January 4, 2009

OP-ED CONTRIBUTORS

How to Repair a Broken Financial World

By MICHAEL LEWIS and DAVID EINHORN

Continued from "The End of the Financial World As We Know It"

Mr. Paulson must have had some reason for doing what he did. No doubt he still believes that without all this frantic activity we'd be far worse off than we are now. All we know for sure, however, is that the Treasury's heroic deal-making has had little effect on what it claims is the problem at hand: the collapse of confidence in the companies atop our financial system.

Weeks after receiving its first $25 billion taxpayer investment, Citigroup returned to the Treasury to confess that — lo! — the markets still didn't trust Citigroup to survive. In response, on Nov. 24, the Treasury handed Citigroup another $20 billion from the Troubled Assets Relief Program, and then simply guaranteed $306 billion of Citigroup's assets. The Treasury didn't ask for its fair share of the action, or management changes, or for that matter anything much at all beyond a teaspoon of warrants and a sliver of preferred stock. The $306 billion guarantee was an undisguised gift. The Treasury didn't even bother to explain what the crisis was, just that the action was taken in response to Citigroup's "declining stock price."

Three hundred billion dollars is still a lot of money. It's almost 2 percent of gross domestic product, and about what we spend annually on the departments of Agriculture, Education, Energy, Homeland Security, Housing and Urban Development and Transportation combined. Had Mr. Paulson executed his initial plan, and bought Citigroup's pile of troubled assets at market prices, there would have been a limit to our exposure, as the money would have counted against the $700 billion Mr. Paulson had been given to dispense. Instead, he in effect granted himself the power to dispense unlimited sums of money without Congressional oversight. Now we don't even know the nature of the assets that the Treasury is standing behind. Under TARP, these would have been disclosed.

THERE are other things the Treasury might do when a major financial firm assumed to be "too big to fail" comes knocking, asking for free money. Here's one: Let it fail.

Not as chaotically as Lehman Brothers was allowed to fail. If a failing firm is deemed "too big" for that honor, then it should be explicitly nationalized, both to limit its effect on other firms and to protect the guts of the system. Its shareholders should be wiped out, and its management replaced. Its valuable parts should be sold off as functioning businesses to the highest bidders — perhaps to some bank that was not swept up in the credit bubble. The rest should be liquidated, in calm markets. Do this and, for everyone except the firms that invented the mess, the pain will likely subside.

This is more plausible than it may sound. Sweden, of all places, did it successfully in 1992. And remember, the Federal Reserve and the Treasury have already accepted, on behalf of the taxpayer, just about all of the downside risk of owning the bigger financial firms. The Treasury and the Federal Reserve would both no doubt argue that if you don't prop up these banks you risk an enormous credit contraction — if they aren't in business who will be left to lend money? But something like the reverse seems more true: propping up failed banks and extending them huge amounts of credit has made business more difficult for the people and companies that had nothing to do with creating the mess. Perfectly solvent companies are being squeezed out of business by their creditors precisely because they are not in the Treasury's fold. With so much lending effectively federally guaranteed, lenders are fleeing anything that is not.

Rather than tackle the source of the problem, the people running the bailout desperately want to reinflate the credit bubble, prop up the stock market and head off a recession. Their efforts are clearly failing: 2008 was a historically bad year for the stock market, and we'll be in recession for some time to come. Our leaders have framed the problem as a "crisis of confidence" but what they actually seem to mean is "please pay no attention to the problems we are failing to address."

In its latest push to compel confidence, for instance, the authorities are placing enormous pressure on the Financial Accounting Standards Board to suspend "mark-to-market" accounting. Basically, this means that the banks will not have to account for the actual value of the assets on their books but can claim instead that they are worth whatever they paid for them.

This will have the double effect of reducing transparency and increasing self-delusion (gorge yourself for months, but refuse to step on a scale, and maybe no one will realize you gained weight). And it will fool no one. When you shout at people "be confident," you shouldn't expect them to be anything but terrified.

If we are going to spend trillions of dollars of taxpayer money, it makes more sense to focus less on the failed institutions at the top of the financial system and more on the individuals at the bottom. Instead of buying dodgy assets and guaranteeing deals that should never have been made in the first place, we should use our money to A) repair the social safety net, now badly rent in ways that cause perfectly rational people to be terrified; and B) transform the bailout of the banks into a rescue of homeowners.

We should begin by breaking the cycle of deteriorating housing values and resulting foreclosures. Many homeowners realize that it doesn't make sense to make payments on a mortgage that exceeds the value of their house. As many as 20 million families face the decision of whether to make the payments or turn in the keys. Congress seems to have understood this problem, which is why last year it created a program under the Federal Housing Authority to issue homeowners new government loans based on the current appraised value of their homes.

And yet the program, called Hope Now, seems to have become one more excellent example of the unhappy political influence of Wall Street. As it now stands, banks must initiate any new loan; and they are loath to do so because it requires them to recognize an immediate loss. They prefer to "work with borrowers" through loan modifications and payment plans that present fewer accounting and earnings problems but fail to resolve and, thereby, prolong the underlying issues. It appears that the banking lobby also somehow inserted into the law the dubious requirement that troubled homeowners repay all home equity loans before qualifying. The result: very few loans will be issued through this program.

THIS could be fixed. Congress might grant qualifying homeowners the ability to get new government loans based on the current appraised values without requiring their bank's consent. When a corporation gets into trouble, its lenders often accept a partial payment in return for some share in any future recovery. Similarly, homeowners should be permitted to satisfy current first mortgages with a combination of the proceeds of the new government loan and a share in any future recovery from the future sale or refinancing of their homes. Lenders who issued second mortgages should be forced to release their claims on property. The important point is that homeowners, not lenders, be granted the right to obtain new government loans. To work, the program needs to be universal and should not require homeowners to file for bankruptcy.

There are also a handful of other perfectly obvious changes in the financial system to be made, to prevent some version of what has happened from happening all over again. A short list:

Stop making big regulatory decisions with long-term consequences based on their short-term effect on stock prices. Stock prices go up and down: let them. An absurd number of the official crises have been negotiated and resolved over weekends so that they may be presented as a fait accompli "before the Asian markets open." The hasty crisis-to-crisis policy decision-making lacks coherence for the obvious reason that it is more or less driven by a desire to please the stock market. The Treasury, the Federal Reserve and the S.E.C. all seem to view propping up stock prices as a critical part of their mission — indeed, the Federal Reserve sometimes seems more concerned than the average Wall Street trader with the market's day-to-day movements. If the policies are sound, the stock market will eventually learn to take care of itself.

End the official status of the rating agencies. Given their performance it's hard to believe credit rating agencies are still around. There's no question that the world is worse off for the existence of companies like Moody's and Standard & Poor's. There should be a rule against issuers paying for ratings. Either investors should pay for them privately or, if public ratings are deemed essential, they should be publicly provided.

Regulate credit-default swaps. There are now tens of trillions of dollars in these contracts between big financial firms. An awful lot of the bad stuff that has happened to our financial system has happened because it was never explained in plain, simple language. Financial innovators were able to create new products and markets without anyone thinking too much about their broader financial consequences — and without regulators knowing very much about them at all. It doesn't matter how transparent financial markets are if no one can understand what's inside them. Until very recently, companies haven't had to provide even cursory disclosure of credit-default swaps in their financial statements.

Credit-default swaps may not be Exhibit No. 1 in the case against financial complexity, but they are useful evidence. Whatever credit defaults are in theory, in practice they have become mainly side bets on whether some company, or some subprime mortgage-backed bond, some municipality, or even the United States government will go bust. In the extreme case, subprime mortgage bonds were created so that smart investors, using credit-default swaps, could bet against them. Call it insurance if you like, but it's not the insurance most people know. It's more like buying fire insurance on your neighbor's house, possibly for many times the value of that house — from a company that probably doesn't have any real ability to pay you if someone sets fire to the whole neighborhood. The most critical role for regulation is to make sure that the sellers of risk have the capital to support their bets.

Impose new capital requirements on banks. The new international standard now being adopted by American banks is known in the trade as Basel II. Basel II is premised on the belief that banks do a better job than regulators of measuring their own risks — because the banks have the greater interest in not failing. Back in 2004, the S.E.C. put in place its own version of this standard for investment banks. We know how that turned out. A better idea would be to require banks to hold less capital in bad times and more capital in good times. Now that we have seen how too-big-to-fail financial institutions behave, it is clear that relieving them of stringent requirements is not the way to go.

Another good solution to the too-big-to-fail problem is to break up any institution that becomes too big to fail.

Close the revolving door between the S.E.C. and Wall Street. At every turn we keep coming back to an enormous barrier to reform: Wall Street's political influence. Its influence over the S.E.C. is further compromised by its ability to enrich the people who work for it. Realistically, there is only so much that can be done to fix the problem, but one measure is obvious: forbid regulators, for some meaningful amount of time after they have left the S.E.C., from accepting high-paying jobs with Wall Street firms.

But keep the door open the other way. If the S.E.C. is to restore its credibility as an investor protection agency, it should have some experienced, respected investors (which is not the same thing as investment bankers) as commissioners. President-elect Barack Obama should nominate at least one with a notable career investing capital, and another with experience uncovering corporate misconduct. As it happens, the most critical job, chief of enforcement, now has a perfect candidate, a civic-minded former investor with firsthand experience of the S.E.C.'s ineptitude: Harry Markopolos.

The funny thing is, there's nothing all that radical about most of these changes. A disinterested person would probably wonder why many of them had not been made long ago. A committee of people whose financial interests are somehow bound up with Wall Street is a different matter.