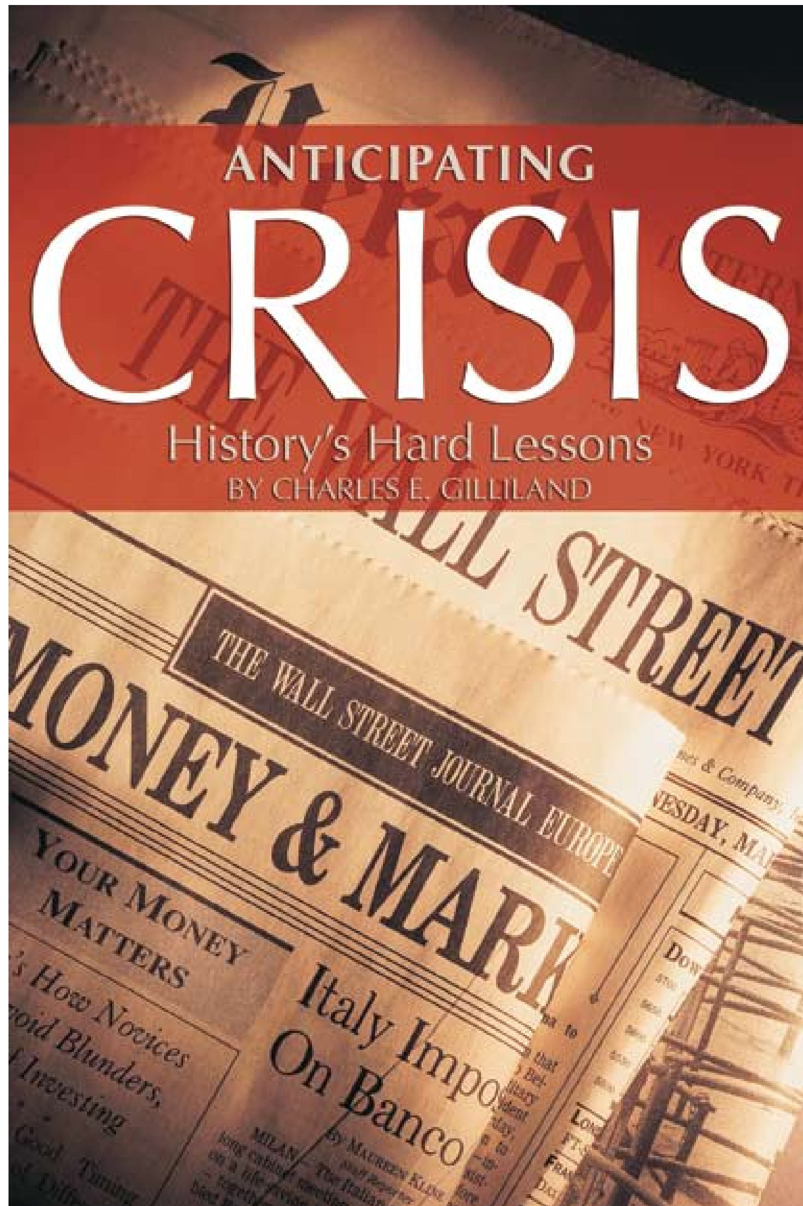
A Reprint from *Tierra Grande*



In the beginning, lenders rushed to make the loans. Perceiving no risk and raking in sumptuous profits, banks ladled huge sums into the lucrative market. The debts were AAA rated, and business boomed.

Then the defaults started. Banks faced sizable write-offs. The bad loans ultimately totaled more than the banks' capital requirements. Their very survival was threatened and the nation faced a financial crisis.

It was 1980, and loans made to the governments of several Latin American countries soured. Defying conventional belief that nations always pay their debts, the countries reneged. Virtually all sizable American banks faced the stark prospect of bankruptcy.

They needed time to rebuild capital and write off the loans that would never be repaid. But financial reporting requirements did not allow sufficient time. In the end, regulators let banks carry the bad loans at inflated values until accumulating profits and stock sales permitted them to clear the assets from their books.

This pattern of reckless lending and subsequent crashes has recurred with disconcerting frequency. The 1980s situation described above parallels today's subprime crisis. Unanticipated defaults from a market that was considered relatively risk free plunged financial markets into turmoil. Now banks, businesses and consumers are nervously tuned into the news in hope of getting a glimpse into the future.

Robert F. Bruner and Sean D. Carr have extensively investigated past crises to identify elements that contribute to their occurrence. In their book, *The Panic of 1907: Lessons Learned from the Market's Perfect Storm*, they describe the origins of paralysis of the financial system and subsequent struggles to prevent it. The analysis continues with a description of the denouement that led to creation of the Federal Reserve System. Based on their studies of past meltdowns, the authors identify conditions common to all of the financial seizures.

The structure of financial markets is complex and system-like, meaning that shocks in one area impact other areas in unanticipated ways. Much like chaos theory's butterfly effect, which suggests that a butterfly flapping its wings may lead to a hurricane on the other side of the world, the system's linkages spread the impact of adverse occurrences to seemingly unrelated entities.

Despite the volumes of reports and data available, the complicated structure of the system creates opacity. Information does not flow freely and market participants come to depend on authoritative sources to vouch for the integrity of the institutions. Experts examine financial statements and evaluate investment risks to assess and understand the system linkages. When the system functions smoothly, commerce proceeds.

In virtually every historical occurrence, financial panic was preceded by booming economic activity. The feverish activity creates a rush-to-invest mentality, and the system responds with a flood of liquidity to support the growth. Fed by inadequate information, optimism prevails and old restraints are perceived as inconvenient obstacles. Those who point out past realities and question the activity often are told "this time

it's different." This environment encourages lenient attitudes — for example, relaxation of mortgage lending standards.

In every case, existing safeguards failed to prevent the problems. Often, protections designed after the previous crises did not address later market realities. In 1907, for example, trusts were relatively new financial entities and were not subject to reserve regulations applied to banks. Today, hedge funds and structured investment vehicles have become major players with virtually no regulation. Further, fed by instant communications, the financial system has moved beyond national borders. This increasingly complex system ensures that existing safeguards cannot effectively curb risky practices.

Heightened uncertainty and eroding confidence stemming from public and private policies are common elements in past financial crises. Leaders whose actions substantially inhibit orderly market functions inject risk into the system. For example, leading up to the 1907 crisis, President Roosevelt and his administration adopted an antagonistic stance toward big business. The U.S. Treasury reduced the money supply just as the recession was taking hold.

Political situations in some parts of the world threaten the validity of legal and financial agreements. Currently, in Venezuela, for example, the government has seized part of the investments of oil companies and has redefined their working agreements. Even decisions made in domestic elections can lead to increased uncertainty. Adverse actions on tax policy, international trade and a host of other issues can complicate the flow of commerce.

Unanticipated shocks can rock the economy and precipitate a reversal of market sentiment as in past financial crises. The 1906 San Francisco earthquake and subsequent demand for rebuilding inflicted a strain on the 1907 economy. Today, we face different kinds of shocks, from defaulting mortgages, declining residential markets, astronomical energy prices and skyrocketing food prices. The convergence of these influences is sowing gloomy expectations on a broad front.

Wall Street oscillates between fear and greed. In times before a financial crisis, irrational greed drives price movements that do not reflect market fundamentals. A price bubble bulges as speculators rush to get in on the action. Then, panic replaces greed with fear, sending prices into a tailspin.

Finally, market collapses reflect a failure of collective action. Cooperation among lenders and depositors may produce better results than when investors and depositors fend for themselves. If individuals begin dumping a stock or withdrawing deposits from investment funds, their action drives down prices. The incentive is to get your money out before things get worse. That can precipitate a downward spiral leading to collapse or a market price well below reasonable levels. The market overshoots.

However, if investors collaborate, damage could be minimized. In a sense, FDIC insurance organizes a collective response among depositors in federally insured banks. The classic run on the bank to withdraw cash before the bank fails no longer occurs for those institutions.

While those institutions with FDIC insurance are protected, other financial entities are still vulnerable because the decisive and effective leadership needed to organize a collective response is not present. J.P. Morgan assumed that role in the 1907 panic. His actions shored up weak institutions and limited the damage. Today, the system depends heavily on the Federal Reserve Bank for such leadership.

Bruner and Carr note that all of these separate elements and conditions are present in the markets to one degree or another most of the time. However, in a panicked market they converge and reinforce each other. Soon market participants begin to expect further failures and lose confidence in the system. Old realities no longer apply. The carnage in the wake of the subprime crisis demonstrates that our financial system remains vulnerable to repeats of past crises.

Ultimately, assessing and curing the system seize-up takes time. Such incidents routinely take up to two years to play out from initial signals of problems through write-downs to a sense that threats of insolvency have abated.

Defusing immediate danger does not mean that systems are fully functional again. For example, the Latin American debt crisis was defused with the change in accounting rules that allowed banks to postpone reporting their losses. However, building the capital needed to allow a write-off of the bad debts took years. Initial write-offs began in earnest in 1986, six years after the initial recognition of the Latin American debt problem.

The impairment of the banking system adversely impacts lending activity as heightened sensitivity to risk leads to tougher lending standards. Often, a recession follows financial crises. Today, the Federal Reserve is scrambling to head off a recession or at least to reduce its severity.

After a collapse, analysts seek to assign blame. Investigations pinpoint ineptitude and outright wrongdoing. Legal actions, both civil and criminal, ensue. New regulations are put in place to safeguard the system against a repeat of the calamity. Finally, a sense of stability returns — at least until the next crisis.

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DRIVERS OF CRISES

- System-like architecture
- Buoyant growth
- Adverse leadership
- Real economic shock
- Failure of collective action
- Inadequate safety buffers
- Undue fear, greed and other behavioral aberrations

Source: *The Panic of 1907: Lessons Learned from the Market's Perfect Storm*

THE TAKEAWAY

Financial crises are usually preceded by booming economic activity. An optimistic atmosphere results in a rush-to-invest mentality that disregards the lessons of the past. After a financial "panic," safeguards are implemented, but those safeguards usually do not address the conditions that cause the next crisis.

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