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Scrap the Summers-Geithner plan

By Laurence J. Kotlikoff | April 7, 2009

IT'S ONE thing for the US Treasury Department to overpay banks for their toxic assets on the prayer that bank shareholders will do something besides pocket it - something that will help the economy. It's another thing to set up a complex leveraged auction scheme to surreptitiously make the transfer. And it's yet a third thing to set up a scheme that will lead the banks to overbid for their own toxics to garner even larger windfalls and end up with the toxics still in their hands.

Suppose the government tells the market that it will match dollar for dollar bids to buy a toxic asset called Troubled from Seamy Bank. Absent the subsidy, Troubled would be worth \$1 billion - only 20 percent of its \$5 billion face value. With the subsidy, bidders will offer \$2 billion since their net cost is just \$1 billion, which is Troubled's true value. Seamy Bank's profit from the "sale" equals \$1 billion (the \$2 billion it receives less the \$1 billion it hands over in the form of surrendering title to Troubled.)

But suppose Seamy Bank isn't happy with getting just \$1 billion for free and sets up a special investment vehicle called Rescue Inc. Rescue bids \$5 billion (the assumed maximum bid). It does so by putting up \$2.5 billion of its own money and using \$2.5 billion provided courtesy of Uncle Sam's subsidy.

But where does Rescue get the \$2.5 billion? From Seamy. Seamy gives Rescue \$2.5 billion, but takes in \$5 billion, so its profits are \$2.5 billion. And we the taxpayers are bilked for \$2.5 billion rather than simply \$1 billion.

Since raising its bid doesn't cost it anything, Seamy will bid as much as it can. Troubled can be worth nothing, and Seamy will still bid the maximum \$5 billion and pocket \$2.5 billion.

The real icing on the cake is that Seamy still ends up owning Troubled, but via its subsidiary Rescue. Once Troubled is back on Seamy's books, Seamy can "sell" it again and pocket another \$2.5 billion.

It's possible that some fine print in the plan by Lawrence Summers, director of National Economic Council, and Treasury Secretary Timothy Geithner of the toxic-owning banks would preclude explicit hyper-self-dealing of the type just described. But when there is free money on the ground, people on Wall Street figure out ways to pick it up. What we need is trust and transparency. Those banks that are insolvent based on market values of their assets should be taken over by the FDIC and reorganized. Over time we need to adopt Limited Purpose Banking, which would make all banks, insurers and financial companies operate as pass-through mutual funds, which would never be allowed to gamble at the public's expense.

Under Limited Purpose Banking, banks sell safe as well as risky collections of securities to the public. Banks act as middlemen, connecting lenders with borrowers and investors with savers. Banks never own financial assets, never borrow short to lend long, and are never in a position to fail.

A new government agency - the Federal Financial Authority - would rate, verify, supervise custody, disclose, and clear all securities purchased, held, and sold by LPB mutual funds. The authority would eliminate insider rating, a key cause of our financial mess. S&P, Moody's, etc. could still operate, but the public would have an independent assessment of financial products.

LPB banks would market cash mutual funds, which would only hold cash and be valued at \$1 per share. All other funds would break or exceed the buck. Owners of cash mutual funds would be free to write checks against their holdings. These cash mutual funds would represent the checking accounts under LPB and, since they'd hold a dollar of cash in reserve to back each dollar of deposits, there'd be no need for FDIC insurance and no chance of bank runs.

LPB would include insurance mutual funds. Contributors would get paid off in proportion to the losses they experience. The Summers-Geithner plan needs to be scrapped. Limited Purpose Banking is the right financial fix, and the sooner we implement it, the sooner we'll really recover.

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