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DJ OP-ED: Fed's Moves Create Unreasonable Moral Hazard

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By Mark Adelson

(This is one in a series of occasional opinion columns by market participants.)

NEW YORK (Dow Jones)--The Fed's decision Friday to bail out Bear Stearns Cos. (BSC) represents a terrible change in public policy. It is tantamount to a declaration that every major bank and securities firm is "too big to fail." When policymakers expand the notion of "too big to fail," they create an unreasonable moral hazard. They promote excessive risk-taking by large banks and brokers. They force taxpayers to become the unwilling guarantors of those institutions.

And, worst of all, they violate the core principles of capitalism by undermining the operation of market discipline.

The fact that the "bail out" has been superseded by JPMorgan's purchase of Bear Stearns does not diminish the policy implications of the Fed's action Friday. The expanded "too big to fail" genie is already out of its bottle. It seems that there is no way to stuff it back in short of standing idly by while a major bank or broker-dealer implodes.

The Fed's further decision to accept risky collateral while increasing its loans to primary dealers is similarly troubling. It too risks taxpayers' money in an attempt to save over-leveraged companies. It too undermines market discipline. In contrast, the Fed's decision Sunday to cut the discount rate to 3.25%, while arguably a mistake, does not fundamentally undercut the workings of the market.

The correct policy action is to let successful businesses succeed and to let failing businesses fail. If capitalism is to work correctly, companies and their shareholders need to bear the consequences of their decisions, both positive and negative; that includes their decisions about leverage, liquidity, and risk management. It also includes their decisions about derivative activities and counterparty risk. Capitalism cannot allocate society's resources to their best and highest uses unless success and failure produce their natural consequences.

The web of linkages within the modern financial system means that the failure of any single important bank or securities firm can produce domino effects. Transactions in over-the-counter derivatives - especially credit default swaps on mortgage-backed and asset-backed securities - are a key area in which the financial firms have become heavily exposed to each others' credit risk. The disruption and pain produced now by the failure of one firm can be amplified and extended to others more than at any time in the past. This calls into question whether the current web of interdependencies and "risk dispersion" should be considered a strength or a weakness of the system.

According to the U.S. Marine Corps, pain is the feeling of weakness leaving the body. By allowing the U.S. financial system to experience some pain today, it can be made stronger for the future. By expanding the concept of "too big to fail" and by propping-up over-leveraged companies with easier standards for secured loans, the Fed is perpetuating weakness in the long run by avoiding pain in the short run. There seems to be little doubt that many areas of the financial system - including the securitization and derivative sectors - need to be strengthened. The Fed would do well to follow the wisdom of the Marine Corps by allowing some weakness to leave the system.

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