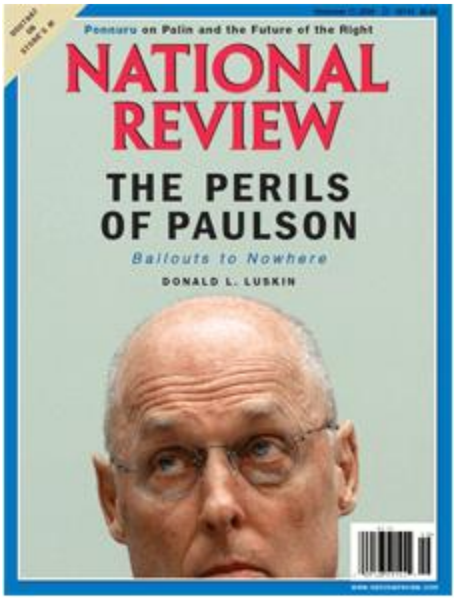

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Death by Rescue

How botched bailouts doomed companies that didn't need to fail

by Donald L. Luskin

The road to hell is paved with bad interventions. This year's emergency sallies into the banking system by the Fed, the Treasury, the FDIC, and the SEC have backfired. They were intended to ameliorate a credit crisis and to keep it from spreading. Instead they've inflamed the crisis into an outright panic that now has spread around the world and triggered a recession.

Conservatives may rightly object to all this government meddling in private markets on general principle. But the more salient objection is that government has botched it. The attempts to deal with failures at Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, AIG, Washington Mutual, and Wachovia were not rescues or bailouts at all — they were wipeouts, seemingly intended more to punish than to rescue. They were government takings of private property for public use — seizures of shareholder wealth in troubled firms in the name of saving the system — without the just compensation promised in the Fifth Amendment and often beyond the legal authority of the government agencies involved.

Each of these seizures was ad hoc, and most were carried out over a weekend in secret. And each was handled differently, with no apparent rhyme or reason as to which agency would be involved, which firms would be saved and which wouldn't, or whose ox would be gored. Stockholders almost always got zeroed out. Bank depositors and insurance-policy holders were always saved. But for bondholders, commercial creditors, derivatives counterparties, and securities-account holders, it was totally arbitrary — different each time. And as often as not, these exercises had powerful unintended consequences, with the government fixing one trouble spot only to create another elsewhere in the system.

The fact that government agencies that should have been rescuers became destroyers instead — and the utter uncertainty about how and when these agencies would exercise their powers — caused investors' confidence to collapse. Federal agencies unintentionally created an incentive structure that rewarded investor behavior that would exacerbate the crisis and punished behavior that would mitigate it.

'I'M FROM THE GOVERNMENT, AND I'M HERE TO HELP'
There were many causes of the credit crisis. Surely the Federal Reserve's keeping interest rates at below-market levels from 2002 to 2005 contributed to the undue growth of credit,

and congressional mandates on Fannie Mae and Freddie Mac intended to encourage low-income home loans contributed to the deterioration of mortgage-lending standards. It is also obvious that many banks took imprudent positions, recklessly leveraging their balance sheets to the extent that even a small correction would lead to large losses that would then ripple through the markets, causing even more losses.

It is clear who bears responsibility for rescuing the global financial system from collapse as such excesses unwind. Through the establishment of safety-net institutions such as the Federal Reserve and the FDIC, the federal government presents itself as the rescuer. So when action becomes necessary, government must do its job and do it well — even if some banks have behaved recklessly, and even if they have done so precisely because they've known they would be rescued. If the *Titanic* is sinking, anyone who promised to save it must save it for the sake of all those on board, even if it means also saving the life of the negligent captain who rammed an iceberg.

Now that Treasury is armed with $700 billion from Congress for more rescues, the risk is greater than ever that government will continue to make matters worse. Happily, it appears that Treasury secretary Henry Paulson has learned from past mistakes; so far, he is using his power wisely. Sadly, much of that power will have to go toward repairing damage from the botched rescues that went before.

The first major mistake, which established the template for all the mistakes to come, was Bear Stearns. In mid-March, Bear was beset by a classic bank run and faced failure. The Fed facilitated an emergency acquisition of Bear by JPMorgan Chase to head off the systemic risk that might arise from a disorderly collapse. The deal was announced on a Sunday night after a weekend of frantic negotiations. Morgan was to acquire Bear for a price of $2 per share — Bear's stock having closed Friday at $30. The Fed made a $30 billion loan to Morgan to buy Bear's portfolio of illiquid mortgage-backed securities, which came with a guarantee that the Fed would take the lion's share of any losses.

A key problem in the Bear deal was the price. As soon as the deal was announced at $2 per share, stockholders began protesting that they could probably recover more in bankruptcy. But bankruptcy was something the Fed couldn't allow to happen because of the systemic risks involved — it simply had to find an acquirer for Bear, and the low price made Morgan a very willing acquirer indeed. In other words, for the sake of the overall financial system, the Fed decided to sacrifice the interests of Bear shareholders to the interests of Morgan shareholders. Ultimately, under the threat of litigation, the deal got renegotiated at $10 — evidence that $2 had been far too low.

The Fed had rationalized the initial price with a "moral hazard" argument. The market, it reasoned, must be taught that a bank couldn't expect the Fed to bail it out after it had taken undue risks. It's hard to fault the sense of rough justice underlying that conclusion. But its unintended consequences would prove, in the end, to be extremely harmful — as is often the case when governments meddle in markets. The Fed, which was created almost 100 years ago specifically to save banks that get in trouble, had with Bear Stearns accidentally created an incentive structure to destroy banks.

When the Fed sets the precedent that it will, on a weekend when normal market processes aren't available, hand over a troubled bank to a competitor at a price well below its market value — below even its value in bankruptcy — there's no incentive to remain a shareholder at all. Long-term shareholders, who ought to be incentivized to stick with banks that run into difficulty, instead receive the message that they should flee at the first sign of trouble lest they be wiped out by the "rescue." Stronger banks, sovereign-wealth funds, and other private investors that might profitably help a troubled bank by investing in it learn instead to wait for trouble to boil over into crisis, at which time the Fed will practically give the bank away on a Sunday night.

What's worse, speculators get the message that they can push banks over the brink by shorting their stocks and spreading rumors, driving share prices so low that it becomes prohibitively costly to raise new capital — assuming anyone would dare invest new capital — and the Fed or some other regulator then has no choice but to step in and put them out of their misery. Such speculative attacks work on any bank the government deems "systemically important" — the new way of saying "too big to fail."

FALLING BY ONE

By creating a perverse incentive system that punished shareholder loyalty and courageous new investments while rewarding mischievous short sellers and rumormongers, the Fed created a situation in which any firm "too big to fail" suddenly became too big *not* to fail. Banks and other financial companies were beset by speculators, abandoned by their shareholders, and rendered unable to raise new capital, until some combination of the Fed, the Treasury, and the FDIC euthanized them. One by one they fell: Fannie, Freddie, Lehman Brothers, Merrill Lynch, AIG, Washington Mutual, and Wachovia.

Consider Fannie Mae and Freddie Mac. In mid-July, Congress rushed legislation to passage that gave Paulson authority to rescue the two troubled mortgage firms. He told Congress the authority would be like "a bazooka," and that simply having it meant he probably wouldn't have to use it. Three weeks later he used it. On the weekend of September 6–7, Paulson threw Fannie and Freddie into "conservatorship" — which is to say, Treasury took them over — wiping out what the day before had been $30 billion in shareholder wealth while making a few short sellers very wealthy.

Why did Paulson use his bazooka after all, and why on that weekend? The reason leaked to the press was that an expert forensic-accounting team had been poring over the GSEs' books and was shocked to discover accounting irregularities; in fact, they had discovered nothing that hadn't already been discussed in great detail in the financial press.

Over the weekend of September 13–14, the Fed and the Treasury found they couldn't arrange a private-sector rescue of Lehman Brothers, so the venerable investment bank was allowed to fail. Its failure set in motion destabilizing systemic consequences in global markets, including the failure of money-market funds that held Lehman's debt — precisely the consequences the authorities had said it was essential to avoid in the case of Bear Stearns. Those consequences will be felt for years to come as they play out in bankruptcy courts in jurisdictions around the world.

Two weekends later, having failed to save Lehman, a bank that needed to be saved, the authorities nearly destroyed Wachovia in the name of saving it — when it didn't need to be saved at all. The FDIC forced Wachovia to be acquired by Citigroup for $1 per share. As part of the deal, the government underwrote much of the risk of Wachovia's mortgage portfolio with taxpayer money. Just days later, Wells Fargo judged that Wachovia was still very much a going concern and offered to pay $7 a share for it, without asking for government guarantees. Wachovia shareholders and taxpayers should be delighted. Citigroup, claiming it had exclusive rights to negotiate a deal, is suing.

So why was Lehman allowed to fail? Statements from the Fed at the time suggest a belief — now, it seems, quite mistaken — that the system could survive its failure. More recently, Fed chairman Ben Bernanke has said that the Fed lacked the legal authority to do what would have been necessary to rescue Lehman. But that rings false, given that the constraints of legal authority were an early casualty of the credit crisis. For example, the Bear Stearns rescue hinged on the $30 billion "loan" to Morgan for Bear's mortgage portfolio, but it wasn't a loan at all — it was an outright acquisition, and it is far from clear that the Fed has any legal authority to acquire busted mortgage-backed securities. The Fed does have the authority to make loans, so the acquisition was disguised as a loan with the help of clever lawyers.

The authority for the Fed's acquisition of a controlling interest in AIG — again, dressed up as a loan — is even more dubious. The Treasury put up the money to fund the Fed's $85 billion injection into AIG — which has now swollen to $120 billion. The Fed was simply a convenient conduit for something Treasury wanted to do but would have needed congressional approval to execute directly. As an independent agency with broad and hazily defined powers, the Fed was better positioned than Treasury to put its signature on the deal. As for the Fed's independence — a cornerstone of its credibility as the most important and prestigious central bank in the world — its complicity with Treasury in the rogue AIG operation pretty much puts an end to that myth.

URGENCY, THEN INACTION

As each domino fell, the panic deepened and made it more likely that the next domino would tumble. Paulson and Bernanke sought to get matters under control with a massive and unified display of power — shock and awe, if you will — and thereby was born

TARP: the $700 billion Troubled Asset Relief Program.

Paulson spent two weeks convincing Congress and the American people that, unless he was immediately granted nearly unbounded power to throw $700 billion at the problem he himself had done so much to create, the nation would enter a depression. At the end of the two weeks — on October 3 — he got his wish. The moment President Bush inked his signature on the legislation authorizing TARP, Paulson should have announced that Treasury was buying hundreds of billions of dollars of troubled assets, in trades arranged over the previous two weeks. Instead, having stressed how urgent it was to act quickly, he did nothing.

Or next to nothing. Paulson put out a press release saying that Treasury, the Fed, the FDIC, and the SEC would have a meeting to decide what to do. And the Treasury website posted "procurement guidelines" for private-sector vendors seeking to work with Treasury on TARP.

The SEC put out a press release too. Having three weeks before enacted a provisional ban on short-selling — to halt the speculative attacks incentivized by the string of botched rescues — the commission announced that with the passage of TARP the ban would be lifted. Only an SEC lawyer could believe that the mere passage of a law giving Treasury authority to act would hold the avalanche of short-selling at bay.

Between Paulson's inaction and the SEC's ineptitude, the S&P 500 lost about 20 percent of its value in the week following the enactment of TARP. Why, Paulson must have wondered, didn't they greet us as liberators? It was time for yet more improvisation, once more on a weekend.

But this time Paulson got it right: Gone was the idea of buying troubled assets. Over the weekend of October 11–12, Paulson met with the CEOs of the nine largest and most powerful U.S. banks. Apparently he got very tough with them: He locked them in a room, reports said, and forced them to accept $125 billion in capital investments from the Treasury, with another $125 billion to go to smaller banks later. One has to suspect that this was a cover story, sleight-of-hand to distract attention from the fact that Treasury's investment was being made on the most generous terms imaginable. Consider that, three weeks apart, Treasury and Warren Buffett both made $10 billion investments in nonvoting perpetual preferred stock of Goldman Sachs. The difference is that Goldman's cost for Buffett's capital is about 18 percent per annum over the next five years. Its cost with Paulson is only about 7 percent. The other banks all got the same sweet deal from Paulson that Goldman did.

It is disturbing that there is not a single word in the TARP legislation that authorizes a direct capital investment in a bank. There are "provisions related to film and television productions" and an "exemption from excise tax for certain wooden arrows designed for use by children." But nothing about Treasury's buying stock in a bank.

Legal questions aside, Treasury's $250 billion investment in U.S. banks marks an important turning point. For the first time in this saga, an institution that is supposed to rescue troubled banks is actually rescuing troubled banks — without wiping out shareholders in the process.

This is the way the authorities should have handled the credit crisis from the very beginning, from Bear Stearns onward. If we're going to do bailouts at all, they should be real bailouts. And this one is.

This bailout is big, too, representing nearly 20 percent of total U.S. bank capital as reported by the FDIC. That $250 billion in fresh capital effectively grants the banking system the staying power to ride out the storm in something like $2.5 trillion in troubled assets, given that banks typically hold assets worth about ten times their capital. That's enough to cover every single U.S. subprime and Alt-A mortgage that isn't already owned or guaranteed by Freddie or Fannie, plus every single junk bond and leveraged bank loan in the world — with a couple hundred billion dollars left over. And that's only $250 billion of Paulson's $700 billion authority.

But then again Paulson, Bernanke, and all the rest have done a great deal of damage. And it's not just in the banking system, and it's not just in the U.S. The banking crisis has infected the real economy, turning a slowdown into a serious recession. And it's a global phenomenon. We won't get out of this mess quickly. But with Paulson finally doing the right thing, at least we can make a start.

About the Author

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