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What We've Learned From the Market Mess

By Bruce Wasserstein
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We are in the midst of a financial maelstrom, and the voices of pain and confusion have reverberated throughout the economic and political world. Financial markets, of course, are cyclical. It's natural for investors and politicians to be disappointed when booms end, but they always do. The issue before us is how to prepare for the future.

We can learn a few lessons from past experience. Sarbanes-Oxley was a kernel of a good idea, but was poorly executed in many ways.

We have learned that the "risk management" emperor had no clothes. Hundreds of Ph.D.s in risk-management positions are now discredited. The protective pyrotechnic mechanisms such as Value At Risk, which were supposed to predict the risk in a portfolio of assets, are duds. The financial controls have proven to be inadequate.

We know that the pace of change is accelerating, and that requires even more adroit adaptation on the part of the market and regulators. Financial technology has outpaced our common sense in absorbing it. In the last 10 years the banks have innovated an array of financial devices, which were brilliant in their conceptualization, and in the early days were disciplined by a due diligence process for the underlying securities. But in their evolved forms, the knowledge of what these innovations were being wrapped around got lost.

So it's not shocking that there are cracks in the system. What is surprising is the sheer size and the high proportion of risky bets that were made. But the real magnification of that risk comes from the nature of the leveraged balance sheets of most financial institutions. The traditional regulatory quantifications of risk were not realistically tested. That's why firms can assert they have enough capital and yet have no liquidity.

The rating agencies are at the vortex of the storm. What were they thinking? In a housing crash situation, which had a reasonable chance of happening, how could the securities rated AAA be worthy of that rarified appellation? They couldn't and shouldn't have been. But it was that label that got institutions around the world to buy into the bubble. That demand generated the hunger for more product and therefore drove "innovations" such as the document-free loan. The losses and write-offs will continue.

What then can be done? First, this issue can't be looked at in isolation. Regulating innovation is a daunting task. Doing it at one level such as at commercial banks, without doing it at hedge funds, investment funds and investment banks on a global basis is illusory. It may feel good, but the systemic risk is still there. Clearly, the rating agencies need an overhaul, and there should be more transparency on the portfolio diversification of financial institutions and the leverage in their positions.

To have incentives and guarantees for reasonable mortgages all sounds sensible, but we must be cautious about thinking that the government should be in the business of supporting hot air. If the Dutch government had said it was going to support the level of tulip prices during the famous tulip bubble of the 17th century, we would have chortled. But no one seems to be smiling at the idea that Congress is going to legislate high real-estate prices.

The main problem today is the liquidity crunch. The banks are simply not lending, and that is very dangerous. Lowering interest rates by itself doesn't help the public when there is no money being lent. In an odd way, banks have reacted to regulators desiring that they clean up their balance sheet by pulling back from new loans. So lending to financial institutions may make some sense, but only if they in turn commence lending, and if the taxpayers get appropriate payment for their loans. Taxpayers shouldn't be in the position of subsidizing commercial institutions without fair payment.

What we should care about is that deserving small businesses and homeowners have access to loans; we need a spark plug to start liquidity, rather than focusing on the losses of the past. In some cases we may need to split the bad bank that needs cleaning up from the newly capitalized bank with fresh funds, which will go back into the business. In many cases, this can be accomplished with private funds, once asset prices are realistic.

There may be situations where federal funding is the financing of last resort or is necessary as a backstop or catalyst to constructive transactions. Rather than have the Federal Reserve do these investments on an ad hoc basis, a preferable structure would be for the Fed to fund the equity for a new institution with professional management, which I call the Liquidity Funding Bank. The analogy is partly to the World Bank and partly to the historic Bank of the United States, but hopefully without the politics.

Its mission would be to help U.S. economic development in the financial sector, but subject to a profit discipline. For example, it might ask for warrants in companies who need to borrow against their illiquid inventory.

This crisis will be painful, but it can be managed. It requires less rhetoric and more coordination, dexterity and thought about consequences. In the long term, the dynamics for global growth are compelling, but this will be a painful valley.

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