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First Thoughts on the New Resolution Trust Corporation

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The extraordinary turmoil and fear in American and other financial markets have triggered equally extraordinary policy actions and proposals in Washington and New York City. Markets have appeared on the brink of collapse, with substantial and harmful impacts on consumers, workers, investors, and businesses both large and small. And there is a great deal about the exact nature of the situation in financial markets that is unknown. Even those in government charged with addressing the crisis—such as Treasury Secretary Paulson, Fed Chairman Bernanke, and New York Fed President Geithner—lack full information.

What we know is that the nation faces a fast-spreading financial contagion and that the risk of that contagion to the broader economy warrants bold, comprehensive, and decisive actions that would otherwise not be contemplated. Under these circumstances, and given the serious threat to the financial fabric of the economy and the economic security of Americans outside the financial industry, it appears that decisive actions are warranted and appropriate. However, many important details remain to be settled, and taxpayer protections must be included.

The stunning breadth of the four measures announced by the Administration between Thursday, September 18, and Friday, September 19, indicates the extent of the concern. Perhaps the most important and most controversial measure is the suggestion that Congress create an entity similar to the Resolution Trust Corporation (RTC). Congress created the original RTC following the savings and loan debacle of the late 1980s and early 1990s. Creating another one requires action by Congress.

The three other measures did not require congressional approval and have already been put into place. These three are themselves extraordinary and raise important policy issues. They are:

- *Insurance for money market accounts.* The Treasury has offered, for a fee, to insure private money market accounts held at qualifying institutions. This insurance is similar in nature to the insurance provided for checking and savings deposits at commercial banks, savings and loans, and credit unions.

  This measure was necessary to restore confidence to money markets that have almost seized up entirely in recent days. However, to avoid distorting markets further and to protect the taxpayer, it is important that the Treasury sets the fee at a level that will properly price the insurance, which means in part that it reflects the level of risk of the fund's assets.

- *Temporary suspension of all short selling in certain equities.* Short selling is a common activity that under normal circumstances creates another

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avenue by which markets set prices. However, short selling tends to lead to enhanced volatility. Under normal circumstances, volatility is neither good nor bad. However, in the current environment volatility arising from short selling has added to the turmoil by distorting market corrections. Therefore, the Securities and Exchange Commission has properly suspended all short selling in the shares of over 800 financial service firms for at least 10 days and up to 40 days. It is important, however, that short selling be permitted again as soon market conditions allow.

- *Significant expansion of Treasury and Fannie Mae and Freddie Mac purchases.* The Treasury placed Fannie Mae and Freddie Mac in conservatorship some days ago because of their financial weakness. The Treasury has now expanded their capital so they can begin purchasing billions of dollars of securities at market prices to help other financial institutions correct their own portfolios. In addition, the Treasury will expand its purchases of mortgage-backed securities on its own account.

  As a rule, the federal government should not buy up private assets as though it were a private investor, either directly or through Fannie Mae and Freddie Mac. However, if the market for mortgage-backed securities seizes up, as it has done in recent days, then direct federal intervention is warranted to help restore normal market conditions. But such interventions should occur only in the event of a market breakdown and should continue only as long as the market continues to struggle to clear.

What Was the Original RTC? Created in 1989, RTC sold the bad assets of failed savings and loans and other thrift institutions ("thrifts") that had been taken over by their deposit insurance fund. For the most part, these assets were made up of real estate and securities that were difficult to move in the tight markets of the early 1990s. Good assets such as the thrift's deposits, offices, and easily sold assets were not given to RTC as they were usually sold to another financial institution at the time the original thrift failed. Between 1989 and its 1995 absorption into the FDIC, the RTC dealt with 747 thrifts with assets of about $394 billion. Overall, the cost to the taxpayers was estimated at $124 billion in 1995 dollars.

A key feature of the RTC was its use of equity partnerships under which pools of assets were partially bought by a private investor, who then liquidated the pool and split the profits with the RTC. Because the RTC's assets were sold gradually instead of being dumped on the market all at once, the total cost to the taxpayers was significantly lower than early estimates that losses could reach several hundred billion dollars.

Regardless of whether the new RTC is structured as a part of the Treasury Department or as a free-standing temporary agency, there would be similarities to the original RTC. While the original RTC liquidated mainly real estate that was left over from failed thrifts, the new RTC would be dealing with financial instruments based upon mortgage-backed securities. Some of these could be so exotic and complex that it would be difficult to give them any realistic value. However, despite the differences in investments, both entities would be dedicated to reducing the cost to taxpayers by orderly selling large pools of investments over time rather than allowing them to be dumped into the markets and sold at distressed prices.

Principles to Guide a New RTC. Congress and the Administration should follow key principles in structuring any new RTC-like entity in order to meet the goal of stabilizing the market with the least danger to the taxpayer:

- *The agency should have a limited scope and lifespan.* Legislation authorizing the new agency should delineate its duties in as much detail as possible to prevent "mission creep" into other types of financial activity such as financing low-income housing, promoting infrastructure development, or anything other than dealing with the current financial crisis. While some flexibility will be required in a time of so much financial uncertainty, any substantial change in the agency's mission should require additional congressional action and should be resisted. In addition, the enacting legislation should be clear that the new entity will have a strictly limited lifespan, after which it will be dissolved. This entity should exist only as long as it takes to

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orderly liquidate the assets it receives and not become a permanent part of government. The original RTC lasted for six years and was dissolved once its work was completed. Hopefully, the new RTC could complete its mission within three years and then be similarly disbanded.

- *The agency should not take an ownership stake in financial institutions.* While the new agency may exchange assets with private financial institutions, it should not own stock in them.
- *Any net profits should go to the taxpayers.* Over time, a substantial proportion of the assets held by any new RTC will likely be sold at a higher price than what the agency paid for them. In such a case, profits should go to the taxpayers to reduce the overall cost of the bailout. Under no circumstances should any profits be used to finance other public policy objectives.
- *Companies should pay for this assistance.* Any assets acquired by the new RTC as part of the process of taking these investments off the balance sheets of financial institutions should be purchased at a discount to their true worth. Alternately, companies using the new RTC could pay a significant fee for those services. Under no circumstances should companies receive these services for free or an inadequate price.
- *The agency should operate using private entities wherever possible.* The purpose of the new RTC should be limited to purchasing and holding poor quality assets, with sales being handled through private entities through either equity partnership or on a contractual basis.
- *The legislation should be kept clean.* Congress should not attach legislation on other subjects to the bill creating the new RTC. These include such items as increasing unemployment insurance, changing capital gains taxation, allowing bankruptcy courts to alter the terms of mortgages, or anything similar. This bill is the response to a major crisis and not an excuse for legislators to advance their pet projects.

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