THE WALL STREET JOURNAL.
WSJ.com

An Army of Bad Banks

By Shasha Dai
February 24, 2009

In all the thorny issues raised by the government's plans to get private firms involved in helping to reboot the financial system, there are two that are particularly prickly. The first is pricing - how best to value these toxic assets given a current lack of demand for them. The second concerns making sure all parties' interests are aligned so the government doesn't leave the impression that it's helping fat cats get fatter while leaving taxpayers on the hook for loss should the investment go awry.

Lucian Bebchuk, a professor at Harvard Law School, tackles both at once in a recent discussion paper, which can be downloaded here.

Bebchuk's main argument is that one aggregator bank, or bad bank, won't work. Instead, he suggests setting up a veritable army of such vehicles, with each bidding against all the others for troubled assets.

"The key problem is that the aggregator bank would add only one additional buyer, albeit a big one, to the market," Bebchuk wrote in the paper. "Rather, it is necessary to introduce a significant number of privately managed buyers armed with sufficient additional capital." This will help create "a well-functioning market for troubled assets."

As for the objective of achieving fairness and making sure that risk and reward are shared equitably among all partners, Bebchuk suggests that the bidding not only be used to set the price of assets, but also to determine how the U.S. and private investors share the total capital contribution to each vehicle.

Private entities should "compete up front for the right to participate in the program and receive funding from the Investment Fund," Bebchuk wrote.

Under his scheme, private investors would indicate how much capital they would like to contribute and in what tranches. The government would then decide a ratio – for example, 40% private equity capital matched with 60% government funding. Because the ratio is determined through bidding, it helps to maximize private capital participation while limiting taxpayer exposure.

To further limit the downside to the public, Bebchuk suggested the government funding come in the form of debt financing, or "non-recourse loans," that carries low interest rates. That gives taxpayers an interest payment and means private investors would take the first hit if the investment goes wrong. However, it also limits the upside to taxpayers.

A senior executive with a New York-based financial services investor said it doesn't matter whether it's one bad bank or several parallel vehicles, but a pricing mechanism absolutely must be created. The executive, who asked not to be named because the Treasury has yet to disclose details of the plan, agreed with Bebchuk on the necessity of the government providing debt financing. "One of the big problems is the cost of capital for buyers. The cost is high because there is no leverage," he said. "But if you can get four to five times leverage, the amount of equity will be low. The government loan helps to bring down the cost of capital."