Lessons from Bailout History

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As the credit crisis deepens, legislative attention has turned to bailouts. The problem is, most governments try to arrange bailouts on the cheap and repeat past mistakes. This week, I cover three main lessons learned from global systemic bailouts, like those in the US in the Great Depression, the US in the 1980s, and Japan in the 1990s. I could add more global examples, but the point is that these are *systemic* bailouts, not individual institutions like Penn Central, Long Term Capital, or other contained events.

In recent weeks, numerous institutions have attracted capital to bolster balance sheets barraged by subprime mortgage and other credit losses. Some institutions have already obtained multiple capital infusions from various sources. So far, institutions have raised nearly $75b of capital from sovereign wealth funds and public sources.

While the seemingly unconstrained supply of capital has, thus far, been a blessing, it is not clear that the flow can continue and it is not clear that investors will continue to support the fundamental conditions of opacity that continue to plague markets. Recent events suggest that private capital sources may be reaching their limits, at least with respect to riskier institutions. While Citi and others obtained capital at 5% and 7%, most recently, MBIA was forced to pay 14% (on AA-rated debt!?!?!) and Ambac canceled their most recent recapitalization attempt, ostensibly because the cost was even higher.

As the price of capital reaches prohibitive levels institutions are looking elsewhere for relief and relief schemes are becoming more creative. For instance, today the Wall Street Journal announced that, “The owners of WestLB AG, one of Germany's largest state-controlled banks, plan to offload about €20 billion ($29.3 billion) in risky assets into an off-balance-sheet, special-purpose vehicle…. By doing so, WestLB avoids having them on its own balance sheet and having to take any related write-downs…. WestLB's move could leave taxpayers with the bill for any losses incurred by the special-purpose vehicle.” A neat way to avoid a direct government bailout.

But direct government bailouts are gaining in popularity as well. The New York State Insurance Commissioner persists in pursuing a bailout for bond insurers, after several banks recently announced steep writedowns on insured bonds as a result of recent bond insurer downgrades. The latest reports suggest the bailout package may consist of a mix of loans and capital infusions totaling approximately $15b.

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Putting aside complaints from the market that the amount is entirely inadequate, there are (at least) three lessons that legislators and regulators – and investors – should be aware of before assembling a bailout for any institution. Those lessons are knowledge accumulated through the history of successful and unsuccessful bailouts, although the lessons seem to be repeated with each successive crisis. It strikes me that getting it right the first time (which rarely happens) can reduce the cost of the bailout and ameliorate the severity of the economic downturn (perhaps averting recession).

1. Bagehot's Rule: Bail out Illiquidity, not Insolvency and Make Sure it Hurts

Before the Great Depression, policy to keep institutions open through bailouts did not exist. Institutions failed and were liquidated on behalf of shareholders.

During the Great Depression policymakers attempted to apply Bagehot's dictum to bailouts. Bagehot's dictum is the classic rule of bank policy (as opposed to monetary policy): lend to illiquid, but not insolvent, institutions at a penalty rate. The problem with applying Bagehot's dictum to bailout policy is that it is difficult to distinguish illiquid from insolvent institutions during a financial crisis.

But it is only when asset exposures are unknown, in the midst of the crisis, that the distinction between illiquidity and insolvency is problematic. After the incidence of loss is known, institutions that are clearly insolvent must be allowed to fail. Even once exposures are revealed, however, there is typically a small amount of remaining uncertainty at the margin of insolvency. Institutions at the margin may be candidates for targeted recapitalizations, but only in tightly supervised conditions. No institution should want a bailout – hence Bagehot's stipulation of a penalty rate.

Still, however, not every institution gets bailed out. When providing bailouts, it is important to target a specific financial instrument or arrangement that is thought to be valuable which is to be preserved. In the Great Depression that was bank lending. But in the Great Depression bank lending primarily funded purchases of real estate and business loans. Loans for new consumer goods, i.e., automobiles and refrigerators, were left out.

Hence, even in the depths of the Great Depression when the Federal Government recapitalized the banking sector, thousands of banks were found to be so deeply in trouble that they were closed rather than recapitalized. Those that received the Federal recapitalization did so through preferred stock investment with full voting rights, which the Reconstruction Finance Corporation used to replace officers and directors and forcibly restore institutions to solvency. No bank wanted the funds and the Federal control that came with them.

2. Loans Don't Help

Nearly every bailout program begins by trying to lend money to the affected institutions. The Great Depression's Reconstruction Finance Corporation attempted loans initially, but Mason (JFSR 2001), showed that loans to weak institutions actually increased the chance of failure. The Discount Window was opened to weak banks in the Thrift Crisis, but Schwartz (FRB St. Louis Review

1992), showed that discount window lending was a similar waste of money and effort. For Japan, Calomiris and Mason (NBER 2003) document the efforts to lend to banks in the early 1990s, and how authorities quickly concluded the effort was a failure and moved to recapitalizations.

In each case the effort was based on the allegation of the effectiveness of Great Depression programs administered by the Reconstruction Finance Corporation. The problem is, Mason (JFSR 2001) showed that those programs didn't work. The short reason is that giving additional leverage to a bank already in trouble will only make the situation worse.

3. Recapitalizations Help, but Close the Back Door

In each of those cases, recapitalizations were the next logical step.

In the Great Depression, the Reconstruction Finance Corporation took a three-step approach: close the weakest banks, recapitalize the sounder institutions, and exert iron-fist control over the banking industry after the Federal Government owned voting stock in nearly every commercial bank (and many nonfinancial corporations) in the US. The Reconstruction Finance Corporation replaced officers and directors of banks and corporations and prohibited dividend payments for as long as they owned stock in the institution.

The Reconstruction Finance Corporation then used that same control to direct credit to strategic industries for the ensuing war effort and post-war recovery. Notably, the Reconstruction Finance Corporation was the only government agency to be shut down after its policies were alleged to part of widespread pattern of greed and corruption in the 1950s.

US officials wanted to reinstate the Reconstruction Finance Corporation recapitalization program in the 1980s Thrift Crisis, but found they did not have adequate authority to do so. Hence, regulators resorted to regulatory goodwill capitalization (forbearance) to fund bank capital, which was ultimately withdrawn by Congress. That withdrawal led to a Supreme Court breach of contract ruling against Congress and in decades of lawsuits (that are still being worked out). Congress' withdrawal of regulatory goodwill was the only time Congress has been successfully sued.

Japan used direct recapitalization to rescue its banking system in the 1990s. Only Calomiris and Mason (NBER 2000) show that the Japanese forgot to restrict dividend payments as the Reconstruction Finance Corporation did in the 1930s US. As a result, much of the capital injected by the Japanese government was immediately tunneled out of the banks in the form of excess shareholder dividends. A second recapitalization program was necessary to make an impact.

Conclusions

Systemic bailouts are notoriously tricky. That is no reason, however, not to address the obvious pitfalls of such programs that have been repeated through history. The problem, however, is that the industry won't like bailouts that come at a cost.