The Paulson Plan: A useful first step but nowhere near enough

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The Paulson Plan addresses market illiquidity for toxic assets but the real problem is a lack of bank capital and the risk of widespread insolvency. Fixing this requires a government injection of new bank capital or a forced conversion of bank debt into equity. This column argues against the former as it would further socialise the US financial system. The Package needs some work, but Congress must stop its infantile posturing and act soon.

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The Paulson plan addresses market illiquidity....

The Paulson plan for using up to $700 bn of federal government money to buy up illiquid securities – mainly complex financial instruments such as asset-backed-securities, and in particular private label retail mortgage backed securities – represents an incomplete step towards dealing with the simplest part of the financial disaster that is threatening to engulf the US financial sector and, with a short lag, the real economy.

Paulson's TARP (Troubled Assets Relief Program), which I prefer to call TAD (Toxic Asset Dump) is a program designed to deal with market illiquidity. It is the most extreme manifestation of the authorities acting as what Anne Sibert and I have called *market maker of last resort* (MMLR) for systemically significant assets whose markets have become illiquid.

The MMLR supports market prices when either there is no market price or when there is a large gap between the actual market price of the asset, which is a fire-sale price resulting from a systemic lack of cash in the market, and the fair or fundamental value of the asset – the present discounted value of its future expected cash flows, discounted at the discount rate that would be used by a risk-neutral, non-liquidity-constrained economic agent (e.g. the government).

The MMLR can do this either by accepting the illiquid security as collateral for a loan or by purchasing it outright. The central bank can, in principle, act as MMLR when the support actions involve just collateralised lending, at the discount window, in repos or at purpose-designed liquidity facilities like the TAF (the Term Auction Facility), the PDCF (the Primary Dealer Credit Facility and the TSLF (Term Securities Lending Facility), but two conditions must be satisfied. First, *ex-ante*, the terms of the collateralised loan must be such as to give the central bank an adequate risk-adjusted rate of return (in excess of the rate on Treasury bills or bonds of the same maturity). It is not the job of the central bank to subsidise the borrowing bank ex-ante. Second, should the collateralised loan default (that is, both the borrowing bank and the issuer of the collateral default at the same time),

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Treasury, but it is the Treasury, and behind it the tax payer, that carries the credit risk.

It is possible for the Treasury, through the outright purchase of illiquid toxic private assets both to help the banks selling the toxic securities and the tax payer. This would be the case if it prices the securities it purchases above their fire-sale market prices but below their fundamental values. It is of course difficult to determine, when markets are illiquid, what the present discounted value of the future cash flows of a security is, even if the purchaser can always choose to hold the security till maturity, as the Treasury can. Even if the fundamental value could be determined somehow, I doubt whether the bulk of the US banking system could survive even with their illiquid assets priced at their fundamental value.

But the real problem now is lack of capital and the threat of widespread insolvency in the banking sector

As the full horror story of the bad investments and bad loans made by so many American banks has gradually been revealed, it is clear that the US banking sector faces an insolvency crisis and not just an illiquidity crisis. The number of impaired mortgages is exploding, and not just in the subprime and Alt-A categories, but across the whole residential mortgage spectrum. Impaired commercial and industrial mortgages are rising fast. Bad loans to the construction industry and to developers are mushrooming. ABS backed by automobile loans, by credit card receivables are tottering in growing numbers as are many other unsecured household loans. With the economy slowing down and probably entering recession soon, even exposures to the non-financial corporate sector will become more vulnerable.

In a nutshell, the US banking sector needs recapitalisation. “Banking sector” here includes the entire ‘shadow banking sector’, including such entities as the financial instruments division of AIG, that leveraged itself to the eyeballs and engaged in massive maturity and liquidity transformation. It needs to shrink overall (as regards employment, value added and especially as regards the number of banks and their leverage), but the much reduced number of banks that ought to survive this crisis badly need additional capital.

Where can American banks get additional capital today? A very few – really only the best-of-breed like Goldman Sachs, which raised $5 billion each from Warren Buffett (through his company Berkshire Hathaway) and from the issuance of new shares to American institutional investors – can get the capital they need at home, in the US; and even then it is expensive (I must declare an interest here – I am a part-time Adviser to Goldman Sachs International). Another possible source of new capital are the nouveaux riches of the Middle East and the Far East – the Sovereign Wealth Funds and large state-owned banks of China, Singapore, Korea and the Gulf States. The supply of capital from these sources is restricted by the rather disastrous (on a marked-to-market basis) first attempts late in 2007 and early in 2008 at diversifying out of Treasuries by these new deep pockets of the future. No doubt they will be back – these institutions take a long-term perspective and are unlikely to become the hapless captives of mark-to-market valuation, but the speed with which they gird their loins is unlikely to match the speed with which the current crisis moves.

That leaves just two sources of capital. The first is the US federal government. It could inject capital into US banks, say by purchasing preference shares. I would uncouple such a capital injection from Paulson’s toxic asset purchase plan. The market illiquidity problem is related to but not the same as the banks’ capital deficiency problem. The government could implement a system-wide capital injection by specifying maximum leverage ratios (or minimum capital ratios) for various categories of financial institutions. It could then inject capital in return for preference shares to bring all these leverage ratios down to the maximum levels (all the capital ratios up to the minimum levels).

My main concern about this way of injecting additional capital is that it would take the socialisation of the US financial system yet a step further. Governments may be able to run the deposit-raising side of an ordinary commercial bank. For the government to decide on other funding strategies, let alone on desirable lending and investment strategies is a bridge I hope not to cross.

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of some of the banks' debt into equity. Again, this could be done by the government specifying maximum leverage ratios (or minimum capital ratios) for various categories of financial institutions. Different kinds of debt then would be mandatorily converted into equity (preference shares or ordinary shares) with the proportion of each category of debt to be converted into stock inversely related to the seniority of the debt. These proportions would have to satisfy the requirement that all leverage ratios be brought down to the maximum levels (all capital ratios up to the minimum levels). There are infinitely many ways of skinning this cat, but it will not be difficult to produce a simple and fair solution.

In the mean time, the Congress fiddles while the financial sector burns...

Given the extreme urgency of the situation, the response of the US Congress has been truly astonishing.

The House and the Senate are acting as if this is politics as usual. Some grandstanding here. The threat of delays or even a filibuster. Amendments and modifications that range from the revoltingly populist to the terminally stupid with the disgustingly opportunistic and self-serving in between.

Admittedly, Secretary Paulson laid an egg by including the following phrase in his proposal: *"Decisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law of any administrative agency".* This reads as though it was personally written by Dick Cheney, the prince of absolute executive authority, no checks and balances, no accountability, no recourse. No administration that brought us WMD in Iraq and the torture camps of Guantanamo Bay and Abu Ghraib should expect anything but hysterical giggles in response to such a request. Not smart.

So, let's put in accountability and oversight and make sure than Paulson cannot donate $700bn to Nature Conservancy. But then let's pass the plan.

Ornaments to hang on the Paulson "Christmas tree"

Instead consider some of the ornaments Congress wants to hang on the Christmas tree:

· Caps on the executive remuneration for executives of companies making use of the facility created under the plan. A figure of $400,000 has been bandied about. From the perspective of fairness, 25 cents would probably too much for some CEOs. Indeed, tarring, feathering and running out of town may well be justified in certain cases. But it would stop the banks from making use of the facility for the very reasons that make the Congress want to punish the CEOs of the banks. If it is true, as many in Congress argue, that greedy and irresponsible CEOs have risked their banks, and imperilled the wellbeing of their communities and the stability of the US economy as a whole, in the pursuit of private gain, then these same CEOs would surely once again risk their banks, imperil the wellbeing of their communities and the stability of the US economy as a whole to avoid the $400,000 cap. "Duh", as my two teenage kids would say. I know there are too many lawyers in Congress, but surely there must be someone with half a brain?

· **Amendments to (personal) bankruptcy laws making it easier for homeowners who cannot service their existing mortgages to remain in their homes rather than face repossession.** This would be both inequitable (why should tax payers who stuck to mortgages they can afford be asked to subsidise the mortgages of those whose eyes were larger than their stomachs?) and inefficient (it would discourage future mortgage lending). Individual homeowners are also not important for systemic stability.

· **Other cookies and goodies for those with mortgages they cannot afford to service** (see the previous bullet point).

· **Equity stakes for the government in the banks it purchases toxic assets from.** This also would discourage banks from accessing the facility, if the acquisition of equity by the government represents a transfer from the bank rather than the quid-pro-quo for a capital injection by the government.

· **Warrants for the government** (options to acquire equity in the banks during some

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doesn't have weeks. It doesn't have too many days, as I see it. Unless it acts now, the freeze of the financial wholesale markets will intensify and the attacks on financial institutions will resume, first in the US, then in the UK, then in the rest of Europe and soon after everywhere in the financially connected world. Short selling restrictions/bans won't help.

If Congress continues its infantile posturing, the crisis of the financial system will mutate into a financial crisis paralysing lending by banks to households and non-financial corporations. Instead of a mere recession, there will be a long and deep depression.

At this stage of the game, liquidity concerns, while still omnipresent, have become the epiphenomena of underlying solvency problems in the financial sector. The US banking sector is seriously undercapitalised. The UK banking sector too is undercapitalised and so, albeit to a lesser-known degree (because of much impaired transparency) are the banking systems of the other European nations. Central banks therefore no longer play the lead part. The national treasuries (ministries of finance) backed by the tax payers and the beneficiaries of other public spending programs are taking centre stage. Unless plans to recapitalise systemically important institutions and to support systemically important financial markets are backed with the full faith and credit of the US Federal Government and the other governments in the North Atlantic Region, the coming year will be one to forget.

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