

Still Skeptical About Banks

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It's getting somewhat lonelier being a large financial institution skeptic, although there still a lot of us left. I would say that among the skeptics, the general view is that we may have seen an end to bank panics for this cycle – I'm not sure anyone is saying there will definitely be another crisis in the near future – but we may not have, and we may come to regret not taking stronger measures now. (How's that for prognostication?)

Lucian Bebchuk, in Project Syndicate (a well-intentioned collaboration that manages to sound ominous and conspiratorial), makes the argument in clear terms. First, the recent stress tests only projected losses through 2010, ignoring the large number of loans and mortgage- and asset-backed securities that mature in later years. More fundamentally, though: “Rather than estimate the economic value of banks’ assets – what the assets would fetch in a well-functioning market – and the extent to which they exceed liabilities, the stress tests merely sought to verify that the banks’ accounting losses over the next two years will not exhaust their capital as recorded in their books.” Put another way, the focus has been on the accounting value of assets, not their economic value; so for a given asset, as long as it doesn't have to be written down before the end of 2010, there is no problem.

Bebchuk also points out that the ability of banks to raise equity capital should not be taken as an “all clear” sign. As he and others have previously argued, equity in large banks by its very nature represents a leveraged bet whose downside risk is limited by the implicit government guarantee. That is, as a shareholder, if the economy does OK and bank assets appreciate in value, you get all of the upside (leveraged by the bank's liabilities); if the economy does terribly and bank assets fall in value, your losses are not only limited to the amount of your investment, they are further limited by the implicit guarantee that the government will not wipe you out. That guarantee is weaker than the implicit guarantee on bank liabilities, but it is still there; given the way the government has treated Citigroup (C), Bank of America (BAC), and GMAC, betting on the “no more Lehmans” policy seems like a sensible bet.

Most attention is now focused on the battle over financial regulation (if it isn't on health care and energy), which is appropriate. But it may be premature to declare victory over the financial crisis.