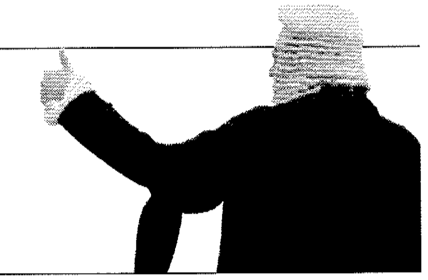
Opinion



Farewell to wigs – another step in uninspiring dress

Chris Breward, page 30

'Punish greedy bankers' is not a rescue plan

Vindictive measures will not solve the financial crisis, but helping out bank shareholders could stave off depression

Anatole Kaletsky

Was the relative calm in the financial markets yesterday merely the eye of the hurricane? Or did it suggest that the worst is over and a period of convalescence now lies ahead? The answer will depend on what happens in Washington this week.

If Congress fails to pass some kind of support package, then banks around the world will continue to fall like dominoes and the world economy will almost certainly suffer a deep depression. But even if American politicians come to their senses and agree a package, policymakers around the world will have to think more carefully and constructively about their attitudes to bank support. After the bodyblow to confidence this week, guaranteeing bank deposits may no longer be sufficient. If wholesale bank nationalisation is to be avoided, especially in America and Britain, politicians will have to stop boasting about punishing greedy bankers and start supporting shareholders, as well as depositors, in big banks.

Although no politician will admit to sympathising with bankers, the fiasco in Washington seems finally to have drawn attention to some of the policy changes urgently needed if private banks owned by stockmarket investors are not to become extinct.

David Cameron, led the way in Britain yesterday with an impressive four-point programme of government guarantees, regulatory reforms and critically important accounting changes. It is hard to see why Gordon Brown should not embrace all these points. Similar policy changes are starting in other countries — most importantly in the US itself.

To understand why the emphasis of policy must switch from punishing bank shareholders to giving them some comfort, we have only to ask why more banks keep failing despite the huge amount of public money being poured into bank "rescues"and "bailouts". The answer is simple: the government rescues that have cost so much money have not been rescues at all. They have been more like demolitions or robberies. Governments have guaranteed bank deposits, but they have wiped out the value of bank shares. This expropriation of bank shareholders has not only put the "rescued" institutions out of business. It has sabotaged the viability of other banks, as investors dump their shares before they are "rescued" like Bradford & Bingley or AIG.

That was the story until Monday. But then something seemed to change, particularly in Washington. After the congressional vote, several congressional rebels demanded two crucial changes to the bank bailout package that could transform the survival prospects of many US banks, but that the Bush Administration had consistently rejected, largely for ideological reasons. Significantly, the Congressmen's demands were very similar to the proposals Mr Cameron outlined yesterday.

The first demand was simply to extend US government guarantees to all bank deposits, instead of limiting them to $100,000. The second demand was to abandon, or at least to suspend, the new system of supposedly market-based accounting, which has been largely responsible for the overnight collapse of banks that were deemed to be solvent less than a month ago. This technical-sounding reform could immediately stabilise the profits of most British and American banks.

Until about five years ago banks all over the world worked out the profits they made from lending money to homeowners, businesses and consumers by estimating the likelihood that borrowers would continue to pay interest and ultimately repay these loans. Regulators then determined the bank's solvency on the basis of such long-term assessments.

In recent years, however, accountants and regulators have replaced such probabilistic judgments of economic fundamentals with a principle called "mark to market". Under this new approach, promoted passionately by conservative financiers and academics who believe that "the market is always right", banks base their profits not on how much income they expect to receive in the future but on how much money they could raise immediately if they sold all their loans and mortgages in the market at the best price they could fetch.

This reform didn't make much difference when markets were working smoothly and financial prices reflected long-term asset values. But in the wildly volatile and panicky conditions of the past 12

A journalist's thumbs-down to the Congress vote on Monday evening

months, mark-to-market accounting has contributed hugely to the crisis.

On Monday several Republican Congressmen who had broken ranks with the Bush Administration were focused mainly on the mark-to-market issue rather than on generalised populist disquiet. One reason for the large vote against the package was a persuasive seminar on Capitol Hill just before the voting. It was held by William Isaac, a prominent financial consultant who formerly ran the federal government's deposit-guarantee fund, and who has long argued that suspension of mark-to-market accounting could save many banks from failure and billions of dollars in taxpayer funds.

It seems likely, therefore, that the Bush Administration will swallow its ideological pride and buy Republican support for the Paulson package by inserting two conditions that will be very beneficial to bank shareholders: suspension of mark-to-market and lifting the ceiling on deposit guarantees. As a quid pro quo, Democrats may well demand stronger government protection against foreclosure and progress towards bankruptcy reform. But these measures would also help bank shareholders, by reducing the number of forced property sales.

A new version of the Paulson package could be much more generous to banks and their shareholders than the one voted down on Monday. If this is widely recognised it will, of course, be controversial. "Punish greedy bankers" is the one slogan on which everybody in Washington — and Westminster — can agree.

But this vindictiveness obscures some crucial facts. The first is that the people punished in recent bank "rescues" have not been the managers and traders who made off with billions. The punishment has fallen mostly on small shareholders and long-term institutional investors. The second is that even if bank shareholders deserve punishment they need not be put to death. For shareholders to lose 50 or 60 per cent in a bank rescue is pretty unpleasant; they do not need to be wiped out. Finally, the most important point anti-bank jihadists ignore: just as there should be no reward without risk in a market economy, there can be no risk without reward. If government bank rescues destroy all hope of reward for investors, there will be no banks.