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The Fed and AIG

If U.S. officials thought that nationalizing giant insurer AIG would stop the financial panic, markets gave them a rude reply yesterday. Stocks fell sharply, gold rose $89 (!) an ounce, and spreads on Morgan Stanley and Goldman Sachs debt widened to canyons over Treasurys. Investors are wondering who's next on the Treasury-Federal Reserve list for a force majeure takeover, and are selling off accordingly.

Perhaps Secretary Hank Paulson was right that AIG had to be rescued to avoid a broader financial collapse. We aren't privy to what he and the New York Fed were hearing about AIG's credit default swaps or its insurance "wraps" for the commercial paper market; maybe unraveling those would have smashed the corporate debt market or caused a run on money-market accounts. So maybe he had no choice but to rescue the part of AIG that was a hedge fund wrapped around the world's largest insurer.

But it's precisely this opacity that is the problem for market psychology: These serial nationalizations are being done out of Mr. Paulson's hip pocket, based on his judgment of what constitutes a systemic risk (Bear Stearns, Fannie Mae, AIG) and what doesn't (Lehman). There's no transparency, and when Treasury decides to act it swoops in with a no-bid transaction that dictates terms to the target company. At the very least a Treasury Secretary should try to justify the nature of such risk when he puts $85 billion in taxpayer cash on the line.

All the more so if the takeovers inspire even more market fear. Three month T-bill yields plunged at one point yesterday nearly to 0%, which means investors are willing to accept essentially no return to get a safe harbor. Gold's leap of more than 11% is also a flight to safety.

The danger is that we will get these financial melodramas every week, if not more frequently. Each one only frightens the public more and extends the panic. The two surviving big investment banks, Morgan Stanley and Goldman, continue to operate with enormous leverage yet profess to have enough capital to survive. That's also what Lehman and AIG thought. Markets are also punishing Washington Mutual, the big savings bank, and Wachovia, the regional bank, with others to follow if housing prices keep falling.

Sooner rather than later, the Fed is going to run out of money to pull off these government takeovers. Its balance sheet was designed to finance open-market operations, plus serve as the occasional lender of last resort for regulated banks. Its assets have long been mainly Treasuries.

Since last December, however, the Fed has made creative use of its discount window with the result that its balance sheet looks uglier all the time. The Fed has guaranteed $29 billion in dodgy Bear Stearns paper, opened its window to ever more colorful collateral, and as of Monday even agreed to accept equity. With its AIG stake, the Fed now owns an insurance company. By our calculations, the Fed has committed some $380 billion of its $888 billion in assets to these mortgage rescue operations. That's nearly half. And yesterday the Treasury announced it will issue new debt to lend to the Fed, not merely to fund government operations.

These are all taxpayer obligations, and as such they pull the Fed ever more deeply into political decisions that compromise its independence. The Fed has been pushed into that situation because Treasury lacks the legal authority for such takeovers (except in the case of Fannie Mae and Freddie Mac), while the Fed could act under section 13(3) of the Federal Reserve Act. But this is unsustainable -- and dangerous.

The first recourse going forward is for Treasury to help Morgan Stanley and other endangered institutions find new private capital, or, better, private merger partners. Merrill Lynch took itself off the run list by selling to Bank of America. More than a few Merrill shareholders griped about the price, but they did much better than AIG holders will with their 80% dilution to Uncle Sam.

If that fails, then the best and perhaps only recourse is to create an entity on the order of a new Resolution Trust Corporation. Such an agency could become a buyer at a fair and transparent price for distressed debt, as well as the workout home for institutions like AIG that failed because of accounting rules and bad subprime debt but retain great underlying value. (See Zachary Karabell here.)

The details are crucial to making this work right -- to avoid political meddling, for example, and to make sure it has an end date. But until home prices stabilize, it may be the only way to stop the panic and serial nationalizations.

We're told Treasury has a proposal ready to send to Congress, but that the Members have told Mr. Paulson they don't want to see it until after Election Day. Mr. Paulson fears that if he does call for action and Congress refuses, then the contagion would be even worse. Well, how much worse can it get than a failure or two a week of a major financial institution? The sooner a resolution agency is up and running, the fewer banks will fail and the lower the ultimate cost to the taxpayer.

Mr. Paulson ought to tell Congress that this authority is essential to stopping a panic, and that the need is urgent. If Harry Reid and Nancy Pelosi say they can't do it until December or later, then they can take responsibility for the nationalizations to come.

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