Wall Street Journal Editorial: â€œA Backdoor Nationalizationâ€•

The latest Treasury brainstorm will retard a banking recovery.

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• “Wholesale equity conversion would mean the government owns a larger share of more banks and is more entangled than ever in their operations.”

EDITORIAL; Tuesday, April 21, 2009

Just when you think the political class may have learned something in months of trying to fix the banking system, the ghost of Hank Paulson returns to haunt the Treasury. The latest Beltway blunder -- and it would be a big one -- is the Obama Administration's weekend news leak that it may insist on converting its preferred shares in some of the nation's largest banks into common equity.

The stock market promptly tumbled by more than 3.5% yesterday, with J.P. Morgan falling 10% and financial stocks as a group off 9%, as measured by the NYSE Financials index. Note to White House: Sneaky nationalizations aren't any more popular with investors than the straightforward kind.

The
occasion for this latest nationalization trial balloon is the looming result of the Treasury's bank strip-tease -- a.k.a. "stress tests." Treasury is worried, with cause, that some of the largest banks lack the capital to ride out future credit losses. Yet Secretary Timothy Geithner and the White House have concluded that they can't risk asking Congress for more bailout cash.

Voila,
they propose a preferred-for-common swap, which can conjure up an extra $100 billion in bank tangible common equity, a core measure of bank capital. Not that this really adds any new capital; it merely shifts the deck chairs on bank balance sheets. Why Treasury thinks anyone would find this reassuring is a mystery. The opposite is the more likely result, since it signals that Treasury no longer believes it can tap more public capital to support the financial system if the losses keep building.

Worse,
wholesale equity conversion would mean the government owns a larger share of more banks and is more entangled than ever in their operations. Giving Barney Frank more voting power is more likely to induce panic than restore confidence. Simply look at the reluctance of some banks -- notably J.P. Morgan Chase -- to participate in Mr. Geithner's private-public toxic asset sale plan. The plan is rigged so taxpayers assume nearly all the downside risk, but the banks still don't want to play lest Congress they become even more subject to political whim.

A
backdoor nationalization also creates more uncertainty, not less, by offering the specter of an even lengthier period of federal control over the banking system. And it creates the fear of even more intrusive government influence over bank lending and the allocation of capital. These fears have only been enhanced by the refusal of Treasury to let more banks repay their Troubled Asset Relief Program (TARP) money.

As
it stands, banks and their owners at least know how much they owe Uncle Sam, and those preferred shares represent a distinct and separate tier of bank capital. Once the government is mixed in with the rest of the equity holders, the value of its investments -- and the cost to the banks of buying out the Treasury -- will fluctuate by the day.

Congress
is also still trying to advance a mortgage-cramdown bill that would hammer the value of already distressed mortgage-backed securities, and now the Administration is talking up legislation to curb credit-card fees and interest. Both of these bills would damage bank profits, but large government ownership stakes would leave the banks helpless to oppose them. (See Citigroup, 36% owned by the feds and now a pro-cramdown lobbyist.)

We've
come to this pass in part because the Obama Administration is afraid to ask Congress for the money for a meaningful bank recapitalization. And it may need that money now in part because Mr. Paulson's Treasury insisted on buying preferred stock in all the big banks instead of looking at each case on its merits. That decision last fall squandered TARP money on banks that probably didn't need it and left the Administration short of funds for banks that really do.

The
sounder strategy -- and the one we've recommended for two years -- is to address systemic financial problems the old-fashioned way: bank by bank, through the Federal Deposit Insurance Corp. and a resolution agency with the capacity to hold troubled assets and work them off over time. If the stress tests reveal that some of our largest institutions are insolvent or nearly so, it's then time to seize the bank, sell off assets and recapitalize the remainder. (Meanwhile, the healthier institutions would get a vote of confidence and could attract new private capital.)

Bondholders
would take a haircut and shareholders may well be wiped out. But converting preferred shares to equity does nothing to help bondholders in the long run anyway. And putting the taxpayer first in line for any losses alongside equity holders offers shareholders little other than an immediate dilution of their ownership stake. Treasury's equity conversion proposal increases the political risks for banks while imposing no discipline on shareholders, bondholders or management at failed or failing institutions.

The
proposal would also be one more example of how Treasury isn't keeping its word. When he forced banks to accept public capital whether they needed it or not, Mr. Paulson said the deal was temporary and the terms wouldn't be onerous. To renege on those promises now will only make a bank recovery longer and more difficult.

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