Big Bad Bank

After Citigroup and Bank of America reported more troubles with markdowns last week, the Treasury Department, the Fed, the FDIC and the incoming Obama economic team seem to have coalesced around another idea to save the financial system. The new plan (which is only a proposal at this point) would use the second $350 billion tranche of the TARP plan to capitalize a government owned “aggregator bank” that would buy up “bad” assets that continue to undermine bank capital.

Last week, in London, Ben Bernanke said, "the presence of these assets significantly increases uncertainty about the underlying value of these institutions and may inhibit both new and private investment and new lending." To paraphrase: As long as these assets have the potential to be marked down, bank capital is at risk. And as long as bank capital is at risk, private investors will remain skeptical and banks will remain conservative, which impinges upon their willingness to lend.

If we look back, every plan the government has proposed or implemented is designed to address this problem. Every plan used taxpayer dollars to fill holes in bank balance sheets or to keep write downs from further eroding capital.

Unfortunately, the government’s interference has often made problems worse. Plans and strategies have changed multiple times. President Bush’s speech on national TV scared people. Investors have been forced to take haircuts and so much government capital is sloshing around, actual market prices are suspect at this point. And the biggest mistake of all is that mark-to-market accounting rules have not yet been suspended.

Compare this to the 1980s, when according to William Isaac (Chairman of the FDIC between 1981-1985), every money center bank would have been bankrupt if forced to write down the value of Latin American debt to 10 cents on the dollar (where it was trading). At that time, the government did not buy up all the debt. Instead, it allowed banks to keep the debt on their balance sheets at or near par.

Short-sellers, and others who oppose the suspension of mark-to-market accounting, argue that the prices in the market today are the correct price and that banks should be forced to recognize them. However, Sheila Bair, current chairman of the FDIC, recently said, “we don’t have really any rational pricing right now for some of these asset categories.”

So, why should banks be forced to mark these assets to market? And, what price should the government actually pay for them?

The government knows all of this. Ben Bernanke has said mark-to-market accounting is pro-cyclical – it encourages banks to lend more in the good times and less in the bad times. But instead of suspending – temporarily, and just for certain assets – mark-to-market accounting, the government continues to spend hundreds of billions of taxpayer dollars on ideas that have not yet fully shored up bank balance sheets.

So, if mark-to-market accounting remains off limits, the government should support a plan (first laid out in our 9/22/2008 piece, Here’s a Plan to Avoid a New RTC), that would put a decentralized TARP in place. Rather than having the government buy all of the bad assets and hold them in a Big Bad Bank, why not allow individual banks that already hold these assets to sequester them and have the federal government provide insurance?

Bad loans will still be bad loans, but the erosion in capital accounts from markdowns will be halted. This is the only real way to stop the vicious cycle of mark-to-market accounting without having the government spend even more hard-earned taxpayer dollars.

<table>
<thead>
<tr>
<th>Date/Time (CST)</th>
<th>U.S. Economic Data</th>
<th>Consensus</th>
<th>First Trust</th>
<th>Actual</th>
<th>Previous</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-22 / 7:30 am</td>
<td>Housing Starts – Dec</td>
<td>0.610 Mil</td>
<td>0.605 Mil</td>
<td>0.625 Mil</td>
<td></td>
</tr>
<tr>
<td>7:30 am</td>
<td>Initial Claims - Jan 17</td>
<td>540K</td>
<td>535K</td>
<td>524K</td>
<td></td>
</tr>
</tbody>
</table>

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.