guardian.co.uk

Paulson abandons plans to buy up America's toxic mortgage assets

Andrew Clark in New York
The Guardian, Thursday 13 November 2008

A larger | smaller

US Treasury secretary Henry Paulson gives an update on the $700bn bail-out plan to rescue stricken financial institutions. Photograph: Alex Wong/Getty Images

The US government has scrapped the central plank of its $700bn financial rescue strategy by abandoning plans to buy toxic mortgage-related assets which have weighed down the balance sheets of troubled banks and Wall Street institutions.

In a sharp about-turn, treasury secretary Henry Paulson announced yesterday he no longer believed that purchasing assets would be the most effective use of the administration's bail-out fund.

"The facts changed and the situation worsened," said Paulson, who added that he would "never apologise" for amending his approach in the light of changing circumstances.

Instead, Paulson intends to use the bail-out fund for further injections of capital into banks in return for equity. This programme is likely to be broadened to non-bank financial institutions.

The decision is a stark admission by the treasury that its original policy has proven inadequate. It is likely to raise hackles in Congress, which only reluctantly approved the $700bn (£470bn) fund after a titanic battle last month, on the understanding that it would be used for asset purchases.

"Our assessment at this time is that this is not the most effective way to use TARP [troubled asset relief programme] funds, but we will continue to examine whether targeted forms of asset purchase can play a useful role," Paulson said.

Paulson's shift came on the eve of the G20 summit in Washington intended to develop coordinated approaches to tackling the global financial crisis. It means that the US has fallen wholeheartedly in line with a strategy promoted by Gordon Brown, who pressed hard for capital injections in leading British banks.

The Bush administration was initially eager to avoid any sniff of nationalisation, citing negative precedents in Japan and fearing objections from free market advocates in the Republican party. But picking off assets has proven to be difficult, largely because of a lack of agreement on how to arrive at a fair value for bombed-out financial instruments bereft of a market.

A Paulson acolyte, fellow former Goldman Sachs banker Neel Kashkari, was put in charge of the initiative at the treasury. Last month, it announced an initial $125bn of investments in nine leading banks, including Goldman Sachs, Morgan Stanley, Bank of America, and Citigroup.

Smaller institutions have clamoured for funds. American Express has become the latest, reportedly asking for $2.5bn after converting itself into a bank to qualify.

The world's second-richest man, Mexican telecoms magnate Carlos Slim, recently urged the treasury to help regional banks, saying that it was essential for these institutions to get credit moving to small and medium-sized companies.

Critics have questioned whether the funds will really be used to unblock lending. Some fear that firms will simply hoard the money - or that they will use it to take over weaker rivals.

Paulson's changing solutions have attracted scepticism. The treasury secretary is increasingly seen as a lame duck, to be replaced in January when Barack Obama takes office.

"He is catering to the political whim," said Robert Andres, chief investment strategist at Portfolio Management Consultants in Philadelphia. "Every time he opened his mouth this summer he said we need to fix the housing market and buy mortgage-backed securities. This whole process got politicised."

Where the money's gone

Of the US treasury's $700bn rescue fund, some $250bn of the $350bn allocated by Congress has been earmarked for capital injections into banks. Of this, $115bn has gone out of the door. Paulson had planned to spend the rest buying "toxic assets" from banks' balance sheets. But instead, it will go towards further capital injections, securing non-bank institutions and averting repossession for struggling homeowners. Another $40bn has been given to stricken insurer AIG, leaving $60bn to dole out before the treasury has to ask Congress for the final $350bn. This year, 19 high street banks have collapsed in the US - more than in the previous four years combined.