



# No Substitute for the “P”-Word in Financial Rescue

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Three months and three-hundred billion dollars of bank rescue efforts have gotten bogged down in a widespread and irrational fear among policymakers: the fear of trying to put a price on banks’ troubled assets. So profound is this fear that the Bush Treasury opted instead for the “suitcase approach,” where large sums of cash were delivered to banks (solvent and insolvent alike) with few strings attached.

The fear of pricing could be seen in the early hours of TARP, as commentator after commentator repeated the need for the Treasury to

avoid setting a price so low that banks would fail or a price so high that the program would be viewed as a bailout. Even worse was the concern that, after a price was established, banks would be obligated to mark-to-market their remaining assets, which was somehow viewed as wiping out bank capital rather than simply better measuring that capital.

Fear of pricing is easy to document in the mainstream media. “The central reason TARP didn’t get off the ground is pricing,” said banking analyst Bert Ely. “It becomes politically controversial. If the price is seen as too high then it’s a taxpayer giveaway. On the other hand, if prices are seen as too low, banks won’t sell, saying they can’t take a hit.”

Senator Charles Schumer (D., N.Y.) was quoted in November as saying, “The more you look at auctions or asset purchases, the more

you have the same problem: How do you set the price?”

## WHY ASSETS NEED TO BE PRICED

Nevertheless, a new consensus has begun to emerge in the last few weeks. Banks need to be divided into two groups: insolvent banks and solvent banks. Insolvent banks need to be taken over promptly by the government. (Some people call this “nationalization”; we prefer to call it “protecting depositors.”) Solvent banks need to have the toxic assets removed from their balance sheets, perhaps by transferring them to a “bad bank,” so that the remaining “good bank” can resume functioning as a normal bank.

It has not yet sunk in that this new consensus requires doing exactly what the policymakers have feared all along—pricing the toxic securities.

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In hopeful moments, they assume that, since you are taking over the insolvent bank, pricing the bank's toxic assets is unnecessary.

But, of course, one cannot determine which banks are solvent and which are not without pricing the assets, either implicitly or explicitly. The only way to tell whether a bank is solvent is by putting a price on the bank's assets and comparing this to the bank's liabilities.

Moreover, the solvent banks are not going to be taken over. (That is where the word "nationalize" could be used appropriately—and where the U.S. Constitution creates suitable impediments.) Some banks hold relatively good mortgage-related securities, while others hold bad securities. If a "bad bank" or government purchase program is to be implemented, it will need to differentiate among these securities using prices.

#### USE REVERSE AUCTIONS FOR PRICING

Auctions are the standard device for determining prices in the face of uncertainty. To go forward with a restoration of the banking system, we need such a process to establish true market prices for the troubled assets. We should not be looking for a political compromise on

prices, but for a bona fide assessment of the true value of assets.

Elements of a successful auction include: using a transparent process that establishes meaningful prices; purchasing only some (and not all) of each troubled security; adhering to well-specified rules that treat all sellers equally; and following an approach that attracts private capital to assist in the government's efforts.

We proposed in a working paper and an Economists' Voice article one design for a troubled asset reverse auction early in the TARP process and, together with colleagues, we ran experiments testing the design in a University of Maryland economics laboratory in October and November. Both the theoretical and experimental results suggest that the proposed design would work well at setting prices for troubled assets. The test also demonstrated the feasibility of implementing auctions quickly for the roughly 8,000 troubled securities using state-of-the-art auction techniques.

Other market design experts such as Paul Milgrom and Paul Klemperer also formulated promising proposals in the fall.

The pricing task is difficult and cannot be accomplished perfectly. In particular, some of

the mortgage-related securities have highly concentrated ownerships that make the functioning of simple auction mechanisms problematic. But this is not an excuse to abdicate on the task and thereby allow our economy to fall further into the abyss.

In November, the government abandoned any pretense of seeking to identify prices of troubled assets, in favor of what we have called the "suitcase approach"—handing banks large sums of cash to keep them from failing. This opaque approach is now recognized as a failure. Solvent banks remained hobbled, as no progress was made on reducing the uncertainty in the value of their assets.

The government needs to restore the banking sector, while protecting the interests of taxpayers. There is no substitute for the P-word.

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