Appalled In Greenwich Connecticut

Clifford S. Asness, Ph.D.
AQR Capital Management, LLC

Preliminary version last updated: January 24th, 2010
Comments welcome: comments@StumblingOnTruth.com
Related essays available at: www.StumblingOnTruth.com

The President, in these last few days following the second revolution against big government started in Massachusetts, has come out swinging savagely against "banks" in numerous ways in numerous speeches. Let's be clear. There are legitimate issues and reforms to be discussed. But my first question is why this exact moment? The answer is simple. When a failing government with authoritarian impulses needs help, it's pretty standard strategy to call down a pogrom against an unpopular class of citizens. The bankers are nothing if not unpopular. Unfortunately for this President, he will, I hope, find the financial community not cowering from his Cossacks on a shtetl in the Pale of Settlement (Greenwich, CT), but meeting his accusations with logic and patriotism.

First let's discuss the President's recent rhetoric. Paraphrasing him, "we will get back all the people's money." And the applause line, "every dime!" OK, fine. But most of the banks, and in particular the ones in the headlines for paying large bonuses, have paid back all their TARP loans.[1] This logic causes him no pause. Apparently, and we must read between the lines as this is the most transparent administration ever, he means all the money lent out to everyone through TARP not just to banks. So, loans to the car companies, and AIG, and FNMA/FHLMC, all must be paid back, but by the banks, who already paid back their own loans.[2] Makes sense. Has this administration seen a human activity they don't instinctively wish to socialize?

Apparently, unlike GM, Chrysler, and the GSEs, the banks didn't get the memo that said when you get a bailout the polite thing to do is to continue to fail.

An argument is often made that even if the banks paid their explicit debt back, they simply would not have survived without the loans. Thus, they owe the government much more than mere repayment. This is riddled with flaws:

- According to bailout alarmists nobody would have survived, neither man nor beast, without TARP, so why is this argument unique to the banks,

[1] Lest you find me too partisan, please note I am not ignoring nor forgetting that TARP and the bailouts began under the Bush administration. Also, not all bailouts were through TARP, but I'm going to use that as short-hand here.
[2] Nobody has really added in the cost of the FNMA/FHLMC bailout yet. It's the bailout the government likes to talk about least. I wonder why?

and again why are they paying back everyone's debt just by virtue of their success?

- Again, as in the Chrysler bankruptcy that drove me to a similar missive last year, the government is seeking to write *ex post facto* rules. It's entirely possible that if during the dark days of the bailout the government told banks, "we get half your profits for the next two years," the banks would have signed the deal. No one asked. The deal was the deal. There is no crying in baseball.

- What exactly do they expect the banks to do with the money they earned in 2009? Well, there are really four choices. 1) Give it to the government as a thank you tip. Their shareholders would sue their brains out and win (and the government would probably just hand it to Louisiana and Nebraska anyway). 2) Give it to their shareholders through dividends. That is more reasonable, though the shareholders themselves should be the ones to weigh in on this and they seem pretty happy paying large bonuses for talent and reaping high stock prices. As a very similar measure to dividends they could keep it as retained earnings. The banks already have too much cash on hand and are being yelled at for not lending it out (by the way, the lack of lending isn't a problem of not enough cash, it's a problem of not enough projects they're confident in, and the fact that many of these "banks" never did commercial lending to begin with). 3) Give it to charity. Goldman Sachs is already forcing their employees to give 10% away, in a gesture of appeasement sure to generate laughs from the Left at the insufficiency, confusion on the Right, and only Neville Chamberlain's ghost smiling in the middle. Goldman, you run a great firm, but the reason it's called C-H-A-R-I-T-Y is that it is voluntary. Or, finally, of course, 4) Pay it to their employees.

- Another basic flaw is the words "bank" and "banker" are used in slippery ways. "Bank" is sometimes used to mean regulated commercial bank, bailout recipient, financial institution in general or any institution controlling large amounts of capital. The "banks" guilty of causing the bubble need not be the same as the "banks" that were rescued and neither group coincides exactly with the "banks" to be taxed. This flexibility is one of the great strengths of unfair scapegoating.

If you were running the banks you'd pay the normal proportion of revenue to your employees, or perhaps a bit less in a gesture of appeasement as banks are doing now. You know you would. Anyone would. Paying less means hurting both employees and shareholders, in order to deflect criticism from people with no interest in the matter save grandstanding.

With regards to the proposed bank tax and other banking restrictions, please note this does not affect the bonus controversy. There's nothing in the proposed bank tax or restrictions that obviously reduces market-clearing wages in the financial industry. So the government, upset about banker bonuses, is penalizing bank shareholders who will bear the brunt of this tax (not bankers) for these same shareholders not getting paid enough of the 2009 profits, which the shareholders were fine with. If that sentence is confusing, do not worry, you are following as well as the government.

I was against the bailout at the end of 2008 (while admitting that the ridiculous cumulative policy of too-big-to-fail left me scared at the consequences). But, for those who were for it, this is the policy you put in place, and the deal you made. Sorry.[3]

Now let's talk about the narrative that's been sold. We hear readily, from politicians of the President's party, and his media choir, statements like "the bankers who brought us this crisis" as a lead-in to any discussion (sometimes about the weather). As one tiny example consider the *New York Times* editorial of January 13, 2010, with the Leftist dream title of, "Tax Them Both." Early on they throw in the simple line "Let's be clear, the crisis spawned by banks' recklessness has cost the country…" Not the crisis <u>aided</u> by banks' recklessness, but the crisis <u>spawned</u> by banks' recklessness, no hint of caveat or nuance. The rest of us were just babes in the woods doing green jobs and singing Disney songs while birds danced on our shoulders, but the bad bank-witch made us eat her poisoned apples. This is one example but if you dare/bet me to come up with 10,000 more, I will win.

Say something stupid and hurtful, but simple and with a compelling villain, long enough and I guess it becomes our society's version of truth (again, the "narrative"). Bankers (and by this I mean Wall Street in general) are certainly guilty of acting irresponsibly and aiding and abetting the bubble, but assigning them sole blame is ridiculous. This is an Agatha Christie novel where everyone is the murderer.

Government encouraged wild lending, virtually creating the sub-prime market, and up until the end our representitives swore the GSE's were all ok (the fact that the President is flanked by Barney Frank while discussing how to 'get' the terrible bankers should alone make you turn the dial and watch cartoons). Government land use restrictions added more than a little oomph to real estate prices, particularly in areas where the bubble grew largest. In addition, government kept money easy (rates low) to grease the bubble's wheels. Note, mixing metaphors is allowed when appalled in Greenwich. In New Canaan it's frowned upon.

Individuals and non-bank companies played their major parts as well, buying and building too many houses, with too little equity contribution. People spent too much on everything, not just houses, and companies cheerfully fed the demand by extending unlimited credit, with the Federal Government the ultimate backstop

[3] By-the-way, I'm not a banker. I'm an asset manager. So we are not talking about my money (yet).

lender (and a very willing one at that). Every sector of the economy, every region of the country, every demographic group except perhaps the Amish was overleveraged (buggies have a very onerous haircut when on repo). No doubt there are plenty of innocent individuals, but it's hard to point to any coherent group of them.

Banks, and Wall Street in general, certainly failed to recognize the risks in time. Or they recognized them but couldn't see how to avoid them as bubbles that do not burst for long periods put skeptics out of business – it is harder to do this real time than many politicians and editorialists think. In rare cases some of the lending may have been fraudulent, but the idea that most of the real estate bubble was the result of predatory lending is a complete fiction. The "victims" were happily getting rich without working, until the music stopped.

But the above, a world gone mad and all of us sharing blame, is not the "narrative." The narrative is Wall Street gravely injured us all, to their sole shame, so now let's get them! Why? Well, politicians certainly aren't going to blame themselves. They aren't going to blame individuals who, what's that thing individuals do again, yeah, they vote. The press, certainly this press, with this government, mainly repeats the party line, sometimes with their legs tingling. So, who should they blame? Well, what better than casting sole blame on the evil bankers? Who likes a banker? I'm not sure I do and many are my friends. I'm not sure their wives or husbands like them. But that doesn't make them guiltier than others. Every financial crisis, for at least our country's history and probably way longer, has been blamed on bankers and speculators, and generally this has been one-sided, exclusionary of the many real culprits, and often dead wrong. The narrative once established is a powerful thing to fight, but fight it we must, as it's simply not true. Bankers deserve their share of castigation, but no more than their share, and that inconvenient truth makes things a lot more complicated.

Another thing to note is that this is now called a financial or banking crisis. This is true without being right (which is a difference with a distinction). Our current economic pain, the high unemployment, the disappointing economic growth, has deep and varied roots. For years, some things were unsustainably high and growing: housing prices, the trade deficit, consumer debt and more recently government debt; while other things were unsustainably low and falling: credit spreads, inflation rates and savings. While people differ on which were the causes and which were the effects, and who was to blame, few believed things could have continued indefinitely (while again, calling the top a very dangerous game to hold the bankers to getting precisely right). Some dramatic change was inevitable, and it was equally inevitable that it would be painful. Perhaps wiser and less greedy bankers would have given us an earlier and gentler wake-up call, but the same is true of wiser and less greedy politicians, central-bankers, non-financial companies and individuals, many of them with more latitude to step off the gas than bankers with shareholders. The economy crashed, not just the banks. It was caused by the entire economy, not just the banks. It's the economy that has to be fixed, not just the banks.

Although the stated reason for punishing banks is the false accusation that they wrecked the economy all on their lonesome, much of the populist resonance of this libel springs from the inconsistent argument that bankers are socially useless parasites skimming money from real transactions. This doublethink is very old. The belief is moneylenders and speculators are powerful enough to cause all our economic problems, but not useful enough to deserve a share of our economic successes. Where this power without usefulness derives from is never clear. In fact, highly skilled bankers (in the broad sense, including lenders, traders, asset managers and deal makers) are essential to an efficient modern economy and some of them will therefore earn very large amounts of money. What they create is as real as a shoemaker, as a modern economy would produce a lot less shoes if instead of banking we relied on something closer to the barter system. If you penalize these services, or legislate away the freedom to innovate and to get rich by doing them better than anyone else, you destroy both a fundamental economic freedom and a key component of economic growth.

With all that said, it's still important to fix the banks. Ignoring the obvious pogrom-like timing of his ire, the President has a point. You can't have a too-big-to-fail policy and not have much tighter rules on the banks and similar institutions (none of this explains the proposed bank tax which is purely grandstanding for the mob). Nobody, including me, likes to see banks profiting on their gains and socializing their losses. I dearly wish the government, if they had to do a bailout, had struck a better deal (the difference is I won't coercively force my preferences after the fact). So, what do we do going forward? Add a ba-jillion (remember, I'm a quant) new rules and restrictions, and have the bureaucrats run the country like they run Congress? Or fix too-big-to-fail itself?

Well I think the answer is obvious. If you fix too-big-to-fail you fix almost everything. You need light regulation as fraud is still illegal and banks bear their own downsides. Risk is run much tighter by financial institutions who know that nobody has their backs. All is well and we can keep on rockin-in-the-free-market (can one legally paraphrase Neil Young while supporting Capitalism?).

So, how do you fix too-big-to-fail? Well, this is complicated, give me a moment. I got it. <u>You let them fail</u>. There's a famous episode of *Happy Days* (ok, by "famous" I mean I remember it) where Ritchie needs help against a bully. The Fonz (yeah, I went there) advises him to bluff, act like a maniac and the bully will back off. Ritchie does this and turns to the Fonz, with his back to the bully, and asks, "is it working?" The Fonz says no and Ritchie asks why? "Well", the Fonz explains, "it turns out that for this to work, some time in your life you have to have actually hit someone." Ritchie responds with those immortal words, "that's a very important detail to have left out, Fonz!" Well our government repeatedly blinking and bailing out those who should have been allowed to fail (including the whole economy which occasionally should've been allowed to suffer more without a "Greenspan Put") was a very important detail to have left out![4]

I admit perhaps by fall/winter of 2008 this was a matter of brinksmanship, and while I would've opted for no bailout (I think Capitalism is very robust), it was scary. But it never should have come to that. From Continental Illinois to Chrysler to LTCM (not technically a bailout but still a confirmation government would ride to the rescue) to the "Greenspan Put" for 20 years, we built up the doctrine of too-big-to-fail until it became a monster. But it can be tamed. How? Well, you start planning for failure, how the piping and legal structure of the system would work for major failures (some are calling these living wills for companies), and you start letting people fail. Capitalism is a beautiful system and free markets work. But failure, no matter how big, is as important as success if not more.

Just a few more things. Let's talk about hindsight bias. That's where everyone thinks they knew something was going to happen after the fact, when few really knew it back then. Bias is the geeky way of saying "hindsight is 20-20." Right now we all find it incredibly obvious that circa 2006 or 2007 a giant real-estate and credit bubble was about to kill us all. Certainly that was discussed by many at the time. Certainly it turned out to be true. But to call it obvious, particularly the timing and magnitude, which is much harder to get right than the existence, is insane (even I say above that it was obvious something bad was coming – but how big was not obvious even well into the crisis). If obvious why did the Fed, possibly soon to be granted more oversight power, not see it and scream a warning? If obvious why didn't we all see it and act on it? If obvious why did Barney Frank famously decide to "roll the dice" a little more with his GSEs (see, I don't even blame Barney). We should have known better, I don't dispute that, but it wasn't as obvious as we all think now. Why is this important? Because the less obvious it was, the less villainously incompetent all players involved were, including Barney and the bankers (a good band name). But that just ruins the "narrative" doesn't it? You can't get a good mob attack off the ground with that kind of even-handed reasoning.

We commonly hear that this crisis was a failure of regulation, but we rarely hear what exact regulation would have saved us, particularly from the real estate bubble that was most of the problem (most real-estate rules that changed in the last few decades were towards Left-leaning rules that exacerbated this bubble). Anyway, I don't argue all regulation is bad, or that we couldn't improve it, but I do argue that doing away with too-big-to-fail is way more important than tinkering with regulation, and in fact renders much of the tinkering moot. Also I'd note that the fixed income markets are far more regulated than the equity markets, which did not fail us this time or in their own meltdown in 2000. Better regulation might

---

[4] Barney Frank got this one right, paraphrasing him, "markets will never believe us until we let a big company die." Yes, in my example, Barney is the Fonz.

be part of the solution, but bad regulation was not the main cause of the crisis and good regulation cannot do much if we retain too-big-to-fail.

We hear a ton about bankers' bonuses. In no way did the large bonuses, or "asymmetric risk and reward" of bonuses, cause the real estate bubble, still the major cause of our pain. And curing too-big-to-fail also cures this bonus problem as if the banks pay out too much and don't have enough left for safety, they are gone along with all their equity. When failure is an option because the government provides a safety net, discipline about bonuses as well as risk goes out the window. Finally, the precedent of the government having any say in what private companies, with shareholder approval, pay their people is chilling to anyone with even the remotest understanding of limited government.[5]

Derivatives also didn't cause the real estate bubble. They probably caused the failures of some banks and insurance companies who made bad bets on the bubble (particularly when used by companies like AIG not to shift their bets but simply to make a much more massive leveraged bet on real estate). But these banks and insurance companies should have known that they'd be allowed to fail if they turned out to be wrong (if so presumably they would've made smaller bets). Instead they knew the opposite. Again, a false culprit is exaggerated (the math guys did it!), and again ending too-big-to-fail fixes the problem. Some lessons from the crisis seem to be reasonable if not a cure-all, e.g., get more derivatives on clearinghouses, but I doubt we need government fiat to move us in that direction going forward.

OK, I'm done, but for a short recap. The bankers are far from without sin, and there are things in the system that need fixing. But the bankers have largely paid back what they borrowed and should not be penalized versus those who cannot repay, simply because the bankers performed well post bailout (wasn't that the hope and intention?). Bankers didn't cause this crisis any more than individuals did, and probably less than government. But those last two are inconvenient villains. In America we're not supposed to choose our villains by convenience, or how good a simple "narrative" is, but we'll leave that for another day.

We should fix the system going forward but by making it more of a free market not less. Punish failure. Don't institutionalize too-big-to-fail by accepting it and then try to regulate away large failures with telephone books of rules and coercive government interference. Cheer outsized rewards when they are the result of two-sided risk where skin was in the game, but castigate then eliminate outsized rewards when they are the result of one-sided risk where the government foolishly has the wrong end of the deal. Get the government out of social engineering and dictating to private individuals how to live, work, invest,

[5] As an aside, most bankers are not very highly paid. Following the confusion we documented above with the term "banker", we often say "banker" but we mean "trader", "asset manager", or "investment banker". Those doing the banking, taking deposits, lending, etc., are, in general, not raking it in. They do however, oddly, have a new target on their backs put there by the commander-in-chief.

and conduct commerce. Most of all, do not look for simple answers and scapegoats, particularly for political gain, it's disgusting and beneath the dignity we should expect from our leaders.

I would end this again, as in my last similar essay, with "I'm ready for my personalized tax rate now" but given the plethora of suggestions in the offing (bonus taxes, capital taxes, transactions taxes), I'm pretty sure that it's in the works anyway.