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The Baseline Scenario
What happened to the global economy and what we can do about it

To Save The Banks We Must Stand Up To The Bankers

Posted on January 27, 2009 by Simon Johnson | 36 Comments

The Financial Times has just published an op ed by Peter Boone and me, arguing that aggressive bank recapitalization and toxic debt clean-up is essential in the U.S. – and that this can be done with strong protections for taxpayers and without nationalization. The FT did a great job cutting our draft down to fit their print edition (of Tuesday, January 27th); I don't think they took out anything crucial. But, just in case, after the jump is the full article as submitted.

(Note: newspapers usually like to choose their own titles for op eds, and the FT is no exception. But I like their choice and I've used it as the heading for this post.)

If you hid the name of the country and just showed them the numbers, there is no doubt what old IMF hands would say when confronted by the current situation of the United States: nationalize the banking system. The government has already essentially guaranteed the liabilities of the banking system (and no one can risk a Lehman re-run), bank assets at market value must be massively lower than liabilities, and a severe global recession may yet turn into the Greatest Depression.

Nationalization would simplify enormously the job of cleaning up the balance sheets of the banking system, without which no amount of recapitalization can make sense. An asset management company would be constructed for each nationalized bank, and loans and securities could be clearly divided into "definitely good" and "everything else". The arbitrariness of this procedure is not a worry when it all belongs to the government in any case.

The good loans would go into a newly recapitalized bank, where the taxpayer not only holds all the risk (as now) but also gets all the upside. Careful disposal of the bad assets would yield lower losses than feared, although the final net addition to government debt would no doubt be in the standard range for major banking fiascos: between 10% and 20% of GDP.

As soon as you reveal that the country in question is the United States, the advice has to change for three reasons. First, nationalization is an anathema in the U.S. Second, there is good reason for this – the government here really has no track record of running successful business enterprises. Third, most important, think about what would happen if the American political system gets the bit of directed credit between its teeth, with all the lobbying that entails. If you want to end up with the economy of Pakistan, the politics of Ukraine, and the inflation rate of Zimbabwe, bank nationalization is the way to go.

Yet no one other than the government is available to recapitalize the banking system, and without sufficient capital, lending cannot be stabilized and any incipient recovery – based on the fiscal stimulus and the pending large mortgage refinancing program – will be strangled at birth.

The problem is not just pervasive financial and macroeconomic instability, it's the scale of the recapitalization needed to cover the real losses faced by banks – remember Citi and Bank of America required "survival bailouts" and today are valued merely as options. Additional capital is also needed to support the banks' (and everyone else's) desire for higher capitalization in the future. And, with the world economy still deteriorating, we need even more capital as a cushion against the worst case recession scenario.

And these are just the direct recapitalization components. The asset management companies must pay cash for the distressed assets. Buying at current market prices should protect most of the taxpayer investment and is the only approach that will find political support.

Adding these together suggests that the government will need to come up with "working capital" in the region of $3trn-4trn. If things go well, at the end of the day the losses to the taxpayer should be quite limited, with the final cost closer to $1trn. But this requires that the taxpayer gets enough upside participation. How is this possible without receiving common equity which, at today's prices, would imply controlling stakes in the banks (i.e., nationalization)?

We could receive a large amount of nonvoting stock, but a majority silent shareholder is an oxymoron who distorts the incentives of managers towards more bad behavior. And the last thing we need is further political backlash.

The most politically robust solution is to have the government acquire not voting stock but warrants – the option to buy such stock. These warrants would convert to common stock when sold, and a Resolution Trust Corporation-type structure can manage the disposal of these controlling stakes into the hands of private equity investors. New owners would restructure bank operations, fire executives, and break up the banks (particularly if some anti-trust provisions are added).

The sticking point will be banks refusing to sell assets at market value. The regulators need to apply without forbearance their existing rules and principles for proper loan provisioning and for the marking to market of all illiquid assets. We know they can do this in individual cases – NCC, for example, was forced out of business despite seeming well-capitalized by any publicly available measure. It's the big, politically powerful banks that have caught way too many breaks.

The law must be used against both accountants and bank executives who deviate from the rules on capital requirements. This will concentrate the minds of our financial elite. Either they will raise capital privately or the government will provide, but this time on terms favorable to the taxpayer. The banker's lobby, of course, will protest loudly. Good thing we now have a U.S. President who can stand up to them, otherwise we would eventually collapse into nationalization.

By Peter Boone and Simon Johnson

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36 RESPONSES TO "TO SAVE THE BANKS WE MUST STAND UP TO THE BANKERS"

Mike Mayo, CFA | January 27, 2009 at 3:04 am |

An plan for banks:
A plan for banks
We believe regulators exacerbated the cycle on the way up and, in our view, are extending the downside, too. We do not believe regulators should run the banks. Instead they would be more effective if they focused on deposit safety and making sure the banks are not creating systemic risks.
We believe that encouraging banks to lend more to help support the economy is akin to making the same mistake twice – i.e., it was excessive lending that helped cause the loan problem in the first place. At the peak of the bubble a couple of years ago, US banks levered
up with new loans to levels that were the highest in 25 years, at least based on the level of tangible common equity and reserves. In the mortgage space, regulators encouraged lending via government subsidies and lower capital requirements for banks with mortgage assets. In the commercial category, where credit quality is still okay, loans are growing the fastest today but will likely feel the pain soon from what we call a rolling recession by asset class. Also, as a reminder, US bank loans comprise less than 1/3rd of US debt (the rest is in capital markets, with fixed income investors, insurance companies, and other participants),
implying that banks are part of a larger problem.
In our opinion, a better goal for banks would be to reduce their dependency on government
funding. In this approach, the industry could pursue lending opportunities which are prudent,
profitable, and in the interests of shareholders. This, in turn, could at least help encourage more private investment in the sector. In comparison, nationalization of banks is a step backward that would only further serve the types of public policy objectives that have so much hurt the industry over the past decade.
Also, here is an important reminder. There are likely to be many more bank failures to come,
although most of the assets of the industry are concentrated at the top, especially given recent bank mergers. The seven largest US banks now comprise almost 80% of US banking assets, up from 20% two decades ago. In other words, when it comes to policy goals that will be achieved via banks, the reality is that the solution is mostly a matter of getting a few firms to stand on their own.
Thus far, execution of policies by regulators has been inconsistent. In problem bank actions,
sometimes the debt and preferred shareholders were punished, and other times regulators

made the point that they wanted common shareholders to suffer. The unintended result has been to increase dependency of banks on government funding. How does an investor know if an investment in a troubled bank will disappear due to an action by the government?

The average top-25 bank at the end of 3Q08 had regulatory capital ratios about double the regulatory minimum but were nevertheless deemed to require new government capital injections. National City was effectively seized even though it had regulatory capital ratios that exceeded minimum levels by almost three times. If banks can exceed minimum regulatory levels by 2-3 times and still get seized, the issue is with the definition of what constitutes "minimum". Also, banks are unable to fully mark-to-market their loans and have limited ability to take write-downs in excess of expected losses over the next year, especially following SEC decisions in 1998 that made banks pay for loan losses more on a pay-as-yougo basis.

We believe a real solution involves establishing an additional minimum capital ratio that could be added to regulatory minimums so that all regulators and rating agencies could be on the same page. For example, the de facto ratio used today is the tangible common equity ratio (to total tangible assets). If this or another ratio had its minimum level exceeded, bank investors could rest and be reassured that their investment in a bank, whether debt, preferred stock, or common stock, would not be reduced due to regulators.

We agree that banks must be realistic with their asset valuations. Yet, the solution should involve a stretching out of lifetime losses over several years to better match the income stream of a bank. For example, the government could act akin to an insurance company that would charge a fixed annual premium over a number of years in return for coverage of loan losses. For instance, instead of a bank recognizing $20B of losses today, it would pay $3B-$4B a year in insurance premiums over 10 years. This would get expensed annually instead of all upfront, and the protected assets would not require capital set aside against them. The hard part would be setting this premium, but this would be less arbitrary than the inconsistent shuttering of entire financial firms.

Regulatory solutions fail to recognize the likelihood that $1 trillion of new capital will be generated by the banks over the next 6-7 years. In other words, this is the current amount of earnings generated by US banks before credit costs (with a 20% discount) that can cushion potential future losses. Thus, while we expect US loan losses to approach the 3% level from the Great Depression, which would hurt earnings by $200B, the earnings generated on the 97% of loans that are still performing well can offset much of the pain. In other words, too many solutions involve capital reductions for lifetime losses on assets without giving credit for earning over a lifetime or even over a few years which would have a benefit to capital.

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of all upfront, and the protected assets would not require capital set aside against them. The
hard part would be setting this premium, but this would be less arbitrary than the inconsistent shuttering of entire financial firms.
The effect would be similar to increased ownership by the government but without the corporate governance that would go along with it. In other words, the government may end
up with rights to one-fourth or so of future internally generated capital (at least at the problem
banks) but without voting rights, management positions, and the like.
The new US regulatory regime has the potential for a new start. In our opinion, any new efforts that do not address our key concerns, will not be sustainable. Our hope is that new efforts will learn from past actions and move forward in a sustainable direction.

norstadt | January 27, 2009 at 3:15 am |

You didn't mention the uninsured creditors getting a big haircut. Why not? Implementing this proposal would result in a huge and unjustifiable transfer of wealth from tax-payers to bond holders. A lot of this transfer has already happened, with the issuance of new FDIC-backed debt. The banks are simply looting the treasury.

Pawel D. | January 27, 2009 at 4:23 am |

"As soon as you reveal that the country in question is the United States, the advice has to change for three reasons..."

I beg to contend that your reasons for why nationalization should not happen in the US (and is according to you presumably OK elsewhere) are rather lame.

Every government is awful at running companies — this applies to the US just as much as it applies to other countries. Giving politicians influence over direct credit decisions is a dangerous idea in the US and elsewhere.

But this being an imperfect world we sometimes need to to use imperfect tools — Sweden nationalized, and did apparently did it with moderate success.

Pingback: Alea | #Links

garth | January 27, 2009 at 7:26 am |

I wonder whether one of your basic assumptions is correct, ie 'Without sufficient capital, lending cannot be stabilised and any incipient recovery will be strangled at birth.'

That assumption is certainly widely accepted, but following it may just help maintain the position of financial elite and bankers (who are happy to accept public capital and/or public funds buying toxic assets, but may not be rushing to restart lending.

Another approach may be called for, in the current situation where governments are the main players remaining with investible funds.

Governments could use their balance sheets to provide funds for households and business, apply a margin, and then disburse the funds via (some) existing financial institutions distribution channels. Governments could provide guidance to financial institutions regarding credit risks to accept when using government funds. Bank employees whose only alternative, absent such an arrangement or a capital injection, may be redundancy may be quite willing to follow directions.

None of this seems to require capital injection and/or the public purchasing toxic assets in order to get credit flowing again.

Of course, there may be other reasons to inject capital (eg concerns about unemployment and wealth effectsif it was confirmed that certain financial institutions had no future) but it's not obvious that it is necessary to inject public capital to get credit flowing again.

Let's minimise the number of issues governments have to address, and increase the pressure on the private financial sector to bear as much of the pain as possible.

Organic George | January 27, 2009 at 8:53 am |

Even the "Maestro" had to concede that he was shocked that the bankers and brokers did not act in the best interest of the shareholders.

Every day we learn of these same pillars of finance are spending TARP money on, corporate planes, lavish decorations, golfing at St Andrews, etc.

I vote for bureaucrats to take over from these theives, who still live in a bubble that allows them to think they are still a privileged class.

I hope when you cash your check quickly, these guys have a way of not caring about small people like you.

Javier | January 27, 2009 at 9:03 am |

Taking for granted that, as you mention, most of the banks balance sheets are bankrupt... An alternative solution to the ones considered in the post is to wipe off shareholders and subordinated debtors of the balance sheet and exchange all the senior debt for equity. My only doubt here is whether some of the deposits should also be exchanged for equity or not (in some cases I suppose this will be necessary depending on the quality of the assets of the

bank).
1) This way there is no moral hazard problem, the ones that were taking the most risk and profit lose all.
2) Senior debtors take what should be now a healthy bank with only deposits and equity in the right hand side of the balance sheet.
3) Depositors maintain their whealth (or most of it).
4) The bank can start lending again as its capital base has been strongly reinforced.
5) there is no nacionalization.
6) taxpayers do not have to spend a cent on the banks (no crowdign out problem, no budget deficit problem, no debt issuance problem, no problems for the Eurozone unity...)
7) you can implement a new stricter regulatory framework as soon as the capital re-structuration has been implemented, so that banks can raise new debt in the future.

Of course the lossers: shareholders, subordinated lenders and stock option holders will prefer a solution where taxpayers and society in general take the cost or the risk of the capital infusion and subsequent deleveraging. However, I think that my proposal is a fairer solution and it can be implemented quite quickly.

Kong Jie | January 27, 2009 at 9:21 am |

Using warrants seems like a hash. It's like pretending not to own the bank when you actually do. The government either puts in the money and gets the power, or puts in the money and doesn't get the power. Your view is that both options are bad. How does buying warrants help?

Whatever RTCs are formed probably won't be able to sell those warrants for years (unless they sell for a pittance and realise huge losses for the government, i.e. no upside). So if anything, your scenario would be more akin to being a silent majority shareholder. Are the warrants merely an obfuscation to hide from the public the fact that they just paid to own the banks while having zero influence over them and their bad behavior?

I suppose in an ideal world managers would use the time up to the warrants being exercised to buck up, in the hope of keeping their jobs when the new owners arrive. Or they may resign themselves to losing their jobs and keep paying themselves fat bonuses for as long as they can. And incidentally, the lower the price for the warrants, the less likely they will be sold, and the longer the gravy train for the managers will keep running. After seeing what Thain did, one could well imagine this less rosy (for the taxpayer) scenario.

Beezer | January 27, 2009 at 10:28 am |

They're not short cash. They're long illiquid securities. They're insolvent and dysfunctional and they are making the recession worse.

Nationalization allows the illiquid securities to be warehoused without "mark to market." The national bank can lend, there's plenty of treasuries on account at the fed. Meanwhile the warehouse can take its sweet time pricing the illiquid securities. There's plenty of unemployed investment traders around who'd be willing to put up their shingle at the warehouse. Put up a sign saying "Call us in the Spring."

Forming a "bad bank," without nationalization means the taxpyer's going to get numbed with another hundreds of billions of dollars in nominal debt put on the bailout figures –even though no one has a clue as to what these illiquid securities are worth, in reality.

This big addition to the nominal bailout, or fiscal stimulus number, is a huge political negative for the Obama administration. It will cripple other investments that are way more important than forming a "bad bank" marked to market which is, in truth, simply a wealth transfer from taxpayers to bank bondholders.

The first time a nationalized banker says "no" to an investment banker looking to leverage his money 30:1 is the first magnificent improvement in banking. Long overdue.

Linus Wilson | January 27, 2009 at 12:42 pm |

I think much of what is said by Mr. Boone and Mr. Johnson is supported by my coauthor and my paper "Common (Stock) Sense about Risk-Shifting and Bank Bailouts" at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321666. In short, it says that if the government buys common stock instead of preferred stock, this much more effective in curing lending incentives. Taking the toxic mortgages of banks books is also very effective. Yet, our research shows that the bailed out banks will not volunteer to sell stock or toxic mortgages at fair market values. (This is because reducing the variance of the stock price reduces the value of current stockholders claims.) It is an open question if the government has the political will to force banks to sell common equity, warrants, or toxic assets at fair market prices. Thus, we may have to settle for a second-best bailout where the government subsidizes the big banks by overpaying for common stock or toxic assets. Further, our paper shows that if bailouts with large price tags in terms of the initial amount paid for the securities are a hard sell, common stock gives taxpayers more bang for their buck than buying toxic assets.

Blair Cherry | January 27, 2009 at 4:07 pm |

You gentlemen failed to look at President Obama's contributor lists. Take a look at the top ten contributing institutions and you will find the big banks very well represented. I doubt that we can rely upon him to stand up to the bankers.

Right now it appears that his economics team came from much the same places that Bush's and Clinton's did.

I would be reluctant to rely on him to do much different than they did.

I strongly suspect that the bankers will win and the taxpayers will lose when this is ultimately settled.

Stefan | January 27, 2009 at 4:34 pm |

Your scheme sounds complicated.

The key points are:
– Write-down of assets to realistic levels
– Wipe-out of existing equity
– Replacement of top management

Anything less is monkey business.

Jessica | January 27, 2009 at 10:14 pm |

I tend to follow Mr. Cherry's line of reasoning. Has anyone glimpsed The American Recovery and Reinvestment Act of 2009 aka "the stimulus package?" If the plans to save our financial system follow a similar path, I fear our only hope is to convince Simon Johnson to publish his final Economic Crisis lecture which he refused to videotape. The "doomsday" lecture may hold the key to our survival. How does one prepare for the "Greatest Depression" should well be the topic for lecture no. 6.

PB | January 28, 2009 at 3:05 am |

Interesting and insightful as usual but you made my day with the comment "If you want to end up with the economy of Pakistan, the politics of Ukraine and the inflation rate of Zimbabwe, bank nationalisation is the way to go."…..great line! Thanks

Mark Gay | January 28, 2009 at 6:41 am |

As I wrote in the linked article, in unapologetically simplified terms for a popular audience (they, after all, will pay the bill for all this) the bank bailout risks default.

The opportunity cost of the bailout is money that could be lent directly that is instead being sucked out of the economy, plus the burden on future productivity.

The banks are not on-lending. The recapitalization of their vaults is, on the evidence so far, money pumped into the walking dead.

The claim that government stakes in the banks will one day be worth something rests on uncertainty. The cost of the money that is diverted into a dead end, is very certainly real.

On these terms bankruptcy would be preferable to nationalization.

http://www.russiatoday.com/business/news/36229

Samihah | January 28, 2009 at 7:04 am |

I find it ironic that as China continues to move towards capitalism, we're moving more towards socialism by getting the government involved, and effectively, partially nationalizing banks. I understand why it was done–primarily to keep banks from failing. But the bailout was done in haste and should have had many more stipulations attached to it to protect tax payers–and to keep this from happening again. By bailing these banks out, we've essentially given them a free pass for the mistakes they have made–who's to say it won't happen again?

Stefan | January 28, 2009 at 7:53 am |

TRUST, SQUARE-DEALING, and RESPONSIBILITY

These are the only technical fixes that can restore health to our banking system.

George Lordos, Sloan MBA 2000 | January 28, 2009 at 7:59 am |

Prof. Johnson,

I think a form of government-managed reorganization for insolvent banks is an option that would avoid all three of the disadvantages of nationalization in the U.S. case because the banks would not stay under the official receiver's control (i.e. government control) for any length of time.

New legislation specific to this exercise might be required to streamline the process. The salient parts, in my opinion, would then have to be:

1) Government-appointed auditors sweep through all banks and conservatively mark their assets to market. Undercapitalized banks are given time to recapitalize privately. If they remain insolvent, the equity is at zero anyway, and they come inside the tent of the government cleanup program in the same way a bankrupt company falls under the "ownership" of the official receiver.

2) Banks in the cleanup program have their assets sorted into good and bad, as per your definition above. The bad assets go to a government-owned RTC-type aggregator or asset manager. The good assets stay with the bank. We now have a stable of healthy banks ready to be immediately privatized and a "big bad bank" which will slowly sell off the assets to minimize the loss.

3) The government immediately auctions off warrants for up to 80% of each cleaned-up bank to new private owners. When the warrants are exercised, the bank receives capital and issues shares to its new private owners. Alternatively, or at the same time, the government gifts a fixed number of warrants to each and every U.S. taxpayer and allows for trading of the warrants before these warrants mature and must be exercised for capital in the bank. The other 20% of each cleaned-up bank's shares is non-voting and is held by the RTC for upside participation (it should also have preferential rights for dividends).

4) The end result is cleaned-up banks with new owners and new management, with all the bad assets in a RTC which also owns a minority stake in each bank. This minority stake will generate future cash flows from the banking system to help pay for the past mess caused by the banking system.

5) If the goodwill of foreign investors who stepped up to the rescue of U.S. banks within the last 12 months is desired, they can be made whole during the bad bank / good bank stage and then given the right to buy warrants before the auction stage. After all, much of the world's surpluses are overseas.

Like your title says, to save the banking system you have to stand up to the bankers.

How does this sound?

George Lordos, Sloan MBA 2000 | January 29, 2009 at 1:06 am |

Just a clarification on my post above – if it is really the case that only government capital is up to the massive task of recapitalizing the banks, then the individual taxpayer can act as the underwriter of the transaction.

In other words, each taxpayer receives a gift of an equal share of the unsold warrants, and the government pays the capital in the banks when the taxpayer exercises his warrant. So in one stroke the banks are capitalized and a massive one-time tax rebate goes to repair household balance sheets. At the expense of a massive one-time jump in federal debt, of course. No free lunches.

Politically it makes all the sense in the world, Wall Street caused a global recession because of its greed and collective foolishness, so the ownership of the banks passes to the American taxpayers who will elect new boards and management to make sure this doesn't happen again. It's not nationalization, it is bankruptcy and transfer to the ownership of the largest creditor – the American taxpayer.

Per Kurowski | January 29, 2009 at 11:36 am |

Desperation is indeed a bad counsel

Sir Peter Boone and Simon Johnson make a proposal for how to re-privatise the de-facto nationalized banks by means of the government receiving and selling warrants which would allow new private equity and shareholders to step in at a more reasonable fiscal cost. To save the banks we must stand up to the bankers, January 27.

That could be, though I remember that one of the reason for the reasonably successful Chilean recovery after their bank crisis was that the old shareholders were given a repurchase option, at a price that compensated the government, and of which I know many have already been executed.

What I do take exception from is when they express that one of the problems is that the banks would refuse to sell their assets and so "the regulators need to apply without forbearance their existing rules and principles for the marking to market of all illiquid assets. The law must be used against accountants and bank executives who deviate from the rules on capital requirement." Are they going berserk? Desperation is clearly a bad counsel. Their intention sounds like forcing everyone who owes more on a house than what it is worth to have to walk away from it even if he is willing to stay. Besides, what does market value really signify when markets do not exist?

Actually the truth is that to save our banks we must first stand up to our financial regulators and who are, without doubt, the first to blame for this crisis. You do not believe it? Go to http://www.theaaa-bomb.blogspot.com/

Zuriel Shiv | January 30, 2009 at 9:49 am |

Losses of this magnitude should be shared by all, including creditors, but short of bankcruptcy or full nationalization, this is not possible – that is, only shareholders and taxpayers will have to foot the bill.

My propsal is a long term agreement of toxic assets purchase:
Pay an absolute minimum for the toxic assets;
Gaurantee the ensuing shortfall;
Let the existing shareholders share the profits of subsequent sale of the toxic assets;
Ownership will be determined by the end of the long terrm agreement.

As can be seen below, the catch for shareholders is that the lower the purchase price the government pays for their toxic assets, the higher their chance of recouping some of their investment.
In other words, if the present owners feel that the price was too low, future sale would compensate them.

Here it is in (very) broad lines:

1. Assets will be purchased by the government at, say, 20% of their book value. Let the amount paid be called "the principal".

2. Shareholders' equity prior to the transaction will be adjusted (i.e., reduced) by an amount equal to the difference between the book value of the purchased assets and the "the principal".

3. By purchasing the assets, the government will provisionally own a share in the bank, reflecting the proportion between "the principal" and the shareholders' adjusted equity.

4. Had the bank's liabilities exceeded its assets as a result of said adjustment, the government will guarantee the excess amount.

4. The purchased assets will be kept in trust by the bank's managers, their task being to reduce "the principal" during the agreement's period by selling the assets at a maximum possible gain for the government.

5. Whatever remains of "the principal" by the end of the agreement's period will constitute the government's share in the bank, as per formula that forms part of the purchasing agreement. The government's share could then be sold to private investors.

6. If by the end of the period, or sooner, "the (whole) principal" would have been sold at a profit, the private shareholders will be sharing the profit.

Zuriel Shiv

Robert Hedinger | January 31, 2009 at 8:55 pm |

Instead of looking at the problem from the top down (saving financial intuitions) look at it from the bottom up (saving homes and families). I just don't believe that trickle down economics will work for the nation's current financial problems.

A proposed Housing Crisis Solution:

Suppose you bought a home that is your primary residence and its market value has decreased to a value that is less than 120% of your current mortgage.

You have three options:

1. You can retain 100% equity in your home and continue with your current mortgage payments.
2. If you can qualify financially for a reduced mortgage, you can sell a fractional ownership of your home to a quasi-government agency and pay down your mortgage with this equity investment,
3. If you can not qualify financially for a reduced mortgage, you can sell 100% of the equity in your home to a quasi-government agency for the outstanding mortgage value and rent it back for the current market rate.

When the home is eventually sold, the quasi-government agency would share in any capital gain in proportion to its equity interest.

The quasi-government agency could then go the financial markets and sell shares in the equity they hold in these homes.

Examples:

Example 1 Example 2 Example 3 Rental
Original Cost $338,000 $338,000 $338,000
Current Mortgage $270,000 $338,000 $338,000
Current Market Value $240,000 $240,000 $240,000
Current Mortgage Payment $1600/mo $2000/mo $2000/mo
120% of Mortgage $324,000 $405,000 $405,000
80% of CMV $192,000 $192,000 $192,000
Equity sale to Government $ 78,000 $146,000 $338,000
Equity Interest of Government 28.9% 43.2% 100%
New Mortgage Payment @6% $1138/mo $1138/mo $1138/mo Rent

An additional option is to have the Mortgage Holder/Bank take less than 100% of the Mortgage value and/or finance the new mortgage at a significantly lower rate.

Pingback: Rahm's Doctrine And Breaking Up The Banks « The Baseline Scenario

HSG at MIT | February 4, 2009 at 10:35 pm |

I thought this was a nice artice that peripherally talks to some of issues you raise with the current incentives of bankers. I'm not sure if firing them all is the way to go–but its interesting to ponder! http://www.economist.com/surveys/displaystory.cfm?story_id=12957761&fsrc=rss

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John Kirkman | February 24, 2009 at 7:10 am |

(1) Wouldn't it be simpler to have the troubled banks just declare, or be forced to declare, bankruptcy under existing law? (2) Boone and Johnson are very eagar to direct the shareholders to bankruptcy;who are these shareholders to excite such animosity? (3) Where were all of these economists and their supposed wisdom when this financial mess was building? (4) Is Sheila Bair the only individual on any side of this discussion who sees clearly the tragedy of the people falling by the wayside?

Pingback: The Bernanke rally | 1800blogger

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