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Commentary

Reforms still required to stop repeat of crisis

Finance bailout only temporarily saves a sinking ship

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As every boater knows, a bailout can only temporarily save a ship from sinking. If nothing is done to patch the holes in the hull, a bailout only delays the inevitable.

The same can be said for our financial system. Now that the Congress has adopted the much-debated "bailout" bill, it is time to assess what must be done to avoid the same financial crisis from recurring.

First, clear thinking about the future requires that we reject the foolish, self-interested rhetoric that clothed the recent past. In particular, we cannot accept the political claim that the bailout was necessary because of Wall Street's "greed."

Greed was a motivation, but it was not limited to investment bankers. Indeed, the money trail that led to Fannie Mae and Freddie Mac ran through the campaign coffers of many elected officials. It may be that Washington, not New York, was the epicenter of the disaster. Furthermore, if "greed" is the problem, "bailout" is not a solution.

What is the solution? Here are five powerful steps:

- First, stop playing with matches. One clear source of the problem -- and the first big dominoes to fall -- was the government-chartered entities Fannie Mae and Freddie Mac. These quasi-public agencies pushed banks to issue and then securitize mortgages that never should have been made. Then, these same agencies used their special government-chartered status to avoid the capital requirements that such risky instruments demanded. Fannie and Freddie claimed only an "implicit" taxpayer guarantee -- until they failed. Now, the rest of us will find out just how expensive an "implicit" guarantee can be.

Given the central role that these government-sponsored entities played in the mess, Congress should disband them. Of course, it will take time to unwind the many Fannie and

Freddie tentacles throughout the financial system, but the signal should be sent immediately that there will be no more unfunded and unaccountable entities running up huge contingent liabilities for the taxpayer to pay.

- Second, get rid of regulations that undermine either the ability, or the incentive, for financial institutions to limit their risk. There are byzantine regulations defining bank holding companies, outmoded Community Reinvestment Act requirements and disparate capital requirements for different types of banks. All these should be reformed so actual investors bear risk, and only the risk they wish to bear.
- Third, shore up the promises the government already makes. Congress should limit its promises to those it can reasonably expect to keep. The promises the government has already made with bank insurance, Social Security, Medicare and other programs are already putting pressure on limited taxpayer resources. The long-term consequences of this bailout could be the undermining of confidence in the U.S. government's ability to keep any of its promises.
- Fourth, get rid of the insanely implemented "mark to market" requirement. This rule, upending four centuries of accounting tradition, forces companies to lower the book value of certain assets based on short-term liquidity problems. As a result, even investments that are fundamentally sound must be devalued, setting up exactly the kind of credit crisis we now are enduring. The bailout bill gives the Securities and Exchange Commission the power to suspend this rule.
- Fifth, ensure that capital requirements for all entities -- especially "government sponsored entities" like the infamous Fannie & Freddie -- match the risk that they take. That will require careful thinking about portions of our regulatory structure that give far greater leeway to some entities than others.

Damning "greed" while subsidizing its fruits will neither avoid a future crisis nor solve this one. Now that they are bailing out so many scoundrels, taxpayers should insist on real reform.

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