Who Broke the Bank?

Nightly news broadcasts recently have been flooded with terminology usually reserved for graduate-level finance classes. Join us as we demystify the most important terms and debates surrounding the current state of the U.S. banking system.

Investment Banks & Commercial Banks

During the Great Depression, the U.S. Congress passed a series of regulatory acts designed to prevent another banking collapse. The most important was the Banking Act of 1933, more commonly known as the Glass-Steagall Act, which separated banks by categories (investment and commercial). Under this law, an investment bank legally could not collect deposits and would be largely unregulated. On the other hand, a commercial bank could collect deposits but would be heavily regulated to protect the depositors. The logic was simple; everyday citizens should have a safe place to put their money, and speculative investors should have a place to take risky bets without endangering the entire banking system. However, as the global economy became more intertwined and complex, the limitations of this system became clear.

By the late 1980s, a growing number of economic leaders considered the Glass-Steagall Act an unhelpful restriction. They argued that separating investment banking from commercial banking created costly inefficiencies, allowing foreign banks to attract investors and make money more quickly than U.S. banks. In 1999, the Banking Act of 1933 was repealed with bipartisan support. The result was an immediate boom in economic prosperity, as banks combined the continuous capital created by regular deposits with the monstrous returns produced by more speculative investments.

It now is becoming clear that many of the profits made over the last several years created a systemic risk for the entire banking system—the effects of which we now are feeling.

Bottom Line: As the current banking problems come into sharper focus, most economists and politicians are reaching a consensus that a balance must be struck between the black-and-white divisions of Glass-Steagall and the "everything goes" atmosphere of the last several years. However, the contours of such a regulatory environment remain unclear.

Fair Value & Market Value

Many of the recent debates about banking policy have hinged on the difference between "fair value" and "market value," and, more importantly, whether or not the current valuations of so-called toxic assets reflect fair value or market value.

Fair value is exactly what it sounds like—the value of an asset, when all conditions are fair to the seller. Market value is the value the market is willing to pay for the asset in current conditions, regardless of their fairness to the seller. In a healthy economy, there is little distinction between these two values. However, several factors can cause the two values to diverge considerably. To understand how this might work, consider the following thought experiment:

Suppose you are selling a car. You believe that the car is worth $17,000, so you list it at that price on several web sites and classified ads. Within two weeks, you have a qualified buyer willing to pay $16,000 for your car, so you agree to sell it at that price. You both have agreed on a fair value for the car: $16,000

Now, imagine you have to sell the same car within 24 hours. You have no time to advertise the car, so your potential buyers are restricted to people you know. After a few dozen phone calls, you find a buyer who agrees the car is worth $16,000, but only has $5,000 in her checking account and no time to apply for a loan. Since you must sell the car in 24 hours, you agree to take $5,000 for the car—less than one-third of the value you both agreed was fair. In this case, the market value is $5,000, even though the fair value is $16,000.

Large banks holding the current "toxic" assets (assets that only can be sold at a loss in the current market) contend that they are experiencing a similar scenario. They know their investments are solid and they have investors who agree, but since the global economy is so skittish right now, many investors can't free up the necessary funds to purchase these assets at the fair value.

Of course, it always is possible that the market value exceeded the fair value for the last several years, and the recent drop in valuation is a correction, and not an anomaly. In other words, it is possible that these assets were toxic from the moment they were acquired and doomed in any market.

Bottom Line: Most economists believe the truth is somewhere in-between—that the banks are projecting an overly optimistic view of their assets' long-term value, but that the current market value is far below the long-term fair value of the assets.

Leverage & Solvency

If the banks holding the toxic assets are right about the long-term value of the assets, if the assets increase dramatically in value over the next several years, then the real problem for the banks is that they are over-leveraged—that is to say, they have invested in too many long-term assets to fulfill their short-term financial obligations. This is what every economist and politician is hoping for, because it is a much more fixable problem than the alternative…

If the banks are wrong about the long-term value of the assets, if the assets actually are valued correctly right now or, worse yet, destined to decrease in value further, then the banks are not simply unable to meet their short-term financial obligations; they owe more than they own. That is a problem known as insolvency, a technical way of saying the company is under water and incapable of paying its creditors.

Bottom Line: Few experts dispute that banks are over-leveraged, but determining whether or not they are insolvent is a matter of constant dispute. The debate is likely to continue for years, since the answer hinges on long-term values of complicated assets and derivatives.