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Study Suggests Buying Toxic Assets Could Work

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Chip Somodevilla

On Nov. 18, U.S. Treasury Secretary Henry Paulson told Congress the financial crisis has changed since lawmakers passed the \$700 billion bailout plan.

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All Things Considered, November 18, 2008 · When U.S. Treasury Secretary Henry Paulson first announced the plan for saving the American economy, it called for using \$700 billion to buy up so-called toxic assets. The idea was for the government to remove the mortgage-backed securities that were sinking banks' balance sheets.

That got one pair of economists very excited. Larry Ausubel and Peter Cramton of the University of Maryland knew just how to carry out Paulson's plan — with an approach known as a reverse auction. Ausubel and Cramton had run these auctions before, and on a large scale. They began working on a plan with officials at the Treasury Department.

Then Paulson changed his strategy, deciding instead to buy stocks directly in banks. Ausubel wasn't happy with the move toward these capital injections.

"Instead of conducting transparent auctions, the Treasury is going to instead distribute suitcases of cash," he says.

But Ausubel and Cramton have not given up hope. With a new administration coming in, they think buying up toxic assets remains a smart and viable choice.

Last month, they did a dry run of an auction, with graduate students playing the role of banks. The students sat in what looked like a boardroom. The set came complete with a long table, wood paneling and forest green leather chairs.

"What we're going to do is go over the instructions, which I just e-mailed to you about an hour before you arrived," Cramton began.

Each student would represent a single bank that owned toxic mortgage-backed securities. The students' goal would be to sell those toxic assets to the government for as much money as possible. Meanwhile, the government hoped the auction would set a fair price, so taxpayers wouldn't get a raw deal.

And there would be real money at stake. If the students played well, each could earn something like \$100 per day, or \$13,000 overall.

As the students faced their computers, Ausubel explained that the software was the real deal. It had facilitated actual auctions. "I think this year, it has been used for approximately \$5 billion of auctions —

electricity, natural gas," he told them. "And some rough diamonds."

In this auction, the banks compete to sell their toxic assets. They place bids for selling prices. One student might offer the government a mortgage-backed security for 60 cents. Another might say, "Wait — I'll sell it to you for 55 cents." It's a reverse auction because the bidding drives prices down instead of up.

The students looked over information about their bank's finances and talked about strategy. Quickly, some of them were peeking over at their neighbors' computer screens.

"We're actually talking about colluding right now," Kahwa Douoguih said. "We're trying to, you know, base our strategy on that extra information."

She didn't exactly consider that cheating. "We're just seeing how easy — or not — it is," she explained.

This was all part of the experiment. If the students could find a way to game the system, then so would the banks in the real world. If the students found a flaw, or if the auction didn't work as designed, this experiment could become very expensive for the university. It might have to pay the students much more than the intended \$13,000.

A few weeks later, Cramton looked over the final result. "I got it right here on the computer," he said. "We also had expenses for coffee bagels and snacks, other things. But the subject expense alone was \$12,855.03." That's a bull's-eye, in budget terms. No one found a way to cheat. The auction was a success. The banks traded their toxic assets for solid capital, and the taxpayers got a fair deal.

Cramton thinks the auction is the most equitable way to distribute the bailout money. Under Paulson's new plan, the government is buying stocks in banks. But its decisions about which banks to save are happening largely in secret. "It really is moving down the path of crony capitalism, in my mind, where the government is picking winners and losers in a nontransparent way," he says. "And furthermore, the new plan does little to remove the toxic securities from the balance sheets of the bank, which is the basic problem."

The Treasury Department's hope is that by shoring up the banks, it won't matter that they're holding toxic securities on their books. In any case, Paulson told NPR last week that buying up the securities would take too long and that he'd need more than \$700 billion to buy up enough of them.

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2/3


