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Preventing Another Bank Disaster

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It's been two years since the Fed and J.P. Morgan rode to Bear Stearns' rescue, heralding a wave of federal bailouts. Jeffrey E. Garten on why so little has been done since to prevent another collapse.

Richard Drew / AP Photo

This Sunday evening marked the second anniversary of the rescue of Bear Stearns by J.P. Morgan, backed by a $30 billion capital commitment from the Federal Reserve. The bailout was the opening curtain for a drama that would see an unprecedented level of federal involvement in the U.S. financial system—even greater than the 1930s when you consider the TARP funds, the Fed's takeover of AIG, and the Fed's purchase of more than $1 trillion of mortgage securities.

The J.P. Morgan/Bear Stearns/Fed deal was put together over a few days of frantic meetings and phone calls among Treasury Secretary Hank Paulson, Fed Chairman Ben Bernanke, New York Fed President Tim Geithner, SEC Chairman Chris Cox, J.P. Morgan CEO Jamie Dimon, and Bear Stearns CEO Alan Schwartz, with Paulson briefing President George W. Bush on multiple occasions. It was a race against time, the administration driven by a fear that if a merger agreement wasn't completed before the Asian markets opened on Monday morning, March 16, then the financial system itself could melt down.

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In the few days of white-knuckle deal-making—J.P. Morgan, at first very reluctant, needed heavy financial inducements from Uncle Sam—all the elements of the worldwide banking crisis that would soon break out in the open were, in retrospect, present. That included banks that had recklessly borrowed 30 or more times their capital; the fear among policymakers that banks were too big and too interconnected to be allowed to fail, and hence needed billions of dollars injection from taxpayers; the appearance of securities that had become too complex and too opaque to understand, let alone value and trade; and all the other features of the financial crisis we have come to know only too well. With the bailout of Bear Stearns, moreover, it became clear that Uncle Sam would never again allow a major global financial firm to fail, no matter how much money it took.

Two years on, here's the question: What has happened to make sure that the financial system never again verges on collapse, and requires so large a federal intervention, with all the collateral economic and human damage that entails? And here is the answer: not much.

To be fair, the problem that had to be addressed was horrendously complex. In the level of debts they acquired, in the peddling of arcane securities they didn't understand, in the sound risk management they disregarded, in the greed they exhibited, the banks were guilty of a degree of irresponsibility that boggles the imagination. But that was just part of the story. From the Fed to the SEC, the regulators' neglect in failing to curb risky banking behavior constituted serious malpractice. The credit agencies, paid by the financial institutions they rated, engaged in egregious conflicts of

interest. The Clinton and Bush administrations, in cahoots with Congress, pushed deregulation well beyond anything that made sense. Senior policymakers allowed the U.S. to run budget and trade deficits that required importing massive capital from abroad, flooding the country with cheap money that found its way to subprime mortgages and other highly risky products. How could the administration and Congress, buried in vicious partisanship and weighed down by a massive and contentious legislative agenda, have possibly addressed all of that effectively?

They have certainly tried. President Obama early on presented a fulsome blueprint for regulatory reform. The House, led by Congressman Barney Frank (D-MA), passed a thoughtful and comprehensive thousand-page bill in December. On Monday, Senator Christopher Dodd (D-CT) is due to report out a bill from his committee without Republican support. The Senate will have to debate it and pass it with 60 votes. Assuming that happens—a big assumption—then the two bills will have to be reconciled, another major challenge because there will be big differences over certain issues, particularly the establishment of a Consumer Protection Agency for financial products. Whether all this can successively transpire in the wake of whatever happens with health-care legislation is highly problematic.

Still, there is reason for hope. The public rancor against big banks is so great that it just may be the Congress will rally for this one. I have been talking to a number of leaders on Wall Street and Washington and my sense is that nearly everyone wants to see something passed, no matter how ridden with holes, just to put a line under this sorry period of American financial history. For the administration and Congress, failure to do something would be the ultimate indictment of inability to govern. For the financial community, the concern will be market instability resulting from continued regulatory uncertainty. But even assuming some legislation passes, there is another reason why not much will have happened since the Bear Stearns collapse.

Congressional efforts, no matter how sincere, are ultimately constrained by the fact that the legislature has only national jurisdiction. On the other hand, the financial problems are global. Thus, while Congress (and the administration) really wants to find a way to close down a major financial institution without bringing down the entire financial system, as the sudden and chaotic bankruptcy of Lehman Brothers almost did, given the global reach of the big banks, an orderly winding down can only be done with a set of rules that involves other key countries. Congress (and the administration) would really like to create a regulator that looks across the entire financial system for risks that are building not just in one bank such as Morgan Stanley, but among many kinds of entities, including insurance companies like AIG. But that requires the establishment of a global institution. The same is true of the oversight of hedge funds or derivatives, or the setting of higher reserve levels for financial institutions. At the moment, there is no international agreement on any of these questions.

In the 1930s, the regulatory reaction was transformative. Commercial banks and investment banks were separated, federal deposit insurance was established for the first time, and the Securities & Exchange Commission was created to provide a quantum leap for investor protection. As deep as the Great Depression was, it was probably simpler to react to it than to deal with what has happened in the past few years. That's because in the wake of the 1929 crash, there were so few regulatory institutions to begin with—and because the global dimension of the solution was not considered important. No such luck now.

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