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Treasury's Bank Capital Purchase Program: Avoiding a Dangerous Legacy

David C. John

Last week, the Treasury Department announced a new approach to addressing the crisis gripping financial markets: the direct purchase of equity stakes in U.S. banks in order to increase the capital levels of those institutions.

While it is a potentially effective step toward rebuilding confidence in the banking system and restarting the credit markets,[1] the action is also a dangerous one. Policymakers must ensure that the result is not a legacy of political control of the financial system, threatening the efficiency of markets and the principle of private ownership.

Under normal circumstances, the very concept of direct government purchase of bank stock of any type would be unthinkable and unacceptable. That is no doubt one reason the Treasury initially contemplated only the purchase of troubled, non-equity assets for its Troubled Assets Relief Program (TARP). But the persisting and severe disruption in financial markets led policymakers to take stronger action.

Moreover, to a large extent, the hand of U.S. policymakers was forced by overseas governments that provided similar capital programs to their banks. If the U.S. government had not established this program, foreign banks would have been seen as safer, and ours would have been at a disadvantage. Subsequently, large depositors and investors would have moved their money to the foreign banks.

However, the U.S. should not allow international pressure to determine its financial regulatory policy. The U.S. government's responsibility is to develop and implement policies that are in our national interest, not to make those interests second to international opinion. While it is reasonable for governments to consult during an international financial crisis, no government should be expected to take actions that put its own citizens' interests at a disadvantage.

The program sparked a generally positive reaction in financial markets and appears so far to be effective. But as a matter of principle, the government should not be allowed to control or unduly influence the management decisions of private banks through partial ownership in them. A banking system free from such government control is an essential part of a free market economy.

In order to minimize this danger, policymakers should stake out clear boundaries for the bank capital system that must not be crossed:

- *It Must Be Temporary.* The program must not lead to either a permanent government ownership stake in financial institutions or government meddling into banks' business decisions. The overall program must have a definite and reasonable termination date, and any restrictions imposed upon banks or their management should end with the program.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm2110.cfm

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- *There Must Be No Attempt to Allocate Credit.* Interference in credit allocation or other business activities must be avoided. The government's role must not extend to bank lending policies (e.g., lending criteria, specific loan decisions, or decisions as to lending amounts). Press reports indicate the federal government plans to—at least indirectly—extend its influence inappropriately into these areas. Financial institutions should seek ironclad assurances that this is not the case before they agree to participate.
- *Any Government Investments Should Include Only Nonvoting Preferred Stock.* Any government ownership stake must include only nonvoting preferred stock—stock that does not allow the holder a stockholder vote—and not any form of common voting shares. No government representatives should be placed on a bank's board of directors. The program currently meets these restrictions.
- *It Must Be Voluntary.* Participation in the program by individual banks must be fully voluntary, and banks that participate should be able to repay government investments at their discretion at any time. However, if a bank does not join and then subsequently fails, management should be liable for at least some of the costs of its resolution. Press reports indicate that while no bank has been formally required to participate, substantial government pressure was applied to induce them to do so. Similar pressure may have been applied to other banks. Such government coercion is inconsistent with what should be a voluntary program and sets a very troubling precedent.
- *Any Restrictions on Executive Pay Must Be Strictly Limited.* Modest restrictions on dividend payment make sense to protect the taxpayers' investment, but limits on executive pay, bonuses, and termination benefits encroach on the principle that government should have no role in the management of these private firms. Thus such limitations are appropriate only if participation in the program is truly voluntary and only if the limitations themselves are temporary and limited and have a definite expiration date.
- *Taxpayers Should Share in Any Profits.* It is appropriate as a condition of participation that banks accepting taxpayer money should provide the program with warrants for future stock purchases that can be sold to private investors to reduce the long-term costs of the program.

Preserving Independent Institutions. Because the recent turmoil in the financial system threatens the operation of the credit markets and could seriously damage the economy, solutions that would be anathema at other times may be justified. The financial situation remains serious, and further steps may be necessary. As a result, policy makers should give the Treasury Department and the financial regulators the flexibility necessary to act.

However, those actions must be carefully controlled and limited in both time and scope so as to preserve over the course of this situation the free market principles and independent institutions that are necessary for America's economic health.

—David C. John is Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

1. The bank capital purchase program was one of many programs that were announced by Treasury last week. FDIC's temporary deposit insurance coverage of all amounts held in non-interest-bearing transaction accounts and its temporary guarantee of bank debt are both appropriate responses to the current financial turmoil. Similarly, the Federal Reserve's temporary commercial paper funding facility is an important step toward restarting the credit markets.