

*Leveraging ourselves out of Crisis—Again!*¹

Aida Sy and Tony Tinker

INTRODUCTION

There is a time-honored banking maxim: “never borrow short to lend long.” For banks, “borrowing short” involves using low-cost, immediately withdrawable deposits. “Lending long” means committing to long-term, not-so-easily liquidated, high-risk, high-return investments. There is no problem provided the value of a bank’s investment portfolio remains unimpaired. Indeed, problems diminish as long as asset-values inflate in inflationary times (or in a speculative bubble). So it was with the housing market for several years. Then, the high returns from a growing investment portfolio exceeded the cost of financing from cheap depositor funds. Depositors remain safe as long as inflationary conditions pertain.

Deposits are the time-bomb on a bank’s balance sheet. Their contractual status entitles them to repayment of principle and payment of interest. Failure to comply with such payments authorizes depositors to sue for payment and ultimately file for a winding-up/bankruptcy of the delinquent bank.

Financial reporting supposedly provides the public with advanced warning of pending leverage risk. Accounting controls can be designed to block high-risk transactions and red-flag such transactions, if they occur. The paper explores how—and why—these safeguards were compromised and the efficacy of the institutional restructuring aimed at resolving the current financial crisis.

DIALECTICAL CONTRADICTIONS OF CAPITALISM

Capitalism is founded on expropriative social relations that underpin all historical moments of this social order. Political interventions at specific “historical moments,” are always possible (Marcuse, 1955/1986;² Gramsci, 1971³).

¹. This paper is based on a presentation to Situations Salon, October 24 2008. The authors are indebted to Salon participants for their comments and suggestions for improving the paper.

².“All Marxian concepts extend ... first ... the complex of given social relations, and second, the complex of elements inherent in the social reality that make for the transformation into a free social order.”

³. “...the philosophy of praxis is a reform and a development of Hegelianism ... it is consciousness full of contradictions, in which the philosopher understood ... individually and as an entire social group, not only grasp the contradictions, but posits himself as an element of the contradiction and elevates this element to a principle of knowledge and therefore action.”

Aida Sy and Tony Tinker

However, because of capitalism's unstable social foundations, dialectical movements are simply negation-of-negations (Adorno, 1973). Their result is not closure, or a synthesis with permanent stability, but an unstable remainder with difference that contains within it the seeds of future crises. Problems are never "solved," they are simply deferred and transformed.

The present financial crisis is composed of the conjunction of three contradictions that jeopardize the capital accumulation process (Gamble, 1976)⁴.

1. The falling rate of profit
2. The Realization Crisis—the disposal of overproduction
3. Concentration and centralization of capital

THE FALLING RATE OF PROFIT

Banking and stock market work has undergone fundamental technological change in recent years. "Trading" has fallen to what Marx termed the "real sub-subsumption of labor," where professional/craft work is radically transformed into low-cost, machine minding, semi-skilled work. Trading and banking transactions are now conducted electronically, at hyper speed, with little or no human intervention. Instantaneous trading transcends time and space—performed on a global stage, 24 hours a day, 7 days a week. Wall Street is now a tourist exhibit, preserved for its nostalgic resonance with a medieval corn market. Brokers and jobbers are obsolete. They have been replaced by software and electronic assemblies (COMEX, the European partner of the NYSE, is a largely automated exchange.)

The competitive deskilling of banking and stock market work is the "falling rate of profit" of banker income.⁵ To counteract these market pressures, institutions and individuals have resorted to more and more exotic, high risk/high return financial instruments. These unstable circumstances persist to this day.

⁴. There is nothing absolute or eternal about these contradictions; they simply epitomize today's most distinctive aspects of capitalism's accumulation crises.

⁵. Some recently laid-off Wall Street workers have interviewed with South-East Asian banks. Salary offers are between a quarter and a third of previous pay rates.

*Leveraging ourselves out of Crisis—Again!***THE REALIZATION CRISIS— THE DISPOSAL OF OVERPRODUCTION**

The competitive drive for greater efficiency results in shedding high cost labor and its replacement with (fewer) cheaper workers. The consequence is greater production with fewer workers and a commensurate reduction in the level of effective demand. Hence, capitalism has a chronic tendency of overproduction and difficulty in disposing of surplus production. Credit—in its many forms—is an attempt to bolster demand to absorb surplus production. This is the “negation” that capitalism utilizes to counter the perennial problem of overproduction.

Home loans/mortgages are a form of credit that has sustained activity in the building/housing sector. Market pressures in the form of commissions to banks and real estate brokers have sustained a level of lending, often well-beyond the capacity of borrowers to repay.⁶ Second mortgages and reverse mortgages are additional lines of credit funded by property as collateral. The concealment of the leverage risk by brokers and bank salespeople is well-documented.

CONCENTRATION AND CENTRALIZATION OF CAPITAL

While elements of the two previous contradictions linger to this day, the “Concentration and centralization of capital” presents the greatest instability, because it is in this arena that today’s “solutions” will become tomorrow’s problems. Many of the institutional re-arrangements, aimed at restoring stability have destroyed the firewalls that would have localized banking failures. The creation of entities that are now “too big to save” is an important focus of the following passages. Before proceeding, however, it is important to review the dialectical movements of instabilities that preceded the present crisis. This “history” is not merely a procession of events, but movements that dialectically connect the past to the present to the future.

⁶ The predatory lending practices that led to the subprime crisis are reminiscent of those deployed by Savings & Loans banks in the 1980s. When the Lincoln Savings & Loans FDIC insured CDs matured, the owners were contacted by bank “salesmen” to flip their CD into another investment. Customers were misled about the absence of FDIC insurance for the new product. The salesmen’s literature encouraged them to target “the old, the meek and infirm.” Florida retirees were especially hard hit by this fraud. Most of them died before any legal redress was secured.

Aida Sy and Tony Tinker

ACCOUNTING PRACTICES FOR DISGUIISING LEVERAGE

LEVERAGE RATIOS AND FINANCIAL RISK

Auditors firms are charged under the 1933-34 Securities Acts and, more recently, the Sarbanes-Oxley legislation of 2002, to certify the accounts of public quoted companies. This charge extends to assessing a firm's system of internal controls, including those of the banks that were selling sub-prime loans to poorly informed borrowers. Hence, SECURITIES AND EXCHANGE COMMISSION RELEASE NOS. 33-8238; 34-47986; IC-26068; File Nos. S7-40-02; S7-06-03] RIN 3235-AI66 and 3235-AI79 states,

“...the auditor is required to attest to management's assessment of internal control over financial reporting ...”⁷

Why did bank managers, auditors, and the regulators (SEC/PCOB) fail to comply with this legal obligation? The root lies in the compromised circumstances of these institutions. Auditors are paid by the corporations they are required to audit.⁸ Notwithstanding additional safeguards introduced by the 2002 Sarbanes-Oxley legislation, this basic contradiction remains in the form of pressure to “please the client.”⁹

This willingness to accommodate the client was evident from the financial reporting practices of Enron, where the auditors (and regulators) allowed the firm to disguise its high-risk practices. The practice is known as “off-balance-sheeting” the risk. The manner in which this was accomplished can be shown with a series of examples. Table 1 below shows the balance sheet of a “normal” firm, with a tolerable risk profile.

7. Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SECURITIES AND EXCHANGE COMMISSION, 17 CFR PARTS 210, 228, 229, 240, 249, 270 and 274, [RELEASE NOS. 33-8238; 34-47986; IC-26068; File Nos. S7-40-02; S7-06-03] RIN 3235-AI66 and 3235-AI79 MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND CERTIFICATION OF DISCLOSURE IN EXCHANGE ACT.

8. The system is akin to schoolchildren paying their teachers. If schoolchildren paid their teachers, all children would get A's. When auditors are paid by their client, the client is likely to receive a clean audit report.

9. For an accounting firm, the retention of a client is worth more than one year's audit fee. It is a series of fees - the present value of an annuity - plus any additional fees that may be extracted from the client by selling additional financial services. There are enormous pressures on audit partners to keep and please the client. Partners frequently received commissions for new business, and loss of income and/or their jobs, if they lose a client.

Leveraging ourselves out of Crisis—Again!

Table I
Normal Inc

ASSETS	\$B	CLAIMS	\$B
Investments	85	Equity	60
Cash	15	Deposits / Loans etc	40
Total	100	Total	100

The important measures of risk are shown in Table 1: the proportions of Equity (\$60B) to Depositors/Loans, etc (\$40B).¹⁰ The 60:40 ratio means that depositors have a cushion of \$6 for every \$4 exposure (or 3:2). If the investments fall in value (a bad trading year, fall in the value of an investment portfolio, a poor real estate investment, etc) then the asset value can drop by \$25B before depositor claims are put in jeopardy. Such a massive decline in investment values is unlikely, which confirms the adequacy of the size of the cushion for depositors. The 60:40 leverage ratio (also called a gearing ratio or coverage ratio) is a reassuring statistic for depositors.

We begin by noting the balance sheet of a typical bank (Table II).

Table II
BearSterns/Lehman/Fannie Mac-Mae/UBC/Citi

ASSETS	\$B	CLAIMS	\$B
Mortgages	97	Equity	4
Cash	3	Deposits / Loans etc	96
Total	100	Total	100

Table II shows a leverage ratio 4:96, compared with a safe leverage ratio of 3:2 in Table I. Table II is a balance sheet of typical bank: banks are—in general—high risk enterprises. A mere 10% decline the Mortgage asset (of \$9.7B) would wipe out the cushion of \$4B and put a bank in a state of technical insolvency. However, as long as inflationary conditions pertain (that is, mortgage and other assets increase in value) depositors are safe. But the recent dramatic decline in mortgage asset values has eclipsed the equity value of many financial institutions. The bubble has burst.

¹⁰ Figures are presented in percentage terms to simply the comparisons.

Aida Sy and Tony Tinker

THE TRANSITORY NATURE OF THE ACCOUNTING SIGN

Accounting can re-present balance sheet values to minimize the appearance of financial risk. In terms of Tables I and II, this involves inflating the Equity Value and deflating Depositor Value—giving a safer leverage statistic than a firm really deserves. Better leverage statistics give greater assurance to existing and potential lenders (Depositors). Lowering the risk profile increases the willingness of lenders/depositors to lend at lower interest rates. We can use Enron as a case study to show how a high-risk entity can be transformed into a low-risk business.

Table III
Enron's Balance Sheet & the Balance Sheet of Enron's
Unconsolidated Dominican Republic Subsidiary

Unconsolidated Balance sheet for Enron US			Balance Sheet for Enron Subsidiary: the Dominican Republic				
\$B Assets	\$B Claims		\$B Assets	\$B Claims			
Dot Com	90%	Equity	50%	Elec. Plant	100%	Equity	5%
Cash	10%	Liabilities	50%			US. Gov. Loan	95%
TOTAL	100%	Total	100%	Total	100%	Total	100%

The two balance sheets in Table III show amounts in percentage terms in order to simplify the explanation. The left hand balance sheet is Enron alone. It shows a reasonable risk profile: a leverage ratio of 5:5. Enron preserved this relatively healthy appearance in two ways:

1. The Equity value (of 50%) was inflated by issuing “shares” that were not really shares. They really should have been classified as debt (liabilities). These “shares” paid interest (not dividends) and this was accepted as such by the IRS. In this sense, the IRS compounded the fabrication.
2. Enron's Liability figure was deflated because Enron was not required to add to its 50% Liabilities the U.S. Government Loan shown on its subsidiary's balance sheet.

Enron avoided consolidating the two balance sheets (and thus was able to present a rosy risk picture) by invoking a little known 5% Rule. Created for Special Purpose Entities (SPEs), it was originally developed for an entirely

Leveraging ourselves out of Crisis—Again!

different set of circumstances.¹¹ Invoking this rule allowed Enron to evade consolidation. The Dominican Republic was one of some 27 poor countries where Enron, using lender-finance from the U.S. government, entered into agreements (often by bribing an indigenous elite) to privatize basic utilities (electricity, gas, water, etc).¹² In all cases, the debt-financing was kept off Enron's balance sheet.

Amalgamating Enron's balance sheet with its Dominican subsidiary provides a glimpse of what they were trying to hide. Table IV—again in percentage terms—presents Enron's consolidated balance sheet.

Table IV
Enron's Consolidated Balance Sheet:
The Parent Co. and the Dominican Republic Subsidiary

\$B ASSETS		\$B CLAIMS	
Dot Com	45%	Equity	27%
Elec. Plant	50%	US. Gov Loan	48%
Cash	5%	Liabilities	25%
Total	100	Total	100

MARGIN TRADING AND MARGIN CALLS

Corporations never carry cash-on-hand to pay immediate expenses, such as payroll and short-term creditors. Rather, firms like Enron borrow on the short-term money market. When investors discovered the extent of Enron's

¹¹. The 5% Rule was originally developed for automobile manufacturers, who had developed credit subsidiaries to help customers buy vehicles on credit. GM Credit and Chrysler Credit were two such entities. If the auto manufacturers had consolidated/combined their banking subsidiary and their own balance sheets, their leverage/financial risk ratios would have been alarmingly high, and the auto firms' cost of raising money would have become prohibitive. For this reason, automobile firms were exempt from consolidating balance sheets, as long as 5% or more of the subsidiary equity was held by outside parties. Enron used this loophole to escape consolidation.

¹². Enron was not only engaged in a massive "off-balance sheeting" of its leverage, but it was also engaged in bully tactics against poor countries. In the Dominican Republic, Enron secured the monopoly contract to upgrade the public electrical supply from an existing productive capacity of 11 MGW to 15 MGW. Once in charge, Enron reduced supply to 8 MGW, causing widespread blackouts, and endangering the lives and health of many citizens. They then argued that only a price increase would allow them to finance the improvements needed to restore capacity. Riots ensued in many countries (sometimes put down by Enron police). Some rioters died. Not until Enron played the same stunt with the Californian electrical supply did Americans begin to question the Enron miracle.

Aida Sy and Tony Tinker

leverage, and therefore leverage risk, they refused to accept Enron's paper/notes. Enron's liquidity thus dried up and the firm was forced to file for bankruptcy.

This pattern of behavior—from high-risk leverage financing in an investment bubble, to the bursting of the bubble, to the withdrawal of credit, to bankruptcy—is a familiar pattern. The object of the bubble investment may differ: it could be real estate, it could be stocks and shares, or tulips. The details are irrelevant. The pattern is important. Consider, for instance, speculation in the recent subprime market.

Table V
Borrowing on Margin and Margin Calls

	Initial Cash Down-payment	Price of House or Securities	Loan or Mortgage from the Bank
Orig. House Purchase	\$0.2M	\$3M	\$1.8M
Increase in property value		\$1M	
Second Bank Loan to purchase securities		\$1M	\$1M
Property price falls to		\$2M	
Bank makes margin call		$\$2.8M - \$2M - \$0.2M = \$0.6M$	

In Table V, a \$2M property is purchased with a down payment of \$0.2 and a mortgage of \$1.8M. The house price increases to \$3M, and the buyer uses the increased value as security for a second mortgage loan of \$1M for investment on the stock market. When property values fall from \$4M to \$2M, the bank will make a margin call of \$0.6M to cover the balance of the loan. As the initial deposit was merely \$0.2M, it is unlikely that the borrower would be able to make the margin call. Thus, the property would be placed in foreclosure and the borrower would be forced to file for bankruptcy.

The pattern repeats itself: borrowing on margin, a burst of the speculative bubble, margin calls, and bankruptcy. Consider Table VI.

Leveraging ourselves out of Crisis—Again!

Table VI

Date	Crises, Regulation and Deregulation
1920's	Florida Real Estate Boom
1929 Crash	Syndicates & Pools
1933	Glass-Steagall Act /FDIC
1933-4	Securities Acts (Audit & Disclosure)
1980	Reagan Repeals Glass-Steagall (Depository Institutions Deregulation and Monetary Control Act)
1980s	Savings & Loans Crisis: Resolution Trust MK1:\$150B, Total—\$500B est.
1990's	Dot Com \$2 -3 Trillion meltdown
1999	Gramm-Leach-Bliley Act (Financial Services Modernization Act) partial repeal of Glass-Steagall. Removed the firewalls between insurance co's. Commercial and investment banks.
2001	Enron Default \$8B
2002	Sarbanes-Oxley (SOX)
2002	Worldcom Default \$12B
2008	Bear Sterns \$29B (J.P. Morgan), Fannie & Freddie \$200B, AIG \$85B, Lehman \$129B, Merrill \$130B (BofA), Morgan Stanley, Goldman Sachs Resolution Trust Mark II: \$700B
2008 and Beyond	Northern Rock (UK) Bradford and Bingley (UK) Wakovia to Wells Fargo WAMU to Bank of America Morgan Stanley to Mitsubishi UFJ Fortis Belgium / France Dextor to France/Holland/Belgium Kaupthing Bank to Iceland to Russia Kaupthing Edge to ING (Holland) Kaupthing Singer & Friedlander (UK) to UK Kaupthing (Austria) to Austria

Table VI is a timeline of the pattern of leverage borrowing, bubble speculation, crisis, margin call, and regulation. As Galbraith (1954) argues, the Florida real estate was boom-and-bust, fueled by leveraged borrowing. Florida was a rehearsal for the Crash of 1929. Each case relied on margin borrowing to fuel a boom, followed by a crash and subsequent margin call, and then default. The two episodes differed only in that, in one case, the object of speculation was real estate, and in the other, margin borrowing to buy stocks and shares.

Aida Sy and Tony Tinker

Table VI shows that, because of the inherent contradictory social relations of capitalism, legal and other solutions to each crisis are never permanent, but merely defer and transform problems (Adorno, 1973). The 1933 Glass-Steagall Act established Federal Deposit Insurance, to restore depositor/lender confidence in commercial banks. But this “solution” only set the stage for the “free rider problem” or the “moral hazard problem.”¹³ The availability of Federally insured deposits was an invitation for reckless, speculative and even fraudulent behavior. Speculators/managers knew that the state would cover their bets. FDIC insurance set the stage for the crisis of the 1980s. Many Savings & Loans engaged in reckless conduct (Lincoln S & L being one of the most notorious).¹⁴ Drexel Burnham’s Michael Milken bragged about using federally insured funds, that Drexel bundled into \$100,000 packets, to invest in junk bonds and high risk real estate ventures.¹⁵

The 1930s also set in place contradictions that would continue to erupt into later years. The 1933-34 Securities Acts created the Securities and Exchange Commission (SEC), which was given oversight powers over publicly quoted companies. The 1934 Act required corporations to publish a prospectus and an annual report that were examined and certified by a Certified Public Accountant. The SEC was empowered to set standards for financial reporting; however, it immediately off-loaded this responsibility the accounting profession. The problem, then and now, is that the auditor is paid by the corporations they are auditing. There is always a temptation to “please the client.” In consequence, there has been a parade of audit and financial failures, including Paramount Pictures, Reliance Insurance, National Student Marketing, Enron, ESM, BCCI, Wordcom, ESM, ZZZZ Best, OPM, Waste Management, Regina Vacuum Cleaner, and the list goes on (Briloff, 1970,

¹³. Free riders are those who consume more than their fair share of a resource, or shoulder less than a fair share of the costs of its production. This is closely related to the “moral hazard problem.” This is also a case of “moral hazard:” the prospect that a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk. Moral hazard arises because an individual or institution does not bear the full consequences of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to bear some responsibility for the consequences of those actions. For example, an individual with insurance against automobile theft may be less vigilant about locking his or her car, because the negative consequences of automobile theft are (partially) borne by the insurance company.

¹⁴. The “unintended consequence” of FDIC insurance eventually cost taxpayers \$150B and an estimated \$350B to private individuals.

¹⁵. Drexel Burnham eventually collapsed and Milken was sentenced to 18 months in a country-club jail, and fined \$750M (half of his net worth).

Leveraging ourselves out of Crisis—Again!

1972). These contradictions were accentuated with the de-funding of regulatory agencies (on entering office, Reagan cut the SEC budget by 30%).

There has been the increasing assimilation of the polity by lobbying (O’Conner, 1973). Politics is now an extension of the corporate market, like advertising expenses (Stigler, 1946, Peltzman, 1978, Tinker, 1984). The Lincoln S & L and Enron (20 years apart) both involved aggressive lobbying in Congress to delay regulatory intervention and compromise improvements in financial reporting. In the Lincoln case, the 6 month delay cost several billion dollars. In the Enron case, executive remuneration with stock options remains to this day largely off-the-books, thanks to heavy congressional lobbying. The result was not just to misstate corporate income, but also to open the floodgates to a bonanza in executive compensation.

CONTRADICTIONS FOR THE PRESENT/FUTURE

The 1999 Gramm-Leach-Bliley Act (Financial Services Modernization Act) partially repealed the Glass-Steagall Act. It removed the firewalls between insurance companies, commercial and investment banks. The purpose of Gramm-Leach-Bliley was to expand profit opportunities of banks; but in doing so, it removed the protective barriers between different lines of business. By allowing banks to expand into different states and beyond, into different countries, the impact of a failure in one sector would no longer be confined to that sector but could engulf the entire entity. Similarly, once upon a time, an insurance failure stayed in insurance. Today, an insurance failure could envelope the FDIC side of a business. And most important, high-street banks (commercial banking) that use FDIC deposits are—as a result of the recent government approved mergers—now exposed to high-risk investment banking.

The list of time bombs is growing. Bear Sterns (an investment bank) has been bought by J.P. Morgan (a commercial bank with Federally Insured Deposits). AIG is a provider of regular insurance, but now it is known to be deeply involved in credit swaps. Investment bank Merrill Lynch was assimilated by a grateful Bank of America (a FDIC commercial bank).

Morgan Stanley and Goldman Sachs are investment banks that have both been granted the status of FDIC/commercial banks. Recent events involving these two banks foreshadow the future. In Romania, these banks are under investigation for short selling the Romanian currency against the Euro. So,

Aida Sy and Tony Tinker

in this new era, federally insured U.S. deposits are exposed to overseas speculative ventures. National boundaries no longer provide a firewall. A meltdown in one country could ricochet onto another. When Iceland nationalized its failing banks, its deposit insurance scheme was not extended to the U.K. customers of these banks. The U.K. government assumed the liability, and sued Iceland for compensation. In short, many of the 2008 bank takeovers, mergers, consolidations, holding company formations, nonbank-bank ventures, and other aspects of the 2008 bailout, have destroyed firewalls between different financial products, and the firewalls between different geographical/legal jurisdictions. The result is that meltdowns can no longer be localized, systemic risk has increased.

WALL STREET: TOO BIG TO FAIL?/TOO BIG TO SAVE?

In the 1980s, the U.S. Government stepped in to save Continental Illinois, the fourth largest bank in the U.S., with assets of \$64 billion. The rationale for this unprecedented intervention was that this bank was “too big to fail.” Its collapse might trigger a systemic meltdown of the entire banking system.

Today, regulators and the state face a new quandary: are some banks “too big to save?” Iceland provided a glimpse of what was coming. Iceland bailed out its banks (Kaupthing) and in doing so, exhausted its foreign currency reserves. This placed the bankrupted nation in IMF receivership. In exchange for IMF support, the IMF required the national bank to raise interest rates to 18% to stem the exodus of the Krona. An 18% cost of capital pushed Iceland’s economy towards acute recession, as internal investment has ground to a standstill. By the same token, Fortis was too big for its host country, Belgium, to rescue. France had to lend a hand in assistance. Table VII is a too big to save index.

Leveraging ourselves out of Crisis—Again!

Table VII
Too Big to Fail Index Top 50 Banks Leverage as % E of Country GDP

COUNTRY **Top 50 Bank Leverage as a percentage
of their Host Country GDP**

Switzerland	595.32
Netherlands	336.86
Belgium	318.84
United Kingdom	206.21
France	198.07
Hong Kong	154.74
Spain	107.77
Japan	102.16
Sweden	82.96
Australia	82.07
Italy	70.32
China	63.26
Germany	49.88
United States	44.19
Canada	28.80

SOURCE <http://www.euromoney.com/Article/1961042/Worlds-largest-banks-2007-Global-bank-rankings-Top-20-global-free-to-access.html>
 EUROBANK

SOURCE <http://www.euromoney.com/Article/1533691/Worlds-largest-banks-Global-bank-rankings-Top-50-by-shareholder-equity-free-to-access.html>
 EUROMONEY

Table VII shows the total leverage of each of the top 50 largest banks in the world, as a percentage of the host country's GDP. For instance, the leverage of Switzerland's two largest banks, expressed as a percentage of that country's GDP, is 595%. Given the fragile nature of banks and national economies, it is difficult to know which time bomb on Table VII will explode first.

MAIN STREET: TOO BIG TO SAVE?

The struggle in Washington is whether the \$170B fund, created by the 2008 EMERGENCY ECONOMIC STABILIZATION ACT (EESA) should be limited to bailing out Wall Street, or whether the fund should be extended to rescuing Main Street. The claims from Main Street are compelling, large and growing.

Aida Sy and Tony Tinker

General Motors, Ford and Daimler-Chrysler head the queue, with requests for \$25B. Not far behind are the airlines, numerous states facing massive deficits, and others.

IMPLICATIONS

At the time of this writing (November 18, 2008), banking industry representatives are appearing before the House Banking Committee, requesting that the government expedite the processing of bank applications for Holding Company status. The aim is to expand the range of financial products banks would be permitted to offer, thereby alleviating their lackluster profits. Once again, the longer term stability is being sacrificed by short-term expedients. Highly leveraged institutions would expand beyond the firewalls, previously set to localize risk. Geographical and product expansion by high-leveraged institutions is creating a time bomb for the future.

The scenario is familiar. Faced with a Savings & Loans crisis in the early 1980s, Ronald Reagan signed the Depository Institutions Deregulation and Monetary Control Act. He repealed parts of the 1933 Glass-Steagall Act and allowed Savings & Loans to use Federally Insured deposits to move beyond home loans into real estate, junk bonds, and other high risk ventures. The Savings & Loans crisis cost the Government's Resolution Trust an estimated \$150B, and private individuals several hundred billion more. Current moves to anoint banks with Holding Company status sets the stage for a new Savings & Loans disaster.

Nor can we expect financial reporting by accountants to laser in on emergent corporate collapses. On the contrary, the big accounting firms, and their banking industry clients, lobbied successfully to insert a poisonous accounting provision into the 2008 EMERGENCY ECONOMIC STABILIZATION ACT. Under this provision, banks are permitted to hide their impaired subprime assets from public view by listing on their balance sheets subprime mortgage assets at their original contracted cost, rather than their current depreciated value. Thus, a mortgage loan by a bank of originally \$1M, that is now uncollectible and worthless, would still be shown on the bank's balance sheet as worth \$1M—allowing the bank to continue to “appear” more profitable and safer than it really is. This accounting legerdemain prevents investors and institutions from being able to distinguish between failing and healthy banks. It is an accounting ploy that perpetuates the caution that has frozen lending in the capital markets.

Leveraging ourselves out of Crisis—Again!

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