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Geithner's Troubling Plan for Troubled Assets

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Over a month after formally announcing the plan, Treasury Secretary Timothy Geithner yesterday released details on his proposal for removing toxic assets from the balance sheets of banks and other financial institutions.

The keystone of the program is the "Public-Private Investment Program" (PPIP), through which these so-called "toxic" or "legacy" assets would be taken off the books of financial institutions. In the wake of the announcement, the stock markets soared, grateful that the Administration was finally clearing up the uncertainty as to its intentions. Substantively, however, while the plan does have positive elements, it is significantly flawed. Just as important, Secretary Geithner has not demonstrated the need for such government intervention.

From TARP to PPIP. The proposal is but the latest in a series of initiatives dating back to last fall to address the problem of toxic assets, the securities and loans held by financial institutions whose value is uncertain in the wake of the financial crisis. Last fall, then-Treasury Secretary Hank Paulson proposed that the federal government purchase such assets directly. This plan was soon abandoned, however, due largely to the problem of determining how much the government should pay for those assets.

Earlier this year, the Obama Administration was reportedly considering a "bad bank" approach, under which toxic assets would be aggregated in a government-owned and -managed bank created for that purpose, thus isolating the assets until they could be sold and leaving banks with clean balance sheets. This plan, however, still offered no way of valuing assets.

The current approach was publicly announced by Secretary Geithner last month.[1] Essentially, the idea is to use federal funds to facilitate the purchase of toxic (or what Treasury now calls "legacy") assets by public-private investment groups, which would bid against each other for the assets. Yesterday's announcement provided details for how this approach would work.

For "legacy" loans, private investors would provide 1/14 (about 7 percent) of the partnership's total assets, matched by another 1/14 provided by the Federal Deposit Insurance Corporation. The remaining amount (6/7 of the total, or about 85 percent) would be covered by guaranteed loans provided by FDIC. For "legacy "securities (as opposed to loans), up to five fund managers pre-qualified by the Treasury Department would raise private capital that would be matched dollar-for-dollar by the government. Treasury would also provide loans to enable the partnership to purchase even more assets.

In both cases, while the government would share profits equally with the private-sector partner, taxpayers bear most of the risk of losses. In other words,

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the private-sector partner cannot lose more than its investment. Any further losses after the private capital is gone would be covered by the taxpayers.

To its credit, this approach involves the private sector in making the investments necessary to address the toxic asset problem. And by allowing competitive bidding, some approximation of a market could be made.

That said, however, the plan still suffers from a number of flaws:

- *Risk of uncertainty transferred, not eliminated.* The main goal of the program is to discover the market price of these assets and to restart the market in them. The plan does a better job at this than prior proposals, using bidding by private investors to determine sale prices. However, much of the valuation will be affected by the government participation and guarantees against losses. In effect, a major portion of the uncertainty as to value is shifted to the taxpayer rather than eliminated.
- *Government entanglement in management.* The plan will almost inevitably lead to even more expanded government micro-management of financial firms. Recent history with the TARP program shows that participants in PPIP can expect controls—sometimes retroactive—over compensation and other management decisions. It is hard to imagine a hedge fund or other investment group enjoying profits under this program without some level of federal restrictions accompanying the deal or following soon thereafter. It is equally possible that if profits exceed some unspecified percentage, there will be an effort to "recapture" them.
- *Lack of participation.* The prospect of such restrictions may very well deter many potential private sector investors from participation in the PPIP program at all in order to avoid federal interference in their business operations. Already several banks either have decided to return TARP money or are considering returning it for these reasons, and initial participation in other programs has been less than anticipated for the same reason.
- *Problems of complexity.* The process both for setting up partnerships and for purchasing assets or loans is extremely complex, necessitating identification of qualified assets, selection of approved fund managers for securities, establishment of bidding rules, conflict of interest rules, and a host of other actions. Although the government predicts that the first transactions could begin in about a month or so, recent experience suggests such a timetable is highly optimistic to say the least. More worrisome, with so many moving parts, the chances of error or poor oversight are substantial, and they only grow if the program is implemented too quickly.

Is It Really Necessary? The American public has justifiably grown skeptical of interventions that create more problems than they solve, entangling the federal government in the management of private-sector businesses. And they have good reason to be skeptical of this plan as well. Since this plan was originally announced, Secretary Geithner has argued that, despite its massive cost and certain flaws, the plan is necessary to avoid a complete collapse of the American financial system. Certainly the banking system is still quite fragile, and for this reason the Administration should be very alert to conditions and ready to respond as appropriate.

However, there is not an imminent threat of a collapse. On the whole, financial markets are impaired but functioning. Indeed, many of these "toxic" assets are still performing despite problems in housing and other markets. Given the dangers of market intervention of this kind—not only to taxpayers in the form of massive costs but potentially to the financial markets themselves—actions such as the PPIP program should be a last resort, engaged in only when absolutely necessary. That standard has not been met.

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1. See David C. John and James L. Gattuso, "Obama's Bank Bailout Plan: Not Ready for Prime Time," Heritage Foundation *WebMemo* No. 2291, February 12, 2009, at *http://www.heritage.org/Research/Economy/wm2291.cfm.*

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