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DEAL JOURNAL

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An up-to-the-minute take on deals and deal makers.
October 9, 2008, 5:13 pm

[The U.S. Treasury: The World's Biggest Hedge Fund](#)

Posted by Heidi N. Moore

What is the difference between the U.S. Treasury and a gigantic hedge fund?

Beats us.

Deal maker Hank Paulson has transformed the Treasury Department into a larger, more powerful form of Goldman Sachs, with extensive direct lending abilities and profit-making stakes in companies including Fannie Mae, Freddie Mac and American International Group, all financed using debt. Now Treasury is considering a new solution to the financial crisis that would leave the department even more intertwined in the business of the financial markets: directly taking stakes in troubled U.S. banks.



Duke University finance Prof. Campbell Harvey asks why the Treasury should stop there. He says the Treasury should instead inject capital into all U.S. banks through a single, centralized fund. Just putting money into troubled banks may stop the bleeding, but it won't heal the wounds of the credit crunch, he says. To get the economy on its feet, the Treasury needs to support good small and midsize banks, who grease the wheels of small businesses that drive the economy. "In order for the equity injection capital to multiply and create credit, you need to target good banks, not just bad banks," said Harvey, who wants the government to take passive equity stakes for injecting as much as 2% to 5% of the equity capital into each bank.

Deal Journal talked with Harvey about his plan.

Wait. First, what's wrong with TARP?:

Harvey says Treasury will end up paying rich prices for troubled mortgage securities. In addition, the troubled assets relief program will take a few weeks to get organized, and it "suffers from the 'throwing good money at bad' problem—i.e. the premium price will effectively bailout some distressed financial institutions that should simply fail," Harvey said. It also isn't clear to many people how TARP—which is to buy mortgage securities at the highest level—would help clear the credit markets. "Right now the credit system is considered frozen," Harvey said. "Unfreezing the commercial paper market won't help because many are too small to use it."

How would Treasury inject money into all U.S. banks?

"The equity stakes would be short-term, five to seven years, and completely passive," Harvey said. So wouldn't Treasury just be a big hedge fund or private-equity fund? "You can think of it as a giant hedge fund that specializes in the financial sector. It's almost identical to setting up a hedge fund. The difference, of course, is that the primary contributor is the government, and they can set their own terms," Harvey said. "What could be interesting is that you could open it up to private investors. You know that just about every hedge fund would have loved to do the AIG deal, but they couldn't do it. But if you open it up to them as a centralized fund, they could contribute investments. It might be hedge funds, large investors, it might be Warren Buffett, it might be sovereign funds. All of this would reduce the upfront cost of the taxpayer, but we would expect the taxpayer to get a return on this."

Why all U.S. banks?

"If we want to get the maximum on the capital, you have to get good banks, not just the bad ones," Harvey said. "You can imagine that a 'bad bank' takes the capital and does nothing with it; we need to spur lending and growth. If you're a bank at the margin, you do not deserve a special equity injection, because it's not going to do anything. You don't want to throw that money into a bad bank... Our strategy has been to put one fire out after another, which is a reactionary strategy rather than pointing out this stuff at the beginning. I prefer a passive strategy rather than the

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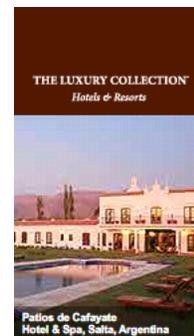
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Deal Journal is an up-to-the-minute take on deals and deal-makers, updated frequently with exclusive running commentary, news flashes, profiles, data and more. The Wall Street Journal's Heidi N. Moore and Dennis Berman are the lead writers, with contributions from other Journal reporters. Send news items, comments and questions to deals@wsj.com.



EVAN NEWMARK
Mean Street

[To Panic or Not to Panic?](#)

You probably are good and panicked by now. Smiling bravely that this too shall pass as your hand gropes for the exit door. Sure, you will be poorer, but you won't be penniless. Now, just hold on a bit longer. Take a deep breath and think about some of your choices. ([Read more](#))

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government running AIG.”

This sounds just like what Sweden did:

Indeed it does, with a big difference: Sweden was helping out far fewer banks. But when the country unwound their positions, they made a decent return for the taxpayer, Harvey noted.

What about saving the “too big to fail” banks?

Harvey said spending all that money on saving big financial institutions is a big mistake, akin to one Japan made in the 1990s. “The growth does not come from large organizations, it comes from the small- and medium-growth businesses, so we need something that generates the credit-generation processes to fuel small and medium businesses. Treasury helping small and midsize banks will also help companies that depend on them. To bail out some troubled bank, it’s not clear that will have the multiplier effect that you want,” he said.

Hank Paulson will be leaving soon. Who at Treasury would be savvy enough to manage this? Economist Vernon Smith noted today of TARP, “Treasury has no expertise in this ridiculous new venture” of auctioning mortgage securities. Harvey said “hedge funds pick winners and losers.” By making a blanket investment, Treasury wouldn’t have to choose as hedge funds do.

On the bright side, Treasury might win more fans among free-market capitalists as a hedge fund than [as a Soviet-era politburo](#).

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October 9, 2008, 3:22 pm

Afternoon Reading: The \$700 Billion Bailout’s No Confidence Vote

Posted by Stephen Grocer

President Bush signed the \$700 billion rescue bill into law Monday.

So far this week, the Dow Jones Industrial Average and S&P 500 are down roughly 12%. The markets have spoken and clearly there clearly is little confidence in the ability of the plan to prevent the financial crisis from spilling over into the broader economy.

So now the Treasury [is considering](#) ways to inject capital directly into banks, possibly by taking equity stakes.

This plan, [according to Yves Smith at Naked Capitalism](#), “is a far better use of funds than buying toxic assets, which is a very indirect and costly way to achieve the same end.”

Of course, having the government buy stakes in banks is exactly what numerous academics argued for, as [Justin Fox](#) over at the [Curious Capitalist](#) [points out](#).

It seems Congress was correct to insist on giving the Treasury the authority to buy equity as part of the bill. [Writes Portfolio.com’s Felix Salmon](#): “Barney Frank, it seems, has been proven more far-sighted than Hank Paulson.”

So what bank will be the first to be nationalized? [Salmon believes](#) it will be Morgan Stanley.

“If Morgan Stanley was in distress back in mid-September, it’s much worse today, trading as low as \$12.50 a share: that’s just 40% of its stated book value. Clearly the market is very skeptical that the injection of cash from Mitsubishi UFJ Financial Group is going to happen—or that even if it does happen, it will be sufficient to stave off insolvency.”

Salmon is hardly alone in this thinking. [Check out this post](#) from [John Carney](#) over at [ClusterStock](#).

National City

Could Goldman Sachs be more than NatCity’s financial adviser?

That is the idea [Reuters’s DealZone is floating](#). Goldman, as DealZone points out, is rumored to be in the market for a commercial bank, has a new investor in Warren Buffett and National City’s shares are trading just above \$2. Alas, there are significant reasons for Goldman not to do the deal, namely Ohio—the state where NatCity is based—has been one of the hardest hit.

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