Every Day Brings a New Plan for Banks: Here's Another

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Another day, another banking plan, this one from two senior partners at McKinsey and Company, which may be the most influential company you may never have heard of.

The authors recognize the toxic-asset pricing problem: If the government buys them at market value, the banks become insolvent instantly; if the government pays book value, it is paying a massive subsidy. They also recognize the rough scale of the problem, predicting another $1 trillion in writedowns. And here’s the proposal:

> [W]e propose that the government step in and establish a voluntary program to create a real market price and terms for the sale of bad assets. Rather than use modeling for valuation, the program would set discounts from either of the two basic approaches to accounting value [fair value and "hold-to-maturity," which isn't quite accurate, but that doesn't matter], based on some recent past date (for instance, December 31, 2008). A reasonable level might be 10 percent off for securities already marked to fair value and 20 percent off for loans being held to maturity. Upon their sale to the government, existing shareholders would absorb the loss taken on the discount, and that loss of common stock value would be replaced by converting TARP preferred stock to nonvoting common (which would be vested with voting rights if sold to private parties).

I don’t see how this creates a “real market price.” If I’m a bank, I can sell to the government, at 10% or 20% off my book value, any assets I think are worth less than that; and I can keep all the ones I think are worth more than that. That’s not a market, it’s a free put option that rewards banks for having overstated the value of their assets. Even if you make the discount percentages bigger, it doesn’t change the basic dynamic: the banks will unload the worst assets, and keep the less bad ones. (Which might be one way to reduce uncertainty about the banks: “I’m really worried about all those toxic assets they are holding.” “Oh, don’t worry - they already dumped all the really bad ones on the taxpayer.”)

The authors argue that the subsidy is compensated for by the preferred-to-common conversion, which increases the government’s ownership stake. However, there’s a problem with this argument. Preferred stock is already worth something: when you convert it for common, you don’t magically get more value. Ordinarily, the value of the common you get should be the same as the value of the preferred you gave up. However, if you’re the government and you’re dealing with Citigroup, the common you get is worth a good deal less than the preferred you gave up. (At current prices, the government is exchanging $25 billion in preferred shares for about $8 billion in common shares. You could say that the preferred stock wasn’t actually worth $25 billion, but that’s only the case because there was risk that Citi might not buy it back when it had to - and if Citi didn’t buy it back, then its common shares would be worth zero.)

But, the argument goes, if you bail out the banks in this way, the common will regain its lost value, and the taxpayer is better off eventually.

> If restoring the ongoing-concern value of banks helped the industry’s valuation to regain its January 2007 level (about 20 percent less than its high), we calculate that the government’s shareholdings would be worth about $560 billion.

The S&P 500 Financial Sector Index spent January 2007 in the 490s. It hit its all-time high of 509 on February 20, 2007. Today, it’s 82. How long do you think it will be before it reaches 490 again?

If the government is going to buy toxic assets, I prefer Lucian Bebchuk’s model.

Separately, Alan Blinder, whom I usually agree with, has an op-ed outlining some of the potential problems with nationalization. Unlike many opponents of nationalization, Blinder has the decency to be clear what he is talking about:

> Because “nationalization” can mean many things, let’s first clarify what the current debate is about. Don’t think Hugo Chávez or even Clement Attlee. Imagine instead that the government acquires a majority interest in — or perhaps 100 percent of — a bank, wipes out the existing shareholders and installs new managers. Then, sometime later, a healthy bank is sold back into private hands, and we all live happily ever after. At least that’s the idea.

However, after listing some reasonable concerns about nationalization, he settles on the good bank/bad bank proposal, without mentioning what Krugman points out: there’s no way to remove bad assets from good banks without someone - that is, the government - taking over the liabilities.