Creating incentives to buy banks' bad assets

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NEW YORK — Say the words "incentive" or "profit" around Wall Street or Washington these days, and risk setting off a firestorm if anyone thinks money is being made off the taxpayers' dime.

Given the public outrage over the $18 billion in bonuses paid by financial firms that got money from the government's bailout fund, such a reaction seems warranted. But there are times — like now, as federal officials search for ways to get illiquid assets off banks' books — where a bit of perspective is in order.

What's becoming increasingly clear is that the government can't do this alone, and that means offering the carrot of possibly large profits to buyers of toxic bank assets to help restore the health of the financial system and the overall economy.

"No one in the private sector will want to buy this stuff unless they have an incentive to do so," said Douglas Elliott, a fellow in economic studies at the Brookings Institution, a liberal-leaning think tank.

For months, mortgage-related assets and other risky securities have been plunging in value as the market for them has completely collapsed. That has caused major writedowns on the banks' balance sheets, constraining capital and contributing to a pullback in lending.

The government has struggled with how to get those assets off the banks' books. Officials have been tripped up over whether taxpayer money should be used to buy them, and how these assets should be valued since there is no current market price for many of them.

It's a Catch-22: Pricing them too low could lead to more devastating writedowns for the banks, but valuing them too high risks overpaying with taxpayer money.

The message from Treasury Secretary Timothy Geithner in recent days is that the government is working toward a fix by way of creating a "public-private" investment fund to provide financing for investors to buy distressed securities. It will have an initial capacity of up to $500 billion, but that could grow to $1 trillion.

Too bad that's all he said — even after a much hyped speech and hours of congressional hearings over the last week.

Lawmakers balked at the slim details, and stockholders ran scared. The Dow Jones industrial average plunged about 5 percent on Tuesday after Geithner's announcement of the proposal.

They seem to be overlooking the fact that this route would somewhat conserve the government's resources and will take advantage of private-sector expertise in pricing the assets, according to Goldman Sachs.

But since Geithner hasn't said how this could work, it requires turning to outsiders for their view of how it could all come together.

Lucian Bebchuk, professor of law, economics and finance at Harvard Law School, favors a plan that gives investors capital and the prospect of profit. The basics of his approach work like this: The Treasury Department could establish, say, 25 funds with capital of $10 billion each, funded by the government's Troubled Asset Relief Program, or TARP, as well as borrowed funds from the Federal Reserve. At the helm of those funds are private managers, who have no conflicts of interest and will be able to get a cut of the profits. They are given a mandate to use the money to buy the troubled assets, or they can park them in Treasury securities. But the only way they make money is by getting an excess return over the Treasury yield.

That would take the government out of the picture when it comes to valuing the assets. Instead, the competition among the fund managers would prevent the prices paid from falling below fair value. At the same time, the fund managers' incentives would keep prices from exceeding fair value, Bebchuk said.

"We just don't want to see a certain volume in transactions, but we want this to give us some idea of the market price," Bebchuk said. "That can then be relied upon by others for a valuation."

Another way to persuade investors to buy the assets could come by offering them cheap financing. Also, the government could provide loss guarantees, which would give investors protection against assets that tumble in value, said Brookings' Elliott. For instance, if an asset was purchased at 50 cents on the dollar of its face value, investors would then have a loss guarantee if it slides below 40 cents. But that guarantee wouldn't be free — there would be a fee paid to the government based on the probability of the loss, Elliott said.

"The more advantageous the terms are for the government, the greater the possibility that investors will not be willing or able to participate on terms that would make it attractive for the banks to sell these assets," Elliott said.

Such an idea wouldn't be foreign to the government, which has offered loss guarantees to financial institutions. Last month, it agreed to guarantee a pool of Bank of America's illiquid assets worth $118 billion. The company would take the first $10 billion in losses; the government would take 90 percent of the remaining, or about $98 billion.

In exchange for that deal, the government got $4 billion in Bank of America preferred shares.

Geithner and his team should consider such ideas because they could get those toxic assets out of the way. We need them to.