

The Coming Crisis

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U.S. Treasury Secretary Henry Paulson's plan to resolve the banking crisis by purchasing preferred stock in banks will probably fail. The plan does not adequately achieve a central objective in creating a well-functioning banking system: Decision-making owners -- owners with considerable voting rights and influence over managers -- must have lots to lose if the bank performs poorly in the long-run. By failing to achieve this fundamental objective, Paulson's plan enables and encourages existing bank owners and managers to reward themselves with large dividends and bonuses, leading to the further demise of the U.S. financial system. While perhaps difficult to believe after the last couple of months, the true crisis is coming.

In the plan, the U.S. Treasury would directly purchase preferred shares in the country's largest banks. Preferred shares are in many respects like debt. Preferred shares pay a specific, fixed dividend that is paid before any dividends are distributed to common stock holders. Like debt, preferred stock holders do not have voting rights. While the U.S. Treasury is immediately infusing major banks with \$150 billion of resources, it does not get to vote on any activities, including the distribution of dividends, executive salaries, bonuses, etc.

Paulson's plan, however, does not provide bank owners with the incentives to operate the bank in a sound, prudent manner. Most of these banks are insolvent, which means the current market value of their assets is less than the amount owed to depositors and debt holders. The only force preventing the stock price from plummeting to zero and pushing the banks into bankruptcy is the government, which insures the deposits, which now insures most of the debt, which allows the banks to value their assets at non-market prices, and which has provided an infusion of money through the preferred debt scheme. Based on market conditions, existing bank owners have already lost their investments, meaning they do not have much more to lose if the banks perform poorly in the long-run.

Rather than establishing sound incentives, Paulson's plan encourages bankers to quickly extract as much as possible from the bank before it fails. The existing owners and managers have little extra to lose if the bank performs poorly in the long-run. Moreover, given (i) the depressed state of the banks and (ii) the large amount of preferred stock, the existing common stock holders and managers have little to gain in the long-run from managing the bank in a prudent manner. However -- and this is the key -- they have lots to gain by extracting dividends, bonuses, and other emoluments in the short-run.

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With distorted incentives, creative bankers can easily design investment strategies that generated legal, though economically phony, accounting profits that foster the quick distribution of dividends and bonuses. These investment strategies hurt the bank and banking system in the long-run, but help the bankers in the short-run. Paulson's plan encourages banks to engage in these strategies, expanding the insolvency of the banking system.

Examples abound. When U.S. Savings and Loans (S&Ls) were provided with similar incentives in the 1980s, they quickly designed schemes to provide no recourse loans to developers, where the loans themselves included fees and interest rates that the developers returned to the banks. These fees and interest rates were immediately booked as profits and distributed as dividends and bonuses. The bankers did not care if the developer's plans succeeded or failed because they could distribute profits now and let the bank fail later. This was so profitable that S&Ls paid finders fees to people able to identify complicit developers. Recently, A.I.G., Fannie Mae and Freddie Mac, and banks designed mechanisms to generate huge current profits at the expense of future solvency even when the risks were well-known. These were ingenious, legal financial strategies. The executives walked away with multimillion dollar bonuses and they are watching the current crisis unfold from their yachts, occasionally jetting into Washington D.C. for a mea culpa in front of Congress.

Unless rectified, Henry Paulson's plan is going to push the country – and world – from crisis to calamity. Japan suffered a ten year recession because of the unwillingness of policymakers to deal aggressively banks and to ensure that decision-making owners have large amounts of their wealth at risk in banks. We are to pay greatly for Paulson's decision to save existing bankers instead of protecting the financial system.