With the upcoming G20 summit, there is discussion all over the world about what the priorities should be for the next steps in battling the financial crisis.

Our answer, focusing on priorities for the U.S., is based on three principles. First, the purpose of intervening in credit markets is to get credit flowing again (and not to achieve any other social goals). We will refer to this as the primary objective. Second, the taxpayer support that is going to be provided through the TARP and perhaps through other channels should be done in the lowest (current and future) cost method that is consistent with achieving the primary objective.

It is apparent that we can be more successful in lowering the taxpayer cost if legislation could be swiftly enacted. But every time in the crisis that we have had Congress act, it has proved difficult to contain the legislation to the problem at hand. Congress has expanded the issues in ways that have subsequently had bad unintended consequences. The clearest danger in considering more legislation is that we make hasty and irreversible decisions on the future of regulation that will prove unwise. Our third principle is that any new legislation that is considered should be narrow and targeted at correcting technical impediments that are impeding rescue efforts. Once the crisis is contained we can move on to fixing the collective regulatory failures that need to be addressed.

Diagnosis: Why Isn’t Credit Flowing?

There are two, inter-related problems plaguing the financial system. One is the hesitation of banks to extend more credit. Proving that they are not lending is hard because the weakness in the economy leads to less overall desired borrowing, but credit standards seem to be continuing to tighten. This is occurring because offering more credit exposes banks to risk of further losses. Banks do not have enough equity capital to absorb such losses and instead have been trying to reduce their exposure to additional risk. This dynamic will continue until the banks either shrink their risk exposure to a level that their existing equity can support, or they raise more equity. Society prefers that they do the latter and policymakers should try to take steps to facilitate this. Simple mandates to lend will not work: if the banks are truly broke they will gamble and look for the riskiest loans to make, or if they are seriously under-capitalized they will do all they can to avoid taking genuine risks. In addition, if competing weak banks are being forced to sell their loans, it may be more profitable to buy them than to make new loans.

The second problem is that over the last decade a great deal of borrowing occurred through markets that have shut down. More specifically, many types of loans (e.g. credit card loans, student loans, auto loans, home equity loans) were initiated by banks but were immediately pooled together and sold as securities that wound up being owned by non-banks. For instance, in the first half of 2007 over $500 billion of these types of securities were created. By the end of 2008, this credit channel had disappeared.
The evaporation of the asset backed securities market has put more stress on banks and other lenders since they must now assume that if they want to initiate credit, they will have to hold the loan. The disappearance of securitization means that restoring lending to its previous level would require bank balance sheets to be much larger than before. So now, many borrowers are not able to get loans because no one wants to buy the securities that they would be turned into, and the banks’ depleted capital leaves them unwilling to take the risk of holding them. The borrowers would be better off getting these loans at high interest rates rather than not getting them at all.

The Federal Reserve’s new Term Asset-Back Security Loan Facility (TALF) is designed to restart this market, by lending to institutions so that they can buy the securitized loans. The Fed legally must be certain that its loans of this sort are risk-free. This is being done in two ways. One is that the securities it will lend against must have the first claim against the loan proceeds. Second, some TARP money will be used to absorb any losses that still could arise. Using TARP money to provide protection is very efficient because it could restart a great deal of lending while taking up very little TARP money.

Despite the ingenuity of the TALF, the perceived risk of participating is high. Partly this is because loans that look safe could still default – consensus forecasts about the recession have been persistently optimistic and investors are much more risk averse than at the start of the crisis. Participants could end up with large profits or large losses. But another source of risk is Congressional interference. In the stimulus bill, the rules regarding pay restrictions for participating in the TARP were re-written after the fact. The mistrust that this has created is tremendous and potential TALF participants fear that the same thing could happen again. It is important that Congress understand that if the TALF succeeds, it is likely hedge funds and other investors may end up with very high profits. This is the cost of repairing the market and the overall economy, and the borrowers who get funded this way are definitely better off. Demonizing the TALF participants that profit will only slow down other efforts where investor trust of the government is needed and raise the long run cost of solving the crisis.

Re-establishing Credit Flows

The TALF is on track to work. So attention should be focused on re-establishing bank lending. This should be done by getting the banks to raise capital so that they can expand their balance sheets. Banks are hesitant to do this for several reasons. One is that any new equity investments make existing debt claims against the banks safer – the new equity would suffer any losses that otherwise would have been borne by bondholders. A second problem is that a new issue, given the very low bank share prices, would dilute the ownership stake of the existing equity holders. They would rather cut back on lending and just hope that things recover so that they still own the institution that emerges from the crisis. A third problem is that it is unclear how new investors in debt, common equity or hybrids such as preferred equity will be treated by the government if the banking industry conditions continue to deteriorate. It would be very useful if banks raising new capital that allows them to share in future losses and gains could treat the new capital differently from common equity.

This suggests that an improved framework for resolving bank holding company undercapitalization should be devised as soon as possible. Without such a framework there is no way to impose some of the losses on anyone except common equity holders or the taxpayer. In a bankruptcy procedure, the bond holders would share in losses if the equity holders were wiped out. Existing bankruptcy rules do not work for complex bank holding companies. Congress should work quickly on a narrow bill to make it possible to intervene and resolve a bank holding company. This is one step that can reduce risk to the taxpayer and allow banks to raise private capital more easily.
A second imperative is to mandate that banks that do not have enough equity capital must raise it, so that they can begin lending. The stress tests underway now are the necessary first step. Without knowing how much more capital is needed, we cannot design a sensible plan to get the money. Having the right resolution mechanism for the banks which remain undercapitalized despite the mandate is an important stick that will help convince the banks that they will be wound down if they do not raise more capital.

Congress could create a second useful stick by requiring all banks to come up with emergency plans for how they could be wound down on short notice. These plans should be akin to the business continuity plans that the banks already must maintain. The goal would be to force the banks to internalize the complexity that they create for supervisors, so that the banks have to contemplate their own demise.

Without an improved and well spelled-out resolution mechanism, there is little that the government can do but continue to inject capital until every claim (except possibly equity) is bailed out. This would achieve the primary objective, but at an unnecessarily large cost, and would establish a bad precedent that all debt of large banks will be implicitly guaranteed by the government. This would also make the government the majority owner of some large institutions, raising difficult issues about how to unwind these positions and how to avoid meddling in the management of the banks.

A much better tactic would be to push the banks to find private capital and use the TARP money to co-invest. Given the uncertainty over what the government might do, private investors are rationally sitting on the sidelines. The Treasury needs to be crystal clear in announcing when it will intervene in a troubled institution that remains undercapitalized and if it has to provide emergency financing, how other investors will be treated. A critical question is how losses on bad assets will be shared if a bank does have to be liquidated.

The public private partnership can play a role by moving some of the risk away from the banks. This partnership is only needed because the private sector will not buy the assets at the going prices. Hence TARP money will have to be used to induce private sector participation. If this happens, then the private sector would likely willingly recapitalize the bank that remains after the bad assets have been removed.

Finally, the Treasury seems determined to begin broad regulatory overhaul of the banks while the crisis is on-going. This is irresponsible. The Treasury and administration do not have the manpower in place now to do this in thoughtful way. This overhaul is likely to last for years, and it requires solving many knotty issues that cannot be done hastily. Moreover, the direction of how best to proceed depends at least partly on how the crisis plays out. Most importantly, a better regulatory scheme requires global coordination. This will take time too. Congress should resist the rush to make broad regulatory reform now. Let’s spend all our energy and expertise trying to put out the fire before we turn to the issue of redesigning the sprinkler system.

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