

Government Bailouts Through the Years

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Need some historic perspective on the latest bailout news? The Finance Professor reviews three historic government interventions.

This year, we've seen an extraordinary string of U.S. government-led or engineered multibillion-dollar bailouts of major financial companies—from Bear Stearns to AIG.

However, this is not the first time in history that a government has had to run to the rescue of an individual company or a whole financial system. And I have no doubt that 2008 will not be the last time, as there is likely to be another financial breakdown in the future that will arise from a yet unknown set of risks.

2008: Bear Stearns and beyond

In March, Bear Stearns, faced with a liquidity crisis, was taken over by JPMorgan Chase, aided by Federal Reserve loan guarantees. Absent those loan guarantees, Bear Stearns would have gone bankrupt, accelerating the bad-debt-induced liquidity crisis across other banks and broker-dealers.

By September, the government-sponsored entities (GSEs) of Fannie Mae and Freddie Mac were in the proverbial financial hot seat. The implicit guarantee of these GSEs became explicit guarantees as Uncle Sam stepped in and took over the two failed mortgage giants.

This month, we also saw roughly \$85 billion in loans given to AIG to help prevent the global insurance company from defaulting on its debt and derivative contracts. Unlike the deal with Bear Stearns, the government received equity warrants as part of the deal with AIG, while AIG remained a public company.

And then, most recently, the Federal Deposit Insurance Corporation announced that it facilitated a deal to save Wachovia from failing. How? Citigroup will buy Wachovia's senior and subordinated debt as well as its banking operations.

Now as U.S. lawmakers on Capitol Hill work to strike an accord for a rescue of our entire financial system, here is a look back at three cases of government intervention in the private sector, and how each one played out.

1982: The Latin American debt crisis

What happened: Over the course of nearly a decade, beginning in the early 1970s, countries such as Mexico, Brazil, and Argentina (to name a few) amassed record amounts of debt. Unlike the financial engineering that helped cause our current crisis, this huge debt was the result of Latin American countries trying to emerge as modern economies.

Fueled by increasing crude oil prices, natural-resource-rich Latin American countries saw their exports rise. However, rising crude oil prices resulted in global runaway inflation, which caused Latin American countries to borrow heavily to support their existing account deficits. These countries relied on foreign debt, which was increasingly subject to higher interest rates. A recession in 1981 led to a drop in crude oil prices, but not a corresponding drop in interest.

Capital began to flow out of Latin America, particularly its largest debtor nation, Mexico. This resulted in massive depreciation of the Mexican peso and other Latin American currencies. In August 1982, Mexico declared that it could no longer service its debt.

The workout: In stepped the International Monetary Fund (IMF) and World Bank to stabilize the credit crisis in 1982. The IMF and World Bank forced the debtor nations to restructure their debt and agree to a strict domestic economic

program that would focus on reducing government spending and restrict domestic economic policy.

Many U.S. institutions were the creditors of the Latin American countries, so in 1989, U.S. Treasury secretary Nicholas Brady devised a plan to convert the Latin American bank debt into a new structure called a Brady bond. Brady bonds were U.S. dollar-denominated bonds that were collateralized by zero-coupon U.S. Treasury bonds. The debtor nations would exchange their defaulted bank debt for Brady bonds and then purchase the zero-coupon bonds. The zero coupons were held in escrow by the U.S. Federal Reserve.

Brady bonds represented a loan workout of foreign sovereigns collateralized by U.S. government securities, whereas our current crisis seeks to rescue domestic public companies.

The epilogue: Two major changes occurred at many of the Latin American nations which were part of this IMF and U.S. Treasury-led workout. First, over the next two decades these economies pulled themselves out of debt and grew into substantial and stable economies. Brazil, Argentina, and Mexico are now significant players in global economics, representing a more significant percentage of global GDP thanks to their rich natural resources, economic stability and free-trade agreements. Second, many of these nations, such as Argentina, that were run by military juntas eventually morphed into democracies.

1998: Long-Term Capital Management meltdown

What happened: Long-Term Capital Management (LTCM) was a hedge fund founded by John Meriwether and featured luminaries such as Nobel Prize winner Myron Scholes. LTCM based its business models on fixed-income arbitrage trading strategies developed at Salomon Brothers, when Meriwether headed up that department. They referred to these as "convergence trades." As the global head of equity swaps at Merrill Lynch at the time, I regularly did business with LTCM, so I knew what the company was doing and where it would go wrong.

LTCM entered into swap contracts, which were nearly infinitely leveraged. Their trades worked very well as European countries embarked on a plan to merge into the European Union and issue a common currency, the euro. However, LTCM made many bets in Asia and Russia. The bets in Russia turned out to be bad ones, as the debt was defaulted upon and the Russian capital markets collapsed.

In many respects, the LTCM episode is akin to Bear Stearns's demise, as the company put its own capital at risk for leveraged speculative investments, which ultimately failed. As a result of LTCM's bad bets, the company was on the hook for large amounts of swap mark-to-market adjustments, which were owed to many of the major banks and broker-dealers, none of which held any collateral except for Bear Stearns. Simply put, the amount owed was far in excess of the collateral on hand.

A failure on the part of LTCM would have resulted in huge losses for all the banks they did business with and there would have been a negative ripple effect throughout the global financial system. Bottom line: The global banking system was at risk for a systemic breakdown.

The workout: LTCM tried to get prominent investors such as George Soros and Warren Buffett to step in and inject some capital into the company. But they declined to do so. Why? Either Soros and Buffett preferred to stay away from complex derivative transactions or they did not receive deal terms to their satisfaction.

In stepped Robert McDonough, president of the New York Federal Reserve. He assembled the heads of the major banks and broker-dealers, all of which had LTCM obligations on their books. After some negotiations and wrangling, a consortium of 11 banks and broker-dealers put together close to \$4 billion to essentially take over LTCM and its positions. However, there was one notable exception.

Bear Stearns opted not to participate in this workout, as the company claimed that, as LTCM's clearing broker, it already had enough risk exposure to the hedge fund. That did not sit well with then Merrill Lynch CEO David Komansky, who led the effort to work out LTCM. Komansky knew that Bear Stearns was the only broker-dealer

holding collateral and felt that Bear Stearns was as much at risk as the other banks and brokers.

(In the current financial-sector shakeout, Merrill Lynch was recently acquired by Bank of America.)

The epilogue: The global financial markets did not sustain a systemic breakdown. LTCM's positions were stabilized and liquidated within two years. The consortium's capital was returned along with some modest profits. A few years later, Meriwether started another hedge fund, JWM Partners, where assets swelled to over \$3 billion by the beginning of 2003. However, that fund lost 24% by the end of March 2008 as a result of the current debt crisis.

The LTCM rescue would come back to haunt Bear Stearns.

This year, when Bear Stearns faced serious liquidity issues, no bank or broker-dealer would come to the institution's rescue, as they all remembered Bear Stearns's unwillingness to participate in the LTCM workout. Bear Stearns was widely seen as injured, and many of its competitors were happy to see it fail. The Federal Reserve had no choice. It had to either let Bear Stearns fail or engineer a sale—as it did via JPMorgan Chase through loan guarantees. I refer to as "the revenge of David Komansky."

1979: Chrysler in critical condition

What happened: Chrysler, the number-three automaker in the United States, was close to bankruptcy. The company was unable to react to rising gasoline prices and failed to produce cars that were fuel efficient. The economy under President Jimmy Carter was already in shambles, with rampant inflation and interest rates hitting double-digit levels. The bankruptcy of Chrysler would result in thousands of lost jobs and create a financial tsunami that would wreak havoc on an already fragile economy and banking system. (Chrysler's competitors, Ford and General Motors, now find themselves in similar financial straits.)

The workout: Then Treasury secretary William Miller produced a plan, which was supported by President Carter, to provide financial support to Chrysler. However, the government did not lend Chrysler money. Instead, it provided loan guarantees on \$1.5 billion in private financing that the company was able to arrange. The government also received warrants (essentially options to buy stock) on Chrysler stock in return for the guarantees. Furthermore, Lee Iacocca, who was well known for designing the successful Ford Mustang, was brought in by Chrysler to head up the company.

The epilogue: Iacocca led a turnaround at Chrysler, featuring a new line of compact fuel-efficient automobiles known as the K-Car line. Its Dodge LeBaron model was one of the most successful cars in the early 1980s. Chrysler's stock soared, the debt was repaid within a few years, and the government made an estimated \$300 million to \$400 million on the warrants it received.

In the late 1990s, Chrysler was acquired by Daimler-Benz. Then in 2007, Daimler sold an 80.1% stake in Chrysler to Cerberus Capital, a private equity firm, for \$7.4 billion. Cerberus is now rumored to be seeking to buy the remaining 19.9% in Chrysler.

Unfortunately, the U.S. auto industry is currently in a dire financial condition, as it generates huge operating losses and struggles with its own financing units. While the Wall Street financial crisis has captured the headlines and Washington's focus, the government has also prepared a \$25 billion financial package to help the ailing auto industry.

Your homework

These are not the only government-led or sponsored bailouts in recent history. Do some research and learn more about these other financial workouts and how they played out:

- The creation of the Resolution Trust Company, which took over many savings-and-loan associations after a real-estate-induced financial crisis in the 1980s.



- The Scandinavian bank rescues of the 1990s, when Sweden and other Nordic nations nationalized their banking system.
- The nationalization of the United States rail system into Amtrak, in the wake of the bankruptcy of Penn Central.