

Condemn Bad Assets

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Treasury Secretary Timothy Geithner's rescue proposal on Feb. 10 met with a resounding thud on Wall Street and elsewhere.

There can be any number of explanations, but one glaring deficiency is that the proposal does not actually deal with what seems to be the biggest problem affecting the ability of banks to start lending again: the billions of dollars of mortgages and mortgage-related assets on the banks' books that everyone admits are worth less than their face amount and less than what the banks paid for them, but nobody knows how much less.

The October bailout bill authorized the Treasury Department to buy up those "toxic" assets, but Treasury did not follow that path, in part because there was no ready market or other appropriate pricing mechanism for them.

That valuation problem has not gone away, and if banks can't lend because they fear that their balance sheets may collapse from the toxic assets, it is time to try another approach. The government should be given the power to condemn some substantial portion of those toxic assets, just as it would condemn a toxic chemical waste site—but with a free-market twist that will make the plan more palatable to the banks and other investors and make it a better deal for the taxpayers. As is true whenever the government takes anyone's property, the bank would be entitled to just compensation if the parties could not agree on a price.

Here's how such a plan might work.

A FORCED SALE

Treasury is already authorized to buy these toxic mortgages, but the banks are unwilling to sell them at a price that Treasury is willing to pay. By adding the power of condemnation, Congress can, in effect, force the banks to sell, and as in all condemnation cases, if the parties cannot agree, a court, or perhaps a special administrative agency, will determine the property's value.

If the government thinks that these toxic mortgages, with uncertain valuations, are the bottleneck in the lending process, it surely has the power to buy them up, just as it has the power to buy up parcels of land that would prevent it from expanding the office space for one of its departments.

Condemnation should be a last resort, but the right to condemn can make the other part of the plan much more workable. Thus, Treasury should offer to buy these toxic assets, at what it considers a current reasonable price, but also offer the seller the option of sharing in the "profit" if the asset eventually sells at a higher price.

An example will illustrate how a simplified version would work: Bank X has a package of mortgages that it bought for \$100 million, but many are in default. Because there are a large number of these mortgages, with the borrowers in various stages of payment or default, and the equity in the homes in a wide range of percentages of the amount of the mortgages, it would be enormously time-consuming and perhaps impossible to value the package accurately.

But to get the process moving, Treasury offers \$30 million in cash immediately and agrees to divide equally with the bank any amounts it receives above that figure. The Treasury would then “own” the mortgages and could make adjustments with the borrowers to keep them in their homes if possible, something it has been unable to do so far without owning the loans.

Some borrowers would default, others would keep up the payments, and eventually the process would sort itself out and Treasury could dispose of the loans, either in a package or individually. Assume that Treasury realized \$70 million from its \$30 million purchase: It would then pay half of the \$40 million excess (\$20 million) to the bank that sold it the mortgages several years before.

The 50-50 split is simply one example of how the deal might work. Treasury and the banks should be free to set whatever ratios and other terms they can agree upon for each particular package. Treasury could also agree to a higher initial price, and in exchange the bank would get a smaller percentage of the amount realized—or vice-versa.

In addition, with Treasury then in the market, other investors might come in with competing offers, or perhaps become joint buyers with Treasury, to become the public-private bank that Geithner envisioned. That would limit the risk to taxpayers and would help set a fair market price.

And with some of these assets written down quite a bit, bank regulators may have to find ways to deal with capital requirements because it would then be clear that the amount shown on their books would no longer be supportable. Otherwise, getting rid of toxic assets might solve one problem, but then the lower actual valuation prices for the assets might

make the bank technically insolvent or otherwise unable to make additional loans.

INTO COURT

Some banks may not like Treasury's offer, and for them Treasury would either have to use its power of condemnation or, perhaps more likely, simply buy mortgages from other banks, because the program's success would not require that all toxic mortgages be acquired by the government.

If condemnation were needed, the parties would go to court, possibly under expedited procedures, to argue about the fair value of the particular package, and the court would set that figure. (Such assessments may not be easy, of course, but courts have dealt with complicated valuations before, and they can do so again here.)

Thus, in the end, the bank would be assured of the constitutionally mandated "just compensation," but, if it turned down Treasury's offer, it would lose out on the right to share in the upside gain if the package turned out to be worth more when the economic situation improves.

In all likelihood, the use of condemnation would be relatively rare, but its availability is essential to bringing banks and the government to the table.

There will doubtless be objections to this approach, and many details have to be filled in. But if this concept is not accepted, Congress or the Treasury has to come up with an alternative means to open the market for toxic mortgages. Treasury's call for a "Public-Private Investment Fund" just doesn't do it.

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