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Obama's Bank Bailout Plan: Not Ready for Prime Time

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The much-anticipated debut of the Obama Administration's bank bailout plan was correctly viewed as a flop on both Wall Street and Capitol Hill.

As announced Tuesday by Treasury Secretary Timothy Geithner, the plan is a grab bag of policies of doubtful effectiveness and uncertain consequences financed with \$2 trillion or more in taxpayer dollars. To make matters worse, key elements of the plan were nothing more than placeholders lacking any meaningful substance about how they would be structured or work.

The one thing that does seem certain is that the massive new programs will increase Washington's control over the financial system, placing politicians in the role of bank managers and hedge fund investors, to the long-term detriment of consumers and workers.

More Questions Than Answers. Geithner has waved off criticism of the problems with the plan, citing the danger of a complete collapse of the financial system. But in fact the Obama plan in many ways seems crafted as much as a further effort to stimulate the economy than as a financial stabilization measure. Rather than wave the red flag of emergency, policymakers need to carefully consider the costs and dangers of the proposed actions.

Among the problems with the plan:

- **Massive purchase of "toxic assets":** The plan includes \$500 billion to establish a "Public-Private Investment Fund" to purchase "toxic assets" from banks. The initial \$500 billion could

grow to as much as \$1 trillion. No detail has been provided on how this would work, but in some fashion Treasury would provide incentives for private investors to purchase bad assets from banks. Although the plan is intended to be a public-private partnership, how private money will be induced to participate in the program is unexplained. The general concept would be similar to the "bad bank" plan the Administration had earlier considered but with the acquisitions filtered through the private sector.

This, however, still leaves the most critical questions unanswered:

How will the purchase price of these assets be determined? There are literally hundreds of asset classes the fund would have to purchase, many of which are extremely complex securities that were difficult to price in the best of times. By definition, the "toxic assets" at issue are those that banks have been unable to set a value for, so there is little reason to believe that government intervention can magically solve this problem.

How will the costs and potential profits of this new type of entity be divided between taxpayers and potential private investors? The answer to this

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question will determine whether private sector money will participate and whether the taxpayers are taken for another ride financially.

Even if these questions are resolved, the approach will take a lengthy period to actually begin operating, and during that time, it will do little to mitigate the toxic effect firms are experiencing from these assets.

- **Expansion of a new and untested asset purchase plan:** The plan expands Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) program from \$200 billion to \$1 trillion. Announced on November 25 by the Bush Administration, when operational the TALF will loan money to holders of asset-backed securities collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. It is intended to stimulate the issuance of new asset-backed securities and thus additional lending. Tuesday's announcement also expands TALF to cover commercial real estate and residential lending. Since the smaller program has just gone into effect, it is unclear how well this approach will work.

There may also be unforeseen consequences from this plan. Policymakers must ensure that this program does not encourage bad lending decisions of the sort that—at least in part—contributed to the present crisis.

- **Refinancing delinquent mortgages:** Geithner also issued a vague statement that the Administration would help refinance delinquent mortgages. Like most of the plan, few details were given. Under any circumstances, however, such an initiative would be not only difficult to administer but more importantly likely to encourage future abuse of the mortgage finance system. Mortgage financing is complex to begin with, and the many types of mortgage-backed securities add yet more layers of complexity making execution and administration of this plan highly questionable. Moreover, just how the Administration would keep this massive program from rewarding borrowers who intentionally abused the system—by lying on mortgage applications, borrowing to speculate, or draining their equity to

live well above their means—at the same time as it helps those who are in trouble through no fault of their own remains unclear. Rewarding those who abused the system sends a strong message that those who sacrificed to pay their mortgage on time should have taken the easy way out.

- **Political interference into business decisions:** The plan, as announced, contains a number of mandates and restrictions on bank operations, including limits on purchasing healthy institutions, salary caps, and caps on dividends. These restrictions, however, are likely only the first steps toward a vastly increased government role, opening the door to additional political micro-management.
- **Lack of any credible exit strategy to return financial services and lending activities to private-sector control over time:** Given the size of the TARP programs and the level of political interference that they are likely to cause, this element must be an essential part of any financial rescue plan.

There is, however, at least one potentially positive element of the program:

- **Stress-testing bank assets:** The plan to have federal banks regulators jointly examine the asset quality of all banks with more than \$100 billion in assets is a good idea. This covers the 15–20 largest banks and the ones that appear to impose the greatest risk to the financial system. A unified regulatory presence is valuable as it would eliminate both contradictory regulatory priorities and the chance that some key element would fall in the cracks between various agencies' jurisdiction. "Stress-testing" the assets to find what problems will develop if the economy continues to deteriorate will make the results even more credible, thus enabling the market to determine the actual risk each bank faces.

The Administration's plan is deeply flawed and in some ways repeats the mistakes made by the Bush Administration and then-Secretary Henry Paulson. Looking strictly at the process, its only improvement over the Paulson era is that, so far at least, all of the programs were announced at once instead of being revealed on a near daily basis that seemed structured to disrupt the financial markets. Unfortunately, Geithner asserted in his remarks that

he expects the policies to adapt over time, thus signaling to markets a continuing government-generated uncertainty reminiscent of Paulson. Not surprisingly, the Geithner plan seems to have had the same result as the Paulson plans in that stock values of financial institutions dropped by as much as 20 percent in a single day.

Waving the Flag of Emergency. Responding to critics of his plan, Geithner has argued that, despite its massive cost and certain flaws, the plan is necessary to avoid a “complete collapse of our financial system.” The banking system is still fragile, and the Administration should be watchful and ready to respond as appropriate. But there is not an imminent threat of a collapse. Financial markets are impaired, but—despite the rhetoric—no substantial markets are “frozen.” Instead of forestalling an imminent collapse of the system, the purpose of TARP will morph under the Administration’s plan into yet another effort to

stimulate the economy. This kind of intervention is ill-suited for that goal.

Today’s problems are real and certainly should not be minimized. This, however, provides further reason for policymakers to carefully evaluate the costs and dangers of proposed actions rather than to ignore them under the flag of emergency.¹

Return to Sender. The Administration’s financial bailout strategy announced by Timothy Geithner, despite some positive elements, is filled with incomplete and unsound policy proposals financed by trillions of taxpayer dollars. The Administration should recognize that this plan is flawed and send it back to the Treasury Department’s drawing boards.

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1. James L. Gattuso, David C. John, and J. D. Foster, Ph.D., “TARP and the Treasury: Time to Allow Markets to Work,” Heritage Foundation *WebMemo* No. 2131, November 14, 2008, at <http://www.heritage.org/Research/Economy/wm2131.cfm>.