Jeremy Siegel's Advice to Banks: Lend That Money Now

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Before the stock market and the broader economy can return to something that looks like normal, banks must start to lend the billions they are getting from the U.S. Treasury's Troubled Asset Recovery Program, says Wharton finance professor Jeremy Siegel in an interview with Knowledge@Wharton. Banks should not be trying to improve their balance sheets by calling in loans to companies that have always paid on time, he adds. Siegel also discusses the government's rescue of Citigroup and the proposed bailout of the U.S. auto industry.

An edited transcript of the conversation follows.

Knowledge@Wharton: Professor Siegel, thank you so much for joining us today. We would like to talk first about the stock market, of course, beginning with its wild gyrations over the past few days, all driven by one news event or another. Are news headlines going to drive the market every day for the foreseeable future?

Siegel: Let's put this in context. Last week, Wednesday and Thursday, there was a meltdown in the commercial real estate market. We know about the meltdown in residential real estate. That's been going on for several years. But everyone said, "Commercial real estate is generally holding." Well, it wasn't holding. And what we saw was, first of all, a frightening drop in real estate investment trusts, the REITs. Unbelievable; a 67% drop, in approximately two months. And prime triple-A commercial mortgages were beginning to sell at $0.70 and $0.80 on the dollar. This is prime lease stuff, in the best cities in the United States. Now, all banks, including Citi, and particularly Citi, have a tremendous amount of these mortgages. And when they were looking at what was going on to the price of these mortgages, they said, "Citi is insolvent." And not only that, they sent all the banks down. There was a panic. And basically, they began working on it last Friday and over the weekend. It's basically a bailout of Citi, in the sense of a huge $306 billion loan on their assets. This is far greater than anything we've seen with Bear or at Lehman. And oh, they didn't do Lehman. AIG that followed that. Huge.

Knowledge@Wharton: Now, on the commercial side, there hadn't been a lot of these --

Siegel: Defaults. No. Not yet.

Knowledge@Wharton: Defaults, or junk mortgages, as there had been on the residential side. Is the commercial decline all driven by the economy?

Siegel: It's driven by the economy, and the fall on the residential -- they're not unlinked. There were too many shopping centers that were being planned, other commercial buildings. If you're going to have a sharp recession, you're not going to have a demand for shopping centers. We know how badly consumption and retail sales are doing. There has already been a few players that have stopped paying on their debt for the -- for commercial developments. Because they said, "I can't fill them at the present time." So even though the actual delinquency right now is very small, looking forward, it looked really scary. And people were beginning to say, "This is the next big shoe to drop." And the panic swept through the markets.

Knowledge@Wharton: And as far as Citigroup is concerned, there doesn't seem to be much disagreement about whether or not the government should have acted.

Siegel: You look at the terms -- and I'm reading from the official terms sheet over here -- up to $306 billion in assets to be guaranteed. Now, $306 billion? First of all, of course, Citigroup has about $2

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trillion worth of assets. Still, it's only about one out of every $6 worth of assets. But it also says, based on valuation agreed upon between the institution and the US government. That's the critical question. Are they looking -- are they valuing these mortgages and these real estate-related assets at the current market value? At book value? Somewhere in between? It was not clear at all where it stood. But the important thing is that they took the troubled assets, which they identified at around $300 billion. The government's going to take 90% of those losses. Citibank is going to take the first $30 billion, approximately, and 10% above that. And basically, what the Fed has done, and the government has done, is said, "We're going to make sure that Citibank does not fail."

Knowledge@Wharton: Now, some of those assets, according to an interview with Citibank's CFO, are trading assets. Maybe you could explain quickly the difference between trading assets, and assets where they actually have money on the --

Siegel: Well, what he meant by "trading assets" means that they probably bought a lot of commercial loans, maybe some residential loans. Maybe they entered into some commercial swaps that have an informal market. Which, of course, the government now wants to bring into high visibility, as a pretty hidden market at the present time. So, that's what they mean by trading assets, rather than loans that they have made and are going to keep to maturity as they pay off over time. But both of those are in trouble. Both the trading assets and the permanent assets. Because if they have any real estate development out there, either in the residential, or I dare say in the commercial side -- they are probably sitting on a loss right now.

Knowledge@Wharton: Don't they have a big exposure in consumer lending also?

Siegel: They have a big consumer lending business. You know, that part, believe it or not, is, at this point, still not as in dire shapes as both the commercial and residential real estate-related, and developmental lending. Delinquencies in credit cards are definitely going up, and in some of the really weak cities like Phoenix and Vegas, et cetera, they are high. But around the country, they're still holding lower than the last recession. Not a panic, yet. Of course, if we're going to have two or three million more people unemployed -- clearly, again, the market looking ahead is worried about those. I don't know how much consumer assets -- maybe they took the delinquent ones of those. But I imagine most of these were real estate-related assets that the government took under its wing.

Knowledge@Wharton: There's much more disagreement about whether or not the government should act to bail out the automobile industry. That's of great interest to the financial sector, including Citigroup, because they have a lot of exposure there. What's your thinking on the bailout proposal? Is bankruptcy an option?

Siegel: Yeah. I think bankruptcy's the best option. I think there is such mammoth misunderstanding of what bankruptcy at GM and Ford and Chrysler would be. You know, the way the companies talk, the way the unions talk is, they're going to just cease operations, and millions of people are going to be laid off. And then that just trickles through the whole economy. Well, again -- and I have mentioned this before -- look at the airlines. They kept on operating. They renegotiated their labor contracts. They -- you know, re-set all sorts of things. They're flying again. And in fact, some of the analysts say that if gasoline prices and oil prices stay down, they could be quite profitable, moving beyond the recession going forward. Some have even called it promising.

And of course, people say, "Well, you can't do that with GM. Because who would buy the car if they didn't have a warrantee?" Well, GM still has $15 billion, $20 billion dollars. They could put away two or $3 billion in trust with the federal government. This is for all our warrantees. And in fact, if you want some government involvement in it, let the government insure the warrantees. The lemons, if need be. The parts, if need be. That still would be a small fraction of a bailout, without the flexibility that you have with bankruptcy. Because without bankruptcy, they have very limited ability to renegotiate with their unions. And now you have a Democratic Congress, a Democratic President. But the union's sitting there and said, "Hey, they promised us all these health benefits." And that's what's really killing Ford and GM. You know? And which side do you think is going to win on that struggle, over there?

Knowledge@Wharton: The auto industry uncertainty is just one of many uncertainties that seem to be tormenting the market these days. Is that the thing that's really missing here, some stability?

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Siegel: The big down-movement the last couple of weeks has been this commercial bank panic. Now it's been shored up a little bit, because basically the government says, "Hey, we're going to stand behind Citigroup, and that probably means we're going to stand behind most of these commercial bank mortgages." The big problem -- really, the big problem is to get the banks to lend. And I don't mean new borrowers. I mean, they must continue the lines of credit to their credit-worthy customers. I've been saying this all along. If I were in the government right today, I would say anybody that took TARP money -- and most of those banks did -- must keep their lines of credit open to their credit-worthy customers. They can't yank them prematurely. They must keep them going for a period of six months. And if they don't like that, then pay the money back to us and you can do whatever you want. But the whole purpose of this was to do lending. And the lending is not taking place.

Knowledge@Wharton: The government doesn't have much of recourse here, because the terms of their loans, of the TARP funding, didn't really require the lending to occur.

Siegel: Yes. Well, they should change that. You know? I mean, listen. You know, you're doing things on the fly. They thought that that would start the lending. It's not starting the lending. Change the rules. You must continue to [lend to] your credit-worthy [customers]. That's what I hear. When I go around to business people and others, they say, "All of a sudden I've got the bank calling my loan. I've never been late. I've always paid exactly on time. I have plenty of collateral. I'm panicked." And this panic is what really is snowballing into this mammoth decline that we see right now. And, you know, I don't like the government to stick its nose into private affairs. But this is a case where ... [banks are] taking that money and they're sitting with it in Treasury bills and reserves at the Fed.

Knowledge@Wharton: Well, the government essentially bought itself a seat on the board. You'd think that they would be able --

Siegel: Yeah. Well, they bought a seat on the board. And, you know, and then there was a very weak letter two weeks ago they sent out. "You know, you're supposed to kind of continue to lend." I couldn't believe how weak it was. This is [an] ... emergency situation. By the way, I think a lot of banks, if they weren't panicked, if they were told by the Fed to keep on lending [they would do so] because [right now] they're all worried that people are going to come in and look at their loans and say, "Hey, you've got this in real estate. You still have this outstanding." And they're worried a little bit about that. If the Fed came in and said, "Listen. These customers are on time. Continue to lend. We'll sort it out later." They could even guarantee 90% of it, just like they did on Citigroup for 180 days. But we must have the lending function continue. And that is very, very critical. Now, whether what's happened here with Citigroup can flow to the rest of the financial sector and encourage the lending, we'll have to see.

Knowledge@Wharton: Will you be surprised if the terms to Citigroup don't actually call for Citigroup to lend the money?

Siegel: Well, you're right. I'm looking over here [at the agreement], and I don't see it. I mean, I'm looking at the term sheet. You know, it doesn't say they have to lend the money. You see, the biggest fallacy of the original TARP proposal was the thought that the only reason the banks are not lending is because they don't have enough capital. "Oh, they're below the limits. The regulators won't allow them to lend." That was only one of many reasons they weren't lending. The biggest reason they weren't lending is that they feared the solvency of their borrowers. And so suddenly the government comes in, and, "Hey. You're above capital ratio." Do you think they're lending? No. They're sitting with that money, and calling in the good loans to pay for the bad loans.

Knowledge@Wharton: Some people are suggesting we should take a different approach on this, though, and start to assure the solvency of the borrowers, rather than guarantee the bank. What's your take on that?

Siegel: My take would be that you go to the banks first and insist on keeping the [credit-worthy customers]. You know, I don't want to bail out bad borrowers. They're late or delinquent, you can

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cut them off. There's no problem. But there are people that have never been late. And now the banks see this as an opportunity to get cash on their books. "Oh, call in the loan. I have the right to do that. See, in paragraph 7.1. We can call this loan." And they're doing that.

And I think that that is adding a tremendous amount of increased anxiety and stress in the system right now.

Knowledge@Wharton: Thank you very much for joining us today.

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