

Bust, Bankruptcy, Bailouts: What Should We Do Now?

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On behalf of the DC chapter of PRMIA, let me thank Alex Pollock and our colleagues at American Enterprise Institute for yet another successful collaboration. Today's panel is especially timely because of the issues we all face, issues with which my colleagues and you are well familiar. Accordingly, I am going to focus my remarks on solutions by focusing on four broad areas of financial policy, areas which I believe must be addressed if we are to deal with the global financial crisis.

Starting as a young man growing up in Washington, I possessed the rather considerable advantage of being the eldest son of Richard and Joan Whalen, two very literate, engaged people who taught their children to think and write independently, and to be good public citizens. My childhood is filled with memories of Presidents, Fed chairmen, Ambassadors and Secretaries of this and that coming and going at all hours of the day and night, many of whom would spend hours in our front parlor talking, drinking and making policy.

My father, in turn, had teachers and mentors during several decades as one of Washington's most celebrated and least remarked upon agents of influence. One of the most memorable was Federal Reserve Board Chairman Arthur Burns, who once was giving a speech at an important conference where his rival, former Texas Governor and Treasury Secretary John Connally was also invited to speak.

"Dick, whenever you are going to make a speech," Chairman Burns told my father before the event, "make sure that you number your points. It makes it look like you actually have a plan. But don't tell Connally!"

And Chairman Burns did number his points and his comments did generate headlines the next day, with the compliant media proclaiming the "Burns Plan." Secretary Connally's comments were also noted in the news reports, albeit further down the page.

With that sound advice in mind, let me suggest four key points that President Obama and his team need address in order to meet the challenges that we face and thereby restore a firm footing for the global economy.

1) Support the Good Banks/Resolve the Bad

The Good Bank/Bad Bank debate that is raging this week within the Obama Administration is really a political battle between the largest banks and the rest of the banking industry and the US economy. As you have already heard from our other panelists, in preparing plans for review by the White House the Fed and OCC are supporting further bailouts for the larger banks, while the rest of the industry is being resolved and recapitalized via an FDIC receivership a la Washington Mutual and Lehman Brothers.

Our estimate for accumulated bank charge offs for 2009 is in the neighborhood of \$1 trillion vs. \$1.5 trillion in Tier 1 Risk Based Capital at all US banks today. The good news, though, is that 2/3 to 3/4 of that loss number comes from the top 4 - Citigroup (NYSE:C), Bank of America (NYSE:BAC), JPMorganChase (NYSE:JPM) and Wells Fargo (NYSE:WFC), in that order of risk profile. Unlike Europe, where much of the banking system is now impaired, the US banking system is in relatively good shape when viewed from the bottom-up.

Juxtapose the Fed/OCC position of 'let's bail out the big banks' (equity and debt) which Tim Geithner established in the Bear Stearns and AIG rescues, and reiterated in his confirmation testimony, with the modified "tough love" position of Sheila Bair, where she proposes to buy bad assets from the Big Four Zombie banks w/o a resolution. It seems clear that both sides of the equation in Washington are prepared to socialize the large bank losses and in particular subsidize the bond holders at public expense, an act of generosity that could cost the banking industry and taxpayers trillions more in expense before all is said and done.

But at as my friend Josh Rosner pointed out in an interview we published earlier this week, at least with the modified tough love proposed by Bair, the US government still would clearly end up as the explicit owner and the existing equity and preferred would be diluted out of existence as the quid pro quo for the bad asset purchases. That is the little detail people in Washington still don't understand. Indeed, if you think about Citigroup as perhaps accounting for one third of the \$1 trillion IRA charge off estimate for 2009, then Washington must impose a haircut on debt or ask the healthy portion of the banking industry and the taxpayer to subsidize the loss.

Remember that the entire banking industry stands in front of the taxpayers in terms of loss absorption at the FDIC, so you can understand why the smaller banks in the industry are becoming very, very angry at the larger banks and their minions in the Obama Administration like Tim Geithner, Larry Summers, and former Citigroup director Robert Rubin, not to mention Fed Chairman Ben Bernanke and the entire Fed board of governors. These leading officials are increasingly taking the side of the large banks in the battle over limited public financial resources, a fact that is causing the community bankers to rise up. Stay tuned.

The better course for the economy outside NYC is to resolve these large institutions over the course of 2009 and beyond, first by diluting the equity (common and preferred) and effecting a conservatorship a la Fannie/Freddie. This eliminates the issue for the markets. Since most of the toxicity in the banking system is concentrated among the larger banks, with perhaps US Bancorp (NYSE:USB) on down viable in the long run, perhaps we can rebuild the industry using the next round of TARP funds to bulk up these relatively smaller banks and thereby end up with 10-15 larger super regionals in the \$300-\$500 billion asset range. There may even be banks of this size still doing business under the current names of Citi, JPMorgan, Bank of America, etc, but these new banks will have new owners and creditors.

Insolvency is the traditional American way of dealing with bad banks, at least in the absence of political meddling by the Fed and the Congress. Let Sheila Bair and the FDIC do the job and we can make the economy rebound with surprising speed. It only takes political courage. We have the money. Unfortunately I expect that the “new” proposal from Treasury Secretary Geithner is more of the same temporizing in the form of asset purchases and guarantees that will not address the underlying issue of solvency. If we do go this route, then look for additional requests for bailouts for the top-two or three banks by the middle of 2009. In the event, the Congress may finally say no.

2) Market Structure: Credit Default Swaps and Unlimited Leverage

One of the least understood but potentially the most damaging aspects of the financial crisis is the market for over-the-counter derivatives and particularly credit default swaps or “CDS.” The losses at American International Group (NYSE:AIG), which was the recipient of a vast public bailout last year financed by the Fed of New York for the benefit of GS, come in large part from the writing of CDS contracts on complex structured assets that AIG did not understand. During the next year, I hope and expect to see legislation that will effectively end the unregulated market for these ersatz insurance contracts.

What is the problem with CDS? Well, the tension over CDS, especially regarding the money centers in particular and banks generally, comes from several basic flaws in the regulatory and legal/business model for these instruments, deliberate flaws that include the lack of a central counterparty, no effective limit on leverage and a schizophrenic pricing methodology that has nothing to do with the several different types of underlying risk contained in these contracts. Suffice to say that the market structure model represented by CDS represents a retrograde step that takes us back to the days prior to the Great Depression and represents the worst type of “New Era” financial engineering.

It is very telling that a year into the crisis, the Fed still refuses to enforce any type of credit margin discipline over the dealers in the CDS markets, this by raising collateral requirements on dealer positions to realistic levels. Thus the short-selling pressure on C and other wounded money centers is magnified many times above the true pool of investors with hedging needs, including the much maligned ranks of the hedge funds.

What the Fed will not tell you is that it is the dealers, not the customers like hedge funds, that are the problem when it comes to CDS and collateral. Let me say that again: the short selling pressure against the largest banks comes not primarily from the rapacious hedge funds, who mostly are forced to post real collateral behind their trades, but from the other dealers and financial institutions in the US and the EU particularly, banks that are writing CDS positions to support short sales against other bank names. That puts a very different complexion on recent moves in banks stocks, does it not?

While I have been critical of those few hedge funds that do or at least did write naked CDS positions without adequate capital, an issue that almost led the New York State Insurance Department to unilaterally begin the regulation of CDS counterparties who were writing risk for regulated insurance companies last year, it now seems that it's the large bank dealers themselves which are the weakest link the chain in terms of systemic risk.

By failing to enforce margin limits on CDS leverage while investing new capital in C, BAC and other large banks via the TARP, the Fed and Treasury are essentially trying to fill up a bucket with a hole in the bottom. The Fed and OCC are entirely complicit in this contradictory effort to protect the ability of the major CDS dealer banks to continue to do business without any basic prudential limitations. If the Congress truly understood the duplicity of the Fed and OCC when it comes to concealing the risk to all banks from OTC derivatives, these agencies would be closed down tomorrow.

As we've said before, if there were nothing wrong with the basic model for CDS, then there would be no need for the industry to have torn up \$30 trillion or half of the notional amount of contracts during the past year! These were positions mostly among and between the dealer banks. But even if you believe that most of the remaining \$30 trillion in notional amount of CDS is not problematic, that still leaves trillions of dollars in net exposure that is concentrated among some of the less savvy players in the global banking and investment worlds, including some of the largest banks in Europe.

When the political classes of the industrial nations reckon the final cost of managing down the CDS bubble, the only sane alternative, I believe, will be to divide the current CDS product into a liquid, exchange traded bond option to help traders track short-term volatility and an insurance product for actually hedging corporate bond defaults with substantially higher collateral requirements than the nonexistent initial margin levels that prevail inside the major dealer banks.

3) Fair Value Accounting

The fair value accounting rule adopted by the SEC and the FASB a little more than a year ago is fueling the global deflation now gripping world markets. Fair value accounting is, in my view, the last remnant of "bubble-think" but this legacy of good intentions gone wildly astray is driving us into the proverbial Thresher (SSN-593) scenario, straight down into the deepest trench of an economic correction that is well-beyond crush depth.

Over the past several months, I have come to the conclusion that we must make a correction in the FVA rule. There seem to be two issues:

First, FVA relies on efficient market theory, namely the Chicago School view that short term price = value and that consequently income, assets and liabilities should be adjusted in real time to reflect same. (This is the same problem with CDS pricing, BTW, as we discussed in our last comment, (["To Stabilize Global Banks, First Tame Credit Default Swaps."](#) The IRA, January 21, 2009.) My colleagues and I think that the collapse of all of the other market efficiency based constructs, from structured assets to hedge funds, ends the discussion of derivative notions such as FVA. But unfortunately the proponents of FVA are religious zealots first and foremost, so it is difficult to get them to appreciate such criticism.

Second, FVA ignores the historical role of depositories, pensions and insurance companies as repositories for long-term value and consequently as havens from swings in short-term market pricing and even economic trends. The whole point of capital adequacy regulation, with the notable exception of broker dealers, is to give such institutions the freedom to take the long view and fund longer dated assets with short-term liabilities like deposits. FVA makes the long view impossible and basically turns what are supposed to be low-beta, low risk, highly solvent hold-to-maturity investment vehicles into mark-to-market liquidations every day via the CDS markets.

Just as you cannot buy bad assets from an insolvent bank at "fair value" without worsening the insolvency, likewise when you mark down assets you are reducing the ability of the entire US financial system to support leverage. When you combine the zero effective collateral and margin operating in the CDS market with the quarterly idiocy of marking down (or even charging off!!) performing securities and loans to satisfy the advocates of FVA, it would be difficult to imagine the enemies of the United States constructing a more perfect weapon to bring about our collective demise.

That said, neither I nor my colleagues at IRA are against disclosing the short-term fair value of assets. In fact, we want to see expanded disclosure of swings in FVA for all public companies, financials and otherwise. We agree with those who believe that a compromise must be struck between the utopian goals of complete and total market efficiency and transparency and the real world of human action and inefficiency. Including our host Alex Pollock and man of his colleague here at AEI. The fact is, normal human beings are simply not able to react to and understand the torrent of short-term swings in assets prices, thus the net effect of FVA is not greater understanding, but instead fear, panic and systemic instability.

Believe me when I say that we have seen the wild eyed, "don't you get it" look from the proponents of FVA in our colleagues in the XBRL community. We love their idealism and their vision, and we share same. But we at IRA also live in the real world of operating and delivering decision support systems for investors and fiduciaries. These systems must operate in the objective and very arbitrary rules of scientific method,

because as Graham and Dodd taught us 80 years ago, the more speculative, the more unstable the data inputs, the less the investment analysis matters.

The subjective, speculative perspective that is the essence of FVA, when applied to illiquid assets has, we believe, the net effect of increasing the instability in the global economy. We'd like to ask the economists listening to this program today to answer the following question: Is FVA accelerating the slowdown in the velocity of money? Because if the answer is yes, than nothing the Fed, Treasury or the Congress try to do in nominal terms will be effective in stabilizing prices or GDP. FVA, imposed just as the great bubble was imploding, is now driving the global economy to a fire sale liquidation.

Disclose swings in market value of assets, you can even put aside reserves against the weaker credits that show moves in fair value, but so long as the asset is money good, it should not be charged off against reserves. We might even construct some type of averaging rule for FVA swings in assets, affecting income and even reserves once the swing in value is confirmed over time, but the notion of instantaneous and immediate price discovery, disclosure and financial adjustment is a childishly idealized notion that must be gently restrained by the adults in the room.

4) Fiscal Stimulus & the Nail Salon Economy

The final area where we need a change in national policy is the area of fiscal stimulus. Members of both political parties in Washington seem to be intent upon throwing money at the problems on Wall Street and on Main Street, in that order of priority. Most of the initiatives being proposed will have no effect on developments in the credit sector or in the wider economy, including a peak level of loss for the banking industry that will be a multiple of the credit trough in the early 1990s and a decline in GDP that could extend into 2010.

Short of declaring a tax holiday for all individuals and businesses, there is nothing that the government in Washington or elsewhere among the industrialized nations can do to stop the collapse of what I call the "nail salon economy," the tendency on the part of many Americans to believe that the services industry is the only economic choice when it comes to career alternatives. There are two sure signs that the service economy is tanking: when your friends in finance start considering careers in journalism and a flurry of new nail salons and barber shops start to appear in place of those old, established business that seem to be disappearing in great number.

But with the real economy shedding jobs and employers at the most rapid pace seen in generations, the refusal of our cowardly political class to allow the US economy to go through recessions and force a new focus on production and transformation as the basis for economic growth is now revealed as a very costly error. President Barack Obama talks about creating millions of new jobs through infrastructure spending and the like, but he and the Congress would be far more honest and also more effective in terms of changing the composition and direction of the US economy if they simply focused on

cleaning up the mess in the banking system and rationalizing policy areas such as derivatives and FVA so that the private sector may again function.

The good news in my overview of the four key financial issues that confront the Obama Administration and the heads of most of the industrial nations is that they are mostly caused by factors within our own control, self inflicted wounds if you will. If we have the courage to tell ourselves and our citizens the truth about these issues, then we can recover the US political economy. But to paraphrase my friend David Stockman yesterday, so far Paulson, Bernanke and Geithner have done nothing but introduce a monumentally destructive brand of Wall Street corporate statism to the American political equation. As David said to me yesterday, these men have essentially destroyed the implicit "economic constitution that once restrained Washington's impulse to intervene in markets."

Now Wall Street throws a hissy fit and we get a panic-driven trillion dollars of bailout and stimulus, a dissipation of the national patrimony that can only cause future inflation and lessen the real economic opportunities and freedom of our citizens. One other piece of wisdom my father imparted years ago is that it is the responsibility of this generation to pass "the bubble" broadly defined to the next generation and intact. If there is any single failure to which we must all plead guilty when it comes to the management of the US economy, it is that we let the bubble grow so large and unwieldy that we failed this basic duty.

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