Insurance against financial fear

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(PhysOrg.com) -- Just one year ago, a worldwide panic was unfolding: Financial markets froze after the collapse of the investment bank Lehman Brothers, leaving businesses without lenders as the economy drastically slowed. How can we stave off such fear-enhanced episodes in the future? Ricardo Caballero, MIT's Ford International Professor of Economics, offers a distinctive solution: Government-issued investment insurance for banks.

"A crisis is a mixture of real problems and a panic component, which at the worst moment of a crisis can be larger than the underlying problems," says Caballero, who presented the plan at the Federal Reserve's high-profile Annual Economic Symposium in Jackson Hole, Wyo., in late August. "The proposal is a sort of financial defibrilator, to

be ready in case it is needed."

The plan, developed with MIT economics PhD student Pablo Kurlat, would require financial institutions to back up their investments by purchasing from the government a minimum number of Tradeable Investment Credits (TICs). The Federal Reserve would let those credits be cashed in during meltdowns. This would not prevent financial mishaps, but limit their effects.

"Yes, there may be credit problems, there may be corporate governance problems, and there may be mistakes of monetary policy," says Caballero, who is also head of the Department of Economics, speaking in his office. "But really to have a major, major crisis of the kind that has developed in the U.S., you need more than that. You need panic. And panic is something we don't have a good diagnosis for." It may not be the only thing we have to fear, in Caballero's view, but a financial fix should address fear itself.

After all, once fear sets in, notes Caballero, its effects multiply: "One of the most destructive things in a crisis is that panic in the financial system creates problems in the rest of the economy, which affects consumer confidence, which worsens the balance sheets of banks. This is a mechanism to sever that feedback loop."

The idea relies in part on Caballero's own research about the way complicated financial networks stymie the flow of information, leaving people facing conditions of "Knightian uncertainty" — where they know they cannot obtain all the data they need to make rational decisions. The concept is named after American economist Frank Knight, who distinguished between situations of measurable risk, on the one hand, and fundamental uncertainty, on the other. In the latter case, economic actors recognize they cannot even calculate whether a transaction will be worthwhile. As Caballero sees it, financial institutions and investors

alike found themselves in this position after Lehman Brothers collapsed, and simply stopped moving capital through the financial system.

The TICs that Caballero and Kurlat describe would function much like the credit-default swaps issued by financial-services firm AIG, which banks used as investment insurance, too. When many of those investments failed at the same time, AIG effectively owed more in insurance payouts than it could afford, leading to a government bailout of the firm. But this plan aims to avoid those problems by creating a far more transparent and structured system than AIG's holdings, in which TICs would be a routine financial instrument.

Granted, the plan would have to be cost-effective. In a working paper released in March, Caballero and Kurlat calculate that in some circumstances a variety of insurance plans could stabilize the value of a bank's assets and shares, and thus save taxpayers money, essentially by lowering the government's payout compared to a financial-sector bailout.

What about the contention that such a plan creates moral hazard, that is, offers a financial safety net that in this case could give banks incentives to take undue risks?

"I think the moral hazard perspective exaggerates how much people react during booms to the presence of insurance against something bad happening," responds Caballero. "People are not even thinking about what happens if they go bankrupt. And even if you get bailed out, you might lose 90 percent."

In Jackson Hole, Caballero's talk was followed by a commentary from Kenneth Rogoff PhD '80, a Harvard University economics and public policy professor, who said the TIC plan was "interesting and will no doubt stimulate further discussion." But Rogoff also asserted that financial fixes should start by limiting the borrowing of banks: "a reining

in of leverage ... would be a very sensible response to the heart attack the economy has just suffered."

Caballero is less convinced that regulation can prevent meltdowns in an ever-evolving financial world. "I don't disagree with many of his points, but you still have to realize what we need to do in a crisis," responds Caballero. Thus he is continuing to circulate the proposal; following Jackson Hole, Caballero gave a similar presentation to New York Federal Reserve officials. This insurance policy may yet gain more subscribers.

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