The New York Times

F.D.R.'s Safety Net Gets a Big Stretch

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Published: March 15, 2008

It was an old-fashioned bank run that forced Bear Stearns to turn to the government for salvation on Friday. The difference is that Bear Stearns is not a commercial bank, and is therefore not eligible for the protections those banks received 75 years ago when Franklin D. Roosevelt halted bank runs with government guarantees.

Bear was, instead, emblematic of a financial system that grew up over the last two decades, one that largely marginalized traditional banking and that enabled lenders to evade much of the regulatory framework that had also begun during the Roosevelt administration.

The new system enabled loans to be made by almost any financial institution with the money coming from the sale of increasingly complicated securities backed by the loans.

Regulators believed that the new system spread out the risk. Alan Greenspan, a former chairman of the Federal Reserve, said the system had transferred risk from banks — which he called "highly leveraged institutions" — to "stable American and international institutions."

It turned out he was wrong. Much of the risk had remained with commercial banks, but packaged in such a way that they were required to put aside fewer reserves to protect against losses. Much of the rest of the risk ended up with financial institutions that relied on their ability to borrow at low rates whenever they needed it.

"A sizable fraction of long-term assets — assets with exposure to different forms of credit risk— ended up in vehicles financed with very short-term liabilities," Timothy F. Geithner, the president of the Federal Reserve Bank of New York, said last week in a speech. "As is often the case during periods of rapid change, more significant concentrations of risk were present than was apparent at the time."

That risk has come to the fore in the last several months, as several mortgage companies and smaller financial institutions have failed. This week Carlyle Capital, a highly leveraged lender formed by the Carlyle Group, a private equity fund, collapsed. It had borrowed more than $30 for every dollar of capital, and it could not meet demands from lenders that it put up more cash even after it got a $150 million loan from the Carlyle Group.

Bear Stearns, which boasts that it has never had a losing year in its 85 years, was plagued by rumors that it owned securities it could not sell and that it might be unable to borrow enough money to hold on to the securities.

In a conference call Friday, Bear's chief executive, Alan D. Schwartz, said that as rumors spread, customers became more nervous, "to the point where a lot of people wanted to get cash out."

At first, Bear could meet those demands, he said. "But they accelerated yesterday, especially late in the day, and as we got through the day, we recognized that at the pace things were going, there could be continued liquidity demands that would outstrip our resources."

Overnight, the Federal Reserve and JPMorgan Chase arranged to provide the cash Bear Stearns needed. Bear could not borrow directly from the Fed because it is not a commercial bank.

The Fed had seen such problems coming, and had announced plans this week to lend money to major dealers in Treasury securities — like Bear — by taking in as collateral mortgage securities that are now hard to sell.

By coincidence, the demands on Bear Stearns came on the 75th anniversary of the day when American banks reopened after the holiday declared by President Roosevelt when he took office. He assured Americans that only safe banks were being allowed to reopen, although there was no way he could really be sure.

The rescue of Bear is not permanent — the loans are for only a month — and there is an expectation that authorities will seek to arrange for Bear to be acquired, perhaps at a low price, or that it will be broken up and sold to more than one buyer.

Such an outcome could avoid systemic risk while leaving Bear's top executives without jobs and perhaps deflecting criticism that they had not had to face the results of their mistakes. Bear stock fell 47 percent on Friday; all of the decline came after the rescue was announced.

Deposit insurance largely ended runs at commercial banks, because depositors with less than $100,000 in a bank believed they did not need to worry even if they heard rumors of trouble.

But when investors do not have such confidence — as in Britain last year, where deposit insurance covered only the first £2,000, or about $4,000 — the rational response is to grab the money and ask questions later. That was one reason Northern Rock, a British bank, saw its depositors flee and in the end was taken over by the government.

Mr. Schwartz, Bear's chief, says his firm remains solvent. But such assurances are seldom credited during panics. As Walter Bagehot, the British financial journalist, wrote in "Lombard Street," a 19th-century book on the monetary system, "Every banker knows that if he has to prove that he is worthy of credit, however good may be his arguments, in fact his credit is gone."

At the bottom of the current crisis is a distrust of many financial institutions and securities that goes beyond Bear Stearns.

"This is a credit problem, not a liquidity problem," said William L. Silber, a finance professor at New York University who has written about the 1933 crisis.

“The root question is,” he said, “Will mortgage borrowers be able to repay their debts? That risk and that uncertainty is still there, and that has brought into question all sorts of credit exposure.” He argues that because that question cannot be resolved soon, in the end the Treasury will have to do as it did in 1933, and issue broad guarantees.

Whether or not that happens, the government may have to revise its regulatory system, which, as Mr. Geithner noted, has “evolved into a very complex and uneven framework, with substantial opportunities for arbitrage, large gaps in coverage, significant inefficiencies and large differences in the degree of oversight and restraint upon institutions that engage in very similar economic activities.”

He called for “a more uniform set of rules applied evenly across entities involved in similar functions,” and added that “institutions that are banks, or are built around banks, with special access to the safety net, need to be subject to a stronger form of consolidated supervision than our current framework provides.”

Friday’s Fed move shows that investment banks have that “special access to the safety net,” a fact that may lead to more regulation.

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