REALIGN THE INTERESTS OF WALL STREET

By Joseph E. Stiglitz

From the seventeenth-century tulip mania to this century's housing bubble, economies have been susceptible to the quest for the easy buck. Clever people will invariably circumvent regulations and accounting standards; they will seize opportunities to prey upon the poor and the ill-informed, to profit by selling the notion of the free lunch. By now most people are aware that over the past five years the financial sector has made bad loans and extremely risky bets, that defaults on the loans and record losses on the bets have seriously damaged the nation's (and the world's) economy. The downturn is likely to be so severe partly because we have succumbed to the opinion that markets work best by themselves, unfettered by government regulations. But the people making this argument are the ones who have been served well by it. We can do far more to protect against self-interest. In particular, we need to improve the incentives that drive those in the finance industry, so that their interests align with those of the society and economy they are meant to serve.

The financial sector is supposed to allocate capital judiciously, making sure that it goes to areas where returns, when adjusted for risk, are highest.

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When capital is well distributed in this way, the economy is more likely to flourish in the short term and grow steadily over time. Capital markets are also supposed to manage risk, transferring it from those parties less able to bear it to those that are more able to do so; distributing risk in this manner encourages entrepreneurship and stabilizes the economy. In return for performing this public service, the financial markets are generously rewarded—in recent years they have garnered nearly a third of all corporate profits.

The financial system is *supposed* to do these things. But it is clear that America's financial institutions have not managed risk; they have created it. The industry allocated hundreds of billions in bad loans to an inflated housing market, resulting in the greatest number of foreclosures since the Great Depression. With economic growth currently at a dreary 1 percent, there is already an immense gap between what we are now producing and what we could be producing if this crisis had not occurred—a cumulative loss I estimate will be in excess of $2 trillion.

Too many bankers and other lenders have been focused on trying to beat the system by getting around accounting and banking regulations (through what is called accounting and regulatory arbitrage). Indeed, with bonuses based on short-term profits, they had every incentive to gamble and connive. And now that there's a bust, no one is being asked to pay back the hefty bonuses earned during the boom. On the contrary, even as they are dismissed, those who helped send their firms and the American economy into a tailspin are rewarded with generous severance packages. They are enriched regardless of what happens to investors, homeowners, and others who lost so much. Unless we reform incentives, the financial sector will only try to circumvent whatever new regulations are put in place. We will simply have a short respite before the next crisis.

One major problem with incentives involves securitization. The selling and reselling of mortgages, with payments chopped into thousands of pieces, creates a new set of information asymmetries, as buyers of securitized mortgages have less information than the originators of the mortgages. To be sure, both investors and regulators should have recognized the scam. But as mortgage originators realized that buyers of securitized mortgages paid little attention to who was taking out the loans and on what terms, they pushed through as many loans as they could, regardless of their risk, and they invented ever more complex and pre-

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carious financial products that no one—not even the originators themselves—fully understood. Loans requiring that less interest be paid than the rate at which it accrues, so that the level of debt increased over the course of a year, were sold on the premise that housing prices were only going to rise. A simple regulation requiring mortgage originators to put their own money at risk in each transaction—say, 20 percent of the loan amount—could curb these abusive practices.

Multiple conflicts of interest in our finance industry also have led to the rewarding of socially destructive behavior. The worst culprits have been the rating agencies, which are paid by the companies whose financial products they were supposed to be evaluating and which make money by consulting with their clients on how to get AAA designation. These financial alchemists announced that the lead of subprime mortgages had been transformed into golden products safe enough to be held by pension funds. Without this collusion, the whole system of deception would not have worked; there would not have been the flow of funds that sustained the subprime mortgage industry. Neither banks (including now investment banks) that can borrow from the Federal Reserve nor pension funds that are responsible for managing other people's money should be allowed to buy or sell risky and non-transparent products.

Finally, we must change how financial executives are personally compensated. We should require that stock options be subject to "expensing" (a more transparent accounting that makes clear their full costs). The present stock-option payment structure encourages CEOs to take actions that bloat the short-term *reported* profits of the firm, thereby inflating the share price, and everyone (except the executives in the know) eventually loses as a result. Their pay must be based on long-term performance, and they should share the losses, not just the gains.

Certain masterminds of Wall Street exhibited great ingenuity in creating new, highly complex products capable of evading accounting rules and taking full advantage of the housing frenzy. But as they were getting rich off these innovations, they failed to design products that help reduce the risks faced by most people in the housing market. Mortgages that would make it easier for Americans to keep their homes as interest rates rise or the economy spirals downward can be developed. But those in the financial sector have been fixated on their own annual bonuses.

Adam Smith argued that in serving their own interests individuals were led "as if by an invisible hand" to serve the interests of society as a whole. But once again we see that only with the right rewards can these interests actually be joined. ❖

ABOLISH STOCK OPTIONS
By Barry C. Lynn

What is the purpose of a corporation? In America today we generally believe that corporations exist to generate profits for their shareholders, who "own" them. Indeed, we have structured much of our economy—and often staked our retirements—on this idea.

Not many years ago, though, most Americans would have found such thinking absurd. From the nation's earliest days until the 1970s, Americans saw the business corporation mainly as a practical tool of development. The aim might be to build a bridge, or to manufacture steel, or to transport people from one city to another. The private corporation was simply the institution best suited—usually, but not always—to organize and govern such work. Profits were a part of the system. After all, the only way to attract capital is to pay for it. But the manufacture of cash was a distinctly secondary goal.

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