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Bloomberg

‘Shoot the Wounded’ to Restore Banks’ Confidence

By Scott A. Shay

Oct. 14, 2008 (Bloomberg) — The economy checked into the hospital suffering from a serious housing crisis. As doctors dealing with the patient administered treatments, other more troubling ailments appeared.

Now it is vital to focus on the liquidity-crisis fever in a comprehensive manner to prevent the disease from killing the patient. So far the treatments have been too narrow. Failure to deal with the fundamental asset issue will mean the patient might stay in the hospital for many years.

Waning confidence in the banking and payment systems might lead to the type of money destruction that was a cause of the Great Depression. The policy moves by the government — the purchase of troubled assets, the injection of capital into large banks and the direct purchase of commercial paper by the Federal Reserve — don’t address the issue of confidence that money put in a bank or money-market fund is safe.

This lack of confidence is forcing even the healthiest banks to hoard liquidity and cut back lending so they can be ready to respond to consumer and business demand for cash. Until this issue is addressed, every policy effort, such as buying certain companies’ commercial paper, will create the unintended consequence of drying up liquidity in another area. Further, at a time when confidence and transparency from our government are critical, ad-hoc policies lead to questions of why some institutions are favored and others aren’t.

Unlimited Guarantee

The best way to fix the real issue is to declare a 180-day period during which the federal government will provide unlimited guarantees to all registered money-market funds and bank deposits. So called too-big-to-fail banks, money-market funds and other institutions shouldn’t be given any preference.

During this period the government must examine every money-market fund and bank. Those funds deemed to have excessive risk would be barred from accepting new funds and would be liquidated over a period of six months or so as their assets mature. Fundholders would be assured of receiving their entire principal by the Treasury.

The Federal Deposit Insurance Corp. would use this same 180-day period to take a serious look at the riskiest banks. The banks the FDIC determines won’t survive should be placed in conservatorship or receivership. Since all deposits would be guaranteed, the payment system could operate freely and no money would be destroyed.

Drip, Drip

The key is to end doubts around the banking system. The FDIC needs to “shoot the wounded” quickly rather than expose public confidence to a drip-by-drip erosion as banks are closed over an extended period.

It is important that even our largest banks go through the process so that institutions can trade with each other with confidence. Some banks judged to be fundamentally healthy but in need of additional capital should be eligible for an infusion of cash in exchange for preferred stock and warrants under the Troubled Asset Relief Program. The key is that at the end of the process, there are no question-mark banks.

After 180 days, federal insurance would no longer apply to money-market mutual funds, and bank-deposit insurance would revert to the $100,000 level. Market discipline could rationally take over.

Under the plan, at the end of the 180 days the public could feel confident that all remaining institutions are credit-worthy, safe and sound.

Two Objections

By lowering the preference for liquidity among consumers and corporations, the plan would give banks and money funds time to evaluate which companies are worthy of receiving loans or whose commercial paper to buy. This would be much more efficient than government intervention.

I suggested such a plan during the short debate on the bailout bill in Congress. Two groups opposed the idea.

The first consisted of the three or four so-called too-big-to-fail banks. Their objection was that adding $2.6 trillion of uninsured deposits to those already insured would put more pressure on the FDIC fund. (Uninsured deposits are now about $1.7 trillion after the increase in insurance coverage to $250,000.) Losses on these additional insured deposits would cause higher premiums that, in part, the big banks would have to pay.

The problem with their argument is that all of the deposits and other obligations of the largest banks are already implicitly insured. Since the smaller banks are paying deposit premiums to insure big banks, these large banks are reluctant to pay their fair share. This incentive has been exacerbated in the current environment in which the very largest banks have traded on their too-big-to-fail guarantee to attract deposits.

Unsung Enablers

The second group objecting are the deposit brokers who make their living by bundling money and then parceling it out in insured amounts of $100,000 to banks. The deposit brokers are among the unsung enablers of our credit crisis, in that they provided the insured funding for some institutions to grow far beyond their natural deposit base.

The providers of funds didn't have to examine the underlying health of the banks, since the deposits were insured. After the proposed 180-day period, brokered deposits should be phased out over a 10-year period, with specific exceptions made for credit-card banks and the like that rely on them. For the rest, brokered deposits should be relegated to the junk yard.

This plan has the potential to provide the confidence needed to solve the liquidity crisis while dealing with the underlying problems of the banking system. With this plan we can anticipate a return to growth, albeit anemic, in 2010. By continuing to manage the liquidity crisis on an ad-hoc basis, we may repeat Japan's lost decade of economic growth.

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