New American Bank Initiative: Removing structural flaws in the economic rescue

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"U.S. banks getting more than $163 billion from the Treasury Department for new lending are on pace to pay more than half of that sum to their shareholders, with government permission, over the next three years."

-Washington Post, October 30th, 2008[3]

"Banks getting $125 billion from U.S. taxpayers to unlock the credit crunch are saying they'd rather hoard the money than use it for loans"

-Bloomberg.com, November 7th, 2008[4]

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[3] Appelbaum, Binyamin. "Banks to Continue Paying Dividends." The Washington Post 30 Oct. 2008: A01.
[4] http://www.bloomberg.com/apps/news?pid=20601087&sid=a1Q..LbJAwcs&refer=home

Abstract

In this paper, we argue for a **New American Bank Initiative: use the $700 billion in government funds to capitalize new banks and distribute the shares of the new entities to the American People[5]. These new banks would then acquire the operational and human capital assets of failed banks in FDIC receivership**.

New structural flaws in the government's rescue plans are revealed on an almost daily basis. The incentives for these plans to work to the benefit of the country, and not the failed firms are poorly aligned. The NABI would involve no moral hazard, no hoarding banks, no government ownership, and no throwing good money after bad. Most importantly, it will immediately provide $7 trillion or more in unencumbered lending capacity to real projects—green energy, infrastructure, auto and other manufacturing, . It is also the best plan for preserving the operational and human assets of failed banks and saving existing solvent institutions by making everyone confident in the availability of funds again.

This effort started out as a short segment on CNN on October 10th, 2008 , but has since been expanded and circulated for criticism and comment. This paper is a much more in-depth discussion and elaboration of the plan, based on the questions raised in that process.

Introduction

The core issue with the current crisis is that the financial system is no longer properly functioning as a conduit of capital from savers to investment projects that generate real economic growth. The focus of every major proposal to date has been to inject liquidity and capital into current institutions in the hope that it will build confidence and start lending again to real projects (i.e., unclog the conduit). Unfortunately, these solutions ignore the fact that every relevant institution is in survival mode and will only use any liquidity or capital injections as a cushion in case their sources of funding dry up or their assets have to be further written down (very likely considering where we are in the economic cycle). Even worse, they all involve some type of moral hazard by cushioning the losses for equity and unsecured debt holders (who are to varying degrees responsible for the crisis). The recent reports of capital injections effectively being used for dividends and deferred compensation is perhaps the most heinous example of tax-payer funds being used to directly pay existing equity holders and management.

In this paper, we will briefly evaluate each of the "bailout" variations so far, their intended effect, why they are unlikely to work, and why they will probably lead to an

[5] A variation of this idea was first suggested to Salman Khan by Todd Plutsky, a friend and classmate from Harvard Business School.

extension of the crisis. Finally, we will propose an alternate plan based on capitalizing new banks with clean balance sheets and discuss its potential effects.

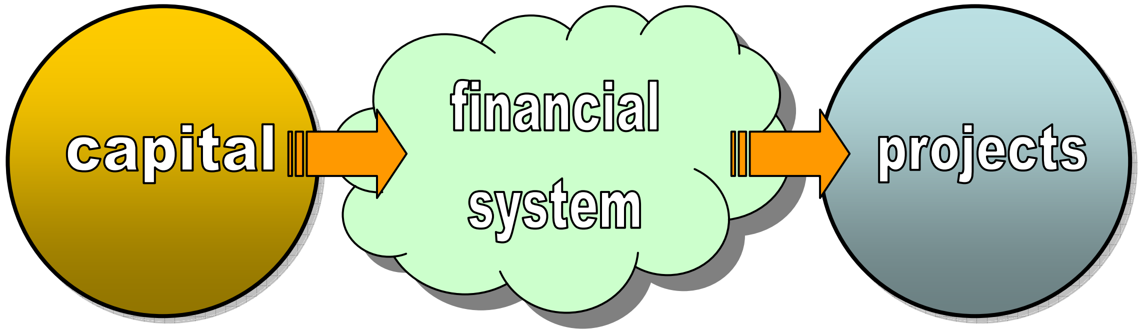

Figure 1: In a normally functioning economy, the financial system (commercial banks, investment banks, mutual funds, etc.) acts as the conduit between savers who have individual pools of capital and the investment projects (like building factories or investing in engineering) that need the capital to grow the economy.

Zombie Banks

The function of banks is to act as a capital conduit from those with savings to those needing capital for investment projects. They generate returns for their investors by borrowing money at low rates and lending at higher rates. This process, however, begins to break down if the banks' access to capital becomes uncertain or the banks believe that their assets may have to be written down further (probably both since no one wants to lend to or invest in someone with shrinking assets).

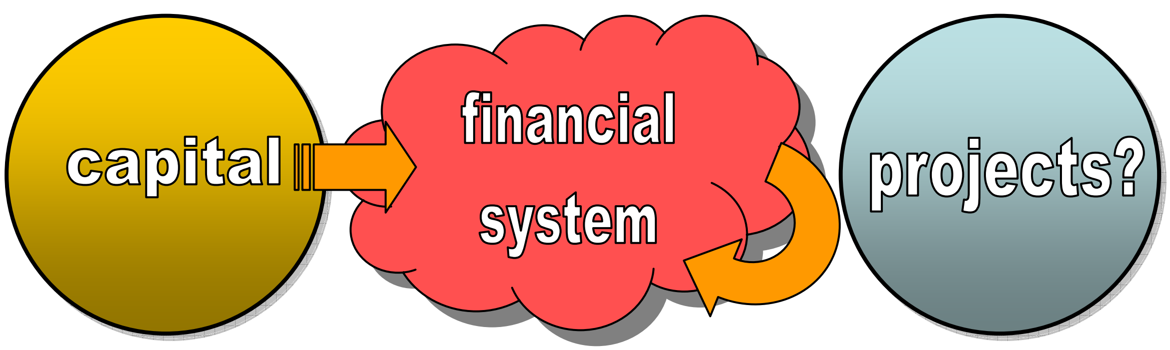

Figure 2: Once banks become uncertain of the degree of future write-downs and their access to funding, they begin hoarding cash and the real investment projects starve for capital.

If a bank is fundamentally insolvent (its assets are worth less than their liabilities) or thinks it might eventually be insolvent, it will delay writing down its assets as much as possible to give the appearance of solvency and attempt to raise new equity capital in the interim. Any new capital injected in the bank will not be used to take on new risk (i.e., make new loans), but, instead, be used as an equity cushion as further asset write-downs are taken. The net effect being that the bank neither lends (lives) or declares bankruptcy (dies) and thus becomes a zombie bank. Any capital injected into it (which could be used for real non-bank investment projects instead) will only slow the bank's death and help cushion the losses that the equity and unsecured credit holders would eventually take. Even worse, delaying its death only prolongs the crisis by extending the period of uncertainty around whether more failures are imminent and who is next. .

Even if a bank is confident of its solvency (i.e., that, after all is said and done, their assets will still be larger than their liabilities), it needs to be acutely aware of its ongoing access to credit. As its current debt matures (often imminently), no bank can be sure than they will be able to replace the debt with new funding. To avoid a future liquidity crisis, they too will hoard any capital they are given through new loans or equity injections and thus become a bank which does not make news loans (i.e., still a zombie, albeit one that is less likely to die).

The bottom line is that it would be irrational and irresponsible (to a bank's shareholders) for any bank with shrinking assets and uncertain access to credit to take on new risk (i.e., make new loans) no matter how much new capital is given to them. Given this, no plan which involves injecting arbitrary amounts of capital into existing banks has a reasonable chance of undoing this zombie logjam in our financial system. If anything, they are more likely to prolong the problem.

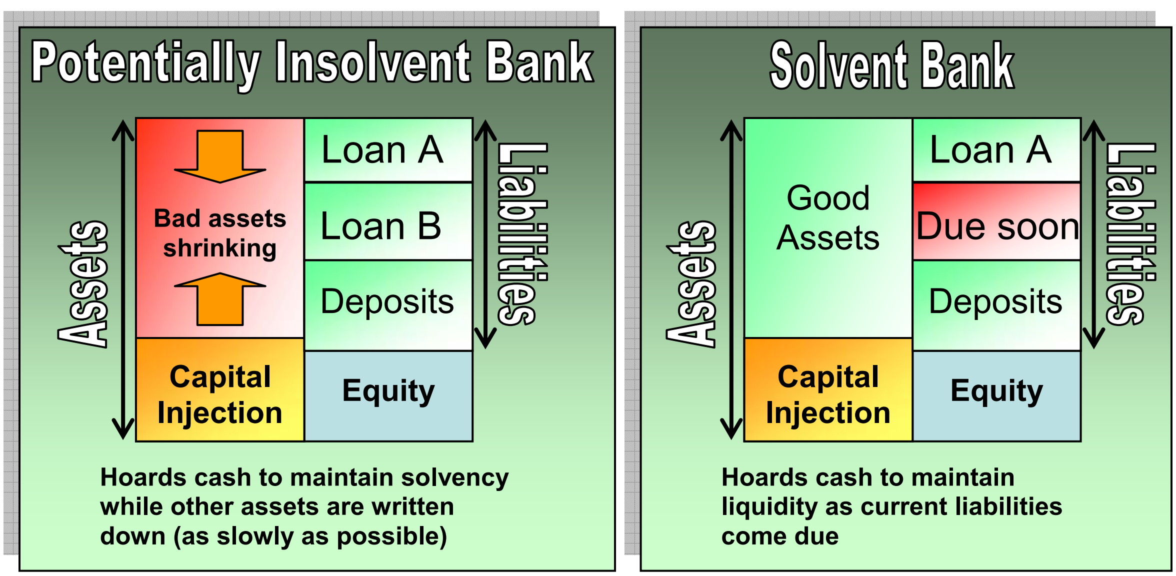

Figure 3: Banks with shrinking assets due to write-downs hoard capital injections to prolong the appearance of solvency. Solvent banks also hoard cash to preserve liquidity in case loans that come due cannot be renewed. It would, in fact, be irrational for any bank to take on new risk (i.e., make new loans) when things are so uncertain.

TARP (Variation 1)

The TARP as it was originally proposed was for the Treasury to spend $700 billion buying "toxic" assets from banks. This was based on the premises that:

1. The banks holding these assets are truly solvent, but that the uncertainty around the value of these assets made other banks less willing to lend to them (since if the assets were written down enough, it may make the holding banks insolvent) and
2. The markets for assets are somehow "broken" which has prevented the banks from selling the assets for "fair" prices

Both of these arguments are marginal at best considering the continuing degradation in the quality of the underlying assets (mainly mortgages), the ongoing rate of write-downs, and what these assets have been sold for in recent transactions between sophisticated parties (all more sophisticated than the government). Even if the two above assumptions were correct, they did absolutely nothing as far as addressing the zombie-but-rational bank behavior described in the previous section. Perhaps most damning of this plan was the fact that Paulson and Bernanke had to "scare the heck out of everyone and destroy all confidence in the financial system" to pass a bill whose purpose was ostensibly "to inject confidence into the financial system".

The TARP-v1, as it was initially marketed, was most probably just an attempt to push the CDO (the toxic assets) markets back into operation by convincing potential investors that the government was about to go in and start throwing around $700 billion willy-nilly. If people believed that this was indeed going to happen, the rational thing to do would be to attempt to "front-run" the government and buy the assets before the government raised the "market" price (through the $700b of artificial demand) and then offload them (possibly to the government itself) at a higher price. It is clear that no one bought Paulson's bluff which explains why the focus was shifted to buying preferred equity shortly after the bill was passed.

TARP (Variation 2)

The Treasury now intends to use the $700b to buy preferred equity in banks based on the premises that:

1. These banks are solvent and liquid
2. Because they are solvent and liquid, they will use the new capital to make new loans

First, the government is in no position to be able to determine which banks are solvent since the write-downs are likely to continue at an increasing pace as the economy worsens (and many of the banks themselves do not know if they are solvent). Even more, any bank that is truly solvent and liquid and willing to make loans needs no new capital to do so. This plan is clearly an attempt to just stave-off another Lehman Brothers scenario with little hope of making the Zombie-institutions alive again.

The government claims that it is "forcing" banks to participate to avoid a stigma being associated with the investments. This statement alone implies that much of the money is going to banks that need it to stay afloat and are thus likely to hoard it. Even more, Goldman Sachs recently sold $5 billion worth of preferred shares to Warren Buffett with a 10% coupon and also gave him more than $1.5b worth of warrants (Buffett is essentially getting a 15%+ return on the preferred shares if you factor in the value of the warrants). They did this willingly so why wouldn't they willingly take an investment from the government with only a 5% coupon? My sense is that the Treasury said it was "forcing" banks so that it doesn't look like they are bailing the banks out (which they are).

A simple scenario analysis shows that this variation of the TARP is indeed a pure government bailout of the banks and a lose-lose scenario for tax-payers. If the banks end up failing, the preferred shares will be wiped out and the tax payer money will have just allayed some of the losses of the unsecured creditors. If the banks end up thriving, the taxpayers only get 5% on their money as long as the banks need it (i.e., we will only get 5% on the money when the risk is highest) and do not participate in any of the equity upside.

This variation of the TARP is, at best, a temporary stopgap to prevent another major institution from failing in the short term. Besides wasting tax payer money with limited upside, it will continue to muddle the picture as far as which banks are truly insolvent and not worth saving. By not allowing the bad banks to die, the government (like Japan in the 90s) is extending the period of time over which the financial sector will be a capital sink versus a capital conduit and over which we are all forced to muddle through in a zombie economy.

European Variations

By taking controlling interests in the banks, the Europeans have injected equity capital in a much more forcible way. This is arguably better than the TARP variations since:

1. The governments now have control and can force lending by the institutions.
2. The European taxpayers will participate in any future upside (not likely since many of the banks are probably insolvent).
3. It properly dilutes the common shareholders and management of the firms in questions.

Unfortunately, these actions will still bailout the unsecured creditors of these banks. Even more, they have a low likelihood of working and may cause more long-term damage than good since they are akin to moving around the limbs of a dead body to make it look alive.

These governments do not have the expertise or resources to force the lending into areas of the real economy where it is needed most. Most likely, they will throw good money after bad investments (in order to avoid further write-downs) causing these banks to become an even bigger black hole of tax payer money than in the TARP variations. Most damningly, it exacerbates the too-big-to-fail problem and will crowd out new, healthy private banks that may have otherwise emerged in the next few years.

A Simple and Bold Solution

$700 billion is a huge amount of money--more than the equity book values of Goldman Sachs, Morgan Stanley, JP Morgan, Citigroup, Washington Mutual, Bank of America and Wachovia **combined**. This money should be used to capitalize new banks throughout the country. To be operational as quickly as possible and to preserve valuable human and operational capital, these banks will buy good operational assets from insolvent banks in FDIC receivership. To avoid a concentration of risk, the capital should be distributed amongst at least 20 new institutions. To avoid the hazards of government ownership or sponsorship, the shares of these institutions should be distributed to the American people (each bank can have 300m shares; one for every American man, woman, or child). Rather than using taxpayer money to cushion losses of previous, bad investments, this will allow all of the capital to facilitate lending to the real economy where it will prevent the current recession from becoming a depression and expedite the recovery which would otherwise be many years away. This plan is akin to preserving the body of banks while replacing their old brains (senior management and risk management policies) and their old hearts (balance sheets).

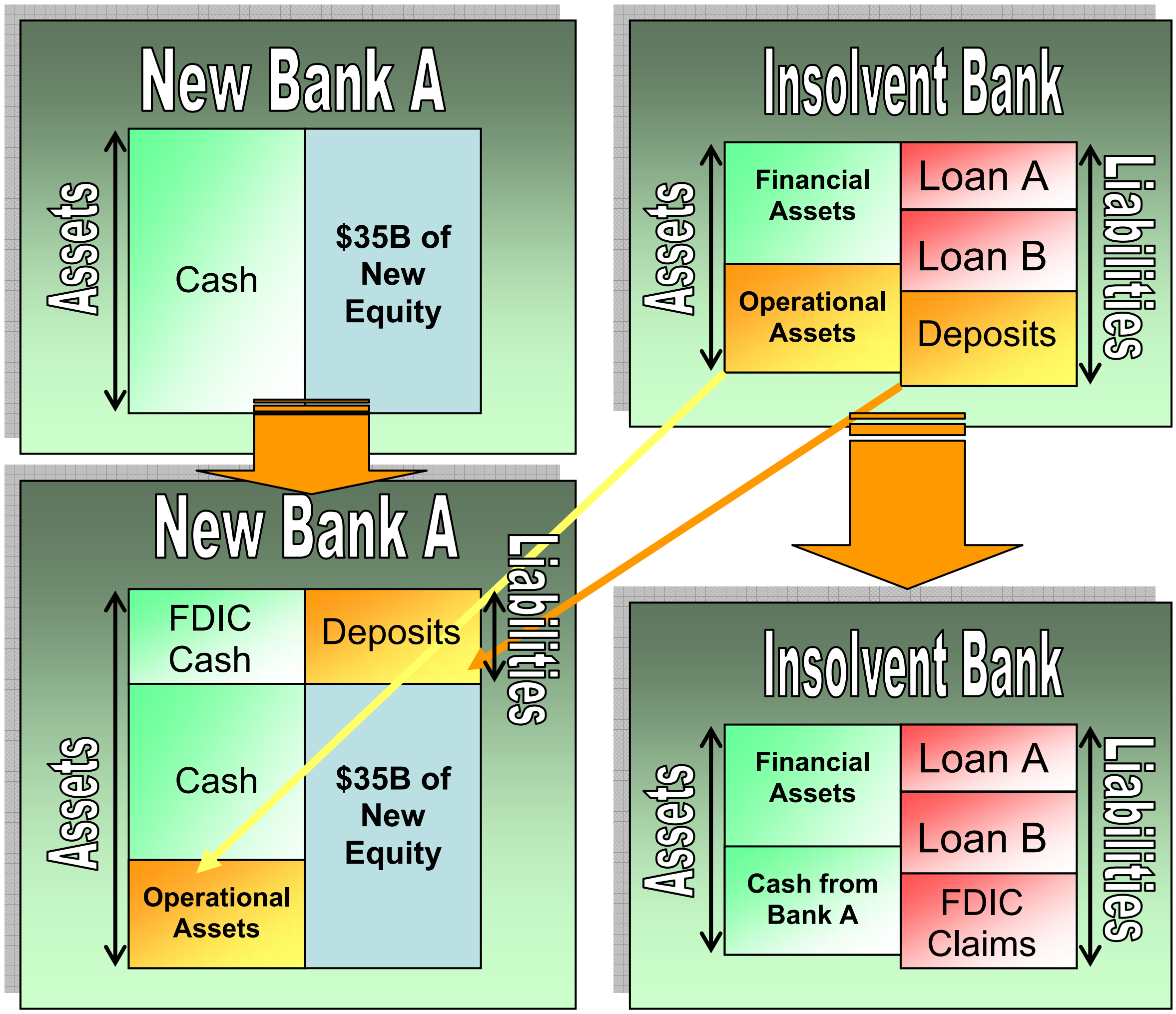

Figure 4: Once an insolvent bank enters FDIC receivership, the deposits, operational assets, and employees will be taken over by newly capitalized Bank A. It will pay book value for the assets. The rest of the assets will stay in receivership and be divided between the creditors and the FDIC. Bank A is able to be quickly operational with 300B+ of lending capacity. Even more, the operational and human assets of the insolvent bank are preserved rather than liquidated.

Newly capitalized banks with clean balance sheets have no reason to hoard capital. If capitalized with $700b, they would have the ability to make $7 trillion in new loans. By being distributed across the country, they will be close to the real projects that need investment. The shares of the new banks will be distributed to the American People and they will be traded on current exchanges, thus avoiding government control and giving private citizens a direct stake in the financial system. Existing solvent banks will benefit from funding from the new banks and are more likely to start lending again as the new banks make access to funding more certain.

$700 billion of new equity capital in new balance sheets could be directly used to fund $7 trillion in lending in the real economy. Not only will it directly address the crux of the problem, but it is actually the best way to save the good current banks. If the risk-reward is there, these new banks could lend directly to the old banks that are solvent. As existing solvent banks regain confidence in the availability of funds, they too will start lending. The insolvent old banks will be allowed to fail gracefully and many of their good operational, human, and intangible assets will be preserved as they are bought by the new banks. Perhaps most importantly, there is a considerable amount of private capital on the sidelines (both home and abroad) that would love to invest in the American financial system, just not in banks with shrinking/toxic assets and uncertain access to credit. Given this, these new banks could easily attract private capital and deposits extending their lending capacity well beyond $7 trillion. More than the capital, the government's real value-add would be streamlining new bank charters, Federal Reserve membership, and the transfer of operational assets out of receivership.

This plan involves no moral hazard of taxpayers taking the downside for imprudent decisions (thus encouraging future bubbles and imprudent decisions) since the old equity and debt holders are left to fight over the financial assets of the insolvent banks (like a normal bankruptcy). It involves no government ownership. It is also much more salable to the American people than any alternative since they get to partake in the success of the new institutions. Even if the powers-that-be are insistent on proceeding with the TARP variations, there needs to be a Plan B for the likely case that the TARP fails (although we would save several hundred billion dollars if this is Plan A). Our economy and financial system will only emerge from the malaise once new, clean banks of respectable scale emerge unfettered by an ugly past. We can wait perhaps 10 years or more for this to happen naturally, or we can seed the process immediately and save the country (and probably the world) from at least a decade of economic stagnation.

Conclusion

What this paper proposes may initially seem drastic, overly ambitious, logistically difficult or insensitive to the importance of current financial institutions. On further thought, however, it is no more drastic than a small cadre of Treasury officials directly managing $700 billion with no controls or oversight or real, overarching direction. Logistically, a government that can orchestrate the complex Bear Sterns, AIG, and Fannie Mae/Freddie Mac deals literally overnight should be able to quickly orchestrate the formation of new, clean banks and the transfer of operational assets into them. As far as the present institutions are concerned, nothing will work better to stop the writing-down of assets and to halt further financial bankruptcies than real lending from new institutions with the confidence to act.

Perhaps even more important than the notion that this plan will actually work is the deeper idea that it is a bold project that will capture the imagination of the American People. This country has no shortage of ethical, financial management talent and they will be attracted to these banks by their sense of patriotic duty and the chance to partake in something of historical significance. It will, in fact, make every American once again feel that they have a real stake in the financial future of our country.

Frequently Asked Questions:

Isn't this plan dismissive of the systemic importance of existing banks and the need to keep them afloat?
No, if anything, we strongly believe that this is the best plan for making sure that existing solvent banks will survive in a non-zombie state since it will make them comfortable with their own access to short term capital. We also need to come to terms with the idea that much of the current banking system is in fact collectively insolvent and the problem is much, much deeper than one of liquidity and confidence. If the current banking system is solvent, this plan will help save it. If it is not solvent, then this plan prevents a financial system collapse from turning into an economic collapse since we will still have new conduit institutions between savers of capital and businesses that need it.

If these new banks can make money in this environment, why isn't the private sector (Hedge Funds, Private Equity Funds, etc.) starting new banks on its own?
The private sector will eventually do this over many years, but only the government can coordinate this type of activity (streamline charters, Fed membership, and transfer of assets from FDIC receivership) and provide capital in the scale necessary to seed entities that will be of sufficient size in the near term. Large private equity funds may be natural partners with the government (their expertise being the takeover/restructuring of operational assets with new capital structures) but they could not do this on their own. Even more, any individual new bank will be overwhelmed by the systemic failures of the current financial system. Only a large number of new banks of scale formed through government coordination can collectively weather this storm (and make positive-return investments which are critical for preserving the injected capital and making sure that the investments are made where they are most needed).

How can a new, large bank be started from scratch in a short amount of time?
Several hundred commercial banks are expected to fail in the next few years and they will go into receivership by the FDIC. The operational hard assets--branches, IT systems, etc.--and the majority of the employees are perfectly good and would most likely be let go and liquidated even if the FDIC were to arrange a shotgun wedding with an existing bank. Rather than dissolving these valuable operational and human capital assets, they could be bought at book value by one of the new banks (which would also take over the deposits). Not only will this allow New Bank A to be operational very quickly, the day-to-day operations of the bank assets could continue uninterrupted (preventing interruptions to capital access by small businesses and access to deposits). The New Bank A team would then replace senior management, define new risk guidelines, and do some restructuring and it will then be a good, operational bank with a clean balance sheet formed in a very short amount of time.

What about directly helping homeowners restructure their mortgages to prevent further asset price contraction?
There is room for restructuring some mortgages (it will probably benefit the lender), but the bulk of recent mortgages (and older ones where the homeowners took on home equity loans) are just flat-out worth more than the house and it would actually be in the borrower's best interest to walk away. It will also be very logistically difficult to renegotiate these mortgages on a one-off basis. Housing prices are still well above both the long-term trend line and what they need to be to "make sense" as an investment and any government intervention now will, at best, temporarily distort markets and prolong the crisis. The single best way that we can help the average American (including renters) is to provide capital to real-world investments with the highest return and lowest risk (since they arguably add the most value to the economy) which is exactly what these new banks will do. A quick housing price correction will be less painful than one drawn out by government intervention.

The Resolution Trust Corporation after the S&L Crisis was successful. Isn't the TARP a similar idea?
The original TARP proposal has been marketed as a plan similar to the seemingly successful Resolution Trust Corporation (RTC) that handled the assets of the failed Savings and Loans in the early 90s. There is, however, one glaring difference: the RTC took over assets AFTER the S&Ls failed while the TARP proposes to take over assets BEFORE the banks fail in an attempt to "inject confidence" and prop them up. There was no moral hazard issue with the RTC since the "guilty parties" were all wiped out and it did not attempt to prop up "zombie" S&Ls. The "New Banks" proposal this paper advocates is actually much closer to the RTC since it advocates preserving the systemic value of banks' operational and human assets while punishing those who made inappropriate decisions. It goes one step further by quickly placing the assets in the hands of multiple private managers (who would be accountable to the American People since they would be the shareholders) rather than a small cadre of government officials.

What about the $60+ trillion in Credit Default Swaps?
Many people fear that if major insolvent institutions are allowed to fail and potentially default on their derivative contracts insuring bonds (credit default swaps), that it would create a chain reaction of derivative defaults, asset write-downs, and further bank failures. This is a valid concern, but existing bailout plans only defer the problem. This could be the subject of another paper, but the government should create a clearinghouse for these contracts as quickly as possible so that we can begin to unwind offsetting claims and have a clearer picture of the net liability. This could be done in conjunction with the initiative described in this paper.

It looks like short-term credit between banks is thawing. Doesn't this mean that the TARP is beginning to work?
There are some indicators that rates for short term, interbank loans have come off their highs. This is more due to the liquidity injections from the Federal Reserve which has increased the size of its balance sheet by $800B relative to only a few months ago. This has nothing to do with the TARP and is an unsustainable situation.

Some people have suggested that the larger banks will us the TARP equity injections to buy weaker banks. Doesn't this solve the problem?

Larger banks buying weaker banks just defers and worsens the problem. If the weaker bank is insolvent and has negative equity (likely), then the acquisition will just infect the balance sheet of the stronger bank (making it potentially insolvent). We will then be left with a more structurally important bank being at risk; a bank that is possibly "too big to fail." Also, as the balance sheets are merged, asset values will become further muddled and opaque which will only increase market uncertainty. Bottom line, this is akin to placing a burning match under a flammable carpet to pretend that it is not there.