An Alternative Bank Rescue Plan

Most agree that an effective banking system that makes loans to credit-worthy borrowers is necessary for an economic recovery. The new bank rescue plan announced by Treasury is centered on the proposition that, in order to get the banks lending again, we *must* get the toxic assets off the bank balance sheets. If the financial condition of a bank is strong enough so that a sale of the toxic assets at a discount will still leave it with substantial capital to support lending, Treasury's plan may have some success. However, if the financial condition of the banks is nowhere near that strong—as many financial analysts believe—the Treasury Plan will be effective *only* if accompanied by a massive recapitalization of the banks by the government.

What receives perhaps less attention than it should in structuring a bank rescue plan is the enormous FDIC exposure on insured deposits. Since the FDIC may ultimately be holding the bag for a failure of a bank to honor its insured deposits, selling toxic assets on the cheap may significantly increase the government's risk on insured deposits.

Private sector participants will invest in the purchase of toxic assets only if they have the prospect of making extremely high returns. They will achieve those returns only if they buy the toxic assets very cheap. Accordingly, the banks would likely realize far more over time by holding and administering the assets and should not sell them now.

The alternative approach advocated in this letter effectively de-couples the operating banks from their balance sheet uncertainties—*without* the government supplying more capital to the banks and *without* the FDIC increasing its risk. The new capital to make this plan work will come from private sector investment in healthy, reorganized operating banks. This plan will (a) keep the banks in private hands, (b) assure that the operating banks have sufficient capital and liquidity to make loans to credit-worthy borrowers, and (c) result in a well-deserved replacement of senior management. The de-coupling plan can be implemented by a reorganization of each troubled major bank in the manner described below:

- Reorganize each troubled bank so it is divided into two entities—a "New Bank" and an "Old Bank". The New

Bank would consist of all the good (“non-toxic”) assets, all of the bank’s branches and existing favorable relationships and enough of the deposit liabilities (including all uninsured deposits) to give the New Bank a zero net worth (before new equity is injected), but with no liabilities other than for deposits. Because it would have a clean balance sheet, the New Bank would be well positioned to raise private sector capital.

- The reorganization is accomplished legally by having the existing troubled bank contribute its good assets to a new subsidiary. The new subsidiary would assume liability for the appropriate amount of deposits. This new subsidiary becomes the New Bank.

- The Old Bank would consist of the questionable (“toxic”) assets, the remainder of the deposit liabilities, and all the other liabilities of the bank—mostly bonds, commercial paper and Credit Default Swap obligations, none of which would be assumed by the New Bank. The Old Bank would also own 100% of the New Bank, which would be diluted down to 49% by the sale of common stock in the New Bank (see below).

- Capital for the New Bank would be raised by the sale to the private sector of 51% of the shares in the New Bank. The capital would be sufficient to bring strong regulatory capital to the New Bank—making the New Bank an effective lender to credit-worthy borrowers. This sale of stock should attract strong interest from the private sector, because a recapitalized, financially solid New Bank can enjoy a very low cost of funds and lend it out at profitable “spreads” and thus would be very profitable.

- The Old Bank would continue to own, manage and collect the toxic assets over time and apply the proceeds first to retire deposit liabilities (they have a priority over other creditors under existing law), then to pay other liabilities of the Old Bank. The Old Bank would become largely a servicer of the toxic assets and a 49% stockholder of the New Bank.

The above plan would have some significant advantages over the Treasury plan:

- The amount to be realized from collecting the toxic assets over time in a gradually improving residential real estate market seems highly likely to exceed any possible sale price today under the Treasury Plan. Accordingly, not selling the toxic assets reduces the risk of the FDIC on insured deposits.

- The alternative plan provides for the recapitalization of the banks—Treasury's plan does not.

- Selling equity in the New Banks should be a lot easier than trying to sell toxic assets. Freed of balance sheet uncertainties (relegated under this plan to the Old Banks), the reorganized New Banks would be healthy and profitable—therefore attractive to new investors. The plan unleashes the value of the major banks' franchises, a value which today is buried under the weight of sick balance sheets.

- Upon raising fresh capital, the New Banks should *immediately* become active, effective players in providing credit. The reorganization can be accomplished quickly, with the stroke of a pen—other than the raising of new capital for the New Banks—and that might well be pre-packaged. The economy simply cannot tolerate a long, indefinite period during which the major banks are not effective lenders. An early end to the credit freeze is too essential for economic recovery.

- Implementing this plan does not require that the government own or manage the New Banks, except possibly for an interim period during which the New Bank is seeking private sector capital.

- By contrast, ridding the banks of toxic assets under Treasury's plan would necessarily occur over a long period of time. Even after disposition of their toxic assets, further uncertainties remain for the banks, such as resolving their uncertain exposure to Credit Default

Swaps (which they issued in the trillions of dollars). The banks will be lending in the manner needed for an economic recovery only when they have sufficient capital. Because of remaining uncertainties, the only source of capital for the banks under their present capital structure will be the government. Convincing a reluctant Congress, understandably sick of bailouts, to fund a major equity infusion to the banks, is highly problematic.

- Under this plan, Credit Default Swap liability and other obligations of the banks could be negotiated away for pennies on the dollar—because counter-parties and other creditors would be disabused of a bailout to fund that liability, and they would realize that they were on line for collection *behind* depositor liability (the priority of deposit liabilities is provided for by law).

- This plan would require no *additional* risk to the FDIC. The FDIC would still be liable for insured deposits, to the extent that assets of the Old Bank were insufficient to cover its deposit liabilities—but it always had that risk. Thus, the FDIC may eventually have to make good on billions of dollars of insured deposits; but because of a higher eventual collection result from the toxic assets and the emerging high value of 49% of New Bank, that existing, substantial risk should be *lessened* by adoption of this plan.

- The new investors in the New Banks would have voting control, assuring a management change. Present management has proven incompetent at risk management, and more allied to their own compensation than to ownership interests. New management, with their accountability to the new capital, should be better management.

- As compared with the government supplying equity capital to the banks in their existing form, thereby putting fresh taxpayer money in a position *junior* to bank debts (including the notorious Credit Default Swap obligations), this plan leaves largely undisturbed existing creditor priorities. Existing creditors of the bank would have no legitimate objection to the plan. Even though it does not provide the same windfall to those creditors as Treasury's plan would, this plan leaves those creditors no worse off than they are today.

Can the existing banks' cooperation be obtained, since present management can be expected to resist? Hopefully, the answer is that Treasury, the FDIC and the Federal Reserve Bank should have sufficient clout to impose this plan—if they will use it. The fact is that *any* of the major banks could today be declared insolvent and taken over by the FDIC. Just the threat of an FDIC takeover should be sufficient. The only way that the existing banks can or should be able to avoid implementing this plan is to satisfy regulators that they have sufficient capital. This plan assumes that many of the major banks will be unable to demonstrate their solvency under real world accounting analysis.

The government may be reluctant to implement this alternative plan, because it requires acknowledging the insolvency of major banks, arguably posing a systemic risk. However, done right, this plan should pose no systemic risk. Each major bank could give birth to a healthy New Bank bearing its name, a bank able to resume lending and meet the need for credit in the economy. Public confidence in the banking system should be enhanced by this plan. The negatives of the Old Banks defaulting on or re-negotiating creditor obligations would be outweighed by the confidence resulting from a public perception that the New Banks are healthy and that we have at last faced the real financial condition of the banks and done something about it.

Even if Treasury went ahead with its plan to dispose of toxic assets, the reorganization proposed above could still produce a faster route to getting the banks lending again through private sector equity funding.

Donald A. Spiegelman

March 27, 2009

The author of this letter is a retired lawyer/businessman, a graduate of Columbia Law School, cum laude, and a past member of the Board *of Editors of the Columbia Law Review. He has practiced law in New York, Michigan and California and has 40 years of experience in distressed real estate, loan workouts, reorganizations and bankruptcy.*