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No one dares call it nationalization

Yet the government’s recent Citibank actions say otherwise; however, there are other possible solutions

SUMMING IT UP

William Rutherford

As we all know, the Obama administration is wrestling with the banking and housing crises. U.S. Treasury Secretary Tim Geithner offered the administration’s solution to Congress, but the financial markets were not satisfied. Since then, the markets have sold off sharply. What is the solution to this problem? What is to be done?

One of the possibilities I mentioned in my last column was the nationalization of some banks. As I said, that approach does not have political support. Indeed the Obama administration has taken pains to say it supports a private banking sector. Federal Reserve chairman Ben Bernanke said in his recent testimony before Congress that the government would prefer a private banking sector.

However, I said previously that, for some banks, nationalization is inevitable – but it may be called reorganization or something else. Sure enough, the government just agreed to convert its preferred shares in Citibank into common shares, and will match new preferred share purchases dollar for dollar with private capital that the bank must raise. This will give the federal government nearly 40 percent of Citibank and make the government investment larger than the market capitalization of Citibank. The government has already invested more than $50 billion in Citibank and guaranteed $300 billion more of its bad assets. I don’t believe the last dollar has been given to Citibank in the bailout. This has been referred to as an investment, not nationalization, but if it looks like a duck, walks like a duck and quacks like a duck, then …

There are other possible solutions to this complex puzzle. Speed is of the essence, however, because the matters become only worse with each passing day.

I believe there are two areas that need to be addressed: home mortgages (where this problem started) and damage sustained by bank balance sheets and the capital markets.

The government’s failure was to sell Congress on the idea of the Troubled Assets Relief Program to remove toxic assets from bank balance sheets, only to shift focus to outright investments. The bank balance sheets were not improved and the capital has simply disappeared, sometimes haphazardly. Hundreds of billions of dollars later, the government still has not addressed the central problem on bank balance sheets: toxic home loans. As I have stated in the past, the housing problem is central to our other problems; it must be fixed.

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There is no first step, because all solutions basically require that actions be performed in tandem. We must get the bad assets off the bank balance sheets and we must stabilize the housing market. At the end of the day, this problem is fundamentally about house prices, which seems to have been forgotten in the race to save the banks. There are many fingers to point and much blame to pass around, but we need to move on and address the fundamental problems.

I would propose that the bad assets be moved off banks’ balance sheets into a new entity – an aggregator or “bad bank.” The assets would be priced, and the government would buy them from the banks and place them in the new entity.

The problem here is the pricing of the assets: If prices are too high, the taxpayers will pay too much for the bad assets; and if prices are too low, the banks will be unduly penalized and be left with capital adequacy at risk. Many solutions to this pricing dilemma have been proposed, and all have problems; however, I would propose that the government state that it has a finite amount of money to buy bad assets and that the financial institutions should offer the assets at their desired selling price. The government would then buy the assets at the price it wants to pay. Each institution would presumably know the price it needs obtain. Some institutions may not obtain the “right” price and would likely go out of business.

In my scenario, when the price is paid, the deal would be done – there would be no ‘do-overs’ if the price is too high or too low. The government would be acting in the role of financier of last resort, and would perhaps benefit or lose from the transaction, but the banks can move forward with clean balance sheets.

At the same time, the government must act to stabilize the housing market, and would at this point have every incentive to do so because it would own an entity full of bad loans. But the government must also take action to aid loans outside the “bad

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bank" or risk polluting all loans.

We already have a lending mechanism in place, so I don't think a new bureaucracy needs to be created. But the government does have to make money available for home loans at interest rates and terms attractive enough to begin to clear the inventory. Economists say this approach will have only marginal impact and others may say that it is too expensive, but the reason that I think it will work is that the government does not have to clear the entire inventory of unsold homes in order to stabilize prices. A start may well be enough. As buyers see home prices stabilizing, private buyers will reenter the market. I believe that as housing prices stabilize, lenders will reenter the market, and the government will not have to do all the heavy lifting. The government needs to see only that the newly energized banks are lending and that adequate capital is available for loans.

I imagine that there will be many critics of such a plan, but time spent criticizing doesn't make much progress toward a solution. I am not saying that it is better to do something rather than nothing, but I am saying that it is time to act and quit dithering; we have been doing that too long. The time to act is now.

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