Why Is the Rescue of US Banks Taking So Long?

Michael Mussa, analyzing the reasons for the delay over the financial bailout, discusses the costs and other factors creating so much public frustration.

Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Our guest is Michael Mussa, a senior fellow at the Institute. We're going to talk about the financial meltdown and the solutions that the Obama administration has devised and is devising to rescue the financial system. Thanks for joining us, Mike.

Michael Mussa: My pleasure.

Steve Weisman: The word that one hears is "dithering." A lot of people say that the administration is dithering in its approach to the financial system, an approach that consists of a stress test, a public-private partnership to purchase toxic assets, and then a facility to purchase securities, both mortgage-backed and other asset-backed securities. Do you think that the charge that these officials are equivocating and delaying the solution is a fair one?

Michael Mussa: No. I think we have here mainly the disappointment of accomplishments relative to expectations. Both people in the financial sector and the public more generally were sort of anticipating a magical solution to these problems, and the magic has not appeared; the economy is still sinking deeper into a recession. So, there is a very profound sense of disappointment and even anger at the fact that things are not getting better.

Steve Weisman: The comparison that you hear most often are to two countries, Sweden and Japan. Sweden is supposed to have responded with greater speed and effectiveness and Japan responded many years too late. You've studied both historical examples. Do you think that those comparisons are fair?

Michael Mussa: During my time at the IMF, from 1991 through 2001, of course, we both dealt with the Swedish and Nordic banking crises and with the Japan problem. In the case of Japan, they only really begin to face up to the problems in the financial sector, which dated back to the early 1990s, in 1997 and 1998. So, they were six, seven years late in addressing those problems in a forceful way. In the case of Sweden, the problems began to emerge in a serious form in 1990 and they acted much more rapidly; that is to say, by the autumn of 1992 and the spring of 1993. It's like two and half years after the crisis started. They began to inject substantial amounts of capital and deal with problem assets in the banking system. But what the United States has been doing has been well ahead of the schedule, not only of Japan but also of Sweden and of past efforts in the United States and in most other industrial countries to deal with these types of problems when they have arisen.

Steve Weisman: There's a feeling among some commentators that unless banks are allowed to fail or be nationalized and broken up, Americans are not going to regain confidence in the system. They seem to want it cleaned out root and branch. I don't know if you agree with that analysis. Do you think it's an accurate way of describing this period that we've been living through in the last year or two?

Michael Mussa: There are a couple of issues here. One is that the public feels, I think quite rightly, that they have suffered very substantial economic and financial damage over the past year and a half or so that is not the consequence of their own misbehavior and mistakes but has been brought upon them by those who run the financial system. If you have equities in your 401(k) or your employer's pension fund, they've declined 50 percent in value. Tens of millions of Americans, particularly those who are approaching retirement, are not happy to see 30 to 50 percent of their retirement savings wiped out in addition to the problems of people who can't pay their mortgages and so forth. There's a very broad swath of the American public that feels the pain, and they're unhappy with the people who they think helped create it and are not entirely pleased with how effective the government has been in addressing the problem. I think that's the reality of the situation.

The difficulty is: What is the reasonable expectation about how rapidly policy can react to these problems and help to right the situation? My personal view is that the actions, which have been very powerful and aggressive especially by the central bank, the US Federal Reserve, will, during the course of this year, bring an end to the recession and start a fairly vigorous recovery. And the evidence of that happening will then begin to lift asset values again. But that's not what we've seen so far this year. The recession has clearly been getting deeper. The decline in stock values and so forth reflects primarily those facts. And it's not going to be until we get some better indication that the economy has stopped shrinking and is about to expand that the asset markets are going to begin to improve. And that's critical for the situation in banks as well. There are a lot of loans on the books of banks that, if the economy continues in recession for the next year and a half, are going to turn into bad loans, but if the economy begins recovering later this year, are going to be perfectly good loans. So, a key part of solving the problems in the financial system is actually getting the economy moving in the right direction.

Steve Weisman: I wonder if you're saying that there's some wisdom in moving cautiously rather than swiftly in applying the stress test for example. A lot of people say, "Well, they don't need to go through these endless weeks of stress testing the banks. They already know their condition, and they should just go in there and take over the ones that are insolvent." But it sounds to me like the contrary argument is that if we just approach the situation more cautiously, things might stabilize and the asset picture might change.

Michael Mussa: I think they're probably going to be done with the stress test in another week or so and reach a determination as to which among the 19 banks—there's over $100 billion of assets on their books—would, in a more extended recession, really be in substantial danger of becoming insolvent and then, once they've reached that determination, decide about additional injections of capital in order to prevent their cataclysmic failure, an event like the Lehman Brothers' failure last year, which caused enormous turbulence in financial markets. I think they need to make that diagnosis before they can prescribe the right amount of medicine for each of these institutions. But it's not helpful to have that go on six months without announcing the results. They need to conclude that assessment fairly quickly, and I think they will do so. I think we'll find on the basis of that assessment, there probably are one or two of these 19 major banks where there is potentially a problem that needs to be addressed. We've already seen Citigroup and Bank of America get additional capital injections. My guess is there may be one or two—not of the four big banks but of the next tier of 15 larger, mainly regional banks—one or two of them that will need additional capitalization. There are others that are quite strong.

Steve Weisman: Is there enough money that has been appropriated by Congress in the Troubled Asset Relief Program (TARP) to put together the capitalization that these banks may need? Or do you think the administration is going to have to go back to Congress at what has to be regarded as an awful time because of public anger over this and AIG?

Michael Mussa: The first half of the TARP has already been fully committed. The second half of the TARP, the additional $350 billion, there's still a fair amount left. So, I think they probably have enough to deal with any of the major banks where the stress test reveals that they need additional capital. Now, they're also of course trying to structure this private-public partnership to be able to acquire troubled assets from banks that wish to sell them. How much capital the government will need to put in is not known. But there may be difficulty here.

Steve Weisman: I think their public figures say $250 billion, don't they?

Michael Mussa: Yes. And that obviously is going to eat up most of the rest of what's in the second tranche of the TARP, leaving the cupboard bare in the event there are any further problems, which is not a good situation to be in.

Steve Weisman: I think that $250 billion was in the budget for them to go back to Congress to try to obtain.

Michael Mussa: They have a so-called placeholder in the proposed budget of a quarter of a trillion dollars. But we've not yet seen the specific request for funding, and I think they're probably going to hold that back in the present climate of public and congressional discontent. Maybe if they can show some evidence of success, they'll get a more hospitable hearing.

Steve Weisman: What about this public-private partnership? Is it workable? It's awfully confusing about how it's going to work.

Michael Mussa: It is indeed, and it confuses me, I think, as well as others. You may recall, this was Secretary Paulson's original idea of purchasing toxic assets from the banks; but he had to give it up basically because there was no other way to figure out how to price these things at a price that was on the one hand helpful to the banks to move these off their balance sheets and on other hand was fair to the taxpayer in terms of taking over the risk inherent in these assets. Making it a partnership in which the government participates with hedge funds and others to buy the assets from the banks doesn't necessarily solve that problem.

Steve Weisman: It does put the onus in theory at least on the private sector and off the government.

Michael Mussa: Except that the government is going to end up taking at least some of the risk as well as providing an important element of the top tranche financing for these public-private partnerships. So, private capital is also becoming involved. And that can be helpful in establishing the pricing for these assets under the assumption that these are fairly shrewd private equity funds and so forth. But they will obviously want to structure things in such a way as to maximize their expected return and minimize their risk and stick the government with as much of the risk as possible.

Steve Weisman: This is a very difficult task. Are they making any progress toward their goal?

Michael Mussa: Yes. I think that if you state the goal as constructing these private-public partnerships to assist with the problem of dealing with the troubled assets—that is, to take part of it off the hands of the banks but not to solve it completely—then I think you can enjoy some success. But I believe an important part of the resolution of this problem is simply to leave many of these assets where they are now on the balance sheets of the banks, and then if the economy does recover, as I hope and forecast it will, the value of these assets will recover from the mark-to-market values at which they're presently being carried. And then the banks will be in much better shape with recovering the value of the assets. It's not necessary to take all the assets off the balance sheets of the banks. An important part of them can sit there, pending resolution of the economic situation.

Steve Weisman: But there would have to be some lenience on marking them to market in terms of determining the bank solvency, wouldn't there?

Michael Mussa: Yes, indeed. And we've seen some of that done directly and indirectly. So, in the arrangement with Citigroup and Bank of America, they each designated a certain pool of assets that the government ensured against loss, with the bank taking the first 10 percent of loss from the present marked-down value and 10 percent of any additional loss, but the government absorbing 90 percent of any additional loss beyond the 10 percent. So that was a mechanism to keep most of the risk off of the balance sheet of the banks, provided that the assets don't depreciate enormously from their present level. So, you can do that with the larger banks, but it is much harder to do it with hundreds of smaller banks. So the public-private partnership may well be better suited to dealing with a large number of smaller banks than these arrangements with the very big banks, which I think are much harder to work out for a large number of things. So, if we think of this new effort as a piece of the puzzle, rather than the whole solution, then I think it probably can enjoy some success.

Steve Weisman: Before we go, let's just talk about the history of the last year and a half. There is this tendency among those who cite the Japan and Sweden examples to say that they did not achieve success in stabilizing and turning their economies around until there were a number of failures or closures of financial institutions, and that the United States similarly won't achieve success until it roots out the problem in the form of shutting down financial institutions. I think you have a different perspective on that.

Michael Mussa: Again, one needs to understand more clearly what the facts are. Obviously, we closed IndyMac, which is a smaller institution but still it was $30 billion. They closed down Washington Mutual, which is the largest bank failure in US history; JP Morgan Chase took over many of the deposits and other operations, but WaMu effectively failed. They dealt with Bear Sterns, again merging its operations into JP Morgan Chase but with the government taking some risk in virtually wiping out the shareholders. Fannie Mae and Freddie Mac, which were private companies, were taken over by the government. AIG is owned 80 percent by the government. Wachovia Bank, which was the fourth largest bank in the United States, was not closed, but its shareholders were much diluted in the takeover by Wells Fargo and the management was moved out. And there were Merrill Lynch and Lehman Brothers. So of the five leading investment banks, three of them are no longer independent entities in any form. And of leading commercial banks and savings institutions, we've gotten rid of three or four of them. So, the amount of restructuring and intervention that has been undertaken, including AIG, which is an insurance company, has really been enormous by the standards of anything that has been done previously in the United States, by the standards of what has been done in most industrial countries that have had to deal with these problems like Sweden or Japan. So, we're not pikers in terms of government intervention. It has been large and it has been very rapid.

Steve Weisman: I can't close without asking you what you make of the AIG bonus furor, still an unfolding drama in which it's not clear how many of the executives at AIG are going to be able to keep their bonuses. What do you make of this furor?

Michael Mussa: Well, I think that people can't understand somebody or a hundred people or whatever it is getting $165 million of bonuses in the financial products division of AIG, and this is the division that caused most of the problems. So, they say, "Well, why are these guys who had an enormously catastrophic season getting a bonus at the end of it?" And people I think are right to be upset at this type of outcome. But the amount of bonuses being paid off amount to a little bit more than 50 cents for each man, woman, and child in America. That's the cost to you and me as shareholders of AIG.

Steve Weisman: Somehow it doesn't comfort me, though.

Michael Mussa: No, it doesn't. But one wants to keep in mind the total amount of money that the government has lent in order to help resolve the problems at AIG without creating a catastrophic financial crisis. That's $170 billion, more than $500 per man, woman, and child in the United States. We want to keep our eyes on the ball and on the difference between 50 cents and $500.

Steve Weisman: There's an old saying in journalism from A.J. Leibling, that journalists separate the wheat from the chaff and then print the chaff. Michael Mussa, thank you very much for sharing your thoughts with us today. I always enjoy it.

Michael Mussa: My pleasure.