

Naked Capitalism, Yves Smith

More on That Dirty Word "Nationalization" and Possible Approaches

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In a post yesterday, some readers bandied about the idea of developing some reasonably thought out proposals for "nationalization" or "receivership" or "pre-privatization", possibly on an open source model of some sort. (Aside: those who know how Linux was developed know that it wasn't free form; Linus Torvalds exercised control, one might think of it as final edit, and he also delegated areas of supervision to key lieutenants. That was obviously a much bigger task than this would be, but I just wanted to give readers a head's up that there needs to be someone, maybe several someones, in charge if we collectively take this to the next step).

That's a long-winded way of saying this is an idea I'd like to pursue, and per my earlier post, I don't see Team Obama moving in this direction soon (as I said, it would be much better were I proven wrong). But to make the most of it, some preliminary discussion would be useful.

One of the things about group problem solving is that people tend to want to drive for solutions before they have all the relevant data at hand. And studies have shown that putting proposals on the table, even at a supposedly early stage in the process (i.e., while fact gathering is being done) winds up cutting down on idea generation (the problem here, of course, is there are already options on the table, but I'd like to focus upstream as much as possible).

The better way to go about it is to segregate problem definition/examination of possibly relevant facts from option generation/assessment. So I'd like to push further on flushing out possible complicating issues.

I also want to address the knee jerk reaction I get from some readers when the word "nationalization" comes up, particularly from those readers who say they'd prefer a form of receivership.

Folks, this is a nomenclature issue. Let me turn the mike over to reader Steve, who worked for the FDIC:

Americans are funny. 'Nationalization' immediately evokes Soviet commissars and bearded guys yelling in Spanish -- the unjust taking of successful businesses by brutes and bullies. If someone does think of the companies that failed into government ownership in Europe, well, those pinko wussies ran them into the ground in the first place and wouldn't let Real Men come in and run them, and I hope they've learned their lesson. But if you say that when Dopey Bank & Trust failed its assets were nationalized, the response is, oh please, that doesn't happen in America. Everybody knows that deposit insurance comes from the tooth fairy.

Ultimately, the taxpayer is on the hook for deposit insurance, so while FDIC is technically a government corporation rather than a government agency, it's still nationalization. The failed bank's assets are removed from the private sector and returned to it over time. Even in an immediate sale, FDIC often retains a loss position; and while the asset sale is technically a receiver's sale, the deposit insurance is paid by FDIC in its corporate capacity, with a due-from receiver to cover the insurance outlay. Under FDICIA, the nationalization aspect is even more pronounced than in the past: FDIC used to share *pari passu* with all general creditors of the failed bank, now it has absolutely priority as a creditor

until it is made whole for the deposit insurance paid and the costs of paying it. Bair has bent this priority quite a bit by paying advanced dividends to excess depositors even when it clear that FDIC will incur a substantial loss on coverage of deposits under the legal limit.

So if you are OK with the FDIC (actually, technically, the chartering authority, namely the OCC, OTS, or state closes the bank, the FDIC is the receiver) taking over dud banks), you are OK with nationalization. What we then need to figure out is what form it would be best to take for big banks, since the normal FDIC process (as discussed in our earlier post) doesn't fit the mega banks too well.

And to clarify: I am not a fan of nationalization or otherwise taking financial firms out and shooting them per se, but the alternative of having them have in effect an open funding source from taxpayers is worse. As Steve Waldman put it:

Zombie banks beg for money. They are very clever. They come up with ways you can give them money while pretending not to give them money, such as guaranteeing their assets, guaranteeing new debt issues, or buying up assets at "hold to maturity" values. Just say no! A healthy financial system cannot be run by zombies. "Rescuing" insolvent banks makes about as much sense as tying string to the arms of a loved one's corpse so it can come to the dinner table as a marionette. For a while that may be comforting (or not), but pretty soon it's sure to smell really bad, and it's gonna ooze. If you think you have engineered a miraculous turnaround, you have only made matters worse. An undead bank is an abomination. It will pretend good health but hide a rot. It will afflict you, over and over and over again, with harrowing near insolvencies (cf Citibank). Dead banks must be allowed to die.

The big problem is the bad incentives. The taxpayer has been putting money in at well below rates the private sector would require, and worse, management and stockholders get the upside. That means they still have reason to take risk since Joe Public will eat any mistakes. And if you think this won't happen, some believe that the reason Merrill's results deteriorated badly in the fourth quarter was due to trader bets gone bad.

Any private investor who had put as much as the government has put into faltering banks would have far more supervision (board seats, probably regular operational reports) and would also have replaced the CEO, with an understanding that he could clean house if he saw fit. Getting a new CEO in is usually standard operating procedure with distressed organizations, but the Treasury and Fed are writing checks and failing to make inquiries. Look at the contrast with the treatment of GM and Chrysler, which are being asked plenty of tough questions and are required to submit turnaround plans that could be rejected or be revised under duress.

Now to some of the problems with nationalization :. I'd like readers to help start an "problems to be addressed" list. One set came up in the prior post: the really big banks, Citi and BofA in particular, have large capital markets operations. There isn't an obvious way to put the trading operations into receivership. The notion of a normal Chapter 11 is creditors are kept at bay, for biggies there is DIP financing to pay for routine expenses (beyond what revenues might cover) while the bankruptcy is on. But trading firms live on credit. The DIP model won't work here.

What remedies or alternatives might there be? Could the trading ops be segregated with a government

backstop to be kept going, and the other non-trading capital markets businesses (prime brokerage, asset management, prop trading, etc) be put into receivership? What are the issues here, regulatory and practical? (This is one reason why Willem Buiters' "good bank" model does not seem applicable to these firms, unless you want to see the investment banking rump of Citi and the former Merrill go into a Lehman style collapse).

Bonds are risk capital, and it would seem better to take out bondholders before having taxpayers pony up. But that is treated as a third rail issue. What are the potential complications that need to be thought through here?

There are also many regulators involved here. The SEC regulates broker dealers and asset managers; the CFTC, any commodity trading; BofA and Citi are subject to foreign regulation of both their banking and securities operations. I don't know to what extent these are mere complications (one could assume they'd largely accede to a reasonable plan from the Treasury/Fed, particularly if the alternatives looked worse, but there could be some sticky issues, like worries that foreign depositors would be shafted, as Icelandic banks did in their meltdown). However, the really bad stuff is OTC debt and derivatives, which are largely unsupervised. Anyone who has any insight here is encouraged to speak up.

Please feel free to address these issues and flag others in comments. If nothing else, this should be instructive for all. Thanks!