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The Balance between Risk and Return Is Everybody's Business

Ann Rutledge

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Get Off My Property
Photo by leoj / Joel (CC)

In America, equality of opportunity has never been viewed as inconsistent with the possibility of great personal wealth. While the Fifth Amendment of the United States Constitution guarantees life, liberty and property under due process of the law, Benjamin Franklin, the quintessential American, reminds us, "the Constitution only gives people the right to pursue happiness. You have to catch it yourself."

More famously he instructs, "God helps those who help themselves."

A key attraction of American culture is its seductive balance of idealism and materialism. New and old Americans share a common belief that, through hard work we can "catch happiness" and amass the commodity that drives the American system: dollars. Dollars drive our elections. Dollars enable us to buy our piece of the American Dream. Yet we are beginning to lose that balance. Buying the American Dream leads some Americans into long-term debt servitude and even homelessness. Modern American living is filled with potential financial snares in all matters affecting life, liberty, and the pursuit of happiness.

Our 2008 taxpayer bailout of the insolvent U.S. financial system is the crown jewel in a 30-year string of corporate restructurings and downsizings that have shifted the risk of the economy from corporations to households and individuals. The trend of employees seeking self-employment after being downsized or quitting the formal economy has grown steadily since the 1980s, reaching 16 percent of the American labor force even before the Dot Com era[1] and showing no sign of abatement since the onset of the credit crisis. Disheartened at being treated as a cost and not as a source of value, they re-emerge as free agents to sell their energies, ideas, and talents, in some cases to the same buyers.

America's self-employed are its true capitalists: their creativity and hard work fuel the real economy against a backdrop of corporate accounting games and scams. By paying for social services *a la carte* and accepting lower benefits than those for which they originally contracted, working Americans are also systematically assuming more of the economic risk. For every self-starter who goes on to build a company that is a financial success, many more subsist from paycheck to paycheck. They know the bargain is unfair but often can't measure how unfair. Calculating risk is much harder than calculating return because it is statistical—invisible to the naked eye.

The bargain for Americans got worse this decade when the habit of institutional risk-shifting spread to home ownership, as non-standard loans of shorter maturity, floating interest and non-declining (or increasing) principal amortization began crowding out borrower-friendly 30-year fixed-rate amortizing mortgages that were part of the New Deal. The new loan type was designed for the self-employed (whose income is harder to verify), but its benefit to lenders was even more substantial. It let them book more

loans and churn more fees, all the while passing the financial risks to clients who were ill-equipped to deal with them. Non-amortizing or (worse) reverse-amortizing principal balance loans are particularly dangerous because the debt service can put borrowers into insolvency.

Isn't the Bank Shooting itself in the Foot by Bankrupting its own Clients?

Not if it can shift the bankruptcy risk, too. Enter securitization, a financing technique whereby private contracts (such as mortgages) are re-underwritten under examination by "independent" third parties (like credit rating agencies and accountants) and refinanced in the capital markets as residential mortgage-backed securities (RMBS). Securitization channeled funds into the residential mortgage sector, leading to price inflation of residential homes in some markets, while at the same time, abuses in the rating process not seen in the first 20 years of the market (1979-1999) gave banks the ability to shift the bankruptcy risk to investors or to hide the risk of securities they could not off-load. (The role of ratings is central to the technical explanation of what happened, but it is beyond the scope of this essay.)

As a structured finance practitioner unaffiliated with either the buy- or the sell-side, I think a lot about fairness in the allocation of risk and return, because that is what I am trained to analyze. Contrary to impression, the discipline of structured finance is about pairing risk and return equitably, using well-established norms of data analysis and statistical modeling. Whereas corporate finance favors the wealthy, pedigreed companies, structured finance is puritanical and pragmatic. Borrowers whose performance data show regular patterns of surplus value production and timely loan repayment earn the right to enjoy a lower cost of capital. Structured finance in its original emphasis on transparency, fairness and equal opportunity is optimistic, forward looking, quintessentially American.

No doubt an intangible reason why countries outside the U.S. imported structured finance market infrastructure in the 2000s was that the money message came tied in a ribbon of hope. The ribbon appealed to markets in search of revitalization.

Those ultimately most traumatized by the credit crisis and financial system downturn of 2007-2009 were especially receptive to American culture and its intersection with their own belief systems. Germany, China and Hong Kong SAR, for whom U..S. institutions were a model of integrity, bought too much bad paper on faith. The European countries that adopted securitization techniques wholesale for mortgage origination (the UK, Ireland, Spain, Australia, Russia) suffered sharp downturns in their residential real estate sectors. The economy of the UK, whose market-centered regulatory philosophies most closely mirror ours, was particularly crippled.

The securitization markets of Latin American countries so far remain intact, but the knock-on effects of the U.S. economic downturn on the credit conditions of markets dependent on the U.S. economy, like Mexico, have been severe. Continued weakness in the U.S. economy may cause them to deteriorate further.

The importation of structured finance methods and concepts outside the U.S. has created demand for instruction all over the globe. For instance, every year since 2003 I have been teaching a spring graduate-level course in asset securitization at The Hong Kong University of Science and Technology. Normally, my focus is on financial technique, but this year I tried to involve students in the issues at a deeper level, by pushing them to explore the difference between abiding by ethics and simply abiding by the rules.

To my exam question, *What is credit?*, one student defined it as basic trustworthiness, then extrapolated this definition to encompass personal, commercial, and financial-systemic responsibility, without exceptions or caveats. I was proud that the student risked going beyond textbook definitions. Happily, this fair-minded, philosophical weekend student is a Hong Kong financial system regulator on weekdays.

Delegates also formed groups to play a high-stakes game set in a depression economy, with an asset portfolio highly concentrated in one industry (real estate), where competition for the same properties leads to raging inflation and shrinking growth. Of course, this is Parker Brothers' game *Monopoly*™ which

dates back to 1935, but it could just as well describe the U.S. economy in the period 1998 to 2007.

At the end of their game, delegates wrote about their reflections on winning and losing and on how the game relates to securitization. Those who had played *Monopoly*™ as children were genuinely surprised to discover there was more to it than rolling dice, advancing to Broadway, and getting out of jail for free. They learned that the game involved elements of everything in their finance courses, from financial analysis and statistics to negotiation and ethics. Many made the connection that winning and losing in *Monopoly*™, as in finance, appeared to hinge on knowing how to exploit the rules. One delegate carried this insight to its logical conclusion:

> "All players understand the rules of *Monopoly*™. All have the same clear objective of wiping out the competition and emerging as the winner. I observed how players tried to increase their odds by interpreting the rules in ways more favorable to themselves in the gray areas, without actually breaking them. In some cases they intentionally misrepresent the rules for gain. E.g., *Monopoly*™ does not specify precisely how asset trading works; players are motivated to negotiate the terms in an innovative, self-serving way. It may seem to contradict the rule, but as long as the behavior is not explicitly prohibited the trade can go through. These same behaviors can be observed in the context of mortgage origination and asset securitization in the lead-up to market collapse...."

The student's observation leads to the supposition that many insiders were bending the rules as far as they could. In contrast, most Americans were caught in a high-stakes financial game where they did not know the rules, and where the analogy to playing a child's game of *Monopoly*™ is apt.

Ordinary Americans are easy marks for predatory lending. They tend to be untrained in financial decision making. They tend to trust people in authority, which in this case means the bank officer. Their goals are more fundamental. A home buyer does not take out a mortgage to bet against the bank; a home buyer takes out a mortgage as the first step towards owning a home. By contrast, the bank making the loans may be engaged in a sophisticated form of betting rather than in providing a service. Its true financial intention can only be surmised by reading the mortgage contract and understanding how the loan is supposed to work. This takes financial literacy, and a willingness to enter into the fray of financial games. These are themes that do not resonate with most Americans unless they are already employed in finance. But is this avoidance sustainable?

The problem with today's financial system is not just that certain large institutions have behaved unethically, or even that they have been inadequately regulated. To be sure, these statements are both true, but the essential problem is broadly systemic and ultimately also philosophical.

Finance and economics have developed around the question of how to cut the pie while ignoring the question of who baked the pie and what the baker knew. Surplus value creation is everybody's business. Who makes it? Who owns it? How should it be allocated between those who make it (labor), those who distribute it (financial markets), and those who regulate and redistribute it (government)?

Marx was right to highlight the question of *surplus value* in his study of capital. We in economics and finance tend to avoid the question of surplus value because it is also political and social. And inconvenient. (Structured finance was a first step towards aligning credit with surplus value directly, and the inconvenience of that question can be gauged by the extent to which the rules of the market have been kept out of the public domain for 30 years.) Yet, address these questions we must. Since the motive of most financial games is to lay claim on the surplus provided by others' labor, ingenuity and know-how, the games will continue to control our lives until we do.

In the American philosophy of financial regulation, the onus is on financially sophisticated institutions to seek their own interest by competing with and policing each other. The stability and fairness of this system depend on whether the information disclosed is material and sufficient for self-regulation, and whether the institutions are willing to play a fair game or seek to exploit the informational asymmetries.

Yet our financial information reporting and risk measurement and risk management systems are simply not informative enough for the task of regulating sophisticated institutions.

Moreover we are conflicted about what we want our institutions to do; we want them to be ethical, but we also want them to make lots of money. Improper conduct that makes profits and cleverly bends the rules is legitimized, even admired by those who understand its technical virtuosity—until it all goes wrong. Think of Enron.

If fair play is not in the self-interest of market institutions, yet those outside the market whose self-interest is served by regulation are not motivated to hold the market institutions to account, then instrumental liberalism as a model for financial system regulation simply does not work.

Now what do we do? Should we ban financial engineering (or capitalism) and return to a financial state of nature with Rousseau? Or, if finance is really a jungle, should it come under the iron control of a Leviathan? And how would changing the model in either of these ways affect our standard of living?

We do not have good answers, but an economic structure like ours where the self-employed and small business owners fuel much of the growth may still be better off with disclosure-based financial regulation, because it is at least egalitarian and adaptive. In addition, a heightened awareness of the ethics of finance, not just the technique, and the development of financial literacy and activism in non-traditional sectors of society (including the self-employed and small business owners) appear to be the keys to checking the financial system's excesses.

How the repeated rippling of the crisis of 2007-2009 through the supply chain of capital, from households to banks, to capital markets, and back again to households, will stimulate ethical consciences and activism has yet to be seen. But here, Ben Franklin offers more wisdom and hope: "Tell me and I forget. Teach me and I remember. Involve me and I learn."

NOTES

1 Pink, Daniel, *Fast Company Magazine*, "Free Agent Nation," Issue 12, December 1997.

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