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The Right to Arm Bears

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A recipe for speculative attack: even greater Treasury powers, and no short-selling ban.

Will they never learn? The Treasury and the SEC are setting the stage for another "bag run" on financial stocks -- a speculative attack in which firms deemed too big to fail become too big to *not* fail. Short-sellers and panicky natural longs drive them into the arms of regulators who, usually over a weekend, wipe out shareholder value in the name of rescuing the financial system as a whole (see "AIG: Rescue or Bag Run?" September 17, 2008). After the effective nationalization of AIG, the only way to halt the "bag run" dynamic was with a clumsy regulatory intervention designed to counterbalance the previous clumsy regulatory intervention -- to ban short-selling of financial stocks (see "If You're Short, Abort" September 19, 2008).

Now, per a statement last Friday citing Congress's enactment of the Emergency Economic Stabilization Act of 2008, the SEC has let the short-selling ban expire, effective with today's trading session. This is potentially a terrible mistake, as the mere enactment of EESA means nothing in and of itself. So far the Treasury has not taken a single substantive action under the Troubled Asset Relief Program authorized in EESA -- no asset purchases, no issuance of insurance, nor anything else (see "Henry Paulson: The Donald Rumsfeld of Bail-Outs" October 6, 2008).

Update to strategic view
US STOCKS, US FINANCIAL STOCKS: The Treasury reportedly now wants to make direct investments in banks. If true, with the ban on short-selling lifted, this is an invitation to speculative attacks in which firms at risk are driven into ruinously dilutive recapitalizations. A safety valve on this dangerous situation is that stocks are now the cheapest they have been in a generation, and financial stocks have finally become cheap as well. But that isn't insurance against another AIG-type "bag run," which would ruin a great company, wipe out its shareholders, and have unpredictable ripple effects throughout the economy and the markets.
[see Investment Strategy Dashboard]

This is especially dangerous, because though Henry Paulson sold EESA to the Congress and the American public as a program to purchase or insure troubled assets, it seems now he intends instead to make direct investments in American banks, as authorities in the United Kingdom announced yesterday they intend to do with British banks. In a statement yesterday in which Paulson listed the new authorities granted to the Treasury secretary under EESA, he chose to mention first "to inject capital into financial institutions." This morning the *New York Times* reported this has "emerged as one of the most favored new options being discussed in Washington and on Wall Street."

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In a market environment in which the restoration of confidence is key, it is unconscionable that Treasury would change directions like this -- from purchasing asset owned by banks, to purchasing banks themselves. Just two weeks ago, Paulson told Congress, "Putting capital into institutions is about failure. This is about success."

What's worse, we cannot find where the Treasury gets the authority under EESA to make such capital investments, only to take warrants or other securities in connection with the purchase of troubled assets. Maybe it's hidden somewhere in this massive bill, but the closest we can come is to note that the "troubled assets" Treasury is authorized to purchase are defined as "any…financial instrument that the Secretary…determines the purchase of which is necessary to promote financial market stability." Perhaps Paulson intends to define banks themselves as "troubled assets." This lawyerly broadening of the authorities granted to the Treasury by Congress is alarming, especially considering how terribly broad the authorities were to begin with.

But legal niceties aside, we are concerned that so long as the Treasury sees the direct investment in banks as something it can do under EESA, and so long as the short-selling ban is lifted, there is an incentive for speculative attacks. The short-sellers now have new reason to believe that banks, brokers and insurers will be stampeded into seeking -- and forced into accepting -- ruinously dilutive investments by the Treasury. At this point the only thing holding short-sellers back is the difficulty of borrowing shares to sell, as many large institutional investors have now withdrawn from participation in the lending market. That may be a significant barrier. But at the same time, long-suffering shareholders have a disincentive to hang in there, and potential private rescuers have a disincentive to make capital contributions. Who wants to be long over a weekend, when the Treasury has arrogated unto itself new powers to nationalize the financial sector?

BOTTOM LINE: The Treasury reportedly now wants to make direct investments in banks. If true, with the ban on short-selling lifted, this is an invitation to speculative attacks in which firms at risk are driven into ruinously dilutive recapitalizations. A safety valve on this dangerous situation is that stocks are now the cheapest they have been in a generation, and financial stocks have finally become cheap as well. But that isn't insurance against another AIG-type "bag run," which would ruin a great company, wipe out its shareholders, and have unpredictable ripple effects throughout the economy and the markets.