

Wall Street Journal, Friday, September 26, 2008

Bailout Proposal Gets Hung Up Over Central Issue: Will It Work?

Lack of Assistance for Homeowners, Small Banks Faulted

By [DEBORAH SOLOMON](#), [DAVID ENRICH](#) and [DANIEL FITZPATRICK](#)

WASHINGTON -- The big question outstanding amid the brinksmanship Thursday over a proposed \$700 billion financial bailout is fundamental. Would it work?

The Bush administration says its plan to buy mortgage-related assets from financial institutions is the only way to get credit flowing again. Without it, the argument goes, banks cannot lend and businesses cannot borrow to cover payroll, inventory, new plants or new hires.

The original proposal was designed to relieve pressure on financial institutions by removing impaired mortgage-related assets from their books. Those assets have fallen in value as the housing sector has fallen, knocking holes in firms' balance sheets and creating a global climate of distrust that has undermined the ability of banks to raise capital.

A crowd gathered outside the New York Stock Exchange on Thursday afternoon to protest the Bush administration's proposed bailout of Wall Street's missteps in the mortgage crisis.

Under the Bush proposal, and subsequent versions hammered out by congressional leaders, the Treasury Department would have offered to buy these assets. That would give companies cash to replace toxic debts, restoring capital, as well as the trust that enables banks to borrow and lend at reasonable terms.

But even before partisan disputes derailed the push to clinch a deal Thursday night, economists and industry figures questioned whether it would work.

Economists and market experts agreed that a government purchase of distressed assets would help reveal the extent of losses at financial institutions, a necessary step before the financial sector can rebuild itself.

Many financial firms are holding assets on their books at unrealistic prices, in part to avoid taking necessary write-downs that accounting rules require when an asset becomes impaired. Because the market has frozen for these assets, companies have been able to avoid reflecting their real value on their books.

One of the most important factors in evaluating the rescue plan has been one of the least clear in negotiations until now: What price would Treasury, and taxpayers, wind up paying?

Some of the nation's biggest banks have spent recent days scouring their balance sheets for securities they'd like to sell to the government and at what price. Without knowing the prices Treasury will offer, banks can't decide how aggressively to unload troubled assets.

Top executives at banks like Citigroup Inc. and J.P. Morgan Chase & Co., which hold tens of billions of dollars in securities that may be eligible for the rescue plan, have been lobbying lawmakers and Treasury officials over the past week. Their goal has been to make sure the program doesn't require banks to take further write-downs to sell assets.

"We'll be an active participant if it's set up right," said a senior executive at a major New York bank. "The devil is so much in the details here."

With Treasury buying these assets in the open market, every institution, whether or not they participate in the program, would have to reflect market prices on their books.

"The market for many of these mortgage-related assets is so illiquid that there's very little price information out there," says Matthew Slaughter, an associate dean at Dartmouth's Tuck School of Business. "Once the government begins buying assets it will help the firms themselves, their investors, and their counterparties better understand their current balance sheets."

Congressional Budget Office Director Peter Orszag told lawmakers on Wednesday "that loss of trust has sharply increased the cost of raising capital and rolling over debt, which threatens the solvency of all financial institutions."

But Robert Shapiro, a former Clinton economic advisor and the chairman of the globalization program at NDN, a Washington think tank, said the program outlined by the administration aimed at the wrong target. Rather than buying assets, he says, the government should provide money to people facing foreclosure, which would prevent the assets from going sour in the first place.

"This crisis will continue until the housing market stabilizes and as increasing foreclosures reduce the value of more mortgage-based securities," Mr. Shapiro said.

Another potentially thorny issue is whether the plan will offer as much help to small banks, which typically didn't buy the kinds of exotic mortgage securities at the center of the market mess. Big banks that are relatively healthy would also have more leeway than small banks to dump troubled assets in a government sale.

"Banks with more diverse revenue and higher capital bases have more options," said Morgan Stanley analyst Betsy Graseck in a research note Thursday. Ms. Graseck said companies such as Bank of New York Mellon Co., State Street Corp. and PNC Financial Services Group Inc. will be best positioned to participate.

While Bank of New York and State Street have had some liquidity-related problems in funds that they manage, the companies overall have weathered the credit crisis better than most commercial

banks. A Bank of New York spokesman wouldn't say whether the company plans to participate. A State Street spokeswoman had no immediate comment.

Pittsburgh-based PNC, which also has largely sidestepped the problems afflicting other lenders, doesn't intend to take advantage of the new federal bailout, said PNC Vice Chairman William Demchak.

Loans to residential developers represent less than 2% of the bank's balance sheet. While PNC does have nonperforming assets on its books, "we have the capital and the liquidity to realize the long term value of those assets and not sell at a distressed price," Mr. Demchak said.

Executives at some small banks are optimistic that they would be able to sell assets to the government as well.

Bradenton, Fla.-based Freedom Bank, for example, is hoping to sell certain loans that are secured by real estate, or real estate acquired via foreclosures. The bank has been trying to raise up to \$25 million in capital to cover expected losses.

"Any amount of help is better than nothing," said Freedom Bank Chief Executive Officer David Zeurn, Pennsylvania's former secretary of banking. "It doesn't have to be every loan we have."

But it's unclear whether the rescue plan would provide a mechanism for banks like Freedom to participate. Much of the focus has been on mortgage-backed securities, not on the so-called whole loans that reside on the books of smaller lenders.

Cynthia Blankenship, chairman of Washington-based trade group Independent Community Bankers of America, said the government's \$700 billion fund won't help smaller lenders unless it accepts whole real-estate loans, which bankers say is unlikely to happen, at least in the early stages of the program.

Ms. Blankenship, who runs Bank of the West in Irving, Texas, said struggling community banks in such once-hot but now sagging real-estate markets as Florida, California and Arizona would be eager to unload distressed mortgage or commercial real-estate loans. "It's vitally important because it allows these banks to have some relief, as well as some big banks," she said. "It's just a matter of fairness."

"We will not benefit from any of the programs that the federal government is proposing," said J. Downey Bridgwater, CEO of Sterling Bancshares Inc., a Houston-based banking company whose \$4.9 billion in assets don't include any toxic mortgage-backed securities. But Mr. Bridgwater said the government's efforts will "hopefully ease any concerns depositors may have about financial institutions across the country."

Another wrinkle could come from expected restrictions on executive pay at banks that are selling assets to the government. Democrats have insisted on such limits.

But the senior executive at the New York bank said the potential pay restrictions aren't likely to represent a serious impediment. "We've spent not a nanosecond discussing it," the executive said. "I don't think that's a consideration at all."

Mr. Zeurn, the Freedom Bank CEO, agreed, noting that the pay limits probably won't affect smaller lenders.

But BB&T Corp. Chief Executive Officer John Allison said a pay ceiling would constitute "a massive subsidy for incompetence." In a Sept. 23 letter to some members of Congress, Mr. Allison wrote: "How will companies attract the leadership talent to manage their business effectively with irrational compensation limits?"