In knots over nationalisation

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State control of some banks is sadly unavoidable. Don't run away from it; focus on doing it well

THERE is a whiff of Alice in Wonderland about the arguments over America's banks. Voices on the free-market right, including Alan Greenspan, a former chairman of the Federal Reserve, and a clutch of Republican senators, suggest that temporary nationalisation may be best for the most troubled big banks. Rather than drip-feeding public support, they argue, the state should take over those banks that have all but failed, clean up their balance sheets and then quickly sell them.

Meanwhile the Democratic Obama administration considers nationalisation taboo. The White House's plans involve injecting more public funds into the biggest banks if new "stress tests" suggest they need it (see article). Addressing Congress on February 24th, Mr Obama made clear that taxpayers would probably have to find more cash. But nobody will admit that this could lead to public control, let alone explain how control would work. This week both Tim Geithner, the treasury secretary, and Ben Bernanke, the Fed chairman, publicly dismissed nationalisation, saying it was not necessary.

Oh dear! I shall be too late

Unfortunately, that is a false hope. A strategy geared to avoiding outright government control will not work as well as one that is honest about what it wants to achieve and how. Nationalisation should not be a goal of policy, but the worsening economy, the scale of likely bank losses and the banks' lack of capital means that some will survive only with a capital infusion big enough to leave them largely in public hands.

Look at Citigroup, which has already been propped up by $45 billion of non-voting government capital and guarantees to limit losses on some $300 billion of its worst assets. As *The Economist* went to press, Citi was on the brink of converting part of the Treasury's aid into a government equity stake as high as 40%. If more capital is needed (as most expect), the Treasury will probably have either to embark on Enron-style creative accounting, or to become a majority shareholder.

Although the administration is unwilling to admit this, the speculation outside government has been that nationalisation is only a matter of time. That has fed a devastating uncertainty. In the past week bank stocks have swooned on fears that shareholders in troubled banks will eventually be wiped out. Led by collapsing bank shares, the Dow Jones Industrial Average fell to an 11-year low on February 23rd. Although bank shares recovered slightly after Mr Bernanke's comments, that says more about shareholders' relief at the stay of execution than about a sudden improvement in the banks' prospects.

The uncertainty over nationalisation is costly and self-defeating. Several big banks have seen their borrowing costs rise as bondholders fear that they, too, will suffer in any government restructuring. Weaker share prices and dearer credit will worsen the economy, further weaken banks' loan books and increase the need for yet more public capital.

It is time for America to move beyond sloganeering and denial. Contrary to the glibness with which some proponents advocate it, government control of big banks is not a quick and painless solution to the banking mess. Given the scale of the crisis, the depth of the recession and the burden of the underlying debt, government involvement in any bank is unlikely to be unwound quickly. Sweden, widely praised for its handling of its early 1990s banking bust, took several years to clean up and privatise the banks it nationalised. Mr Obama's people are right to worry about the risk of bureaucratic management and political meddling in lending decisions.

You are old, Father Ben

Yet politicians, including Mr Obama's team, are already meddling. Congress has imposed sweeping controls on bankers' pay; banks that receive public capital must already provide regular reports on how much they lend and to whom; complaints from within Citi suggest that managers are distracted and bewildered by demands from politicians and regulators about day-to-day operations. Mr Obama this week left little doubt that he wants more oversight. Explicit government ownership would be an improvement over the onerous, fiddly and capricious intervention of today. An arms-length bank management board would both keep the interferers at bay, and also require the public sector to bear the consequences of its meddling on the bank's performance. Rather than an escalation of public control, as government capital is gradually converted into common equity to cover the banks' losses, it would be better to lay out the scale and scope of public ownership as soon as possible.

The administration's "stress tests" may show that some banks need a lot of capital. If the government has to provide it, taking control as it does so in some cases, so be it. If the government becomes the owner, it needs to act as such, selling businesses, breaking them up and firing managers if needs be.

If that happens, shareholders will be heavily diluted—though, crucially, they will not be wiped out, as investors now fear. It is tempting to suggest that the bondholders of big banks should suffer too, just as they can suffer when small banks fail and are taken over by the Federal Deposit Insurance Corporation. Though that would indeed set an example (and drastically lower the cost to the public purse) it risks a catastrophic Lehman-style flight from all bank debt. With their noses held, the Obama team should state plainly and clearly (as the Swedish did) that these banks' liabilities will be left whole.

The odd thing is that Mr Obama's fiscal policy has been far clearer. The budget, due to be presented on February 26th, promises to eschew accounting gimmicks, paint an unvarnished picture of America's fiscal future, and to reduce the deficit to 3% of GDP by 2013. It is not perfect—there is too little focus on entitlement or tax reform. But it seems an honest attempt to put the recent stimulus in the context of a plausibly responsible medium-term fiscal path. Laying out the template of bank rescues is harder, but no less important. Unless America's financial system recovers, the economy will remain in a funk and Mr Obama's budget goals will turn out to be as elusive as the world beyond the looking glass.

A ghoulish prospect

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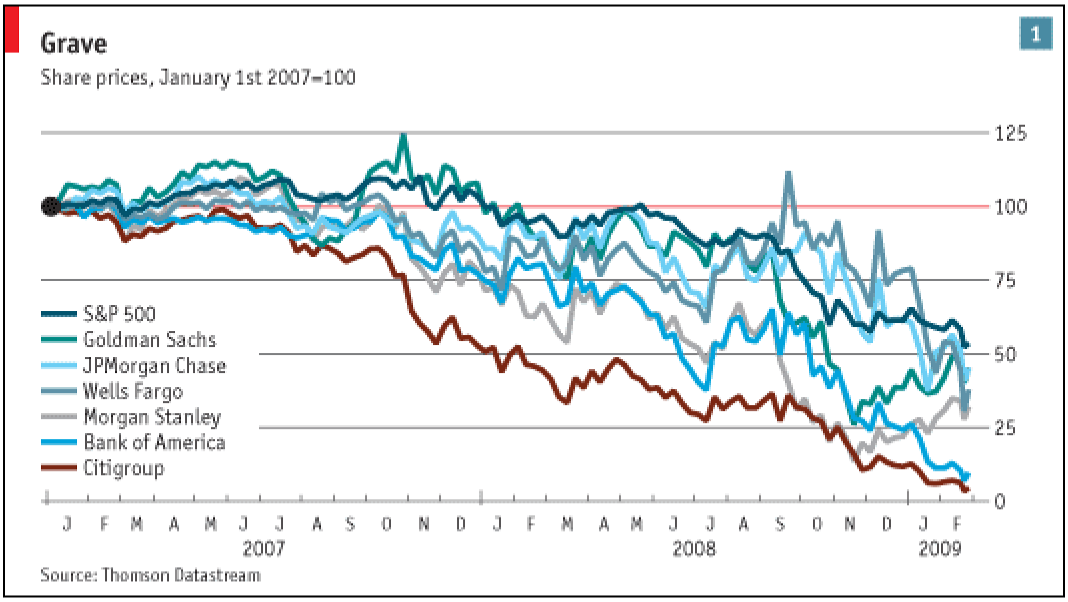
Nationalisation carries risks, but it may still be the best way to deal with American banking's undead

IN A classic horror film, "Night of the Living Dead", a terrified group of people barricade themselves in a rural farmhouse to escape hordes of flesh-eating zombies. Today Americans are gripped by a similar fear, but this time the walking corpses in their nightmares are banks, tearing insatiably at the public purse. As the Obama administration struggles to get its poorly received bank-rescue plan up and running, it is being pressed to respond to suspicions that some large banks are on the edge of insolvency, if not already there.

In a matter of weeks nationalisation has gone from taboo to talking point. Economists debate its pros and cons across the blogosphere. Politicians on both left and right accept that America's sickest banks may need to be taken over and restructured and their good parts returned to private ownership. Even Alan Greenspan has become an advocate.

Although the government continues to resist such calls, its hand may be forced by the results of the "stress tests" that it began to perform on February 25th on the 19 largest banks. Officials' own stress levels are running in inverse relation to the banks' share prices. Those of Citigroup and Bank of America plumbed new lows on February 20th (see chart 1). That prompted the Treasury and a group of regulators to declare that they stood "firmly" behind the banking system, but that their "strong presumption" was that banks would remain in private hands. Ben Bernanke, the chairman of the Federal Reserve, went further, saying in congressional testimony this week that nationalisation "is when the government seizes the bank and zeroes out the shareholders...we don't plan anything like that."



Even so, the neediest banks are heading that way. As *The Economist* went to press, the government was in talks with Citigroup over what would in essence be partial nationalisation: the conversion into common equity of a chunk of its preferred stock, obtained in return for pumping capital into Citi last year. This would give it a stake of up to 40%—eight times the holding of Prince Alwaleed bin Talal, the most influential existing shareholder—and voting power to match.

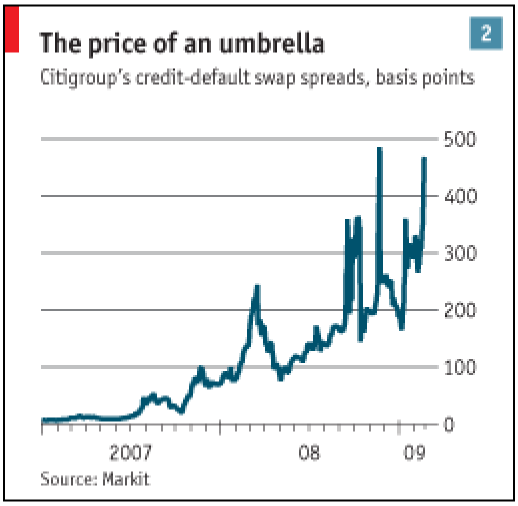
Citi approached regulators about the conversion, fearful of being swamped by further losses as the recession and housing crisis deepen. The deal would mark the bank's surrender in its battle to persuade investors that its reasonably healthy "tier-one" ratio is a convincing measure of capital adequacy. These days markets prefer measures using tangible common equity, which is undiluted by hybrid capital such as preferred stock.

The government may end up repeating this across the industry. The first step in its Capital Assistance Program will be the stress tests, which will take a few weeks. The aim will be to map potential losses in a two-year recession with unemployment rising as high as 10.3% and house prices continuing to tumble. If the testing shows that banks need more capital, they can first try to raise it over six months from private sources. If they fail, they will get government help. The state will take preferred stock (paying a 9% dividend) that converts into common equity if needed.

This strikes some as fiddly at a time when the markets crave boldness. Drip-feeding equity as needed avoids the appearance of nationalisation. But by adding to the complexity of banks' capital structures and not revealing what would constitute adequate capital it risks sowing confusion about their ability to ride out losses.

Next for shaving

Nor has the government brought clarity to its treatment of bondholders, which was anything but consistent under the previous administration: Bear Stearns's creditors got their money, Washington Mutual's were all but wiped out. Credit-default swaps on Citi have widened lately (see chart 2), as have those on other big banks. This reflects fears that the state, in return for injecting more capital, might force a "haircut" on creditors, who sit above shareholders in the capital structure.



Compelling troubled banks to default on their debt may seem just. Christopher Whalen, an independent banking analyst, argues that some banks' bondholders may have to take a hit if depositors are to be made whole. The danger, however, is that this causes the sort of liquidity runs that wreaked havoc after the demise of Lehman Brothers last September.

If bond investors are forced to share the pain, they may at least want some potential gain. Some restructuring specialists have suggested that bondholders be handed shares in the most troubled banks through debt-for-equity swaps, a common device in non-financial corporate workouts. That, however, would leave the banks partly owned by foreign governments and central banks. American politicians may find this unpalatable.

Doubt also surrounds a centrepiece of the bail-out plan announced by Tim Geithner, the treasury secretary, on February 10th: a public-private partnership to buy distressed mortgages and other bad assets. Mr Geithner envisages vulture investors snapping up as much as $1 trillion-worth of the stuff, helped by cheap government loans and perhaps a floor under prices. But details are still being worked on, leaving potential participants sceptical of its merits. Under Hank Paulson, his predecessor, two asset-buying plans foundered after proving unworkable.

Bank executives, meanwhile, are livid that they have not been consulted on the plan's mechanics. They also question the logic of performing stress tests that do not take account of the gains in store, at least for some banks, if a market for distressed assets takes off. It could send the prices of the most illiquid securities up by 80% in short order, reckons one chief executive.

Even if banks can offload at reasonable prices the dross they piled up in the boom, they have lots of other assets that will sour this year, from credit-card debt to corporate loans. High-quality, or "prime", mortgages look ever wobblier, too, as joblessness climbs towards 8%. American banks have recognised more than $1 trillion in credit losses, but most analysts think this is only around half the final tally. The most pessimistic expect losses on American loans to reach $3 trillion-4 trillion.

Regulators insist that the big banks are, by and large, well capitalised despite their flurry of write-offs. Just as important, the industry as a whole is still producing fairly strong cash flows: higher in the rocky third quarter of 2008 than in the calm first quarter of 2007, points out Dick Bove of Rochdale Research.

But this masks huge variation. Some regional banks are thriving, especially those that avoided dodgy mortgages and loans to property developers. Hudson City Bancorp, a New Jersey thrift that wrote only high-quality mortgages through the boom and insisted on down-payments of 20%, recently announced record profits. According to a survey by Greenwich Associates, such conservative lenders are picking up market share from rivals that rely on government support. But Hudson is in the minority. The number of banks on the Federal Deposit Insurance Corporation's problem list was expected to rise sharply, from 171, when the FDIC published its quarterly update on February 26th, after *The Economist* went to press.

Fortunes vary among the giants, too. No one doubts that the sums still needed to put Citi on a sure footing exceed its current market value of about $14 billion. The capital conversion would be its third bail-out in four months. Bank of America is also in poor shape, thanks to its disastrous purchase of Merrill Lynch and its heavy exposure to enfeebled consumers. JPMorgan Chase, the healthiest of the big banks, is nevertheless taking no chances. It cut its dividend this week to save $5 billion in equity. It said this was a precaution, in case conditions worsen dramatically.

What should be done with "systemically important" banks that perform poorly in the stress test? Throwing yet more capital at them risks perpetuating what Paul Krugman, a Nobel prize-winning economist, calls "lemon socialism", in which banks reap the gains but taxpayers eat the losses. It was handouts without proper workouts that led to Japan's "lost decade".

Hence the growing calls for the clean break offered by temporary nationalisation—or "conservatorship", as some prefer. This involves several steps: ascertain which banks are insolvent, take them over, sever the most toxic assets and sell them over time or hold them to maturity. The good parts would be sold to the public or a strategic buyer as quickly as is feasible. These healthy banks would be fit to lend, benefiting the overall economy. The taxpayer may even avoid losses.

This may present another opportunity: to accelerate the break-up of banks that have become too big to fail. This was a problem before the crisis. Shotgun takeovers of weaklings, such as Bear Stearns, Merrill and Wachovia, have made it worse. Citi is considered particularly unmanageable.

Death and taxes

This degree of interference would strike some as un-American. But the government's tentacles are already wrapped around the banking industry, through debt guarantees, loss-sharing agreements, central-bank facilities and capital infusions, not to mention pay caps. It may take up voting rights on its common stock. As Mr Bernanke pointed out this week, banks cannot do whatever they like with capital they receive from the state. Citi already has to clear strategic decisions with regulators.

Moreover, far from being an alien concept, nationalisation is, as Mr Krugman has put it, "as American as apple pie". Banks have often been seized by the state, in the form of the FDIC. Some of them, such as Washington Mutual, have been big. The FDIC runs those with assets that it cannot sell quickly, as it did with IndyMac, a Californian lender, before finding a group of private-equity buyers in January.

Even the most vocal proponents of this approach accept the need to tread with care. Those banks deemed insolvent would have to be dealt with in one go, to avoid the seizure of one bank starting a run on the liabilities of others that are seen as weak, points out Nouriel Roubini of New York University's Stern School.

That is not the only risk. Political owners find it hard not to meddle: they have wasted no time turning America's mortgage agencies and Northern Rock, a British bank, into tools of the state, or arm-twisting banks that took taxpayer money into modifying mortgages. And state control tends to rattle nerves abroad. Mexico's authorities, for instance, are sure to frown on Citi's local subsidiary, Banamex, falling into the hands of another government.

Moreover, the nationalisation of American International Group, an insurer, is no advertisement. In state hands AIG has gone from bad to worse. Already in hock to the taxpayer for $150 billion, it is estimated to have lost another $60 billion in the last quarter of 2008 and is reported to be in talks about a further bail-out and possible break-up. Adding to its woe, the auction of an Asian subsidiary faltered this week.

Then there is the exit strategy. Governments can become attached to banks they get their hands on. Those that resist the temptation cannot always find buyers. It took the FDIC seven years to sell Continental Illinois, which failed in 1984. Sweden deftly managed its overhaul and flotation of bust banks in the 1990s, but its financial system was much smaller and simpler than America's today.

Finally, government takeovers are risky amid a systemic crisis because of the scale and distribution of creditors' potential losses. Jeffrey Gordon of Columbia Law School cites Citi as an example. With total liabilities of $1.9 trillion and deposits of just $800 billion, not all of them insured, it has over $1.1 trillion of claims at risk in the event of a seizure. Their value would depend on how much the receiver would get for the bank's assets. Were it to push for a quick sale, the price would doubtless be low, clobbering creditors that included pension and money-market funds. Though full-blown nationalisation "appeals to the desire for a clean sweep and the punitive distribution of losses", it is, Mr Gordon argues, a gamble.

Is there a way to deal with bombed-out banks that falls short of greatly increased government ownership? Some, nostalgic for the past, point to the Latin American debt crisis of the 1980s. Then, Western regulators went soft on their banks, allowing even the insolvent to limp along until they had regained enough strength to withstand the Brady-bond restructuring. But that is an imperfect parallel. The economy was in better shape, so it was easier for banks to return to health. And there was no mark-to-market accounting. Suspending that today would ease the burden on banks, but would also make it easier to avoid admitting to losses.

With such forbearance unlikely this time, greater state control seems inevitable, despite its drawbacks. To keep recapitalising hopelessly insolvent banks without more draconian measures merely necessitates further bail-outs, argues Joseph Mason, an expert on banking crises at Louisiana State University. He suggests the Depression as a model: the Reconstruction Finance Corporation ended up with effective control over large parts of the banking system. It used its power to fire executives and shake up operations, with dramatic results. In each successive crisis, he says, authorities have to relearn the lessons applied by private-equity firms: "Keep control of the firm and the capital."

That is hard to swallow in a country that likes its capitalism red in tooth and claw. But better a temporary ward of the state than a permanent zombie.