Credit crunch: Regulating chaos

by the St. Louis Post-Dispatch

The Federal Reserve last week became a major lender to the investment banking business, pumping $29 billion directly to Wall Street firms with promises of more to come.

The Fed also agreed to risk $30 billion of taxpayers' money to keep Bear Stearns breathing.

The U.S. taxpayer now has skin directly in the investment banking game. That being the case, shouldn't those taxpayers have more say in how that game is played?

A cry is going up in Congress for more government regulation of investment banks. While that's generally a good idea, it won't be easy to implement. Nor would it necessarily prevent the sort of rolling crisis that now threatens the credit system.

The Fed has long played lender of last resort to commercial banks. When no one else will lend to a bank, the Fed steps up. That, plus federal deposit insurance, explains why there are no longer "runs" on commercial banks, and why they rarely fail.

Investment banks had no such guarantee. So, when rumors spread that Bear Stearns might fail, investors and trading partners rushed to pull their money out and cut off business with the firm. It was a classic bank run, and few solvent firms could survive it.

Given the shaky state of the credit markets, the Fed worried that Bear's failure could set off a panic, leading to runs on other investment banks. Large parts of the lending system could freeze up, turning a mild recession into a lollapalooza.

So the Fed made low-rate loans available to major investment banks for the first time since the Great Depression. Among commercial banks, such federal backup comes with a catch - heavy regulation. Government bank examiners troop through each bank yearly, checking the quality of the bank's loans and securities. When things look shaky, regulators force the bank to shore up its finances or sell itself off.

Over the decades, Wall Street has become a much bigger part of the credit system, while remaining scantily regulated. Now we're seeing what can happen when billionaires and multi-millionaires make mega-mistakes at investment banks. They can threaten the economy and leave millions of Americans poorer. Hence the cry for regulation.

Some steps are no-brainers. The government should increase capital and reserve requirements, forcing owners to keep more of their own money in their operation as a cushion against losses and bank runs. That will cut profits, so expect investment bankers to whine.

Regulate too firmly and they could also say goodbye. "You could chase them out of the country to a place where they're not regulated," said finance professor Mike Alderson at St. Louis University.

Even tough regulation isn't a cure-all. The investment game is so bogglingly complex, and the players so interdependent, that few people understand it. There's no guarantee that regulators would be better at spotting approaching tsunamis than the people running the banks.

The subprime mortgage mess is a prime example. The Federal Reserve already has the power to set rules for the mortgage industry, and the Fed missed the warning signals as the subprime mess built.

In the early 1980s, Congress leaned on bank regulators to go easy on the savings and loan industry. A few years later, the industry collapsed, costing taxpayers dearly and helping to usher in the 1990 recession.

The Fed can't let that happen to the mortgage industry. The subprime mess got out of hand because lenders could make bad loans, pass them off to investors, and wash their hands of the consequences. At the end, lenders weren't even verifying a borrower's ability to repay. The Fed must impose basic standards for mortgage lending.

The Financial Times reports that the Fed and other central banks are thinking about bailing out the banks by buying mortgage securities that no one else will touch. That could make the S&L bailout, which cost taxpayers the equivalent of about $200 billion in 2008 dollars, look like a bargain.

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