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The Administration's New Financial Rescue Plan

Douglas J. Elliott

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INTRODUCTION

The new rescue plan for the banking sector, outlined by Secretary Geithner today, employs a broad range of tools. There is one excellent feature, the inclusion of an improved version of capital infusions into banks, and one troubling proposal, for a "bad bank" that would operate as a public/private partnership. The bad bank, which will be fleshed out over the next several weeks, will be extremely tricky to design effectively. At best, it will be modestly inferior to the solution of providing a guaranteed floor value for toxic assets without requiring banks to sell them to gain the protection. At worst, the plan may fizzle by failing to achieve a large volume of purchases or may prove considerably more expensive for taxpayers than anticipated.

On the positive side, continuing to offer substantial capital injections to banks, despite the intense political unpopularity of those done under the Bush Administration, shows a measure of political courage. In addition, the new plan makes a number of improvements that should help with both the political and practical problems that arose earlier. In particular, the capital infusions will be targeted much more selectively towards the banks that both need the help and will be able to increase lending after receiving that assistance.

Please see the author's previous paper, "'Bad Banks', 'Nationalization', 'Guaranteeing Toxic Assets': Choosing Among the Options,", for further discussion of the main alternatives that have been proposed, some of which are included in the Administration's plan.

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SUMMARY Of THE PLAN

- **Continued significant use of direct capital injections,** but on tougher terms and more selectively focused on weaker banks. Instead of buying ordinary preferred stock, the government's shares would be converted into common stock automatically at the end of seven years if the bank were judged to need the capital. New injections of capital would be focused on banks weak enough to need the capital, but strong enough to be able to increase lending after receiving the new capital. (The strength of the banks would be measured in part against a new "stress test," looking at a bank's ability to withstand a significant worsening in the economic environment.) This contrasts with the previous approach of injecting additional capital into all but the weakest banks in order to restore confidence in the wider banking system. There would be a number of new strings attached, requiring detailed reporting, cooperation with mortgage foreclosure mitigation programs, and increased lending, along with the previously disclosed compensation limits.

- **A public/private partnership to buy toxic assets from the banks.** (Although the Administration will eschew the term, the purchasing entity will almost certainly be referred to by most everyone else as a "bad bank".) Geithner provided few details on this important piece, which will be designed over the next few weeks. The intention would be to persuade private sector investors to buy substantial amounts of toxic assets from the banks by providing significant federal incentives, which could include guaranteeing the floor value of the assets or providing subsidized financing. This could mean a great many things. Most likely it will end up as some amalgam of the earlier proposals for a "bad bank", those for government guarantees of toxic assets on bank books, aspects of the Federal Reserve's Term Asset-backed Lending Facilities (TALF) program, and probably elements unique to the new plan. See below for a longer discussion of the possibilities.

- **Expansion of the Federal Reserve's TALF program.** Additional classes of lending would be eligible for inclusion and the total amount authorized would be expanded. The TALF program encourages participation in asset-backed securitization of new consumer loans by providing high levels of relatively cheap financing and an effective guarantee of the floor value of the asset-backed securities. The plan is now to expand the size and range of activities within the realm of asset-backed securities.

- **Increased incentives for banks and mortgage servicers to avoid foreclosure by restructuring loans** Geithner indicated that there will be an announcement in the near future of specific programs to reduce mortgage foreclosure rates and that banks that have received government capital would be expected to cooperate with these programs.

As expected, the Secretary focused on the big picture, omitting a number of key details that will be critical to the ultimate success or failure of the plan. It is unclear in some cases whether the lack of detail is a communication decision or a sign that the Administration is still discussing these points. In the case of the bad bank, it was explicitly stated that design work is ongoing.

An Assessment of the Plan

It is reassuring that the Administration recognizes the importance of significant new capital injections, despite their political unpopularity. On the other hand, it is not at all clear that the proposed bad bank could be designed in a way that would make it better than simply guaranteeing toxic assets on the books of the banks, as advocated in my earlier

paper. The remaining elements of the plan seem promising, but will warrant further study.

Capital injections

The banking system needs more capital in order to exorcise the demon of losses from toxic assets and to restore a willingness to lend more freely. Capital ratios are too low, given the suspicions that many assets are still overvalued and the knowledge that recessions are hard on bank capital. Some observers suggest that the system needs another $500 billion, or more, of capital to make up for previous and future credit losses. The private sector will eventually step up to provide new capital, but not soon enough, so the government will need to be a significant provider of capital to bridge the gap.

The Administration did a good job of balancing between pressures to "nationalize" the banks and a desire not to scare away private investment. Bankers are extremely unpopular right now and there is a strong push to extract a pound of flesh in exchange for any future capital infusions. Many have argued that the government ought to buy common stock in the weak banks, rather than preferred shares, thus capturing more of the upside and giving at least the potential for significant voting control. However, existing shareholders are extremely concerned about handing over large stakes in their banks at what seem to them to be "fire sale" stock prices. Fears of exactly this kind of dilution of value have hit the stocks of Bank of America and other banks that were judged potential recipients of such a government investment.

If the government took a significant share of the common stock of some of the weakest banks, those that are perceived as the most vulnerable of the remaining banks would likely see their share prices decline sharply. This has two bad effects. First, many other constituents, such as lenders and trading counterparties, take the share price as a leading indicator of changes in creditworthiness. As we saw in September and October, sharp declines in share prices can lead to a kind of run on the bank by these creditors and trading counterparties. Unfortunately, such runs tend to be contagious, weakening confidence in the entire financial system. Second, it will take longer and be harder to entice new private investment into banks when the system starts to stabilize, if investors are worried about the prospect of nationalization should the economy have another setback.

In this context, the idea of convertible preferred is appealing, because it causes less dilution to current shareholders, especially if the preferred stock can be bought out prior to conversion if the bank becomes stronger. Of course, that ability to buy the preferred back reduces the economic value to the taxpayers of having the conversion feature, since it would most likely occur if the conversion feature becomes quite valuable as a result of a run-up in the value of the bank's common stock. This reduction of the economic value of the conversion feature needs to be considered in the design of the initial terms of the security.

Encouragingly, the Administration appears ready to deal with banks on more of a customized basis, rather than using a "one size fits all" approach. The banks differ too much for the right answers to be exactly the same for each one, despite strong political pressures to be "fair" and provide similar terms to all banks, regardless of significant differences in their situations and the risks they present. The taxpayers will be better off with a more nuanced approach. Hopefully this will be carried through in practice – politicians and bureaucrats do not find it easy to defend differential treatment, even where there are good reasons for it. This tendency can be minimized by a clear statement of the principles behind any differences in treatment, but it will always be easier to claim that uniform treatment is fairer than anything else.

Designing the bad bank

It is difficult to see why the bad bank would be better overall than the guarantee approach, which is faster, simpler, cheaper, and would likely pass less

risk on to taxpayers. (Again, see my earlier paper, referenced above.) However, it is impossible to provide a detailed comparison without knowing at least the broad terms of what the Administration intends. There are a myriad of ways to design the public/private partnership, differing on critical dimensions, including:

Sharing of the upside and downside. Probably the most critical decision is what priority the government will place on sharing in the upside versus limiting its downside. At one extreme, taxpayers could fully share in the upside and downside by funding the bad bank with $3 of investment for every $1 committed by private investors. The bad bank would then buy the toxic assets and the taxpayers and investors would share in the gains and losses proportionally. Of course, it is more likely the government would have to lure investors with guarantees, or cheap financing, or substantial management fees, since few are stepping forward currently at prices acceptable to the banks. At the other extreme, the government could serve merely as a guarantee provider, ensuring that investors could lose no more than, say, 20% of the price they paid for the assets, in exchange for a guarantee fee. Taxpayers would most likely prefer this option to one in which more of their money is placed at risk, even if they would also receive more upside. In practice, there are many variations that lie between these two extremes.

Degree of subsidization. Private investors can already buy toxic assets without government assistance, but they are only doing this in small volumes. It may be that providing downside protection would be enough to generate the targeted volume of purchases. However, it is also possible that charging an economically fair price for the downside protection, one commensurate with the risk, would discourage investors from participating at prices acceptable to the banks. It may be necessary to provide some form of subsidy, such as a lower guarantee fee, in order to achieve the larger public policy objective. Doing this explicitly could be difficult politically, but attempting to embed a subsidy in the technical calculations is both bad public policy and one that could backfire if it came to light. Look at the uproar after the Congressional Budget Office and the Congressional Oversight Panel calculated that the private market would have required better economic terms than the government did on the TARP preferred investments. (This was not necessarily a bad choice, but many had not understood it was being done.)

Alignment of interests. Unless the government and private sector investors share exactly proportionately in the upside and downside, which is unlikely, it will be important to consider the incentive effects on private sector decisions of these differences. We do not want private investors "picking off" the taxpayers. For example, if the government is providing a guaranteed floor value on thousands of different securities, it will need to set a different guarantee fee and/or floor value for each security, since their risks and prices will differ. If the government's approach to setting these levels is too rigid or has a systematic bias, then private investors will have an incentive to buy those securities where the guarantee is mispriced. Given the complexity of these securities and the wide range of uncertainty about their true current and likely future values, some level of mispricing is quite possible. This could lead to significant hidden subsidies from taxpayers to the private investors.

It is worth noting that this problem would not exist to nearly the same extent if guarantees were being provided to banks on toxic assets held on their books. First, they already have a given portfolio of these assets, rather than being in the position to easily pick among all possible securities. Second, diversification within the portfolio should mean that some of the mispricing will cancel out, with some valuations too high and some too low.

Administrative structure. The pure guarantee structure has the advantage of leaving the management of the assets in place, with managers who have learned the details of their investments, usually at great pain and cost. There is no need to hire many new employees and less need for a transfer of ex-

pertise. The bad bank cannot avoid some of these inefficiencies, but can minimize them by good design. The worst approach would likely be for a large bureaucracy to be developed to run the bad bank, although it is possible that the alignment of interest problems with the private sector could be severe enough to force a substantial investment in people and resources.

Provision of financing. One way to lure investors into participating alongside the government is to provide government funding, or government guarantees of the debt. It is true that the federal government borrows more cheaply than everyone else, but this does not make this transaction structure costless to the taxpayers. At a minimum, there is the opportunity cost of foregoing another opportunity to borrow at treasury rates and invest in a project with the same risk as exists in providing the financing. (Please see my paper, "Measuring the Cost of the TARP")

Likelihood of actually buying significant amounts of the assets. The more advantageous the terms are for the government, the greater the possibility that investors will not be willing or able to participate on terms that would make it attractive for the banks to sell these assets. One risk here is that a politically and economically clean approach will be designed that simply will not result in many transactions. Again, guaranteeing the toxic assets on the books of the banks would almost certainly be more likely to generate the target volume of transactions. The banks have a high incentive to remove uncertainty from their books, as long as they do not have to generate significant realized losses by doing so. A guarantee structure provides this, but the bad bank may not, at the prices private investors are willing to offer for the assets, even with the benefit of some guarantees on their end of the transaction.

In sum, the devil will indeed be in the details of the construction of the bad bank and the pricing mechanisms. The author starts with the belief that it will be difficult to find an attractive approach that avoids all the pitfalls, but will reserve final judgment until there is a clear plan.

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