GMAC's Sweet Government Ride

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The government bailout of **GMAC** is a complicated affair, probably the most intricate government bailout to date — at least until the inevitable future workouts of **General Motors** and **Chrysler**.

The rescue of GMAC, which is G.M.'s financing arm, involves a debt exchange and cash offer, the reorganization of GMAC's ownership structure, the partial severing of the exclusive G.M.-GMAC relationship, a government investment of up to $6 billion, and a redesignation of GMAC as a bank holding company, allowing it to tap into the aforementioned federal bailout funds via the Treasury's Troubled Asset Relief Program (or more particularly, the freshly minted Automotive Industry Financing Program).

Like the bailout itself, this deal was never going to be pretty, but there are a number of things that taxpayers may find particularly irksome about this latest government action.

1. Easy Terms. The Treasury Department is investing $5 billion dollars into GMAC and in exchange receiving nonvoting, nonconvertible preferred interests in GMAC bearing 8 percent interest per annum. Treasury is also receiving warrants exercisable for a nonconvertible preferred interest on the same terms, except this preferred bears interest at 9 percent. The warrants are equivalent to 5 percent of the value of the $5 billion investment.

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Unlike other Treasury investments under the TARP, Treasury is not receiving warrants convertible into common equity of GMAC and so will receive no upside. Instead, the best Treasury can do on this deal is be paid back its investment plus interest. In addition, the 5 percent warrant value is below the 15 percent in value that other TARP recipients had to agree to and the program requirements specify. (See the specifications here.)

Moreover, the value invested in GMAC appears to be disproportionate compared with what other financial institutions received relative to their bank deposit base. (GMAC bank has $33 billion in assets, according to the Federal Reserve.) The end result is that GMAC and its owners — **Cerberus Capital Management**, Cerberus's limited partners and G.M. — will be able to receive the full benefit of any subsequent turnaround, with the government and taxpayer bearing the significant risk.

2. Ford's Penalty. The day after the completion of the infusion, General Motors announced "Significant New Loan Financing as Low as 0% APR" and GMAC lowered its credit score for financing to 621, which is one point above what is generally considered a subprime loan. Both entities asserted that these new offers were made possible by the government bailout. Of course, the sales that G.M. reaps on the government's financing subsidy will come at the expense of **Ford** and the transplant automakers. Notably, Ford has refused government funds so far and is now being penalized at taxpayer expense. How about them apples?

3. The SUV Sale. The list of cars for which G.M. is offering this special financing can be accessed here. Note that the best deals at 0 percent financing are for the 2008 Chevrolet TrailBlazer; GMC Envoy; and Saab 9-3, 9-5, 9-7X. The Trailblazer and GMC Envoy are SUVs, and Saabs are made abroad in Sweden.

According to Yahoo's auto Web site, the mile-per-gallon EPA rating for the Envoy SLE-1 4WD is 15 in the city, 21 on the highway. The rest of the list is loaded up with similar brands including the Hummer 2 & 3. This financing appears to be going to support sales of less-efficient gas vehicles and cars made outside the United States. I suppose that is fine, as this will clear out G.M.'s inventory in sales to relatively risky borrowers, but it can't make the Democrats particularly happy — nor does it appear in line with the environmentalist credo G.M. was spouting at the second round of Congressional hearings.

Of course, to the extent this clears out 2008 models for more gas-efficient 2009 models, this would be a benefit — though again beside the point of making G.M. profitable — but for this, we will have to wait and see.

4. Bank Holding Company Status. Under the Bank Holding Company Act, to be a bank holding company, a company must be "well capitalized" — this generally means that its Tier 1 risk-based capital ratio must exceed 6 percent — and be "well managed." GMAC was allowed to assume this status on an emergency, expedited basis. Make your own judgments on this one.

5. The Merkin Factor. By all public accounts, J. Ezra Merkin is still a member and chairman of the GMAC board. Mr. Merkin, as you may know, headed up **Ascot Partners**, a feeder fund to Bernie Madoff's fund. Mr. Merkin was also supposedly responsible for Yeshiva University's investment with Mr. Madoff and subsequent loss of $14.5 million ($110 million if you include the lost profits, but apparently, some inexplicably don't.) Mr. Merkin at least has resigned from the board of Yeshiva University. Here, there was no word.

In fairness to the government, I should point out that as part of this deal, G.M. and Cerberus will both partially divest their interests in GMAC in order to be below the 14.9 percent threshold set by the Bank Holding Company Act. Cerberus will reduce its interest to 14.9 percent of the voting shares and distribute the rest to investors; GM will transfer its interests above 10 percent of the voting shares to a trust with a trustee designated by the government and G.M., who will arrange for the G.M. interest to be sold within three years.

Moreover, the board of GMAC is being reorganized by March 24, 2009, and then Cerberus will have only one board designee. The trust holding G.M.'s excess interest in GMAC will appoint two more managers, while one manager will be the GMAC chief executive and three seats will be independent, to be appointed by the other managers. So, Mr. Merkin is likely to yet go.

This is the second time that Treasury has avoided taking a board seat and a measure of direct control, instead making appointments through a trust. Similarly, the appointees at **American International Group** are made by a trust for the benefit of Treasury. In both instances, this allows Treasury to keep the next administration from asserting direct control over these entities and maintains control with the management of the bailed-out entity in the case of GMAC.

6. Equity. In connection with the transaction, G.M. is investing up to another $1 billion in equity in GMAC. The money for this is coming from Treasury in the form of a loan at 3 percent over the greater of three-month LIBOR or 2 percent. This loan is securitized by G.M.'s interest in GMAC and nothing more. More risk for the government on this deal.

Treasury's GMAC bailout is yet another act in what David Zaring, a professor at the University of Pennsylvania, and I call "Regulation by Deal." (Here's an abstract of our article.) The government is approaching this bailout as a deal, with every transaction to be uniquely negotiated and *ex post facto* papered over with a new program.

In fact, you can read the Treasury's justification for the **Citigroup** bailout in its most recent program announced on Jan. 2, the Targeted Investment Program. According to the program's terms, "Treasury will determine the form, terms, and conditions of any investment made pursuant to this program on a case-by-case basis in accordance with the considerations mandated in EESA." This is the regulatory way of saying we can bailout whomever we want on the terms we deem appropriate.

Part of this is the nature of the financial crisis, which in some measure necessitated an ad hoc response. But there are drawbacks here, as noted by Tyler Cowen, an economic professor at George Mason University, who commented on our concept of regulation by deal in a recent op-ed in The New York Times. The lack of consistency may have contributed to instability in the capital markets, though, as Eric Posner, a professor at the University of Chicago's Law School, points out in this blog post, there may have been no choice, at least for the bailouts of financial institutions.

Moreover, the auto industry bailout reflects the political nature of the TARP program. Initially, Treasury Secretary Henry Paulson Jr. submitted a three-page bill that allowed him to purchase mortgage-related assets. Some members of Congress threw a hissy fit, describing this as a power grab, and then proceeded to give Mr. Paulson more power than he asked for. The final bill provided Treasury the power to purchase securities in any institution established and regulated under the laws of the United States or any state.

At the time, I predicted that this large grant of discretion would result in bailout creep. And sure enough, here we are.

With this ad hoc approach to the automakers, the government risks losing its objective for meaningful reform of these institutions. The interests involved (management, labor, dealers, suppliers) know full well that the government is increasingly all-in on an auto bailout. This will make gaining concessions from them more difficult and result in only partial reform at best. After all, why sacrifice when the government has said it will back you anyway?

And here, the actions of the government belie its tough words. The government provided G.M. and Chrysler their money but will only assess their progress on Feb. 17, the date by which the automakers must submit their restructuring plans. It increasingly looks as if this will be a punt, and the automakers will not be able to achieve the goals expected of them under their loans.

Instead, GMAC will be the first of a string of auto deals on kind terms, forgoing — at taxpayer expense — the hard choices the auto industry must make. That would be a shame and a loss for us all.