

Is It Possible to Reprivatize the US Financial System? Or What's the Exit Strategy?

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Presented at the American Enterprise Institute for Public Policy
Research

November 12, 2009

The Problem

- US embarked upon a series of ad hoc rescue policies to address the perceived financial crisis
 - There was no end game or exit strategy against which to assess the consequences of alternative rescue strategies
- The result was deep government financial involvement in the financial system and in particular in very large institutions
- Problem now is now twofold – to devise what the new financial structure will look like after the crisis is over and how to unwind these policies

Dimensions of the Problem: Gov't Commitment to Financial Institutions (1)

- Freddie and Fannie are in conservatorship
 - Government has invested over \$112 billion in the firms
 - It has pledged to put as much as \$200 billion into each
 - Fannie has indicated it will request another \$15 billion which would raise the amount injected to date to \$61 billion.
 - Freddie has also indicated it will seek additional funds as well.
 - There is no plan to unwind or resolve these institutions
 - Fed holds \$146 billion in Federal Agency debt Securities
 - Fed holds \$774 Billion in MBS guaranteed by Freddie, Fannie and Ginnie Mae
 - All of these have a maturity in excess of 10 years
 - Fed's holdings of Treasuries have 46% in excess of 5 years
 - Treasury holds \$177 billion in MBS guaranteed by Freddie, Fannie and Ginnie Mae

Dimensions of the Problem: Gov't Commitment to Financial Institutions (2)

- US is the major shareholder of AIG
 - Total authorized assistance \$182.3 billion with \$120.7 billion outstanding
 - Assistance was in form of loans, equity investments, commercial paper facility and NY Fed loans through SPVs to purchase RMBS associated with securities lending pgm.
 - Treasury has provided \$41.6 billion in preferred stock and \$3.2 billion of equity from authorized amount of \$29.835 billion

Dimensions of the Problem: Gov't Commitment to Financial Institutions (3)

- US has injected \$ 204.7 B of capital through TARP into more than 588 US financial institutions of which \$70.8 B has been repaid.
 - Government has taken warrants in most cases and is now subjecting firms that received government funds to pay and other restrictions on their activities
- Government guarantees of transactions accounts, debt and deposits have to be wound down and credibly terminated.

Restructuring Raises Three Key Issues

- What is government housing policy going forward?
 - Continued subsidization through direct government lending or indirect subsidization through financial institutions
 - We have Freddie, Fannie, Ginnie and FHA
 - What to do about Fed's subsidization of securitization market
 - Essentially the Fed is printing money to support the mortgage market
- What is the vision for financial structure and competition
 - Are we to return to largely private markets or
 - Are we to have a two tiered set of institutions – those with and those without government guarantees?
 - Regardless of what we may decide, the international community will pursue its own objectives since they too have provided government support to their financial institutions
 - In a global market, those with implicit guarantees may win in the short run and will likely cause future crises.
- How do we address Too-Big-To-Fail?

Options to Reprivatize F&F

- Reprivatization of Freddie and Fannie will be difficult because of their links to housing policy
- US government has now over a \$1 trillion stake in these institutions through capital investments, debt holdings and holdings of MBS
 - This does not include the direct obligations of Freddie and Fannie and FHA
- Three options
 - A. Spin off a before – but this will only revive implicit guarantee and market now has confirmation that it is real
 - B. Carve up into several separate segments
 - To be effective mechanism will have to be devised to make separation from government implicit guarantee credible
 - C. Phase sell off and liquidation of assets
 - Requires restructuring of US housing policies

Options to Unwind Commitments to Banks and AIG

- All options now risk moral hazard since markets now perceive that the government will step in to save large institutions
 - Large now encompasses the 28 largest firms as well as any institution on an explicit or secret list
 - Government has expanded deposit and debt guarantees on an hoc basis and even if phased out, markets will assume they will be protected in the future
 - This rules out role of subordinated debt and other uninsured debt instruments as a source of market discipline
 - Current policies place uninsured debt instrument in limbo with respect to their guarantee status which have implications for risk premiums going forward
- Bottom line is no statement about “no more bailouts or guarantees” is credible.

Current Approach

- More regulation
 - More capital
 - Break up large firms
 - Limit use of derivatives
 - Limit pay
 - Return to Glass-Steagall
- None of these deal with fundamental issues nor do they extract government from future guarantees or bailouts
- There is no one focusing on the future competitive landscape

Elephant In the Room

- What to do about “Too-Big-To-Fail?”

