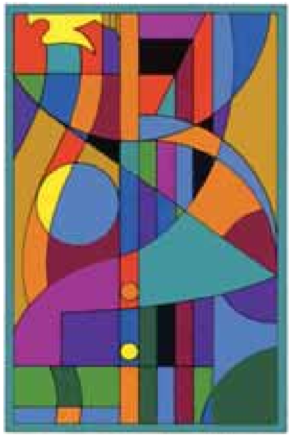

The Monetary Realist

The Four Horsemen of Subprime Stupidity

By Adam S. Posen

Given the sums of money involved, it is no wonder that financial companies would like us to believe that their businesses are complex and special. Real rocket scientists perform mathematical prestidigitation on trading floors where transactions unfold in split seconds. Smart policy economists have gotten caught up in concerns about the opacity of pricing their distressed products, and educating the public about the difference between mere risk and "Knightian uncertainty."

Yet the business mistakes of the major banks and investment houses in recent months really have little to do with the complexities of their products. Just as high-tech firms' relative fortunes depend less upon the intricacies of airframe assembly and genetic engineering than upon strategic, marketing, and production decisions, the fault here is with basic management failures. And public policy should not be guided astray into excessive restraint in dispensing haircuts or in punishing fraud as a result of distraction by financial complexity.

Forget the arguments about financial complexity. The fault here is with basic management failures.

The major financial intermediaries in trouble all made some combination of four bad basic strategic calls. First, they blew their inventory management. There is a high correlation between the degree of trouble in which these firms find themselves, and the extent to which they kept on their books securitized assets in hopes of capital gains rather than selling them off. This kind of warehousing—practiced egregiously by Freddie Mac and Fannie Mae in direct exploitation of their implicit government guarantees—is no different than that of the grain broker or Beanie Babies distributor who gambles that the future price of their products will be higher than the price currently available in the markets.

So the banks got caught short when that wager fell through and they did not rely solely on income from fees and markups on repackaging their inputs. Whatever the perceived difficulties of pricing their products, supervisory measures to force institutions with deposit guarantees and discount window access to provision for assets on their balance sheets are not rocket science. They just have to be enforced.

The key is not to allow this to be turned into a brief against securitization. Current proposals to force intermediaries to retain some capital stake in their products when sold go exactly the wrong way. The point is to force these firms (and especially the agencies) to be intermediaries warehousing as little of their inventory as possible, getting securities off of their balance sheets as quickly as possible.

The second major error was offering specialized products too tailored for specific customers. Every relationship business has to decide how much to specialize for clients versus how much to offer off-the-shelf; there is nothing special about financial services having to make this call either. On the popular MTV show "Pimp My Ride," if the

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garage tricks out an NBA star's ride to create a lime-green convertible Hummer with a rotating basketball on the hood and a Fresca dispenser in the back seat, and the prospective purchaser gets cut from the team before delivery, no one at the garage expects to be able to sell that car to someone else. The value is zero plus any spare parts upon disassembly.

The same is true for financial firms if they sell a derivative on weekly volatility of acid rainfall on soybeans longer than three centimeters in western Kansas—if Archer Daniels Midland decides not to buy it, the value is zero or something pretty close. So these financial firms just have to grow up and realize that they made a marketing mistake by tailoring products too narrowly, and they have to return to some greater mass production or at least products with more than one potential purchaser.

The regulators should be making these banks write down the products quickly at zero value, and then do the necessary recapitalization (plenty of foreign investors are available, as the United States told the Japanese in the 1990s). One cannot simultaneously express fear of a fire sale and state that there is illiquidity because these products have only one or two buyers. If there's no substitutability, then there should be little price effect on more broadly marketable products by writing off these distressed assets.

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Third, the banks and mortgage lenders did not live up to reasonable consumer standards in the products they sold to retail investors and borrowers. This has been well-documented and remarked upon, as well as demagogued, so there is no point in belaboring it. But what this means is that borrowers should get rewritten mortgage contracts when what they were sold had a fraudulent design—the approach proposed by Congressman Barney Frank (D-MA)—that is based on the type of product sold, and not on the basis of ability to repay or of potential losses to the lenders (we have limited and direct safety nets for both of those types of distress). That criterion would also direct losses to the appropriate target of moral hazard concern: exploitative behavior.

Finally, the financial firms underestimated the reputational spillovers that tied them to their products. This was most clear with the structured investment vehicles and other "off-balance-sheet" vehicles with which they thought that they could maintain credit ties and brand identification, somehow without incurring reputational damage when they got into trouble. On this, it again goes to basic business strategy—does BMW or Porsche contract out its name to a scooter maker to leverage its brand into new markets, and then really expect the scooter purchasers not to show up at their dealers for refunds and lawsuits if the wheels fall off? Luckily, this is one place where the market lesson and regulatory discipline seem to have it right, and the banks are taking these back on to their balance sheets.

Yes, the functioning of financial markets and particularly the core banking system do have special meaning for public policy. That uniqueness does not stem from the complexity of their products, however, but from the dependence of other activities in the economy upon their practices.

All the more reason for regulators and central bankers to look beyond the supposed complexity of pricing products to the real sources of financial turmoil, calmly enforce write-downs, defend securitization, and go after fraud directly. ◆