Different Needs, Different Solutions to the Financial Crisis

Financial fears not seen since the savings & loan crisis in the late 1980s, maybe since the Great Depression, swept the economic landscape the week before last. The culminating event that week saw a late-night meeting between Secretary Paulson, Chairman Bernanke, and leaders of the Congress. The leaders heard that the financial system stood on the brink of a meltdown within days. In the markets, we saw short-term lending collapse by hundreds of billions of dollars.

Last week the world watched as the Congress intensely debated and reluctantly passed an emergency plan to stop the financial meltdown in its tracks. The $700 billion authorization gives the Treasury the resources to purchase the bad mortgage-backed securities from the balance sheets of financial institutions. This legislation addresses our most pressing short-term need – unfreezing our credit markets – but does not address our primary long-term need – revamping our regulatory structure to focus on the financial markets of the 21st century.

This op-ed outlines how we got into the current situation and how we can work our way out of it. Subprime mortgage lending obligations, mortgage-backed securities, went underwater with the bursting of the housing bubble and rising mortgage interest rates. Holders of these bad securities wrote down their value, which reduced their equity (capital) position. Low capitalized firms now faced problems. In addition, the lack of transparency in the financial markets hid from participants the exposures faced at individual financial institutions. Moreover, questions arise about other securitized loan packages – auto loans, credit card debt, and so on.

Fear spread like wildfire and lenders tried to flee to safe havens, such as Treasury securities and cash. As a result, financial institutions found it difficult to roll over their short-term liabilities to continue funding their operations. The shortage of short-term lending forced some financial institutions to sell off some assets, which put downward pressure on asset prices, a viscous spiral that fed on itself. That is, since institutions could not easily roll over their short-term financing, they sold assets. This process led to a liquidity crisis that sparked the late night meeting with Congressional leaders.

The Federal Reserve System introduced a series of innovations into their operations, forsaking, in large measure, the interest rate tool to supply credit to the markets through various schemes. The culmination of this process to date led to the opening of discount borrowing privileges to financial institutions other than banks. But, their efforts did not stem the tide. We saw the bailouts of Bear Stern, Fannie Mae, and Freddie Mac, the failure of Lehman Brothers, and then the bailout of AIG. This piecemeal approach to solving the financial crisis with the daily announcements of new problem institutions led to the proposal for a new broad-based approach. Moreover, bailouts extend to the rest of the world with recent problems in the UK, Germany, Belgium, France, Hong Kong, and so on. Ireland and Germany now insure all deposit accounts. More government intervention and action will occur in the near term.

Two major, but different, approaches to the broad-based approach exist – purchasing bad mortgage-backed securities from the financial institutions – the adopted Paulson-Bernanke proposal – and recapitalizing weak financial institutions – proposed by numerous pundits. Both approaches require much information that does not now reside with the federal officials. To wit, who actually holds the bad mortgage-backed securities and should qualify for the government purchase? Or, which institutions face dire straits and require capital injections to survive?

These two solutions imply different beneficiaries at the margin. That is, some financial institutions that need capital injections may not hold significant amounts of bad mortgage-backed securities. Their poor capitalization reflects other factors. On the other hand, some institutions with significant holdings of bad mortgage-backed securities may not need a capital injection. They can survive without government assistance.

The fear in the markets reflects in large measure the inability to assess the credit worthiness of financial institutions because the public does not know who actually holds the bad mortgage-backed securities. The Paulson-Bernanke proposal does offer the advantage of revealing, at least after the fact, the institutions that held the bad mortgage-backed securities. The other approach provides less transparency on this particular issue.

The Paulson-Bernanke proposal and other alternatives basically must restore the private sector's confidence in the financial markets. Until that renewed confidence emerges, we will continue to struggle with continuing stories of problems in the financial sector. Moreover, the problems of the financial sector will spill over and affect output (real GDP), employment, and unemployment, exacerbating the as yet undeclared recession. Thus, restoring confidence must occur.

Assuming that we successfully navigate the troubled waters of the current financial mess in the short run, we still face the longer-run issue of rethinking our regulatory structure. Many argue, correctly in my view, that the regulatory structure that currently exists makes sense for the financial markets that existed in the past. Financial innovation and the consolidation in the financial sector require a more comprehensive and coordinated regulatory structure. That is, we need to abandon the structure of segmented regulatory institutions and think about consolidation.

But an even more fundamental question needs an answer before redesigning the regulatory structure. To wit, who can better provide monitoring and control of financial institutions – government regulators or market participants? Given the right set of circumstances, market participants, who put their own money at risk, possess the incentives to monitor the actions of the financial institutions.

What needs to happen so that market participants can do their own regulation? They must receive complete and accurate information about the operations of the financial institutions. Absent such information, the private sector cannot oversee and correct poor management practices. Then, government regulation must substitute for this market failure to self-regulate.

More openness and transparency of the operations of financial institutions can go a long way to solving the problems of asymmetric information – largely moral hazard. Moral hazard means that the incentives of the managers of a financial institution do not correspond to the interests of the stockholders or clients of that institution. For example, financial institutions took on risky mortgage backed securities because they paid high rates of return. They also came with high levels of risk, but the performance of the institutions, which led to higher managerial pay, dominated the exposure to "unreasonable" risk.

If some information about financial institution operations cannot legitimately enter the public domain, then a role exists for government regulators to monitor that information of individual institutions and how it may, or may not, impinge on the performance of those institutions.

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