Building Better Bailouts: The Federal Government Investment Corporation

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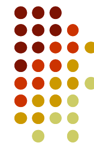
The Case for Institutionalizing an Investor of Last Resort

- **The "Bailout Gap" in the Dodd-Frank Act**
  - Failure to create a framework for bailouts
  - Default of ad hoc bailouts, opportunism, and an absence of disincentives for financial overstretch
- **Blueprint for the Federal Government Investment Corporation ("FGIC")**
  - FGIC would serve as an investor of last resort.
    - Make the U.S. government's bailout role explicit by institutionalizing and delineating the contours of intervention
    - Depoliticize bailouts by vesting authority for bailouts in an independent agency
    - Establish express, ex ante conditions for aid that would temper risk taking and establish bounds to bailouts.
    - Provide taxpayers with long-term returns consistent with the risks assumed in offering financing to systemically important firms.

Crafting an Investor Paradigm

- **The Proportional Share Approach to Government Investing**
    - FGIC's convertible preferred stock stakes would be in proportion to contributions to each beneficiary's market capitalization
    - Five-year time horizon for investment with deferred returns
    - Priority over ordinary shareholders for distributions
    - Government option for convertibility to common stock and liquidation of stakes.
  - Middle ground strategy for government investing.
    - Tempers potential (natural) monopoly power and exploitation of full government leverage
    - Limits ability for political favoritism or laxness in financing terms
    - Limits on duration and scale of investments
    - Gradual draw-downs to mitigate market impact.

Principles for Establishing a Bailout Framework

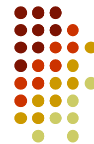


- (1) Deterrence of prospective bailout beneficiaries by reducing the stakes of managers, shareholders, and creditors
  - Key is reduction of creditors' stakes since they serve as a missing link of corporate accountability
- (2) Alignment of interests with the FGIC for recouping investment
  - Tie returns to taxpayers to the long-term returns of beneficiaries to ensure that taxpayers reap returns in proportion to investments.
- (3) Linkage of corporate governance and systemic risk reforms to bailout investments.
  - Paradox of the current approach is that bailouts served as stabilizers and removed political and economic urgency for regulatory reform.
  - Bailout conditions to implement corporate governance and risk management reforms.
  - Enhance internal monitoring of risk taking by requiring beneficiaries to seat truly independent directors on their boards.

The Need to Impose Limits on the FGIC

- Restrict FGIC eligibility to companies whose potential default raises systemic risks
- Need to establish minimum capital requirement guidelines for beneficiaries to ensure the FGIC has a reasonable prospect of recouping the government's investment
- Substantive limits in the amount and duration of government investments
- Balancing greater accountability of beneficiaries with concerns about excessive entanglement between a government entity and private firms
  - Ex. outside board to pick independent directors

Challenges Facing FGIC



- Need to Sustain FGIC independence
  - Ability to draw funds without case-by-case congressional approval
- Concern about FGIC Overstretch and Oversight
  - Limits on FGIC to protect it from over-stretch
- Role in Assessing and Addressing Systemic Risks
- Conclusion
  - FGIC would serve as bailout complement to the FDIC framework for winding up insolvent financial firms in a depoliticized way
  - Political hurdles, but plausible pathway for defusing future financial crises and protecting taxpayers in the process