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How to Value Toxic Bank Assets

The government and banks can share in any upside.

By ROBERT C. POZEN

The Obama administration is reportedly developing a plan to buy from U.S. banks some of their "toxic" assets -- troubled debt securities backed by subprime mortgages or complex derivatives. Many commentators agree that banks will not ramp up their lending until these assets are taken off their balance sheets.

However, the purchase of these securities faces a major challenge -- no one really knows how they should be priced since most have not traded for six months, a long time. Although the Treasury department could hire experts to estimate their prices by methods like discounted cash flow, these estimates would be educated guesses with considerable margin for error.

The pricing challenge is politically explosive. If Treasury pays too much for these assets, Congress and taxpayers will protest. If the prices offered by the Treasury are too low, the banks won't sell.

Here's a practical solution: After making its best estimate of an asset's current value, Treasury should offer the bank a cash payment equal to 80% of that value. For the remaining 20%, Treasury should provide the bank with a capital certificate, which would count as common stock in determining whether the bank meets its capital requirement.

The certificate will also entitle the bank to 80% of the actual price at which the asset is later sold by the government -- but only to the extent that the actual price exceeds the initial cash payment.

For example, suppose the Treasury estimates that a toxic asset is worth $700,000. It would pay the bank $560,000 in cash plus a capital certificate for $140,000.

If the government later sold that security for $660,000, the bank would receive an additional cash payment of $80,000 (80% of $100,000, the excess of $660,000 over $560,000). The Treasury would receive the remaining $20,000 of the excess.

On the other hand, if the government later sold the security for $550,000, the bank would receive nothing more. The Treasury would absorb a loss of $10,000.

This pricing plan should stimulate more lending by banks since they will immediately have cash on hand, instead of an illiquid toxic asset. Banks will also have the chance to receive more cash in the future if the toxic asset is sold at a price above the initial cash payment. In the interim, the capital certificate will help prevent the bank from becoming insolvent, since it will preserve the bank's capital for regulatory purposes.

The plan should also help banks sell new stock to institutional investors, instead of relying entirely on capital infusions from the Treasury. Institutional investors will not buy a bank's stock if they are worried that it will later announce large write-downs of its toxic assets. Now Treasury would effectively be setting a floor on the price of the asset equal to 80% of its estimated value.

Investors will rely on this floor in buying new stock from the bank. They will heavily discount the potential for payments on the subsequent sale of the asset.

Most importantly, the plan would be good for American citizens. They would benefit from more lending by banks, and more private investment in bank stocks instead of government capital infusions.

By limiting the initial cash payment to 80% of an asset's estimated value, the Treasury would be protecting taxpayers from overpaying in most cases. And the Treasury would periodically earn a commission for taxpayers by selling the toxic asset for more than its initial cash payment to the bank.

This plan would allow the government to remove toxic assets from the balance sheets of banks without having to nationalize or liquidate the banks. Under either of these alternatives, U.S. taxpayers would own all the toxic assets of these banks. Although the method of pricing proposed here is not perfect, it is better than these alternatives.

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