

LET'S EXPLORE THE 'BAD BANK' SOLUTION

What is it and how would it work?

Will setting up a 'bad bank' be a good move for the U.S. economy?

A bad bank, perhaps run by the Federal Deposit Insurance Corp., would take \$1 trillion or more of troubled loans and securities off the books of banks.

However, a bad bank would not eliminate the toughest choices that need to be made. In particular, Treasury Secretary Timothy Geithner, FDIC head Sheila Bair and other regulators would still have to decide which banks are insolvent and need to be closed, partly nationalized, or completely taken over.

The basic outlines of the problem are clear. U.S. commercial banks hold \$3.8 trillion in residential and commercial mortgages, according to Federal Reserve data, plus \$1.1 trillion in mortgage-related securities. That represents more than 50% of banks' total financial assets of \$9 trillion, which means they are highly exposed to the still-plunging real estate market.

A government-owned bad bank would take on a hefty chunk of these troubled securities, including many actual mortgages. The big question, though, is what happens to the private bank that owned the assets. How much money does it get for the bad assets? And does it still exist afterward?

One straightforward solution is for the government to pay more for the bad assets than their current market price, assuming that values will eventually rebound. That's a big gift for bank shareholders and debt holders.

However, this approach could leave taxpayers on the hook, big time. If unemployment and business failures keep rising, (The U.S. Department of Labor dropped a bombshell Friday, reporting that the number of workers receiving unemployment benefits has just hit a new, all-time record high. 125,000 jobs lost in January '09 alone. And thousands of mid-sized and smaller businesses — our nation's largest employers — are also set to hand out record numbers of pink slips) the mortgage-default rate will soar. The troubled assets absorbed by the bad bank will fall in value, and the U.S. government — and by extension, taxpayers — will become the biggest owner of foreclosed real estate in the world.

A cheaper and better way of solving this problem, in my opinion, would be more difficult politically. Regulators can be sent into banks to take a close look at their books and assign a more realistic value to their assets, taking into account that housing prices may not bounce back anytime soon. That would likely produce a larger number of insolvent banks. If a bank is found to be insolvent, the troubled securities and loans would be taken by the government, and its shareholders and debtholders would be partially or fully wiped out. Meanwhile, the remaining depositors and customers would be shifted into a

surviving bank, which would sell its bad assets to the government and get a capital injection.

Such a “pick-and-choose” approach would require smaller taxpayer outlays. It will run into resistance from investors, though, since some shareholders and debtholders will be devastated, while others will do much better. However, this targeted approach is similar to the way that the savings and loan crisis of the 1980s was eventually resolved. The Resolution Trust Corp. – the equivalent to the bad bank – took over insolvent thrifts, paid off insured depositors, and then prepared the banks for sale by stripping out their assets and pumping in fresh cash. Whatever money the RTC raised from selling the bad assets went toward defraying its costs and paying off uninsured depositors.

Of course, today’s crisis is much bigger than the S & L mess. If a huge bank is deemed insolvent, the government may want to operate it for an extended period – in a word, nationalization – before selling it back to private investors. Partial nationalization is possible, too, where the government accepts a majority ownership share in a bank in exchange for the bad assets.

In the end, the virtue of the bad bank is that it makes the situation painfully clear. No matter what we do, it won’t be easy, and it won’t be fun.

BOTTOM LINE: This article further reinforces the fact that great uncertainty exists within the financial/banking industry, and therefore no one can guarantee what will happen when you go to the bank (any bank) and try to get your money out. This is why I continue to stress to you; (1) keep as little money in the bank as absolutely necessary and (2) keep as much money as possible in safe (but low yielding) investments like short-term U S Treasuries.

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