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Viewpoint: Use Receivership to Restore Confidence

American Banker | Friday, February 27, 2009

By Catherine A. Ghiglieri and Robert M. Krasne

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Much has been written about the need for the nascent Obama administration to craft a comprehensive bailout package to promote confidence in our banking system and calm the roiling markets. All the plans discussed so far have been so complicated that even administration officials cannot explain them in a way that promotes confidence in the banking system by the American public.

We propose a more simplified plan that would re-establish the long-term viability of our banking system, reaffirm our commitment to the capitalist principles of risk and reward, and likely even prove less costly than many alternatives. Furthermore, it can re-establish our mortgage market and assuage Americans' concerns that too much focus and too many resources are being dedicated to Wall Street, rather than Main Street.

The essential element of the plan is set forth in the Federal Deposit Insurance Act, which enables the various bank regulators — or, if they fail to act, the FDIC — to take control of banks that are insolvent or nearly insolvent by putting them into receivership or conservatorship.

By putting banks facing capital or liquidity crises into receivership or conservatorship, the federal government, through the FDIC, would be promoting the least costly solution to the financial problems those institutions face. Instead of trying to prop them up by purchasing illiquid or unmarketable 'assets' at illusory prices, we would be stripping deposits and good assets out of the troubled institutions and leaving the impaired assets and off-balance-sheet liabilities behind for the FDIC to liquidate in an orderly manner, enabling it to maximize asset values over time and to minimize the potential losses.

The troubled banks would be sanitized in the future; the government would not be buying assets below investment grade to bail out institutions and covering the losses in off-balance-sheet entities or notional accounts of indeterminate size. Boards and managers of failed or near-failing institutions would be replaced, so they could do no further damage. And equity investors in insolvent institutions would lose their investments. This would re-establish the idea that shareholders cannot win on the way up and be protected by the government on the way down, promoting more engaged investors and more active corporate governance.

Ultimately, the FDIC would sell the newly sanitized institutions, thereby reaffirming the American approach to banking since the Great Depression — protect depositors first and attract private capital second. IndyMac is a good example of how well this works. The FDIC attracted more than a billion dollars of capital within six months after taking it over from private investors.

However, this process should not come without restrictions. We suggest that no sanitized bank be part of a bank holding company that engages in any form of investment banking; that the sanitized banks have mortgage origination functions that would underwrite conventional loans (in compliance with old Fannie Mae guidelines); and that the sanitized banks do not participate in the purchase of synthetic securities without regulatory approval. (Perhaps that approach should be taken for all insured institutions.)

The greatest difference between what we propose and where the administration and Congress appear to be heading is the focus of the respective plans.

Though the government appears properly focused on ensuring adequate capital in our nation's banks, they are trying to do so as the banks continue to hold assets and remain exposed to liabilities whose size cannot be readily determined in these turbulent financial times. Because the values cannot be readily determined for certain of the banks' assets or

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contingent liabilities, capital cannot be calculated with any certainty either.

By contrast, we propose stripping the more volatile assets and potential nondeposit liabilities out of the banks and quantifying the potential capital shortfall according to the formula of total deposits minus stable or marketable assets. The Obama administration is attempting to find solutions to the many ills of the banking system. They need only look at the tried and true regulatory policies of the past to find a framework that would work just fine for the current banking crisis.

These policies would take us back to where we need to be: finding safety for depositors, imposing good corporate governance on directors, and requiring a true risk/reward analysis for shareholders.

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