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The Ethics of Governance

Justice Gordon Goodman[*]

I. INTRODUCTION

In this Article, I discuss the need for a board of last resort to set financial values during periods of extreme economic stress, i.e., the "liquidity black hole" events discussed below. The purpose of this proposed board, the "Independent Treasury Board," would be to address valuation uncertainty during bust periods immediately following major financial crises.

If an Independent Treasury Board existed prior to 2008, it could have helped rein in some valuations that were among the causes for the Great Recession.[1] More importantly, it could have quickened recovery from the Great Recession during the period immediately following the financial crisis by shortening the period of valuation uncertainty. If created now, the Independent Treasury Board should become a permanent part of the United States Treasury Department.

II. LIQUIDITY BLACK HOLE EVENTS

There are many ways to describe liquidity black hole events, below is one example:

> Occasionally, financial markets experience episodes of turbulence of such an extreme kind that it appears to stop functioning. Such episodes are marked by a heavily one-sided

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1. *See* Robert C. Pozen, *Is It Fair to Blame Fair Value Accounting for the Financial Crisis*, HARV. BUS. REV. (Nov. 2009); John Weinberg, *The Great Recession and its Aftermath*, FEDERAL RES. HIST. (Nov. 22, 2013).

> order flow, rapid price changes and financial distress on the part of many of the traders. The 1987 stock market crash is perhaps the most glaring example . . . Practitioners dub such episodes as . . . "liquidity black holes."[2]

Though other financial risks, such as price and credit risk, may be better known to the public, liquidity risk presents the most profound systemic risk to our financial systems. A simple way of thinking about liquidity is to compare it with the physical concept of buoyancy. Buyers in the marketplace exert upward pressure on financial instruments, while sellers provide downward pressure. When buyers exit a market due to overvaluations towards the end of a boom period, even the smallest downward pressure from sellers can drive values below normal levels, thus creating a "bust."

III. EVENTS LEADING UP TO THE GREAT RECESSION

In an earlier article that I wrote on liquidity risk,[3] I noted that the collateral, or liquidity, provisions contained in almost every over-the-counter financial industry contract (including swaps, options, and derivatives of all kinds) have hard collateral triggers that can cause unintended consequences during periods of extreme financial stress. All such unregulated contracts require one of the parties to set the "fair value" for these financial instruments, a process that becomes difficult when markets dry up since most valuations rely upon recent, arms-length, comparable transactions.

I have also previously written about techniques that may be available to predict future financial collapse events.[4] In July 2007, I published an article in which I noted that a form of measurable credit risk had fallen to "zero" probability, and since it could not fall any further, credit risk would inevitably have to be corrected by going back up.[5] Though I was accurate in making this particular prediction, the ability to forecast financial crises accurately is limited.

2. Stephen Edward Morris & Hyun Song Shin, *Liquidity Black Holes*, COWLES FOUND. FOR RES. IN ECONOMICS, YALE UNIV., Discussion Paper No. 1434 (Sept. 2003).

3. Gordon E. Goodman, *Liquidity Risk Management: Where the Bucks Stop*, GARP RISK REVIEW, Nov./Dec. 2005, at 11.

4. Gordon E. Goodman, *Credit Risk: Will the "Bubble" Burst?*, GARP RISK REVIEW, July/Aug. 2007.

5. *Id*. at 43.

IV. PROFESSOR TAUS AND THE INDEPENDENT TREASURY SYSTEM

In talking about the risks that can arise from liquidity black hole events, I note that they are distinct from normal liquidity problems and seasonal fund flows. As an example of these seasonal flows, the late, distinguished Professor Esther Taus described the "annual autumnal stringencies" that arose throughout the 19th century and early 20th century, which were associated with funding requirements for agriculture in the southern and western regions of the United States.[6] A detailed analysis of the pragmatic techniques adopted by the U.S. Treasury Department through its "Independent Treasury System" (a precursor to the Federal Reserve System) appears in Taus's comprehensive study of the central banking functions in the United States.[7] The Independent Treasury System existed from 1846 through 1920.

A revived and repurposed Independent Treasury System, working with the Federal Reserve System, could serve as a bulwark against valuation confusion in the days immediately following a financial crisis. Valuations of last resort by an Independent Treasury Board, backed by a Sub-Treasury, could provide immediate stability and certainty before longer term liquidity programs (like the Federal Reserve's recent "Quantitative Easing Program," which covered only a small subset of financial instruments)[8] can begin to repair long-term damage. Quantitative Easing is a form of unconventional monetary policy under which central banks purchase ". . . financial assets such as Treasuries or mortgage-backed securities in an attempt to reduce yield, boost lending, and stimulate economic activities."[9]

6. ESTHER ROGOFF TAUS, CENTRAL BANKING FUNCTIONS OF THE UNITED STATES TREASURY, 1789-1941 104 (1967). In describing this process, Professor Taus notes: "[b]ut even a slight contraction in the amount of money available for reserve may have an important effect on the money market, especially if reserves are near the legal minimum. Contraction (though apparently insignificant in amount) may contribute to or even produce a money stringency. This in turn may result in a violent reaction in the general level of price, a disturbance in interbank settlements and disorder in almost every part of business activity." *Id*. at 79.

7. *See id*. at 85–133 (The Independent Treasury as the Real Central Bank, 1890-1912).

8. *See* INDRANEEL CHAKRABORTY, ITAY GOLDSTEIN & ANDREW MACKINLAY, MONETARY STIMULUS AND BANK LENDING (2019), *available at* http://finance.wharton.upenn.edu/~itayg/Files?qebanklending-forthcoming.pdf (last visited Feb. 27, 2020).

9. *Id*. at 2.

V. EFFORTS TO PROVIDE VALUATION STABILITY IN 2008

From 2007 to 2013, I served on the Financial Accounting Standards Board's ("FASB's") Valuation Resource Group (the "VRG"), which was formed as problems in setting the value for certain financial instruments became apparent. Banks and other companies in the financial industry were finding it increasingly difficult to identify comparable values for mortgage-backed securities and other exotic financial instruments that were being bundled and sold at that time.[10]

Though banks had reverse engineered the process used by major rating agencies to obtain relatively high ratings for unconventional instruments versus other more traditional investments, the growing lack of appetite for these complex instruments, regardless of their ratings, made valuations problematic. At the VRG, among the many questions we received, was whether older and less reliable transactions could be used in setting the fair value for these instruments.

When the crisis finally came to a head with the Lehman Brothers bankruptcy filing in September 2008, the members of the VRG discussed how best to bring stability back to financial markets. Several members suggested that a system for setting authoritative fair values (and not just advisory opinions), often in the absence of recent market transactions, could be important in restoring investor confidence to markets. This system could be critical for certain financial instruments that are: (1) subject to fair value measurement under generally accepted accounting principles (the "GAAP");[11] (2) subject to reporting requirements in standard financial reports for public corporations under SEC rules;[12] but (3) are not valued through a regulated exchange.

As a result of these discussions, on September 24, 2008, I along with another member of the VRG wrote the following letter to the Secretary of the Treasury Department, Mr. Henry M. Paulson, Jr.:

> The undersigned are members of the Financial Accounting Standards Board's Valuation Resource Group, which is known as the 'VRG.' We are writing to you today however as individual

10. The structure of the VRG, an advisory board to FASB, composed of leading financial, accounting, and legal experts, is a possible model for a new Independent Treasury Board.

11. *See, e.g.*, 15 U.S.C. §§ 77s(a), 78m(b)(1) (granting SEC authority to establish GAAP applicable to financial statements and other documents filed under Securities Act of 1933 and Securities Exchange Act of 1934); SEC Accounting Series Release No. 150, 5 Fed. Sec. L. Rep. (CCH) ¶ 72,172 (Dec. 20, 1973) (delegating authority to establish GAAP to Financial Accounting Standards Board).

12. *See, e.g.*, 15 U.S.C. § 78m(a)(2) (requiring issuers of securities to file "annual reports" and "quarterly reports" as prescribed by SEC); 17 C.F.R. Part 230 (setting forth General Rules and Regulations applicable to annual and quarterly reports).

> valuation experts and concerned citizens. A copy of this note is being sent to Mr. Robert Herz, the Chairman of FASB, with whom we have discussed the following proposal to assist Treasury.
>
> On a voluntary basis, we offer to assist Treasury in designing and implementing an orderly process for valuing certain financial instruments, which are to be acquired by Treasury under a bill now pending in Congress. We have had extensive hands-on experience in calculating the fair value of complex derivative instruments in addition to our policy work for the VRG.
>
> Please let us know if we can be of assistance to you and Treasury.[13]

Perhaps not surprisingly, given the urgency of the crisis, we did not hear back from the Treasury Department on our offer. As a result, on October 7, 2008, we wrote a follow-up letter to the Secretary in which we offered to serve on a "Credit Review Committee" that was being discussed at that time. Though this Committee was authorized to be formed under the Emergency Economic Stabilization Act of 2008,[14] it never came into existence.

VI. CREATION OF A NEW "INDEPENDENT TREASURY BOARD"

During the current period of relative calm in U.S. financial markets, and before the next financial crisis occurs, Congress should consider passing a new Independent Treasury Act that would create a revived Independent Treasury System. This system should include an Independent Treasury Board and a Sub-Treasury. The Independent Treasury System would be in addition to the Federal Reserve System.

The Independent Treasury Board should report to the Secretary of the Treasury and the Chairman of FASB and be composed of leading financial, accounting, and legal experts. During nonemergency periods, the Independent Treasury Board should function like the Valuation Resource Group did at FASB and provide advisory opinions on complex valuation questions for investors and creditors. In this role, it should primarily report to the Chairman of FASB.

13. Letter from the VRG to Henry M. Paulson, Jr. (Sept. 24, 2008) (on file with author).

14. 12 U.S.C. § 5214(f) ("The Financial Stability Oversight Board may appoint a credit review committee for the purpose of evaluating the exercise of the purchase authority provided under this chapter and the assets acquired through the exercise of such authority, as the Financial Stability Oversight Board determines appropriate.").

At any time, the Independent Treasury Board should be able to notify the Treasury Secretary of an impending or existing financial crisis (i.e., an emergency period). During such emergency periods, the Independent Treasury Board should report to the Secretary of the Treasury; the opinions it issues on complex valuation questions for investors and creditors should be authoritative and set the binding fair value of certain financial instruments for all purposes both legal and contractual.

Under the new Independent Treasury System, a Sub-Treasury should also be established and authorized during emergency periods to purchase certain financial instruments at fair values that have been previously determined by the Independent Treasury Board. In turn, this Sub-Treasury should be authorized to sell notes to the public that are guaranteed by these acquired financial instruments.

VII. CONCLUSION

A liquidity crisis is in many ways a financial manifestation of the classical concept of chaos and the more modern concept of uncertainty. During emergency periods, it is less important whether the values of certain financial instruments are set high or low (so long as they are calculated rigorously and impartially), but it is critically important that they be set in an authoritative manner. The lack of knowledge about the value of these financial instruments during a liquidity crisis and resulting public confusion are what create most of the long-term economic destruction and not the short-term financial losses themselves. Having an Independent Treasury Board in place when emergency periods begin should make future transitions from crisis back to stability smoother and less problematic for the investing public.