

# Incentive roots of the securitisation crisis and its early mismanagement

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The disastrous meltdown of structured securitisation represents a dual failure of market discipline and government supervision. At every stage of the securitisation process, incentive conflicts tempted private and government supervisors to short-cut and outsource duties of due diligence that they owed not only to one another, but to customers, investors, and taxpayers.

When commissions and other fees for service are paid upfront, managers and line employees of firms that originate, securitise, rate, or insure loans fear that they are passing up short-run income whenever they nix a questionable deal. At the same time, accountants, appraisers, and even government supervisors know that they can win business from competing enterprises in the short run by establishing a reputation for not challenging a troubled client's dodgy representations about asset values or assessing its efforts to transfer risks off balance sheet as conscientiously as a third party might suppose.

**...to reduce the threat of future crises, the critical task is not to reform the architecture of financial regulation, but to repair defects in the incentive structure under which private and government supervisors manage a nation's financial safety net.**

For government supervisors, incentive conflicts trace principally to short horizons, clientele influence, and pressure to support the expansion of homeownership for low-income households. As credit spreads increased in 2007-08, these incentive conflicts led authorities to temporise by adopting policies that risked allowing the depth and duration of the crisis to increase. Ignoring the lessons of the Savings and Loan (S&L) Mess, Federal Reserve press releases (e.g., that of March 16, 2009) and

speeches by Chairman Bernanke and New York Federal Reserve President Geithner repeatedly misframed the difficulties that highly leveraged and short-funded institutions faced in rolling over their debt as evidencing a shortfall in aggregate market liquidity rather than volatile and widespread concerns about the individual solvency of troubled institutions. The following passage typifies the way Fed officials interpreted the crisis before September 2008:

*"In this environment, banks have faced several different types of liquidity and funding challenges. They have been called on to fund a range of different contingent liquidity and credit commitments, as is typically the case in crises. The substantial impairment of securitisation and syndication markets has been an additional challenge because it has reduced banks' access to liquidity and their capacity to move assets off balance sheets. As the market value of many securities has declined, and investors have reduced their willingness to finance more risky assets, liquidity conditions have eroded further. In response, even the strongest institutions have become much more cautious, building up large cushions of liquidity, bringing down leverage and reducing financing for their leveraged counterparties." (Geithner 2008)*

This paper attributes the ongoing financial crisis instead to economic and political difficulties of monitoring and controlling the production and distribution of safety-net subsidies. Crisis pressures will not relent until access to safety-net subsidies has been capped and managers and authorities acting together find a way to quell doubts about the future viability of institutions known to be struggling with outsized losses. This can be done in the short run by temporarily nationalising zombie firms and by producing and publicising convincing forensic evidence that their insolvency has been repaired.

The paper goes on to argue that, to reduce the threat

of future crises, the critical task is not to reform the architecture of financial regulation, but to repair defects in the incentive structure under which private and government supervisors manage a nation's financial safety net. As explained in earlier research (Kane 2001), a country's financial safety net is a multidimensional policy scheme whose mission is to balance the costs and benefits generated by: (1) protecting financial-institution customers from being blindsided by insolvencies; (2) limiting aggressive risk-taking by financial firms; (3) preventing and controlling damage from runs; (4) detecting and resolving insolvent institutions; and (5) allocating across society whatever losses occur when an insolvent institution is closed. Unless the safety net is backed up by solid crisis planning, cumulative extensions of the safety net are apt to result in less frequent but more devastating crises. This is because the more effective a nation's safety net becomes, the less likely it is that regulatory personnel will have prior hands-on experience in coping with the severity of crisis pressures.

### Each generation of regulators and supervisors inherit tools that are tailored to previous crisis experience.

Proposals that would redesign regulatory instruments (such as risk-based capital requirements) or rearrange bureaucratic responsibilities for administering particular elements of the safety (by merging two or three related agencies or expanding the mission of the Federal Reserve) without remedying the incentive conflicts that reward the mismanagement of safety-net resources will postpone rather than promote genuine reform. Genuine reform entails making financial-institution managers and federal regulators jointly responsible for conscientiously estimating and controlling in a timely manner the safety-net consequences of emerging financial contracts and institutional forms.

### Financial crises and bubbles

Financial crises and bubbles are inevitable. Every country's financial sector passes through successive three-stage sequences of: (1) precrisis bubbles in the price of important assets, (2) a period of actual crisis, and (3) a postcrisis interval of healthy economic recovery. Although crises make themselves known immediately, no one can say precisely when a healthy recovery degenerates into a bubble. Moreover, authorities must expect parties that benefit from sustaining an emerging bubble to resist supervisory attempts to label such transitions honestly.

It is important to recognise the nature and extent of industry and governmental disinformation and to understand how disinformation prolongs the course of bubbles and crises. Bubbles and crises arise dialectically. During a bubble, regulated institutions routinely enlarge their access to implicit safety-net subsidies by devising innovative instruments that serve in part to increase information asymmetries between risk-takers and whatever private and governmental parties are charged with monitoring their risk-taking.

Each generation of regulators and supervisors inherit tools that are tailored to previous crisis experience. Part of the work of what we might call a "bubble-blower" is to undercut the ability of these tools to control safety-net subsidies. Institutions extract subsidies from the safety net indirectly by expanding their leverage and/or mismatching the duration of their assets and liabilities. The more complicated a firm's loss exposures become, the easier it is for its managers to shift responsibility for absorbing its deepest downside risks onto national safety nets. Under the cover of what are purported to be purely resource-saving innovations, financial institutions can expand both forms of risk-taking in hard-to-observe ways.

The securitisation bubble is best understood as a complicated extension of the simpler government credit-allocation scheme that subsidised builders and homeowners during the bubble stage of the Savings and Loan (S&L) mess. Until the bubble burst in 1989, implicit subsidies were routed to favoured borrowers through federal deposit insurers and shared with institutions whose deposit liabilities federal agencies explicitly insured.

Lenders have been willing to shade the interest rates they charged on housing loans because they presumed that the safety-net costs generated by these loans would be supervised with a lighter hand than they deserved and that, in times of banking turmoil, authorities would expand a troubled institution's access to implicit and explicit federal loans and guarantees. In line with the second presumption, when the S&L bubble burst, the obligations of the insolvent S&L deposit insurer (the Federal Savings and Loan Insurance Corporation) were sustained by a massive injection of funds from hapless taxpayers.

### To lessen the costs generated by regulation-induced innovations, authorities must continually adapt their surveillance systems to observe the safety-net implications of new financial instruments...

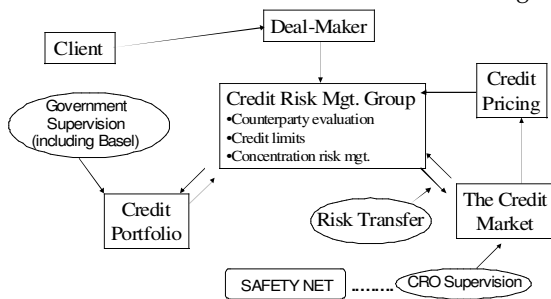
To contrast the securitisation bubble with the S&L mess, we must introduce the subsidy-induced participation of important new players into the activities of the housing-finance sector. Poorly capitalised, state-chartered nonbank mortgage brokers stepped in to help originate loans, especially to low-income households targeted by the post-2004 affordable-housing program. To provide an alternative to insured deposit financing of mortgage loans, a new layer of agents developed between lenders and safety-net managers. It is convenient to call these mediating agents "financial engineers." They claimed that by their joint intervention they could accomplish the quasi-magical task of turning extremely risky mortgage loans to under-resourced households into riskless securities. These would-be financial alchemists (accountants, appraisers, investment banks, derivatives dealers, credit raters, statistical model builders, credit insurers, and financial servicers)

co-operated in overstating collateral values and understating institutional leverage and other risks. Finally, government-sponsored enterprises (especially Fannie Mae and Freddie Mac) became the main channel for distributing housing-finance subsidies. However, as the scheme began to unravel, the GSEs were assisted by the Federal Reserve, Federal Home Loan Banks, and the US Treasury.

Exhibit 1 illustrates the incremental deal-making and oversight entailed in the financial-engineering business model. As shown in the lower right-hand portion of the diagram, securitisation introduces a market in which credit exposures can be priced and transferred synthetically. Although the safety-net costs that defective underwriting can generate synthetically are just as worrisome as those produced in traditional forms of deal-making, supervisory authorities allowed profit-making credit-rating organisations (CROs) to oversee the synthetic market. Although the SEC acquired authority to supervise CRO activities in the Credit Rating Agency Reform Act of 2006 (P. Law No. 109-291), that authority focused on registering these companies and overseeing their operations. The language of the Act in no way tasked the SEC with exploring the safety-net consequences that mistakes in CRO certifications might generate.

#### Exhibit 1

Financial Engineering: The Modern Credit-Risk Management Process Uses More Outside Information and Entails Extra Dealmaking



This gap in the structure of governmental oversight of safety-net loss exposures is not accidental. It reflects a series of deeper gaps in society's ability to enforce five ethical duties that a totally selfless regulator would gladly embrace. These duties may be seen to operationalise obligations of competence, loyalty, and care that Kantian logic and common-sense ethics imply that private and governmental regulators and supervisors owe to US taxpayers.

The first of these duties is Vision. To lessen the costs generated by regulation-induced innovations, authorities must continually adapt their surveillance systems to observe the safety-net implications of new financial instruments and evolving networks of intracompany and intercompany connectedness. The second duty is that of Prompt Corrective Action. As envisaged in the FDIC Improvement Act of 1991 (Pub. L. No. 102-242), supervisors must accept responsibility for seeing that loss-making institutions are closed or recapitalised before they can impose large losses onto the safety net.

The third duty is that of Efficient Operation. To manage the size of safety-net expenditures, this duty entails detecting and resolving financial-institution weakness at minimum resource cost. The fourth duty is that of Conscientious Representation. It asks regulatory officials as stewards of the economy to put society's interest coequal or even ahead of their own (particularly in times of stress).

### Moribund firms need either to be sent to a corporate morgue or to be put into conservatorship before the effects of rot and zombieness can set in.

The fifth and most important duty is that of Accountability. As a way of bonding their commitment to fulfil each of the first four duties, internal and external supervisors must make themselves accountable for neglecting or botching them. This requires that authorities explain and document at least the following three points: why they adopt one set of policies rather than another, how they expected these policies to work, and how (if at all) results diverged from their plan.

### Principles of crisis management

Financial crises unfold in two dimensions. The first dimension takes place in the arena of political economy. It centres on identifying losses and continuing loss exposures that troubled financial institutions and their counterparties can unload onto taxpayers. Uncertainties about the ultimate size of these losses and about who will end up having to bear them keep a crisis going. For troubled firms, the idea is to frame the dangers particular losses pose in a manner that makes it seem to be in society's interest not to let the losses reside with parties who volunteered to absorb them when the bubble was expanding.

The second dimension is administrative. Ideally, officials should resolve both uncertainties promptly, decisively, and efficiently. Implementing such a strategy can establish confidence in the judgment and competence of top officials. Adopting and holding to a sensible program can also make it easier to persuade the public that the pattern of loss-shifting chosen is an appropriate one and that the beneficiaries of the program deserve the assistance they have been offered. However, in practice, officials tend to act chaotically.

For crisis managers, the first steps are both the most important and the hardest to execute well (Kane and Klingebiel 2004). A financial crisis resembles a battlefield. The financial arena is littered with wounded firms, all screaming for immediate treatment. The policy problem is how best to contain the further loss of life and limb. Containment begins with sorting firms into three groups: those that are beyond help, those that need virtually no assistance, and those that might be able to survive with a reasonable degree of government intervention.

Supervisory "medics" charged with this task face hostile fire from lobbyists and have limited tools with which

to accomplish the kind of triage that would be most effective. In most countries, even if they could prioritise wounded firms appropriately, safety-net officials lack the administrative vehicles they need to move the wounded where they ought to go. Certifiably healthy institutions should be patted on the back and sent back into the fray. Moribund firms need either to be sent to a corporate morgue or to be put into conservatorship before the effects of rot and zombieness can set in. Provisional survivors should be assigned to a watch list administered by a deposit-insurer's resolution division whose staffs ought to have been carefully trained (and given experience) in restructuring failing enterprises.

Exhibit 2 presents a flow chart that outlines the dialectical sequence of the governmental policies that supported the housing-finance bubble and the choke points that subsequently led to its bursting. The second panel presumes that, when a bubble first begins to burst, incentive conflicts lead authorities to try to cover up the depth of emerging insolvencies and to adopt showy, but ineffective patterns of response. Their hope is to move the problem temporarily off the public's radar screen. If successful, this shifts responsibility for truly resolving the problem to the next generation of government officials (Kane 1989).

#### Exhibit 2

##### Dialectics of Bubble and Crisis

###### THESIS: UNSUSTAINABLE POLICY MIX

- Low interest rates fueled the Loss-Causing Credit-Allocation Scheme ("politically sabotaged loans") vs. the Consequent Desupervision of Risk and Rising Costs of Providing Loans and Guarantees to Loss-Making Institutions

###### ANTITHESIS: MARKET FORCES TEST GOVERNMENTS' ABILITY TO MANAGE THE EXPANDING COSTS OF NATIONAL SAFETY NETS

- In a Banking Crisis, Market Tests consist of Silent Runs (Symptomized in 2007-8 by a Generalized Flight to Both Quality and Simplicity)
- The probability of further tests and a deepening crisis grows the longer authorities play "coverup", create new uncertainties, and delay action designed to contain the damage and instead help zombie institutions to stay in play

###### SYNTHESIS: MEANINGFUL REFORM OCCURS WHEN AUTHORITIES CAN NO LONGER QUELL MARKET DOUBTS ABOUT THEIR ABILITY TO SUSTAIN THE CONTRADICTIONARY POLICY MIX OF SUBSIDIZING AND LIMITING LEVERAGE

- Credit-allocation scheme unravels
- Costs of sustaining decapitalized institutions becomes manifest
- Regulatory/Supervisory System is Reorganized in a Plausible way

The third panel clarifies that keeping zombie institutions in play is extremely costly and that, as these costs multiply and become manifest, the need to undertake effective triage eventually becomes inescapable.

The last panel represents the situation in which authorities find themselves today. The credit-allocation scheme has broken down and authorities recognise the need for "plausible" reform of regulatory and supervisory systems. The issue is whether the politics of policy-making can allow re-regulation to include ways of measuring and controlling the creative manner in which institutions extract implicit and explicit subsidies from the safety net.

#### A medley of potentially effective reforms

There is no way to prevent bubbles and crises from emerging (Kindleberger 1978). Still, numerous complementary actions could improve the odds of getting less-destructive bubbles and better crisis management in the future. To be effective, a program of reform will have to rework in both the private and public sectors the way in which supervisory activities are performed and compensated. More importantly, it will have to make sure that compensation schemes and the division of labour mesh across private and governmental elements of the financial-engineering transaction chain depicted in Exhibit 1. A preliminary test of the value of each and every program element is to analyse whether and how it might have improved the interaction of private and governmental incentives during the securitisation bubble and its aftermath.

**To improve incentives in government requires reworking the employment contracts of top officials in ways that would define their missions more sharply and make them personally accountable for outsized safety-net expenses.**

It is convenient to consider first some purely private-sector reforms. Some of these will be adopted even in the absence of any government mandate. This will occur if and only if the reform is seen to improve the competitive positions of firms that adopt it. The first reform is to incorporate explicit and effective contractual clawbacks for subsequent interruptions in securitised cash flows into the contracts of employees and firms at all stages of securitisation. It is unwise to allow employees and firms that can make, securitise, or over-rate bad loans to collect compensation in advance without bonding their work by accepting liability for future defaults. Second, much like the bottom lines of corporate income and balance-sheet statements, the evolving value of the pools of assets backing various securitised claims needs to be tracked and reported explicitly at regular intervals (say, monthly). This would make it easier for investors and supervisors to identify securitisation chains in which the performance of due diligence is subpar. Third, credit-rating organisations must change the way they rate asset-backed securities and take explicit responsibility for errors they make in rating

them. In my ideal world, CROs would: (1) disclose the information they rely on in forming a rating; (2) bond themselves against negligent construction of rating models or using unrepresentative samples of data to estimate model parameters; and (3) report not just an instrument's rating, but also its downward volatility.

Additional reforms could be made in the management and financing of large financial firms. The crisis makes it clear that such firms failed to plan sufficiently for the downside. To remedy this, Richard Herring and Jacopo Carmassi have proposed that managers be required to prepare and file with their principal regulator a standby plan with which to handle their firm's bankruptcy and be obliged to update and refine this plan yearly (Herring and Carmassi 2009). The existence of these plans would make the threat of putting an insolvent institution into failure or conservatorship more credible because it would lower the costs of executing the threat. Having a benchmark winding-up scheme in place would also make it much easier for authorities both to close out the claims of stockholders and to haircut uninsured creditors at the moment of takeover. Explicitly planning for crisis management might also make it politically and administratively feasible to re-establish some form of extended liability for owners of financial-institution stock.

**Society's problem is that, during the bubble, Product-Quality Inspectors located at each station (i.e., supervisors) were using their computer scanners to entertain themselves rather than to inspect the quality of the work passing by.**

To improve incentives in government requires reworking the employment contracts of top officials in ways that would define their missions more sharply and make them personally accountable for outsized safety-net expenses. Building on the information used to construct bankruptcy plans at regulated firms, I would require regulators to establish, publicise, and test regularly a benchmark market-mimicking scheme for crisis management. While authorities would be free to deviate from this plan, they would be obliged to explain why they are doing so. To help them to put crisis-management plans into operation more promptly, I would also require regulators to collect and analyse estimates of safety-net subsidies from every regulated institution and consolidate these estimates in ways that would track over time the aggregate value of safety-net subsidies for the firms they supervise. To finish the task, I would ask the Treasury, Fed, and the FDIC to use these estimates and other relevant data to construct independent estimates of the evolving value of safety-net subsidies to the financial sector as a whole.

Because these reforms would make the jobs of top regulators more difficult, I would also raise the salaries of these officials. However, to lengthen the horizons of safety-net managers, I would fund this raise as deferred compensation that would have to be forfeited if a crisis

occurred within three or five years of their leaving office. This would have the further benefit of making new appointees more cognizant of unresolved problems that his or her predecessor might be leaving behind. To discourage elected officials from trying to win special breaks for firms that contribute money to their campaigns, I would require that regulatory personnel report fully on interactions with elected officials that occur outside the public eye.

A third approach to sharpening monitoring and loss-control responsibilities would be to establish schemes in which private and governmental monitors could hold one another responsible for the quality of their work. For example, it has been widely proposed that safety-net managers be required to move trading in over-the-counter derivative and other securities to clearinghouses or exchanges when and as their volume becomes large enough to pose material safety-net consequences. Potential suppliers of clearinghouse services would have strong incentives to see that authorities carry out this duty. A second variation on this approach would be for deposit insurers to reinsure their coverages with private parties. This could be done either by writing credit default swaps or by transacting in reinsurance markets. Changes in the maturity structure of reinsurance or swap premiums would forecast future safety-net expenditures. As a third example, federal regulators could refuse to recognise CRO ratings in setting capital requirements and other risk-management rules unless the CRO issuing the rating bonded the government against safety-net losses that could be traced directly to incompetence or negligence in the rating process.

### Summary implications

Structured securitisations may be visualised as manufacturing risk exposures in a series of work stations located alongside a conveyor belt. The different stations produce contracts that create, disguise, assess, reassign, or insure the risk exposures that move steadily along the belt. Society's problem is that, during the bubble, Product-Quality Inspectors located at each station (i.e., supervisors) were using their computer scanners to entertain themselves rather than to inspect the quality of the work passing by.

Although it is dishonest, it is natural for supervisors to blame the poor quality of the final product on weaknesses either in their lines of sight or in the supervisory equipment they had to work with. But giving supervisors more and better scanners or relocating their work stations will not cure the root problem.

The root problem is the de facto corruption of supervisory incentives that poorly monitored safety-net subsidies create and sustain. Exhibit 3 shows how massive these subsidies have become. This table is part of a larger recipient-by-recipient table on the [opensecrets.org](http://opensecrets.org) website showing that TARP recipients paid out \$76.7 million on lobbying and \$37 million on federal campaign contributions in 2008 and (through Feb 2, 2009) received access to \$295.2 billion in TARP funds. The ratio of lobbying expense to TARP receipts suggests that, during the initial stages of the crisis, financial

institutions have reaped extraordinary benefits from investing in efforts to scare federal officials and to tell them how "best" to dispel crisis pressures. Following this self-interested advice has been ineffective partly because the return from expanding large firms' investments in lobbying activity has dwarfed the return they could expect to earn from diligently attending to their ordinary business of intermediating the nation's flow of savings and investment.

**Exhibit 3**

**THE BALANCE OF INFLUENCE**

Lobbying expenses for 2008 by selected large firms that received government help

Company	2008 lobbying amount	Government investment to Feb. 2, 2009
Bank of America (includes Merrill Lynch)	\$8.8 million	\$45 billion
Citigroup	\$7.6 million	\$50 billion
AIG	\$9.7 million	\$40 billion
JPMorgan Chase	\$5.4 million	\$25 billion
Wells Fargo	\$1.2 million	\$25 billion
Goldman Sachs	\$3.3 million	\$10 billion
Morgan Stanley	\$3.1 million	\$10 billion
PNC Bank	0	\$7.6 billion
U.S. Bancorp	\$570 thousand	\$6.6 billion
Capital One	\$1.1 million	\$3.6 billion

Source: Center for Responsive Politics (downloaded from [opensecrets.org](http://opensecrets.org) website)

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