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Time for Plan B?

BY MICHAEL BOSKIN

Wasn't the key to restoring the credit markets eliminating the banks' toxic assets?

Early signs of a manufacturing rebound, already strong in Asia, lend hope for some modest recovery from today's deep global recession. But a strong and durable economic expansion is unlikely until progress is made in dealing with the toxic assets poisoning the balance sheets of financial institutions and bedeviling policymakers almost everywhere.

The financial system is a complex interaction of lenders and borrowers, buyers and sellers, and savers and investors. When it functions well, it balances risk and reward, and innovation and safety.

Banks and other financial firms borrow short—increasingly in recent years from the commercial securities market, not deposits—and lend long at higher interest rates, taking on both credit risk (of default) and interest rate risk. Increasing leverage boosts returns on the upside but is very risky on the downside. No surprise, then, that the large financial firms that failed—Bear Stearns, Fannie Mae and Freddie Mac, AIG, and Lehman Brothers—had the highest leverage, in the range of thirty or forty times their capital.

From 2002–07, trillions of dollars were loaned for subprime and prime mortgages, autos, credit cards, commercial real estate, private equity, and more, on the assumption by (most) borrowers and lenders that strong global growth, rising home prices and cheap, readily available short-term credit would continue for the foreseeable future. Once the music stopped, the assets plunged in value. The complexity of securitized pools of loans that were sold worldwide—bilaterally over the counter—as pieces of various tranches, meant that nobody was certain about who owned what or what it was worth.

This difficulty in valuing what are now called toxic assets remains at the core of today's credit difficulties. The immense response by central banks and finance ministries has eased the strain. The U.S. Federal Reserve's commercial paper facility was helpful in reopening the commercial paper market (although other of its facilities have been less successful).

The barometer of stress watched most closely by experts, the LIBOR-OIS (Overnight Indexed Swap) spread is down substantially from its stratospheric crisis levels. Some government programs are shrinking from lack of demand. But there remain little new securitization and bank debt offerings without government backup.

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Can banks generate enough profits for long enough to buy time to write down smaller losses and raise private capital later in a stronger economy? Or are the losses so large—and in danger of mounting further as others (such as commercial real estate) are added—that a gradual workout is unlikely, if not impossible?

Estimates of the losses on U.S. loans and securities range from under $1 trillion to almost $4 trillion. The International Monetary Fund puts them at $2.7 trillion, but the range of uncertainty is enormous. More than half is held by banks and broker-dealers. And analogous problems exist in Western Europe (for example, for loans to Eastern Europe) and Asia.

Gradualism and profitability, and eventually U.S. Brady bonds, worked in the Latin American debt crisis in the 1980s. But a difficult economy will drive down the value of toxic assets and make more assets toxic. For example, falling home prices put more families in negative equity—mortgages worth more than the home. This creates an incentive to default, which increases foreclosures and lowers the value of the mortgage-backed securities on financial firms' books.

Policymakers need a Plan B in the event that one proves necessary, modeled on America's rapid resolution of insolvent savings and loans in the early 1990s, together with sales of toxic assets in large blocks (to prevent so-called adverse selection from unraveling any bidding process). History is instructive.

Of the $500 billion that America required for the Resolution Trust Corporation (equivalent to $1.25 trillion today), $400 billion was returned from asset sales, for a net cost of $100 billion, one-tenth the worst-case private forecasts of $1 trillion. The final tab on the toxic mortgage bailout and other assets is likely to be a larger percentage of a larger amount, but still far less than the face value of the loans, because the underlying assets will in many cases retain considerable value.

In addition to bailouts and toxic asset plans, governments worldwide want central banks to monitor macroeconomic and overall financial-sector risk (as opposed to focusing on individual firms). Barack Obama's administration would anoint the Fed, whose history has been to recognize crises late. The Bank of England seeks similar powers. The European Union wants to establish a European Systemic Risk Board composed of the national central bank governors, chaired by the European Central Bank.

What will these central bankers do to advise on macro-prudential risk? Demand adjustments in large current-account imbalances? Call for reductions in taxes, spending, and government debt, which are the primary systemic risks? To do that could jeopardize monetary policy independence and heighten the threat of future inflation.

Dealing with financial institutions deemed too big to fail won't be easy. The current system, which allows privatized gains from highly leveraged risk-taking but socializes losses in the event of failure, must be changed to avoid episodic financial meltdowns.

To balance the benefits of scale and scope with the socialized losses to taxpayers, firms deemed too big to fail should be required to have more capital, and the amount should rise disproportionately with size. Converting some portion of debt to equity under predetermined solvency-threatening conditions would provide an extra layer of protection. Add a higher bar for government bailouts, and these stronger incentives would induce private financial institutions and investors to take responsibility before disaster strikes. ◆

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