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On Focus and In Depth

Turmoil in Financial and Credit Markets

The Crisis So Far: The Road to Recovery

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Last in a series

Stipulate banks' grand failure in managing risk, their startling miscalculations about liquidity, and their lack of self-control in originating, bundling, and selling assets, but those mistakes have not proven fatal.

Asset writedowns, rising credit provisions, and economic uncertainty have reminded bankers that ample capital is important, and that leverage's juicy returns are fraught with risk. Even better for the industry, the reminder came during a time of relative abundance.

According to the Federal Deposit Insurance Corp., 99.74% of the 8,444 institutions with depository charters were considered well-capitalized at the end of last year. Banks with more than $1 billion of assets had an aggregate core capital ratio of 11%, compared with just over 7% at the end of 1990.

Though undoubtedly there has been additional deterioration since the end of last year, in recent days and weeks banks have had little trouble raising additional capital, likely because raising capital to restore an appropriate cushion is more palatable to investors than raising capital to prevent outright, imminent insolvency.

That relative capital flexibility and availability has conferred to banks one important advantage that was not available in previous downturns: the ability to recognize substantial losses without suffering a mortal blow.

For the most part, U.S. banks have not attempted to avoid an accounting of loss, as their Japanese counterparts did during their lost decade. Amputation to stop infection assuredly makes for some near-term pain, but it also gives the best chance for longer-term survival.

"Banks still have a lot of capital on hand. The institutions seem proactive and want to recognize the losses, clean up the balance sheet, and move on, and they generally appear to have the resources to do so," said Richard Brown, the chief economist of the Federal Deposit Insurance Corp.

The driving factor behind rapid loss recognition has less to do with bankers' beneficence and candor and more to do with fair-value accounting. But that has hardly led to a groundswell in favor of the accounting model. In fact, even some of the most ardent advocates for loss recognition have little stomach for mark-to-market accounting.

It's easy to pardon that apparent contradiction. The concept of valuing assets at their market value has real allure. It forces bankers to be realistic about the quality of the assets they hold, and in theory it puts market reality over management preference. But the model does not acknowledge a difference between market price and inherent value, and bankers argue that the gap between the two has widened in the less-than-liquid markets for many bank assets. And, perhaps as important, the model does not recognize that banks have different reasons for holding assets than other companies.

Bankers generally have explained that writedowns on illiquid structured products and leveraged loans are noncash charges, but they nonetheless have a very real effect on tangible capital. Companies at the center of the writedowns — Citigroup Inc., Washington Mutual Inc., UBS AG, Merrill Lynch & Co., Wachovia Corp., and National City Corp., among others — have all raised capital in recent weeks.

Despite the costs and dilution associated with raising capital, some investors wonder whether there might be a more sinister motivation for the multibillion-dollar mark-to-market charges taken by some banking companies.

Though the accounting forces a reckoning of some kind, it is a reckoning whose dimensions are dictated by internal models, and one could reasonably understand if investors were less than convinced about the accuracy and provenance of those models. Inaccurate models, after all, led to the markdowns in the first place.

Auditors and regulators are looking at internal bank models, but accountants agree bankers have wide latitude in determining marks. That has led some investors to wonder whether companies are taking huge losses they intend to recoup when the markets ultimately recover.

Given the mounting uncertainty about where these companies will get revenue growth in the coming years, **sandbagging has become a plausible conspiracy theory**. Just as credit recoveries drove profits in the middle part of the decade, recapturing writedowns could be a revenue engine by the end of the decade.

Bankers could reasonably argue that future gains are a result of the same factors that have driven the losses. They are marking assets against indexes pummeled by investor fear that borders on panic; when markets find their bottom and buyers step back in, the indexes are likely reflect that confidence. Positive marks may follow and would be felt directly in the income statement.

Overshooting their losses is a problem that bankers would love to have, but there can be no overshooting until the bottom is reached. Market experts expect a bottom in the pricing of structured products long before the economy plays out on the on-balance-sheet portfolio.

In the meantime, if price has truly fallen beneath value, that spells opportunity for the right buyer at the right time to make big profits — and restore confidence. But we are not there yet.

"The idea of being the one to stick your neck out and take the risk when you see the potential for great returns — and sending a signal to the market around a critical asset class — is not yet being seen, which indicates that we have not yet bottomed out," said Toos Daruvala, who heads McKinsey & Co.'s banking and securities practice for North America. "But I think it will happen as greed once again begins to outweigh fear."

The emergence of bottom feeders will mark the turning point in the cycle. As soon as they make their presence known, others are bound to jump back in.

"Recovery will come when we see leaders come back and show confidence in the markets and some of the riskier asset classes, and then watch other people follow," Mr. Brown said. "There are huge sources of funds in the global economy looking to invest, so when someone figures out a recipe that provides transparency and protects investors' interests, the flow of capital can turn right back on."