

**It is no longer illiquidity!**

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 little bit of arithmetic helps illustrate the consequences. Say an investment bank, levered about 24 to 1, had 96 dollars of debt and 4 dollars of equity capital funding 100 dollars of assets, before the crisis. And suppose 90 dollars of those assets were liquid securities and 10 dollars were mortgage backed securities. As mortgage backed securities plunged in value, say to 70 cents on the dollar, and nobody was willing to lend against them, the bank had two problems.

One was an immediate liquidity problem. It had to find a way to finance the 10 dollars of mortgage backed securities that were previously financed with debt. Four of those could be financed with the book capital it had, but it had to find six more dollars somewhere.

The second was a capital problem. Because the market value of its assets was now down to 97 dollars as a result of the fall in the market value of mortgage backed securities, it was very thinly capitalized on a market value basis. But this problem could be handled later.

This is 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. The Fed was willing to take the 10 dollars of mortgage backed securities as collateral and lend up to 6 dollars against it. 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. The mortgage backed securities have now fallen to 40 cents on the dollar, the assets of the bank are now worth 94 dollars, and it has 96 dollars of debt (including the loan from the central bank) outstanding. 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 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? There is still a belief that we only have a liquidity problem in the banking sector, hence the focus on buying distressed assets in the Paulson plan 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. The authorities risk, yet again, falling behind the curve.

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. Yet, in many ways these are semantic differences. The rejection of the Paulson plan does indicate the public at large is not fooled. If so, why not bite the bullet and do the necessary thing?

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 in these columns and elsewhere. In addition to asset purchases, a quick audit of the large financial institutions, 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. 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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