



PPIP-the 'crony capitalist' solution to toxic asset pricing

Nobel laureate Joe Stiglitz has pointed out what any financial economist must have realized when the PPIP plan was announced by the Treasury Secretary. ("Obama's Ersatz Capitalism," NY Times 4/1/09).¹ Private investors are being given a chance to purchase toxic assets with a downside guarantee on the value of the assets purchased. Therefore, it is essentially an option on the value of the toxic assets coupled to significant government financing with downside protection except for the initial investor equity slice. Taxpayers, who will ultimately fund this process, should hope that Real Estate prices start rising and continue to rise because there are indeed real risks that the taxpayers could wind up losers. Stiglitz's analysis, however, leaves out some critical points, the most important of which is how the price of the option will be determined. (He terms it a call---the cost of which is the investor's initial stake---but others term it a put in that the investor can put back the financed stake to the Government. The precise designation is not critical. What is critical is the limitation on the investor loss coupled with unlimited upside). The way this game is currently structured, it will be a 'crony capitalist' model of pricing. Why?

The PPIP plan announced by the Treasury seems to imply that a public auction process will allow demand and supply of a given set of toxic assets to be equated. In theory that could occur, but straight-forward public auctions may not result in satisfying **all** the Government's objectives. Without a great deal of trial and error, the sellers (presumably banks), will have to determine which toxics to sell considering the impact such sales will have on their balance sheets. However, the Government wants to get the banks to lend again and that means that sales of the toxic assets need to cause replacement of 'dead' capital with real cash as well as an acceptable level of capital, acceptable that is to the Government who is currently stress testing these banks). Different banks will treat valuations differently. What counts are the marks an individual offering bank has given to its to-be-sold toxic assets in comparison with what it will receive at the auction. Further, there may be further implications for balance sheet valuation from any "first" sale on the remaining toxic assets that remain on a bank's balance sheet.

An "acceptable" level of capital (alternatively an acceptable level of leverage) is subjective. Now that we have "too big to fail" (TBTF) banks, what is acceptable is what the Government regulators say is acceptable. Will the sale of toxic assets produce sufficient capital? That depends heavily on where the TBTF banks are currently marking these assets. Sales above their 'marks' result in fresh cash and improvement in the balance sheet. Sales below will result in write downs and, therefore, a lower level of "acceptable" capital. Notice that the Government is not only going to be a "partner on the buy side, but it is also a partner on the sell side due to its decision to allow TBTF banks. Which objective counts more? Unfortunately, the Government is trying to serve more than one master. It must not only try to keep the TBTF banks in business, but it must create a "sale" that will be attractive to the putative buyers, the private partner "buyers" of these toxic assets. To make it simple, forget the variety of toxic assets and for the moment ignore the Stiglitz contention that the auction will be subject to adverse selection: namely the bank will likely want to sell the worst toxics in its portfolio.

The Government has to insure that the result of the auction leaves the selling bank viable. Can Government do that and at the same time attract buyers of these options? If the auction process had reserve pricing and the Government could re-open the auctions, maybe buyers would finally step up to the plate at prices that were "acceptable" after repeated rounds. Maybe not. At lower prices that would attract buyers, it is

¹ It was published on April Fools Day. The "fool" in this story is not clear!



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quite likely that an auction will result in a big hole in the TBTF bank balance sheets. That leaves the Government in the unenviable position of having to repair the implied capital deficiency. Additionally, the Government must worry how it will do its capital repair. Remember that these TBTF banks are widely held by many pension funds. Does the Government wish to wipe out all the holders of the common stock of these large financials through dilution?

What about the “stress testing” that is now going on at the banks? Clearly, the examiners are concerned with the issue of capital adequacy. They have to determine how vulnerable the banks are now to further deterioration of loans and various mortgage related assets, and they are also asking what the impact on bank balance sheets will be if these toxic assets are sold off at various, hypothetical prices. That may explain why the market has heard nothing of the results of these stress tests. Is it possible that Government is thinking to supply long term debt instead of preferred or common to the banks to fill the hole in bank balance sheets that would result from a low value auction price? That would make the existing common holders happy, but it will leave the taxpayer holding more risk.

Undoubtedly there is some discussion going on with potential asset management companies as to what these asset managers think the “values” ought to be. If the Government wants successful auctions, it is now in the middle of trying to resolve the disparate interests of buyers, sellers and taxpayers. That's what scuttled Paulsen's initial plan. He couldn't do it. What has changed that makes it feasible now? Little.

Without a market testing process, there is no way to arrive at a well founded calculation of winners and losers. The Government has already decided that whatever the outcome, the TBTF banks are not going to fail, and the Government certainly is conscious that the common of such banks appears in many, many investor portfolios. PPIP partners will certainly try to cherry pick the inventory of toxics to avoid the adverse selection problem, but taken in conjunction with the Government's desire to have these banks survive, it argues that Government will have a hand not only in the pricing, but in the composition of the portfolios of toxics offered up for sale. Government is, therefore, involved in the composition, the offer prices that are “acceptable” and the buying prices that will produce new buyers. Talk about a recipe for “Crony Capitalism!”

Government cannot have an open auction with thousands of buyers and still secure its diverse objectives. It must have a small number of buyers and the TBTF banks must likewise be sellers. How else to purge their balance sheets and revive lending? This is outcome pricing not market determined pricing.

The Treasury Secretary has already told the public that remaining TARP funds will be used to capitalize this process, and equally, that he will go back to Congress to seek funds if more funds are needed. Surely, in the context of the emerging and large funding requests that are coming down the pike, this is not an auspicious setting for further Congressional funding of the TARP or TARP-like procedures. Asking Congress for more funds means transparency and transparency is not good for negotiations between a small number of buyers and sellers with the Government in the middle. This is a dilemma that Stiglitz did not touch.

The bottom line is that the only way that this is a win-win-win strategy for banks, for PPIP participants and for the taxpayer is that the Real Estate market rises from the dead and keeps going upward. If all of us knew that, all of us could be PPIP buyers! But that would be market capitalism and that isn't very likely to be created under this program.