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Short-Term Solutions to Long-Term Problems

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Does the government have a plan?

The federal government has responded to the financial crisis by creating an alphabet soup of programs reminiscent of the New Deal. There is the CAP, TARP, TALF, the Financial Stability Plan, Relief for Responsible Homeowners and Unlocking Credit for Small Businesses, as well as special programs for institutions that are systemically failing and for the automotive industry.

These programs are an attempt to create order out of chaos. Yet the public remains wary, and many financial observers are puzzled by the government's seemingly shifting responses.

The government's difficulties arise from its overall approach. It has treated each program and individual bailout as unique, to be negotiated like any other corporate transaction. But the short-term response has locked the government into an inflexible course that does not permit long-term planning. It has been putting out fires, and the apparent lack of an overall plan has created yet more issues and bailouts, engendering public consternation instead of confidence. No greater example of this appears than the bailout of the American International Group.

If you asked a congressman who owned **A.I.G.**, the likely response would be that

the government does, at least 80 percent of it. That would be half-right. When this bailout was first negotiated in September, the Federal Reserve Bank of New York (headed by the man who is now Treasury secretary, Timothy F. Geithner) extended a line of credit up to \$85 billion to the company.

In connection with this loan, A.I.G. issued 79.9 percent of its voting shares to the Treasury Department, which placed these shares into a trust for the Treasury's benefit. Three trustees have virtually absolute discretion to run A.I.G. The trust is unbreakable, and the government has no control over the trustees' actions, so long as their decisions are not contrary to the interests of the government.

In the initial bailout, the government erected a careful structure to separate its ownership of A.I.G. from its control. This was presumably done to prevent political interference with ownership interest. In addition, the government imposed punitive lending restrictions on A.I.G. to dismember it.

But A.I.G. floundered, and the government's bailout was reworked twice more, in November and March. In November the terms of the loan were eased, but the government provided the company with additional help, about \$90 billion. In March, the government began to cordon off A.I.G.'s subsidiaries. Its two main life insurance companies were placed into special-purpose vehicles so the subsidiaries could be seized separately by the government if A.I.G. went into bankruptcy.

By planning for a possible A.I.G. bankruptcy, the government was beginning to address the accusations that the company was holding the government hostage.

The government's approach has led to two significant criticisms. First, about \$85 billion of the government assistance provided to A.I.G. has been used by the company to pay third-party banks to satisfy collateral calls and unwind credit default swaps. These payments were made by A.I.G. at the face price of the securities, not the lower market value. If the government had instead taken control of A.I.G. and negotiated directly with these third parties to pay a lower price, it could have saved some of the \$85 billion.

Second, government control could have allowed it to cap A.I.G.'s losses. Last fall, the government could have cordoned off all of A.I.G.'s subsidiaries into vehicles

insulated from a bankruptcy, but it did so with only two of them, and only this month. If it had taken stronger action earlier, it would now be in a position to throw A.I.G. into bankruptcy, if necessary, and offer direct support to affected financial institutions.

These are big ifs, though, and the government was acting under severe time constraints last fall. Moreover, A.I.G. has substantial assets, and the bailout money provided to A.I.G. could still be repaid in full.

Still, there are some clear problems with the government's approach. In each of its three successive bailouts of A.I.G., the government put into place a rigid and different structure for each one. First, it extended a harsh loan to force a breakup of A.I.G.; then it reworked the loan to keep A.I.G. afloat; and finally, six months later, it set up a structure allowing for bankruptcy. There does not appear to be much long-term planning here.

These clever legal structures may have met the government's near-term political needs — saving A.I.G. and calming the financial system while avoiding nationalization — but they failed to include flexibility and control to respond to unforeseen events.

The government is still bound to pour more money into A.I.G. if it's needed, but it still has only indirect control of the company to which it has extended credit and a potential \$183 billion in bailout money.

Citigroup is another example of the government's short-term approach. It has invested \$45 billion in Citigroup through three separate programs. Yet its ownership stake is capped at 36 percent, albeit with voting control and apparently no trust arrangement, as there was with A.I.G.

Again, the government has negotiated a one-of-a-kind transaction and gotten only soft control when it could have bargained for much greater rights.

Many questions remain: Will **Citi** need more money? And why were Citi and A.I.G. treated so differently? Compare these two bailouts with those of the automakers, which have been put on a much tighter leash. In that example, the government has demanded an actual say on their expenditures in connection with

their bailouts.

Financial panics result from unbalanced information. An investor, unsure of a financial institution's soundness, runs for security to another institution. Moreover, in recessions, consumer confidence must be restored before a true economic turnaround can occur.

But in structuring each bailout as a one-off transaction — no different from those made by an investment banker — the government has left the public wary. The government has succeeded in saving these institutions, and must be given credit for that. But government by deal is not a complete plan and leaves many lacking confidence in the sustainability of the system.

We are at war against the financial crisis, and in times of war, there is self-sacrifice. The government is asking the citizenry to sacrifice, but it is financially engineering discrete solutions that pay benefits to a select few, like A.I.G.

Instead of a taking a haphazard approach of ad-hoc bailouts, the government would do better to offer a comprehensive plan that calls for shared sacrifice by all, including the members of financial institutions. Mr. Geithner's recent call for a new type of receivership for financial institutions is a good start. But the administration needs to follow through on this and offer other holistic measures.

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