Too Much The Investment Banker

BY ABE DE RAMOS

Why U.S. Treasury Secretary Hank Paulson should approach the banking crisis more like a regulator.

The trillion-dollar commitments made so far by governments, with the exception of Britain's, have been biased toward restoring market confidence instead of healing the core of what ails banks. So it might be a good idea for them to look to Asia to help them get the job done, and to do it right, both in terms of strategy and funding.

Ending the crisis requires not only easing liquidity, but also repairing banks' balance sheets and rebuilding their capital base. While the times call for a systematic approach, the solutions offered have been disjointed or inadequate. Guarantees on interbank lending won't reduce bad loans; purchasing bad loans won't improve banks' ability to lend; and taking minority stakes in banks with marquee names ignores smaller ones that are just as likely to be badly exposed to subprime debt and thus unable to serve the local businesses and consumers that oil the economy.

One of the astounding things about the ongoing efforts to resolve the crisis has been the lack of a clear initiative to inspect banks' balance sheets thoroughly. Regulators need to know just how many banks are in trouble and approximate how bad their situations are in order to design and implement targeted solutions. The measures that Asian governments took to repair their financial sectors during the Asian crisis ten years ago could provide a template for the U.S. and European bailouts.

Asian governments borrowed heavily from the International Monetary Fund to bail out their crumbling financial systems. They assessed the health of major financial institutions, and then established asset management companies to acquire non-performing loans at a fraction of face value, as well as restructuring agencies to close insolvent banks, nationalize ailing ones, and recapitalize viable ones.

Those that survived the cull were forced to consolidate and then were recapitalized. Weaker banks merged with stronger rivals, or combined to form new, stronger entities

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under state supervision. In some cases, banks were given a timetable for meeting capital-adequacy ratios. Eventually, the state agencies sold controlling stakes in the nationalized banks to foreign investors, and auctioned off the bad loans they had repackaged.

Now substitute the IMF loan with the American and European rescue packages, the bad loans with subprime debt, and you have virtually parallel situations and transplantable measures with which to fix the U.S. and European financial sectors.

It is, of course, clear that the United States and others in the G7 are wary of even temporary nationalization. But the bitter pill of bankruptcies, consolidation, and recapitalization is what the system needs to repair itself. By buying minority stakes in a handful of banks, U.S. Treasury Secretary Henry Paulson is acting like an investment banker who focuses on instant results, not like a regulator who takes aim at the root of the problem. British Prime Minister Gordon Brown deserves the accolades he is now receiving. His actions toward HBOS and RBS show that his government is prepared to take control, not just equity.

One option that Western regulators can pursue to boost their banks is to bring in Asian sovereign wealth funds and large financial institutions. Learning from their own hardships has helped some Asian countries become the cash-rich sovereigns they are today. China, which dealt with its own bad-loan problems in the first half of this decade, now has nearly $2 trillion in foreign reserves, almost three times the size of the U.S. bailout budget.

There is no reason why the United States and Europe should not take advantage of the wealth of Asian institutions. This would help reduce the cost to taxpayers of the bailout, and, by keeping bigger banks in the hands of eager players, the government could focus on nationalizing and rehabilitating the smaller banks and thrifts that serve a greater number of consumers.

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In return, the Asian institutions would have a chance at the rich returns they desperately seek but cannot receive at home. Sovereign wealth funds are meant to diversify state investments to higher-risk, higher-return assets. China, Korea, Singapore, and Japan all have aging populations and massive pension obligations that need immediate funding. Likewise, many of their banks are overcapitalized with nowhere to go: after the Asian crisis and the Japanese asset bubble of the 1990s, companies have become conservative borrowers, while banks' opportunities to expand within the region remain limited by restrictions on foreign ownership of local banks.

Unfortunately, some sovereign wealth funds that invested in financial institutions in the earlier part of the year have seen their portfolios decline in value. But it would be foolish to make that a reason for ignoring the opportunities before them now.

It therefore behooves the United States and Europe to reach out to Asian institutions to participate in mending their financial systems. A key to the success of Asia's restructuring effort, despite massive social, political, and economic obstacles, is the defined and systematic way in which each market dealt with its banks to reorganize the sector. This approach, so far, has been lacking in the West. As the crisis threatens the global economy, regulators do not have the luxury of taking their time. ◆

Henry Paulson

Gordon Brown

Dealmaker vs. Regulator

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—*A. De Ramos*