The federal government is about to mount what could be the largest bank rescue since the Great Depression, as it prepares to clear troubled assets off lenders' balance sheets and get credit moving through the troubled economy.

Treasury Secretary Timothy Geithner next week is expected to unveil an ambitious plan putting the federal government in the central position of backstopping lenders against losses from hundreds of billions of dollars of "toxic assets" such as mortgage-backed securities. There's a palpable fear that without dramatic action, bank losses could spiral out of control as mountains of toxic debt soak up all the capital in lenders' books, including billions of dollars in current federal aid. Further erosion in banking would prolong and deepen the global recession.

"Banks provide the grease which lubricates the wheels of commerce; without that, the economy is frozen," says Samuel Hayes, professor of finance emeritus at Harvard Business School.

The numbers are staggering — U.S. commercial banks hold $3.8 trillion in residential and commercial mortgages, plus $700 billion in mortgage-related securities, according to Federal Reserve data. That represents close to half of banks' total financial assets of $9.8 trillion, as of Jan. 30.

Even though the Treasury Department has pledged nearly $350 billion in new capital to banks since early October, credit remains historically tight, and lenders are under growing stress as the value of mortgage-backed securities and other assets continues to fall. Companies across the country need access to credit to operate and make payroll. But 65% of lenders have tightened business credit terms in recent months, while many have cut existing lines of credit to firms and consumers.

The Obama administration is under intense economic and political pressure as it prepares its bank rescue plan. Lawmakers are furious about the way former Treasury secretary Henry Paulson managed the previous financial bailout, charging that Paulson lacked a clear strategy and wasn't upfront about how taxpayers' money was spent.

At a Senate Banking Committee hearing Thursday, Harvard professor Elizabeth Warren, who chairs a special Congressional Oversight Panel on the bailout, said the Treasury shelled out $254 billion to banks in 2008, in return for $176 billion in assets — a nearly $80 billion gap. Sen. Robert Bennett, R-Utah, said that if Geithner does not put forth an acceptable plan, "the political support for putting up the money will not be there."

Banks are failing regularly, six in January alone, compared with 25 in 2008 and three in 2007. The worst problems are centered in the nation's big banks, however, which are considered "too big to fail" because of the damage their collapse would cause the financial system. The government has poured $90 billion into Citigroup and Bank of America, two of the top 10 U.S. institutions that now control 70% of the country's banking assets.

Because these megabanks have global exposure, their deepening problems could send ripples through global money markets that could be difficult to contain. Economists and analysts say many large banks are basically insolvent, and they warn that unless the government takes decisive action, the situation could get even worse.

"We're not getting what we wanted, and it's obvious we need a new approach," says Campbell Harvey, professor at Duke University's Fuqua School of Business.
With no expectations that the bloodletting will stop any time soon, the government is weighing multiple options. The challenge is to throw life preservers without scaring the stock market, and restoring enough confidence to bring back private investors, and ultimately, foster lending.

The Treasury Department appears to be pulling together a program that could encompass several different approaches. While some economists advocate outright nationalization of large lenders, Geithner has so far resisted such calls.

Instead, the Treasury has been considering ways to either buy up problem assets in a "bad bank," or beef up current backstops and provide insurance for troubled lenders. The government will take more aggressive steps to refinance homeowners who cannot meet current mortgage payments, hoping to contain foreclosures and home price declines. The Federal Reserve could also expand an alphabet soup's worth of programs such as the TALF (Term Asset-Backed Securities Loan Facility) targeted at specific credit markets. The TALF program, designed for credit card, student loan and auto lending, could be increased to cover commercial mortgage-backed securities, for instance.

The ultimate price tag will probably be well in excess of the $350 billion remaining from last year's $700 billion economic rescue plan, though the Treasury might resist asking for additional money right away.

Here are some elements of what a new rescue might look like:

'Bad bank' and insurer

Think of Yucca Mountain — the proposed federal site in Nevada that would store all the nation's radioactive waste. Similarly, a government-created "bad bank" would become the repository for banks' toxic assets — complex securities tied to mortgages and other now-questionable loans that are weakening banks' balance sheets.

Banks can't sell those assets because there's no market for them. Yet, as their value falls, accounting rules force banks to put aside capital to cover the losses. If the government buys them, the thinking goes, banks will lend that capital instead of hoarding it to protect themselves from rising defaults.

"We're supportive of the creation of a bad bank to buy illiquid and non-performing assets" among a menu of options to solve the crisis, said Scott Talbott, senior vice president at the Financial Services Roundtable, which represents banks.

However, since there's no market for these assets, it's hard to say what price the government should pay. If the government insists on fire-sale prices, the banks would have to mark down asset values so much, they'd have to be declared insolvent. That's why bank stocks rose Thursday on reports that the government might change or suspend so-called mark-to-market accounting rules as part of its rescue plan.

On the other hand, if the government pays too much, taxpayers will take on more risk for future losses from banks' bad decisions.

"The easy answer is, let the taxpayer pick up the tab, but it's not going to be easy for the taxpayer," says Rep. Spencer Bachus, R-Ala., on the House Financial Services Committee.

"A full bad bank ends up costing as much as $3 trillion," says Sen. Charles Schumer, D-N.Y., vice chairman of the Joint Economic Committee of Congress.

If the economy starts recovering, and loans are paid, some of these assets might be worth a lot of money. But if it doesn't, and home defaults rise, taxpayers would bear the losses.

An idea that's picking up steam in Washington is for the government to buy some of the most toxic assets from the banks and guarantee some of the rest. That's a far less expensive option for the government in the near term than buying all the assets.

"There may be a temptation to guarantee assets rather than buy them, given that a guarantee does not require borrowing and a large upfront capital commitment," says Richard Ramsden, banking analyst at Goldman Sachs. He believes that such agreements don't resolve the problem that these assets pose for the banks' balance sheets.

The government has already tested this option in the last two months, twice, and in both instances, it has failed to restore confidence to the marketplace. In November, the government agreed to guarantee 90% of the losses on a pool of $306 billion in loans held by Citigroup. Citi would have to absorb the first $30 billion of losses.

Last month, it provided a similar guarantee on $118 billion of Bank of America's loans. The bank would absorb the first $10 billion of losses. In both instances, the government also gave cash of $20 billion. The stocks have traded down since then, reflecting investors' concerns about future losses.

Government-run banks?

More than 300 banks have given the government preferred shares in return for more than $200 billion in cash, but the shares don't come with...
the voting rights of common stock.

However, more bank failures and short-term government takeovers are viewed as desirable.

"There's too much risk in the system, and the government needs to show that it's in charge by taking control of some of these banks temporarily," says Duke's Harvey.

By doing that, the government can also assist private investors in acquiring insolvent banks, as it did in the case of IndyMac, the California bank that the Federal Deposit Insurance Corp. seized last year. It sold the bank to a group of private investors.

"IndyMac is a good model. Private equity would flow in if the government cleaned up some of these banks and supported the deals," says Whitney Tilson, founder of value investor Tilson Mutual Funds.

A buyer for banks' new loans

Congress' main objective was to spur lending when it created the $700 billion fund to rescue the financial system last fall. Yet, banks receiving money were not required to step up lending.

Geithner's biggest challenge will be to get credit flowing at a time of economic contraction, when neither businesses nor consumers want to borrow.

At the same time, those who need to borrow are finding it difficult to get credit. The credit markets are stuck, because investors such as hedge funds and money managers have less cash to buy the securities that the loans are usually bundled into. With the loss of this fresh capital, banks are afraid to write more loans for which there are no buyers.

The government is poised to assume that role, by buying new loans the banks make and replenishing the capital they need to make more loans. For example, the Federal Reserve has set a target of buying $500 billion in mortgage-backed securities issued by Fannie Mae and Freddie Mac, which buy mortgages from banks. So far in January, the Fed says, it has bought $53 billion worth of securities.

After years of cheap credit and lax lending standards, consumers are cutting back in fear of losing their jobs, if they haven't already, and banks are tightening up. In this new era, it's hard to expect bank lending to soar.

"Everyone wants the quick fix," says Joshua Siegel, managing principal of StoneCastle Partners, which invests in community banks.

"But we have to remember that we do not want to go back to where we were."

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