Stanford Law School
Rock Center for Corporate Governance

The Big Put:
The Pervasive Nature of
Governmental Insurance and
Implications for Financial Markets

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The First Law of Finance

If you owe your bank $10 million,
you have a problem.

If you owe your bank $10 billion,
your bank has a problem.

Genesis 1:1

Puts are Ubiquitous

- Physical property
    - Property in flood plains
    - Property along shorelines
    - Property in fire zones
    - Property in seismic zones (Stanford)
- Businesses
    - Chrysler (the government took equity and profited)
    - Airlines after 9/11

- Political jurisdictions
    - New York City

- International Interventions
    - Mexico
    - Thailand, Indonesia, Korea

- Social safety net
    - Medicare
    - Social Security
    - Unemployment insurance

- Each of these puts, express or implied, generates moral hazard, and each is off-balance sheet to the government.

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Why are Puts Ubiquitous?

- There is no budget hit for providing under-priced insurance to politically influential constituencies.

- These programs are often rationalized as supporting socially valuable objectives: housing formation, international economic stability, community preservation, health care, etc.

- The moral hazard risk is remote and amorphous. The benefit of the intervention is real and immediate.   Beneficiaries are identifiable and exert political influence. Losses are shared by anonymous taxpayers in the future. Freddie and Fannie are current, excellent examples of the phenomenon.

- The fig leaf of insurance pricing: The government charges for insurance, but the rates are generally below-market and thus constitute a subsidy.

- The limits of regulation: Regulations imposed in connection with the insurance are often inefficient and generate various forms of arbitrage. Basel Accords as an example?

- Is this the politically perfect form of pork?

The Demand for Moral Hazard

- A perfectly implemented, market-priced, governmentally supported insurance program does not provide off-budget subsidies to key constituencies.

- Any such system is therefore of minimal political value.

- The demand for governmental insurance, or the necessity of a governmental backstop, even if not in the form of insurance, therefore translates into demand for moral hazard.

- Thesis: Moral hazard, like the poor, will therefore always be with us. The best we can do is to learn to control moral hazard intelligently, and modulate its impact.

Getting Smart About Moral Hazard in Financial Markets

- The goal is to optimize the form and incidence of moral hazard, not to eliminate it, because moral hazard can't be eliminated as a pragmatic matter.

- Placing equity and debt providers at risk of total loss in the event of insolvency is a necessary but insufficient condition for addressing moral hazard.

  - The limited liability inherent in the corporate form combined with express or implied governmental insurance means that moral hazard is likely to exist even if capital is wiped out in the event of failure.

  - Simple example: A project with a binary outcome where the adverse result bankrupts the entity and leaves a large deficit to be absorbed by the government, even after wiping out the equity and debt-holders.

- More substantive controls, as exist in private insurance markets, are therefore necessary. But they are very, very, difficult to design and implement in the financial markets.

  - Basel Accords as an example.

  - Unstable probability distributions: Historical loss ratios may be unrelated to the efficient insurance premium. The current housing crisis may be an example.

  - Combine the pragmatic difficulties encountered even by the most objective observer with the political incentives that arise in the real world.

  - The risk that innovation will be stifled or taxed at an unreasonable rate.

The Credibility of Commitments

- Rules or Standards? A classic debate in literature and in the law.
- Neoclassical law and economic analysis presumes that rules are firm because if they are flexible they become subject to interpretation and become standards. Given this assumption, the traditional conclusion is that "Rules typically are more costly than standards to create, whereas standards tend to be more costly for individuals to interpret when deciding how to act and for an adjudicator to apply to past conduct. [Thus], when individuals can determine the application of rules to their contemplated acts more cheaply, conduct is more likely to reflect the content of previously promulgated rules than of standards that will be given content only after individuals act." Kaplow, Rules v. Standards, An Economic Analysis, 42 Duke L.J. 557 (1992).
- Rules are thus preferred when pre-commitment is necessary, precision is possible, and the cost of delay or adjudication are high.
- But these conclusions depend critically on the assumption that the rules are firm, can be clearly interpreted, and will be applied as written, not subject to re-negotiation.
- Odysseus tied himself to the mast so as not to be seduced by the siren's song. Example of a rule with a binding pre-commitment.
- Can Federal regulators be relied upon to tie themselves to the mast when facing the siren song of relief in the face of a financial melt-down?

Time Consistency

- Classic 1977 flood plain example by Kydland and Prescott.

- "Time inconsistent" policies provide short-term benefits but generate greater long-term costs.

- "Time consistent" policies harmonize short and long-run objectives.

- Rules promote time-consistent policies because they promote credibility.

- Need for exceptions related to unforeseen circumstances.

- What if the rules are wrong?

- How do rules change over time?
  - Constitutional rules
  - Statutory rules
  - Regulatory rules

- Inter-generational issues.

Credibility and Monetary Policy

- Expectations are the engine that drives inflation, and credibility is a driving force in forming expectations.

- In the 1930's, Henry Simons observed that monetary rules reduce price uncertainty.

- Friedman extends the argument by emphasizing the danger of mis-informed or opportunistic intervention.

- Brennan and Buchanan emphasize the political dangers of standards-based approaches.

- The Taylor Rule as a contemporary example of a rules-based approach to monetary policy.

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Political Black Holes and Commitment Credibility

- In physics, the "event window" is the defining feature of a black hole. It is the surface in space-time that marks the point of no return; the point beyond which not even light can escape because of the power of the black hole's gravitational field.

- In politics, the black hole is defined by the event window from which the politician's reputation never escapes. The politician's job is to keep his or her reputation away from political event windows.

- Thesis: The political system's ability to make a credible pre-commitment is limited by the size and location of future political event windows, which are temporally unstable, strongly susceptible to changes in the political environment, and therefore unpredictable.

- Bottom line: Every formal rule is subject to renegotiation in the neighborhood of a political event horizon; Circe isn't always around to warn Odysseus that it's time to get lashed to the mast; a not every Odysseus is willing to heed Circe's warning; and not every Circe is always correct.

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Bear Stearns

- Excellent example of the evolution of moral hazard and of the difficulties of making binding commitments in the neighborhood of a political black hole.

- Not a bailout as much as a shotgun wedding with a complicated dowry backstopped by the federal government.

- No one knows for certain what would have happened had the government not stepped in, but the authorities determined that they did not want to run the experiment. The perceived political black hole risk was too high.

- The presumption now is that any institution similar to Bear that finds itself in a similar situation will treated similarly: counterparties will be protected though capital providers may take large losses.

- The extension of this implied guarantee reduces the probability that other institutions will find themselves in Bear's position but also increases the moral hazard risk that pervades the system, especially in the absence of the additional monitoring that is rational if such insurance is extended, implicitly or expressly.