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Nov 12 2009, 4:11 pm by Daniel Indiviglio

How Badly Did Banks Want To Be Saved?

Today I listened to a panel discussion at the Cato Institute about the financial crisis. The participants debated aspects of Robert Pozen's new book "Too Big To Save?" In it, he dissects the causes of the crisis and explains how he believes those problems could be prevented in the future. There was an interesting point of disagreement among Pozen and another panelist concerning whether the U.S. government should have provided the banks with such attractive terms for the bailout money they accepted. Pozen doesn't think so, and I agree.

Let me explain the dispute. Pozen argues that the U.S. government, and consequently taxpayers, did not do well enough on the capital it "invested" in banks. He uses Goldman Sachs as an example and cites that Warren Buffett -- who also invested in Goldman -- had a rate of return that was something like six times as great as Uncle Sam's. He thinks this did taxpayers a disservice, because they should have been rewarded with a similar return to what any market investor obtained.

One panelist, Georgetown Business School professor Phillip Swagel disagreed. He said that overly attractive terms were necessary for the banks to accept the bailout money. In a time of near economic collapse, he believes the government could not have negotiated a fairer rate of return with financial institutions, because if they refused to take it, the crisis would have worsened. He further asserted that in a free market, the government can't force banks to take money, so it must provide terms that they will accept.

Although I don't find Swagel's argument completely ridiculous, I have to side with Pozen on this one. I've heard stories of banks that didn't want the bailout money, but I think that those were the exception and not the rule. I'd imagine that the discussion would go something like this:

Government*: You need capital, so you can have some taxpayer money with terms that a private investor would demand.*

Bank*: No way. We don't want your money under those terms.*

Government*: Okay, then you will fail, because private investors will not provide enough capital for you to survive. We will begin your resolution immediately.*

Bank*: Oh. On second thought, what were those terms again? Maybe they aren't so bad.*

I'm willing to call a bank's bluff that it would fail just to spite the government, rather than take taxpayer money at a rate of return a private investor would require. And if this is a situation where the bank wasn't facing failure, then I'm not sure why it's being bailed out in the first place.

Of course, if some of the new regulatory measures work as planned, we might be able to avoid future bailouts, with a non-bank resolution authority in place. But in the event that the government does find itself in an unavoidable situation like this again, I agree with Pozen. The Treasury shouldn't allow banks to take advantage of taxpayers -- our money is just as green as Buffett's.

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There's one potential problem with your line of logic, which is that all banks would have given the same answer. Suppose the conversation went like this:

Government: You need capital, so you can have some taxpayer money with terms that a private investor would demand.

Bank: No way. We don't want your money under those terms.

Government: Okay, then you will fail, because private investors will not provide enough capital for you to survive. We will begin your resolution immediately.

GS/MS/JPM/BNY-Mellon/etc.: F*** you, we're solvent. You are the Treasury and have no legal authority to begin any resolution.

Citi/BofA: Where do I sign?

Then you have the classic Stigma problem- 2 of the 3 biggest banks in the country have announced to the world that they are insolvent by taking terms no solvent bank did, at which point they fail within days and the government a) will have utterly failed in preventing the collapse which was the whole purpose of the capital injection b) own C and BOA's mess in its entirety ala AIG.

To prevent that situation, you have to offer terms each of the banks will accept, which means terms

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