

Chapter 15: Executive Summary

The Financial Sector “Bailout”: Sowing the Seeds of the Next Crisis?

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Background

The two-month period from September to November 2008 has been witness to the most extraordinary level of direct US government involvement in financial markets in over seven decades. In part, this intervention took on the form of *ad hoc* institution-specific rescue packages such as those applied to Bear Stearns, Fannie Mae, Freddie Mac, AIG, and Citigroup. But a substantial part of the effort and huge sums of money have also been committed in an attempt to address the systemic problems which led to the freezing of credit markets. A multi-pronged approach has finally emerged with three key schemes:

1. A loan-guarantee scheme administered by the Federal Deposit Insurance Corporation (FDIC) under which the FDIC guarantees newly-issued senior unsecured debt of banks up to a maturity of three years.
2. A bank recapitalization scheme undertaken by the US Treasury in which the Treasury purchases preferred equity stakes in banks.
3. A commercial paper funding facility (CPFF) operated by the Federal Reserve.

The Issues

The sheer magnitude of this intervention has raised two central questions of interest:

1. At what prices are these schemes being offered? Are the terms fair from the taxpayer standpoint? Are the terms fair to healthy banks and financial institutions?
2. And equally important, will the bailout achieve its intended purpose of assuaging counterparty risk concerns (which have arisen because the market does not know which banks are healthy and which are not) and thawing the freeze in credit markets at large?

Our analysis of the salient features of each of these programs, their possible economic consequences and, where relevant, comparisons with similar efforts undertaken in other countries, notably the UK, have led us to conclude that:

1. By adopting a one-size-fits-all pricing scheme that is set at too low a level relative to the market, the US loan-guarantee scheme represents a transfer of between \$13 billion and \$70 billion of taxpayer wealth to the banks. In contrast, the UK scheme, which uses a market-based fee structure, appears to price the guarantee fairly.
2. By offering very little in terms of optionality in participation, the US loan guarantee scheme is effectively forced on all banks, giving rise to a pooling outcome. The UK scheme, in comparison, provides considerable optionality in participation which, combined with its pricing structure, has induced a separating equilibrium where healthy banks have not availed of government guarantees but weaker banks have. Implicitly, the US scheme encourages a system where banks are likely to remain (and to want to remain) on government guarantees until the crisis abates, whereas the UK scheme has paved the way for a smooth transition to market-based outcomes.
3. The US recapitalization scheme has also provided little in terms of participation optionality for the large banks, but it too is otherwise generous to the banks in that it imposes little direct discipline in the form of replacement of top management or curbs on executive pay, and furthermore secures no voting rights for the government. The UK scheme allows for optionality in accepting government funds, and is associated with government voting rights, replacement of management in some cases, and significant curbs on dividend and executive pay.
4. By requiring a threshold credit quality and using a wider spread, the US commercial paper funding facility appears to be more fairly priced than the loan-guarantee scheme, and does not appear to represent a net cost to taxpayers.

Overall, the UK bailout plan appears to be much better grounded in sound economic principles. While bailouts are unavoidable under extreme economic stress, they ought to be designed and priced correctly even in such times of crisis.

Policy Recommendations

What follows are some simple rules for regulators to follow:

1. Do not employ a one-size-fits-all approach in pricing; this makes it harder to separate good and bad banks, and ultimately to move back to a market-based system. As corollaries to this overall principle:
2. Rely on market prices wherever available;
3. Reward those institutions that did well more relative to those that did not; and
4. Review incentive systems within banks that led to the crisis in the first place.

By and large, adherence to these principles would reduce any unintended consequences (due to moral hazard) and ensure that the outcomes from the bailout

represent a rescue of the system but still in a manner that accrues no undue advantage to a small set of institutions. When bailouts are organized in such fashion, market participants are still disciplined *ex ante* by the prospect of relative gains and losses.

A final issue that arises is what the regulators have planned in terms of exit from the guarantees and recapitalization programs. The US regulators have not priced the guarantees right, and they have offered them for as long as three years. Have they, as a result, raised the possibility of substitution by banks into inefficient assets (for example, by undertaking acquisitions that are profitable *only* with the guarantee)? The typically sticky nature of regulatory responses during past crises makes planned exit an important issue for regulators to ponder, lest we sow the seeds of the next crisis. When the economic outlook improves, we do not want to see abundant liquidity at artificially low prices (due to guarantees) because it creates the possibility that the sequence of events we have just been witnessing—excessive leverage, inefficient allocations, asset price bubbles and finally, a crash—may recur.

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