How to Avoid Overpaying for Toxic Assets

By LUCIAN BEBCHUK

The pricing of troubled assets has been a key sticking point in the Treasury Department’s plan to work with private investors to get the assets off banks’ balance sheets. Lucian Bebchuk, professor of law, economics, and finance and director of the corporate governance program at Harvard University Law School, says investors don’t have to overpay for the assets. This op-ed is based on his white paper, “Buying Troubled Assets.”

Opponents of the administration’s current plan for buying troubled assets — including Joseph Stiglitz, Jeffrey Sachs and Peyton Young — strongly criticize it for providing private parties with highly skewed incentives to overpay for such assets at taxpayers’ expense. This problem, however, isn’t fatal. It can be fixed, and fixing it would do a great deal both to increase the plan’s benefits and reduce its costs.

Under the plan’s current design, the private side — the manager and the private investors affiliated with it — will contribute as little as 8% of the capital of funds set under the program, with the rest funded by the Treasury and Fed. In return for this 8% of capital, the private side will get 50% of the upside but bear half of the downside only up to 16% of the fund’s capital. Such asymmetric payoffs would provide powerful incentives to seek assets with volatile value and overpay for them.

While such overpaying would be consistent with the private manager’s interests, it would impose losses — which could well exceed the private side’s profits — on the public capital participating in the funds. Moreover, the overpaying would undermine one of the plan’s main objectives — to produce market prices providing reliable information about the value of troubled assets still remaining on banks’ books.

Rather than getting skewed payoffs, with the resulting large distortions, the private side should receive payoffs that parallel those of the public capital invested in the funds. To this end, the private side should get a specified fixed percentage of the fund’s final value, both on the upside and the downside. To the extent that the public capital comes in both equity and debt forms, the private side should also participate in debt and equity in the same proportions as the public capital.
But isn’t the partial insulation of the private side from downside risks necessary to attract private capital? Not at all. Even if the private side needs to receive somewhat favorable terms to participate, such a “subsidy” can be given in a form that would not distort subsequent incentives.

Suppose that the government wishes to stick with having the private side contribute 8% of the fund’s capital. Rather than entice the private side with unequal shares of the upside and the downside, the private side could be given a percentage of the fund’s final value that exceeds 8%. If the private side gets, say, 12% of the fund’s value for its investment of 8% of the initial capital, the extra 4% would represent a subsidy meant to induce the private side’s participation and management of the fund. Unlike under the administration’s current design, however, once the private side is in, it will have incentives aligned with those of taxpayers.

The private side’s fixed share, and hence the size of the subsidy, can be determined through a competitive process that would ensure that the level of subsidy will be kept at a minimum. Potential private manager will submit bids indicating the minimum fraction of the fund’s value that would accept in return for contributing 8% of a fund’s initial capital, as well as the size of the fund they would establish if admitted. The government will then set the private side’s fixed share of payoffs in funds set under the program at the lowest level that would be consistent with establishing funds that collectively have the aggregate target capital.

Note that, under the proposed approach, the government would be getting a much higher share of the upside than the 50% under the administration’s design. Even more important, taxpayers will benefit from the improved incentives to maximize the value of the funds in which taxpayers will be so heavily invested.

It might be argued that, even though the proposed fix would eliminate incentives to overpay for troubled assets, such overpaying is what the administration seeks in order to bolster banks’ capital. But overpaying, which can be easily avoided by the proposed design, shouldn’t be a goal of the program. The government should inject capital only in those banks that need it and to do so in exchange for securities — not confer a benefit without consideration on all banks holding troubled assets.

For the administration plan to work well, fund managers’ incentives should be aligned with maximizing the value of the fund’s capital. The proposed re-design would make the plan much more effective and much less costly.

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