

**The Problem of Expert Agency
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Our current decade has been marked by stunning financial failures. The decade opened with the failure of Enron. More recently, we've seen the implosion of the entire market for mortgage-backed securities, followed shortly thereafter by the failure of such esteemed institutions as AIG, Bear Stearns, and Lehman Brothers. My thesis tonight is that there is at least one common thread that runs through each of these disasters. I propose to pull that thread, explore the implication of this flaw in the fabric of our financial system, and propose a solution for your consideration.

But first, a disclaimer. I take seriously the club ethos that the topic of our talks are to be in "areas outside our professional expertise." As financial advisor, this topic is of more than casual importance to my "area of professional interest (note I chose to avoid the word expertise after the events of the past 24 months...). Nevertheless, I beg forbearance on the relatively flimsy ground that while I am a consumer of economic analysis, I am not a practicing economist, and while a victim (as are you) of creators of public policy, I rarely have an opportunity to hold forth on matters of public policy.

Returning to the familiar story of Enron, the company collapsed after it was discovered that a significant amount of assets were mispriced due to their value being fraudulently established during transactions that were not arms-length transactions between independent entities. At the core of the fraud was the role of Arthur Anderson, Enron's accountant. At a crucial juncture the Anderson partner recognized that the transactions exchanging Enron cash for various financial instruments sold by partnerships formed by Enron senior managers may not have the value or liquidity reflected in Enron's financial statements. At that point, the Anderson partner informs Enron senior management that he is unable to provide a "clean" audit report. And, it is at that point that Enron senior management, led by CEO Kenneth Lay, begins to exert tremendous pressure on Anderson through its lead partner. In the end, the partner decides to delay recording the asset impairment, and the rest is, as they say, "history." A major Fortune 500 firm fails overnight, wiping out the retirement funds of many of its employees (another abuse, for another discussion). As the role of Arthur Anderson becomes understood, that firm implodes as well. Much has been written about the partner's failure, at a crucial moment, to do the "right" thing and yet we can all sympathize with the position that the partner found himself in. While his duty was to the integrity of his profession and Enron stock holders, he was being compensated by Enron management, and failure to "deliver the goods" with a clean audit would clearly have significant costs for his firm and himself. Caught by a misalignment between the entity paying for the service and the end user of his service, it is understandable that the audit process was corrupted.

Consider my second example, the implosion of the mortgage-backed security market. By early 2008 a number of abuses in retail mortgage lending were becoming better understood. One area of abuse (among many), was the corruption of the independence and reliability of the real estate

appraisal system. The purpose of the real estate appraisal is to provide an independent, dependable estimate of the market value of collateral. The real estate appraisal becomes a part of the loan documentation, and provides the basis for a third party to confidently extend capital without knowledge of the specific real estate market. Well, at least that's how the system was supposed to function. I have direct personal experience of sitting in a mortgage brokers office (although it was disguised as an office of a well respected bank) with a client. We were discussing whether a certain transaction would be feasible for my client. The Broker assures the client that the transaction would be feasible, and then in front of us, calls his favorite appraiser and says "George, I have a deal for you... the number needs to be \$410,000." Now, to be fair, I was not privy to George's response, but a couple of days later, my client informs me that the deal was "on" and the appraisal, miraculously, came back at \$410,000. A fortuitous coincidence? According to congressional testimony regarding abuses in the appraisal industry, it was not. In hindsight it's easy to explain what happened. George has worked hard to become the "favorite" appraiser for a broker who was doing approximately one thousand transactions in a year. As a matter of fact, this one broker became George's major source of revenue. This key customer calls with a specific request. George's choice is "deliver the goods" or risk the loss of a profitable relationship. In the heat of the moment, George decides to accommodate his key customer, and send the risk of overpriced collateral into the financial system, for some faceless investor to bear. It is important to note here that the ultimate customer for George's expert opinion is not the broker, but the investor who will be extending capital based on, in part, an independent, third party appraisal of the value of the collateral. So, in a situation very similar the Anderson partner, George's judgment is impaired because the person paying for his expert services is not the same person who depends upon the quality and integrity of that service.

Turn now to my third example, the abrupt change in financial condition of a number of highly rated financial institutions last fall. While not yet fully investigated and documented, the misjudgment of bond rating agencies regarding the credit worthiness of a number of large financial institutions clearly contributed to the scale of the financial crisis. Bear Stearns, and Lehman Brothers utilized tremendous amounts of financial leverage to deliver market leading financial results to their shareholders. As we can all appreciate, leverage amplifies the results of investments. This amplification of results can be both positive and negative, so that typically, more highly leveraged companies are seen to represent higher risks. In the case of Lehman and Bear Stearns, the amount of leverage has been disclosed to have been in excess of \$30 of borrowed money collateralized by \$1 of assets. (For those of us who are numerically challenged, that's the equivalent of buying a \$300,000 home with a \$10,000 down payment). This level of leverage did not occur suddenly, but evolved over a period of time, as management of these companies drove to continually increase profit margins. One might therefore expect that as the level of leverage increased, there would be a related decline in the credit rating assigned to the debt of those companies. This however is not the case, and both carried an "investment grade" rating within 30 days of their final failure. The case of AIG was somewhat different, but the result was the same. In AIG's case, the company assumed a number of contingent liabilities by virtue of trading in complex derivatives. The exact nature and magnitude of these liabilities were difficult for the "financial engineers" who created them to quantify. Nevertheless, when faced with the task of assessing the overall financial strength of AIG the various rating agencies (both bond rating agencies and insurance company rating agencies) failed to take note that there were undefined risks and provide AIG with a rating that reflected their inability to accurately assess

that risk. The unanswered question (so far) is how did this happen? There are occasional articles in the financial press commenting on “Congress to investigate Rating Agencies”, but so far nothing definitive has been produced. However, it’s interesting for our purposes this evening to observe that once again, there is an inherent disconnect between the entity paying the expert agent and the people depending upon the accuracy of that agent’s work.

Put crudely, my thesis is that each of these three cases are variations on the old axiom “He who pays the piper calls the tune.” Before we move to analyzing potential solutions to this problem, let’s take a step back and understand the role of “expert agents” in the economic system.

Classical economic theory postulates that a willing seller and interested buyer can, with sufficient information, set a mutually agreeable price and complete a transaction. It’s important to note the role of information in the transaction. In most transactions, there is an asymmetry of information. The seller likely knows a lot more about the item being sold than the buyer. One of the risks that the buyer assumes is that information unknown to him could significantly impair the value of his purchase. In response to this “information risk” the buyer may demand a discount from an otherwise fair price, or at least, significantly lengthen the time over which the transaction is considered. These outcomes work against the interest of seller.

The role of the “expert agent” is an answer to the information problem. The role of the expert agent is to collect, organize in a standard fashion, validate, and deliver to prospective buyers, information material to the value of the item in question. By doing so, the “expert agent” lowers the information risk of the buyer. This produces potentially higher prices for the seller, and increases the speed of transaction. Please note that “speed of transaction” is not an inconsequential benefit, because speed of transaction directly relates to volume of transactions, and ultimately the amount of profit available from a specific type of transaction.

The problem of expert agency is that while the buyer is the ultimate “consumer” of the expert’s work, in most cases it is the seller who controls the selection and compensation of the expert agent. It is this disconnect between duty and reward system that leads to conflicts of interest and ultimately the corruption we’ve observed in our three examples. So how do we address this issue?

As I began thinking about this problem, I felt the obvious solution would be to simply realign the compensation system so that the consumer of “expert agents” directly selects and compensates the agent. By doing so, we align the rewards system with the duty of the agent and needs of the buyer. It is a simple solution, applying market forces to provide the necessary checks and balances. However, in considering this solution further, it quickly becomes clear that blind application of free market dogma can have terrible unintended consequences. Full implementation of this system would have publically traded companies being continuously inspected by any number of “buyers agents,” each demanding somewhat different information. Imagine being Herman Miller, and entertaining detailed inspections from each of your major (and potentially minor) shareholders on a regular basis. The long term effect of this solution is a tremendous amount of duplication of effort, lost efficiency, increased cost, and, likely, a loss of accuracy and meaningful analysis due to the sheer volume of the work being done. While an ideologically elegant solution, it is completely unworkable.

A second option would be to create a system of independent “expert agents” whose selection and compensation is not controlled by the seller. Breaking the financial connection to the seller would serve to eliminate the inherent conflict of interest, and allow the “expert agent” to focus on performing their duties for the benefit of the consumer of their work. However, the question arises how would this system be organized and controlled?

One answer to this question would be that we would delegate the organization and control of the system to our government. There is a lot of precedent for this approach. Tonight we are gathered in this lovely structure without thought regarding the possibility that, at any minute, the entire structure could collapse on us. We are able to do this because our interests in the integrity of this structure were represented during the building process by a building inspector, an expert agent engaged by the local unit of government who applies a set of national standards (the building code) throughout the process of construction. Likewise, we have just consumed this delightful dinner without conscious concern regarding the possibility botulism or ecoli contamination because we understand that the kitchen, and indeed the entire food chain, is subject to regular comprehensive inspection by a variety of governmental agencies. Government organization and control of the “expert agent” system obviously works, however, there are some serious drawbacks which can be illustrated by discussion of the examples I’ve just cited.

Governmental systems are subject to corruption. Taxpayers rarely appreciate the value created by expert agents and tend to under compensate them compared to the commercial value of their knowledge in the general economy. That, combined with the potential economic impact of adverse judgments, can bring tremendous pressure on individual agents, with sometimes regrettable results. There are numerous cases locally and nationally, of outright corruption in building and health inspectors.

Governmental systems are subject to cooption. More subtle than outright corruption, governmental agents can, over time, be co-opted by gradual “identification” with the individuals they are charged with inspecting. This tendency is accelerated when there is an active tradition of a “service rotation” where the expert agents move regularly from the side of the regulator to the side of the regulated. The talent exchange between the SEC and Goldman Sachs has been documented, and may explain, in part the lack of regulatory rigor that appears to have developed in that agency over the past decade. At a very practical level, it’s hard to be unbiased when you’re inspecting an enterprise where you’re likely to be interviewing in the future.

Governmental systems can interject partisan political considerations, and opens the system to additional pressures from the regulated group through administrative control and funding discussions. Governmental systems are continuously exposed to discussions of administrative rules and funding that are, many times, completely unrelated to their mission. The result is that accuracy and efficiency are not the overriding consideration when resources and operating methods are being considered.

Governmental systems tend to be inefficient, bureaucratic and fail to adjust sufficiently quickly to changes in the economic landscape. Governmental stewardship of the Patent Office is a good example where the nature of the task has changed radically, and our government has been woefully inadequate in keeping up with the demands of the market place. One of the advantages

of our current system of “expert agents” in the financial system is that they are continually challenged to remain relevant to the current needs of both the buyer and seller in a transaction. Government regulatory control is inherently less adaptable.

So if our system of “expert agents” are not going to be imbedded into the government, what should this system look like? Ironically, I believe we should move to a system that is structurally similar to the one that we currently have, but with some significant changes in focus and orientation.

As we begin this portion of my argument, let me note that at least one aspect of the current system has already been significantly modified. In the cases of auditors and appraisers the answer of “who chooses the agent” has recently been changed. In the case of auditors, the choice of auditor in public companies is now a matter for shareholder vote. While a small step (indeed the whole idea of shareholder proxies deserves review), the shareholder vote at least removes the selection of the firm from the direct control of the corporate management (the individuals being audited). In the case of appraisers, I understand that recently financial institutions have gone to a system of maintaining a “bench” of qualified appraisers who are assigned to specific cases administratively, and not selected by the broker. This system reduces, but does not eliminate, the pressure on the appraiser to deliver favorable results in a specific transaction.

But we can go further in promoting systems of independent, objective “expert agents”. The start would be to recognize that being an “expert agent” is a career within itself, and is not a stepping stone to positions among the subject industry. Next, we need to reassert a code of professional ethics that clearly articulates that the duty of the profession is to the individuals actually using the information and analysis created. The professional standard would be established and evaluated by the efficacy of the services in the hands of the end user.

Additionally, there would be a clearly articulated duty to the integrity of the profession itself. Benjamin Franklin once observed “Gentlemen, we must all hang together, or assuredly we shall all hang separately.” This is particularly true of a system of “expert agents” on two levels. On a macro level, the system either produces value, or it will be replaced with a system that does. Remember, the role of the “expert agent” was to create value by removing information risk from a transaction.

The need for professional integrity is also present at the level of the interdependence within the profession. It is interesting to observe clients of Fairfield Greenwich sue KPMG Peat Marwick alleging that KPMG failed in their audit responsibilities because they accepted at face value the “audited” reports provided by Madoff Securities. The suit argues that it is reasonable to expect an KPMG to test the adequacy of fellow practitioners before incorporating their work product into their audit. If this suit is successful, the demands on inspection and validation of work product will increase significantly.

The need for professional interdependence extends beyond mere considerations of liability. True adherence to a consistent code of professional practice protects the expert agent from client pressure. Imagine the outcome of the Enron case if the Anderson Partner could have responded

to Ken Lay “Ken, I know you’re upset, and that you’re going to dismiss Anderson. What you need to understand is that any other auditor you retain will reach the same conclusion.” Confidence in the universal adoption of the code significantly reduces the probability of “opinion shopping”.

What would an effective system of professional standards look like? The best existing model that I am aware of is the medical model. This model includes quantitative measures of quality (timeliness and accuracy of charts, etc.) along with regular peer review and constant continuing education. To be certain, the medical model is not perfect. Discussions with practitioners indicate that their current system is cumbersome, time consuming, and at times does not seem directly related to the quality of care received by the patient. However, it appears that the results of medicine’s investment of time and money has been an overall decrease in the range of variation of outcomes and an overall increase in the quality of care delivered. And, one critical aspect of this system is that it is “owned” and operated by the practitioners themselves. Because of this, it is adapting as quickly as the practice of medicine is changing. This type of system would not have allowed the widespread use of derivatives at AIG without a clear understanding of the possible “side effects”.

Another aspect of the medical model is the impact upon practitioners of non-compliance. One reason that this system works is the consequences to the individual practitioner are severe. Loss of income, loss of assets, and possible criminal sanctions enforce the need to actively embrace the cannon of professional standards.

The effect of adopting a “medical” system of control for the accounting, appraisal, and rating professions will have some negative implications. I can foresee that in response to heightened personal risk (the consequences listed above), expert agents would require higher compensation. Comprehensive review systems take time and money to support, which again will increase the overall cost of the system. However, these costs are virtually meaningless when compared to the financial and economic costs of our current system.

Allow me to close with a simple observation. Last year’s failure of the financial system did not occur for lack of money in the financial system. There was sufficient money supply to support the level of economic activity. What suddenly failed was the confidence that owners of capital had in the integrity of the system. The role of expert agents is to provide accurate, dependable information that allows capital owners to act with a reasonable understanding of known risks. Even Adam Smith did not believe that the “invisible hand” of market forces could be allowed to operate independent of a system of rules that enforced honesty and transparency in dealings. In high irony, efficient, free markets depend upon consistently enforced rules to function.