Paulson, Bernanke Describe Mechanics of Auction Proposal

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WASHINGTON—Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke labored Tuesday to describe the mechanics of an auction in which the government would buy as much as $700 billion of assets from financial institutions—a plan raising questions ranging from the prices taxpayers will pay for the assets to potential conflicts of interest among the asset managers the Treasury plans to hire.

At a five-hour Senate Banking Committee hearing, skeptical senators pressed Messrs. Paulson and Bernanke for details, and the two officials pleaded for maximum flexibility. Mr. Bernanke, early in the hearing, distinguished between what he called fire-sale prices—which he defined as "the price a security would fetch today if sold quickly into an illiquid market"—and a hold-to-maturity price, or the value of a loan if the borrower eventually pays it off.

"If the Treasury bids for and then buys assets at a price close to the hold-to-maturity price," he said, "there will be substantial benefits."

That produced speculation that Mr. Bernanke was advocating the purchase of assets at prices other than market-determined values, a development that could benefit banks at the expense of taxpayers. In answering subsequent questions, however, Messrs. Bernanke and Paulson appeared to indicate otherwise, arguing—in effect—that a well-designed auction process would lift the market prices of the assets above today's fire-sale values by restoring liquidity.

Establishing those new prices in the market would be a big plus. "Where there is some value that the market can look at, then private capital will come in," Mr. Paulson said.

"The holders have a view of what they think it [the asset] is worth. It's hard for outsiders to know," Mr. Bernanke said. The point of an auction is to reveal those prices. "If you have an appropriate auction mechanism... what you'll do is restart this market," Mr. Bernanke added. "Just as when you sell a painting at Sotheby's, nobody knows what it's worth until the auction is over," he said.

The two men vowed to consult outside experts to design an auction mechanism that would minimize the cost to taxpayers and encourage financial institutions to compete to *reduce* the prices at which they offer to sell.

Under one scenario being discussed, Treasury would put out a list of specific securities it is willing to buy and would hold auctions for a preannounced quantity of each security or class of security. Holders of securities who wanted to sell them would compete with one another to offer them to Treasury at attractive—that is, lower—prices. Treasury would rank the bids from cheapest to highest and buy as many as it seeks at the cheapest price.

"This is not going to be a normal auction, because the Treasury is going to be there with a $700 billion checkbook," said Sen. Bob Bennett (R., Utah).

If the prices set in the auction are very low, financial institutions that hold those securities—both those selling at the auction and those that aren't—may have to take deeper write-downs than they have already, an unwelcome prospect at a moment of financial fragility. But if the prices are high, then banks are benefiting at taxpayer expense.

One concern raised by members of Congress and others is the potential conflicts of interest among the asset managers who would be hired to run the program. Some critics worry that the program would create incentives for asset managers—or a future Treasury secretary—to benefit institutions with which they have financial or personal ties.

"To the extent that any of the people that they hire or institutions they hire have clients or affiliates that are on the buy side or the sell side of these same assets, there is huge potential for conflict," said Cornelius Hurley, director of Boston University's Morin Center for Banking and Financial Law.

Senate Banking Committee Chairman Christopher Dodd (D., Conn.) has suggested giving a role in the management of these assets to the Federal Deposit Insurance Corp., which manages and disposes of assets it takes on after bank failures. Mr. Dodd said the FDIC has experience dealing with many of the issues that asset managers for Treasury's potential program might face. FDIC Chairman Sheila Bair has been in close talks with policy makers in recent days, but it is unclear what role her agency might play, if any. She was unavailable for comment Tuesday.

Treasury plans to solicit bids from asset managers with experience in handling large portfolios—managers who likely have related assets already in their portfolios. That could create a conflict, as the manager would essentially be using the government's money to buy and sell assets in which it has a financial stake.

Another wrinkle, says Douglas Elmendorf of the Brookings Institution, a former Treasury official, is that many of the assets are highly concentrated in one or two financial institutions. Choosing to buy certain assets could benefit an individual bank, essentially giving the asset managers—and the Treasury secretary—the ability to reward individual firms.

Mr. Paulson said he was "very conscious" of potential issues regarding conflicts of interest. "We have procedures that are designed to mitigate against conflicts, but we need to move very quickly here, so we can't go through all the normal processes or it won't work for the markets," he told the Senate committee.

Mr. Paulson said Treasury is expected to buy assets in phases, but asked that Congress give him the authority to pull the full amount, so he or his successor wouldn't have to come back to Congress for more authority, a prospect that would reduce the initiative's chances of stabilizing markets.

The Treasury secretary, while offering few details, said Treasury probably would begin with simpler assets, such as mortgage-backed securities, and then move to collateralized-debt obligations and other more-complex securities.

There is precedent for government officials to hire financial firms as portfolio managers. The Federal Reserve Bank of New York hired BlackRock Financial Management to manage the $30 billion portfolio of assets it took from Bear Stearns Cos. in order to induce J. P. Morgan Chase & Co. to buy the investment bank. The New York Fed has released few details of its arrangement with BlackRock.