Now that Mr. Geithner is confirmed as the new Secretary of Treasury, the urgent business begins. Secretary 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.

Though Mr. Geithner comes to this job with the best qualifications, 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. I hope Mr. Geithner will allow me a few suggestions.

**The Need for Strategy and Consistency**

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 Yale endowment manager David Swensen 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 it any other effort is in vain since the option value of waiting is high. Reducing policy uncertainty is critical to unleashing private capital and minimizing overall public expenditures.

In designing this strategy it is important to keep in mind the interest of the country does not necessarily coincide with the interest of bank equity holders, bank management or bank creditors. 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 G.M. were one and the same. Nobody would dare to say it now. And neither do the interests of the U.S. and Citigroup coincide perfectly.

The danger for you and your agency 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.

WELL-CAPITALIZED BANKS ARE A VITAL NATIONAL INTEREST—AND TO GET THERE SOMEONE IS GOING TO BEAR THE COSTS

To be sure, well capitalized banks are in the interest of the country. We need to fix the banking sector and we need to do it fast. But this does not imply bailing out investors and bankers—they (not the taxpayers) need to bear the cost. Not only is a bailout extremely costly for the taxpayers, it also gets in the way of a speedy resolution. And it sows the seed of the next crisis. One of the causes of the current crisis is 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. Bankers were delighted to receive 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. Without it Merrill Lynch employees would not have received $4 billion in bonuses. So it is clear bankers like government money and they want more. But what is in it for taxpayers?

The first round of equity infusion and debt guarantees transferred $108 billion to banks’ investors. 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 did taxpayers received in exchange? One could argue they were spared a collapse of the payment system. But the FDIC could have intervened to save it at a much smaller cost to taxpayers. TARP was mainly sold as a way to sustain banks’ lending. But in that way it failed completely. As reported by the New York Times, bankers privately admit that they did not use the TARP money for new loans, but only to consolidate their balance sheet and survive longer. This finding is consistent with a study of the market reaction to TARP: the intervention does not create aggregate wealth, but only transfers it from taxpayers to financial investors. This effect can be most clearly seen 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. It means that each dollar donated to financial investors cost $1.36 to taxpayers, with no additional benefit. 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 real possibility of their banks failing might restart taking risks because they were offered a life line is wishful thinking. If the government really wanted to use the banking wreckages to restart the economy, it should have taken over these banks and directed the flow of credit, or should have poured in 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 this implies. And it would have required a massive amount of money.

**SOLUTIONS THAT COULD WORK**

Only solvent banks will lend and in October my rough estimate in *The Economists’ Voice* was $600 billion in equity just to recapitalize the top ten banks. I am afraid I was too optimistic. But this is assuming that the existing capital structure is maintained so that bond holders remain whole. Solvency can be achieved by working both sides of the balance sheet and to date little effort has been placed on reworking bank liabilities beyond simply adding more equity.

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.

First, recognize that you must take a position on who is going to bear the losses, and the faster you do this, the faster lending standards will return to normal levels. Second, rather than you choosing winners and losers, let the market choose these for you. What market mechanisms can you then use?

One solution is the “Plan B” that I advanced last Fall in *The Economists’ Voice*. 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 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 reproposed 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 been reconvened after the election, but there has been no discussion of this alternative that can save hundreds of billions of dollars to taxpayers.

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” (with lending etc.), along the line of the restructuring done in 1988 by Mellon bank. Ownership of these two entities will be allocated pro quota 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. If the losses are so severe as to trigger the FDIC to intervene to protect the depositors, the taxpayers will have to bear some of the cost. But unfortunately, this is what the insurance was designed to do. The good news is that these entities could be let 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 the sovereign wealth funds that tried to take advantage of the situation experienced enormous losses. In November 2007, for instance, when the Abu Dhabi’s sovereign wealth fund took a stake in Citigroup the stock was trading at $29 per share, while today 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 (at least on a massive scale)? First, because 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, 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 of a lower overall repayment for the debtholders.

This problem, however, 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. If it was possible to write a $700 billion check to Paulson, and...
if it is possible to approve a $825 billion stim-
ulus package, why is it not possible to pass a
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 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 tax-
payers (no small feat in a time of ballooning
deficits). Yes, we can Mr. Geithner, … if you
lead us there.

Letters commenting on this piece or others may
be submitted at http://www.bepress.com/cgi/
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