Moral Hazard and the End Game

Over the past year, as the financial crisis evolved, US officials have generally pursued a reactionary, ad-hoc approach. For more than half a year, some observers have been advocating some kind of comprehensive approach. It has taken a serious attack on the very foundation of the US financial system to get many officials to overcome their ideological resistance. The failure of Lehman, the forced marriage of Bank America and Merrill and other tie-ups between investment and commercial banks appears in the works, the nationalization of AIG, and the breaking of the sacrosanct $1 share value of some large and prestigious money markets and paralysis of the money markets has created a sense of urgency that has not existed before. **This very well may mark the beginning of the end of the crisis.**

Many officials have said this is the worst financial crisis since the Great Depression and yet were reluctant to follow that analysis to its logical conclusion. Now, however, Depression-era institutions, like the Home Owners Loan Corporation and the Reconstruction Finance Corporation (and the 1980s version, the Resolution Trust Corporation, for the savings and loan banks), are being resurrected as models for dealing with the current crisis.

Recall how these government institutions worked. They would buy distressed assets and later sell them. The RTC, which is the most recent example, was initially funded by Congress in 1989 with $50 bln. Over the course of the S&L crisis some 727 banks failed and the RTC took nearly $400 bln worth of assets. It took several years to sell-off the assets, but this was accomplished and the RTC closed down in 1995.

Treasury Secretary Paulson indicated that several hundred billion dollars of tax payer money will be needed. Many private sector estimates are in the range of $500 bln to $1 trillion. Paulson wants to remove illiquid assets from the balance sheets of financial institutions. Level 3 assets are illiquid and among just six of the largest banks, they have roughly $500 bln of such assets.

Through the first year of the crisis key decisions were made by the Federal Reserve and to a lesser extent the Treasury Department. Congress has played little role. However, that also has to change. **Many Congressional leaders were already frustrated that important decisions were left to the discretion of unelected officials**. Moreover, with hundreds of billions of dollars of tax payer money to be on the line, Congressional participation is critical. Although Congressional leadership seems to appreciate the urgency and a vote on a plan that may not be presented until Sunday or Monday could still be voted on before the end of next week.

Yet there are many in Congress and elsewhere who are reluctant to support any more government efforts to protect imprudent lenders or borrowers. Some, including Republican Presidential candidate John McCain, have been critical of the bailouts to date. When the Federal Reserve refused to support Lehman many in this camp were pleased. Not every one will be bailed out. Yet, within hours, it nationalized not a bank but an insurance company.

Vincent Reinhart, a former director of the Federal Reserve Board's Division of Monetary Affairs and now at the American Enterprise Institute, spoke for many when he told Bloomberg News that, "The government drew a line with Lehman and then erased a portion of the line" with AIG. The loan does "in fact raise issues about what the central bank is supposed to do." Similarly, Adam Posen, the deputy director of the Peterson Institute, told the news wire that the AIG action was "very bad news and it is a very confused precedent."

While admittedly opaque, there does seem to be logic to the Treasury and Federal Reserve decisions**. The litmus test was systemic risk.** The failure of Freddie Mac and Fannie Mae would jeopardize not only the US financial system but possibly the world's. It could not be accepted. It was judged that Lehman's failure would not pose systemic risk, even if it caused some market disruption. Reasonable people, with an understanding of the highly complex exposures, can differ on the judgment, but the Fed's actions have had the US Treasury's support and have generally been supported by global financial officials.

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One of the key issues that the critics of the Federal Reserve and Treasury actions press is that of moral hazard. The idea is that a person who is insulated from risk may behave differently than one who is fully exposed. An individual or an institution that does not have to bear the full consequences of their actions may be less careful. This has clear intuitive appeal and there are many examples of its validity.

However, it is not a comprehensive explanation for human behavior. **A person who buys home owners insurance to protect from fire and theft will not by simple virtue of the insurance begin playing with matches or leaving their door unlocked.** Similarly, the idea that the Fed and Treasury's actions pose a moral hazard because it will encourage greater risk taking seems misplaced. In fact, the tolerance of risk has steadily declined as the crisis has unfolded. Lenders and borrowers have become more prudent and possibly too much so as the Treasury and Fed acted to prevent a system meltdown.

At some point in the future, the risk appetite and animal spirits will be rekindled, but not because of the current official action, but because of the financial incentives at the time and the healing of scar tissue. Consider that for 40-50 years after the 1929 stock market crash (and the various reforms that grew out of it) American households were not significant buyers of equities, which were regarded as too risky for most. And if the gap between protecting imprudent investors and the rekindling of the risk appetite is measured in years, it would seem to call into question the cause-effect relationship.

In addition, even if one does not find this argument compelling, surely reasonable people can agree that sometimes there are more important, more pressing considerations than moral hazard. **The time to teach one not to play with matches is not as one's house and one's neighbor's house is burning down**. And in effect the House of Finance appeared to be on fire.

Just as there are religious fundamentalists, there are market fundamentalists. **They are willing to sacrifice the financial system to teach people a lesson. That seems to be, pardon the expression, but un-American.** The success of America and an important element to its economic prowess is not an ideological fixation, but a deeply-rooted pragmatism. With a straight face, can one really accuse the former CEO of Goldman Sachs Hank Paulson of being a Socialist?

During World War I, as the communists took control of the Russian empire and socialism was on the **rise** in Europe, US President Woodrow Wilson nationalized the US railroads. Afterwards, there were some who wanted the railroads to stay nationalized. Instead, they were privatized again. **What many perceive to be encroachments into the market place are likely to prove largely temporary and occurring during an emergency. This is not a permanent situation.**

While it may be important to dress for success, on the way to the guillotine, is not the time to worry about one's haircut.

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