Why the Crisis?

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Predictably, Congress and much of the media are looking for evildoers to explain why the subprime mortgage market brought on a financial crisis. Just as predictably they will find some bad apples and practices and will offer new legislation to prevent repetition. And they will do their best to smear the reputations of those responsible for policy earlier in this decade.

Finding scapegoats and passing new legislation may satisfy the public. It does nothing to prevent a similar crisis a few years from now.

The main puzzle is that most of the buyers and sellers of the trash that is now nearly worthless were MBA graduates of elite business schools. Better than most, they knew enough to avoid making loans with no down payment to borrowers who had few assets and a poor credit record. It doesn't require an MBA from an elite institution to recognize garbage.

They didn't because their incentives encourage many of them to ignore the quality of what they sell or buy. Unlike any other large industry, financial markets pay enormous bonuses for "performance". For several years, the profits were great and the bonuses large and, for many, irresistible. Their supervisors had the same incentives. The main incentive was to increase the size of the bonus by increasing the bottom line.

Even worse, failure to play to the game could cost you your job, not just your bonus. Two or three years later, you get to say "I told you so" from the unemployment line.

The compensation system creates these incentives. By the time, the inevitable crisis came, the originators had sold the junk to someone else along with assurances from the MBAs at the rating agencies.

Where were the financial regulators? The Basel Accords required banks to increase capital if they held these securities. Instead of holding the assets in a monitored financial system, the mortgages and claims went ...goodness knows where. We find out only when the holders are in distress or about to declare bankruptcy. Despite the many shortcomings of past bank regulation and supervision, the Basel Accords created new incentives to hide risky assets off the banks' balance sheets. A big mistake.

More regulation is not the answer. Decades of regulation to protect the savings and loans ended in enormous losses paid for by the taxpayers and the end of the industry. Sarbanes Oxley has harmful, unintended consequences that legislators did not foresee. More than fifty years passed before Congress repealed the disincentives imposed by the Glass-Seagall Act and interest rate regulation.

Regulation creates incentives that are not foreseen. Interest rate regulation brought money market funds just as the Basel Accords created incentives for avoidance of capital requirements. There are many examples.

As long as current inventives remain, financial problems will come again in a different form. The financial industry must be encouraged to revise its compensation system to reduce the incentives that end in financial crises by rewarding socially costly behavior. The administration must rethink the incentives created by the Basel Accords.

That's not what the administration and the Federal Reserve have done and what the Congress is likely to do when it returns. They seek to protect people who made bad decisions by changing the terms in the contracts. There is no surer way to create future crises than to push these losses onto the taxpayers.

Capitalism without failure is like religion without sin. It doesn't work.