# Good Bailouts and Bad

DAVID O. BEIM

The U.S. government, faced with the worst financial crisis since the 1930s, has announced a $700 billion plan to purchase bad mortgage assets from banks. Is this a good bailout or a bad one? The difference is important, because history shows that *bad bailouts actually make financial crises worse*.

## PAST BAILOUTS

The Japanese government's handling of their massive bank crisis in the 1990s was bad bailout policy: the government at first ignored the problem, then decided not to enforce its own rules requiring sufficient bank capital ("forbearance"), then began investing government funds into insolvent banks through preferred stock and subordinated debt. The banking crisis only grew larger, and was probably the major reason for Japan's poor economic performance during the 1990s and for several years thereafter.

A good bailout is one focused on liquidity. The government acts appropriately when it helps institutions with liquidity at a time of crisis by lending against collateral or by purchasing bank assets at fair market prices. A bad bailout is one that tries to help with solvency. The government acts badly when it invests money directly into failing banks without closing them. If some banks, even many banks, are actually insolvent (i.e. their liabilities exceed the value of their assets) then best practice dictates that they should be closed.

Closing banks is less draconian than it sounds. A closed bank is not blown up and thrown away; on the contrary, every effort is made to preserve the bank's franchise value and maintain continuity with customers and employees. Normally, the government cleanses the bank of its bad assets after closure, and transfers the cleaned-up business to new owners as rapidly as possible.

A central feature of good bailouts is that the shareholders of insolvent banks are wiped out and their senior management is dismissed. Why? Because these are the people who created the problem, they must be seen to pay a high price. Remember that most banks are conservative, well-run and solvent; only a minority got over-extended.

The problem with the Japanese banks in the 1990s was not just the bubble economy

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of the 1980s, but a continuing unwillingness by the banks and government to acknowledge bad lending practices and change them. A few banks were eventually closed and one of them became Japan's greatest banking success: Long-Term Credit Bank was closed and sold to an American buyout fund, which resurrected it under the name Shinsei Bank.

During the period 1986–1992, the FDIC closed over 2,300 banks and thrifts. The Resolution Trust Company (RTC) was established to move the bad real estate assets back into the economy as promptly as possible. The RTC was much admired for its speed and efficiency. Note that it did not try to buoy up failing banks; it handled their assets after the failing banks were closed.

### THE CURRENT BAILOUT

So is the current administration plan a good bailout or a bad one? At this point the proposal is written in a very general way, and the details are unclear. It could turn either way—the devil is in the details. The test will be whether the government plans to buy assets at something resembling their fair market value or not.

Suppose a bank has made a $10 million loan that is actually worth about $6 million. If the government buys the loan at $6 million, then that is liquidity assistance, which is fine. But if the government buys the bad loan for $10 million, it is giving the bank a $4 million gift. Handing out gifts to misbehaving banks would be a very expensive, bad bailout.

Secretary Paulson has spoken of buying the bad assets at a deep discount, but this is not written into his proposal. It should be a requirement. That would minimize the ultimate cost to the U.S. taxpayers, and increase the chances that this is a good bailout.

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