Life Boats for the Banks—Let the Holding Companies Swim

MICHAEL CRAGG AND GEORGE OLDFIELD

No solution to the banking problem and our accelerating economic meltdown can exist until policy makers and the general public acknowledge that U.S. bank companies still have unfunded losses of approximately $810 billion.[1] This $810 billion balance sheet crater exists despite the approximate $790 billion in new capital raised by bank holding companies since 2007.[2] However, the balance sheet craters in bank holding companies do not necessarily imply the insolvency of the banks themselves.

Dr. Michael Cragg is a principal of The Brattle Group, and holds a Ph.D. from Stanford University and an M.A. from the University of British Columbia. Dr. George Oldfield is a principal of The Brattle Group, and holds a Ph.D. and M.A. from The Wharton School of the University of Pennsylvania.

Banks and bank holding companies are not identical. Ultimately, holding company solvency requires that the $810 billion in unfunded losses must be realized either by bank holding company shareholders, holding company creditors, or taxpayers. Without addressing this problem by isolating solvent banks from the losses of their holding companies, credit markets will remain tight and monetary policy ineffective. Other holding company subsidiaries like finance companies, insurance companies, and SIVs provide credit to borrowers along with the bank subsidiaries. Indeed, nonbank financial institutions outside bank holding companies do so as well. But every nonbank credit advance rests ultimately on bank credit first supplied to the nonbank by a bank, then advanced and multiplied through the nonbanks. Thus solvent banks are the foundation of the economy's whole credit pyramid.

ANALYSIS OF PROPOSED SOLUTIONS

What are the proposed solutions? Shell game number one—also known as TARP—involves providing equity capital to bank holding companies, but not necessarily to banks. On net, the $329 billion capital injection from TARP, much of which were loans or preferred stock and not common equity, was not sufficient to close the hole in bank holding company balance sheets.[3]

Shell game number two—also known as TAF—involves the Federal Reserve auctioning off loans that must be fully collateralized. Again, cash goes into the bank holding companies but like-valued assets come out, and on net, the $810 billion hole remains. Shell game number three—the Fed's Commercial Funding Facility, works the same way as TAF—it provides cash liquidity to banks, without solving the real problem of unfunded losses.

Shell game number four now underway involves a government agency purchasing toxic assets. Unless the government overpays or provides guarantees (which would actually solve the bank holding company solvency problem), the only benefit of this plan over TAF is that it protects the banks from the market risk of *further* unexpected degradation of assets. However, it still leaves the bank holding companies short the same $810 billion. The guarantees in the Public Private Investment Program for Legacy Assets announced March 19, 2009 can act as free credit default swaps. Therefore, one way the $810 billion can go away is through the payment over time of insurance claims under PPIP or the forbearance of non-recourse debt provided by the FDIC. This is an age old version of off balance sheet financing except this time paid for by taxpayers not shareholders—this would only be a shell game to the extent that Congress has not authorized this spending.

'GOOD BANK-BAD BANK' RESTRUCTURING

The only solution that appears to address the problem is a so-called 'good bank-bad bank' restructuring of bank holding companies, à la 1988 Mellon Bank-Grant Street Bank transaction. This would be used to separate public and private solvency concerns by separating performing assets and commercial banks from toxic assets and non-bank financial institutions.

Virtually every troubled 'bank' is actually a bank holding company with one or more commercial bank subsidiaries and other finance-related subsidiaries (broker-dealers, insurance underwriters, finance companies, etc.). Two different sources of concern in the current structure are the potentially insolvent commercial banks and apparently toxic assets held by all the subsidiaries in the bank holding companies. Bank holding company shares still trade above zero, so positive equity remains in the bank holding companies.[4]

The solution to the banking problem must differentiate between bank holding companies and commercial banks. Commercial banks, with charters granted by public agencies, are delegated to run the national monetary payment system and transmit Federal Reserve policy to the economy; they are also provided with subsidized deposit insurance. In return, public policy requires that these commercial banks be run safely and soundly.

Bank holding companies are simply shareholder-owned corporations that own banks. The holding company structure provides a natural path for separating commercial banks from toxic assets and for recapitalizing the commercial banks. Unlike past good bank-bad bank transactions, the current situation calls for a spin-off of the bank from its bank holding company, rather than a spin-off of the bad bank from the good one. Here is how one straightforward version could work.

Step 1. Mark-to-market. Mark all assets in all bank holding company subsidiaries to market.

Step 2. Honest shuffle. Move all toxic assets out of the bank and into other holding company subsidiaries and enough good assets from the same subsidiaries into the bank to make the bank a safe and sound enterprise by regulatory standards. The same rule would apply for moving equity from the parent and other subsidiaries into the bank to allow the bank to meet Basel II capitalization standards. The bank holding company would be compensated for moving good assets into the bank by having the bank issue preferred stock back to the holding company for the difference between the book value of assets moved into the bank, and the book value of assets moved out. If the whole holding company had insufficient equity to recapitalize the bank, TARP funds would be used.

Step 3. Spin-off. Separate the bank from the holding company by giving the holding company shareholders new shares in the stand-alone bank. The holding company shareholders would be no worse off (they own both bank shares and holding company shares) but the bank (whose solvency is a legitimate public concern) would be isolated from the toxic assets retained in the holding company. The holding company management, which would be separated entirely from the bank, now would be able to focus interest on an effective workout of the toxic assets. The toxic assets themselves would not be a matter of special public concern.

Step 4. Put option. At the spin-off point, the holding company would issue the bank five-year put options on every asset in the bank, with a strike price equal to the market price of the asset calculated in step 1. This would keep the initial asset marks honest at the reshuffle stage.

CONCLUSION

Such a spin-off solution enhances commercial banks' solvency while keeping them out of bankruptcy or nationalization. All of the traditional banking functionality would be retained and unfettered by public sector distortions, while the solvency problems associated with toxic assets would be confined to the now non-bank holding companies and their non-bank subsidiaries. This solution focuses on the actual public policy problem—solvency of the commercial banks.

Of course, this solution does not address the political lightening rod of who will bear the $810 billion in additional losses (assuming that the TARP money is not repaid). However, by grounding this political lightening rod, we can quickly and safely put the commercial banking sector back on its feet and leave the less relevant shell game of loss realization to holding companies.

Letters commenting on this piece or others may be submitted at http://www.bepress.com/cgi/submit.cgi?context=ev.

NOTES

1. "Global Financial Stability Report," *International Monetary Fund*, April 2009, Table 1.3 reports expected bank losses at $1.6 trillion. Table 1.4 finds that bank capital raised is $391 billion, calculated as the difference between capital raised and potential writedowns in the U.S. banking sector. We add $400 billion in additional capital to account for TARP and other government funding not included in the IMF capital raised statistic.
2. "Global Financial Stability Report," *International Monetary Fund*, April 2009, Table 1.4.
3. As of March 19, 2009, $623 billion had been allotted, and $329 billion spent (http://www.usbudgetwatch.org/stimulus?filter0=80&filter1=&filter2=&filter3=), according to the Committee for a Responsible Federal Budget. The money committed, includes but is not limited to:
   - $250 billion to purchase bank equity shares through the Capital Purchase Program ($198 billion spent);
   - $40 billion to purchase preferred shares of American International Group (AIG, Fortune 500) through the program for Systemically Significant Failing Institutions ($40 billion spent);

• $80 billion to back any losses that the Federal Reserve Bank of New York might incur under the Term Asset-Backed Securities Loan Facility (none spent);
• $40 billion in preferred stock purchases of Citigroup and Bank of America ($20 billion each) through the Targeted Investment Program ($40 billion spent);
• $12.5 billion in loan guarantees for Citigroup ($5 billion) and Bank of America ($8 billion) through the Asset Guarantee Program (none spent);
• $25 billion in loans to automakers and their financing arms through the Automotive Industry Financing Program ($25 billion spent);
• $75 billion for the Public-Private investment fund (none spent);
• $50 billion for the Home Affordable Modification program ($11 billion spent).

4. As noted by Aaron Edlin and Dwight Jaffee, "There is a stark difference between the views of the regulators and those of the markets on bank capitalization. As recently as February 23, 2009, The Federal Reserve has declared the major banks all to be "well capitalized," the highest standard set." (See The Economists' Voice http://www.bepress.com/ev/vol6/iss4/art8/ March 2009 page 2.)

REFERENCES FOR FURTHER READING

Edlin, Aaron and Dwight Jaffee (2009) "Show Me The Money," The Economist's Voice, 6(4): Art. 8. Available at: http://www.bepress.com/ev/vol6/iss4/art8.