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Calling J.P. Morgan

He was more effective than Paulson and Bernanke combined.

By L. GORDON CROVITZ

In the fall of 1907, it took J.P. Morgan just eight weeks to resolve a credit crisis similar to ours. Several years of buoyant growth and too much risk-taking in poorly understood investments led to needs for capital that could not be met. Morgan, then 70, locked the nation's top bankers into the ornate library at his home for late-night confession sessions. He asked them to lay bare their balance sheets, keeping himself alert with endless Havana cigars.

The bankers reviewed one another's assets and liabilities. Morgan then decided which financial institutions had to go and which would live, getting commitments from the survivors and from the U.S. Treasury for infusions of capital. This Panic of 1907 had rattled the New York Stock Exchange and the markets for gold and municipal bonds, ruined several banks and trust companies, and nearly bankrupted New York City. Share prices fell by half. But once Morgan was done knocking banking heads together, markets swiftly recovered.

In other words, Morgan was more effective in his day than the combination of Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke have been in ours. We're now well over a year into this credit crisis. One big difference is that each of the bankers in Morgan's smoke-filled room actually knew the details of his bank's respective assets and liabilities. Today, financial instruments are so complex that banks are still trying to unravel the different pieces of mortgage-related securities.

"J.P. Morgan and his men had direct access to the books of nearly every troubled institution, enabling them to fairly appraise their value," wrote Robert Bruner and Sean Carr, authors of "The Panic of 1907," in *Newsday*. Now, "despite mandated regulatory reporting, it is difficult, if not impossible, for financial decision-makers to know with clarity what is going on."

As sophisticated as we are now, with hundreds of categories of debt available on a single trading screen, in some ways more information about assets and liabilities was available in 1907, when the workflow device for traders was a simple pencil and scrap paper. We also seem to have forgotten a basic point well known to Morgan, who would have recalled the panics of 1837, 1857, 1873 and 1897: Until prices are established, credit panics will not end and financial firms

will remain frozen. The lesson of previous credit crises is that the sooner new valuations are set for bank assets and liabilities, the sooner recovery begins.

A key holdup to getting past this crisis is the continuing unknown of the remaining value of mortgage-based securities. In Morgan's day, price discovery resulted when he went around the room seeking details of balance sheets. Today we need to achieve price discovery more actively, such as by holding auctions of the bad debt so that the market can find a new normal. Getting our arms around the scope of the bad debt would define the capital needs for banks, and there would be prices set that potential private-sector buyers of the debt could consider.

There have been few efforts to determine the true value of the mortgage-related securities. One was the 22 cents on the dollar that Merrill Lynch got in July by selling some \$30 billion in supposed value of mortgage-backed derivatives for just under \$7 billion. The average portfolio might be worth closer to 60 cents on the dollar, but whatever the level, once prices settle, financial recovery can begin.

The difficulty in establishing value suggests the need for more disclosure. Added transparency is a familiar goal for regulators, with the 1933 and 1934 Securities Acts based on the idea that disclosure makes for the most efficient markets, with the fewest surprises. Many of today's most mispriced financial instruments have no disclosure requirements.

Indeed, perhaps the biggest remaining unknown is the some \$60 trillion of notional debt outstanding in credit-default swaps. This instrument was a smart innovation, even if there was too much of a good thing. These swaps give lenders protection from bad borrowers, thus increasing funds available for investments. But swaps are private contracts, not securities, and because they don't trade on exchanges, they are not subject to disclosure requirements. Securities and Exchange Commission Chairman Chris Cox has urged that some level of disclosure be required.

We can't stop credit crises, which inevitably occur as innovative financial instruments are periodically put to the test. As we're now painfully reminded, trial and error is a tough system, but it's also the only system known to markets. We're not powerless, however. We can make it easier to resolve future panics with a more transparent investing environment. More disclosure, to match the complexity of evolving financial instruments, would at least make the next credit crisis less of a surprise and ultimately more manageable.

Write to informationage@wsj.com

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