Decoding the Geithner Plan

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Timothy Geithner has announced his intention of making a full-scale attack on the nation’s banking problems. Clearly, the objective of making banks willing to lend again, with them paying due, but not excessive, attention to risks is the right one. To achieve this, not only do banks have to be confidant about their own financial health, they have to feel that there are no more pennies waiting to drop, the system is stable enough that asset prices will not fall significantly, so that they can start locking their money up in term loans. The Geithner Plan to stabilize the system should be judged according to whether it meets the test of the 4 Cs: being comprehensive, clear, cost-effective, and credible.

Geithner’s plan has four elements. First, it seeks to audit banks and measure how much capital they will need, with an offer to offer to invest government money in the preferred stock of banks that cannot raise private capital. Presumably, the government will close down unviable banks but we do not know how tough regulators will be. Moreover, the government seems to want to avoid roiling existing shareholders and bond-holders by talking about closure or announcing its intentions about sharing losses, but this creates substantial uncertainty in the market. It is important that this phase of the plan be effected quickly, with some burden sharing with existing investors where necessary, to restore clarity and reduce costs to the taxpayer.

Second, the plan seeks to buy toxic assets from banks through a Public Private partnership, thus freeing banks to raise new capital without new investors being worried about being saddled with further losses. This is the murkiest part of the plan – there is little trade in these “legacy” assets partly because private investors are unsure about the size of potential losses they will have to bear if they buy these assets, while banks are unwilling to sell at the prices on offer. Investors will want to know what share of the losses the government will bear before they participate. And the government will have to determine what fraction of the upside it will need so that the deal is fair. Too little upside and the taxpayer will end up subsidizing private investors, too much and the government will elicit little private participation.

The Public Private partnership does not absolve the government of assessing, pricing, and sharing the risk in these assets, and there is far too little clarity on how this will be done. A comprehensive plan must tackle these issues and show that there are sufficient resources available to resolve the uncertainty. A good first step would be to share reasoning used to determine the size of this program so as to build confidence that the plan can succeed.

Third, Federal Reserve programs to purchase securities issued against packages of loans (such as student loans, auto loans, and commercial real estate) will be expanded from $200 billion to $1 trillion. This will clearly encourage banks to make such loans, knowing they can securitize them, and can help boost lending, provided there are enough credit-worthy borrowers.
Finally, the plan praises efforts to help home owners. Yet there is little in the initial proposal that suggests any dramatic new initiatives. Perhaps this is appropriate, for other than facilitating the restructuring of mortgages when both borrower and lender are willing, many of the extant proposals seem to attempt to postpone the inevitable adjustment of house prices.

The plan should be evaluated not just on what it proposes, but what it does not touch. For instance, while there have been many calls to impose lending requirements on banks that take public money, such requirements would be crude, and may create more risk for taxpayers as banks are forced into unwise decisions. The plan takes an intermediate (and appropriately balanced) approach by requiring more transparency about bank actions, while not mandating lending. It also takes long overdue actions like banning banks that take public money from paying dividends.

As a whole then, the plan takes important steps in the right direction, but it is unclear in critical aspects. We do not know whether this is because the Treasury cannot afford to be too clear, or whether it is because the Treasury still has little idea about what to do. The coming days will tell.

Finally, the plan will need public and political support to be credible. This means that bankers and existing investors should not be seen as benefiting at the expense of the taxpayer, and that all the government investment should start paying off in the not too distant future. While the Treasury has resisted the urge to ceremonially sacrifice the bankers, this makes it even more imperative that President Obama’s political skills be used to sell the plan.

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