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How to Save the Financial System

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I am astounded and deeply saddened to witness the senseless destruction in the U.S. financial system, which has been the envy of the world. We have always gone through periods of correction, but today's problems are so much worse than they needed to be.

The Securities and Exchange Commission and bank regulators must act immediately to suspend the Fair Value Accounting rules, clamp down on abuses by short sellers, and withdraw the Basel II capital rules. These three actions will go a long way toward arresting the carnage in our financial system.

During the 1980s, our underlying economic problems were far more serious than the economic problems we're facing this time around. The prime rate exceeded 21%. The savings bank industry was more than $100 billion insolvent (if we had valued it on a market basis), the S&L industry was in even worse shape, the economy plunged into a deep recession, and the agricultural sector was in a depression.

These economic problems led to massive credit problems in the banking and thrift industries. Some 3,000 banks and thrifts ultimately failed, and many others were merged out of existence. Continental Illinois failed, many of the regional banks tanked, hundreds of farm banks went down, and thousands of thrifts failed or were taken over.

It could have been much worse. The country's 10-largest banks were loaded up with Third World debt that was valued in the markets at cents on the dollar. If we had marked those loans to market prices, virtually every one of them would have been insolvent. Indeed, we developed contingency plans to nationalize them.

At the outset of the current crisis in the credit markets, we had no serious economic problems. Inflation was under control, GDP growth was good, unemployment was low, and there were no major credit problems in the banking system.

The dark cloud on the horizon was about $1.2 trillion of subprime mortgage-backed securities, about $200 billion to $300 billion of which was estimated to be held by FDIC-insured banks and thrifts. The rest were spread among investors throughout the world.

The likely losses on these assets were estimated by regulators to be roughly 20%. Losses of this magnitude would have caused pain for institutions that held these assets, but would have been quite manageable.

How did we let this serious but manageable situation get so far out of hand -- to the point where several of our most respected American financial companies are being put out of business, sometimes involving massive government bailouts?

Lots of folks are assigning blame for the underlying problems -- management greed, inept regulation, rating-agency incompetency, unregulated mortgage brokers and too much government emphasis on creating more housing stock. My interest is not in assigning blame for the problems but in trying to identify what is causing a situation, that should have been resolved easily, to develop into a crisis that is spreading like a cancer throughout the financial system.

The biggest culprit is a change in our accounting rules that the Financial Accounting Standards Board and the SEC put into place over the past 15 years: Fair Value Accounting. Fair Value Accounting dictates that financial institutions holding financial instruments available for sale (such as mortgage-backed securities) must mark those assets to market. That sounds reasonable. But what do we do when the already thin market for those assets freezes up and only a handful of transactions occur at extremely depressed prices?

The answer to date from the SEC, FASB, bank regulators and the Treasury has been (more or less) "mark the assets to market even though there is no meaningful market." The accounting profession, scarred by decades of costly litigation, just keeps marking down the assets as fast as it can.

This is contrary to everything we know about bank regulation. When there are temporary impairments of asset values due to economic and marketplace events, regulators must give institutions an opportunity to survive the temporary impairment. Assets should not be marked to unrealistic fire-sale prices. Regulators must evaluate the assets on the basis of their true economic value (a discounted cash-flow analysis).

If we had followed today's approach during the 1980s, we would have nationalized all of the major banks in the country and thousands of additional banks and thrifts would have failed. I have little doubt that the country would have gone from a serious recession into a depression.

If we do not halt the insanity of forcing financial firms to mark assets to a nonexistent market rather than their realistic economic value, the cancer will keep spreading and will plunge the world into very difficult economic times for years to come.

I argued against adopting Fair Value Accounting as it was being considered two decades ago. I believed we would come to regret its implementation when we hit the next big financial crisis, as it would deny regulators the ability to exercise judgment when circumstances called for restraint. That day has clearly arrived.

Equally egregious are the actions by the SEC in recent years lifting the restraints on short sellers of stocks to allow "naked selling" (shorting a stock without actually possessing it) and to eliminate the requirement that short sellers could sell only on an uptick in the market.

On top of this, it is my understanding that short sellers are engaged in abuses such as purchasing credit default swaps on corporate bonds (essentially bets on whether a borrower will default), which lowers the price of the bonds, which in turn causes the price of the company's stock to decline further. Then the ratings agencies pile on and reduce the ratings of a company because its reduced stock price will prevent it from raising new capital. The SEC must act immediately to eliminate these and other potential abuses by short sellers.

The Basel II capital rules adopted by the FDIC, Federal Reserve, Office of Thrift Supervision and the Comptroller of the Currency last year are too new to have caused big problems, but they must be eliminated before they do. Basel II requires the use of very complex mathematical models to set capital levels in banks. The models use historical data to project future losses. If banks have a period of low losses (such as in the mid-1990s to the mid-2000s), the models require relatively little capital and encourage even more heated growth. When we go into a period like today where losses are enormous (on paper, at least), the models require more capital when none is available, forcing banks to cut back lending.

As I write this article, I am seeing proposals by some to create a new Resolution Trust Corp., as we did in the 1990s to clean up the S&L problems. The RTC managed and sold assets from S&Ls that had already failed. It was run by the FDIC, just like the FDIC. We needed to create the RTC in the 1990s only because we could not comingle the assets from failed banks with those of failed thrifts, because we had two separate deposit insurance funds absorbing the respective losses from bank and thrift failures.

I can't imagine why we would want to create another government bureaucracy to handle the assets from bank failures. What we need to do urgently is stop the failures, and an RTC won't do that.

Again, we must take three immediate steps to prevent a further rash of financial failures and taxpayer bailouts. First, the SEC must suspend Fair Value Accounting and require that assets be marked to their true economic value.

Second, the SEC needs to immediately clamp down on abusive practices by short sellers. It has taken a first step in reinstituting the prohibition against "naked selling." Finally, the bank regulators need to acknowledge that the Basel II capital rules represent a serious policy mistake and repeal the rules before they do real damage.

We are almost out of time if we hope to eradicate the cancer in our financial system.

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