

How to End the Subprime Crisis

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Reforms often do more harm than good. This is currently the case with the “mark-to-market” rule, which is imploding the US financial system by requiring financial institutions to value subprime mortgages at their current market values.

This makes a big problem for balance sheets. These financial instruments became troubled prior to a market being established for them, as they were marketed direct from issuers to investors. Now that they are troubled and with their true values unknown, no one wants them. Their lack of liquidity assigns them a low value.

The result is tremendous pressure on balance sheets. The plummeting value of subprime derivatives is pushing institutions that own them into insolvency, destroying their own stock values and forcing the financial institutions to sell untroubled liquid assets, thus resulting in an overall decline in the stock market.

The solution is to suspend the mark-to-market rule. Instead, allow financial institutions to keep the troubled instruments at book value, or 85-90% of book value, until a market forms that can sort out values, and allow financial institutions to write down the subprime mortgages and other troubled instruments over time.

Suspending the mark-to-market rule would take pressure off the stock market and make it unnecessary for the Fed to lower interest rates in an effort to force liquidity into the economy through an impaired banking system. The problem is not a general lack of liquidity, but liquidity for poorly conceived new financial instruments. Low US interest rates could worsen the crisis by accelerating the dollar’s decline. Now that inflation has raised its head, more liquidity from the Fed adds to the economic distress.

It is mindless to allow a “reform” to cause a financial crisis, but that is what is happening. Unfortunately, there are people who argue that anything less than financial armageddon would create a “moral hazard.”

It is certainly true that securitized subprime mortgage instruments were a bad idea, that a lot of people who should have known better opened floodgates to greed and fraud, and that “somebody should pay.” But it shouldn’t be the general public and the economy that pays.

It is also true that without the Federal Reserve’s irresponsible low interest rate monetary policy, which produced a housing boom, the subprime instruments would not have been created, or at least not in such amounts. Rapidly rising real estate prices were expected to make the risky loans good. What were issuers and the Federal Reserve thinking?

No doubt but that greed, fraud, and bad policy all played their roles. But at the heart of the

problem is a 1999 “reform” that repealed an earlier reform known as the Glass-Steagall Act.

In 1933 the Glass-Steagall Act separated commercial banking from the securities business. It prevented securities speculation from destroying bank capital and shrinking bank deposits from bank failures and runs on banks by depositors. Congress and President Bill Clinton foolishly repealed the Glass-Steagall Act in 1999.

The repeal of the 1933 law was driven by profit lust in the banking industry and by “free market” ideology, which claims the unfettered marketplace is always superior to regulation. In pushing the repeal forward, Congress and Clinton ignored warnings from the General Accounting Office that the banks needed to build up their capital levels before being permitted to enter a broad range of securities businesses. The GAO also noted that there were no regulatory structures in place to monitor the new financial networks that would result from removing the wall between commercial and investment banking.

However, greed and ideology won over sound advice. The result is a crisis that, if mishandled, will be calamitous.

Paul Craig Roberts was Assistant Secretary of the Treasury during President Reagan’s first term. He was Associate Editor of the Wall Street Journal. He has held numerous academic appointments, including the William E. Simon Chair, Center for Strategic and International Studies, Georgetown University, and Senior Research Fellow, Hoover Institution, Stanford University. He was awarded the Legion of Honor by French President Francois Mitterrand.

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