

---

---

## The Bailout is Already Underway (and failing)

JOSEPH R. MASON†

Bailouts are already underway, no matter the administration's claims to the contrary. The TAF is making discount window lending anonymous while the Fed is rapidly increasing the size of their lending program. Last week the Fed raised its commitment to the TAF facility to \$100 billion, accompanied by another \$100 billion in repurchase agreement authority.

The problem is that this precisely the wrong type of bailout. The Federal Reserve is warning of capital deficiencies in the banking sector, which cannot be fixed with loans (and for which loans violate the Federal Reserve's own Regulation A).

The following text describes why, by historical inference, the TAF's anonymity is protecting the guilty. After reviewing why bailouts are sometimes necessary, I describe successful and unsuccessful bailouts and their application through history. I show how bailouts are being applied today and why they will not work in their current incarnation. The lesson at the end of the day is that we need to move beyond denying the capital crisis and move to restoring transparency to the financial system in a manner that will attract sufficient capital to restore market and economic growth.

### PROMISES AND PITFALLS OF BAILOUTS

It is not always clear why bailouts are necessary. With banks, the issue is (relatively) simple. Banks are thought to intermediate high-asymmetric information assets, particularly small business loans, that are thought to be the source of significant economic growth.

That, in itself, however is not generally sufficient to justify such radical support by the government. Banks also aggregate small short-term deposits and lend them in the form of larger longer-term loans. Hence, bank intermediation of information, as well as denomination and maturity make them socially and economically "special" and, perhaps, worthy of occasional government support.

But there are problems with bailouts. Banks that need bailouts often increase their own risk by responding to skewed incentives in an incomplete regulatory framework. Skewing incentives further with bailouts often worsens the problem.

Also, as Willie Sutton famously said, banks are "where the money is." Politicians, therefore, tend to favor bailouts when they can control how the proceeds are distributed. Economists call this the "dark side" of bank bailouts.

---

† Associate Professor of Finance, Drexel University LeBow College of Business, Senior Fellow at the Wharton School, and Financial Industry Consultant, Criterion Economics, LLC. Contact information: [joseph.r.mason@gmail.com](mailto:joseph.r.mason@gmail.com); (202) 683-8909 office. Copyright Joseph R. Mason, 2007. All rights reserved. Past commentaries and testimony are archived at [http://www.criterioneconomics.com/pubs/articles\\_mason.php](http://www.criterioneconomics.com/pubs/articles_mason.php).

Banks are repositories of economic and political power – a source not only of funds but also of substantial discretionary power over the economy.

For example, Krueger and Yoo (2001) show that in Korea resources allocated to bail out banks were channeled in large part to value-destroying large firms. Thus, bank bailouts must be combined with effective reforms of lending practices. Arguments in favor of assisting banks therefore rely on attendant reforms in bank lending practices that will ensure that bank credit is channeled to firms on the basis of the merit of their investments. Too often such reforms are lacking.

As a result of those very real costs and benefits, it is important to think hard about WHY bailouts may be necessary in any particular instance. “The central goal of bank bailout policy is to design bank assistance to meet the legitimate goals of mitigating credit supply contraction for value-creating bank-dependent borrowers, while minimizing the potential abuse of assistance.” (Calomiris and Mason 2004 NBER)

It is also important to think hard about the total package of measures that mitigate the credit supply effect while *making sure appropriate business reforms are carried out* as a firm condition of the bailout package.

It is rare that both those conditions are satisfied in any bailout package.

*Figure 1: Resolution Costs of Selected Bank Crises*

<i>Country</i>	<i>Years</i>	<i>Cost as Percent of GDP</i>
Argentina	1980–1982	55%
Benin	1988–1990	17
Bulgaria	1990s	13
Chile	1981–1983	41
China	1990s	47
Côte d’Ivoire	1988–1991	25
Czech Republic	1991–1994	12
Finland	1991–1994	11
Hungary	1991–1995	10
Indonesia	1997–1999	50
Israel	1977–1983	30
Japan	1990s	12
Korea	1997–1999	20
Macedonia	1993–1994	32
Malaysia	1997–1999	20
Mauritania	1984–1993	15
Mexico	1995	15
Philippines	1981–1987	19
Senegal	1988–1991	17
Spain	1977–1985	17
Taiwan	1997	11
Tanzania	1987	10
Thailand	1997–1999	42
Uruguay	1981–1984	24
Venezuela	1994–1995	18

Source: Calomiris and Beim

## COSTS OF BAILOUTS

Banking history, both recent and past, provides ample lessons about the pros and cons of bank bailouts.

Lesson one is that bank bailouts are very costly. Figure one illustrates that point. In cases like China in the 1990s, the costs reached toward 50% of GDP, and even 55% of GDP in Argentina in the early 1990s. Typically the costs aggregate to only around 20% of GDP.

*Figure 2: Instances of Bailouts in Industrialized Countries*

<b>Industrialized Countries</b>		
<b>Finland</b> 1991–1994	Savings banking sector badly affected; government took control of three banks that together accounted for 31% of total system deposits	Recapitalization costs amounted to 11% of GDP
<b>Japan</b> 1990s	Banks suffering from sharp decline in stock market and real estate prices; official estimate of NPLs: ¥40 trillion (US\$469 billion) in 1995 (10% of GDP); unofficial estimates put NPLs at ¥1 trillion or 25% of GDP; banks have already made provisions for some bad loans. At year-end 1998, total banking system NPLs estimated at ¥87.5 trillion (US\$725 billion), about 17.9% of GDP; in March 1999, Hokkaido Takushodu bank closed, Long Term Credit Bank nationalized, Yatsuda Trust merged with Fuji Bank, and Mitsui Trust merged with Chuo Trust	In 1996, rescue costs estimated at over US\$100 billion  In 1998, government announced Obuchi Plan, which provides ¥60 trillion (US\$500 billion), about 12.3% of GDP, in public funds for loan losses, recapitalization of banks, and depositor protection
<b>Norway</b> 1987–1993	Central Bank provided special loans to six banks, suffering from post-oil recession of 1985–1986 and from problem real estate loans; state took control of three largest banks (equivalent to 85% of banking system assets, whose loan losses had wiped out capital), partly through a Government Bank Investment Fund (Nkr 5 billion) and the state-backed Bank Insurance Fund had to increase capital to Nkr 11 billion.	Recapitalization costs amounted to 8% of GDP
<b>Spain</b> 1977–1985	1978–1983: 24 institutions rescued; four liquidated, four merged, and 20 small/medium-sized banks (Rumasa Group) nationalized. In total, 52 of 110 banks experiencing solvency problems, representing 20% of total banking system deposits	Estimated losses of banks were equivalent to approximately 16.8% of GNP
<b>Sweden</b> 1991	Nordbanken and Gota Bank insolvent, accounting for 21.6% of total banking system assets; Sparbanken Foresta intervened, accounting for 24% of total banking system assets; overall, five of six largest banks, accounting for over 70% of banking system assets, experienced difficulties	Cost of recapitalization amounted to 4% of GDP

Source: Calomiris and Beim

We can be tempted to suppose that developed countries are immune from such costs. Not so. Figure 2 shows the effects are not limited to lesser-developed countries.

Figure 2 shows that Japan's costs of the "lost decade" have so far exceeded 12% of GDP, Finland's costs of 1991-1994 came in at about 11%, Norway 1987-1993 about 8%, Spain 1977-1985 about 17%, and Sweden of 1991 about 4%.

It is important to realize that Sweden is often held as a model case of a well-managed program. Now let's discuss what a "well managed" program is.

## CHARACTERISTICS OF MODEL BAILOUTS

Policymakers face two main policy choices for bailouts: loans and recapitalizations. (In Europe they call recapitalizations "nationalizations," but we don't like that term in the US.)

No matter what you call them, the choice comes down to the type of crisis that afflicts that economy. For quick liquidity crisis, loans are sufficient. Deeper problems, i.e., more than a week or so, are typically credit solvency problems, necessitating capital injections.

Let's look at the properties of each, in turn.

#### *Lending in Liquidity Crises*

Loan-based assistance is based on Bagehot's rule. (Note, however, that what we call Bagehot's Rule is actually a bit bastardized, as it is unclear that Bagehot envisioned a central bank undertaking these functions, but I digress.)

There are two main problems with Bagehot's rule. First, it is difficult, if not impossible, to distinguish illiquid from insolvent banks in a crisis market. Second, banks don't like a true penalty rate, claiming it is too expensive. The point is, however, that if the bank was solvent, it would be able to pay!

But and even more important point is that Bagehot's rule has never really been followed

Almost from the Fed's inception, they have flaunted Bagehot's rule at the discount window. The Fed did this by lending to noticeably insolvent institutions as if they were illiquid.

As mentioned previously, one good measure of liquidity is whether the institution needs help for an extended period of time. Is one week enough? One month? Six months? One year? Liquidity crises are quick because they are typified by a situation where prices are known but money is lacking. Since such situations cannot last very long before money becomes available, liquidity crises are short. (In contrast, today money is there but we don't know prices.)

To see how the problem can grow, even before the Great Depression the Fed was propping up banks that were at risk of failure. According to Anna Schwartz (FRB St. Louis, 1992), an early investigation of Federal Reserve lending to weak banks showed that of 457 banks that borrowed continuous borrowers in 1926, 41 banks suspended operations in 1927, while 24 liquidated voluntarily or merged

When the Fed was reaching capacity, in the early 1930s, the Reconstruction Finance Corporation entered the picture, lending to banks, railroads, and other firms explicitly to provide capital. The RFC made short maturity (six-month) loans at high rates (6%) collateralized by banks' best quality, most liquid assets. Loans were typically rolled over at the end of the six months' time, facilitating a supply of long-term credit to the banks.

Statistical studies of the program's success concluded, "The RFC's practice of subordinating depositors' and investors' interests through senior claims on banks' best assets may have caused banks to fail." (Mason 2001 JFSR) Hence, most of those loans were associate the subsequent failure of the borrower institution. The idea is simple: you can't fix a solvency problem with more leverage.

A similar program was implemented during the Thrift Crisis of the 1980s. After the Thrift Crisis, the House Banking Committee ordered an investigation of Federal Reserve Discount Window lending.

Importantly, in earlier crises one could plausibly argue that it is difficult to discern between illiquid and insolvent institutions. But by the 1980s regulators had the benefit of ongoing surveillance and regularly updated CAMELs ratios that gave quick insight into bank conditions. (If a bank is rated CAMEL 4 it is in dire difficulty; 5, it is on the brink of failure.)

The results of the House Banking Committee investigation are therefore stunning: “Of 530 borrowers from 1985 on that failed within three years of the onset of their borrowings, 437 were classified as most problem-ridden with a CAMEL rating of 5, the poorest rating; 51 borrowers had the next lowest rating, CAMEL 4.”

The losses were also astonishing: Discount Window loans outstanding to banks at the time of failure amounted to almost \$10b. At the time of failure, 60 percent of the borrowers had outstanding discount window loans. These loans were granted almost daily to institutions with a high probability of insolvency in the near term, new borrowings rolling over balances due. In aggregate, the loans of this group at the time of failure amounted to \$8.3 billion, of which \$7.9 billion was extended when the institutions were operating with a CAMEL 5 rating.

Japanese authorities followed the same strategy in the 1990s, based in part upon the perceived success of the US RFC. The program extended ¥1,726b of bonds in 1998, with little economic effect.

The interesting part of the story is that the Fed knew all along that the Discount Window lending was problematic. In 1932, the Fed admonished: “Central banks must not in any way supply capital on a permanent basis either to member banks or to the public, which may lack it for the conduct of their business”

In 1954, the Fed pronounced the problem eradicated, and promoted, “an established tradition against member bank reliance on the discount facility as a supplement to its resources.” The Fed reiterated its position in 1973 in the text of Regulation A, and again in the text of Regulation A in 1980 and 1990, while at the same time extending loans to weak bank liberally through the Discount Window, attaining a maximum exposure of about \$18b within three months of bank failures during the height of the Thrift Crisis.

Hence there is a clear pattern in the 20th century: each time, loan programs are promoted on the basis of their historical effectiveness, despite evidence in support of the ineffectiveness of those programs.

#### *Recapitalization Programs for Solvency Crises*

As Mason (2001) noted “An effective policy to enhance recovery from banking crises and prevent them from resulting in a more widespread economic downturn relies critically upon assuming substantial default risk.” Even in the 1930s, at the time of the Reconstruction Finance Corporation, policymakers were not fooled.

Nonetheless, authorities typically lend to insolvent banks until the crisis rises to such unmanageable proportions that a recapitalization is obviously necessary, which is the only point at which the costs of such an action can be fully justified. Unfortunately, that means we must all suffer through this a bit longer until things *really* get bad.

But each successive time authorities also need to be convinced, again, of the need to address credit crisis (if at all) with capital. Each time, as well, they re-learn the lessons used by private capital firms: keep control of the firm and the proceeds advanced.

The US Reconstruction Finance Corporation advanced sums of money for voting preferred stock shares of banks that made the loan program look comparatively small.

---

Note, however, that those investments carried strict conditions, much like those that private equity firms today impose on their own investments. Full voting rights, board seats, and dividend restrictions.

Before the Depression was through, the government owned stock in nearly every institution in the US, and often had effective control by way of owning the largest voting block of shares. The RFC used that power to fire CEOs and install its own managers to nurse the institutions back to health. As private equity investors know today, however, do otherwise would be a waste of money.

The results were dramatic. Dividends were certainly restricted, but bank capital and bank loans increased. Now, the program still couldn't halt the decline in the capital/asset ratio or the loan/asset ratio, because asset still needed writedowns to reflect true credit quality. The point, however, is that loans were made available and the banking sector was rescued.

Now look at what happened in Japan. Massive capital infusions in 1998 and 1999, totaling some ¥7,500b were undertaken between 1998 and 1999 to little economic effect. The reason is simple: the Japanese authorities did not restrict dividends or otherwise undertake regulatory reforms that strengthened the banking system. As a result, dividend payments were increased after 1999, as proceeds were tunneled to keiritsu stockholders. Since the capital did not encourage loan supply growth, roughly ¥7,500b (roughly \$75b) were wasted.

### **THE SITUATION TODAY**

The situation today is similar. The TAF is making discount window lending anonymous. Furthermore, the Fed is rapidly increasing the size of their lending program. Last week the Fed raised its commitment to the TAF facility to \$100 billion, accompanied by another \$100 billion in repurchase agreement authority.

Precisely as the Federal Reserve is warning of capital deficiencies in the banking sector. But somehow the sector raised \$500 million to inject Ambac with additional capital. Where did that come from in a broadly capital-deficient banking system? The answer sure seems like it came from the Fed lending facilities.

By historical inference presented above, the TAF's anonymity is protecting the guilty. Perhaps the House Banking Committee should again request data on TAF and Discount Window lending and monitor its application during the present crisis.

Classically, no authority is addressing regulatory reform related to the incestuous relationship between the monolines and the credit rating agencies. Back-of-the envelope calculations suggest that monolines are the source of almost 30% of ratings agency revenue. Clearly, that is a substantial disincentive to the credit rating agencies for downgrading the monolines.

But I argue that this is just the beginning. The fact is that the US financial system needs capital. By reasonably estimated, the monolines need some \$15 billion to bail them out in any meaningful way. Most tellingly, private equity investors are gone and the bailout package is stalled.

Commercial banks are estimated to have some \$70 billion exposure to the monolines and have already written off some \$150 billion in subprime loan losses. Hence, Timothy Geithner's assertion that the industry needs to raise more capital seems quite apt.

