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Newsweek

Gaming The Financial System

Can a pair of professors and their graduate students make the $700 billion bailout work?

Matthew Philips
NEWSWEEK

Oleg Baranov is a 27-year-old Russian earning his Ph.D. in economics at the University of Maryland. But for the last month he's been more actor than academic. His unenviable role: playing the part of an American bank with a balance sheet riddled with toxic mortgage-backed securities. Rounding out the cast are 15 of Baranov's classmates, all of whom are also pretending to be similarly troubled financial institutions. For the past month, they've been spending several very real hours each week hunched in front of computers, competing against each other to sell make-believe assets to a make-believe U.S. Treasury Department, played by Maryland economics professors Peter Cramton and Larry Ausubel.

What's the point of this little academic role playing game? The professors wanted to prove that a relatively obscure financial transaction known as a reverse auction might just be the best way to implement the $700 billion rescue plan Congress passed Oct. 3. Shortly after the bailout was approved, Congress was supposed to be using reverse auctions to buy up toxic assets from troubled banks to help stabilize the financial system, boost confidence and ease the credit crunch. That didn't happen, partly because pricing problematic mortgage-backed securities was thought to be too difficult. Instead, Treasury Secretary Henry Paulson is now favoring a plan to inject capital directly into struggling banks and companies. Whether or not that plan of attack will work or is a good use of taxpayer money is debatable.

So what will work? A reverse auction shouldn't be ruled out, say Ausubel and Cramton. Unlike regular auctions, in which buyers outbid each other to win goods or services, the sellers in a reverse auction lower their prices in order to win new business. The benefits are twofold, say the Stanford-trained professors. "First, it establishes a price for these assets by providing a secondary market for them," says Cramton. "And second, it gives banks so much needed liquidity."

To prove their point, they made their auction experiment as real as possible by giving each student a portfolio of assets similar to the mortgage-backed securities that are weighing down the books of hundreds of banks and financial institutions. Subjecting their students to a series of intense three-hour sessions, they plied them with Red Bull and granola bars to keep them focused. And for an extra bit of reality, they had their students play with real money: $20,000 each. The students (a.k.a. "banks") that established the best prices and ended up with the most money received cash awards. After four lengthy sessions, Baranov came away as the top earner with a little more than $1,500. "It was pretty intense," he says. "It helped me understand the problem, and I earned some money too, so it's good all around."

Ausubel and Cramton have been touting that kind of win-win situation during regular conversations with Treasury officials, with whom they've shared their results. They hope to convince officials that not only does a reverse auction work, but, in the event the Treasury conducts one, to run it off their patented software platform. Ausubel and Cramton own two auction-services companies, Power Auctions and Market Design, each of which handle the back end of auctions for companies and foreign governments. They've already helped the French government sell electricity off its grid and Dutch energy companies auction off natural gas.

After crunching the final results, Ausubel and Cramton feel their experiment did exactly what they hoped it would: prove that a reverse auction would result in the best use of taxpayer dollars spent through the bailout. They never paid more than a dollar for a dollar's worth of assets they bought from students—an even deal at worst. But in many cases, they were able to buy about a $1.20 of assets for every dollar they spent. Applied to the real world, this means that taxpayers won't be overpaying for what Treasury buys; in fact, they may get a bargain. "It wound up being a great deal for the taxpayer," says Cramton. "Not only did we get value for the money we spent, but we were able to establish a price for these assets."

In the real world, the biggest problem with the 10,000 or so mortgage-backed securities that banks and financial institutions are holding right now is that no one knows what they're worth. The general consensus is that most of them are worth far less than what they were sold for, but just how much less is anyone's guess. As each separate security is comprised of lots of different pieces of lots of different mortgages, it's virtually impossible to go through them piecemeal and determine their value. The banks holding them may have an idea of their deflated value—they probably do—but it's not in their interest to share that with anyone. As soon as they did, they'd have to write them down as a loss, deepening the hole they've already blown into their balance sheets. It's as if each bank has a closet full of these toxic mortgages, but none of them are willing to open up because they're afraid of letting the public see what's inside. Those banks whose closets *have* been opened, Bear Stearns and Lehman Brothers, for example, haven't been pretty to look at. But by offering to buy some of what's out there, Treasury could at least coax them into shedding light on the situation, and thereby establish what some of them are truly worth as banks compete for Treasury's cash. "The whole problem of the financial crisis has been a lack of transparency," says Ausubel. "Banks aren't lending to each other because they don't know who's solvent and who's not. By buying and pricing them, you add a tremendous amount of transparency to the situation."

Ausubel and Cramton ran their final experiment on the night of Nov. 11. The next morning, though, they, along with the rest of the world, learned that Treasury had changed its mind when Secretary Henry Paulson announced he had scrapped the plan to buy assets from banks in favor of something a bit more fuzzy: offering aid not just to banks but to firms that issue consumer debt (credit-card and auto-loan companies, and insurance agencies, too) by somehow jump-starting the market that provides financing for these companies. The details, said Paulson, are still getting worked out, but the message was clear: buying troubled assets from banks was too complicated, too time-consuming and too rife with potential conflicts of interest. The banks they were likely going to contract to help run the auction were likely going to be the same ones looking to sell their bad assets.

While agreeing that the financial crisis has clearly seeped from the balance sheets of banks into the consumer lending market, Ausubel and Cramton were more than a little disappointed by the news. "I think there's a general lack of understanding within the Treasury Department of how the auction mechanism would work and how it could be done," says Cramton. "And that's a big part of the problem, one that, frankly, we hadn't anticipated."

One theory as to why the Treasury scrapped its plan to buy assets through an auction is that it would have created too much volatility and thinned the banking herd. "The danger of the reverse auction is its exact purpose, that it would find the price of these securities," says Jerry Driscoll, a former vice president of the Dallas Federal Reserve and a senior fellow at the Cato Institute. He believes the prices discovered through an auction would have been drastically lower, forcing banks to write down considerable amounts of their assets even further and forcing some out of business. "The auction would likely have worked with deadly efficiency, and that probably made a lot of people nervous."

Rather than buy assets from banks, Treasury has decided to buy equity in them instead. To date, Treasury has devoted $250 billion to injecting capital straight into banks, and given another $40 billion to stumbling insurance giant AIG. The hope was that it would prod them to increase lending, but so far that hasn't happened. Two days after Paulson made his announcement, lawmakers at a Senate Finance Committee hearing discussed how some recipients have continued to pay dividends to stockholders and give pay raises and bonuses to executives and other employees. As a friendly reminder, the Federal Reserve issued a statement last week reminding banks that they should be lending to creditworthy institutions.

Still, Ausubel and Cramton are continuing to make the case for a reverse auction and are hopeful that an Obama administration will be open to the idea. "Just because Paulson isn't going the auction route, doesn't mean the new administration won't," says Cramton, who declined to say whether he and Ausubel have been in touch with members of the new administration about the possibility of running an auction at a future date. A spokesperson for the Obama transition team could not comment. Whoever succeeds Paulson as Treasury secretary will likely inherit roughly $410 billion of remaining bailout money. How it gets spent is, at this point, anyone's guess.

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