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Bad Accounting Rules Helped Sink AIG

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The decision by the Federal Reserve to loan insurance giant AIG $85 billion in return for as much as 80% ownership of the company is by any measure dramatic. The takeover early last week of Fannie Mae and Freddie Mac represented the culmination of years of intermingling of public and private interests. But the AIG move is de facto a government nationalization of an ailing private company, which, if not unprecedented, has rarely happened in the United States. Even if the intervention was imperative, its scope is startling.

The crisis on Wall Street has, of course, become a political football. Cries of "moral hazard" and "socialism" on one side are drowned out by charges that the current mess is the result of deregulation, and too cozy a relationship between "Wall Street fat cats" and the current administration in Washington. If only reality were that simple. The blame game will continue, but it won't do much to fix what's broken.

Let's get a few canards out of the way: First, yes, stupidity and cupidity and complacency and hubris are involved, and yes, there is gambling in Casablanca. Second, the idea that there is this thing called "the free market" that governments tame or muck up with regulation is a fiction. Governments create the legal conditions for markets; markets shape what governments can do or are willing to do. Regulation versus free-market is a false dichotomy. Maybe in some theoretical universe, if we could start with a blank slate and construct society anew, it wouldn't be. But we exist in a web of markets and regulations, and the challenge is to respond to problems in such a way so that we decrease the odds of future crises.

And that is where AIG becomes instructive. Even good regulations can't prevent all future crises, especially ones that are the result of new technologies and changes that result from them. The capital flows, derivatives contracts and nearly frictionless interlinking of global markets today are the direct result of the information technologies of the 1990s. The implications weren't known until very recently, so it would have been nearly impossible for regulations to have prevented what is happening. But if good regulation can't prevent crises, bad regulations can cause them.

The current meltdown isn't the result of too much regulation or too little. The root cause is bad regulation.

Call it the revenge of Enron. The collapse of Enron in 2002 triggered a wave of regulations, most notably Sarbanes-Oxley. Less noticed but ultimately more consequential for today were accounting rules that forced financial service companies to change the way they report the value of their assets (or liabilities). Enron valued future contracts in such a way as to vastly inflate its reported profits. In response, accounting standards were shifted by the Financial Accounting Standards Board and validated by the SEC. The new standards force companies to value or "mark" their assets according to a different set of standards and levels.

The rules are complicated and arcane; the result isn't. Beginning last year, financial companies exposed to the mortgage market began to mark down their assets, quickly and steeply. That created a chain reaction, as losses that were reported on balance sheets led to declining stock prices and lower credit ratings, forcing these companies to put aside ever larger reserves (also dictated by banking regulations) to cover those losses.

In the case of AIG, the issues are even more arcane. In February, as its balance sheet continued to sharply decline, the company issued a statement saying that it "believes that its mark-to-market unrealized losses on the super senior credit default swap portfolio . . . are not indicative of the losses it may realize over time." Unless one is steeped in these issues, that statement is completely incomprehensible. Yet the inside baseball of accounting rules, regulation and markets adds up to the very comprehensible $85 billion of taxpayer money.

What AIG was saying then, and what others from Lehman to Bear Stearns to the world at large have been saying since, is that the losses showing up aren't "real." Yes, the layer upon layer of derivatives built on the foundation of mortgages is mind-boggling. One reason that AIG had floated beneath the radar screen of the business media (relative to Wall Street investment firms) is that its business model is so complex and opaque that it is impossible to describe simply. It was briefly in the news in 2005, after it was accused of improper accounting by the SEC and the New York attorney general. Then it faded from view, until now.

Among its many products, AIG offered insurance on derivatives built on other derivatives built on mortgages. It priced those according to computer models that no one person could have generated, not even the quantitative magicians who programmed them. And when default rates and home prices moved in ways that no model had predicted, the whole pricing structure was thrown out of whack.

The value of the underlying assets -- homes and mortgages -- declined, sometimes 10%, sometimes 20%, rarely more. That is a hit to the system, but on its own should never have led to the implosion of Wall Street. What has leveled Wall Street is that the value of the derivatives has declined to zero in some cases, at least according to what these companies are reporting.

There's something wrong with that picture: Down 20% doesn't equal down 100%. In a paralyzed environment, where few are buying and everyone is selling, a market price could well be near zero. But that is hardly the "real" price. If someone had to sell a home in Galveston, Texas, last week before Hurricane Ike, it might have sold for pennies on the dollar. Who would buy a home in the path of a hurricane? But only for those few days was that value "real."

The regulations were passed to prevent a repeat of Enron, but regulations are always a work of hindsight. Good regulatory regimes can mitigate future crises, and over the past hundred years, economic crises world-wide have become less disruptive. The panics of the late 1800s, the bank runs, the Great Depression in Europe and the United States, were all far more severe than what is unfolding today in terms of business failures and jobs, homes and savings lost.

But bad regulation is something to be feared, especially as industries become more complicated. Legislators and agencies would be wary of passing rules regulating how a semiconductor chip is programmed; they would recognize that while the outcomes those chips produce might be simple, the way they produce them is not. Yet financial service regulations sometimes act as if we still live in a time when deposits consisted of sacks of money in a vault.

A few years from now, there will be a magazine cover with someone we've never heard of who bought all of those mortgages and derivatives for next to nothing on the correct assumption that they were indeed worth quite a bit. In the interim, there will almost certainly be a wave of regulations designed to prevent the flood that has already occurred, some of which are likely to trigger another crisis down the line. Until we can have a more rational, measured public discussion about what government and regulations can and should do vis-à-vis financial markets, we are unlikely to break the cycle.

There is one final irony: AIG was founded in Shanghai in 1919, when China was emerging from millennia of imperial rule. Over the next century, China turned away from capitalism. Almost 90 years later, AIG is now being taken over by the U.S. government just as the Chinese government is moving as quickly as possible to divest itself of control of major companies. One of those countries is growing fast; one isn't. Perhaps that is a coincidence; perhaps not.

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next year by Simon & Schuster.

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