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**The Financial Stability Plan and the Reverse Auction**

Everyone agrees that we need to cleanse the banking system of toxic assets, but none of the proposals to date have effectively dealt with the pricing problem of removing assets from the bank balance sheets. Price the assets too high and the banks get a windfall, price too low and the banks are driven to insolvency. Fortunately, there is a market mechanism using auctions that fits with Secretary Geithner's program as outlined. This approach is transparent, fair, and market driven. Most importantly, this method eliminates the need for individual security price discovery.

Most people agree that the banking sector is close to being, or perhaps already is, insolvent, and that the financial crisis and its effect on the overall economy will not be resolved until the banks are recapitalized. To put this into context, the market value of the financial industry is currently \$770 billion, down from \$2.3 trillion a year ago. Some analysts believe that banks may still take another trillion dollars in write-offs.

The government's TARP program last fall was supposed to be the vehicle for bank recapitalization. The initial plan was for the government to purchase troubled illiquid assets, providing banks with fresh capital while removing the murkiness and uncertainty from their balance sheets. However, it soon became apparent that there was no market mechanism or, for that matter, government mechanism for arriving at prices for all the unique assets floating in the toxic waste dumps of bank balance sheets.

Instead, Secretary Paulson and team elected to directly inject cash into the banks in return for preferred stock positions. While this action provided capital to the banks, it did absolutely nothing to provide transparency or clean up the balance sheets. Indeed, as economic conditions continued to worsen through the fall and winter, the existing troubled assets deteriorated further, pressuring the banks to squirrel away the new government cash. Not surprisingly, potential equity investors other than the government have kept their distance from the banks, not wishing to add capital to sinking ships.

Now the country is about to embark on a new Financial Stability Plan, and Secretary Geithner proposes to remove the troubled assets and place them into a national Public-Private Investment Fund. However, there have been few details as to how to go about pricing and acquiring these assets. Thankfully, there is an easy and transparent method to acquire assets and recapitalize the banks while providing economic value to taxpayers.

The government should set up a new Aggregator Bank (A-Bank) that will acquire these troubled assets. This bank could be seeded with government equity from TARP 2 and then raise additional funds in the public debt market. For example, TARP 2 could contribute \$100 billion of equity and then A-Bank could raise an additional \$900 billion in the debt market.

A-Bank would then hold a series of Reverse Auctions for Toxic Assets (RATAs). At each auction, the A-Bank would define a target security type, (e.g. whole loans, commercial loans, mortgage backed securities) and purchase troubled assets of this type at the current mark on the bank's balance sheet. Most people agree that the current marks are higher than the value that could be realized by selling the assets on the open market. Therefore, in return for purchasing the assets at the marked value, A-Bank would receive equity warrants, struck at current stock prices, from the selling bank. The percentage of equity give-up would be the auction variable; participating banks themselves decide how much equity they are willing to give up in order to sell the toxic assets at their marked value. Mechanically, A-Bank will set the range of acceptable offers, perhaps 10-50% of the purchase price of the troubled assets.

For example, assume Bank X wants to sell to A-Bank \$3 billion of troubled assets with a current marked, or book value, of \$2 billion. In addition, assume the current market value of Bank X is \$10 billion. The bank could offer to sell the assets to A-Bank for \$2 billion cash and an equity give-up of 20%, which would be \$400 million in face amount of warrants. Therefore, in return for \$2 billion, A-Bank will receive the \$3 billion face amount of troubled assets and equity warrants representing 4% of Bank X. Or, Bank X may choose to further mark down their assets prior to offering them for sale to A-Bank, thereby reducing the amount of equity give-up.

Bank Y might offer to give up 25% in warrants, which would be superior to Bank X's offer, irrespective of either bank's mark level. As with typical single price auctions, the clearing offer would set the warrant percentage for all purchased assets. The banks giving the higher equity give-ups would be the 'winners' while those below the clearing level (lower give-ups) would be out. The auctions could even be "open" in the sense that the entire auction variable curve would be public, though anonymous, revealing the relative equity pricing of the assets both above and below the clearing level.

The attractiveness of this approach is that banks themselves have an incentive to further mark down their assets prior to offering them, as this reduces the amount of equity warrants given up in the transaction. The auction allows the banks to compete for government funds via the equity penalty. Furthermore, it is an efficient methodology that does not require A-Bank to independently value individual securities. They would be booked on purchase at the weighted average purchase price. This approach therefore eliminates the need for individual security price discovery, heretofore the stumbling block to transferring toxic assets. Assets can be rapidly removed from bank balance sheets, releasing capital for further lending, and removing the major impediment to private capital flowing to the banking sector.

A-Bank would have an investment portfolio consisting of fixed income assets and financial sector warrants. The warrants, by definition, would be calls on equity in healthier companies, since the auction winners were able to transfer risk from their balance sheets to A-Bank. These exposures would also result in immediate gains for A-Bank, since they were initially struck at pre-auction spot prices – all participating companies make offers to give up equity at then market stock prices, but A-Bank only gets stakes in winning and thus healthier companies. These warrants are, in a sense, reserves against and, ultimately, compensation for taking on the uncertain toxic assets. At some future point in time A-Bank could conduct an IPO to welcome private sector equity, and/or allow the government to reduce its equity position.

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