Additional Thoughts on the Credit Crisis

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The Fed and the Treasury do not view the Bear Stearns situation as a rescue, nor do the shareholders of Bear Stearns. They view Bear Stearns as a forced sale into JP Morgan Chase, just as Countrywide was forced into Bank of America. In those cases, the government tried to avoid the market chaos that would have resulted from the liquidation of the companies in contentious bankruptcies. The government was not concerned with either the managers or shareholders of the two failing companies. But, they were willing to pay something to avoid market chaos and contagion. The government guarantee was necessary to facilitate the sale of Bear Stearns because of the very large prime brokerage exposure of Bear, and the speed with which the crisis developed.

In the cases of Fannie Mae (FNM) and Freddie Mac (FRE), the government was more harsh, putting both companies into conservatorship. The government treated them both the same although FNM had raised capital and FRE had not. The financial ratios for FNM were also better than those for FRE, but both had absurd rules for recognition of loss. By failing to respect the preferred stock holders of FNM after forcing FNM to raise capital via preferred stock, the government probably made a serious mistake. They severely damaged the market for financial industry preferred stocks. But, their goal was to signal to international holders of GSE bonds and notes, particularly central banks, that their holdings would be protected.

In the case of Lehman, the Treasury and the Fed had tried to find a buyer for Lehman, but there was some irritation with Lehman because they had six months after the Bear crisis and failed to do anything to improve their position. There were no buyers for Lehman who would make an offer without a government guarantee because of the large real estate exposure of Lehman on short term debt. There were buyers for parts of Lehman in bankruptcy. After looking at the books of Lehman and failing to find a buyer for the whole, the government decided to let them fail. Bank of America, one of the banks asked to look at Lehman, decided to buy Merrill Lynch instead. Merrill was a better fit with Bank of America in any case. However, Bank of America is still digesting LaSalle and Countrywide and already has a regulatory waiver because its total deposits are more than 10% of national banking deposits. Bank of America has moved from being too big to fail to being much too big to fail, an apparent conflict with the declared desires of the Fed and the Treasury.

AIG was a special case that was complicated by its international spread and its insurance holding company structure. The company claimed that it had a liquidity problem and not a solvency problem. But, that was true only if one ignored the ability of insurance regulators around the world to strip the insurance companies out of the holding company if they were to fear that the holding company might impair the insurance companies. I am not an insider, but I believe that the investment assets of the holding company were impaired and that the holding company was insolvent if it could not tap the insurance companies. The Treasury and Fed decision was forced by the inability of AIG to roll over its holding company debt, by the importance of AIG as a credit guarantor in multiple markets from traditional construction bonds to more exotic Credit Default Swaps, and by the concern that their global insurance network would be impaired and would spread contagion. The terms for providing a bridge loan to them were intentionally made very painful, and are, for the first time, consistent with guidelines for central bank crisis management drawn up by Walter Bagehot in "Lombard Street" a hundred thirty years ago. The Feds will get a warrant for 79.9% of the company and will charge a penalty rate for the bridge loan to force an expeditious sale of assets. The Feds also forced a change of management at AIG.

The speed of the crisis during recent weeks appears to have been accelerated by abusive, naked short selling and by some manipulation of the credit default swap market by hedge funds and private equity funds. The SEC has finally acted to stop the abusive short selling with some new regulations. They were not enforcing the old regulations in order to allow the development of exotic products such as double short exchange traded funds. The SEC has been devoid of intelligence through the bubble and the correction. They still have a proposed regulation pending that would allow a return to the anything goes behavior that almost destroyed the money market fund industry in the 1980s. Institutions have begun to respond to the abusive short selling against financial companies by withdrawing their stock from securities lending programs. Hopefully the remaining banks are smart enough to withdraw lines of credit from the hedge funds that have been attacking them.

We still have some bank and investment banking situations to resolve. Washington Mutual is now accepting bids for a takeover. Wells Fargo is talking to Citibank. Wachovia and Morgan Stanley are talking, as are Morgan Stanley and HSBC, etc. Some mergers in Europe are also in discussion, with Lloyds-HBOS the most public among them.

There are many complaints about the mark to market accounting rules as an accelerant of this crisis. During the bubble, valuations were abusively inflated and impairments were slow to be reported. But, the sudden change to honest accounting after values began to fall rapidly was disruptive. There are also legitimate complaints about the Credit Default Swap market. The lack of standard documents, the lack of a clearing house structure, and the over-the-counter nature of the market were kept in place by the dealers because they kept spreads wide and dealer profits inflated. But, they also allowed market manipulation during this crisis. Banking regulators should reject credit default swaps as a credit enhancement unless the CDS meet minimum standards.