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Pre-emptive Bank Nationalization Would Present Thorny Problems

A number of prominent voices have recently called for a swift nationalization of the weakest among our largest banking groups and the press has consistently identified the likely candidates as Citigroup and, to a lesser extent, Bank of America. There are many misconceptions about how a takeover of either of these behemoths could be accomplished. The longer-term negatives mean that such a nationalization should be a "last resort" measure. (Please see "Bank Nationalization: What is it? Should we do it?" for a comprehensive overview.) Even the first step of taking over the banks would be risky and difficult, as this paper will demonstrate.

A paper on such a sensitive topic written in the middle of a major financial crisis brings with it special responsibilities, so I will start with several caveats and declarations. First, I do not have a position in the securities of Citigroup, Bank of America, or any other banking group for which there have been significant fears of nationalization, nor do I intend to acquire such positions. Second, the figures used here for those two banks, which are taken from public sources, are intended to be illustrative rather than comprehensive. These are very complex entities and no one set of numbers can accurately present their situation. Third, I make no recommendation as to the desirability of purchasing or selling any securities. Finally, I am not a lawyer. I have consulted with some knowledgeable attorneys in preparing this paper, but the intention is to provide an overview of the issues suitable for a non-expert audience, rather than a comprehensive legal analysis.

Summary

A swift nationalization of Citigroup or Bank of America would likely require buying out the shareholders. This action would then make it very difficult to force debtholders to bear a portion of the losses, despite the desire of many of those calling for nationalization. This protection of shareholders and debtholders results from the interaction of the structure of our banking system, the public policy rationale for regulating banks, and our constitutional protections of private property, including ownership of banks.

All large banks in the U.S. are owned by holding companies, which are standard corporations, not banks. Our banking laws are designed principally to ensure the viability of the banks themselves, rather than of the holding companies. As a result, there are provisions for the swift seizure of banks that are in deep trouble, but no such provisions to deal with their holding companies. These are governed instead by standard corporate bankruptcy law, which gives the government no special control rights.

The Citigroup and Bank of America holding companies retain a substantial capacity to bolster their banks by taking actions that would be painful for the stockholders of the holding companies, but less painful than allowing the government to seize the banks without compensation. This ability, combined with the

substantial capital already at the banks, means that regulators would have to take quite extreme actions to justify seizing the banks. The government therefore seems to face a choice between: buying the cooperation of the holding companies; stretching the regulators' discretionary authority to seize the banks to such an extent that it could lead to major lawsuits and create panic at other banks; or putting any nationalization on a much slower track.

Each of these options has major disadvantages. There would be great political resistance to "rescuing" the shareholders and creditors of banks that the public perceives to have failed abysmally. However, appearing to be ready to seize banks arbitrarily could cause a "run" on other banks by their creditors, customers, and shareholders, with each group's reactions magnifying the panic of the others. In addition, the threat of a lawsuit is not trivial. The government has already paid out large sums as a result of losing lawsuits after the Savings and Loan crisis as a result of actions that were judged to be "takings" of private property. Finally, starting the moves that could lead more slowly to seizing the banks without compensation would risk panic by key constituents of Citigroup and Bank of America, making the ultimate nationalization more costly by reducing the value of the banks in the meantime.

Ownership and regulatory structure of the banks

Citigroup and Bank of America, in common with all large banking groups, use a bank holding company structure. That is, there is a corporation at the top of the ownership structure which does not directly transact banking business. This holding company owns the banks within the group, as well as any non-banking subsidiaries, and generally has publicly traded shares. It may also transact financial business directly, as long as those activities do not require a banking license. Holding company structures are very common across the world because they allow the groups to have greater flexibility to combine various forms of financial activities, as well as providing more leeway for dividend payments, share repurchases, and certain other transactions. (One note on nomenclature: the main U.S. bank owned by Citigroup is "Citibank N.A.". This paper will refer to "Citibank" when focused specifically on the bank and will otherwise refer to "Citigroup" for either the holding company or the group as a whole.)

Holding companies are regulated in most ways as standard corporations, including falling under the auspices of the regular corporate bankruptcy regime rather than being covered by the special insolvency statutes governing banks. In addition, though, the Federal Reserve Board has certain regulatory authority over bank holding companies, requiring them, for example, to maintain minimum levels of capital.

The major U.S. banks in the Citigroup and Bank of America groups have the Office of the Comptroller of the Currency (OCC) as their primary federal regulator and the Federal Deposit Insurance Corporation (FDIC) as an additional regulator. The Federal Deposit Insurance Act (FDIA) and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) also establish the FDIC as the entity that would take over an insolvent bank through a receivership or a conservatorship.

The holding companies for both Citigroup and Bank of America also own a number of foreign banks and financial institutions, which are subject to the relevant countries' regulators and insolvency provisions.

This is particularly important in Citigroup's case, since historically roughly half of its earnings came from operations in over 100 foreign countries.

Implementing a nationalization

Logically, there are four possibilities for a swift nationalization of either of these behemoths, each of which presents serious implementation problems. The possibilities are outlined below, followed by a section discussing the details.

Seize the U.S. banks. The government could take over the U.S. banks that are owned by the holding companies. The key problem would be finding adequate legal authority to justify the seizure without stretching regulatory discretion so far that it creates panic at other banks or a massive lawsuit.

Seize the bank holding companies. There does not appear to be a legal basis for doing this. The special insolvency laws governing banks do not extend to their holding companies. The Fed's role as regulator of bank holding companies allows them to force holding companies to divest their banks, but not to seize those holding companies or to force them into bankruptcy.

Buy the U.S. banks. The government could offer to buy the banks from their holding companies, on a voluntary basis. The Board of Directors of the holding companies would presumably be willing to sell, at the right price; indeed, they would have a fiduciary duty to do so, if the economics were compelling. However, they would need to take into account the effects on the rest of their empire, including their foreign and investment banking operations, which are intertwined with the U.S. banks and would lose substantial value without a continuing relationship with the core bank.

Buy the bank holding companies. The government could also offer to buy the bank holding companies in their entirety. Their battered stock prices make this a more realistic option than would have been true a year ago, although the prices would still be high in absolute terms. The key problems with this approach would likely be political, as it could appear to be a rescue of investors, since much of the public fears that these firms are secretly insolvent.

Seize the U.S. banks

Under current law, banks can only be seized by the government if certain conditions are met. New legislation could be passed to expand these conditions, but it would need to follow the same broad principle of avoiding an arbitrary take-over, otherwise it would be in violation of the "takings" clause of the Constitution. Revising the law now could also easily set off a panic among shareholders and creditors of other banks, potentially creating the financial meltdown that everyone has been working to avoid. The discussion below therefore assumes that current law would apply.

FDICIA is the primary law governing bank seizures. It lists a number of acceptable justifications for a seizure, most of which are unlikely to apply to Citibank or Bank of America. The ones that seem most relevant are:

Inability to meet obligations. This is essentially a test of liquidity, the ability of the bank to meet its near-term obligations. The other major reason for an inability to pay, that it simply owes more than the value of its assets, would be captured directly by the capitalization tests below. Citibank and Bank of America are unlikely to be caught in a liquidity trap anytime soon, given the existing programs by which the government is either directly or indirectly providing liquidity to banks, combined with their sensible accumulation of liquidity reserves at the holding companies.

Losses. This clause would be invoked if a bank has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the institution to become adequately capitalized without federal assistance. As discussed below, the "stress test" process that the largest 19 banks are currently undergoing could provide the necessary information to justify use of this clause.

Undercapitalization. This applies if a bank is undercapitalized and: (i) has no reasonable prospect of becoming adequately capitalized; or (ii) fails to become adequately capitalized when required to do so; or (iii) fails to submit a capital restoration plan acceptable to its primary regulator and the FDIC within the prescribed time; or (iv) materially fails to implement an agreed capital restoration plan. "Undercapitalized" for this purpose would most likely mean having Tier 1 capital of less than 4% of the bank's total assets. (Banks otherwise viewed as strong by the FDIC may operate at a 3% ratio without being undercapitalized, but in the situation we are envisioning that would not apply.) The FDIC has a wide-ranging ability to require a higher ratio for a bank about which it is worried, but may be reluctant to make this the basis of an eventual seizure in such an important and controversial situation as the nationalization of one of the nation's largest banks.

There appear to be two major obstacles to using the "undercapitalization" test to justify a seizure. First, the bank has to be given at least 45 days to respond with a capital restoration plan and then the FDIC must consider that plan before acting. In today's fraught environment, a great deal of damage could be done in a short time if word leaked out that Citibank or Bank of America faced such a situation. Second, it might be very difficult for the FDIC and the OCC to conclude that there was "no reasonable prospect of [the bank] becoming adequately capitalized." (See below for an analysis of the relevant financial information for Citibank and Bank of America.) Drawing such a conclusion could seem arbitrary and punitive, setting off panic among shareholders, debtholders, and counterparties of other relatively weak banks.

Critical undercapitalization. This applies when a bank is critically undercapitalized, based on a ratio of Tier 1 capital to total assets. FDICIA has established a minimum leverage ratio of 2% for this test, although the FDIC has reserved its right to act even when the ratio is higher. The statute also allows seizure if the bank "otherwise has substantially insufficient capital." The leverage test seems a likely way in which regulators might attempt to justify a seizure of one of the banks.

Based on these four tests, there appear to be two principal, and overlapping, avenues the government could pursue in the case of Citibank or Bank of America. The first is to force the banks to write down the value of their "toxic assets," and increase their loss reserves for other credit risks, to a level which caused them to breach the rules on "critical undercapitalization." This would almost certainly involve the 2% leverage test, since invoking the clause "otherwise has substantially insufficient capital," has the potential to create messy litigation, as well as spooking investors in many other banks. The analysis below shows that it would be difficult to force a write-down of toxic assets sufficient to breach this level at the principal banks of Citigroup and Bank of America. The imposition of a new de facto accounting standard tough enough to accomplish this would produce a major hit to the capital of the other large banks when applied to them. This could force them to raise far more capital than the federal government otherwise wishes to require of them.

The second avenue is to argue that the recession looks to be so tough that the banks are "likely to incur" losses that would deplete substantially all of their capital. The "stress tests" that the 19 largest banks are currently undergoing could be the basis for such a justification, if they were to show sufficiently large losses. The regulators would not wish to use the "stress test" per se, since they are arguing elsewhere that those conditions are not likely to occur, but they could use the results of the "expected" case that is being run at the same time. The calculations could include further writedowns of the toxic assets, since the regulators could argue that declines in the mark-to-market value of the toxic assets would naturally accompany the worsening of the recession that is anticipated.

The major difficulty with the second avenue is fundamentally the same as for the first approach. If the standards applied to Citibank or Bank of America are tough enough to justify seizure, they will also be tough enough to create huge capital needs at the other banks being tested. In addition, using the forward-looking test based on future losses would introduce a significant delay as the bank would have a right to contest the regulator's view that all or substantially all of the bank's capital would be depleted and that there is no reasonable prospect of avoiding that situation without federal assistance.

Effects of regulatory demands sufficient to justify "critical undercapitalization"

It is possible to gauge roughly how big a hit to reported capital the regulators would have to mandate in order to justify seizing Citibank or Bank of America, if we assume the test is that Tier 1 capital has to fall below 2% of total assets. This would either represent (a) the up-front writedown that would have to be demanded if the regulators choose to argue that the books of the banks are currently inaccurate or (b) the future net losses that would have to be assumed if the "likely to incur losses" test is used.

Table 1 looks at the Tier 1 capital level and total assets of the main U.S. banks of the two groups as of December 2008 and shows the effects of the regulators imposing a hit to capital consistent with breaching the 2% leverage ratio. It then shows the effect of a proportionate reduction in asset values at two of the strongest of the five largest banking groups in the U.S., J.P. Morgan Chase and Wells Fargo, which recently acquired Wachovia. The figures strongly support the earlier conclusion that imposing a capital hit of this magnitude on either Citigroup or Bank of America would imply that regulatory consistency could require damaging the rest of the banking system too much to be feasible in practice. Certainly there would be great danger of marketwide panic based on this concern.

Table 1 Implications of a hit to capital producing critical undercapitalization, (figures in $ billions)

	Citibank	Bank of America	JPMorgan Chase	Wells Fargo	Wachovia
Tier 1 capital	71	89	101	33	33
Total assets	1,220	1,498	1,714	525	610
Leverage ratio (capital divided by assets)	5.8%	5.9%	5.9%	6.3%	5.4%
Reduction in Tier 1 capital to hit 2% leverage ratio	47	59	67	23	21
Citigroup parent company liquidity	67				
Total "hit" required to reach 2% leverage	114				
Hit as a % of total assets at Citibank	9.3%				
Hit at other banks if same % of assets		139	160	49	57
Leverage ratio if other banks took same % hit		-3.7%	-3.8%	-3.3%	-4.3%
Groupwide leverage ratio	6.1%	6.4%	6.9%	6.6%	See Wells
Groupwide leverage ratio after hit	0.3%	-1.1%	-1.3%	-1.6%	See Wells

Note: figures are from each company's 2008 10-K and bank call reports or from calculations made by the author.

The first three lines of Table 1 show that all of the principal banks of these groups have conservative leverage ratios as of the end of last year, averaging from 5.4% to 6.3%, where 4% is normally sufficient for a bank to be considered well-capitalized. (Note: the figures for Bank of America group are prior to the merger with Merrill Lynch, which occurred in January of this year. The merger should not have significantly affected the figures for Bank of America N.A., but would have made the groupwide figures at the bottom of the table less conservative.)

The next line shows the amount by which assets would have to be written down, and capital thereby reduced, to breach the 2% leverage ratio. However, this reckons without the ability of the holding companies to add capital to the threatened banks. The following line shows an estimate of readily available funds at Citigroup which could be injected as capital. This is based on disclosure in Citigroup's 10-K report of the amount of cash and readily salable securities that it keeps as a liquidity reserve at the holding company and as excess funds at the securities subsidiaries. Bank of America does not make such a disclosure, but its holding company has a level of cash deposited in subsidiary banks that implies it has a similar or greater level of funds available for capital infusions to its main bank. In both cases, the figures may be conservative since the groups might be able to find still more funds, given a little time. Citigroup, for example, owns some highly regarded foreign banks that could be sold, albeit at "fire sale" prices. It is safe to assume that a holding company would take even extreme steps to avoid having its main bank taken over without compensation.

Factoring in the liquidity reserve implies that regulators would have to insist on $114 billion of additional losses, or likely future losses net of earnings, at Citigroup. This represents over 9% of the total value of its assets. Since many of these assets are not very risky and therefore unlikely to be subject to much price adjustment, this would mean a much greater percentage hit to the more vulnerable assets.

Applying the same proportionate hit to the assets of the main banks of the other groups would, in the first instance, produce leverage ratios of -3 to -4%. The holding companies for these groups would have to inject capital equal to at least 5% of the total assets of these banks in order to keep them operating at the critically undercapitalized level. If they were to restore the capitalization to where it was earlier, it would require over $400 billion of capital infusions at just these four banking groups.

It is possible that regulators and the markets would believe that Citibank's assets were appreciably worse or more aggressively valued than those at the other banks, but it would be implausible to conclude that the other major banks would be able to avoid writing down assets as a result of the standards applied to Citibank in our hypothetical exercise. The asset quality differences are simply not as large as that would imply. A hit of this magnitude would definitely imply substantial reductions in asset values at the other banks.

The reductions in capital would also hit the consolidated figures for each group. Citigroup would retain a very modest level of positive Tier 1 capital while the other groups would fall to negative levels. All of the groups would have to raise additional outside capital quickly in order to avoid a requirement from the Federal Reserve that they divest their banking subsidiaries.

In sum, regulatory actions sufficient to reduce Citibank's capital to the "critically undercapitalized" level, and to keep it there after emergency infusions of capital from Citigroup, would have dire consequences for the banking system. It would be difficult to take these actions without quickly nationalizing a number of the other major banks as well. At a minimum, the government would have to infuse many hundreds of billions of dollars rapidly into the other banks in the system.

Seize the bank holding company

As indicated above, unlike for a bank, the regulators have no special authority to seize a bank holding company. A bank holding company is subject to standard corporate bankruptcy law, which does not really have a pre-emptive feature, unless the holding company's management chooses to take it voluntarily into bankruptcy. Even in bankruptcy, the government has no special right to acquire the holding company or its assets, although it could bid for them alongside any other potential bidders.

The Fed does have the right to force a bank holding company to divest its banks if the holding company fails to meet minimum capital requirements and cannot remedy the deficiency, although the holding company generally needs to be given 180 days to complete this divestiture. Alternatively, the government could potentially buy out the shareholders and take over the holding company and thereby its banking and other subsidiaries, as discussed below.

Buy the U.S. banks

If the government determined that it could not or should not simply seize the banks, it could offer to buy the banks from the holding companies. (The Emergency Economic Stabilization Act allows the Treasury broad authority to buy the securities of a financial institution, including its stock.) The Board of Directors would have to weigh the offer and determine whether to accept. This also may constitute a divestiture of a sufficiently large portion of the group's assets that it would trigger a requirement for a vote by the shareholders of the holding company.

The government could increase the chance of acceptance by having the regulators indicate that they would otherwise require a strong set of actions to bolster the banks, actions which would doubtless be unattractive for the bank holding company. The banks are struggling enough that there are likely to be a number of avenues for the regulators to justify requiring such actions. As discussed above, the downside is that creditors, counterparties, and shareholders of other relatively weak banks might view this as tantamount to extortion, leading them to rush to the exits.

Buy the bank holding companies

The final option is to buy the shares of the holding company from the public holders. This would be a much less expensive option now than it would have been a year ago, given the dramatic share price declines, but the cost would still be high in absolute terms. If the government paid recent market prices, it would cost approximately $40 billion to buy out the existing shares of Citigroup that the government would not already own. (This calculation includes those common shares owned by private and public parties that will exist after the recently announced conversion of preferred stock.) The price for Bank of America would be about $45 billion.

In practice, the government would likely have to pay a premium to the current market price in order to induce shareholders to sell. Many of the shareholders have purchased the stock because they believe that there is a strong probability that the firm will survive and that, if it does, the franchise value of the firm will justify a substantially higher future stock price. Such shareholders are unlikely to wish to sell at the present price. This dynamic is virtually always the case in pure private sector transactions as well – a premium is almost always necessary to persuade a sufficient number of shareholders to support a sale.

The fastest method for acquiring the shares would be to reach a deal with the Board of Directors of the holding company, which is the publicly traded entity. There are a variety of methods to implement the agreement and a host of legal complexities that would need to be worked out, which are beyond the scope of this paper. As one example, it might be possible to reach an agreement to sell the bank holding company, subject to shareholder approval, in combination with an immediate sale of the main U.S. bank or banks.

Whatever the details, the Board of Directors would need to be convinced that a sale to the government was a better option than continuing to operate independently or, in theory, selling the firm to someone else. A sale at any reasonable price is very unlikely under current circumstances and stand-alone operations would be extremely difficult if the regulators felt the situation was sufficiently dire to justify nationalization, so there would be strong pressure to agree. However, the Board would be put in a very difficult position if the government were to offer a price below the then-current market price. Even a very modest premium might not be sufficient to spare the members years of extremely painful litigation, which would almost certainly be a significant factor in their individual thought processes. A key way in which they would reduce their risk in that circumstance is to make clear that the government was essentially giving the company no choice. Such a message would raise the specter of "expropriation" in the minds of stockholders of other banks, potentially creating the panic discussed above. It might well be worth paying a more standard acquisition premium in order to eliminate that risk.

The government could also make a tender offer directly to the shareholders, offering to buy the shares. However, this would likely be at least a two month process and would create great uncertainty for the banks in the meantime. Dealing with the Board of Directors would doubtless be a better option.

As discussed in the next section, the primary obstacles to this approach of buying the bank holding company fall in the realm of politics and public policy, rather than revolving around the shareholders.

Implications of buying the banks or the bank holding companies

Banks and bankers are extremely unpopular at the moment. Paying taxpayer money to buy either the banks themselves or their holding companies would provoke a firestorm of criticism, especially as much of the public believes that these banks are already broke. Paying billions of dollars to buy something that taxpayers think is worthless is not a recipe for political or bureaucratic success, particularly not when you are perceived to be overpaying a class of people who are currently loathed.

There is also a public policy question to which the answer is not obvious. Even if you were certain that one of these banks was going to need to be nationalized, a big "if", would you be better off buying it now or waiting for it to deteriorate sufficiently that it could be seized without up-front compensation? On the one hand, beginning the clean-up early has definite advantages. On the other hand, those advantages might not outweigh the financial and political price that would have to be paid to accelerate the nationalization.

Beyond this is an even bigger public policy issue. Some observers have called for debtholders of the bank holding companies to absorb some of the losses. This is a large and tempting pool of funds which could more than cover any losses. Citigroup, for example, has almost half a trillion dollars of debt outstanding. There are good policy reasons to favor sharing the pain with these creditors, principally the enormous savings to the taxpayers and the reduction of future "moral hazard" issues by forcing debtholders to think very carefully about the risks being taken by the banks to which they lend. However, strong as these arguments are, they have been, and probably should be, more than offset by a larger point. We need investors to remain comfortable investing in new debt issuances by banks now and in the coming years, otherwise the government will be called upon to supply very large sums of capital over time, dwarfing even the present commitments. Investors will be reluctant to buy bonds, and will charge substantially higher interest rates, if they witness large creditor losses in one or more nationalizations in the near future.

This issue is complex and should be dealt with separately. For purposes of this paper, the point is that there are some observers who want the debtholders to share the losses. This would be very difficult to do if the government has paid the stockholders for their shares. First, the only way to force debtholders to take losses is through the bankruptcy process. However, it would be very difficult for the government to pay off the shareholders, on the basis that there is value in the bank or bank holding company, and then to turn around and initiate a bankruptcy proceeding. Second, even if the government wished to do so, it would be negating a central principle of bankruptcy law, that value be paid out first to the creditors, with only a residual value going to shareholders after all other claimants are paid. Perhaps a clever lawyer could find a way around both of these points, but it would not be good public policy even if it were legal.

Conclusions

Swiftly moving to nationalize the weakest large banks would provide an appealing emotional catharsis and has some clear policy benefits, in addition to the political ones. However, the disadvantages are enormous and outweigh the positives except if a bank is clearly not viable. The author has previously written at length about the pros and cons of nationalization from a longer-term perspective. This paper shows that even the initial implementation step of taking over the banks would be costly, difficult, and risky.