This Wednesday Mr. Geithner will be confirmed as the new Secretary of Treasury. Never before in U.S. history has this position been so important. Mr. Geithner’s decisions in the next few weeks will have a dramatic impact on the length and the depth of this recession and will shape the financial sector for decades to come. Mr. Geithner comes to this job with the best qualifications. But in the last several months, he has constantly been in the eye of the financial storm and thus he might benefit from an outside perspective. Given that the prosperity of our country is at stake, I hope Mr. Geithner will allow me a few suggestions.

To begin, you need an overall strategy. Even a mediocre strategy is better than an ad hoc approach that confuses markets and fuels the perception of playing favorites. Legendary portfolio manager David Swensen (who in 23 years transformed the $1 billion of Yale endowment into $23 billion) in reference to the government intervention in this crisis commented “the government has done it with an extreme degree of inconsistency. You almost have to be trying to do things in an incoherent and inconsistent way to end up with the huge range of ways they have come up with to address these problems.”

The cost of this inconsistency is that it has forced the private capital to stay on the sideline. Short of a complete nationalization of the financial sector (which we hope is not in the plan), the problem cannot be resolved without the help of private capital. But a necessary condition to attract private capital back is a consistent and predictable strategy by the government, without which any other effort is in vain.

In designing this strategy, it is important to keep in mind the interest of the country does not necessarily coincide with the interest of the banks. Charles Erwin Wilson, who became Secretary of Defense in the Eisenhower Administration after a long career at General Motors, declared in his confirmation hearings that the interest of the country and that of GM were one and the same. Nobody would dare to say it now. The problem is that an excessive familiarity with one interest may distort the judgment of even the most well intended people. Please do not fall into this trap, Mr. Geithner.

What makes this distinction difficult is that well-capitalized banks are in the interest of the country. I agree that we need to fix the banking sector and we need to do it fast. But I disagree that this implies bailing out investors and bankers. Not only is this extremely costly for the taxpayers, but it gets in the way of a speedy resolution. And it sows the seeds of the next crisis. The current crisis is the direct consequence of the Long Term Capital Management bailout orchestrated by the Federal Reserve of New York ten years ago. It was the conviction that the Fed would always intervene to rescue traders in a liquidity squeeze that induced banks and financial institutions to leverage up to and take increasingly aggressive gambles.

The fact that the interest of banks does not necessarily coincide with the interest of the country can be appreciated from the first phase of TARP. After an initial surprise (they could not believe

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1 http://www.youtube.com/watch?v=RsnXZgEPMSg
their ears), bankers were delighted at receiving the government money. Without it, Vikram Pandit would no longer be the CEO of Citigroup and former Secretary of Treasury Rubin would have found it more difficult to cash out the $115 million earned at Citigroup. So it is clear they like it and they want more. But what is in it for taxpayers? The first round of equity infusion and debt guarantees transferred to banks’ investors $108 billion. This is not the cost of the investment; it is the size of the gift taxpayers made to banks’ investors, as a reward for the good job done running their firms and monitoring their managers.

What do taxpayers receive in exchange? Nothing. As reported by the *New Your Times*, bankers privately admit that they do not use the TARP money for new loans, but only to consolidate their balance sheet and survive longer. This is also consistent with our findings that the intervention does not create aggregate wealth, but only transfers it from taxpayers to financial investors. In the second bailout of Citigroup, where no systemic effects are likely, taxpayers poured $60 billion into Citigroup, increasing the value of Citigroup financial claims by only $44 billion, with a net loss of $16 billion. This means that each dollar donated to financial investors cost the taxpayers $1.36. This is hardly an attractive proposition.

This outcome was easily predictable. If in the middle of a hurricane you help a damaged cargo ship to stay afloat, you cannot expect it to restart its shipping route immediately afterwards. For that to happen, either the boat should be completely refurbished or the hurricane should have passed or both. Hoping that bankers who saw the writing on the wall might restart taking risks because they were offered a lifeline is wishful thinking. If the government really wanted to use the banking wrecksages to restart the economy, it should have taken over these banks and directed the flow of credit or should have poured an amount of capital so large that even scared bankers would consider restarting the lending process. Either way it would have been tantamount to a nationalization of the banking sector, with the problems that implies. And it would have required a massive amount of money. In October, my rough estimate was $600 billion in equity just for the top ten banks. I am afraid I was too optimistic. Is there any limit in the subsidy taxpayers have to provide to bail out bankers?

Only in the absence of any feasible alternative to restart the lending process would this massive bailout be in the interest of the country. This is the way secretary Paulson presented it to the nation. Ironically, however, he kept changing the solution that had no alternatives. Mr. Geithner, please do not fall into this trap. We can save the banks as institutions and restart lending without a massive transfer of money from taxpayers to investors and bankers, and here is how.

One solution is the one I advanced last Fall. It requires passing a new piece of legislation introducing a new form of bankruptcy for banks, where derivative contracts are kept in place and the long-term debt is swapped into equity. As Pietro Veronesi and I have shown in a recent article, such conversion will fully recapitalize the banking sector and bring down the level of

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5 Zingales, Luigi 2008b, “Plan B,” The Economists’ Voice: Vol. 5: Iss. 6, Article 4.
risk of debt (as measured by the credit default swaps level) to pre-crisis level. When I proposed it in September, they told me that there was not time. When I re-proposed it in October, they told me that there was no chance to reconvene Congress after the election. But time has passed and the Congress has reconvened after the election, but there has been no discussion of this alternative that can save taxpayers hundreds of billions of dollars.

That is not the only possible plan. An alternative would be to allow banks to divide themselves into two entities, a bad bank with all the toxic assets and a good bank, with lending etc. Ownership of these two entities will be allocated pro rata to all the financial investors as a proportion of the most updated accounting value of these assets. So a bank with 30 billion of bad assets and 70 billion of good assets will see its debt divided 30-70 and its equity divided 30-70. Each $100 debt claim will become a $30 debt claim in the bad bank and a $70 debt claim in the good bank. The same would be true for equity.

On the face of it, it looks like a useless exercise. If each investor receives pro rata the two parts of the bank, what difference does it make? The answer is very simple. After the spin off, the toxic assets will not contaminate the lending part of the business anymore. On the one hand, bad banks would simply be closed-end funds holding the toxic assets. If these assets turn out to be worth more, the original investors will be rewarded. If they are worth less, the most junior claimants (common and preferred equity) will be wiped out. The good news is that these entities could be allowed to fail because their failure would only be a rearrangement of their liability structure with no negative consequences on the economy. On the other hand, good banks will have a clean balance sheet and will be able to raise private capital without too many problems. If private capital is nowhere to be seen it is because sovereign wealth funds that tried to take advantage of the situation experienced enormous losses. In November 2007, for instance, when the Abu Dhabi sovereign wealth fund took a stake in Citigroup the stock was trading at $29 per share, while today it is worth only $3.5. After these bad early experiences, all smart money stayed away.

By eliminating the uncertainty on the magnitude of the losses in good banks, the spinoff will make it appealing for private capital to invest in these banks. Even if private capital would not flow back (which I doubt), a government equity infusion in the good banks would be cheaper and more effective. Cheaper because the value of debt in the good banks would be close to par and thus an equity infusion will not go to bail out the existing creditors, but only to promote lending. More effective, because instead of trying to improve the capital ratio of a $100 billion entity (in the example), the government will do it only with respect to a $70 billion one.

If the solution is so simple why has it not be done before? First, it is much simpler to get money from the government than to obtain it through hard work. So, no bank would consider doing this spinoff if it hopes to receive extra TARP money. Second, because most bank debt has covenants prohibiting exactly these splits. Even if the liabilities are shared equally between the two entities, the equityholders tend to gain from this split and the debtholders tend to lose. If the shortfall in the value of toxic assets is large enough equity in the whole entity would be entirely wiped out, while with the two split entities equityholders will retain some value in the good bank, at the cost

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of a lower overall repayment for the debtholders.\textsuperscript{8}

However, this problem can be dealt with by giving debtholders of the bad bank a warrant on the equity of the good bank, increasing their payoff at the expense of the equityholders. Furthermore, the creditors have benefitted so greatly from all the government infusions of money so far that it would only be fair that they will share some of the pain for their bad investment. To allow banks to spin themselves off in two units, however, we need to pass a new law. As in October, the “nay sayers” will say it is impossible. It was possible to write a $700 billion check to Paulson, it is possible to approve an $825 billion stimulus packages, why it is not possible to pass a very short law allowing banks to spin off?

Mr. Geithner, incumbent bankers and their lobbyists will always make you believe there is no alternative to the plan that benefits them the most. You cannot fall for this old trick. The alternatives I have outlined above are not only possible, but also fair. They penalize those who invested poorly and help provide loans to businesses in need. On top of this, they achieve these goals at zero cost to taxpayers (no small feat in a time of ballooning deficits). Yes, we can Mr. Geithner…if you lead us there.

\textsuperscript{8} More technically, since equity is an option on the value of the underlying assets, the option on a portfolio of assets is worth less than a portfolio of options on the same assets.