
Jeffrey Sachs: Will Geithner and Summers Succeed in Raiding the FDIC and Fed?

Geithner and Summers have now announced their plan to raid the Federal Deposit Insurance Corporation (FDIC) and Federal Reserve (Fed) to subsidize investors to buy toxic assets from the banks at inflated prices. If carried out, the result will be a massive transfer of wealth -- of perhaps hundreds of billions of dollars -- to bank shareholders from the taxpayers (who will absorb losses at the FDIC and Fed). Soaring bank share prices on the morning of the announcement, and in the week of leaks and hints that preceded it, are an indication of the mass bailout at work. There are much fairer and more effective ways to accomplish the goal of cleaning the bank balance sheets.

A major part of the plan works as follows. One or more giant investment funds will be created to buy up toxic assets from the commercial banks. The investment funds will have the following balance sheet. For every \$1 of toxic assets that they buy from the banks, the FDIC will lend up to 85.7 cents (six-sevenths of \$1), and the Treasury and private investors will each put in 7.15 cents in equity to cover the remaining balance. The Federal Deposit Insurance Corporation (FDIC) loans will be non-recourse, meaning that if the toxic assets purchased by private investors fall in value below the amount of the FDIC loans, the investment funds will default on the loans, and the FDIC will end up holding the toxic assets.

To understand the essence of the giveaway to bank shareholders, it's useful to use a numerical illustration. Consider a portfolio of toxic assets with a face value of \$1 trillion. Assume that these assets have a

20 percent chance of paying out their full face value (\$1 trillion) and an 80 percent chance of paying out only \$200 billion. The market value of these assets is given by their expected payout, which is 20 percent of \$1 trillion plus 80 percent of \$200 billion, which sums to \$360 billion. The assets therefore currently trade at 36 percent of face value.

Investment funds will bid for these assets. It might seem at first that the investment funds would bid \$360 billion for these toxic assets, but this is not correct. The investors will bid substantially more than \$360 billion because of the massive subsidy implicit in the FDIC loan. The FDIC is giving a «heads you win, tails the taxpayer loses» offer to the private investors.

Specifically, the FDIC is lending money at a low interest rate and on a non-recourse basis even though the FDIC is likely to experience a massive default on its loans to the investment funds. The FDIC subsidy shows up as a bid price for the toxic assets that is far above \$360 billion. In essence, the FDIC is transferring hundreds of billions of dollars of taxpayer wealth to the banks.

With a little arithmetic, we can calculate the size of that transfer. In this scenario, the private investors (who manage the investment fund) will actually be willing to bid \$636 billion for the \$360 billion of real market value of the toxic assets, in effect transferring excess \$276 billion from the FDIC (taxpayers) to the bank shareholders! Here's why.

Under the rule of the Geithner-Summers Plan, the investors and the TARP each put in 7.15 percent of the purchase price of \$636 billion, equal to \$45 billion. The FDIC will loan \$546 billion. (All numbers

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are rounded). If the toxic assets actually pay out the full \$1 trillion, there will be a profit of \$454 billion, equal to \$1 trillion payout minus the repayment of the FDIC loan of \$546 billion. The private investors and the TARP will each get half of the profit, or \$227 billion.

Since this outcome occurs only 20 percent of the time, the expected profits to the private investors are 20 percent of \$227 billion, or \$45 billion, exactly what they invested. Similarly, the TARP's expected profits are also equal to the TARP investment of \$45 billion. Thus, both the TARP and the private investors break even. As competitive bidders, they have bid the maximum price that allows them to break even.

The bank shareholders, however, come out \$276 billion ahead of the game, while the FDIC bears \$276 billion in expected losses! This transfer occurs because the investment fund defaults on the FDIC loan when the toxic assets in fact pay only \$200 billion, an outcome that occurs 80 percent of the time. When that happens, the investment fund is «underwater» (holding more in FDIC debt than in payouts on the toxic assets). The investment fund then defaults on its debt to the FDIC. The FDIC gets \$200 billion instead of repayment of \$546 billion, for a net loss of \$346 billion. Since this outcome occurs 80 percent of the time, the expected loss to the taxpayers is 80 percent of \$346 billion, or \$276 billion. This is exactly equal to the overpayment to the banks in the first place.

Soaring bank stock prices during the last week, and then again on the day of the announcement, demonstrate the bailout in action. From March 9 to March 20, the KBW bank index rose by 33 percent, while the overall Dow Industrials rose by only 11 percent, indicating how the rumors were especially good for the banks. This morning, bank shares across the board soared in value. Citibank has tripled in value since its low in early March. The value of the bailout dwarfs the AIG and Merrill bonuses, but

since the bailout is much less obvious than the bonuses, the public's reactions have been muted, at least at the start.

The plan should not go forward on such unfair terms. Under the law, Congress should apply the Federal Credit Reform Act of 1990, which requires budget appropriations to cover expected losses on government loans programs, which would presumably include the expected losses on FDIC and Treasury loans under the Geithner-Summers Plan. With proper credit accounting, the entire operation in our little illustration would require a budget appropriation of \$276 billion, equal to the expected losses of the FDIC and Treasury. If the Administration goes to Congress for such an appropriation it will be shot out of the water. The public will not accept overpaying for the toxic assets at taxpayers' expense. Thus, it is very likely that the Administration will attempt to avoid Congressional oversight of the plan, and to count on confusion and the evident «good news» of soaring stock market prices to justify their actions.

The Geithner-Summers plans for the FDIC are not the only off-budget transfers to bank shareholders taking place. Other parts of the plan support subsidized loans from the Treasury and, even more, from the Fed. The Fed is already buying up hundreds of billions of dollars of toxic assets with little if any oversight or offsetting appropriations. Since the Federal Reserve profits and losses eventually show up on the budget, the Fed's purchases of toxic assets also should fall under the Federal Credit Reform Act and should be explicitly budgeted.

There are countless preferable and more transparent courses of action. The toxic assets could be sold at market prices, not inflated prices, making the bank shareholders bear the costs of the losses of the toxic assets. If the banks then need more capital, the government could invest directly into bank shares. This would bail out the banking system without bailing out the bank shareholders. The process would

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be much fairer, less costly, and more transparent to the taxpayer.

Banks that are already insolvent should be intervened directly by the FDIC, that is, temporarily taken into receivership. The shareholder value would be wiped out, except perhaps for some residual claims in the event that the toxic assets vastly outperform their current market expectations. As I've written before, the allocation of bank shares between the taxpayers and the current bank shareholders could be made contingent on the eventual value of the toxic assets (http://www.huffingtonpost.com/jeffrey-sachs/a-proposal-on-how-to-leave_b_166303.html), ensuring fairness between the shareholders and the taxpayers.

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Americans will justifiably ask who got us into this mess. The answer, in part, is the same man who has yet to come up with a coherent plan to get us out of it:

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[Stop Bashing the Obama Economic Plan](#)

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The new economy, the one that not only gets us out of this crisis, but keeps us out of the next, will not have a place for either AIG type bonuses or Jim Cramer-type journalism.

[Good Work, AIG!](#)

The bonuses may seem greedy, but look what quality stuff they're producing!...

[A Real Simple Solution to the AIG Bonus Mess](#)

Rather than allow these bonuses to remain intact or to take them away outright, how about deferring them until the companies and their troubled business units turn their financial fortunes around?

[Unacceptable Excuse of the Day](#)

The ongoing AIG mess provides us with an interesting sidelight today -- the use of an excuse that is no longer acceptable in the unwired global universe in which we now live.

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The sums of money going to bail out the financial industry dwarf the waste and pork that get John McCain and other budget hawks excited. Yet they are strangely calm about the bailout money.

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By fueling anger over AIG bonuses, Bernanke is playing a very old game. By aiming at AIG, he is distracting public anger from the Federal Reserve. He is protecting his reputation and legacy.

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It's admirable that our leaders now want to be frugal with our money but let's remember what the taxpayers themselves have been buying with money not rendered unto Uncle Sam.

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Such knee-jerk populist rage is precisely what gave populist rage a bad name in the first place, whereby a valid democratic outlook is construed as nothing more than an angry-mob uprising.

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It seems to have finally dawned on government leaders that bonus recipients are not the only ones who should be afraid.

[AIG, Populist Rage, and the Future of Banks](#)

Lately the torches-and-pitchforks voices have begun to drown out serious discussion. Time to take a deep breath or two: populist rage is a rotten basis for policy-making.

[How to Recoup the AIG Bonuses](#)

Let's get real. This may be a nation of laws, but contracts are not sacred, and employment contracts are less sacred than any.

[Why are People Defending the Bonuses?](#)

There was no risk management on Wall Street, there was mostly excessive risk-taking. And it was largely due to outsized bonuses that rewarded risky banking while penalizing minimally for losses.

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Amid all the hand-wringing about whether or not the government has the power to stop AIG from paying bonuses to the very people who helped...

[Ain't I Greedy!](#)

Ever since AIG entered the public consciousness in a very negative way last fall, people have been wondering what the initials stand for.

[It's Gut-Check Time](#)

Right now Obama is trying to walk on an incredibly narrow line with no safety net beneath, but this is gut-check time: he has to decide which side he's on.

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[Capitalism and Moral Sentiments](#)

The fascinating thing about this Wall Street greed is that it is so deeply ingrained that neither the bankers themselves nor our economic leadership understands just how disgusting and dangerous it is.

[Smoking Gun Points to Geithner](#)

How long will and should Obama continue to defend Geithner in the face of the smoking gun proof of what he knew about AIG and when he knew it?

[Perp Walks Instead of Bonuses](#)

The collusion to save AIG in order to salvage the rogue financiers who conspired to enrich themselves by impoverishing millions is being revealed as the greatest financial scandal in U.S. history.

[Missing The Point On AIG Bonuses](#)

It's easy to get outraged at the announcement that AIG will be paying over one hundred and fifty million dollars out as bonuses, after taxpayers...

[A Disturbing D.C. Whodunit](#)

The mystery over who killed a provision in the stimulus package that would have curtailed bonuses at bailed out companies is a disturbing D.C. whodunit. But even more disturbing is what it reveals about how our government is run. «It is the ultimate indictment of what Washington has become,» Sen. Ron Wyden, co-sponsor of the eliminated provision told me. «It's a place where, again and again, the public interest is deep-sixed without any fingerprints.» Wyden has no idea who killed the provision. And, so far, no one in the administration of a president who promised that transparency would be a «touchstone» of his presidency has demanded that whoever is responsible own up to it. We deserve better. **READ MORE**

[Come on, AIG Guys! Cough it Up.](#)

How to restore that trust? I can think of one thing that could be done immediately. It's not easy. It's totally counter-intuitive. It will never happen. But it would be an excellent gesture.

[How to Stop AIG's Bonuses](#)

Today the task is to stop a grotesque abuse before it is too late. The path we outline here would do it, without throwing markets into turmoil.

[Other Types of Bonuses Deserve an Examination](#)

There would be enormous value in seeing bank executives demonstrate that they know we're all in this together, that they too have changed their way of life and that they too can sacrifice in times of crisis.

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[Obama Really Wall Street CEO In Chief?](#)

So far, I've laid the Obama administration's decision to keep propping up failed banks at Tim Geithner's feet. Obama, meanwhile, has so far avoided blame. I wonder how long that will last.

[The Two Faces of Tim Geithner](#)

Like the president he serves, Geithner is a pragmatist, a progressive and a Democrat, and seems willing, if market strategies fail (as they will), to abandon them in favor of whatever works.

[Geithner's Five Big Misconceptions](#)

Geithner views the crisis the same way Wall Street does -- as a temporary liquidity problem -- and his plans to fix it are designed with the best interests of Wall Street in mind.

[The «Populists» Are Right About Wall Street](#)

How has a popular Democratic president with a convincing electoral mandate failed to translate the opportunities of recent events into the «change» for which voters clamored?

[Fake Outrage by Politicians About AIG Bonuses](#)

Time after time, Bush, Obama and Congress had an opportunity to attach limits on executive pay to legislation authorizing bailout money. And time after time, they refused. So, spare me the outrage.

[The Geithner Plan](#)

There is nothing forcing banks to participate in the program. And that is the real problem. And there is a big reason keeping the banks from participating: finding out that various assets aren't worth anything.

[AIG: Will We Solve the Underlying Problem?](#)

AIG gave more than \$9 million in campaign contributions to Congress -- making the list of the top 100 contributors of all time, splitting its money evenly between those in both parties.

[Obama's Rugged Week](#)

Is Geithner's plan another bailout to Wall Street? Or is it needed pragmatism to work with a deeply troubled, farcically entitled though still necessary private financial sector?

[The Death of a Brand](#)

AIG's predicament will be studied for years to come in marketing and communications classes. When the president of the United States starts bad mouthing your brand, it's not going to survive.

[The Real Scandal of AIG](#)

When our very own Secretary of the Treasury cannot make stick his decision that AIG's bonuses should not be paid, only one conclusion can be drawn: AIG is accountable to no one.

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[Geithner's Last Stand](#)

The indignation over AIG will serve a useful purpose if it focuses public attention on the much larger issue of the failure of the entire approach that Tim Geithner and Larry Summers are using to rescue the banking system.

[AIG Bonus Money is Kid's Play: Literally](#)

If AIG were to donate the 418 bonuses to charity, it would be a brilliant preemptive PR move to neutralize its current out of touch public persona. Here's what the money could provide.

[Lessons from AIG](#)

What is vital now is that the public's righteous anger is not expressed only as «no.» There are a lot of things to which We The People do need to say «no.» But we need a lot of «yes's,» too.