How Toxic Are They?

TIME
By Justin Fox
March 26, 2009

When treasury secretary Tim Geithner rolled out his long-awaited plan for buying up toxic mortgage loans and securities on March 23, reaction was split. Financial markets cheered, with the Dow Jones industrial average rocketing 497 points, or 6.8%, on the day. The chattering classes mostly grumbled, with Princeton economist and New York Times columnist Paul Krugman gloomily leading the way: "It fills me with a sense of despair," he wrote of the plan before it was released but after many details had leaked out.

One simple explanation for this divide is that the Geithner plan — which calls for Treasury, the Federal Reserve and the Federal Deposit Insurance Corporation to finance the bulk of up to $1 trillion in toxic-asset purchases by private investors — is a great deal for the investors and a big risk for the taxpayers. The math calls for the government to take on most of the downside risk while evenly sharing the rewards with hedge funds, money managers and other buyers. In the loan-buying program, private investors would put up 7% of the capital for a shot at close to 50% of the gains. The ratio in the securities-buying program isn't entirely set yet and will probably vary, but it should offer a similarly favorable risk-reward profile. (See 25 people to blame for the financial crisis.)

This is — there's really no denying it, although Geithner has tried — yet another giveaway to the rich and well connected. Then again, it's supposed to be. Luring smart, informed investors, who've been on the sidelines, into currently dysfunctional markets for mortgages and mortgage securities is the whole point. Some amount of wheel-greasing subsidy is needed — and the question of whether the plan offers too much is pretty much unanswerable. It will be easy to tell if it offers too little: no one will participate.

But once we get to the actual buying of what Treasury is gingerly calling "legacy assets" (I'm hoping for a public-service ad campaign with the slogan "It's not toxic, it's a legacy"), things may shake out much differently from what Wall Street hopes and Krugman & Co. fear. Both sides in the debate seem to expect that the asset purchases will provide nothing but benefits to the banks that sell. That's not a safe assumption. We don't yet know what private investors will be willing to pay for those once-thought-to-be-valuable legacies. With the government stimulating demand, the toxic assets will presumably go for more than the fire-sale prices currently prevailing. But with profit-hungry private investors doing the bidding, the selling prices will presumably be lower than what the banks are currently valuing the assets at. (See the best business deals of 2008.)

That may lead to a standoff, given that many banks are like underwater homeowners — hoping to hold on until prices rebound. "The challenge is going to be to get the prices high enough for banks to sell," FDIC Chairman Sheila Bair told reporters the day the plan was unveiled. "The problem is going to be low pricing, not high pricing."

Once some banks do sell, though, it could force a widespread, and revealing, revaluation of similar assets on every bank's books. The banks have been asking regulators and accountants for, and getting, relief from having to mark some of their assets to market prices because the markets for many debt securities are so clearly broken. But the prices prevailing in a smoothly functioning government-subsidized market will be hard to ignore. This has led to speculation in the economics blogosphere that banks might game the program by conniving with investors to overbid for assets. That's not inconceivable, but it would be hard to pull off. Which means banks may be headed for a shakeout.

"One value of doing this is it would clarify which banks are and which banks aren't undercapitalized," says Harvard Law professor Lucian Bebchuk, whose September proposal for toxic-asset purchases by competing investors seems to have provided a template for Treasury's plan. "It's reasonable to expect that restarting the market for troubled assets will lead us to discover that some banks are in a healthy position and will make it absolutely clear that some banks are in an unacceptable position."

Along with the "stress tests" big banks are conducting under regulators' supervision, the asset sales could move the government farther down the road toward closing or taking over the most troubled banks. The operative word here is could — Geithner and top White House economic adviser Larry Summers have been awfully cagey about what comes next. The more plainspoken Bair allowed that the asset-purchase plan "will be a significant benefit to many banks, but some will be beyond help." Soon we may find out which hopeless banks she's talking about.