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IT'S NOT THE TOXIC ASSETS, IT'S THE TOXIC MANAGEMENT

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For months we have been waiting for the U.S. Treasury to tell us specifically how it intends to handle the problem of a banking system loaded down with and frozen by toxic assets. Banks are reluctant to confess that they even hold such assets for fear it would frighten the public and correspondent banks. The government is afraid of paying too much for those assets and saddling the taxpayer with more debt or paying too little and further draining the net worth of the troubled banks. In other words, what's the right price for toxic assets in a market where buyers and sellers are holding back and therefore the exchange process has broken down and banks are trapped by their own toxic assets?

Let us assume, for the moment, that the government is able to purchase those assets at a price that is acceptable to taxpayers and bank stockholders. Does that solve our problems with the banking/financial sector?

Sadly, it does not. Those assets were purchased by senior executives who were eager to pad bank revenues with the enhanced earnings to be gotten from holding those assets but who did not investigate the quality of those assets carefully enough and seriously underestimated the risk involved. They did not know what they were buying and failed tragically to exercise due diligence and practice the required moderation.

Does capping the annual compensation of senior executives at $500,000 as a condition for getting monies from the Treasury solve the problem? *Yes*, if the salary ceiling shames them into changing their ways. *No*, if it leaves in place precisely the management which got us into this problem, and the directors who failed to protect the interests of the stockholders. To illustrate, if senior executives had rejected those assets when they were offered and directors had insisted on following that course of action, mortgages would not have been made available to persons/families who could not afford to make their monthly payments, housing prices would not have been inflated, the defaults which followed would not have taken place, the housing bubble would not have developed, and the credit freeze would not have happened because banks would have continued to trust one another knowing that due diligence and moderation protected them against collapse. The current crisis was set in motion by human beings and will take humans to put the proper remedies in place.

We need to transform the senior management and directors, either by replacing them outright or changing the way they operate. If we decide to replace the senior management and directors, will we be able to find trustworthy and competent replacements to assume

the management and direction of those problem banking institutions? Would those replacements not be drawn from the very same institutional culture which boosted performance by reckless decision-making rewarded and reinforced by huge bonuses? What would keep the expelled senior executives from simply finding work at other banks?

If these people indeed cannot be replaced, how do we change the institutional culture so that sound judgment and steadfastness are restored and recklessness and greed are driven out? This is the age-old question which has puzzled humankind since the ancient Greek philosophers. At this very moment, we face a terribly troubling dilemma: leave the senior management and directors in place and risk a repeat performance or replace them and risk poor performance.

There are two factors working in our favor: fear and role-modeling. Some senior executives and their junior-level colleagues can be frightened into changing their behavior by severely punishing the ones who have most egregiously violated the public trust. Today that would be the men who have amassed enormous wealth through ponzi schemes. They must be publicly disgraced, stripped of their holdings to the full extent possible so that their victims can recoup their investments to the full extent possible. And they should be prosecuted with no plea bargaining and no "country-club" imprisonment. Upon release they should be banned for life from owning, working in, or serving as a director of a financial institution. Likewise for those elected officials sitting on Congressional oversight committees and public regulators who have either pushed the financial institutions under their supervision into risky behavior or turned a blind eye to clear abuses.

Other bank executives can change their behavior by the role-modeling of superiors and mentors who are recruited from the pool of retired military officers whose lives have been shaped and formed by the six articles of the military code of conduct and by duty, honor, and country. Other high-level replacements can be drawn from the senior management of regional banks and local banks who have steered their institutions away from the false promises offered by bundles of high-risk assets.

Reforming and reconstructing our banking institutions in a one-time effort which assures that the current crisis will not happen again is doomed to failure. Recall a similar mess in the 1980s with U.S. savings and loans which in a reckless pursuit of higher returns from risky investments collapsed under the weight of bad loans. It follows that reform efforts must be ongoing in order to change a dangerous and ultimately dysfunctional institutional culture. To extend Thomas Jefferson well-known admonition, "eternal vigilance is the price of freedom, fairness, and security in financial affairs."

Finally, there is nothing fundamentally wrong with being paid handsomely for work done well and nothing intrinsically right about imposing a ceiling on the compensation of senior executives. The financial gains from work done well is the stuff which makes possible sharing and caring for others. There are more than one million public charities and private foundations in the United States which in the end not only rely on contributions from persons who have earned their financial rewards but also provide opportunities for their donors to transform financial gain into human virtue. And virtue, to the ancient Greeks, is the secret of the good life. The Treasury may find a way to remove toxic assets from bank

balance sheets but unless virtue somehow is infused into the system there is no way to get rid of a toxic culture poisoning the ranks of senior bank executives.

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