

The Good and Bad of a “Bad Bank”

By **BRIAN S. WESBURY**

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If you look back to mid-2007, it seems clear that the more government has done to save the economy, the worse things have become. And with the Obama administration pushing to spend another \$2 trillion or so of taxpayer money to bail us out, it's as if our regulators are saying, “We may have missed before, but you can trust us now with generations of your offspring's money because we finally figured it out.”

So should we trust them? Have they figured it out? And will the newest bright idea — a big “bad bank” that will buy toxic assets from financial institutions and hold them on a government-constructed balance sheet — actually work?

Taking a step back from the cynicism, I think this plan may just do the trick. While there is a long list of very important issues to work through, a bad bank could end the constant undermining of bank capital ratios. This is the essential ingredient to getting the banking system healthy again.

If the government takes all the toxic assets out there and puts them under its wing, the threat to bank capital accounts as assets get marked down will be removed. In essence, what the bad-bank plan does is provide a workaround for mark-to-market accounting. If politicians insist on enforcing an accounting rule that has generated hundreds of billions in losses, overwhelming the system with cash is the only alternative if we want to end financial problems quickly.

In this regard the bad-bank model is a very expensive workaround. There

are probably \$1 trillion (some say double that amount) of toxic assets on financial-company balance sheets. But the Troubled Assets Relief Program (TARP), which is where the funding is coming from, has only \$300 billion to \$400 billion left to spend. So the government (possibly through the FDIC) will capitalize a new bank with the TARP funds and then issue debt to raise cash. This cash will then be used to purchase toxic assets from banks so the banks can avoid any more mark-to-market losses.

Another way to do this would be for the bad bank to trade an equity position for the toxic assets. For instance, if the toxic debt that an established bank sold to the government represented 5 percent of the total assets in the new bad bank, the established bank would own 5 percent of the new bank and could profit from any gains. The one drawback here is that banks would receive no cash, and therefore would have no new resources to make loans. It's possible that a combination of cash and equity may be used, but these plans are rather convoluted.

The other issue is the price at which the bad bank will buy toxic assets. Given illiquid markets, the trading prices of many securities are well below the net present value of current cash flows. In other words, the price isn't right. Let's say a pool of mortgages is selling in the market for 40 cents on the dollar, while 80 percent of its underlying mortgages are still paying on time. If the government tries to buy these assets at 40 cents, banks will have no incentive to participate. And if the government were to pay 80 cents on the dollar for the assets, there would be little upside potential for taxpayers.

So the appropriate price would be somewhere in the middle, preferably above the average of the cash-flow value and the market value—say, 65 cents. At this price, banks would participate, and some could book a profit (the difference between the current mark-to-market accounting value and the sales prices). As a result, capital ratios would soar and banks would be more willing to lend.

If this is what the government is thinking, the plan will work. Pricing assets at illiquid market prices would undermine the plan's effectiveness since this would lock-in losses based on a market priced for Armageddon. What's so ironic about this entire process is that many of the very same analysts and policymakers who argue that free markets have failed are willing to force banks to price assets at current market prices and say that the market knows best.

The big question, however, is what massive government interference in the system will mean over the long run. Will the government buy from all the banks, or only those that agree to some covenants — like community lending or “green” investment rules? And once the government owns these sliced-and-diced mortgages, what will it do with them? Will the government use its market power to pick winners and losers, by way of some political matrix or means-testing to renegotiate mortgages?

These are very important questions. And some politicians seem to have answers that indicate a willingness to move rapidly away from free-

market principles and perhaps even violate property rights.

Much of this could be avoided. Rather than having the government buy all the toxic assets, these assets could be left on bank balance sheets with insurance against loss. This decentralized bad-bank approach would allow banks to avoid the markdown of assets and the loss of capital without having the government own huge swaths of American real estate with no real way to dispose of it.

In the 1980s and 1990s a huge number of banks in America were bankrupt on a mark-to-market basis. Latin American debt was selling at 10 cents on the dollar, oil loans were

collapsing as oil prices fell, and savings-and-loans had 5 or 6 percent mortgages on their books while deposits cost 15 percent or more. But rather than marking all these losses to market, the system was allowed to run for many years as problems were slowly worked out. Eventually, either the banks healed or the government's Resolution Trust Corporation took over assets from those that could not.

Today, because of the near-religious belief in mark-to-market accounting, the lessons of the 1980s and 1990s are being ignored. Accounting rules are forcing 10 or 15 years of potential (model-based) losses down the throat of the financial system in 12 or 18 months. The result is that proposals for government intervention are growing

at a faster rate than ever in U.S. history.

The good news is that using massive amounts of taxpayer money to transfer the risk of bad assets to society as a whole will end the erosion of capital in the financial system. The bad news is that integrating the government in the economy in such a massive way is likely to cause longer-term erosion of growth prospects and freedom.

Brian Wesbury is chief economist at First Trust Portfolios, L.P.