Initiative on
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Bank Nationalization: A Survival Manual

Douglas J. Elliott

The Initiative on Business and Public Policy provides analytical research and constructive recommendations on public policy issues affecting the business sector in the United States and around the world.

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INTRODUCTION

Prominent voices call for the nationalization of the weakest major U.S. banks, although advocates of that step are still in a distinct minority. In my view, nationalization should only be a last resort measure, as has historically been the case. (The government has frequently taken over smaller banks, but on only rare occasions has it taken over one of the largest banks in the country.) However, such a nationalization could happen in the current crisis, either because we reach the stage of last resorts or because the anger and desperation of the public creates a political consensus for this drastic action.[1]

Nationalization of a major banking group would be extremely complicated, so we need to be prepared in case it occurs. This paper presents a "survival manual," with suggestions for minimizing the damage from nationalization. Examining the practical issues should also make clear why nationalization is a choice to be avoided, if possible.

There are many definitions of "nationalization." Here it will refer to a federal takeover of a bank where the government takes full, or nearly full, ownership and chooses to actively play the role of controlling shareholder.

This paper is designed around 15 essential steps to minimize the damage to taxpayers and the country in the event of a nationalization. These are:

Step 1: Decide the criteria for nationalization, including the legal authority to use

Step 2: Determine which large banks meet these criteria

Step 3: Choose when to act

Step 4: Calculate the size of the hole to be filled and ensure funds are available

Step 5: Decide how to allocate the losses between taxpayers, shareholders, and creditors

Step 6: Design a preliminary exit strategy

Step 7: Create an ownership structure for the government's stakes

Step 8: Line up a few key managers

Step 9a: Announce the nationalization(s)

Step 9b: Shore up confidence in the rest of the banks

Step 10: Create a sound financial base; institute a good bank/bad bank structure

Step 11: Make the necessary managerial changes

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Step 13: Implement the new plan

Step 14: Sell the government's stake over time

1. Please see "Bank Nationalization: What is it? Should we do it?" for a comprehensive overview.

Step 1: Decide the criteria for nationalization, including legal authority

There are multiple reasons why it is critical that the government consistently use a coherent set of criteria for determining whether to nationalize a bank:

Legal authority. This point is sometimes overlooked in calls for nationalization. The Bill of Rights in the Constitution specifically forbids arbitrary "takings" of property, which would include bank shares. Therefore, the government does not have the right to simply seize a bank without meeting specific legal criteria, such as the failure of the bank to maintain a legal minimum of capital to operate. Please see **"Pre-emptive Bank Nationalization Would Present Thorny Problems,"** which surveys in much more detail the potential methods for taking over a troubled large bank or bank holding company.

That paper concludes that it would be very difficult under current law to move swiftly to nationalize one of the larger banks, unless the government were prepared to buy out the shareholders and leave the creditors largely intact. The Administration has proposed legislation that would substantially expand the regulator's authority to take over a bank holding company. If passed, this would ease, but not eliminate the difficulties.

There are two core issues that would make it difficult to swiftly seize a major U.S. bank or bank holding company under today's laws and economic conditions. First, regulators wishing to seize the bank itself would need to show that it is already very weakly capitalized, or soon will be, and that there are no reasonably possible steps that could be taken to remedy this condition. However, the major banks are all owned by holding companies, like Citigroup, that have maintained large pools of liquid assets which could be added to the capital of their subsidiary bank to prevent a regulatory seizure. Dangerous as the loss of that buffer of liquidity would be, it would be much less painful than losing their key banking unit altogether.

As a result, regulators would have to force a reduction of the accounting value of the aggregate assets of the weakest banks by close to 10% in order to exhaust existing bank capital plus the readily available liquid assets of the holding company that could bolster that capital. This large a hit would strike terror in the shareholders, debtholders, and trading counterparties of all but the strongest other banks since a similar action would wipe out the value of most large banks. That kind of terror would risk the kind of financial meltdown that the government has been at great pains to avoid. A seizure using this draconian a rationale would also be vulnerable to a massive lawsuit, potentially considerably worse than the ones that the government has lost stemming from the Savings & Loan crisis.

Second, regulators do not have the legal authority to seize a bank holding company, nor, in many cases, some of the other key financial subsidiaries. Bank holding companies are "normal" corporations that are subject to bankruptcy law, rather than the special insolvency laws for banks. Bankruptcy law gives the government few if any special rights and does not have an effective pre-emptive action provision to allow a company to be forced into bankruptcy prior to the point where it ceases to pay its bills on time.

The net effect of these constraints is that the government would either have to resign itself to a slow process leading to a bank seizure or would have to buy out the shareholders of the bank or its holding company. It seems virtually impossible politically to simultaneously make the case that a bank is in enough danger to warrant a nationalization and at the same time that there is enough value in the banks that the government has to pay off the shareholders.

Reassurance for the markets. The government will need to make its criteria clear to the financial markets in order to avoid undue panic among creditors and investors who own stakes in other banks that are not being taken over. (See Step 9b for more.)

Optimization of the effort. Finally, it simply makes sense to have a clear basis for choosing which banks will be taken over. The government has limited resources, both managerial and financial. These need to be allocated in an efficient manner across the financial rescue efforts, including any nationalizations.

The stress tests currently being run on the 19 largest banks could provide the key data to be used for applying these criteria, because they will produce a detailed analysis of the capital adequacy of the banks under both the expected economic case and a more stringent, pessimistic case.[2] However, these results are unlikely to be sufficient on their own as a legal justification. Beyond what is required for legal reasons, there may be additional market signals that could usefully be incorporated into the policy decisions, including stock prices, views of private sector debt and equity analysts, credit default swap spreads, etc.

2. Please see "Bank Capital and the Stress Tests."

Step 2: Determine which large banks meet these criteria

This step is at one level mechanical. The criteria should be applied to each of the large banks to see which should clearly be taken over and which are on the borderline. Please note that we emphasize "large" banks here. These behemoths are central to the economy in a way that smaller banks are not, simply as a result of their large market shares. The same principles may need to be applied to smaller banks, but the emphasis should be on the largest banks.

As will be discussed in steps 9a and 9b, certain banks that are on the borderline for the chosen criteria may need to be taken over at the same time as those that fall squarely within the criteria. Otherwise, they may be so weakened by that first set of nationalizations that they almost immediately constitute a second round in their own right. In essence, the criteria need to be chosen to provide a "firebreak" between the nationalized banks and the next nearest major bank.

Step 3: Choose when to act

There are two broad questions here. Most importantly, should the government wait until nationalization becomes unavoidable or are there compelling reasons to move as soon as it starts to seem likely to be necessary? Put another way, is the test more like in a criminal trial, "beyond a reasonable doubt," or a civil one, "the preponderance of the evidence." In addition, there is the "micro" issue of precisely when to act.

There is a strong, almost instinctive, preference for swift movement, because past crises have shown how badly banks can deteriorate once they go off the rails. The unwillingness or inability of regulators to move quickly in the Savings & Loan crisis is almost universally believed to have allowed the problem to swell to a much bigger one than if it had been dealt with quickly. Similarly, the experience of Japan's Lost Decade argues powerfully for confronting the problem and moving on. On the positive side, Sweden is applauded for taking a fairly swift, active approach, which is believed to have contributed to a less painful outcome in its crisis of the early 1990's than other countries experienced with their crises.

There is a great deal of merit in these arguments, but the timing question is not as simple it may appear at first sight. The necessity, or lack thereof, for widespread nationalization appears heavily dependent on how the economy performs through the remainder of the recession and into the early stages of the recovery. The consensus economic forecast as of February was consistent with a level of credit losses that could be absorbed by the banking system without substantial capital additions beyond what have already been provided or are being made available by the government under current plans.[3] The considerably more pessimistic economic scenario foreseen by Dr. Nouriel Roubini would have produced enough additional losses to give serious weight to the argument for nationalizing a number of the major banks.

We will not know for some months which economists are correct, leaving us with a critical question. Should we start nationalizing when and if we discover there is a 30% chance it will prove necessary, a 50% chance, a 75% chance, or what level? This depends heavily on what the harm would be in waiting compared to the damage from acting unnecessarily. Several of my previous papers discuss the pros and cons of nationalization, which have led me to conclude that the downsides considerably exceed the benefits, as long as a bank is still viable without a takeover.

So, what is the offsetting harm in waiting until we see the economic future more clearly? There seem to be five potential dangers, sometimes illustrated by the ramifications of mistakes made in previous crises.

Banks may take foolish risks, particularly on the investment side, in an effort to gamble their way back to health. The Savings & Loan crisis is Exhibit A for this fear. Many of these institutions were effectively insolvent, but allowed to continue operating in the hopes that they could earn their way out of their hole. Since they were already broke, they had little to lose by making high risk, potentially high return investments. If this worked out, the institution was saved. If not, the additional losses would fall on the insurance fund. (This is often referred to as a "moral hazard" issue.)

There appears to be little anecdotal or statistical evidence that banks in the U.S. are making risky

3. Please see "Bank Nationalization: What is it? Should we do it?", for more details.

new investments. Indeed, most policymakers are concerned that the banks are now too risk-averse, contributing to a severe credit crunch. The good news about a credit crunch is that banks are able to turn down weak potential borrowers and to demand higher returns for supplying funds. Thus, unlike in the Savings & Loan crisis, there is strong reason to believe that banks will earn excellent returns on the new risks they take. Even the old investments that have been "marked to market" now have built in the expectation of unusually high returns, reflecting the rates of returns demanded by the capital markets today. Some may argue that the decline in new bank lending, which banks ascribe principally to a lower demand for loans, contradicts this assertion about the economic value of new loans. However, there is plenty of evidence that tighter credit criteria and higher credit charges are at work, in combination with a fall in natural demand as companies and individuals try to claw back spending.

Banks may fail to force restructurings of "zombie" borrowers. In Japan's lost decade, the "zombie" banks begat "zombie" borrowers. The weak banks could not call their bad corporate loans and force restructurings, since this would force them to admit that their credit losses were so bad as to severely deplete, or even wipe out, their own capital. In many cases, they even made new loans to keep the borrowers temporarily afloat. So far, there appears to be little anecdotal evidence that U.S. banks are acting in this manner with their business loans. There are far more complaints about banks tightening their standards and invoking protective covenants that force restructurings than about the opposite. On the other hand, some of the reluctance to restructure individual mortgages may stem from unwillingness to crystallize losses out of concern over banks' capital bases, although it appears that other factors are more important in the mortgage restructuring decision.

"Zombie" banks may pull back their lending. This is the opposite of the fear that banks will splash out and take too many chances. Weakened capital bases make it hard to extend new credit, unless a bank does decide to go the route of taking excessive risk in the hopes of restoring its fortunes. It may appear that this is in fact happening with the U.S. banks, since we are undergoing a major credit crunch. However, the problem is a bit different than it might appear. The banking system is actually holding onto nearly the same volume of loans as they were before the crisis. The bigger problem is that they are failing to step up to fill the very large hole created by the virtual disappearance of the securitization market.

Prior to the crisis, a large percentage of lending made its way to end investors who were not banks, usually via the securitization process. This market has largely vanished, although there are some signs of revival, in part due to help from the Fed and Treasury. If the banks were stronger, they would have been in a position to step up their lending to fill a large part of the void. It is not clear that nationalizing the weak banks would be a more effective way of filling the securitization void than would more direct actions, such as the existing Fed/Treasury efforts.

Banks that are in trouble tend to deteriorate internally. This point is difficult to prove, but it appears very likely to be operating. Good employees leave, as do good customers. Morale crumbles and political infighting worsens, making the remaining employees less productive. It might be better to undergo nationalization, despite its own traumas, than to suffer the death of a thousand cuts. However, this issue appears to be less important than the other potential problems outlined above. It is also hard to know how to balance the harmful effects of continued malaise versus the problems that would result from nationalization.

Restoration of consumer and business confidence may require dramatic action. It is possible that the public will not believe the banking system has been restored until it sees one or more major banks taken over. Historically, nationalization has sent a strong signal, but it is not clear that it is the only way to send a sufficiently strong message.

In my view, the damage caused by waiting is real, but significantly less severe than it was in past financial crises. This reflects the unique characteristics of the present crisis, including the existence and then sudden disappearance of the securitization market, the nature of the complex securities that triggered the initial problems, and a commercial banking system that started with relatively strong levels of capital. It also reflects the earlier actions taken by the Administration and regulators, representing very large resource commitments to restoring the financial sector.

In addition to the overarching timing question just discussed, the government will also want to think through the exact timing of a seizure, which could be affected by other economic or political events, upcoming quarterly financial reports, etc.

Step 4: Calculate the size of the hole to be filled and ensure funds are available

The next step is to determine the need for funds to be infused into the bank(s) upon nationalization. The bank needs to be on a sound financial basis as quickly as possible after the nationalization, preferably from the beginning. In order to justify nationalization, the government would need to show that the bank's capital either is, or will be, very low. Filling the capital bucket back up would therefore require a large infusion. Note that this assumes the government will not simply shut the entire organization down, an outcome that appears very unlikely. Please see Step 6 for further discussion of this point.

Let us take the example of Citigroup, the large bank provoking the most speculation about nationalization. Assume the government declared that Citigroup's ratio of Tier 1 capital to risk-weighted assets on a realistic basis was 2%, one threshold for seizure, and that it restored the ratio to the "well-capitalized" level of 6%. This would require adding Tier 1 capital equal to 4% of the risk-weighted assets, or approximately $40 billion in Citigroup's case. Given the likelihood of additional large losses and the uncertainties about asset values, the government might wish to bring the ratio back above 10%, requiring at least $80 billion. This is on top of the funds that the government has already invested, and the guarantees it has provided, which are already factored into the capital calculation.

Why run the bank with normal private sector capital ratios when the government owns it and stands behind it? If the government intends to sell the bank, as a whole or in large pieces, it is important to retain a private sector culture as much as possible in order to facilitate the eventual exit by the government. Capital ratios affect many decisions within a bank. Essentially, every activity needs to earn an adequate return on capital in order to be worthwhile. The more capital that is employed the higher that return needs to be. Many activities can make sense when only a thin base of capital is required, but would not be entertained with a larger capital requirement.

One might argue for relying on an implicit or explicit government guarantee instead. Either approach seems mistaken, especially relying on an implicit guarantee. The markets have become quite wary of implicit government guarantees, since there is a fear that Congress might not authorize the funds necessary to make good on them or the Administration might find it necessary to alter the implicit guarantee, which is much easier since it has not been stated. As a result, financing for the nationalized bank would likely remain expensive, losing a major potential advantage of nationalization.

An explicit guarantee would be better, but it is worth noting that some bank debt is already being issued with explicit government guarantees. The interest rate on the debt is generally running tens of basis points higher than on direct government borrowing. (A basis point is one-hundred of one percent.) This cost may seem small in relation to the total size of the rescue, but it is unclear what the policy benefit would be of following this approach, since an explicit guarantee means the taxpayer is on the hook just as much as if Treasury supplied the funds directly. Perhaps there would be a political benefit, although it is not clear currently what this would be. Importantly, the Emergency Economic Stabilization Act, which authorized the federal rescue efforts, counts each guarantee dollar for dollar against the cap on authorized activity, just as if it were the direct purchase of a bank's securities. The effect on the federal budget is also essentially the same regardless of whether it is a loan or a guarantee of a loan.

It appears that there would only be two good reasons for choosing not to infuse the money directly. One would be because the government is not truly committed to keeping the bank adequately capitalized, which would be a mistake. The second would be because there was a political constraint on the amount of money directly put into the bank. This could end up being the case, but it would create needless interest expense and would make it more difficult to move to reprivatization.

Ironically, it might also be necessary to pay existing shareholders for their stock, as discussed under Step 1, if the government otherwise lacks the full legal basis to seize the bank as quickly as it would like. For example, it might not have sufficient evidence to force the assets to be marked all the way down to what it sees as the true market value, leaving the accounting value of the Tier 1 capital above the 2% leverage threshold.

This assumes that any existing preferred stocks, bonds, or other debt would be left in place. It may be considered desirable to pay off some high-cost debt, if the contract terms allow, in which case still more funds would be needed. It may also be possible to write down the volume of debt; see Step 5 for a discussion as to whether to force debtholders to share in the cost of the rescue.

Step 5: Decide how to allocate the losses between taxpayers, shareholders, and creditors

The taxpayer is not the only potential source of value to fill the hole. There are common shareholders, preferred shareholders, bondholders, and other creditors who potentially could be forced to share in the cost by having their investments seized, diluted, or written down.

The most obvious candidate is to eliminate the value of the common shares, although the ability to force this action would be dependent on the legal issues discussed earlier. Beyond that, there may not be a lot of value left in the stock compared to the gap to be filled. It would be close to an absolute legal requirement that the accounting value of the common stock be reduced to near zero before the regulators could seize the bank or, under potential future regulation, the bank holding company.

The next candidates for loss-sharing are the holders of preferred shares. These represent equity investments and the holders should theoretically have been the second most prepared to lose their investments if the bank went off the rails, since their bankruptcy priority lies just above that of the common shareholders and below everyone else. Eliminating or reducing the value of these shares would face the same legal issues as with common shares. The amount of preferred shares outstanding is significant, but still not large enough, in all likelihood, to completely fill the value gap. Finally, eliminating the value of the preferred shares would raise a milder form of some of the same issues that will be discussed next in reference to giving a "haircut" to the value of outstanding debt.

The real jackpot would be writing down the value of the debt. The volume of bonds outstanding at the major banks is generally larger than the size of the potential financial rescue, meaning that a bank could be restructured financially without a penny of taxpayer money. However, debt investors developed a strong belief over a period of many years that bank bonds were safe and that there was an implicit government guarantee of the debt of the largest banks, those that were considered "Too Big to Fail." This is a slightly weaker version of the belief among investors that Fannie Mae and Freddie Mac had implicit government guarantees – a belief that proved in the end to be justified.

There are number of implications of the existence of this market belief that have caused a large majority of policymakers and analysts to advise against forcing "haircuts" of the value of the bonds. Even Gary Stern, the President of the Minneapolis Federal Reserve Bank, and a prominent and passionate advocate of eliminating the Too Big to Fail doctrine, believes that it would do more harm than good to haircut the value of bank debt in the midst of the current crisis. He believes that reforms must be made that will eliminate the issue going forward, but with time for the markets to adjust to the changes. On the other hand, there is a vocal minority of analysts that call for haircuts to be applied in future bank rescues. This is a complex question that needs to be dealt with in a separate paper, as the author hopes to do shortly. However, the principal pros and cons can be summarized briefly as follows:

Pros of debt haircuts

Save taxpayer money. Taxpayer funds can be replaced dollar for dollar by reductions in the amount of debt outstanding. A dollar of debt reduction increases the bank's capital by a dollar, meaning the government needs to infuse that much less to achieve an acceptable capital ratio for the restructured bank. As noted, the volume of bank debt often exceeds the needed capital infusion and therefore could eliminate the need for taxpayer funds.

Give debtholders an incentive to monitor banks carefully in the future. Taking losses now, or seeing other investors do so, should make debt investors much more careful. They did not make a sufficient distinction in the past between banks that represented higher and lower risks, since they believed it was highly likely that the government would rescue any of the largest banks. This substantially reduced the signaling benefits that active investors can provide to the management and regulators of a large bank. Ideally, profit-motivated investors would react to mistaken or risky management strategies by pushing down the market value of the debt and raising the interest rate on any new debt.

Encourage less debt leverage in the future. Reducing or eliminating the effect of perceived implicit federal guarantees should increase the interest rates charged by debt investors, especially for riskier banks. This should produce at least a marginal move towards less debt in the capital structure and more common stock, making the banks less risky.

It is fair that debtholders bear a cost they agreed to take. The debt contracts and insolvency laws clearly indicated that the debtholders could lose their money. Nor was there any explicit government guarantee. Some would argue that it is therefore only fair that the investors carry out their side of the bargain and take losses if the value of the bank falls far enough to wipe out the common and preferred stockholders.

Gain greater public support for the financial rescues. Many in the public, and in Congress, believe that the bank rescues have taken money out of the pockets of the taxpayer and handed it to "Wall Street." Having investors share in the losses, while reducing the cost to taxpayers, would presumably broaden support for the efforts.

Cons of debt haircuts

Opponents of debt haircuts in the current crisis generally acknowledge the validity of most or all of the previous arguments and often strongly support finding a way to implement debt haircuts in future crises. However, they believe that several critical factors mean that such haircuts would do massive harm to a fragile financial system in the current environment.

Risk of a "run" on the other banks by creditors. If debt investors take losses on a nationalization, they and their peers will factor a substantially increased risk into their valuations of bank bonds. There would be a dual adjustment. Bonds would be riskier because the implicit federal guarantee has vanished and also because the government has just demonstrated that it will indeed nationalize a large bank. Bond prices on weaker banks would plummet and interest rates and credit default spreads would soar. These reactions, plus the likely reactions of the stock market, could spark a flight by trading counterparties and customers, weakening these banks further. Other types of financial institutions, such as life insurers, could be similarly hit, although likely to a lesser extent as they generally are not perceived as having as much potential government support.

Damage to the overall bond markets and to the health of other financial institutions. Direct losses on bonds of nationalized banks, plus the potentially larger aggregate loss of market value of bonds of other weaker banks, could hit bond investors hard. Bonds of financial institutions make up a large part of the bond market which means this would have a major impact on debt investors. Many of these investors are life insurers, banks, or other financial institutions that the federal government might feel the need to rescue.

Reduction of the ability of banks to raise debt capital as they recover from this crisis. There will come a time when the crisis eases enough for private capital to begin flowing more freely back into the banks. (Goldman Sachs, for example, just raised $5 billion by selling common stock.) Much of this capital would come in the form of bond purchases. Raising that capital would be significantly harder and more expensive if debt investors have just seen large losses due to a nationalization.

Structural complications somewhat hinder the process of implementing the haircuts. There are several complications. First, much of the debt at the large banking groups is actually at the level of the bank holding company. Under current law, haircutting those bonds would either require a bankruptcy filing or persuading the bondholders to accept an out of court settlement, probably using the threat of a filing. Bankruptcies are exceedingly messy and reaching an out of court settlement can be very difficult. Worse, the process of pushing for a bankruptcy or pursuing an agreement with the bondholders would almost certainly create a crisis of confidence for the bank if pursued prior to a nationalization or would add great complications if pursued afterwards. Second, it is very difficult legally to force bondholders to take losses without also forcing losses on other creditors who are in the same broad group of "general creditors" for bankruptcy purposes. This would include suppliers, employees who are owed money, etc. If nothing else, this adds political difficulties to the process by substantially expanding the range of parties who are damaged. It should be noted that the Administration has requested expanded "resolution" authority that would extend to bank holding companies, which might eliminate or reduce these complications.

Gives current debtholders more say in the bank's future. It is difficult to force losses on debtholders without also giving them a claim on future recoveries from the bank or bank holding company. In practice, this means that debtholders would likely receive stock in exchange for taking their haircuts. This would mean that the government would need to take into account these minority shareholdings in the bank as it made decisions going forward. At the extreme, if little new taxpayer money is infused, the government might be trying to control an institution in which it owned a minority of the shares. It also means that the government would have to share the value recovered from the bank through future sales of all or part of the organization.

Step 6: Design a preliminary exit strategy

The government should have a general plan for how to exit the banking business before deciding on nationalization. This plan would be a key determinant of a number of other decisions.

There appear to be four broad plans to choose from, with innumerable variations:

Plan A: Keep the bank operating and try to maximize the sale value over time

Plan B: Keep the bank in government ownership for the long haul

Plan C: Liquidate the bank as quickly as possible: sell any viable pieces quickly and shut down the rest

Plan D: Break up the bank into smaller pieces which would continue operating

This topic is another one that deserves its own paper. In brief, I believe that the government would choose Plan A and therefore the rest of the paper will assume this approach is in place. However, it is important to understand the pros and cons of the other potential options.

Plan B

It is easy to dismiss Plan B in the real world of American politics and policy. Unlike in Europe, there is no strong constituency that would support the idea of a large general-purpose federally-owned bank, although we do have some large specialty federal banks, such as the student loan program and the Small Business Administration, not to mention financial institutions like the FHA.

Plan C

Plan C is a more realistic possibility than Plan B. However, it seems politically unlikely that the government would choose to create a massive disruption to a major lender in the midst of a credit crunch. As just one example, small businesses, a politically favored group, are particularly vulnerable to the loss of banking relationships. It would be very difficult for many of them to pick up and move to another bank in the middle of a credit crunch, especially as there is a strong subjective element in the decisions of lending officers with regard to businesses of this size, so relationships matter. New loans would also likely come with much tougher terms than those that were set up in the past. It is true that the government's bank could retain the existing loans while liquidating the unit that provided them, but businesses tend to need an ongoing relationship. For example, they may need some covenants to be waived as they deal with the financial crisis. This is much easier to get from an organization that is looking at a continuing profitable relationship, not just the outcome on this single loan.

From a policy viewpoint, there is also the concern that liquidation would create a massive loss of value from those parts of the bank that are good. For example, new loans being generated today appear to be offering banks very good value as a result of the credit crunch. The banks can choose among the best borrowers and are able to extract better rates and terms than they have for years. Many of the bank's units may be losing money when results of old and new business are combined, but are in line to make considerable money on the new business. Shutting the unit down would leave the government with the losses, but not the new profits that the network of relationships could bring in.

In theory, both the political and policy issues could be minimized by taking those units with good future prospects, cleaning away the problem assets, and selling the units either individually or in packages. In practice, this is much more difficult and time-consuming than it may appear. It also loses much of the very substantial synergies that exist from cross-selling across different units of the organization, as well as some of the economies of scale that hold down expenses. Even putting that aside, this is not a good environment in which to extract a fair price from potential buyers of financial institutions. The government may not wish to bear the losses from a series of "fire sales" starting soon after taking over the bank.

The attempt to minimize all of these problems would likely lead in practice to a Plan C that looked very much like Plan A, which is why that Plan seems by far the more likely to be implemented. Again, this issue warrants its own paper – the preceding discussion has hardly done full justice to this key question.

Plan D

Plan D is a variation of Plan A in which the nationalized bank is broken into smaller banks, perhaps on a regional basis, in order to deal with the concerns about banks that are Too Big to Fail. This theoretical possibility seems unlikely to be chosen. First, the government will be struggling with a massive set of political, financial, and administrative decisions related to the nationalization. It is improbable that they would want to add the break-up of a bank to the list. Second, the broken-up bank is unlikely to be worth as much in pieces as it is as a whole. There are sound economic reasons why bank mergers have created larger and larger entities and these reasons go well beyond capturing the funding benefit of being considered Too Big to Fail. The benefits of cross-selling, expense reduction, and risk diversification can be quite significant. Public policy reasons may outweigh these gains, but the government may not wish to inflict the costs directly on the taxpayer by starting with the break-up of its own bank(s). So, again, Plan A seems much more likely to be implemented than the other potential plans.

Timing Issues on Plan A

There is a strong consensus among proponents of nationalization of U.S. banks that this should be seen as a temporary receivership/conservatorship, with the banks cleaned up and resold as soon as possible. Unfortunately, if the decision is made to continue to operate while trying to avoid the loss of value from fire sales, the government is likely to be the primary owner for a number of years. Continental Illinois and AIG serve as object lessons here. Continental was nationalized in 1984, but the last of the government stake was not sold until 1991. This was despite a strong bull market during most of the period and a lack of competing offerings from other formerly-troubled financial institutions. When AIG was taken over last year, there was much optimistic talk about the high quality of many of its insurance subsidiaries and the consequent ability to auction them off at good prices. In reality, the auctions have been a real disappointment, in large part because this is a very bad time to try to sell a financial institution.

There are few natural buyers in the current environment for a nationalized bank. These few buyers have a multitude of other opportunities to invest in the sector, which gives them the ability to drive a very hard bargain. It is also very difficult for them to raise capital themselves to fund any acquisitions of the size required by a major nationalization. The great likelihood is that much of the purchase price would be in stock, leaving the taxpayer with continued exposure to a combined bank. This environment will change over time, but it may be a number of years before a fair price is obtainable, especially if the taxpayers face the need to dispose of multiple major banks.

The plan, therefore, should be one that contemplates government ownership for years, not weeks or months. This requires establishing an infrastructure to manage the government's stake and to oversee the management of the nationalized bank.

Step 7: Create an ownership structure

The government will need to decide how to own and manage the nationalized bank(s). This question becomes particularly pressing if multiple banks are nationalized. There are a number of sub-questions to be answered up-front, since there seems to be no point in waiting until later. The answers are essentially decisions about principles, rather than being heavily dependent on the particulars of the nationalization(s).

Should there be one overall ownership and oversight organization for all the nationalized banks? This seems clear. It makes a great deal of sense to have a single organization responsible for the government's majority ownership stakes, in order to avoid overlapping functions and inconsistent strategies. It may also make sense to house the government's other investments in banks in the same institution, although it will be important to have strong information compartmentalization so that the government-owned banks do not have the advantage of confidential information about the banks in which the government has a more passive investment and vice versa.

Where should this organization sit? It would be best to have a stand-alone, independent organization, in order to provide some protection against the inevitable politicization of banking decisions. Keeping it separate from Treasury or other parts of the Administration also reduces the distractions that could be caused if everyone who wants something from a nationalized bank runs to Secretary Geithner to lobby.

How actively should the government manage the nationalized banks? The ideal appears to be for the government to act in the capacity of a strong Board of Directors that chooses a CEO, signs off on major strategic decisions, and holds the CEO accountable, replacing him or her, if necessary. This balance allows the government the level of control it deserves as the owner while preserving the benefits of the traditional corporate structure and reducing the potential problems of politicization. This approach worked well at Continental Illinois. In that case, Jim Swearingen, the retired CEO of Amoco, was brought in as Chairman. He replaced many members of the management team and brought in new hires, eventually handing over the reins to Thomas Theobald, a highly respected banker.

Should certain functions be centralized? It might produce short-run benefits to combine certain functions across the nationalized banks, but, even if it did, it would run counter to the intention to sell the banks back to the private sector. The banks should be run, as much as possible, in the form that they are intended to be sold. This will make that transition quicker and easier, as well as bringing in the highest price, since there will be a track record directly relevant to the potential acquirer. That said, if certain functions are permanently removed from the banks, such as taking out the worst assets and managing them in a "bad bank," there is no harm in combining these functions across the nationalized banks, if that is otherwise the most effective structure.

Step 8: Line up a few key managers

Ideally, the government would have one or more potential CEO's "on call" as a nationalization approached. The ability to announce a strong new CEO at the same time as the nationalization would considerably alleviate fears of chaos at the nationalized bank(s) and of immediate politicization. The strength of the CEO would go a long way towards indicating the government's intention of being an active investor, but not the direct manager of the bank.

One problem that would arise is to find CEO candidates who are well-qualified, interested in the position, and acceptable to the public and to Congress. The current attitude towards bankers may not make this simple. It would be easy to raise questions about a large number of the leaders of the industry, either because of actions they have personally taken or the troubles into which their institutions have fallen. There are very few bankers in positions of real responsibility who did not participate in some manner in the follies of the past few years. For one thing, a complete refusal to be a part of booming markets would have been viewed by many shareholders as a lack of aggressiveness in pursuing profits, endangering the CEO's job.

Take the case of Jamie Dimon, the CEO of J.P. Morgan Chase, whose already strong reputation rose considerably over the course of the crisis. He has been open in admitting that Morgan's relative performance was so good, not because it performed well, but because it performed less badly than its key competitors. His firm was less involved in the activities that look so foolish in retrospect, but it did make many subprime mortgages, it does own large amounts of "toxic assets," and it otherwise participated in some manner in most of the problems that have bedeviled the banking sector. This is not to suggest that he would be a politically unacceptable CEO, but rather to say that if these issues exist for someone of this strong a reputation, they will also be an issue for many others.

Further, those CEO's and high-level executives without too much tarnish on their reputations may not find it appealing to run a nationalized bank in the current highly-charged environment. When new management was brought in to Continental Illinois, they faced relatively few politically sensitive issues. Today, the public's expectations of the CEO of a nationalized bank would be much higher. They likely would be expected to open the throttle on mortgage and small business lending, clean up the legacy problems, change the culture of their banks, generate profits, set up the bank for re-privatization, respond to frequent Congressional calls for information about their activities, and do all this for a modest compensation package.

On the positive side, this would be an excellent opportunity for a public-spirited CEO candidate to take on a daunting challenge. If successful, they would ensure themselves a place in history and, if desired, the ability to move on to another CEO position that would pay far better or perhaps into a political career or a cabinet position.

These positives ensure that there will be candidates with at least marginally acceptable qualifications. However, the vetting process will be an important one and doubtless a time-consuming one, if done carefully. The Administration would be wise to start designing a process now, in case it ever proves necessary.

The preceding discussion assumed that a new CEO would come out of the ranks of existing bank senior managers. This, or a successful recently retired manager, would be the best option because the position is not one for a rookie. There are doubtless many at the Fed and in other positions of public service who understand banks well, but it is one thing to be able to analyze a bank and another to have the experience to run one.

Step 9a: Announce the nationalization(s)

The announcement itself is worth very careful consideration. Among the key issues are:

Maintaining confidentiality until the takeover. As will be discussed in Step 9b, it will be necessary to make a comprehensive announcement that reassures a number of different constituencies, including the stakeholders in other large banks who may fear nationalization as well. Having the information leak out piecemeal in advance would present a grave risk of panicking the markets and possibly forcing premature action. Banking regulators have a very good history of maintaining confidentiality, but they have never faced a challenge this formidable, both in terms of the financial impact of a takeover and in terms of the number of policymakers and advisors who ideally would be involved.

Making a clear case for the actions. It has proven to be very difficult to explain the various steps in the financial rescue packages in a way that resonated with all key constituencies, including: the public; Congress; the banks; and the broader financial markets. The Administration and the various regulators will need to have a clear, compelling set of justifications for their actions, which will be a true challenge. For example, there are multiple overlapping arguments put forward by advocates of nationalization. The government needs to choose among them, since it is unlikely that the actual takeover policies chosen will be consistent with all the different potential rationales.[4]

Putting the full weight of the government behind the actions. This will be a momentous step if it is taken. The success of the seizures may well determine whether the recession ends soon or turns into a true nightmare that will be remembered for decades. The beginning would be one of the most dangerous and promising moments. The President will need to be front and center in explaining and supporting the action, while the appropriate regulators and Treasury officials each play their proper roles. Ideally, key Congressional leaders would quickly show their support.

4. Please see, "Bank Nationalization: What is it? Should we do it?", for a longer explanation of the different arguments.

Step 9b: Shore up confidence in the other banks

Nationalizing one or more of the nation's largest banks is likely to catch a number of observers by surprise. There is a real risk of a "run" on those of the remaining banks that are perceived to be weaker. It is possible that there would be a run by depositors, although the FDIC retains great credibility and nationalization may be seen as effectively adding a full government guarantee of deposits, whether or not such an action is announced. The greater risk is that there is a chain reaction of panic. The share prices of other weak banks may plummet from already low levels. In the past year or so, we have seen such price declines lead to withdrawal of support from other key constituents, including trading counterparties, creditors, and customers. The negative publicity surrounding those actions might lead to deposit runs, which could be exacerbated by the feeling that the newly government-owned banks are a safer place to keep money.

Even if such a panic did not cause additional bank failures, it would likely further dampen lending and other risk-taking at the remaining banks. The weaker ones could become totally preoccupied with preserving their independence by shoring up their capital ratios and otherwise reducing their risk exposure.

It is therefore very important that the government make clear its comfort with the remaining large banks. This should not extend to guaranteeing immunity from a future seizure, but should provide real confidence that such an action is unlikely to be necessary. This could be done in several ways, including:

Providing a clear rationale for which banks survive and which are taken over. The government should be as open as possible about the criteria that were used to determine which banks were seized. As noted earlier, there needs to be a wide "firebreak" between the nationalized banks and the next weakest bank. This clarity may require providing more information about the valuations that were applied to the "toxic assets" and other assets, especially loans, which were on the nationalized banks' balance sheets. Without sufficient clarity, it would be hard to know whether the remaining banks were really viewed as having sufficient capital or whether too much of their stated capital was seen by the government as illusory.

Injecting capital. One way of widening the "firebreak" would be to add new government capital to the weakest remaining banks, so that their capital ratios and other indicators of their health would more clearly differentiate them from the just-nationalized banks. A related idea is for the government to stand ready to add capital, much as they have offered with the Capital Assistance Program tied to the stress tests currently being undergone by the banks. A key obstacle to either approach is that there is not sufficient remaining authorization of TARP money for this to be credible. It would be necessary to go back to Congress for larger authorizations in order for this approach to provide the needed confidence.

Widening guarantees of new bank liabilities. It may make sense to expand the FDIC's current program providing guarantees on new debt issuances by banks. This would ensure that everyone could see that the banks will not run out of the cash necessary for their operations, even if there is a temporary panic after the nationalization(s). The policy issues around such guarantees would be substantially different depending on whether the government had decided to protect debtholders of the nationalized bank(s) or force them to absorb a haircut. If the plan is to protect existing debtholders, then the guarantees of new debt would effectively cost very little, since those debtholders would likely have been protected in the future anyway, at least until well past the current economic crisis. Explicit guarantees would be replacing strongly implied ones.

The issue becomes much more complex if the nationalization is accompanied by losses to existing bondholders. On the one hand, the interest rates demanded on new debt issuances by weaker banks would rise sharply, perhaps imperiling their ability to raise capital, which would argue for adding explicit guarantees on new issues for at least a period of time. On the other hand, there would be real consequences to providing a guarantee, since otherwise the government might have chosen to let the full losses fall on the shareholders and debtholders in any future nationalization, as it had just done with this round of seizures.

Broadening the guarantees of deposits. It might also be useful to provide a blanket deposit guarantee or to considerably increase the amounts guaranteed. The Swedes, who have been much praised by advocates of nationalization in the U.S., provided a blanket guarantee of bank liabilities, including both debts and deposits. However, such a blanket guarantee would remove any remaining discipline on banks that results from creditor or depositor caution about the banks' solvency. It is not clear that there is much discipline of this type remaining for the large banks that are perceived as Too Big to Fail, but the effect is likely still present to some extent at medium-sized and smaller banks.

Announcing a moratorium on new nationalizations of the largest banks for some period of time. This seems like a poor choice since there would be at least a chance that conditions would change, or new information would come to light, that made additional nationalizations desirable. It would be better to deal with the conditions that might create a need for nationalizations, such as through the other actions outlined above, rather than to promise not to do something that might prove to be necessary.

Step 10: Create a sound financial base; institute a good bank/bad bank structure

As noted in Step 4, the newly nationalized bank should start with, or swiftly achieve, a capital structure that represents a sound financial base for its desired operations. In addition to capital infusions and the possibility of forcing bondholders to take losses, discussed earlier, it will likely be sensible to create a "good bank/bad bank" structure.[5]

Removing the securities and loans with the greatest uncertainty from its books would allow the nationalized bank to go forward on a cleansed basis. Once these problem assets were identified and removed, management at the remaining "good bank" could focus forward. Further, potential buyers of all or part of the bank would not need to worry about hidden losses in these assets. At the same time, specialists in distressed assets could be added to those already at the bank and given the chance to work out the bad loans and securities in as effective manner as possible.

The good bank/bad bank structure makes a great deal of sense for these large banks, but it is not a panacea. For one thing, it now appears that perhaps two-thirds of credit losses will be from categories of loans and securities that one would not normally label "toxic." For example, it now appears that commercial and industrial loans will have a loss ratio of 4-7%, probably towards the higher end. This does not sound large, and certainly does not indicate the kind of underwriting, pricing, and transparency problems that existed with the toxic assets. Yet, there are such large volumes of these loans that a rate in that range still creates quite a large absolute loss.

It would be relatively easy to determine which securities represented toxic assets and the same is true for parts of the loan book. Other parts of the loan book may be harder to differentiate. One of the things about a severe recession is that it tends to produce surprises, bringing down some companies that had seemed quite safe and hurting some loan categories more than one would have expected.

Skeptics may wonder why large banks have not already split into good banks and bad banks. Citigroup has in fact already done something similar, but without taking the critical, defining step of setting up a separately capitalized unit that is not supported by the capital of the good bank nor has a mutual parent who is responsible for maintaining sufficient capital at the bad bank. For a bad bank to be effective in freeing the good bank to move forward it has to truly stand on its own.

It may be that the extra benefits of a truly separate bad bank are weaker than appears to be the case, perhaps because the internal management of these assets already lies with specialists who do not operate much differently than they would in a truly separate bad bank. More likely it is because a separate bad bank requires separate capital, which effectively crystallizes the value of losses for everyone to see. That is, the separate bad bank will have to have enough capital to reassure regulators and all other relevant constituents that it can indeed absorb the losses that may still exist in the toxic assets. However, the good bank's stakeholders are unlikely to give it any credit for possible overcapitalization at the bad bank, even if it legally has some residual upside. Therefore, any capital moved into the bad bank represents a capital loss to the good bank, unless it is obtained from new outside investors in the bad bank, who are likely to strike a very hard bargain for supplying that capital.

In sum, from the good bank's point of view, moving the bad assets to a separate unit would look very much like keeping those assets and writing them down to their lowest reasonable valuation. The capital hit would be very large and could very well be much larger than the economics would warrant, if there is indeed a significant element of "fire sale" pricing in today's highly illiquid market for these assets.

The government would be in a different situation. It is true that it would need to infuse capital into the good bank to make up for taking away assets and therefore capital. (Even toxic assets generally have some value, often substantial, and are likely to be carried on the books at that economic value or greater.) However, it does not need to directly capitalize the bad bank, since it is not intended to be an operating entity with external customers. The "capital" of the unit would effectively just be the government's willingness to accept that the losses on the bad assets might prove to be greater than the capital it infused into the good bank when the government took on the bad assets. Ultimately, this capital transfer between two units both initially owned by the government is not the core concern. The real question is whether the combined value of the good and bad banks goes up by more than the amount of any capital infusions necessary to implement that restructuring.

5. Please see "Good bank/bad bank", "Nationalization," and "Guarantees of Toxic Assets" for more on the basic structure.

Step 11: Make the necessary managerial changes

One of the trickier operational steps of the nationalization will be changing the management. The new CEO will hopefully be named on Day One. If not, it should be very soon thereafter. They may come with a core of a few managers that they know well and trust to take some of the key positions or to act as close advisors. However, the CEO will need many more good managers than they will have in their stable to start with. Much like the famous Rumsfeld quote about "going to war with the army you have, not the army you wish you had," any CEO will end up having to rely to a considerable extent on existing managers at the nationalized bank. In addition to the inability to manage such a massive hiring project as replacing all the existing managers of any importance, there is also a great deal of institutional knowledge inside the heads of the existing managers.

The CEO will need considerable time to get to know his or her key subordinates and to determine their capabilities and weaknesses, including which ones are largely telling the truth and which ones are feeding him or her distortions. The CEO will then determine the top management team, made up of his or her direct reports and perhaps some key second level reports. However, the changes are far from done at that point. Each direct report will need to go through a similar process, unless they remain in a position they already held. In practice, many of the existing managers will remain in place, but know that they are there on sufferance – the CEO or their immediate boss has yet to really decide if they are long-term survivors or not.

As with a merger or takeover, it is agreed by virtually all that fast moves on managerial changes are best. However, it is likely not to be possible to move terribly swiftly except at the very top of the chain of command. Even there, it is possible that there will be a considerably longer vetting process than executives are normally used to, since there will be strong political oversight.

Step 12: Announce a new strategic plan

Strategic planning for the newly nationalized bank is likely to be a two-step process. First, some strategy has to be announced very quickly if the intent is to operate differently going forward. There will be a strong tendency to operate on auto-pilot, moving in the same direction as before, unless there are explicit, coherent directions otherwise. Most likely, the initial strategy announcement would only deal with the most glaring issues to be addressed. For example, Citigroup owns a wide range of foreign banks, often ones that are quite important locally. In some countries these cannot legally be owned by a foreign government like the U.S., even indirectly. Therefore, there would be the need to take some major step fairly quickly, most likely to put any such banks on the auction block.

There might be other changes in direction that are dictated by policymakers, such as cutting back on the volume of proprietary trading positions or targeting an increase in mortgage lending.

One of the first steps of the new CEO would doubtless be the initiation of a major strategic review. It is important to move quickly on this, but it is at least as important to develop a sound plan. The best plan would incorporate the following principles:

Determine which units and activities are central to the bank's mission. This is always a critical part of any strategic plan that is more than a modest revision of an existing plan, but it is of particular importance in this case. First, the radical action of nationalization provides a fresh start without the preconceptions that can build up within any organization. Second, taxpayer support for the government's financial rescues is based on enhancing the banks' abilities to perform their core missions, principally acting as an intermediary between savers and those who need funds.

There will be units which are clearly in the core and others that clearly are not. However, there will also be some tough judgment calls. For example, would Citigroup's wide-ranging international activities be part of the core, because the decision is for it to be a truly global bank, or non-core, because the government's main interest is the U.S. financial system?

Tailor strategic decisions to take into account the new government ownership. There may be some activities that make sense as a purely business matter, but which feel inconsistent with the business mission of a nationalized bank. For example, proprietary trading can be a profitable activity that takes advantage of the expertise resident in a bank, and the many opportunities that it sees as a financial intermediary, to trade profitably for the bank's own account. However, it tends to be capital-intensive at a time when taxpayers are supplying the capital and it can seem like gambling to the public. Large proprietary trading losses would present a very unfortunate image for the newly nationalized bank.

Some operating decisions may need to be altered. Certainly there will need to be careful attention paid to the compensation strategy. Tax strategy is another area that may need to be altered. Corporate tax laws are extremely complex and there are often ways to hold down taxes where there can be a legitimate difference of opinion as to the proper treatment. Some banks are more conservative, while others are more aggressive in their tax positions. A nationalized bank will need to be conservative in this regard. It would send the wrong signal for a government-owned institution to be seen as pushing the edges of the envelope in this area.

Determine how to fix the core businesses. The answers here will depend heavily on specifics. It is possible that the main problems have already been fixed as a result of the intense scrutiny resulting from the financial crisis. The strategies and tactics for new business may already be appropriate and working well. However, it is certainly possible that major changes still need to be made.

Sell off the viable non-core units. Most of the large banking groups own some units that do not have close ties with the rest of the organization. These should not be retained within a nationalized bank for longer than necessary to obtain a reasonable price. If this will take many years, it may be necessary to accept a fire sale price today. A nationalized bank will be very difficult to run, more difficult than one in the private sector. It makes sense to simplify wherever the price for that simplicity is not exorbitant.

Keep an eye on the eventual sale. Managers run a company differently when it is clear that it will be sold eventually. Some of these actions are gimmickry which should be avoided, such as cutting necessary expenses when the damage will not show until after the sale or taking more aggressive accounting or tax strategies that would store up trouble for the future. However, many of the choices reflect a legitimate recognition that the new owners may wish to run the company differently than it would be run on a stand-alone basis. It may not make sense to implement certain actions that would pay off in the long run if the bank stayed independent, but which might need to be reversed or aborted under a different owner. In general, there should be few new initiatives that aim for 5-year results, unless the strategy is so basic that it would make sense in almost any scenario.

Step 13: Implement the new plan

Most people in business would agree that it is harder to implement a plan well than to design a good one in the first place. First, a strategic plan must necessarily be at a high level of generality, leaving the question of how to accomplish the goals to the managers themselves. Second, conditions change. The economy and financial markets swing; competitors respond to your moves or make their own; customers alter their own behavior; etc. Third, strategic plans are almost invariably flawed in some respects. The best that can be done is to hold down the number and scale of the imperfections. Inconsistencies, wishful thinking, ignorance, and power plays work their way into the plans, making it impossible to fully achieve the goals.

Long books are written on how to achieve the goals in a business plan, so it is pointless to attempt a definitive discussion here. However, there are a few key points that are specific to a nationalized bank, including:

Channel the political inputs. It is legitimate for our political leaders to express views on how a nationalized bank should operate, but there is also huge potential to create problems if handled inappropriately. The wrong approaches would invite graft and political favoritism. Even without these more extreme problems, political interference could create inefficiencies, confusion, and the waste of resources. Ideally all political inputs would be channeled through the government entity that acts as the controlling shareholder, which would then communicate with the CEO and designated high-ranking officers. Others at the bank should be shielded as much as possible from direct contact with politicians and lobbyists.

Keep in mind that it is the taxpayers' money. The various scandals and furors surrounding the actions of recipients of TARP funding have clearly emphasized that taxpayer money brings special responsibilities and sensitivities. This awareness should not be a strait jacket that keeps the managers from pursuing sensible business tactics, but there will be a need to consider how actions would appear to the public. One of the difficult tasks for the CEO and other top officers will be to make the case to the public for actions that are necessary for the bank to take, but which will intuitively seem wrong to much of the public. It is possible that sales conferences in resort locations may be one of these issues, considering how important a motivator these are for many people in sales activities.

Keep the team focused on maximizing profits. It is exceedingly difficult, sometimes impossible, to maximize two different variables at the same time. Trying to do so can create inconsistencies and inefficiencies that reduce the ability to do anything well. Senior management should choose short and long-term strategies that take account of the public policy objectives and they may need to set some explicit constraints. Within the range of activities consistent with the objectives and constraints, the team should focus on maximizing profits. This approach does not need to be so strict that there is no reward for generating ideas that aid in achieving public policy objectives, but it would be a mistake to scatter the effort in too many different directions. The intention is to create a profit-making bank that can be re-privatized, not to use the bank as a long-term tool of public policy.

Step 14: Sell the government's stake over time

There are three principal routes to a sale of the government's stake:

Look for a strategic buyer. Generally a seller will get the best price by finding a purchaser in the same industry that has the expertise to evaluate the firm and the ability to find synergies by combining the two businesses. These synergies can consist of expense reductions, from which bank mergers frequently benefit, or cross-selling opportunities or other ways of increasing revenues. This route may be harder than normal. First, the buyer would almost certainly need to be quite large in its own right, which could raise anti-trust concerns or simply go against a general attempt to fight the Too Big to Fail phenomenon. Second, the government may be reluctant for political or policy reasons to sell to a foreign acquirer, potentially ruling out another set of buyers.

Sell to a financial buyer. In recent years, the most common non-strategic buyers have been private equity funds or other investors who rely on financial leverage. This is normally more difficult to pull off when buying a financial institution, because such firms are already highly levered, so it can be excessively risky to add much additional financial leverage. It is hard with a bank to be sure of a steady stream of dividends to pay off the interest and principal on the loans that support the acquisition. However, the government may be willing to guarantee a substantial amount of acquisition borrowing in order to extract the best price for the bank and in order to move it into private hands more quickly. This would leave the risk that it would essentially have to repossess the bank later, but if that risk is low enough, it may be worthwhile.

Make an Initial Public Offering (IPO.) The other main option is to sell all or part of the bank in a public offering. This has the advantage that it is essentially run as an auction, gaining the benefit of price competition. On the downside, IPO's historically have to be priced below the expected trading price of the stock in order to lure enough investors to buy in up-front. (There are a number of reasons for this, ranging from the absence of a trading history in the stock, which increases the riskiness of estimating where it will trade going forward, to the need to motivate a large number of investors to buy on a given day. The potential buyers are usually less motivated to buy than the owner is to sell.) This price discount tends to be substantially lower for any future offerings, once there is a trading market establishing the fair price of the stock. A common strategy is to have an IPO for perhaps 20% of the stock and to follow it with later offerings, after the stock has a reasonable trading history. The government ended up disposing of most of its stake in Continental Illinois through such share sales, with the final disposition being a strategic sale of the whole bank to Bank of America after the government's ownership was down to 20%.

It is difficult to know in advance what the right sales method will be. The government should discuss the issue with investment bankers and potential purchasers early on to get an idea of the initial options. Most likely the government will conclude that the initial price is too low and that it needs to clean up the bank and start to produce an operating history as a reorganized entity. The right strategic plan may not be much affected by the ultimate form of sale – the best approach is to build value and reduce risks, regardless of who the buyer will be in the end.

The timing of a sale is similarly hard to predict in advance, other than the likelihood that it will not be soon, unless the government places a very high value on a quick disposition at the expense of maximizing the price received.

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