The current credit crisis and the resulting market drop and volatility have prompted the United States government to propose several measures to help banks.

The Federal Reserve extended loan guarantees to investment banks earlier this year. Congress recently approved a US$700 billion ($1 trillion) bailout plan, using taxpayers’ money to buy toxic assets from banks.

And on Tuesday, the Fed proposed yet another plan to buy unsecured short-term debt (commercial paper) directly from banks and corporations.

The premise of all these interventions is that a reduction in asset values is fundamentally bad for an economy. Indeed, what constitutes a financial crisis in the press or policy circles appears to be a large reduction in prices in the stock or bond market.

A further presumption is that such reductions may lead to downward price spirals — fire sales, in effect — over and above the reductions in fundamental values. If not stopped, such fire sales, it is believed, will lead to a domino effect throughout the economy.

In joint research with Viral Acharya at London Business School and Sreehari Bharath at University of Michigan, we found that fire sales can indeed affect debt prices negatively. On the other hand, experiments by Nobel laureate Vernon Smith have disclosed the possibility of bubbles building up in asset prices.

One possible reason for an inflation of asset values into a bubble is something popularly called “the greater fool theory.” You would buy an asset even if you thought it was overvalued if you believed you could resell it to a greater fool for a profit. Such risk-taking behaviour can give rise to bubbles. As John Maynard Keynes put it memorably, “Successful investing is anticipating the anticipations of others.”

So where are we now? In a fire sale world or in a bubble correction world? Even if we were in a fire sale world, do we need massive government intervention? One must answer this question before proposing reasonable policy responses.

The policy responses of the US government make it obvious that it believes we are in a fire sale world. Furthermore, it assumes private investors generally would be unwilling to buy these heavily discounted assets. Mr Warren Buffett’s investment in Goldman Sachs and Teakle Holdings in Merrill Lynch are obvious counter-examples to this notion.

Even if one took the view that the need of the hour is a quick response — the detailed analysis can wait — what form exactly should that response take? I would argue that, in any crisis, the quick response should be crafted to mitigate the adverse impact on economically disadvantaged sections of society.

In the current crisis, only a reduction in interest rates, which may benefit some economically disadvantaged households, would satisfy this criterion. The US$700 billion bailout plan and the proposal to directly buy commercial paper are not exactly targeted at the poor.

Understanding the cause of this crisis is essential before we decide on short-term, as well as long-term, responses. The crisis was caused principally by lax lending standards caused by a particular model of asset securitisation. The originate-and-sell model used for mortgage securitisation implied that the lender of a mortgage had no stake in conducting proper due diligence on the borrower, for the loan was quickly securitised and sold to investors around the world.

Indeed, recent academic research by the London Business School’s Vikrant Vig and others showed that lenders (banks, for example) were less rigorous in approving mortgages that were marked for securitisation as compared with mortgages that they planned to hold themselves. This is a clear example of moral hazard. The lax lending standards, in turn, resulted in a substantial increase in demand for housing, ultimately leading to a housing bubble.

Given this fundamental cause for the housing bubble and resulting credit crisis, what should be done? The regulatory responses to the Internet bubble and Enron bankruptcy provide clues. As in the current crisis, investors lost billions of dollars in those debacles. The regulatory response was the passage of Sarbanes-Oxley Act that put a greater burden on the top management of companies to make sure that they made proper disclosures. Several major Wall Street firms also paid fines to regulatory agencies in part for putting out shady optimistic analyst reports.

Corporate governance and transparency are of crucial importance in the prevention of a crisis. They are also important in promoting a speedy recovery once a crisis occurs. The appropriate regulatory response to the current crisis should insist on greater disclosure of the assets underpinning mortgage-backed securities or any other asset-backed security.

The government could also help by conducting orderly auctions of these securities (without actually participating in the auctions itself). For the longer term, the securitisation industry should evolve standards in terms of the minimum amount to be held by the lenders who actually made the initial loan. Further, rating agencies would need to re-evaluate the processes by which they rate securitisation pools.

All these measures would require little taxpayer money. But they would provide good short-term relief, as well as long-term solutions. While none of these measures would, by themselves, stop bubbles and crashes — which are often based on herd behaviour — they would at least prevent loose lending standards being the cause of further crises in asset-backed security markets.

Lastly, the current crisis does not mean the end of mortgage or asset securitisation. Rather, it signals a characteristic misstep most markets make in the early stages of their evolution. Securitisation makes full economic sense. It is here to stay.

The writer is Associate Professor of Finance at the National University of Singapore. This is the fifth of 50 articles in the ST/NUS Business School series on the financial crisis.