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The president's puzzle: Can he solve it?

Which strategy will Obama choose to combat the financial crisis?

SUMMING IT UP

William Rutherford

In August 2007 I was a guest on CNBC and was asked my views of the then-incipient financial crisis. I said that the Federal Reserve had to contain the crisis to the financial sector, and not let it seep into the credit markets and consumer spending. The key, I thought, was to contain the problems in the housing market because if the problem were allowed to spread, we would encounter many more problems.

In December 2007, the Federal Reserve, after a slow start, offered a variety of special funds to aid the housing, credit and financial markets. One of these funds was the Troubled Assets Relief Program. The purpose was to remove troubled assets from bank balance sheets and get the economy moving again.

Following this effort, we saw the failures of Bear Stearns, Washington Mutual, Lehman Brothers and many other banks. Wachovia Bank was sold to Wells Fargo, and Merrill Lynch was sold to Bank of America. Congress passed a $750 billion relief package. By December 2008, the federal government was injecting taxpayer funds directly into banks, insurance and auto companies as the focus of TARP and the stimulus package changed.

In 2008, equity markets had one of their worst years since the Great Depression, including a stunning 30-percent, 3,500-point drop in a three-week period in October, as the impact of the Lehman failure sunk in.

Now, with a new administration in the White House and with a clear Democrat majority in Congress, President Obama seeks a solution to this complicated mess. His choices seem to have narrowed to about three, with variations on each. They are: continue the current program, nationalize the banks or employ a "bad bank" or "aggregator bank" alternative.

The current program should be dismissed out of hand. It is clearly not working. Taxpayers have injected billions of dollars into banks with the expectation that banks would do what banks do: accept deposits, buy bonds, make loans and generally keep the credit markets working. So far, the banks have accepted deposits (except when there is a run on the bank, as happened in the case of Washington Mutual), but that's about it. Some have distinguished themselves by making exceptionally bad decisions. Bank of America paid more for Merrill Lynch than the combined companies were worth after the merger. John Thain, CEO of Merrill Lynch, asked for a $10 million bonus after the deal was inked, and then paid $4.5 billion in bonuses to Merrill Lynch executives. Bank of America was forced to ask the federal government for another $25 billion in taxpayer money to pay for the bonuses and other Merrill Lynch losses. Some banks have been good at promoting people who have lost billions of dollars. In December, Bank of America promoted the head of trading for Merrill Lynch after his department racked up about $7 billion of the firm's nearly $15 billion quarterly loss. Also, one of Obama's chief advisors, Robert Rubin, was paid $126 million during his tenure at Citigroup, and he claims no responsibility for anything that happened there.

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Lending has nearly stopped and credit markets are still struggling. What some of the banks seem to be really good at is destroying capital, paying out big bonuses, hoarding funds, and generally making the economy and housing market worse. We can expect they will be back for more taxpayer money soon.

Another alternative, sometimes discussed in Washington, is nationalizing the banks. This would involve Washington taking over the banks, crushing shareholders and bondholders, and assuming responsibility for the bad assets of the banks and also their operations. This alternative was used in Sweden several years ago when that country found itself in trouble. The strategy restored confidence in the banking sector and the Swedish currency, and the country got back on track. The Swedes highly recommend it. The U.K. is bumping up against this approach now. Needless to say, bank owners and executives do not favor this approach, and have expressed their opinions to politicians. Now, this approach does not have political support.

Another approach, which is gaining momentum, is a "bad bank" or "aggregator bank." The purpose of this approach would be to reassign the responsibility for all bad assets of banks to the federal government. This would indeed restore the health of the banks'

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financial statements, but would it get banks to lend? Based on their current conduct, I don't think so. I think they would continue to do what they are doing now – hoard cash.

Another problem with the "bad bank" plan is deciding how the bad assets would be valued. If the values were set too low, the banks would suffer additional losses and maybe need to raise more capital; meanwhile, the number of people willing to invest in banks is dwindling. So the federal government would likely again be assigned the role of investor. I think the assets could be valued by announcing to the banks that the government has a certain amount of money to buy bad assets, and to get your bids in if you want that money. Beginning with the lowest prices, the government would buy the assets until the money was gone. Weaker banks would have to ask for higher prices or go out of business or be bought. Banks that didn't get the funds they need at the prices they need would go out of business or be bought. Either way, the banking system would be purged and the stronger banks would survive.

Ah, but how do we pay for all this? It's a good question, and yet another rub. But there are precedents that could provide valuable experience. During the Savings and Loan crisis the government established the Resolution Trust Company, which took over the failed S&Ls. The whole thing was a badly managed mess, and a lot of nefarious things happened, but maybe we could learn from our mistakes and improve the system.

In order to pay for all the bad assets in the "bad bank," the government would have to use taxpayer funds, swell the liabilities on the Federal Reserve books or sell bonds. We might end up with a combination approach, but since they amount involved will be a number bigger than a trillion dollars, no doubt some bonds will have to be sold. With the government's balance sheet eroding and massive budget deficits as far as the eye can see, who would want the bonds? And what interest rate would they require? And what would happen to the U.S. currency? And what would be the effects on inflation?

In future columns I will address some of these questions, which directly impact you, your retirement and your family.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a five-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.