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First Trust

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Economic Commentary

We Need a Game Changer, Now!

The Treasury's $700 billion plan to purchase troubled assets has had no visible effect on financial markets. Since the bill's passage, the Dow has fallen 1500 points.

One reason for this could be that the market hates the bill and does not like the idea of government interfering with financial markets. Another could be that the bill did not include a suspension of mark-to-market accounting. In fact, news of a potential change by the SEC to fair value accounting rules fueled a 400 point rally in the Dow on September 30th. This rally faded rapidly when these rumors proved false.

Both of these arguments are probably accurate, but it is also true that the Treasury will not make its first purchase of assets with its new fund for at least two weeks. In today's world, this is a long time…too long. Every firm that fails increases the odds that another will fail. And every failure undermines confidence in the economy and causes a deeper distrust of the capital markets. We need a game changer, now.

The Treasury should use the broad latitude it has been granted with its $700 billion rescue fund to enter the market directly to help firms that face liquidity or capital issues. This could take the form of buying preferred shares, or directly helping with short-term funding needs.

There are three problems facing investors. The first is that a continued decline in asset values (even when cash flows are positive) is putting pressure on capital. These pressures, exacerbated by mark-to-market accounting rules, scare off potential investors because they worry that further write-downs will force a further dilution of equity holders. This happens even if the losses are just paper losses caused by fire sale prices.

The second fear is that even when firms get bailed out by the Treasury or the Fed, the terms are so onerous (in an attempt to protect the taxpayer), that shareholders are wiped out. As a result, investors are leery of government action and use this as another excuse for holding back.

This concern is magnified by the fact that there does not seem to be any guiding principles for market intervention. Why was AIG saved, but Lehman allowed to fail? Why was Wachovia forced to sell to Citigroup for so much less than it was seemingly worth, at least to Wells Fargo?

Third, liquidity is now a problem. A firm could be well capitalized, but a run can occur on its deposit base if it is a bank, or on its short-term operating capital in the case of non-bank firms. This has the same impact as a capital crisis because it forces companies to either raise more cash, or sell assets at a fire sale price.

The end result of all of this is that we have a cascading series of problems which seem to have no end in sight. We can no longer wait for the Treasury to build up a brand new business to purchase illiquid assets and put a floor under prices. The Treasury must use its authority to intervene and provide liquidity directly to firms that need it right now.

There are two ways to do this. The Treasury can become a direct shareholder in a financial firm by buying preferred securities, or it can provide short-term financing.

Unfortunately, up to this point the government has proven to be a harsh investor. By taking 79.9% of a firm, the Treasury has wiped out shareholders. In an attempt to protect the taxpayer, these actions have driven away private investors who fear they will be diluted to near nothing.

The Treasury should think in the long-term (not just the short-term) interests of the taxpayer. This means saving the economy from cascading financial firm failures to protect its long-term tax revenues rather than just trying to protect itself from investment losses.

There is a risk that if Treasury takes too much skin, the plan backfires. What firms need now is liquidity to keep operating and capital enough to build confidence, not takeovers by the government. As a result, if the Treasury cannot keep itself from taking too much equity, maybe commercial paper is a better way to go.

A good two-pronged approach would be to first suspend mark-to-market accounting regulations so that the pressure on capital accounts from any more paper losses is no longer a threat. This will provide a more stable landscape for potential investors and is really what the $700 billion fund is designed to accomplish. Second, use the wide latitude of the Treasury plan to buy commercial paper, or otherwise directly invest in companies who need liquidity to operate.

The Federal Reserve is already doing this, but this puts monetary policy at risk. Using the Treasury fund to do this will convince investors that liquidity problems will not spread any further. Not only can these actions be taken immediately, but the government can extricate itself more quickly from these types of financial arrangements as problems dissipate than it can if it takes an equity stake.

By fixing the problem of fire sale write downs, and providing the liquidity necessary to keep operating, the Treasury can stop failures without increasing its ownership stake in the financial sector. At this point, keeping one more domino from tipping over is the simplest and easiest way to stop the crisis from spreading in a completely out of control process. At the least, these actions will provide a bridge, allowing the Treasury time to ramp up its fund and prepare to buy assets in the open market.

We are hearing that the Treasury is thinking hard about these options and are hopeful that a move in this direction will be taken quickly.

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