Trust, Risk, and Regulation

by

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Times are tough and expected to get tougher. With astonishing quickness the public mind went immediately to the Great Depression, while Washington was still trying to throw cold water on the talk of recession. It isn't that Washington doesn't get it, it's that Washington has been lying about it for years and they are slow to tumble to the fact that the lies aren't sticking any more. I don't know if we are heading into a depression, though that does seem quite possible. By the way, the difference between a recession and a depression is easy to explain, and straightening out the difference is a good place to start this discussion.

I know this is usually the setup line for a stand up joke, but in this case I am being serious. The difference is that in a recession the banks lose money but in a depression everyone loses money. The consequence is that in a recession people worry about their money, they sell stocks and bonds, and the stock market goes down. In a depression people worry about their livelihood and many lose their jobs, while their investments are already in the tank due to the recession that preceded the depression. Since banks and other financial institution employ only a small fraction of the working population, unemployment is not too serious a problem in a recession, but since the depression strikes every employer it results in much higher unemployment.

The great mystery of recessions and depressions is that they happen even though no one wants them. How can it be that events can happen in the world, and even in our own country, that hit with the force of fate even though no one wants them? Why don't we just agree not to have any recessions or depressions? This is a democracy after all. Well, the reason is that we have very imperfect and often distorted view of what is going on around us. Much that is happening is simply invisible to us, and much of the rest is visible, but we refuse to recognize it for what it is. We fool ourselves and we allow ourselves to be fooled for as long as we can. Only when we hear the punch line do we suddenly get smart. Like the naked emperor with only fantasy clothes on, we do not gradually tumble to the reality. It has to grab us and shake us, and then we have a crisis. I think we all recognize that that is how the world works, but we still cannot fully accept it because we don't see why it should be so.

Good Times.

Hard times are the inevitable consequence of good times. Indeed, how serious the crash will be is directly a function of how good and prolonged the good times were. It isn't that prosperity actually causes a crash. The crash comes when some combination of events reveals inconsistencies in the existing state of affairs, and a resulting need for major, wrenching change. How good the good times were does not directly trigger that sequence of events. What it does instead is to guarantee that those inconsistencies, or some other equally grave inconsistencies, will build up, and it guarantees also that we won't see what is going on until it is too late. It is not hard for human beings to accept change and to accommodate it when that seems wise. What is true is that it is hard for human beings to notice when change is needed.

We could not work and live together in this world without a great deal of trust. A shopkeeper has to let his patrons browse through the store on their own. He wouldn't want to supervise them if he could, because he wants them to react freely to the displays, and to experience a sudden need for things that they didn't have any desire for previously. If the patrons are mostly thieves, the owner of the shop will soon be bankrupt, but luckily most of them are pretty honest, and he trusts them. We are conditioned to trust because, on the one hand, we work together in many ways, but we do not know each others' thoughts. We have to trust. Without trust we would all be living a permanent depression. At least by trusting we have some chance of working together successfully. In practice moreover success is the normal state of affairs, and we are rewarded generously for being trusting.

The need to trust is much broader than the need to trust each other. We need to trust our luck in many different ways and all through the day. The shopkeeper, to renew an earlier example, has to trust as he plans his day that customers will arrive in the morning, because if no one is coming he could spend his morning more profitably not opening his shop but doing something else. He doesn't know if anyone will come, but he knows that they usually do, and so he is forced to trust that what usually happens will in fact happen that morning. This is not self deception. If asked, he would acknowledge immediately that he was guessing because he couldn't possibly know whether he would have customers or not, but he is completely comfortable guessing. He does it every morning. He has to guess one way or another. There is no point in agonizing over the

uncertainty of his choice, it wouldn't do any good. He has adopted a policy of how he will decide whether to open his shop, and he will actually act as though the future was certain and the action his policy adopts is always the right one. For obvious reasons, for most persons and under most circumstances the policy will be based on the proposition that what usually happens will happen this time too. Not every policy works that way, or else no one would ever buy a ticket in the Lottery, but it is true of most policies. All of us proceed to make decisions in our lives not on knowledge itself, but on general knowledge filtered through policies, and largely without benefit of specific knowledge. Thankfully, experience teaches that we can be quite successful doing that and in fact we are not inclined to worry about the implications of our ignorance.

There are other contexts as well in which we rely on trust. One of the most important of these is that we have to trust many voices that provide ideas about what policies we should adopt, and that feed signals – which we think of as data – to the ones we do use. We do not trust this information blindly. We test the policies we develop repeated, while we are formulating them and when we have put them into practice. Trust is by no mean folly. Quite the contrary, it is a highly rational compromise with our lack of knowledge about the unknowable. Like other instances of trust, moreover, we are generally rewarded for trusting information that comes to us from other sources, although the quality of the source and of the information are matters that need to be monitored routinely.

Dangerous Times

In comes as no surprise that the trust that serves us so well in good times becomes a major handicap in perilous times, for reasons that are quite easy to explain. In good times we are rewarded for trusting. What we trust in works, and we profit accordingly. I want to focus specifically on financial and business matters here, but life is better in every way in boon times. This implication works not only in general, qualitative terms. How well our trust has served us depends directly on how long the good times lasted and how unflinchingly good they were. The longer and the better, the more liberally we are served and, accordingly, the more attached we become to whatever it is that we trust in. I should qualify this assertion by pointing out that I am assuming that the trust we trusted

in was in fact prudent and well thought out. Foolish trust is not going to be rewarded at any time, but that truth does not qualify my statement in any important way. During good times, those who trust, and more specifically those who trust that the good times would continue, are well served, and this is a factual and prudent trust.

So, logically, the longer and better the run of good times, the more trusting people become. In matters of money and business this trust is evident in two complementary actions. Since borrowers are able to repay their debts, it is prudent to lend and, more to the point, it is prudent to assign higher and higher confidence to their evidence of debt: I.O.U.'s, bond indentures, structured notes, mortgages, and the like. It becomes prudent to treat these instruments as being equivalent to money, or nearly so. Secondly, it is prudent to put cash to work earning equity returns, which for the general public means to put money to work in the stock market. At the end of the day, the balance sheet of the average investor is filled with I.O.U.'s from other people and other businesses and governments, and with common stock. Those positions are prudent because they have worked. Well, let's say they ***seem*** prudent. I will return to this point in a moment. It is prudent to trust.

> ***At the point in time that I am describing one fact stands out with frightening clarity: nothing further could go right, and almost everything could go terribly wrong. Trust has banished risk. Not actual risk, but perceived risk. But it is important – it is crucial – to recognize that at that moment there is no risk. Take an opinion poll; we all agree that there is no risk. Not because we are stupid. No, because we are capable adults who learn from experience.***

It isn't exactly true that the public think there is no risk. Almost everyone has experienced some bad times at some point, and that memory does not go away. It remains, fortunately, to urge a kind of caution, but it is not really very helpful. It is a very blunt instrument because even for those who know that there are risks out there, nothing in their recent experience helps them to identify the nature of the risk or the signals that danger is near, while in a world of economic and financial innovation, more distant

experience has questionable relevance. There is no way to project where hazards lurk or to quantify their possible magnitude without data, but in good times the only thing that is not for sale is data on financial risk.

The Crash

The crash propels two parallel events: the real wealth of the public and of businesses and financial institutions is slashed, and the money in circulation evaporates. These events are obviously linked, because money is a form of wealth, but they are distinct in terms of risk. In a bear market, real wealth shrinks regrettably, but there is not necessarily a crash, because it is the highest risk assets that suffer losses. No one is happy about it, but at the same time no one is surprised either. When on the other hand it is money itself that disappears, this diminishes not only wealth, but takes away the lowest risk assert on the national balance sheet.

Where does the money go? Well, it was a fantasy all along. The story of money creation through credit is easy to understand. Let's say Mr. A has $10,000 which he does not need immediately, so he lends it to Mr. B. B writes a promissory note to A, takes the cash, and goes on vacation. Since times are good and B is an old friend, A is sure he will be repaid. The note is worth $10,000 to him, so the moment the loan is done both men have $10,000 to spend. $10,000 has expanded to $20,000 by the simple expedient of credit. Now, if B's ability to honor his note starts to be questioned, the note is not worth its face value. It falls to $5,000, or $1,000. However much its value has fallen, that amount of the money supply has disappeared, and Mr. A needs to raise cash to replace it. The central dynamic is that when B's credit comes into question, the "money" that he issued with his promissory note starts to evaporate like the morning dew. His creditors are disappointed but not shocked. This has happened before. But they need to raise cash to restore the low risk part of their wealth.

Raising cash seems on the face of it to be quite easy. Sell some valuable assets, like stocks, bonds, or real estate. Focusing on the stock market for the moment, Mr. A is not worried because he has E-trade, and so his problem can be solved in an instant. Except… Yes, except that his fellow shareholders have no cash. They all plunged into the stock market, just as he did. Who is he going to sell his shares to? If A is the only citizen

who needs cash, there will surely be enough of it laying around to make this problem go away, but if a lot of citizens are in the same predicament at the same time, everyone begins to feel the pinch: too many shares of stock and too little cash to cover them. The crisis is heightened immensely by the fact that Mr. A really wants to hold onto the cash he raises. Under normal circumstances, when someone sells shares he has the proceeds available to invest in something else. He was just selling as a tactical decision. But in the crisis, the cash is a precious commodity in its own right; it is precisely what the public wanted to have more of. So here we have it: ***because*** the outstanding quantity of money in circulation has fallen, the amount of money the public wants to have has expanded!

In the early stages of the crisis, Wall Street broker-dealers are able to finance the purchases of shares by the public. They have deep resources of cash available to float the positions they are taking on from the public, and so now it becomes a matter of the numbers. How much stock does the public want to sell and how much can the dealers afford to pay for it? The situation is however precarious because as the stock market begins to retreat there is added selling by persons who suddenly discover a powerful desire to turn stocks into cash. The retreat – the Crash – feeds on itself.

Why do Crashes Happen?

Can a crash happen for no objective reason? It is obvious of course that if at the start of these events the public had become aware that events out of their control had destroyed a part of the wealth of the community, it is only logical that a crash would result. Earthquakes and tornadoes, floods, invasions of locusts and invasions of aggressive, foul-smelling barbarians, and many other verifiable historical events all have the capacity to cause a crash. That does not answer the question however. Can a crash strike without an objective cause? Can the public suddenly, and for no visible reason, begin to question the future, and question to validity of all the promises other have made them to repay debts in full? That is, to apply an old cliché to it, the sixty-four dollar question.

One part of this question can be answered right at the start. Although the Crash has wiped out vast amounts of financial wealth in the stock market, there did not need to be event that actually damaged the actual businesses that the shareholders own. The

public didn't sell shares because they questioned the capabilities of the management. They didn't even stop to ask about the management; they just wanted the cash. The clear logic of that point can be turned around to apply to the future too. Since the crash is not necessarily a statement about the companies with stocks on the stock market, it is not logically necessary for them to actually suffer any loss of real value. In 1987 the stock market crashed with a suddenness that left everyone gasping, and that left several broker-dealers facing bankruptcy. Yet within a few months the whole ugly affair was a thing of the past, stocks rebounded, and all was well until the mortgage lending disaster of that time descended on the public a few years later. The stock market can crash for no reason.[1]

What Role for Regulators?

This brings us to the bête noir of liberals: the lack of regulations governing the securities business. We can all agree that if there is out there a cohort of clairvoyant angels willing to serve as regulators, we should hire them immediately. Perfect foresight is always a much cherished talent, though a rare one.

On the assumption that the ranks of regulators of financial institutions will actually be drawn from the merely mortal, we may have to take a second look at what they can provide in the way of help. As we think this through, one fact becomes immediately evident: regulators have to make whatever contribution they are going to make during the good times, and in fact they will make it during the very best of the good times. That is the only time when they can help anyone avoid painful losses. At any other time they can at best help to assign blame and wag their fingers at the miscreants. The money is already gone and the pain is firmly established. So this narrows the question: what can regulators accomplish when times are good?

Now we have stumbled on a very deep paradox. When times are good and everyone is making money the old fashioned way – by trusting to the unknowable future – the life of an intrusive regulator is not a pleasant one. Not only is he treated as out-of-

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[1] This is an over-simplification. It has emerged recently that the U.S. was undergoing a very mild recession at that time, though not one that would lead to a crash of the size that was experienced. The main culprit in the 1987 crash was the computer systems that were being put in place, whose goal was to facilitate electronic trading. The crash was caused – in the sense that a selloff was turned into a crash – by failures of the new systems.

touch, and possibly delusional – misanthrope, he has very limited ability to defend his role. Let him try to prove that there is risk. Well, everyone will agree as a general truism that there is risk, but that will not help him to justify his role. He has to demonstrate that this or that policy is risky – indeed, highly risky – and that is very hard to do. Every day that has passed gave evidence either of risk or of opportunity. It is impossible to extract signals of both risk and return from any single event. If the outcome was bad, we know that either the policy was risky or that it was foolish. Similarly, if the results were good, either its risk was very low or it was very opportunistic. Since moreover we are by assumption viewing history from somewhere in the middle of good times, most days will have been showered with good results.

The regulator will strain against this paradox, but in the end it forces him to try to extract information from events that didn't actually happen, and to convince the regulated that they should look beyond the evidence of their own senses, to give due credit to the dangers he perceives. In the financial world, risk management – which is the role of a regulator – means attaching values to actions, the values being scaled in terms of potential losses or the likelihood of a loss, or some similar quantity. It is possible in principle to use the F.B.I. as the regulator, or in other ways to empower regulators who do not even claim any particular insight but who simply wield the power to command and to threaten. That approach will however never work. If the regulator cannot justify his rules by reference to the real world and the real experience of financial markets, he will simply be viewed as the enemy: the enemy of profits. That sort of regulator will wear out his welcome very fast and will end up as a complete irrelevance. Among other things, the regulated will quickly find that the doors of members of Congress are always open to them, and they will be quick to use their good offices to undermine the authority of the regulators.

Regulators bring lobbyists as surely as night brings the dawn. If we were to liken an industry to an animal and similarly liken regulators forced on them by Washington as a kind of disease, then lobbyists are the white blood cells and other instruments of immune defense which are fielded by the creature in order to neutralize the invaders. You and I might find that metaphor a bit hostile, but it is nonetheless true. If the regulator therefore cannot point to a firm basis for his decisions, a basis in actual experience and

research, he will not be effective for very long. It will be an easy matter for the industry's natural defenses to sideline him.

There is one kind of behavioral rule that does work and that always has sufficient support even in the industry, and that is reserve requirements. They apply in many different circumstances but they always have the same form: "If you – the bank, the investor, the whoever – take this action, you must set aside this sum of money in a safe place in order to cover any losses you might incur." Reserves are galling to the more aggressive players in any industry because they diminish the pool of capital that could be out working for the high returns that aggressive investing promise. Even the most aggressive however are generally wise enough to accept that reserves are prudent and necessary, even if they eat into profits in the short run. Requiring reserves of capital is credible because it has worked to enable firms to survive large losses, and it has worked in many different environments and for a long time. It has the further advantage of being very simple. The regulated will not fight reserve requirements because they know few disinterested parties – even members of the Congress – will side with them.

It is not enough however to impose reserve requirements, and this is where there is a role not only for regulation, but for supervision. The regulated will sometimes not protest against having to reserve against risky positions, if they think that they can use lottery tickets as reserve assets. In other words, if they have discretion over what is counted as reserves, they can make the requirement effectively an empty fiction. There have to be regulations about what can be counted as a reserve asset, and there have to be audits to verify that the regulations are actually being enforced.

Reserves are a way of ensuring that some firms or most firms that suffer reverses still have enough capital to survive and to do business for another day. They are not a way to guarantee that all firms will survive. Reserve requirements do turn large, systemic problems in which most firms fail into smaller, individual problems in which a few firms fail. The difference is not just quantitative, it is qualitative. If most firms will fail, it is the industry itself that fails. It is highly likely that Washington will perceive a problem of "too big to fail:" of too big a failure to let pass. They will respond by trying to resuscitate the wounded and in so doing undermine the logic of free enterprise. If however it is only a few firms that fail, it is not a national crisis and they can be allowed to go under.

We shall always have crashes, and indeed it could fairly be said that it would be a very distorted world that was free from them. They take a lot of casualties, but the number of casualties can be regulated to a large extent by requiring those who take investment and credit risk to cover themselves partially with safe reserves.

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