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## **Privatizing Rube Goldberg for the Greater Good**

*By Frank Martin<sup>1</sup>*

The politicized \$700 billion bailout plan that emerged from Congress has all the makings of a Rube Goldberg contraption. Experience leaves no doubt in the public's mind that the speed and efficiency of the plan will be inversely proportional to the number of parochial interests concocting it. The risk of a boondoggle grew with each passing hour of compromise to the point that the bailout's efficacy as a stopgap solution to the crisis didn't even last a weekend.

Consider a new, simpler plan where mission-critical incentives and motives are more closely aligned between the public and private sectors.

Imagine a public/private partnership bearing the imprimatur of the American capitalist whose integrity and business and investment acumen has won him the respect of public and private leaders around the world. Warren Buffett, the icon of virtuous capitalism whose \$100 thousand salary does not even match that of a freshman congressman, whose mortgage on his modest house which he's owned for over 50 years was paid off decades ago, and whose richest-person-in-the-world wealth will go to charity upon his death, could just be the man of the hour. Warren Buffett might be the person to lead the way in restoring confidence to Wall Street and Main Street alike—to say nothing about the institutional of capitalism itself. In making atypically public investments in floundering Goldman Sachs and General Electric in recent days he has done far more than demonstrate his sagacity as a businessman and investor. By burnishing the tarnished images of these humbled giants with Berkshire's capital, he has performed wonders in bolstering confidence in beleaguered institutions.

More to the moment, in several televised interviews during the last couple days Buffett has hinted that a private sector solution to the financial crisis may have merit worth considering by an anxious Congress. The following is a back of the envelope idea that just might employ the right incentives to bring the best out of the public and private sectors working in concert on a common problem.

Imagine if you will, Berkshire Hathaway, with Warren Buffett at the helm, and the U.S. Treasury partnering by initially investing equity capital in a newly-created privately-managed Reconstruction Finance Corporation (RFC): Berkshire, \$10 billion and the Treasury, \$90 billion, amounts chosen for the sake of getting dialogue started. The Treasury would issue an initial \$250 billion line of credit at an interest rate to be determined by negotiation between the Treasury and RFC. Additional funding,

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equity or debt, as determined necessary by field experience and through ongoing deliberations and negotiations between the Treasury and the Board of Directors of RFC, would be provided up to a Congressionally-imposed limit.

The RFC would recruit a Board of Directors selected on the same basis as one might have hand-picked the framers of our Constitution: the virtues of integrity, honor, wisdom, experience and clear subordination of their personal interests to those of the Nation. The board should be large enough to be representative but small enough to function efficiently. Beyond Warren Buffett, the kind of men who might be recruited to serve the Nation might include Paul Volcker, Jack Bogle, Peter Bernstein, just to name a few.

The RFC would function as an investor in capital-needy financial institutions. The dollar amount of each investment and the ownership interests such investment purchases would be situation specific and would be negotiated between institutions and the RFC. Importantly, the RFC would be limited to providing equity capital and not buying assets.

The RFC would engage knowledgeable parties from the private sector to carry out day-to-day operations. One need only read Buffett's testimony before Congress in 1991 when, with great reluctance, he rescued Salomon Brothers from its own greed and avarice to appreciate that there will be zero tolerance for ethical misconduct by those engaged to carry out the work of the RFC.

The profits and/or losses of the RFC would be shared in proportion to the ownership percentages of Berkshire and the U.S. Treasury. The RFC would remain in existence until the equity stakes acquired were propitiously spun off.

### **The Virtues of Privatization**

Instead of centralizing decision-making as the means of pursuing a solution to an incredibly complex set of problems that by their very nature defy the means of centralization, the RFC would, through its understanding of motives and the application of commonsensical incentive systems, selectively enlist the largest number of private sector participants who would come voluntarily in pursuit of honest gain. For example, by providing equity capital only to the organizations that would approach the RFC for funding, such organizations would be incentivized, because of the high cost of dilution, to use the capital wisely and efficiently in disposing of the kind of assets that would restore their balance sheets to viability and eventually lead to restoration of confidence in the institution itself. Those who were on watch when the problems emerged will have the opportunity to redeem themselves by finding solutions that optimize the value for shareholders. Beyond troubled debt, the prime target of the bailout being considered, many financial institution balance sheets are riddled with credit default swaps and other difficult-to-value derivatives. A government entity would surely find it nearly impossible to address all of the issues in the opaque world of modern-day financial innovation. If those who are supposed to know the subtleties of these instruments fail to perform

their duty of rebuilding balance sheets to the satisfaction of shareholders, mechanisms are already in place to replace them by those who can.

The RFC would take into consideration the egregious compensation programs when pricing the equity capital infusions to any organizations that come calling. Subsequently, these agents (CEOs and others) would be accountable to all their shareholder principals, including the RFC. If privatization is to work effectively, institutional shareholders who are the majority owners of most American businesses must represent the interest of the ultimate owners vigorously. Given the mood of the country, it's unlikely that excessive compensation programs will be commonplace. If institutional and individual shareholders are vigilant, the end of the era of "golden parachutes" will be at hand. However, not a single new law will be required to accomplish the objective.

The risk of adverse selection will, of course, be present. Again, properly conceived incentives may contain this risk. If the RFC only cherry-picks, and a systemic meltdown results, even the cherries will be spoiled.

The risk of partisan politics, changing of the guard as a new administration takes over in January, bureaucratic gridlock, among other risks associated with government-controlled central planning will be greatly reduced by the ongoing continuity and stability of the privatization solution. Adam Smith's "invisible hand" will be vigorously at work—so long as the private sector minority owners and Board of Directors of the RFC conduct themselves with the kind of moral integrity that Smith deemed absolutely essential for the success of free-market capitalism. In attempting to optimize over time the return on Berkshire's 10% initial investment in RFC, it will, thanks to the "invisible hand," optimize the return on the 90% investment provided by taxpayers through the U.S. Treasury. The word "optimize" rather than "maximize" is more than a matter of semantics. If the RFC drives such a hard bargain that the financial system is again reduced to shambles, it may have maximized its return in the short run only to fail miserably at optimizing the return to itself, and the taxpayers who indirectly own 90% of the RFC, in the long run.

### **What about Relief for the Mortgagees?**

Once again, privatization and the proper alignment of incentives may provide a solution. Financial institutions may find it in the best interests of all parties to negotiate debt service concessions in exchange for some form of equity consideration. While laws must catch up with the current realities, philosophically such a plan has merit. For one thing, the vast number of Americans who have managed their mortgage debt responsibly will not be picking up the tab for those who haven't.