Bailout of Long-Term Capital: A Bad Precedent?
By TYLER COWEN
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THE financial crisis is a result of many bad decisions, but one of them hasn't received enough attention: the 1998 bailout of the Long-Term Capital Management hedge fund. If regulators had been less concerned with protecting the fund's creditors, our current problems might not be quite so bad.

Long-Term Capital was advised by finance quants, or quantitative analysts, who made a number of unsound, esoteric bets, including investments in interest rate derivatives. When Russia's inability to pay its debts roiled global markets, the fund, saddled with high-leverage and off-balance-sheet obligations, was near collapse.

Because Long-Term Capital owed large sums to banks and other financial institutions, the Federal Reserve Bank of New York organized a consortium of companies to buy it out and cover the debts. Alan Greenspan, then the Fed chairman, eased monetary policy to restart capital markets, which were starting to freeze up. Long-Term Capital's shareholders were wiped out, but none of the creditors took losses.

At the time, it may have seemed that regulators did the right thing. The bailout did not require upfront money from the government, and the world avoided an even bigger financial crisis. Today, however, that ad hoc intervention by the government no longer looks so wise. With the Long-Term Capital bailout as a precedent, creditors came to believe that their loans to unsound financial institutions would be made good by the Fed — as long as the collapse of those institutions would threaten the global credit system. Bolstered by this sense of security, bad loans mushroomed.

Of course, there were many reasons for the reckless lending and failures of risk management that led to the most recent systemic credit shocks. And we have now entered the realm of trillion-dollar bailouts, vast contagion across financial institutions, rapid deleveraging of banks and an economic crisis that some people are starting to compare to the Great Depression.

The Long-Term Capital episode looks small when viewed against all of that. But it was important precisely because the fund was not a major firm. At the time of its near demise, it was not even a major money center bank, but a hedge fund with about 200 employees. Such funds hadn't previously been brought under regulatory protection this way. After the episode, financial markets knew that even relatively obscure institutions — through government intervention — might be able to pay back bad loans.

The major creditors of the fund included Bear Stearns, Merrill Lynch and Lehman Brothers, all of which went on to lend and invest recklessly and, to one degree or another, pay the consequences. But 1998 should have been the time to send a credible warning that bad loans to overleveraged institutions would mean losses, and that neither the Fed nor the Treasury would make these losses good.

What would have happened without a Fed-organized bailout of Long-Term Capital? It remains an open question. An entirely private consortium led by Warren E. Buffett might have bought the fund, but capital markets might still have frozen because of the realization that bailouts were not guaranteed.

And Fed inaction might have had graver economic consequences, especially if a Buffett deal had fallen through. In that case, a rapid financial deleveraging would have followed, and the economy would have probably plunged into recession. That sounds bad, but it might have been better to have experienced a milder version of a downturn in 1998 than the more severe version of 10 years later.

In 1998, there was no collapsed housing bubble, the government's budget was in surplus rather than deficit, bank leverage was much lower, and derivatives markets were smaller and less far-reaching. A financial crisis related to Long-Term Capital, however painful, probably would have been easier to handle than the perfect storm of recent months.

The ad hoc aspect of the bailout created a precedent for what has come to be called "regulation by deal" — now the government's modus operandi. Rather than publicizing definite standards and expectations for bailouts in advance, the Fed and the Treasury confront each particular crisis anew. Decisions are made as to whether a merger is possible, whether a consortium can be organized, what kind of loan guarantees can be offered and what kind of concessions will be extracted in return. So far, every deal — or lack thereof, in the case of Lehman Brothers — has been different.

While there are some advantages to leaving discretion in regulators' hands, this hasn't worked out very well. It has become increasingly apparent that the market doesn't know what to expect and that many financial institutions are sitting on the sidelines, waiting to see what regulators will do next. Regulatory uncertainty is stifling the ability of financial markets to engineer at least a partial recovery.

John Maynard Keynes famously proclaimed that "in the long run we are all dead." From the vantage point of 1998, today is indeed the "long run."

We're not quite dead, but we are seriously ailing. As we look ahead, we may be tempted again to put off the hard choices. But perhaps the next "long run," too, is no more than 10 years away. If we take the Keynesian maxim too seriously, and focus only on the short run, our prospects will be grim indeed.

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