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Wall Street Bank Run

By David Ignatius
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It doesn't look like an old-fashioned bank run because it involves the biggest financial institutions trading paper assets so complicated that even top executives don't fully understand the transactions. But that's what it is -- a spreading fear among financial institutions that their brethren can't be trusted to honor their obligations.

Frightened financiers are pulling back from credit markets -- going on strike, if you will -- to escape the unraveling daisy chain of securitized assets and promissory notes that binds the global financial system. As each financier tries to protect against the next one's mistakes, the whole system begins to sag. That's what we're seeing now, as credit market troubles spread from bundles of subprime residential mortgages to bundles of other kinds of debt -- from student loans to retailers' receivables to municipal bonds.

Investors are nervous because they aren't sure how to value these bundles of securitized assets. So buyers stay away, prices fall further, and the damage spreads.

The public, fortunately, doesn't understand how bad the situation is. If it did, we might have a real panic on our hands. And there would be more pressure for bad policies -- ones that try to freeze the damage, rather than letting prices fall to levels where buyers will return and the markets will clear. Hillary Clinton's proposed moratorium on home foreclosures, in that respect, is one of the truly bad ideas of our time. It would make the situation worse by increasing even more the illiquidity and inflexibility of the housing market.

The answer to Wall Street's bank run may be a version of what saved Main Street banks during the Great Depression. President Franklin Roosevelt created the Federal Deposit Insurance Corporation in 1933 to reassure the public that there was an insurer of last resort for the banks -- and that people's money was safe even if they couldn't see it or touch it or put it under a mattress. Rep. Barney Frank and other congressional experts are weighing different approaches to this problem of how to backstop the markets without Clinton's misguided moratorium.

These markets are now so complicated that most of us can't begin to understand the details. So I asked the chief financial officer of a leading concern to walk me through what has been happening. The problem, he said, is that financial institutions are required to "mark to market" their tradable assets (which is a fancy term for setting a value) even when there isn't a functioning market. In many cases dealers can do little more than guess at the value -- and other investors down the line know it.

To explain how this happened, the CFO took a simple example of residential mortgages. As financial engineering improved in the 1990s, these individual loans were gathered into bundles -- 10,000 home loans of $100,000 each, let's say -- and turned into a $1 billion security that could be traded in ways the individual mortgages never could. But that wasn't enough. The financiers realized they could boost their profits by carving the $1 billion package into different slices, with different risk levels. In that way, a pool of B-rated mortgage assets could generate a slice that was rated AAA, because it was judged the slice most likely to be repaid.

But what happened when the real estate market confounded recent history and began to turn down? People holding the paper could no longer be sure if or when their particular slice would be repaid. The traditional accounting approach -- of estimating the projected cash flow and then discounting for the risk -- didn't work. With 10,000 disparate mortgages underlying the paper, both the rate of cash payments and the risk of default were impossible to predict. So the pyramid began to wobble.

The hubris in this system was Wall Street's confidence that it could value paper securities that had been sliced and diced so many times that they no longer had solid connections to their underlying assets. The nation's leading financier, Warren Buffett, had warned years before that "derivatives," whose value was balanced loosely on the real assets underneath, were the equivalent of "financial weapons of mass destruction." But in the rush for profits, nobody listened.

I've saved the worst for last. Do you want to know who is bailing out America's biggest banks and financial institutions from the consequences of their folly -- by acting as the lender of last resort and controller of the system? Why, it's the sovereign wealth funds, owned by such nations as China and the Persian Gulf oil producers. The new titans are coming to the rescue, if that's the right word for their mortgage on America's future.

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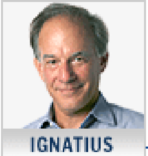

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