Policy Memorandum

ECONOMIC POLICY INSTITUTE • SEPTEMBER 22, 2008 • POLICY MEMORANDUM #128

Financial industry bailout plan needs to protect taxpayers

BY JOHN IRONS, JARED BERNSTEIN, AND ROSS EISENBREY

The turmoil in financial markets is clearly deep and threatening. The economy, especially the job market, is already facing recessionary conditions, and a further meltdown in credit markets could absolutely deepen this crisis. Piecemeal attempts to repair the damage created by years of inadequate oversight, over-leveraging, and reckless lending and borrowing standards have not worked.

Thus, we support a systematic intervention, but believe that the one proposed by Secretary Paulson is fundamentally flawed. Most important, by committing the government to the purchase of vast amounts of failing debt without any compensation, it fails to protect taxpayers from exposure to significant losses. The way the Paulson plan is structured, taxpayers are likely to pay a premium for "toxic" debt (i.e., more than the underlying value) with little likelihood that they will ever recoup the expense. Moreover, this shortcoming can be easily fixed in such a way that does not threaten to derail the process, given the urgency of the situation.

To do so, the government should follow the lead offered by Congressional Democrats and demand equity for the debt it purchases. We elaborate on this below, but the idea is for the government to act like a private investor—lending money in exchange for a share of the firm. If the loans are effective, and the company once again prospers, the government sells its shares at a premium. If the firm fails, the government has the right to claim the value of any remaining assets.

This is but one condition we believe should be part of the deal—we note others below. While we recognize the urgency of the crisis and the need for quick action, we do not believe that it requires acceding to every aspect of the Paulson plan—and we are relieved to see that some key members of Congress agree. These times call for bipartisan negotiations that protect the taxpayer, offset the government's expense, and re-regulate markets to reduce the distortions that gave rise to this unfortunate situation in the first place.

With $700 billion of taxpayer money at stake, Congress, the administration, and Secretary Paulson must represent all of us, not just the financial markets. This means paying attention to distressed mortgage holders and to job seekers facing an unemployment rate of 6.1% (more than 10% for African Americans). To offset whatever costs emerge from this bailout, we will need to raise revenues—we suggest levying a tax on financial transactions and raising the tax on income from capital gains and dividends to the same rate as wages. Otherwise, the nation's needs for expanded health

care and investments in infrastructure, renewable energy, and education will be curtailed. We also must make sure that those who are bailed out do not enrich themselves further with excessive salaries and benefits.

Specifically, Congress needs to ensure that there are adequate safeguards for taxpayers included in any bailout package. These measures include:

Equity stakes. Federal assistance must be accompanied by steps to minimize the costs to taxpayers and to ensure that taxpayers participate in any future market gains. The bailout cannot simply be a giveaway to companies that made poor decisions.

Federal purchases of mortgage or related assets should result in taxpayers receiving a share of those companies that participate. The preferred equity stake should be proportional to the size of aid the firms receive. In particular, if assets are purchased by the government at a level above fair value, the equity stake must reflect at least that inflated value. In addition, any injections of capital by the government should be secured by an equity stake at least as large as the cash infusion. Consequently, shareholders and taxpayers will share in both the cost and potential benefits of the bailout.

Further, a "clawback" provision would hold companies responsible for the future performance of the assets they sell to the government. If a given firm's assets perform significantly worse than others in the same asset class in the wider market over a period of five years, the difference should be paid by the companies to the government. This will blunt incentives for firms to swap only their worst assets for equity stakes with the government.

Transparency. If private companies are allowed to participate, they must be subject to the same regulatory and reporting requirements as public firms, including the reporting of all liabilities. Off-the-books accounting should not be allowed.

Compensation. Firms that participate in the program must agree to freeze executives' compensation at or below a reasonable level—say the salary of the President of the United States—for as long as the government holds an equity stake in the firm. Congress should also include a requirement that compensation packages for public companies be approved by a majority of those shareholders—including government shareholders.

Regulation. Federal legislation must include a timeline for the Treasury and Congressional committees to propose new financial-industry regulations that would significantly reduce systemic risk. Congressional leaders on a bi-partisan basis should publicly commit now to a set of principles that will guide systemic reform in the next Congress. These principles should include tighter and more broadly applied asset reserve requirements, the elimination of off-balance sheet entities and liabilities, tighter control of conflicts of interest, and a crackdown on predatory mortgage lending and lax underwriting standards. Any congressional deal must include a commitment from both parties in Congress to take up legislation to reform the regulatory structure.

Home owner relief. Bankruptcy judges should be allowed to modify the terms of mortgages when the appraised value of a home falls below the mortgage value. Further, home owners whose loans are modified, either through the court or through a "workout" with a bank, should not be penalized on their credit scores.

Process. The program to purchase certain kinds of financial securities should be reviewed frequently by the administration, and the Treasury Secretary should be required to report to Congress on the program at least every 90 days.

Beyond the immediate crisis

Congress needs to act soon to address structural problems to ensure that this kind of crisis cannot reoccur. These measures include:

Reform financial regulations. Publicly traded companies should have financial books that fully reveal the extent of all liabilities and assets. There is no justification for hiding liabilities from lenders or investors, or the government. Off-balance sheet entities or transactions should be prohibited.

Any institution that assumes a role of insuring financial transactions must have reserves adequate to pay off its reasonably anticipated obligations, and much of current finance involves credit derivative swaps and other transactions that hedge or insure against financial events. Yet non-depositary financial institutions like Bear Sterns are permitted to operate with debt-to-capital ratios in excess of 30-1, grossly inadequate to cover potential losses. Regulators should set and enforce asset responsible reserve requirements for investment banks, hedge funds, and other financial institutions.

Mortgage brokers were at the heart of the financial crisis. The natural restraint on lending to people unable to repay has been undermined by the securitization of mortgages. Once brokers could sell a mortgage to an investment bank without concern for the borrower's ability to repay, the number of bad loans skyrocketed, and foreclosures followed. Tough underwriting standards must be enacted, and brokers must be prohibited from writing loans that they do not reasonably expect can be repaid.

Conflicts of interest, such as those that permitted rating agencies to accept payment from the investment banks whose securities were being rated, must be rooted out and prohibited

Address the fundamentals of the economy. While it is important to ensure that financial markets continue to function properly, we should also bear in mind that the broader economy continues to struggle with rising unemployment, stagnating wages and incomes, and increasing prices for energy and food.

Home owners should not be left out. This assistance should include, at a minimum, backing for state efforts to provide counseling and temporary relief, and an expansion of judges' ability to coordinate adjustments in mortgage terms to allow more people to stay in their houses.

Congress should pass an economic stimulus package that includes infrastructure investments, aid to states, and additional payments for low- and moderate-income families. Such a bill, if large enough, would provide a needed spark to complement the efforts on Wall Street. To have a significant impact, a job creation package must be at least as large as the $162 billion package passed earlier this year (though the outlays might be spread over the next 18 months.)

Shared sacrifice. While it may be necessary to provide a backstop to the broader market, it is also clear that many of those on Wall Street have benefited greatly from the excesses of the last few years. The costs of this bailout are unknown since the value of the assets that will be taken over by the federal government is unknowable at this time. It is important, however, that the costs of this bailout not prevent our nation from addressing its many needs, such as health care, education, investments in energy renewables, etc.

We must demand that the costs of the bailout are shared equitably. That means raising taxes on those with high incomes and setting capital gains and dividends tax rates at the same level as ordinary income. Also, a financial transactions tax should be implemented starting in 2009; this tax alone could yield from $50 to $100 billion to meet the costs of the bailout and other needs.