
Lessons for Continued Restructuring

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While the monoline restructuring is not by any means over, there are already interesting lessons to be had from the experience so far. Those lessons will be important going forward into FASB, SEC, and bank regulatory revisions that are to come. Hence, it may be time for a brief summary and review.

The first lesson is the insolvencies and near-insolvencies are out there and cannot be ignored. Despite the forward-looking statements of the monolines, neither their primary regulators nor investors believed in the going concern value without some intervention. Of course, this is true of many investment firms, pension funds, and banks, too, but the regulatory and legislative pressure is still building there. When that pressure builds strong enough, the call to action will be too loud to ignore.

Extended to the FASB reform, the acceptance of insolvencies (not just illiquidity) means that the decisions between on- and off-balance sheet treatment is simple: on-balance sheet is the only way to go. The conditions revealed by such treatment will be severe, but the treatment will allow investors to value the exposures at levels commensurate with their risk.

With accurate disclosure of just book value, if arrangements are truly bankruptcy-remote, investors can reduce the risk exposure to zero. If arrangements do not represent meaningful risk transfer, however, investors are free to evaluate transparently the possible exposure to the firm. Since my own research shows that investors usually treat securitizations as financing rather than sales, the on-balance sheet treatment will allow investors to better understand firm leverage from all varied sources.

The second lesson is that the socially valuable part of the enterprise can be preserved without a full bailout of the entire firm. With the monolines, the (arguably) socially valuable core was the municipal bond insurance. With pensions, it is the long-term value of the investment fund. With mortgages, it is the value of loans to individuals that really *want to buy* houses (not just live in them or speculate on them).

With banks, the socially valuable part of the enterprise is the value of financial intermediation. If securitization is truly a valuable component of bank

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funding, let's see how much funding there is out there in need of stabilization. FASB on-balance sheet reform will reveal who is exposed to funding problems and which, among those, are solvent and which are insolvent. Once regulators like the FDIC sort out the solvency problem they can focus on liquidating the institutions or sub-portfolios that are insolvent and helping those institutions and portfolios that are solvent obtain continued funding.

The third lesson is that a gradual approach is fine, but only if there is a commitment to carry through with firm deadlines. This part of the lesson is still in doubt, as Ambac still has not restructured (although their rating was already affirmed despite ratings agencies claims last summer and fall that they only rerated on *actual* performance, not *prospective* performance) and MBIA is said to be taking a five-year timeline. Such doubtful terms will need to be revised if reforms are to lead to clarity and transparency that can help restore monetary policy effectiveness and economic performance.

In conclusion, flexibility and creativity will triumph over dogmatism. The question, therefore, is not whether to reform but how? It will take significant legislative and regulatory effort to deal effectively with three decades of Wall Street creativity. But those efforts are crucially important because the transparency they will foster is the key to economic recovery. As with the monolines, if all the firms that *say* they are not exposed are really fine the losses will not be that big. Buffet led the way with the monolines: it's time to call firms' (and regulators') bluff.