

## **Bank Stability: A More Radical Solution**

Gradually, in increments of tens of billions of dollars, we are nationalizing America's banking system. Without a plan, without an organizational structure to oversee the new ownership and without an exit strategy, the nation is in the midst of a seminal shift in the relationship between the public and private financial sectors.

We learned that in December, Bank of America's chief executive Ken Lewis told the Federal Reserve Chairman and Treasury officials that he was concerned about the condition of Merrill Lynch and the risks to the bank from the merger. The Chairman urged completion of the merger for the good of the financial system and Mr. Lewis moved forward for "patriotic" reasons. These revelations come at the end of a six month period in which the Secretary of the Treasury and the Chairman of the Federal Reserve consistently reacted in an ad hoc manner to the destruction of the commercial and investment banking businesses as we have known them for over 70 years.

We have reached the point where only the federal government, with its unlimited resources, can stabilize the financial sector. As we take the momentous step of abandoning the fundamental capitalist principle separating business and government, let us, at the least, explicitly acknowledge what we are doing. Let our leaders articulate the rationale and have a plan that taxpayers can understand and support.

It was always clear that the severity of the financial crisis took the Bush Administration by surprise. The Troubled Asset Recovery Program (TARP) has been run in fits and starts. First, the Secretary proposed a plan to buy toxic loans and then shifted to a strategy of buying preferred stock in many commercial and investment banks to stimulate credit extension. In between, TARP has been used to buy a nearly 80% equity stake in AIG (now overseen by three government appointed trustees), to prop up the automobile companies, to provide capital to auto finance companies, and in a modest way, to relieve the mortgage crisis. The Federal Reserve has worked hand-in-glove with the Treasury. It has, among other actions, bought mortgages from Fannie Mae and Freddie Mac, supplied credit to banks and entered into loss sharing arrangements, first with Citicorp and now Bank of America. It has also pushed interest rates on Treasuries to almost zero. The Fed seems to have lost its independence and its balance sheet has swollen to over \$2 trillion.

The conversations between Mr. Lewis and federal officials aren't a surprise given what we see about the government's role in the break-up of Citicorp. Apparently, as some sort of quid pro quo for Treasury support, the bank is spinning off its retail arm, Smith Barney, and will dispose of other operations. It also agreed to a plan to make it easier for homeowners to renegotiate their mortgages.

Thus, while Congress has been rightfully wondering about accountability for the TARP funds and what bonuses and dividends the recipients will pay using taxpayer money, it should be debating where we are going and what lines we have crossed.

Hegel wrote, "The owl of Minerva begins its flight when the shades of twilight have already fallen". Too late to be effective, Mr. Paulson discovered that incrementalism didn't work. As he left office, he proposed a mega bank to take over bad loans from the banks. Organizational change comes after a plan. It isn't a substitute for the plan itself.

We propose that the Obama Administration and Secretary Geithner immediately announce that the Treasury will seek increased equity ownership in any financial institution that requires additional capital or in any entity – including finance companies – that needs more than \$1 billion. The Treasury will become an active partner in distressed commercial banks. President Obama would reject the passive oversight, inadequate accountability and the process of striking deals in the obscurity of the Federal Reserve and Treasury conference rooms. Reflecting its shibboleth of change, let the Obama Administration be explicit about a changed relationship between government and private banking. Active involvement including, perhaps, board representation, is necessary as the taxpayer finally provides capital sufficient to permit a sound financial system.

Leadership inspires confidence. Confidence begets credit. President Obama would be well advised to use the confidence the Nation has in his leadership to acknowledge the radical steps needed to get the banking system functioning for the good of the country.

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