DOC. N.º 27

Real Time Economics

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7:31 am ET
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Guest Contribution: The Real Geithner Plan, a 'Nuclear Option'

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By GUEST CONTRIBUTOR

*The Obama administration is seeking broad new resolution authority for banks, **Peter Boone** and **Simon Johnson** argue that the powers should be approved by Congress and used quickly and decisively. Boone is chairman of **Effective Intervention**, a U.K.-based charity, and a research associate at the Centre for Economic Performance, **London School of Economics**, and Johnson is a former **IMF** chief economist, and is currently a professor at **MIT Sloan School of Management** and a senior fellow at the **Peterson Institute for International Economics**. They run the economic crisis Web site **http://BaselineScenario.com**.*

The Obama administration last week proposed draft legislation for a "**resolution authority**" that would effectively permit the government to liquidate or restructure large systemic financial institutions. If passed by Congress, these powers would allow the governments to treat nonbank financial institutions more like regulated deposit-taking banks. This authority offers a clear path to recapitalize institutions without using taxpayer money and therefore avoiding some dimensions of moral hazard but, if implemented poorly, the existence of this "nuclear option" can cause panic in financial markets and substantially delay recovery. This fear may be with us already — despite all of the material and moral support already on the table, the market is pricing in the highest ever risk of default for Citigroup senior debt, i.e., about a one in three chance over the next five years. (**See the credit-default spreads for major banks.**)

Imagine what happens when these powers are passed. The U.S. Treasury and FDIC would immediately have the tools need to walk into America's largest financial institutions, such as Citibank or Bank of America, and liquidate them, or rewrite their contracts and capital structures. Such powers are clearly useful: if the banks are undercapitalized, and private money is not available, then the government could force creditors to swap claims into equity, thus instantly recapitalizing the banks while avoiding use of taxpayer funds. With such steps, the problem of moral hazard, where creditors to banks are bailed out by taxpayers, would at once be forgotten. Shareholders in banks would lose through dilution, some (unsecured?) creditors would lose with debt-equity swaps, while the nation would be better off having a well-capitalized banking system. The banks would remain private but now be controlled by (ex)creditors.

However, today these powers don't exist, and none of us know exactly how this authority would be used if it ever lands on Mr. Geithner's desk. We'll now have a healthy debate in Congress and then see revised versions passed and signed into law. But as this debate proceeds, creditors and shareholders in all such institutions will be nervous. We'll be giving the Treasury a "nuclear option" and no one can be sure who is safe. A natural reaction by clients and investors of these banks will be to edge towards the exit immediately and to stay away until the dust has settled. It won't matter whether institutions are solvent: Due to the uncertainty and risk of losses, investors and clients may run. We've seen repeated waves of such panics over the last year, and we can live through them, but each successive one hurts the institutions we are trying to save and delays recovery.

What should the administration do to prevent the panics that can ensue from this legislation? First, if they plan to use it soon, they need to pass this legislation quickly. There is good logic behind requiring creditors to bear part of the cost of restructuring, but we can't afford to have this hanging over credit markets for months to come.

Second, once passed, the new authority should be used. There is no point in incurring the political and financial costs of passing this legislation now unless it is really needed.

Third, as in any major crisis, the aim should be to use this weapon once and decisively. If the government first hits one "weak" institution then another, and piecemeal restructures the sector, then investors and creditors will constantly "game" the system. This will drive down share and debt prices, forcing the government into action, gradually moving down the chain of institutions. We've seen this with successive panics at Bear Stearns, Lehman, AIG, Citigroup, etc. The most solvent institutions today could be made insolvent through higher credit costs brought on by the uncertainty, and the recession will be deeper.

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To be decisive, the government needs to implement this authority on large scale at once. For example, they could use a very rigorous stress test to triage institutions (i.e., more serious than the current stress test). Those that would be clearly insolvent in the face of a severe recession can be intervened over a weekend. The government could force a debt-equity swap to recapitalize the institutions, and then reopen them the following Monday as highly capitalized entities. While not all creditors with the same seniority would be treated equally — this would be a major difference and potential advantage relative to bankruptcy — the benefits of rapid actions can be justified for the economy as a whole. The institutions that are solvent, but require more capital, could be given a short timeframe to raise funds in private markets. If they cannot raise funds, the government could still intervene. With a gun to their head, there is no doubt they will find new capital, at very low share prices, that will ensure they are highly solvent.

This route to recapitalization would not be pleasant. Bank shareholders and creditors will cry foul. There will be several months of turmoil in markets, and there will be substantial disruption since bond holders and some creditors may be required to take losses when they receive equity. It will also send shockwaves to other undercapitalized institutions around the world, and could lead to their share and debt prices falling in anticipation that other governments will follow America's example.

However, it is surely better than doing nothing, or too little, and waiting to see what happens. America needs a well capitalized financial system to restore confidence in general and the flow of credit in particular. Given there is little chance of new funding for banks from Congress, there is no easy path to recapitalize banks. Creditors probably do have to pay — this legislation will simplify and help manage that process. Let's hope the Treasury understands how to use the weapon it is seeking.

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CLEAR POST

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9:41 pm August 1, 2013

http://www.customizedjerseyforsale.com/ wrote:

"This time, I really have always been keeping a low profile." Anthony said in an interview, "I hope the management to do their thing and this summer, we got Metta World Peace addition Bargnani this transactions also earned, he can help us on the court opened the space coupled with JR's return, we basically retain the core team. " Last season, Customized NFL Jerseysthe Knicks in the regular season record of 54 wins and 28 losses and all the way into the Eastern Conference semifinals, but was eventually eliminated the Pacers. Anthony is currently two years left on his contract, but he can choose out of contract in the summer of next year and become a free agent.

2:26 pm September 15, 2009

Anonymous wrote:

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A shadow govt began the very year of our independence. Kissinger plans to prime Obama for the One World Order. Research the REAL facts of the Federal Reserve, Council on Foreign Relations, International Monetary Ffund, Illuminati, Tri-Lateral Commission, the Bilderbergs, etc. Don't kid yourself. They will resort to force.

9:29 pm April 16, 2009

doonousia wrote:

nice, really nice!

7:48 am April 7, 2009

Paulie wrote:

What would this do to commercial paper issued by these financial institutions? Isn't CP unsecured? Have we extended the guarantees of the money market funds? Thought it was only if you "held it at a certain date."

10:48 pm April 1, 2009

Tall Guy wrote:

Let em have the powers...all they want...they are fixing the wrong end of the horse...it is the CONSUMER who needs fixing...think about it from the perspective of say, 2014...looking back, the banks are PRISTINE, CLEAN and READY FOR ACTION...and outside, is the consumer...still laden with the sack of debt...garnered from spending 8 years worth of income in...4 years...