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Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Paul L. Kasriel
Director of
Economic Research
312.444.4145
312.557.2675 fax
plk1@ntrs.com

Channeling Bob Laurent for a Market-Based "Bad" Bank Solution

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Robert D. (Bob) Laurent was the smartest person I have ever encountered. I had the privilege of learning from and working with him at the Chicago Fed. Bob had a knack for coming up with market-based solutions for all kinds of political-economic challenges. One example that comes to mind is at what value to assess residential real estate for tax purposes. Bob's recommendation was to let the owner of the real estate place the value on his property with the proviso that the taxing authority could purchase the property at the owner-decided value. This would deter owners from placing too low a value on their properties. Because rational property owners would have no desire to pay excessive taxes, they would not place too high a value on their properties.

Unfortunately for all of us, Bob passed away at an all-too-young age several years ago. In these turbulent economic times, I have thought of engaging the services of a psychic in order to "channel" Bob for his wisdom. I especially would like to ask Bob for a market-based solution to valuing toxic assets on the books of banks that would enable the Treasury to set up a so-called "bad" or "aggregator" bank that would not end up penalizing taxpayers or bank stockholders and bondholders. I wracked my brain trying to come up with a plan similar to Bob's for valuing properties for tax purposes.

But then, Eureka! While perusing the website RealClearMarkets.com, I happened on a January 23, 2009 article entitled "One Way to Deal with Toxic Assets" by Louis R. Woodhill. Mr. Woodhill's idea is to set up a government bad or aggregator bank to purchase toxic assets from banks at prices *set by the selling banks*. The securities purchased by the government would be put in a segregated account for each bank participating in the program. The account would be charged an interest rate equal to the government's cost of funding the account and some account administrative fee. The interest rate charged would apply to the dollar amount of securities purchased by the government. In consideration for the funds the government paid the participating banks, the government would get something Mr. Woodhill calls contingent variable warrants (CVWs), which would be redeemable in cash or common stock in the participating banks.

Over time, as the assets in these segregated accounts generated principal and interest payments, these proceeds would be invested in Treasury securities. *The performance of each account would be posted daily on a website for all interested parties to view*, which, as you will see, is very important.

After all of the toxic assets in these accounts had been resolved – either paid off or defaulted on – there would be a certain dollar amount of Treasury securities in each account. If this amount were less than what the government had originally paid for the toxic assets, the government would be entitled to this deficit in cash or common equity from the individual bank. If the account ending amount were in excess of what the government originally paid for the toxic assets, the excess would be shared between the government, i.e., taxpayers, and the banks. Mr. Woodhill suggests a 50-50 split.

Why would not a bank price its toxic assets at inflated prices? One reason is that it would be setting itself up for future losses when it would be required to fork over cash or common equity shares for any account deficit. Moreover, current and prospective common equity shareholders would see what the bank was originally valuing these toxic assets at and would see how they were performing on a daily basis. If the toxic assets were sold to the government at unrealistically-high prices, existing stockholders would likely bail and prospective stockholders would pull their bids. Conceivably, the bank's share price would approach zero. This would occur not *arbitrarily* by the assessment of some regulator, but effectively by the bank's pricing decision. The same would be true if the toxic assets performed worse than the bank's honest effort to value these securities for sale to the government.

Why would not a bank price its toxic assets at unduly depressed prices? It would be forgoing immediate cash. Moreover, it would be taking an immediate unnecessarily-high hit to capital, which could jeopardize its solvency.

Suppose a bank believed that it would be found to be insolvent if it participated in the program? In this case, why not take your chances on these assets becoming money-good over time? I would require all nonparticipating banks to make public all of their assets so that the public could see what they have, the price at which similar assets were sold to the government and how these similar assets were performing. I also would forbid any nonparticipating bank from posting any collateral other than U.S. Treasury securities at the Fed discount window. I suspect this would provide a strong incentive to participate. Moreover, seeing the value that participating banks were assigning to similar assets, bank regulators could less arbitrarily determine the solvency of nonparticipating banks. That is, if a nonparticipating bank's assets were valued at less than its liabilities based on the prices of assets set by participating banks, then it would be a straightforward decision by the regulators to declare that nonparticipating bank as insolvent and close it.

In sum, Mr. Woodhill's proposal would put the burden of pricing toxic bank assets on the banks themselves. If they priced these assets at too high a price, their stockholders would bear the cost *along with* taxpayers, but *not at the expense of* taxpayers. If the banks priced these assets at too low a price, they would only be hurting their stockholders.

I think Mr. Woodhill's plan would have appealed to Bob Laurent. But like so many of Bob's logical solutions to problems, this one, too, is unlikely to be implemented. It is too rational.

Note: I have attempted to explain Mr. Woodhill's proposal as I understand it. Any errors in the explanation are mine, not necessarily Mr. Woodhill's.

Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy