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Commentary: What a long strange trip

Wed Oct 1, 2008 1:21pm EDT

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By Sreedhar T. Bharath and Amiyatosh Purnanandam

ANN ARBOR, Mich (Reuters.com) -- Those who cannot remember the past are condemned to repeat it, said philosopher George Santayana.

Many observers seem shocked at the possibility that while Wall Street's profits remain private, its losses will be socialized. The troubled asset relief program -- or as one wag put it, total abdication of responsibility to (common) people -- seeks to empower the Treasury Department to purchase up to \$700 billion of distressed mortgage-backed securities. The truth is, the U.S. model of capitalism has always indulged in bailouts in the last century.

In 1989, in the aftermath of the Savings and Loan Crisis (S&L), the Resolution Trust Corp. was formed to rescue 747 S&Ls at a taxpayer cost of \$125 billion. The Wall Street Crash of 1929 saw FDR expand the Reconstruction Finance Corporation set up by Herbert Hoover to bail out banks during the great depression. The cost? An estimated \$9.5 billion of taxpayer money in those times. The Federal Reserve itself was born in 1913 as a response to the banker's panic of 1907. Not to mention the nonsystemic bailouts: Chrysler in 1979, hedge fund LTCM in 1997, Penn Central in 1970. The list goes on.

So what's unique about this crisis? The sheer scale of this bailout package deserves some mention. Otherwise, it is history re-run all over again. It is the "heads I win, tails you lose" moral hazard mentality of Wall Street at its best (or, shall we say at its worst).

Many of these financial institutions crying for help today operated with exorbitant levels of debt without any meaningful regulatory oversight. They put borrowed money into businesses they had little grip on -- complex (call it imaginary) derivative securities backed by mortgages owned by Main Street America. Add to that the multi-million dollar incentive packages for the top brass of these firms, which fuel them to do more of these deals, and you have a recipe for disaster. All of this in the name of free markets! Free

markets as long as the bet was paying off. Once the bet goes bad, the toxic waste is being dumped on Main Street.

To us, the real danger is not the preservation of financial flexibility today, but limiting the moral hazard problem tomorrow. Can we be sure that a bigger bailout package is not needed 10 years from now? What guarantees have been offered that this bailout package won't encourage excessive risk-seeking behavior in the future? Yes, we need to survive today, but we should survive while preserving the long-term viability and virtues of free markets.

We have to start with better disclosure and transparency in the financial markets. As of today, we are still unable to assess the dollar value on the securities held by these financial institutions. Second, we must think hard about executive incentives and design-compensation schemes that limit "excessive risk-taking". And finally, financial firms must encourage a culture of risk-management across their organizations. Risk-management is not a luxury, but a necessity, for highly levered institutions. We have been having a thousand-year flood every 10 years on Wall Street for too long. While we might still get out of this hole, we need to learn our lessons from history for good. Otherwise, the next market conflagration around the corner might well be the financial equivalent of a nuclear winter.

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