IRET *Congressional Advisory*

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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RUSH TO BAILOUT

Treasury Secretary Paulson has put forward a plan for a dramatic intervention by the government to shore up the financial system. It is predicated on the fear that credit markets could freeze up and damage the entire economy.

Many banks and other institutions are unable to sell distressed assets immediately for the cash they need to meet current obligations. Mark-to-market rules require the banks to value the distressed assets at current fire-sale prices, which may be well below their intrinsic value. The low valuations are bringing the banks up against their minimum capital requirements imposed by bank regulators. This raises the threat that the banks will be closed, making it hard to tap their normal sources of credit. The panic becomes a self-fulfilling prophecy.

Secretary Paulson's solution is to have the government purchase the impaired, and consequently illiquid, mortgage backed securities that are at the heart of the trouble. This would remove them from the books of distressed financial institutions.

He is hopeful that the assets retain a good deal of their face value (some Administration estimates run as high as 93 percent). If so, and depending on how much the government paid for the assets, the government might be able to recover the outlays at a modest cost or perhaps even make a profit for the taxpayers.

The program would help the banks preserve their capital, although the extent of that would depend on how much the government paid for the assets. The higher the price the government were to pay, the less of a hit the banks would take to their capital cushion from selling the mortgage related securities at a loss. This would get them back on their feet, while buying time to sort the assets out. However, it would increase the risk to the taxpayers.

The best solution requires some time. It would involve an orderly unbundling of the mortgage backed securities to separate the good from the bad loans. This would make it possible to value the securities, and enable them to trade again. Those banks that suffered serious losses would have to raise new capital to restore their solvency. Those that could not would have to go into FDIC receivership, and be sold off to other institutions or liquidated. This approach would not involve risk to the taxpayers.

The key question is one of time. If there is an imminent threat of a credit market meltdown, then we may be forced to accept the proposed intervention. If there is a way to buy more time to sort things out, then less drastic remedies are available.

Is this haste really necessary?

The economy and the markets are not falling apart.

The financial sector, the housing sector, and the auto sector are having trouble. The technology sector, agriculture, energy, health care, and other services are doing pretty well.

Credit markets are open to most business and consumer borrowers on Main Street. Interest rates may be higher than a few weeks ago, but the credit is still flowing. Commercial and industrial loans were 20% higher at the end of July than a year earlier.

Focus on the consumer

We should not hold harmless everyone who bought and held bonds or homes that have lost value. These investors took risks that they either could or could not afford. Those who could afford to do so need no bailout. Those who could not afford to do so should not be rewarded for such bad judgment.

The national policy concern is to keep the economy moving forward. That requires that credit remain available to ordinary consumers and businesses, and that ordinary financial services continue to be available. The institutions that provide credit, accept deposits, and pay checks must be able to function, because the public needs those services. The object of any intervention should be to defend those who rely on these services. That should be the focus of the rescue — not the shareholders or managers, not the creditors to the financial firms, and not the bondholders. The latter should suffer the full value of the losses on the investments they made.

Traditional avenues of financial support

Traditional avenues of relief are working and can buy time to sort out the mortgage debt. The FDIC, the Treasury, and the Federal Reserve can do a great deal with current authority.

<u>FDIC</u>

The Federal Deposit Insurance Corporation (FDIC) insures deposits at member banks and thrifts for up to $100,000 per account (or $250,000 for retirement accounts).

Last week, the FDIC quietly and efficiently took over Washington Mutual, the nation's largest thrift institution, and sold it to JPMorgan Chase for $1.9 billion. Depositors were protected in a seamless transition to new ownership and management. Even in the current difficult climate, a private sector borrower willing to add capital to the bank was quickly found.

The FDIC must often absorb losses when it takes over a failed bank, and must clean up its balance sheet before selling the bank to a new owner. However, it recoups those losses with insurance fees collected from the banking system over time. The cost is not shifted to the taxpayer.

The FDIC still has money to work with to handle additional bank failures. If it runs low, it has a line of credit with the Treasury. Reaffirming and increasing that line of credit now would be helpful. Any borrowing would be repaid out of future fees.

Money market mutual funds now hold a large portion of the short term investments of the country, and they offer check writing privileges. Many businesses and individuals have large accounts at such institutions, and must access them daily to pay bills, including business payrolls. The funds invest heavily in commercial paper, and other short term loans to banks and businesses backed by high quality collateral. This source of short term credit is essential for the economy.

To support the commercial paper market, the government has temporarily extended deposit insurance protection to these funds to prevent panic withdrawals. This coverage should be continued for the duration of the credit market crisis. The mutual funds should be charged the same insurance fee as the banks, and for as far into the future as is needed to make up for any net outlays incurred in the current situation.

It would greatly help the payments system to increase FDIC coverage to all checkable accounts, without the $100,000 limit. Many businesses deposit sums far larger than that into their accounts the day before issuing payroll checks.

The failure of Lehman Brothers was not handled by the FDIC. It had limited market impact, parts were sold off, and the creditors took a haircut. This was not a major jolt to the credit markets.

Most of the really large wounded beasts have been put out of their misery already. They either went bankrupt, were bought out at a deep discount by others, or were transformed into bank holding companies eligible to borrow from the Federal Reserve and eligible for FDIC insurance. There is less systemic risk now than before these changes. There is more financial restructuring to come, but the existing institutions can handle it.

Federal Reserve

The Federal Reserve has been lending to banks and brokerage firms freely, and for longer terms than usual. It accepts investment grade securities as collateral. These include mortgage backed instruments, although they are supposed to be ones with performing loans.

The Fed could increase the liquidity of the "toxic" mortgage backed bonds by accepting them at something less than face value for discounting purposes. The banks would be responsible for buying them back from the Fed at a later date, but could access part of their value now to satisfy short term cash requirements.

As the Federal Reserve has increased its lending to institutions that need added liquidity, it has sold Treasury bills from its own portfolio. Otherwise, the added lending would have increased total bank reserves and the money supply, and risked inflation.

Federal Reserve / Treasury coordination

The Federal Reserve has sold off over 60 percent of its Treasury securities. At some point, it could run out of assets to sell to sterilize the effect on the money supply. However, the Treasury can assist with that function.

Treasury has recently issued more Treasury bills by borrowing more than it needed to cover current government spending. The added cash was deposited at the Federal Reserve, removing it from bank reserves.

Working together, the Treasury and the Federal Reserve can provide nearly unlimited liquidity to the distressed areas of the financial system without being inflationary.

The Treasury may need an increase in the federal debt limit to issue additional Treasury bills, either to lend to the FDIC or to support the Federal Reserve's money management objectives. The debt limit should be increased now to accommodate these actions. (The Paulson plan also requires a debt limit increase.)

Buying time to disentangle the mortgage bonds

Some process still must be found to disentangle the non-performing mortgages from the good ones. The Administration has indicated that as many as 93 percent of the mortgages may be good, and the net cost of the Paulson plan may be very low.

Secretary Paulson has urged his plan out of concern that there is no time for such an evaluation before the credit markets cease to function. However, we could do more through the normal channels of support to find buyers for distressed institutions and to lend against distressed securities. That would buy time to evaluate the mortgage backed securities.

That evaluation could be carried out by a private consortium. There is no need for the Treasury to become the actual owner of the assets. We surely do not want the Treasury to end up as a national landlord, trying to arrange for the management of and rent collection on distressed properties.

Recapitalizing the banks

Whatever approach is taken to revaluing the distressed debt, the banks that have suffered heavy

losses will have to find additional capital. It is not clear that the capital has to come from the taxpayer. Previous government bailouts have involved warrants or other ownership claims on the institutions being helped. However, if the value of the distressed assets and the residual value of the distressed banks can be clarified, then it should be possible to find private buyers to provide the capital and take the risks.

Bulking up the value of the distressed loans or properties

Some economists and politicians have suggested giving financial aid to the home buyers to enable them to service their mortgages, restoring the value of the distressed bonds. This would be folly, and, unlike the other options, would certainly be at taxpayer expense. The government would be buying people houses that would be bigger than the people could normally afford. It would be as if the government were saying, "Everyone should have a car. Let's make up the difference between what people can pay and the cost of a Model X."

It is sad that too many people gambled by taking on debt they could not afford in order to buy homes they could not afford on their incomes. Some were encouraged by artificially low interest rates to take a plunge into real estate speculation. Some lied on their credit applications to do so.

It does no favor to a low income family to saddle them with a mortgage (even a restructured one) that they can barely afford, to keep them is a house that is too large and too expensive to maintain on their limited budget. It does no favor to the taxpayers who will have to pay the bill.

There is also no sensible way to bulk up the value of the excess inventory of homes. There was overbuilding. The excess supply of housing is real and must be worked off over time.

Stephen J. Entin
President and Executive Director

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