The Money Marathon: WE MAY BE GOING DOWN THE ROAD TO RUIN (Constitution Tribune for March 6th)

I know this heading sounds very pessimistic and I pride myself in being a positive person; however I believe we may be going down the wrong road. The consequences of the direction we are going are awful and it did not have to happen. Therefore I am speaking out in this article. Yes, I have called both my Senators and Congressman – multiple times to explain this. Now maybe you can help too because otherwise I fear we may face a near depression that we won't recover from for many, many years.

I had an article all about saving to publish this month: however, this subject is so important I have moved the saving article to next month.

The popular sentiment today is to burn bankers at the stake. Bankers are a good scapegoat to blame for everything. The President and most all of Congress and most of the news media lead this charge to string up a banker.

Never mind that this current crisis had roots in cheap money after 9-11 set by the Federal Reserve that helped create a housing bubble. Additionally, the Community Reinvestment Act required banks to make loans to people that couldn't afford them and two different Housing Acts passed by Congress required Fannie Mae and Freddie Mac to make up to 40% of their loans to low and moderate income families, that in hind sight many could not afford. This sponsorship and supposed safety net of expanded housing to nearly everyone made it difficult to think that housing prices would ever plummet like they have.

Sure some banks contributed to the problem with low documentation loans, adjustable rates, and interest only loans. But real estate brokers, underwriters, and individual borrowers themselves also played a role. No one could have expected what may turn out to be a 50% drop in home prices nationally when it is all said and done.

Regardless, of all the reasons, the solution is more important than the blame game. In my opinion, there is one solution that continues to be ignored that could have minimized the damage and could still save us from ruin if it would be implemented. That solution is to repeal the "mark to market" accounting rule that was put into effect several years ago. This accounting rule forces banks and other financial firms to mark their investments down to the fair market value. In theory mark to market sounds like a reasonable idea and probably works in normal times. Unfortunately, these are not normal times. Mortgage products owned by the major banks do not have a market because the panic and fear means there are almost no buyers for many of these mortgage pools. The only market is set by sales made by sellers who have no choice but to sell at any price creating a lower and lower market as fear and panic creates lower and lower sales. This forces banks out of capital as they mark these products down to a lower and lower value. These assets have an economic or net realized value of much higher than the mark to market value. In other words if banks would be allowed to carry this assets at the net realized value which subtracts expected losses and figures expected cash flow they could write the assets up significantly over their current values and would have capital to then expand their lending.

Imagine that you purchased a house for $200,000,(your asset) borrowed $160,000 (your debt or liability) and put $40,000 of your own money as a down payment(your net worth) Six months later for some reason, all of a sudden, no one wants to own a home and so there is no market. That is not a problem for you because you say to yourself that you will just stay in your house and not sell it. However, now let's imagine in this situation you are a bank and your neighbor down the street who also has a $200,000 house is going bankrupt and has to sell his house at any price. No one wants to buy the house but finally someone buys it at a ridiculously low $20,000. Although your house was not affected, if you are a major bank you have to mark the value of your house down to $20,000 because that is now the market which gives you a $20,000 asset (your new mark to market value) and a $160,000 debt or liability and now a $140,000 negative net worth. You are broke under mark to market. In practice banks have mortgage pools that say were purchased or originated at a value of $100,000,000 as an example. The current economic value based on subtracting current expected losses and calculating expected cash flow from people who are still paying is worth say $80,000,000-a $20,000,000 reduction which is accurate and reflects what is happening in these assets. However, these assets are being marked down to say $10,000,000 rather than $80,000,000 because there is basically no market. This runs banks out of capital unnecessarily which causes panic, huge amounts of government funds pumped into banks and others unnecessarily, a frozen credit market and consequently fear, which slows business in general and leads to massive layouts and unemployment.

In the 80's and the 90's if we had mark to market at that time there would have been massive bank failures. Remember when prime rate was 20% in the 80's? Most banks that I know would have been broke, declared insolvent and closed if mark to market had been in place but banks could wait it out back then because we didn't have this rule. When the government closes banks unnecessarily it then sells assets at pennies on the dollar which causes massive losses to the tax payer.

Proponents of keeping mark to market are concerned that business would keep assets on their books that are not worth was they say and would hurt the integrity of the balance sheet. If you look at many balance sheets of major companies, in today's environment you can not tell what their company is worth anyway. Companies with huge net worth one day are required to write down the value of assets purchased many years ago because now they are not worth much in today's environment which makes financial statements almost impossible to analyze anyway. Remember we didn't have mark to market for years and we were not in this situation.

If we stay on the path we are on, the seven major banks that control two thirds of bank deposits in the country will be run out of capital. The government will nationalize them and wipe our shareholders. This does two things. It sends fear through the market that capitalism as we know it could change dramatically-this could happen to any industry. Also, the government running the finance industry is scary and means inefficiencies and political agendas in the finance industry. The banking industry and finance is a major component of an economic recovery and without a private banking system the economy will be greatly restrained from recovering. Steve Forbes, the editor of Forbes magazine, and William Isaacs, the former head of the FDIC are just a couple of advocates of suspending the mark to market rule.

Imagine a boat in the ocean representing our economy that is full of water and is sinking. We as a country are spending billions for pumping equipment to try to keep the water out of the boat .represented by TARP funds and stimulus packages. All we really need to do is to put our thumb over the hole in the boat (suspend mark to market accounting). This mark to market change is not a political commentary in that the past administration and the current administration have both failed to take action. If we had done this a year ago I am convinced that the current situation would not have been nearly as bad as it is now. I would like to be optimistic, but unless our leaders make this change immediately, I think we are headed to a disastrous situation. This does not just affect Wall Street. It will ultimately affect all of Main Street (everyone) and it could lead to the worst economy and markets we have had since 1929. Alternately, if this rule were changed today, you would see a jump in the stock market like you have never seen before and confidence could start to be restored.

I encourage you to call Senator McCaskell (202-224-6154, Senator Bond (202-224-5721) and Congressman Graves (202-225-7041) and tell them to do whatever they can to get the message to Treasury Secretary Geithner and President Obama that mark to market accounting needs to be suspended now.

(Remember every investor's situation is unique and it is important to review your specific situation with a financial professional.)

Ed Douglas is a Certified Financial Planner/Consultant, Chairman Emeritus of Citizens Bancshares and author of two books, "Making a Million With Only $2000-Every Young Person Can Do It" and his new book "The Money Marathon: 7 Simple Steps to Financial Freedom" available at www.eddouglas.com . Ed can be contacted at ed@eddouglas.com or 660-646-2066.