Analysts: Bank creditors, policy-makers need new plan

Ex-Fed official Poole calls systemic-risk-regulator notion flawed

By Ronald D. Orol, MarketWatch
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PHILADELPHIA (MarketWatch) -- Legislators in Washington and bondholders in New York have to take a new approach to resolving the financial crisis, according to a group of economists and analysts.

"You're not going to get out of this financial crisis unless you get the bondholders to come to the table," said Christopher Whalen, managing director at Institutional Risk Analytics in Torrance, Calif., at a Wednesday event in Philadelphia hosted by the Global Interdependence Center.

Whalen joined William Poole, former president of the Federal Reserve Bank of St. Louis, in arguing that troubled banks will not complete the restructuring they need until bank bondholders and private preferred shareholders recognize that they also will need to take some losses. Whalen said bank executives should take steps to expedite candid conversations with bank creditors.

"Invite them to form a creditors committee and say, 'We'd like to talk to you -- we'll give you a week.' If they haven't formed a creditors committee by then, then you just resolve the holding company," Whalen said.

Poole, now a Cato Institute fellow, also raised issues over how bondholders have handled the situation so far. "Some creditors of banks that are at risk of a loss must take a hit," he said. "It shouldn't be just equity owners that take a loss."

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— William Poole, former president of St. Louis Fed

In addition debt-holder matters, participants at the event, hosted by Drexel University, discussed issues they also are having with the way federal policy-makers are handling the financial crisis.

Defining 'systemic'

Poole said he had several problems with legislative efforts underway in Washington, citing the example of a systemic-risk regulator overseeing banks, hedge funds and other large financial institutions.

While details about such a regulatory entity are still limited, he conceded, it is possible it would also be responsible for unwinding so-called too-big-to-fail banks, as necessary.

Poole argued that it would be difficult to identify which banks and other institutions would be subject to such an approach. He also said lawmakers are unlikely to provide details about what specific institutions would fall under this approach.

"It is an extraordinary dangerous idea for authorities to be able to take over any firm, and we probably won't know how they justified such a takeover," Poole said. "We need to find a way to get these troubled entities into a bankruptcy process that works rather than use an approach that is outside bankruptcy."

Charter members

Instead of a systemic-risk regulator, Poole argued that banks should be required to set up charters requiring them to hold 10% of their total liabilities in subordinated debt with no collateral behind it. The approach would be a market mechanism to control a bank's size, Poole said. A 10-year subordinated-debt security would require banks to refinance 10% of the bond annually. If the bank took the bond to the market to finance the interest and could find no takers, the bank's balance sheet would need to contract by 10% through asset sales.

'Say hello to Glass Steagall because it's coming back.'

— Nancy Bush, NAB Research

"They would be subject to all that market discipline, so it would be a market mechanism to make sure banks aren't too big too fail. They could shrink more gradually, and it wouldn't cause a shock to the system," Poole said. "Bankers have to go for a market mechanism of this kind or they will find themselves under enormous constraints in years to come."

However, Nancy Bush of NAB Research LLC in New Jersey, said she expects policy-makers to take swifter action. She said Washington will likely dismantle large financial institutions as part of an effort to limit the collapse of too-big-to-fail banks.

She argued that regulators may reinstall key provisions of the landmark Glass Steagall Act of 1933, which prohibited bank holding companies from owning other financial institutions. That prohibition was repealed in 1999 by the Gramm-Leach-Bliley Act.

"Say hello to Glass Steagall because it's coming back," Bush said. "I'm going to have to look at how to value J.P. Morgan Chase (JPM) , which conducts both investment and commercial banking, because now they may have to take themselves apart."

Bush argued that the government's bank-bailout program "ensures mediocrity" in the banking sector. "It's enormously destructive."

She added that she was disappointed that the program morphed from its intended approach of removing illiquid mortgage securities from bank balance sheets to an approach that provides capital injections to banks.

"The Treasury program started out to be about finding prices of assets -- marking them down getting it off the books -- [and] I don't know when it morphed into give them capital, and never mind about when they should give it back," Bush said.

Troubles in the automotive sector, coupled with some banks located in that region, will lead to a confluence of problems for the Midwestern U.S.

"We have to pay a lot of attention to the Midwest," she said.

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