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The Financial Bailout (and the New Resolution Trust Corp.) Must Restore the Markets and Protect the Taxpayer

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The House and Senate must have two objectives when putting together their versions of the financial bailout proposal made by the Treasury and Federal Reserve: They must (1) restore the markets and (2) protect the taxpayers. Congress should act clearly and decisively to address the turmoil in the financial markets and not burden this legislation with other issues, problems, or projects.

These objectives should be resolved in the regular order of business. This legislation must not become a Christmas tree. If it does, it will likely backfire, and the intentions of either or both objectives will fail. Sadly, the Senate's version is already on the wrong track, and the House's is likely to follow suit.

The Good and the Bad in the Treasury Draft Proposal. While the new Resolution Trust Corporation (RTC)–like authority will need a certain amount of flexibility if it is to succeed in its mission, neither the RTC nor the Treasury secretary should be given a blank check or be free of responsible oversight. This is true regardless of whether the new authority is structured as an independent agency or as a subsidiary agency of the Treasury Department or another existing agency. The new RTC-like authority must:

- *Have strict oversight over all the new RTC's activities.* The new RTC should not operate without close and continuous oversight. While Treasury's draft proposal would exempt the new RTC from judicial or other oversight, such a move would be a serious mistake and should not be approved. Instead, Congress should establish an independent council of financial professionals to provide regular oversight of the RTC. To assure its independence, the new oversight board should not include representatives of either Treasury or the Federal Reserve. This council would review the agency's activities with specific firms and securities. This oversight should allow the RTC to act quickly and decisively. This oversight counsel would augment with professional expertise whatever oversight Congress chooses to perform on its own.
- *Be able to exercise rights of the purchased securities.* The new RTC should not be just a passive holder of these securities. Instead, it should be allowed to restructure them or take any other actions to protect the taxpayers' interest that any other holder would be able to do. This includes taking a role in managing assets underwritten by a financial instrument and refinancing some asset classes if this reduces the costs to the taxpayers.

This paper, in its entirety, can be found at:
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- *Be able to hold assets without sunsets.* While the draft legislation wisely requires the new RTC to end its purchasing activities after two years, it also allows the agency to continue to hold securities after that date. This ability to hold assets until they can be sold for a better price instead of being required to dump them at a set date is key to the taxpayers' ability to receive full value from this entity. Both a limit on the purchase time and no limit for holding assets should be included in any final legislation.
- *Allow asset sales over time to limit losses.* In order to ensure that taxpayers receive the best value for the funds given to the new RTC, that entity should be allowed and encouraged to sell, restructure, or otherwise liquidate them over time. While the new RTC should be expected to liquidate its assets as rapidly as markets will bear consistent with the taxpayers' interest, it should not be subject to an artificial time horizon. If it is forced to essentially dump securities into the market, this will force down prices, thus further destabilizing the market and increasing any costs that would be borne by the taxpayers.
- *Limit taxpayer exposure.* While the new RTC must have flexibility to stabilize the financial markets, it must not be void of any limits whatsoever. The Treasury's proposal included an authorization limit of $700 billion—an estimate of what it would take to have the markets functioning again—that limits the costs to the taxpayer.

Ideas Missing from the Treasury Draft

- *Severance packages should be at risk.* In order to ensure that incompetent executives do not benefit from their criminal mismanagement, damaged parties should be encouraged to use their existing legal rights to file civil suits to recover bonuses or termination compensation obtained in violation of law or in breach of their fiduciary duties.
- *Additional limits.* To reduce the possibilities of moral hazard, additional limits beyond the dollar amount should be included. What started as a housing problem has infiltrated to other areas of the financial markets. So, while the new RTC should have flexibility to stabilize the markets, it should purchase securities only at a deep discount, where the market for the security is having difficulty clearing. This will exact a cost on the asset holder and ensure that only dysfunctional markets are eligible.

A Clean Bill Is Essential. As Congress considers this legislation, it is hearing from many quarters about additional and often extraneous proposals various members and special interests want to see added. Some of these include otherwise worthy proposals such as indexing capital gains for inflation, related but foolish proposals like adding funds so community organizations can purchase more idle private property, and the truly absurd like adding bailout money for the Big Three automakers. In addition, one suggestion is to attach the whole package to the Continuing Resolution to provide the funding needed so the federal government can continue to operate.

To show that it can act decisively, Congress should pass a clean, standalone bill addressing the immediate financial market issues only. If the bill is weighed down with other proposals, then the President should veto it and force Congress to come back and do it right. The Senate's language takes a bad step in that direction, and the House proposal contains similar worries.

Proposals in the Senate Version That Should Be Avoided. Sadly, the Senate failed to resist the temptation to load up the legislation with its own pet provisions, and including them would be a serious mistake. The new RTC should focus on restoring the markets, not on providing funding for other programs or serving as a platform for other goals. Already, the draft Senate legislation, which has been endorsed in general by House Financial Services Chairman Barney Frank (D–MA), includes a number of these bad ideas. Congress should avoid the following misguided provisions:

- *Provide capital to financial institutions in return for equity.* As proposed in the Senate draft, contingent shares of either debt or stock would be issued to Treasury at the time a financial institution sold bad assets to the new RTC. If the assets sold for less than what Treasury paid for them, then the shares or debt in the amount of 125 percent of the loss would become the property of the agency. Government ownership of financial insti-

tutions should be avoided, and bureaucrats should not have a say in the management of any firm.

- *Allowing bankruptcy courts to revise mortgages.* It would allow bankruptcy judges to arbitrarily reduce mortgage payments by either reducing the interest rate to the current market level or reducing the amount owed to the current value of the house. Since mortgages are secured by using the house as collateral that could be sold in the event of a default, bankruptcy courts until now have given borrowers the choice of either paying the mortgage contract as written or surrendering the home to the lender. Such a move builds in a greater chance that the mortgage contract will not be paid as agreed. In order to protect their shareholders, financial institutions must price that uncertainty and add it to the cost of a mortgage. As a result, it will be much harder for new or low-income homebuyers to find mortgages, and all homebuyers will find it more expensive to get a mortgage.
- *Placing caps on executive compensation.* While legislators and others are understandably angry at the financial executives who caused the problem, a pay cap will be counterproductive by driving the most talented executives to companies not affected by the proposed bailout. Placing weakened firms in the hands of lesser talent just increases the chance that the firms will be mismanaged. Pay should be decided by the company, its shareholders, and the executive, not managed by a congressman or a bureaucrat. In addition, every congressional attempt to impose pay caps on executives has failed because the market devised new ways to pay them.
- *Diverting funds from the new RTC to pay for other programs.* This provision would require that 20 percent of any profitable transaction would be deposited into a special fund that pays for low-income housing. This would apply regardless of whether the overall activities of the new RTC are profitable, which is highly unlikely. This provision would only increase the cost to the taxpayer. In addition, it circumvents the usual appropriations process, thus making it harder to keep track of spending.

Other Provisions That Should Not Be Added

- *Using the bill to impose new regulations on financial firms.* While the current financial regulatory structure is archaic and needs to better reflect the current state of the industry, this should be done through considered, well-reasoned effort, not as a knee-jerk reaction to the current financial situation. The financial industry should not be "Sarboxed" in the same way that the accounting industry was damaged by Sarbanes-Oxley.
- *Requiring firms to raise capital.* A number of firms have already fallen short in their attempts to raise new capital, and this approach is unlikely to have much impact as a stand-alone reform. Instead, it would be likely to force yet more firms into cut-rate mergers.
- *Easing capital standards.* One of the primary causes of the savings and loan crisis in the early 1980s was Congress's decision to reduce their capital standards under the theory that they would grow out of the problem. Such a move failed then—in fact, it added to the problems—and would be no more successful now. A major problem today is the loss of confidence in financial institutions, not their capital levels. For instance, HBOS in the U.K. was forced into a merger despite its being well capitalized and exceeding minimum capital standards.

Keep the Right Focus. Members of Congress should focus on restoring the financial markets, and they should do so with the interests of the taxpayers at the forefront. These two critical goals can be achieved by ensuring the new RTC-like authority has the flexibility it needs to address the turmoil in the financial markets under a stringent and appropriate level of oversight and with limits firmly in place. The legislation should not become a springboard for funding for other programs or as a platform for other goals. Such measures will not restore the markets, and they will not protect the taxpayers.

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