Todd averted with the mention of China. Financiers don't really care about borders. They only care about where the highest rates of return (given the risk) are. The regulatory structures, on the other hand, are national in scope. Borderless capital needs regulators who cannot be easily foiled by the water's edge, allowing either a race to the bottom or regulatory arbitrage. Coordination among governments in this area is yet in its early stages. Just yesterday, the United States rejected a proposal by the European Union that we agree to back up interbank lending. The Europeans had said that we should all guarantee interbank lending, much of which happens to occur in London and profits bankers there. These are issues that lawyers are particularly adept at—thinking about who governs and who needs to be held responsible in these kinds of situations.

In addition to the legal nature of the issues at stake, there is the fact that lawyers are involved in both creating the problems and fixing them. Who created these innovative structures in the first instance? It was bankers working with accountants and lawyers. We were a crucial leg in that three-legged stool. When these complicated financial structures were created we could not responsibly have said that it was someone else's responsibility to understand them. Tom Harkin reminds us of how we once spoke of Alan Greenspan—as though he were an oracle, as though we could not and should not question the economic experts. But we cannot afford to hive off economic and financial issues from the law and other areas of life. One of the crucial things you learn as a practitioner is to not just take the words of bankers and others as oracular statements not susceptible to the understanding of ordinary mortals.

Finally, as I said, we might be the ones called upon to solve these problems. As it turns out, Barack Obama is a lawyer. Robert Rubin, who solved similar crises abroad during the last decade, is a lawyer. The crucial players in many of these instances are lawyers. And I'm happy to see that you are all here to think about these things and help prevent them or resolve them in the future.

M. Todd Henderson*: Let me add a couple of comments, and then I will add a macroeconomic element to this discussion.

There's this country called China. And we like things that are made in China, and so we send them $500 billion in cash, actual dollar bills, every month—roughly. They get it, but what can they do with it? Well, they can't give it out to their citizens, because you can't buy things in China with dollars. So they've got to invest it. Well, this is a nice thing, because it's going to come back to us in investment. But what can they

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invest in? Well, they have three choices—let's say there are three choices—only three things in the world that one can invest in. One is the U.S. Government, the other one is houses, and then of course there is Google. They've now taken over and own everything in the United States in terms of production.

So now China can invest in one of these three things. Historically, they invested in the U.S. Government, something called Treasury bills. The Government would sell these bills, China would give us $500 billion, and that's how we paid for No Child Left Behind and killing people in Iraq. That's what we do with that money. But the problem was that after 9/11, Greenspan lowered interest rates, so the interest rate to borrow money went to nearly zero. This was a loose monetary policy, inflationary credit policy; that is, money was very cheap. This is what first got us into our problem, and it's funny because we're now lowering interest rates to get ourselves out of it.

But China doesn't want to invest $500 billion in something that's going to give them a one-percent return. They can invest in Google, since Google has something like a 100-percent return in recent years. So this is the future of China. They don't trust Sergey and whatever that guy's name is. They could use the $500 billion to buy the Portland Trail Blazers, but what good would that be to China?

But what about houses? Someone comes to them and says, look, you can invest in U.S. houses and, because of what Douglas suggested, the return on these things is 10, 15 percent, and "wink wink"—this is Uncle Sam winking at China—this thing Fannie Mae is backed by the U.S. government—if it fails, the government will bail you out. That is, China becomes basically a bondholder of Fannie Mae, and we promise to bail them out, which is exactly what we did.

So you have a situation where you have an implicit promise from U.S. Government that they can invest in these securities and earn returns that are higher than what they should be, because they're not bearing the full risk. What does that mean? That means that this money is funneled to houses. That is bad government policy, it is social engineering gone awry, this pressure to push people into houses. What is so good about homeownership? It doesn't make any sense. The entire social policy, from mortgage interest deduction to encouraging subprime lending, is terrible. But you know, bad government policies exist everywhere. The real problem is when you add bad government policy to the natural greed of human beings.

The natural greed of humans is always there and always in the background, but when bad government policy gets into the mix, hold onto your wallets. It is fire and fuel, and we have seen this innumerable times in American history. The greed of people who can make money based on these implicit government promises is enormous. As a consequence, we had a huge investment in this country in houses that turned out to be not worth so much. And you had people who took real equity out of their houses and bought things like plasma TVs and flipped houses, and the stuff just was not worth what it appeared to be worth.

So, we have bad government policy coupled with the natural greed of people who were investors—all of us, anybody in here who wanted to flip a house, anybody in here who ever thought they could invest in a condo with no money down, all the mortgage brokers who were cheating and scamming people and making $85,000 a month. These people proliferated during the boom time. And now, we have to figure out what we're going to do with this huge over-investment in houses. One option would be just to let all the banks just fail—let the U.S. government fail for that matter, and watch this entire welfare structure, a house of cards just like the housing bubble, come crashing down in a real reckoning. But that would be really painful. That's cats and dogs living together, mass hysteria; terrible. The harm would be enormous. It's the error end of the curve. We might come back up, or try to preserve the bleeding and drag it out like we did in the New Deal, but I think the reason for the bailout—the reason I feel the Government has to do something—is because we don't live in a world where everybody takes their reckoning and people are punished for their bad mistakes. We don't live in this hypothetical world. There are real social consequences for letting people fall, letting people out of their houses. And the human cost could be enormous.

It reminds me of Milton Friedman who, once at a dinner party in the living room I now own, was ranting against rent control, and a little old lady from Hyde Park jumped up and said, Milton, are you really going to throw these people out of their house? And he said, no, of course not. This is in theory; we should try to do away with rent control, but we can't. We're stuck in the world that we're in. And I, too, think we're stuck in the world we're in.

The reason Government wants to bail out Wall Street, as opposed to letting these banks fail and new ones arise to connect lenders and borrowers, is that we need money from China. China is not investing, and we need China to invest. If Goldman Sachs and Bank of America fail, China is not going to give money to the Baird & Henderson Bank to give to people. The reputations and potential costs of that are too high for them.

So the $700 billion is a way of building a bridge between borrowers and lenders, but our bridges have holes in them and it may take us a while to get to the point where people feel comfortable crossing those bridges again. This is us repairing broken bridges in an attempt to salvage and stifle the human misery. I think, sadly, the consequences for short-term benefits are potentially long-term gain, but we could talk more about that.

Rosalind Dixon[*]: How you frame the bailout has a big impact on how you think about solutions. I think Professors Henderson, Baird and Chander all had a very good theory—certainly a lot better than, well, the President—about what has caused this crisis. But I'm going to add something to what they said. I think they found their "answer" to how to think about

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the bailout by framing the underlying problem which caused it in a way that leaves out one piece of the puzzle. Professor Baird [not included] basically told you that if the people who price credit derivative swaps—i.e. the guys (and girls) at Standard & Poor's—were just a bit smarter and a bit more careful, we would not have inherited this problem. Professor Chander said, well, you know, actually the problem was about moral hazard… it was because the banks were subject to moral hazard, and the guys at Standard & Poor's also, that we face this crisis. On this view, we just need a few more University of Chicago law students to work at Standard & Poor's, or better tailored incentives for bankers and S&P employees, in order to avoid the problem in the future.

Well, that's surely one part of the answer. Professor Henderson's diagnosis of the problem also adds another potentially important lesson for the future. He tells us that what happened in this area was that bad government policy hooked up with greed on Wall Street. Good policy in this area, according to Professor Henderson, might be allowing really poor people to get a very concrete and relatively small transfer to allow them to have a home. The really bad policy, in his view, was allowing people who did not live in those homes, who were not really poor people, to get access to Fannie and Freddie funds in order to have second and third condo investments, which they weren't going to be able to repay. And because it is hard to figure out how to prevent similar forms of bad policy from happening again in the future, his solution seems to be, don't let government policy get hooked up with the private sector.

That is troubling to me as a general prescription, and I think it creates a very strong tilt in the future towards a much more limited form of government intervention than is justified, regardless of your substantive preferences around a particular set of policy demands.

It also ignores one important factor we can identify which contributed to us ending up with such a bad housing policy… ; namely, a lack of transparency. As Professor Henderson himself said, one of the causes of this crisis was a form of subsidy that was completely hidden to the American people—no one went to the polling stations in 2000, or 1990 for that matter, saying, I'm really worried about housing subsidies. This was a form of extremely non-transparent public policy, and it had very damaging consequences.

There is another way in which transparency and poor oversight and regulation were essential to this story. A major cause of this crisis was the degree to which banks became over-leveraged, and came to hold highly inter-connected portfolios of credit default swaps, and all this happened with very, very little public disclosure, knowledge or oversight. The current law imposes very few disclosure requirements in this area, and almost none of the investment banks or hedge funds engaged in serious voluntarily disclosure. And so it was extremely hard for people to figure out how leveraged financial institutions were and how much they were using [certain] extremely risky assets that had been misvalued as part of their total asset base for the purposes of leverage. No one could figure out what they were doing in a way that made the market unable to price assets appropriately or deal with them in an appropriate, qualified way. This led to the result that, as Professor Baird said, a relatively small miscalculation in the value of particular assets had very large flow-on effects….

Once you see the problem in this way, part of the solution is to insist that investment banks should convert themselves into a commercial bank structure, and therefore be subject to a maximum leverage ratio of something like 8:1 instead of 30:1.... Another part of the solution will be to impose increased transparency requirements across the board, so that in the future, the mispricing of assets is more likely to come out and the market to punish it at earlier stage, so that the mistake doesn't spread and multiply through the whole economy, as it has in this case.

So to me, it is important to recognize that there's a connection between how we characterize the causes of the current financial crisis and how we think of solutions. There were probably lots of causes, but which ones we elevate above others will have important ramifications for how we address the problem in this and related areas.

Having said that, I don't think that there is a perfect correlation between identifying the cause of the problem and the solution to it. It may be that lowering interest rates post-9/11 helped cause the current problem, but it might still be the right thing to do to further lower interest rates in order to help correct the problem. It may be that we put too much money into housing to begin with, which is what helped create the problem, but that the right thing to do is to put more money into housing, which is effectively what the bailout is doing. It may also be that moral hazard, as Professor Chandler said, helped caused the problem, and that the bailout itself creates more risk of moral hazard problem, because it tells people that if they take risky behavior, they may be bailed out after the fact, but that that it is still the right thing to do. So there's a certain trap here, of getting too fixed on avoiding the mistakes of the past.

Lastly, I want to say that I think this is an area which crosses partisan divides, and which requires us all to try and see the other side of the story. Some people insist the derivatives are largely good, and so you shouldn't regulate them. Others insist that, because there has been "bad" trading in derivatives, we should be against derivatives generally. There is an article on the front page of the *New York Times* arguing that the problem in this area was that Greenspan had too much faith in derivatives. But derivatives are an enormously helpful and important financial instrument. As the Federal Reserve said, the insurance they provide to purchasers is extremely positive from a welfare perspective. But once you have derivative markets of the kind we have been talking about, you get massive speculation. Speculation itself can be good because it creates liquidity in the market, but it also means that real oversight must be there, because tiny distortions in the market can have massive flow-on effects.