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Statement of the Shadow Financial Regulatory Committee on

Refocusing Financial Rescue Plans

May 4, 2009

Data on loss experience in resolving failed banks posted on the FDIC's website show that during the last two and a half years the FDIC has experienced average loss rates in excess of 20% of the assets. These loss rates indicate that the federal regulatory agencies need to focus more closely on the economic value of banks' reported net worth. The root problem is the difficulty in assessing the solvency of distressed institutions. FDIC losses flow from a bank's entire balance sheet and not just from a few specific asset categories. For this reason it is hard to square the FDIC's losses with the limited focus of the Financial Stability Plan, developed by the bank regulators and the U.S. Treasury. Their Plan focuses on only a few categories of troubled assets rather than on an institution's overall solvency.

The Financial Stability Plan seeks to help troubled institutions by restarting the markets for selected categories of so-called legacy assets and getting them off bank balance sheets. Specifically, the new Public-Private Investment Program (PPIP) and Term Asset-Backed Securities Lending Facility (TALF) seek to establish prices and to create liquidity for selected bank loans and asset-backed securities, respectively.

Program plan administrators will have to over-pay for these assets to persuade distressed institutions to sell assets that promise huge upside returns in favorable circumstances. While these assets might be attractive to institutions that have the funding to carry them profitably, such high-risk assets are especially attractive to troubled institutions that have little or no capital left to lose. The safety net promises to absorb the downside of further losses while upside returns might repair the capital deficiency in their balance sheet. Such moral hazard behavior through high-stakes gambles may represent some firms' only hope of repaying its government guarantees and other forms of credit support. The Financial Stability Plan is in fact a form of capital forbearance that treats institutions unequally. Those that happen to have concentrated portfolios of designated legacy assets will have greater access to Plan benefits, regardless of whether they are financially sound or distressed.

Treating a troubled institution's capital deficiency by tying subsidies to particular assets misdiagnoses the industry's root problem in the current crisis and runs contrary to the least cost resolution provisions of FDICIA. The S&L mess should have taught authorities that the longer forbearance is offered, the larger the FDIC's loss rates will become. The TALF and PPIP programs are dangerous because they provide ways for distressed institutions to increase their effective leverage and to increase it quickly. The TALF loans are non-recourse, which makes them equivalent to a contingent sale of whatever collateral the Federal Reserve chooses to lend against. This means that institutions that default on TALF loans are permitted to surrender their collateral without incurring further liability. PPIP investment vehicles can be highly profitable even if the investors buy assets at the same or higher values than the prices at which they are sold into the program. What makes these investments profitable is the degree of leverage contemplated and low cost of government-supported funding. At a minimum, to guard against abuse of the plan, the Committee recommends that banks selling assets into the program should be prohibited from participating directly in any Public-Private Investment Fund (PPIF) formed to buy legacy assets. In addition, program guidelines should also prevent asset sellers from funding directly or indirectly the PPIF vehicles.

It is important that the public recognize that the TALF and PPIP programs are simply devices to shift risks from troubled banks and their shareholders to taxpayers through the use of government subsidies to leveraged risk-taking that finesse the congressional appropriations process.