Get Real About the Financial Crisis

By CHRISTIAN LEUZ  | From today's Wall Street Journal Europe

Until last week, the conventional wisdom in Europe was that the financial crisis originated in the U.S. and that therefore the U.S. had to be first in line to respond to it. Now that the crisis has become a much more serious threat to Europe and its banks, regulators and governments are scrambling to come up with a response.

There are many proposals on the table, but a number of them are missing the forest for the trees; the recent push to ease accounting rules is the clearest example. While the financial trouble started in the U.S. housing market and with mortgage-backed securities, the root causes are high leverage and a shortage of capital, coupled with a transparency problem: Nobody knows where exactly the bad loans and assets are. The events of last week have illustrated that what began as a liquidity problem has become a solvency problem. This problem, however, is equally present in Europe. In fact, by some measures, large European banks are even more highly leveraged than the no-longer-existent U.S. investment banks were, in some cases by a factor of two.

Instead of saving one failing bank at a time or competing with each other for deposit insurance, European regulators and governments should unite and come up with a joint response to the crisis before the situation spirals out of control. Despite all its problems, mark-to-market accounting is not the key issue. If central banks and regulators are concerned that banks engage in fire sales to satisfy regulatory capital requirements, they should consider severing the ties with banks’ capital requirements.

The market still needs to have information about asset values, and banks should still provide their best guesses as to what their assets are worth in the current environment. Besides, nobody is preventing banks from also providing information about the value of their assets if they are held to maturity. Suspending mark-to-market accounting or allowing banks to reclassify securities into the held-to-maturity category to avoid write-downs would reduce banks’ incentives to provide such information and exacerbate the transparency problem.
At this point, the regulatory capital requirements are no longer the real constraint. The markets are concerned about the undercapitalization of banks regardless of the regulatory rules. So we need to address the capital shortage head on. Everything else is a distraction. Here is where Europe could lead the way and avoid making the same mistakes as the U.S.

There are several ways to recapitalize the banking system. One promising proposal is to insist that banks raise the equivalent of, say, 2% of their assets through a rights offer. Such a mandate would be easier to coordinate than a European rescue fund and would not require taxpayer money. A mandatory recapitalization avoids the negative signal to the market that an effort to raise capital by a single bank would send in this environment. The prices at which banks have to sell the new equity in the rights offer would reflect the market’s assessment of each bank’s solvency. Better capitalized banks could sell the equity at a higher price, making the rights offer less costly to them. The mandate treats banks differently depending on how prudent or reckless they have been in the past. If need be, the government could provide further capital to less well-capitalized banks in return for preferred stocks or warrants, as the U.K. government on Wednesday proposed to do.

If asset prices are really depressed by fire sales, a capital injection would also have the added benefit of allowing well-capitalized banks to buy -- and profit from -- assets that have fallen below their fundamental value, which would reward them for being better capitalized in the first place. As an important side effect, this should ultimately restore asset values and bring them back to their fundamentals, which would also fix the problem with mark-to-market accounting.

The steep market declines of this week send a clear message. It is time for European leaders to confront the root causes, rather than the symptoms.

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