Paulson bailout: seizing moral high ground can be hazardous

David Wighton: Business editor's commentary

They are at it again, the moral hazard fundamentalists. Critics of the Paulson bailout plan insist that the banks must pay for having their toxic assets removed. Otherwise, the proposal "completely eviscerates the concept of moral hazard", according to Henry Waxman, a leading Democratic congressman. This is because it would enrich the Wall Street executives whose reckless investments caused the financial crisis.

Having learnt the term, people tend to get a great deal too excited about moral hazard, the idea that by compensating people for the cost of their own reckless behaviour you encourage similar behaviour in the future. The US Federal Reserve was accused of ignoring moral hazard when it helped JPMorgan Chase to rescue Bear Stearns. As if arranging for shareholders to get $2 a share for stock with a book value of $80 would encourage reckless lending in future.

Last weekend, the Fed refused to support Lehman Brothers partly on the grounds of moral hazard. Once again, the risk of encouraging bad behaviour seemed pretty modest compared with the risk to the wider financial system. The collapse of Lehman turned out to be very damaging, accelerating the implosion of AIG and the panic over Goldman Sachs and Morgan Stanley.

As Charles Goodhart said in the FT this week, the time to worry about moral hazard is in the boom. Worrying about moral hazard now is like "refusing to sell fire insurance just after the Great Fire of London for fear of adversely affecting future behaviour".

The concern about moral hazard also seems misplaced in relation to the Paulson plan. This is not because it is wrong to make people pay for their mistakes. It is right and proper. It is only wrong if other innocent people suffer from that desire for retribution (and, let's be honest, when many people talk about moral hazard, they really mean retribution),

In the case of the Paulson bailout, it seems perfectly possible to make people pay for their mistakes without harming the broader financial system. It seems perfectly reasonable, as the critics suggest, that the Government should get some sort of stake in the banks that use the scheme so that the taxpayers — who will be shelling out $5,000 ($2,700) apecie — can benefit in the upside. It also seems perfectly reasonable that the Government should restrict the pay of executives at the banks that are being helped.

John McCain's suggestion that no executive should be allowed to earn more than the US President — a mere $400,000 a year — hardly looks practical. That is roughly the average pay of Goldman Sachs's 30,000 staff last year. A $400,000 cap would lead to an exodus of bank executives to other industries or other countries — even Bradford & Bingley could afford that. No great loss, you might say, given the record of US bank executives — but the more likely result would be that only the most desperate banks would take advantage of the scheme, limiting the benefit to the financial system.

The US authorities' previous efforts to contain the fallout from the credit crunch have hardly been flawless and the sums of
money involved in the Tarp (Troubled Asset Relief Program) are so huge that Congress is quite right to take some time to improve it.

Of course, there is a danger of delay as Congress seeks to hang irrelevant ornaments on to the Christmas tree, but the dangers in rushing something through without proper consideration seem greater. This Bill is important not just for the people paying for it, but for all of us.

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