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Reshaping the banks: time to ask the IMF for help

by Raghuram Rajan

Financial markets are in panic. Central banks are willing to lend against all manner of collateral. Yet inter-bank credit markets are freezing up. Why? Have central banks contributed to the problem? And what do we do now?

The root of the problem, of course, lies in one class of assets, mortgage backed securities, rising in complexity as a result of defaults on the underlying housing mortgages, and falling in liquidity and value. Banks found they could no longer pledge these assets as collateral against borrowing. A bank now had two problems.

One was an immediate liquidity problem. It had to find a way to finance the mortgage backed securities that were previously financed with debt. The second was a capital problem. Because the market value of its assets had fallen, it was very thinly capitalized on a market value basis. But this problem could be handled later.

This, in a sense, was the Bear Sterns situation – illiquidity rather than insolvency. Central banks reacted by expanding the range of entities they would lend to and the range of assets they would accept as collateral. This immediately alleviated the liquidity problem, as banks borrowed pledging illiquid assets at the central bank.

But having solved the liquidity problem, banks did little to bolster their capital. Indeed, the capital problem has been getting worse. Moreover, with much of the collateral pledged, the bank has to rely on unsecured funding. Unsecured lenders to the bank (and the inter-bank market is unsecured) are now unwilling to lend, knowing that their claims will be hit when the bank defaults. And unless the central bank is willing to substitute for the entire unsecured loan market, the bank will have to default. What was a liquidity problem is now a solvency problem, which cannot be solved by further small increases in liquidity infusion.

Why have the banks not been more pro-active in raising capital? Clearly they felt they had time, in large part because the assistance from the central banks alleviated the liquidity problem. Rather than selling equity when asset prices were moderately depressed, they thought they could wait the crisis out. And central banks may have been at fault in not pressing the issue harder when it was easier to raise capital, especially given that their liquidity assistance was helping banks postpone capital raising.

What now? In the United States, the Treasury Plan has focused on buying distressed assets rather than on recapitalizing banks. Of course, if the price of mortgage backed assets can be boosted sufficiently and quickly, some banks will be recapitalized, but given that the values of many other assets are falling, this may only be a partial fix, even if it works. And it may be too late. Hopefully, the authority obtained from Congress can be quickly redeployed in recapitalizing banks more directly.

The reluctance to call this a problem of inadequate capital is, partly, prudence (which central banker wants to say parts of the banking system are insolvent) and partly optics. A liquidity intervention could perhaps be passed off as something that need not cost the taxpayer, while a capital infusion by the government seems a more final use of taxpayer money. Politicians still may believe drastic action is not warranted, though it seems that buying assets at made-up prices is as drastic, if not more, than buying equity or preferred shares at market prices.

The more Machiavellian view is that large players in the banking sector like the way it is currently being reshaped, as these too-big-to-fail entities are willing to run down their capital ratios buying the lucrative businesses of entities that have failed. They prefer a selective and limited rescue. While a reshaping of the banking system may be needed, it would be unfortunate if access to government protection rather than efficiency determined how it was reshaped.

There have been many suggestions on what to do. A temporary guarantee of the short term liabilities of all levered financial institutions, a quick audit, followed by speedy resolution of those that are beyond revival, and a recapitalization plan, perhaps including government money, for those that can survive, are all elements of what needs to be done. Key here is to provide incentives for private capital to participate, and even do the bulk of the lifting. Purchases of distressed assets from banks will be part of the solution, but it cannot be the sole item. Indeed, there is tremendous experience in the IMF of how this can be done. All the United States needs to do is ask!

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