

Where Do We Go from Here? Part II

The Atlantic: A Failure of Capitalism

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In this second part of a two-part entry, I discuss two far-reaching reforms that, it has been suggested, might help prevent a repetition of the financial crisis: regulating the compensation of top management of financial institutions that pose systemic risk; and tightening regulation of derivatives, including credit-default swaps.

The first proposal, in the form that I will consider, is the brainchild of Lucian Bebchuk, a very able lawyer and economist who teaches at Harvard Law School. Bebchuk is a leading critic of overcompensation of CEOs, but his proposal concerning the compensation of financial executives is distinct, and even (as I'll argue) inconsistent with his general position on overcompensation. He proposes that the top executives of financial institutions that pose systemic risk should be required to take most of their compensation in forms (such as common stock that the executive cannot sell for a specified number of years, or cash bonuses that can be "clawed back" at a later date should the profits out of which the bonuses were paid prove to be illusory) that assure that if such risk should materialize and the firms experience a deep loss in value, they will not profit from the risky activity that led to the disaster.

Bebchuk limits his proposal to top management. This may seem to overlook the fact that highly risky loans and other risky investments are made at the trading level rather than by top management. But Bebchuk is well aware of that, and reasons that if the losses at the trading level are made losses to the senior executives, the latter will take measures to rein in the risky behavior of their subordinates--and they are in a better position to design effective measures than the government is. Motivated to limit risks that may cause losses to themselves, the top executives may for example decide to shrink the firm, because control of subordinates is more difficult the larger a firm is, or to spin off the riskiest parts of the firm. Combining different organizational cultures--one of safe lending, for example, and the other of risky trading--in the same firm is problematic at best. The risky part of the firm is likely to generate greater profits and pay employees better, creating resentment among employees in the less-risky part of the firm, and, of particular concern in the present context, impelling them to take more risk in order to increase their relative earnings. A separation of the two parts into separate companies can solve the problem, and leave one part, at least, safe.

I remain skeptical about any proposal for regulating the compensation of executives of financial institutions, for reasons I have explained in earlier entries in this blog, but if any such proposal should be taken seriously and studied carefully, it is Bebchuk's. I must however note a tension between the proposal and Bebchuk's solution to the more general problem of compensation of CEOs and other top executives. Bebchuk fears correctly that boards of directors are not faithful agents of the shareholders and as a result fail to prevent top management from appropriating, in the form of excessive salary, bonuses, and other forms of compensation, corporate income that should really enure to the shareholders. He recommends measures for making boards, and through boards top corporate executives, more faithful agents of shareholders.

The problem from the standpoint of economic stability is that shareholders are likely to be less risk averse than top executives, because the former have a lesser stake in the continued survival of the corporation. By holding a diversified portfolio of common stocks, a shareholder can mitigate the risk to him of a collapse of the value of an individual stock. In contrast, a corporate executive is likely to have both a large financial and a large reputational stake in his firm. Measures that align the executive's interest with that of the shareholders may thus increase the danger of a corporate collapse, and such measures, if adopted, would therefore undercut Bebchuk's proposal for regulating the compensation of top financial executives.

The last proposal in this two-part blog entry that I want to address is the proposal to regulate credit-default swaps by requiring that they be channeled through clearinghouses. Credit-default swaps are, in the first instance, private contracts to insure loans and other investments. The issuer might for example promise a creditor that if the value of the creditor's loan fell below its face value, the issuer would make up the difference. But credit-default swaps are also devices for speculation as distinct from insurance (not that insurance can't involve an element of speculation). So A might promise B that if C should default on its loan from D, A will pay B the amount of loss sustained by D. In other words, A and B might be gambling on the outcome of C's transaction with D, rather than insuring D against a loss caused by C's defaulting.

There is nothing wrong with either loan insurance or speculation. The problem with credit-default swaps is a lack of regulation, resulting in a lack of information about the value of the swaps and the liabilities of the issuers. Without such information, it is difficult to determine the creditworthiness of a borrower. This seems to have been a factor in the credit freeze that followed the collapse of Lehman Brothers and other major financial firms last September. LIBOR (London Interbank Offered Rate), a commonly used interest rate for unsecured loans between banks, soared because a bank asked to make such a loan couldn't gauge the solvency of the bank seeking it. A further complication is that credit-default swaps were not required to be backed by reserves, so that the ability of an issuer of such a swap to make good on its promise to pay if the insured-against event occurred was often unclear, though many buyers of such swaps did insist on collateral.

Still a further problem was that, since credit-default swaps were not limited to insurable interests, but could be used as purely speculative commodities, they invited and received securitization, and securitized packages of credit-default swaps were extremely difficult to value, adding to uncertainty about the solvency of the financial institutions that had invested in them.

These problems would be ameliorated if credit-default swaps were required to be traded through clearinghouses. When a clearinghouse is used for the trading of derivatives or other financial instruments, the clearinghouse guarantees payment and protects itself by requiring margin (collateral) calculated on a daily basis. Suppose that A pays \$100 to B for a commitment by B to pay C's \$10,000 debt to A if C defaults. The clearinghouse would require B to post a certain amount of collateral to provide assurance that it could make good on its promise should C default. If as time passed a default seemed more or less likely, as indicated by the prices at which that or similar credit-default swaps were trading, the clearinghouse could demand more, or require less, collateral. The financial industry and the financial regulators would understand the

commitments of the issuers of the credit-default swaps and have reasonable assurance that the commitments could be honored if need be.

The clearinghouse solution is incomplete because even a fully regulated insurance market can collapse. Insurance is effective against independent risks, but not against correlated ones. If a plague carried off half the U.S. population, the entire life insurance industry would be broke. And it is because the risk of insolvency of financial firms created by the collapse of housing prices was a correlated risk that when it materialized, it brought down much of the financial industry.

A second limitation of the clearinghouse solution is that it presupposes uniform contracts, which can be traded without the traders' having to master complex contracts. But many credit-default swaps are custom-designed to fit particular circumstances. The more of these non-clearinghouse swaps there are (measured by value), the less the clearinghouse approach will succeed in making the commitments embodied in swaps perceptible to the markets and to the regulators.

But despite these drawbacks, as with Bebchuk's proposal the proposal of a clearinghouse for credit-default swaps has sufficient promise, relative to the alternatives, to merit careful study.