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After the Fall: Saving Capitalism from Wall Street – and Washington

This is a book review of After the Fall, authored by Nicole Gelinas, a senior Fellow at the Manhattan Institute. I became aware of it after it was reviewed in CFA magazine. I really enjoyed it and recommend it to others. I read it straight through, which is really unusual for me as I usually have about 5 books going at the same time. Gelinas does a great job putting the recent financial crisis in historical context, discussing the cyclical nature of financial regulation and spreading the blame around. It is especially interesting to hear some of the quotes from politicians who have been so hard on Wall Street recently. She also seems to infer that she does not think the crisis is over, couching her comments whenever she talks about the end of the period.

Working from New York City, it is unusual to see someone take contrarian views from that perch. She starts by reflecting on regulatory changes made during the Great Depression of the 1930s, countered by unwinding starting with the Continental Illinois precedent of too big to fail. That was the first instance where all lenders were made whole. Future bailouts can thank CI for leading the way. Under both Republican and Democratic administrations increasingly larger firms were bailed out continuously. What trust in markets is there if there is no creative destruction? If firms are not allowed to go under how can smaller firms ever get across the moat and other barriers to entry? When lenders are made whole but shareholders wiped out, this impacts future prices and relative spreads between various classes of capital.

Too many of our regulatory policies are based on dealing with a crisis after the fact. Just as with personal health, preventive measures are always cheaper to do but harder to implement.

Transparency is another key to market trust. Income statements driven by accrual accounting provide little information about the current value of the firm. Insider knowledge is required to truly value these firms.

Gelinas explains the uptick rule in a way that even I as someone who has avoided short sales can understand. It keeps the herd from completely destroying a company when it gets excited and forces it to think just a bit.

Some of the parallels to the Depression are eerie. She notes that Wall Street initially (in the 1930s) thought that the new rules would be temporary and they could quickly return to their old practices (given the repeal of Glass-Steagall perhaps that was just a time horizon mistake).

Using size to define "too big to fail" is a recipe for disaster, as the banks with that designation enjoy lower borrowing rates and are incented to take more risk while those smaller face daunting challenges to grow and compete. A natural career seems to include large bank and then public service, ensuring that too big to fail is implemented when needed.

Insurers hold capital based on both liabilities and assets, and measure liquidity by comparing a ratio of funds available to funds needed across various time horizons. Banks in the past have assumed liquid sources of funds, unworried about whether they bring in insured deposits with long time horizons or borrow on a nightly basis. Hedge funds don't hold any capital at all. Off-balance-sheet assets and liabilities should also be recognized.

Principles-based approaches to capital such as Basle II and insurance PBA have a downside in that they produce countercyclical results. When times are good, assumptions are loosened and capital requirements fall. This allows risk to grow when no one is looking (as the tide rises according to Warren Buffett). Rules-based methods have other problems, but tend to release capital during times of need. Accounting rules often do not allow firms to set up additional capital in good times to weather the bad times. Setting up extra savings during good times rather than spending it is good advice for individuals too.

Those who borrow short and invest long in tradable securities face a "double jeopardy", according to Gelinas. When liquidity dries up they move in opposite directions. Avoiding this time horizon gap will reduce the ALM (asset-liability management) risk at banks. She also suggests that publicly traded firms not managed by their owners should hold more capital than partnerships where managers are playing with their own chips.

Rating agencies, as I have written before, while not blameless have become scapegoats for the financial crisis. Investors should perform their own due diligence and not outsource this key component of their job. Gelinas notes that rating agencies and their employees tend to be homogeneous and operate under a consensus model. This does not encourage the skeptical discussions necessary to make bold pronouncements or challenge a bubble. This lack of due diligence creates enablers, those who buy the instruments that have been mispriced. This group of supposedly sophisticated investors consistently buys what the investment bankers have to sell, no matter how complex the asset is.

It is interesting that mark-to-market comes up over and over with respect to financial crises yet the accountants continue to insist that it is more appropriate than anything else for income statement reporting. The reality is that it creates huge volatility in balance sheet and income statement results for accrual items. For insurers you might have a secondary market for assets readily available but none exists for the liabilities so you get an accounting mismatch on top of everything else. Enron discovered the secret of bringing all future profits into today's financials and created a huge Ponzi scheme that eventually collapsed under its own weight. Securitized assets became the tool as home mortgages were rolled up and redistributed. MTM would work if markets were fully efficient, but they are not. The herd mentality takes values alternately too high and too low. It is intriguing that Andy Fastow, CFO at Enron after devising many of the financial tricks while at McKinsey, had his first job at Continental Illinois right after their government bailout.

Gelinas describes a number of unintended consequences. For instance, if you own the AAA tranche of a CDO you have little incentive to work with the homeowners unless the losses get large enough to reach you. The initial losses go to the lower tranches, and that is why you purchased the higher rated and more protected tranche in the first place.

Another interesting point she makes is that the seemingly minor single entity disasters, like Orange County and Proctor & Gamble, were really warning signs for the systemic risks building in the system. Even Long Term Capital Management (LTCM) could be placed in this category.

To paraphrase Dave Ingram's Theory of Risk & Light, risks accumulate and build when they are not noticed. Gelinas feels this is a key driver of systemic risk as well. It is interesting that the recently enacted Dodd-Frank bill does not seem to address this risk. Having an emerging risks lookout that can adjust over time with contrarian views may be the most valuable risk management tool we have.

Any time you have a bailout others are encouraged in similar circumstances to take on more risk. Gelinas credits Alan Greenspan with recognizing this after the first Chrysler bailout, that "he feared the bailout's success more than its failure, since success would pave the way for more bailouts." It appears that he forgot his own message over time.

Gelinas believes that risk limits prescribed using exposures, enforced by normal people, works better than fancy models designed as black boxes. LTCM is a great example, but CDOs and other Wall Street inventions also meet these requirements. I have also found this to be true in my own experience. If I can't understand a product I now challenge it and perhaps recommend walking away from the risk.

While I agree with most of Gelinas' arguments, she also proposes that capital should be held ignoring the level of risk. I assume this means you base it on the total value. I can see more conservatism being added for less risky assets but to hold the same capital for all assets would seem to provide the wrong incentives.

When everyone uses the same models to value the same assets, any assumptions that are suspect get used by everyone. When these assumptions change they disrupt the market. We see this with the Black-Scholes model, where it is used for both pricing and valuation purposes. There are no checks and balances. In the CDO market, when default assumptions proved untrue, these black boxes changed values very quickly. In Michael Lewis' The Big Short he describes the investment bank practices for credit default swaps on CDOs of asking for collateral from counterparties as inconsistent with when they were to pay the collateral. They held all the cards.

Government has a large share of the blame it has yet to accept. Keeping interest rates low after the tech bubble and 9/11 did not allow markets to clear. It is hard to accept that some pain must be accepted now in order to prosper in the future. Politicians don't get elected by following that path. Legislation forced Fannie Mae and Freddie Mac to accept growing amounts of sub-prime loans and loosen their standards, which they willingly did. Other legislation lifted the uptick rule and repealed Glass-Steagall. Recent challenges to contract law and capital structures have created additional risk.

Large firms need a way to fail without destroying the overall economy or building systemic risk. It needs to be orderly and fair. The government should not be able to pick and choose who it chooses to survive. That is way too political. Did holders of AIG credit default swaps get paid? In my mind they should have but my guess is that they did not.

People can get into trouble very quickly with their investments either by borrowing too much or making speculative purchases. When they are combined the risk expands quickly.

In After the Fall, Gelinas concludes that free markets need prices, disclosure, failure, and fairness. Until these are met capitalism is unlikely to meet its full potential. Predictable and consistent application of transparent principles leads to trust in markets. Movement away from these tenets will encourage money to be invested elsewhere. Government should set a disciplined process for business to operate under, not choose winners and losers and certainly not own a financial institution that others have to compete against. She does not support a systemic risk regulator because she thinks that market participants would assume someone was looking out for them and avoid doing the due diligence themselves. I agree with her that no one can identify the specific risks about to happen, but I do think that a team identifying emerging risks can add flexibility to the risk management process. A bit of humility goes a long way.

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