A shotgun-marriage proposal

by Lawrence_Kudlow

Is it really necessary for taxpayers to spend another dime on the TARP? We've already committed $700 billion, half of which was spent under President Bush and half of which is coming under President Obama. And now, as we wait with baited breath for Treasury-man Tim Geithner's detailed plan to purchase bank toxic assets, the TARP could rise by another $1 trillion or more.

But we may not need it at all. Here's why:

Out of the blue, bank stocks mounted an impressive rally this week, jumping nearly 40 percent on the S&P financial list. One after another, big-bank CEOs like Vikram Pandit of Citi, Ken Lewis of B of A, and Jamie Dimon of JPMorgan are telling investors they will turn a handsome profit in the first quarter, their best money gain since 2007. This is big news. And it triggered the first weekly stock gain for the Obama administration.

But this anticipated-profits turnaround doesn't seem to have anything to do with the TARP. It's about something called the Treasury yield curve â€” a medical diagnostic chart for banks and the economy.

When the Fed loosens money, and short-term rates are pulled well below long rates, banks profit enormously from the upward-sloping yield curve. This is principally because banks borrow short in order to lend long. If bankers can buy money for near zero cost, and loan it for 2, 3 or 4 percent, they're in fat city. Their broker-dealer operations make money, as do all their lending divisions.

So the upward-sloped yield curve is the real bailout for the banking system.

Now, turn the clock back to 2006 and 2007. In those days, the Treasury curve was upside down. Due to the Federal Reserve's extremely tight credit policies, short-term rates moved well above long-term rates for an extended period, and that played a major role in producing the credit crunch. Since interest margins turned negative, the banks had to turn off the credit spigot, and all those exotic securities â€” like mortgage-backed bonds and various credit derivatives â€” could no longer be financed.

The Fed's long-lived credit-tightening also wreaked havoc on home prices and was directly responsible for the recession that began in late 2007. At the time, Fed head Ben Bernanke said the inverted yield curve wouldn't matter. Gosh was he wrong.

Today, however, after about a year of a positively sloped yield curve, bank interest margins and profits are turning up. In fact, despite the perpetual pessimism, the normalized yield curve is a leading indicator of economic recovery, according to models created by the New York Fed and others.

Here's the second big point: Instead of spending a trillion TARP dollars to rescue toxic assets, why not ease or liberalize mark-to-market accounting rules? You see, banks still have a bunch of underwater toxic assets on their balance sheets. And unless the SEC or someone in Washington changes these rules, the banks may have to erase their new cash-flow-rich profit margins by marking down the value of mortgage- and consumer-related loans.

These loans can't be sold in the current market. But if somebody tells the banks they don't have to sell these loans at distressed prices, and therefore don't have to take a big hit on profits and capital, the banks will enjoy plenty of breathing room to reap the benefits of the upward-sloping yield curve.

Let the banks hold these investments over a long period, rather than force them to sell now. The economy will get better, as will housing and other impaired assets.

You could even have a two-tiered disclosure process: Accounting purists could be satisfied with a full mark-to-market disclosure, while regulators could forbear capital-standard rules that shouldn't apply during this period of severe distress. As a result, banks would be in better shape to pass the Treasury's new stress test and wouldn't need new TARP capital injections that further extend taxpayer liabilities.

Think of this: As net interest and profit margins rise while the yield curve is upward-sloping, higher bank profits can be used to replenish capital. Meanwhile, government authorities can cease and desist â€” not only their punishment of private-equity shareholders, but also their clumsy attempts to control various bank operations (compensation, golf outings, means of transportation, etc.). Then, if bankers are so dumb they still can't make money with zero borrowing costs, the FDIC should shutter them and sell them off piece by piece.

Right now, there are promising signs of mark-to market reform, with bipartisan support in Congress. New SEC Chair Mary Shapiro says she's looking into it, as is Robert Herz, the head of the Financial Accounting Standards Board (FASB).

So let's have a shotgun marriage. Let's wed the upward-sloping yield curve with mark-to-market reform. It sure beats another trillion in taxpayer dough, or a federal takeover of our biggest banks.

It all seems like such a simple solution.

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