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ROOM for DEBATE

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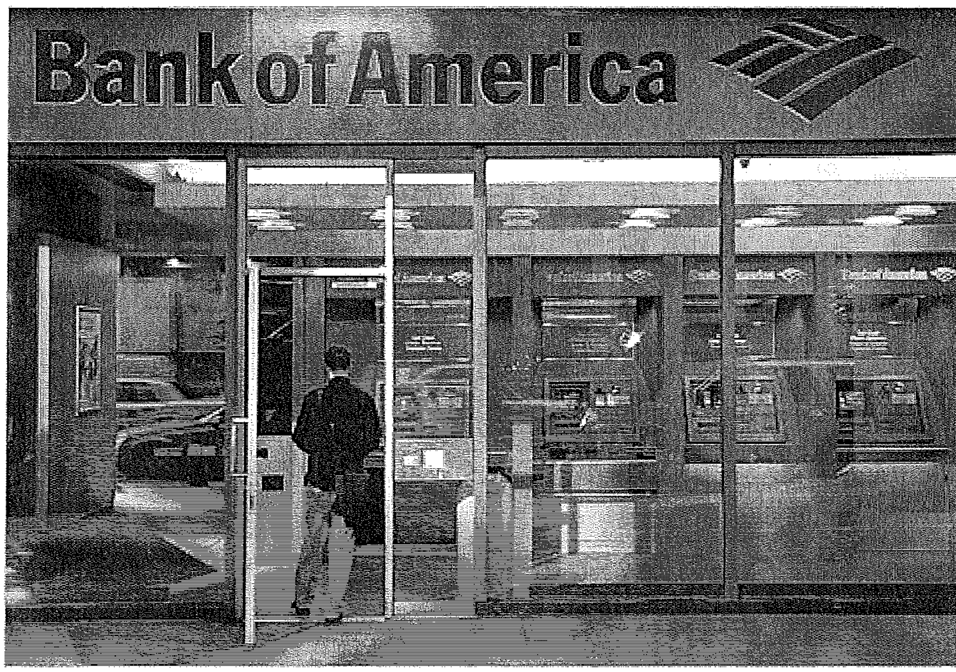
Nationalizing the Bank Problem



(Photo: Stan Honda/Agence France-Presse — Getty Images)

A new wave of bank losses is the most pressing financial problem faced by the Obama administration. Should the federal government move to nationalize lending institutions? Room for Debate asked several experts on financial history to comment.

- Liaquat Ahamed, investment manager
- Charles R. Morris, lawyer and former banker
- Jeffry A. Frieden, professor of government
- Scott Reynolds Nelson, professor of history

The Last and Only Resort

***Liaquat Ahamed** is the author of "Lords of Finance," about the causes of the Great Depression. A former economist for the World Bank, he spent 25 years as an investment manager in London and New York.*

It is now clear that the scale of bank losses has been so great that much of the system is insolvent. Since there is agreement that the largest banks in this country cannot be allowed to fail, we need to find a way to recapitalize them.

There are three potential sources of capital.

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One possibility is to require banks to earn their way out of the hole into which they have dug themselves. Because of government deposit insurance, even insolvent banks can actually survive for a while and function. That is what happened in the early 1990s. Because of losses on emerging market debt and commercial real estate, several major New York money center banks were in effect insolvent. But helped by a nod and a wink from the Fed and cheap money, these money center banks, which were close to going under in 1991-1992, were able to rebuild their capital base over time by earning profits on new business and eventually re-established themselves as viable institutions.

Unfortunately a similar route is not available today. The losses are too large. Nor do we have the luxury of time.

A second potential source of capital is new private investors. For much of last year, this was the path taken. During 2008, while banks were writing off $1 trillion in losses, they were able to turn around and raise almost that amount by tapping new sources of equity, especially from the sovereign wealth funds in the Persian Gulf and Asia.

> "Banks have not simply lost a lot of money. The real problem is that neither they nor anyone else knows how much they have lost."

That game is now over. Banks have not simply lost a lot of money. The real problem is that neither they nor anyone else knows how much they have lost. Not only is the banking system insolvent, the magnitude of the hole in its collective balance sheet is almost anyone's guess. As a consequence private investors are refusing to put any more equity into banks, fearing that all they will be doing is underwriting the losses of the past.

The various complicated schemes currently being mooted — the British idea that the government insure the banking system against catastrophic losses beyond a certain point, the proposal for a "bad bank" in the U.S. — are all mechanisms designed to deal with this uncertainty by getting the government to bear the downside risks. The uncertainty is so enormous, however, that the correct price of these forms of insurance is likely to be very high. Banks certainly don't have the money to pay the government the necessary insurance premium. All they can do is issue equity to the government. Which in turn leads inexorably to nationalization.

The third route is plain and simple nationalization — that is for the government to inject capital into banks in return for common equity. As a matter of arithmetic, because most of the capital of banks has already been wiped out, this would give the government a majority stake in many banks. We could of course ask the taxpayer to provide capital to banks but allow the current shareholders to retain the bulk of the ownership and control. Indeed that is what we seem to have been doing the last few months. There used to be name for that: "crony capitalism." Far better that if the public is to provide the risk capital and take on the prospect of further losses, it should get the benefits of any upside.

I agree that nationalization of banks is a last resort. But we are at the point of last resorts.

It Will Be a Mess

Charles R. Morris, *a lawyer and former banker, is the author, most recently, of "The Trillion Dollar Meltdown." His other books include "The Tycoons" and "Money, Greed, and Risk."*

Should we nationalize the banking system? Respected commentators, like The Times's Paul Krugman, the economist Willem Buiter and Portfolio.com's Felix Salmon are getting behind the idea. Here's why:

> "By any measure, nationalizing all or most of the banking system is a dreadful idea."

1. We've already shoveled some $1 trillion into the banks, but they're not lending, because they know they have at least another trillion of unrealized losses to go. But they're still paying bonuses and most are paying dividends.

2. TARP, now reborn as the F.D.I.C. chief Sheila Bair's "aggregator bank," was supposed to unblock the banks by buying up their toxic assets. But since no one knows how to price them, the haggling could drag out forever, and the taxpayer is sure to get raped. So the banks stay catatonic, on billion-dollar IV drips.

Nationalization seems to cut that knot. If the government owns both the banks and the toxic-asset dump, pricing doesn't matter. The banks can throw anything shaky into the dump, and get on with their business. When everything gets back to normal, and the dump is shut down, the government can sell the banks back to the public.

What's wrong with that?

1. Current shareholders and bondholders get wiped out. But investors take that risk.

2. It will be a mess. For sure. (Nostalgia for the S & L Resolution Trust Corporation obscures what a mess that was, and it was much, much smaller.)

But the current reluctant ooze toward nationalization surely isn't better. In the last two weeks the government put up some $450 billion in cash and guarantees for just Citigroup and Bank of America. The taxpayers got very little in return, and both banks are still bleeding on the emergency room floor.

By any measure, nationalizing all or most of the banking system is a dreadful idea. But until someone comes up with something better, and workable, it will keep gathering momentum.

Socialism It's Not

***Jeffry A. Frieden**, a professor of government at Harvard, is the author of "Global Capitalism: Its Fall and Rise in the Twentieth Century."*

Debate swirls around the possibility that the Obama administration might nationalize troubled banks. The proposal, supported prominently by Paul Krugman, remains controversial, but also remains possible. Indeed, the British and Irish governments — whose economic philosophies appear close to those of the Obama team — have nationalized huge swaths of their financial systems.

Much of the debate over bank nationalization assumes that opposition to nationalization is ideological. And some of it certainly is; but other issues are also at stake. After all, in 1984 the Reagan administration nationalized the Continental Illinois National Bank and Trust Company, one of the country's largest banks. And the Reagan and Bush I administrations dealt with the much smaller savings and loan crisis of the middle 1980s by effectively nationalizing hundreds of failed financial institutions, at a cost estimated at over $150 billion.

There is little question that nationalizing troubled banks — that is, having the federal government take direct ownership and control of them — is the simplest way for the government to tackle the financial crisis and its implications.

> "It is potentially extremely costly, in that it loads hundreds of billions — perhaps trillions — of dollars of questionable assets onto the books of the federal government."

However, the costs of nationalization may also be high. The purpose of taking over the banks would be to return them to solvency so that they can begin lending again, and resume their central role in the market economy. But when the government takes over failed and failing financial institutions, it takes on responsibility for what is on their books. If many of their assets turn out to be worthless, or worth less than expected, the government has to make up the difference. This will undoubtedly be very expensive; and it is a direct expense that taxpayers will have to bear.

A recent paper by two distinguished economists, Carmen Reinhart and Ken Rogoff, tries to come up with numbers for some of these costs. They look at a series of comparable banking crises and find, for example, that after such crises, unemployment rose by more than 7 percent on average and GDP declined by more than 9 percent. These are staggering numbers, implying a much more serious recession than even most pessimists anticipate. But the costs of a government response are also extraordinary: the average crisis-ridden government increased its debt by 86 percent — that is, nearly doubled it — as a result of the crisis, primarily due to lost revenue. This would take the federal debt from its current level of around $11 trillion to over $20 trillion.

Complicating the debate is the fact that the actual costs are largely unknowable. We don't know how badly continuing rounds of bank failures would hurt the economy; and we don't know how expensive taking over the banks will be. We also don't know who would actually run the banks, how they would run them, and to whom they would be accountable.

We do know that nationalizing troubled banks would not be a step on the road to socialism — unless one considers the Reagan-Bush Continental Illinois or Savings and Loan policies socialist. It is attractive in that it provides the government with the direct levers to address the most serious financial effects. It is potentially extremely costly, in that it loads hundreds of billions — perhaps trillions — of dollars of questionable assets onto the books of the federal government. Neither choice is attractive, but the administration will have to make a choice.

Echoes of 1893

Scott Reynolds Nelson*, a professor of history at the College of William and Mary, is the author of the forthcoming "Crash: An Uncommon History of America's Financial Panics."*

The nut of our current banking crisis has to do with Bank of America, Citibank and others being able to create and circulate bonds with little or no underlying value. Is this new? Not really. In fact, it was made possible by the current bond rating system, which actually started out as a reform, in response to the panic of 1893.

In the 1893 crisis, investment banks had marketed bonds that proved valueless. Creditors were wiped out. The Populists pushed to nationalize the banks. The banking industry smelled danger, and suggested something different: a ranking system for corporate bonds.

> "For the last 50 years or so investment banks have repeatedly duped the rating agencies established to measure them."

The rating agencies, Standard & Poor's, along with Moody's, had previously issued elaborate descriptions of the activities of railroads and other industries. What customers needed, bankers argued, were less confusing measures to understand the worth of commercial bonds. And so S & P began to give the bonds that banks created for industrial or commercial clients simple ratings from AAA to F.

This shift is important. Rather than having an investor examine a bonded note to judge bank and debtor, rather than looking through a dense book that described a railway company's operations, rating agencies took on the task of informing investors of the risk.

But the fight was not over. In 1913, Democrats in Congress (including former Populists) determined that federal bonds, at least, should be marketed through a system of federal banks, and that these federal banks should act as a lender of the last resort in banking crises. They nationalized federal banking. This hybrid system — of private banks and a 12-region federal reserve system — is the banking system we have today.

Yet for the last 50 years or so investment banks have repeatedly duped the rating agencies established to measure them. The S & L crisis of the Reagan years, Enron, WorldCom and the current mortgage meltdown have all demonstrated rating agencies' inability to act as our eyes and ears, to intelligently tell us if a bond represents a real asset like railway cars, factories or property. The bond rating does all the talking; bonds are otherwise unreadable bills.

And so a bank with a compelling sales pitch can turn valueless straw into gold. Rating agencies, none the wiser, label them investment grade, allowing even heavily regulated institutional investors — insurance companies, mutual funds, state agencies, and city governments — to buy them.

What can we learn from this and earlier banking crises? The analysis of market-grade securities is badly broken. Investors are regulated, but they rely on the eyes and ears of rating institutions that have grown blind and deaf.

Economy, Politics, Bank of America, banking system, banks, finance, nationalization

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