A few weeks ago, we blogged about a discussion paper written by Harvard Law School Professor Lucian Bebchuk that contained some concrete proposals on how the U.S. government could partner with private equity firms to invest in toxic assets. Shortly thereafter, The Wall Street Journal reported on some preliminary details of the Treasury’s plans for those programs, which appear to be quite similar to what Bebchuk suggests. We talked to Bebchuk about his ideas, which he says could also be applied to TALF - Term Asset-Backed Securities Loan Facility.

Q: The government’s public-private investment fund plan contains provisions very similar to those suggested in your discussion paper. Have you spoken with anyone in the government?

I can’t really comment on that. But I do think the government is moving in the right direction. And it would be useful to have additional competitive elements that I wrote about that would keep taxpayers’ cost at minimum.

Q: The paper we wrote about earlier primarily discusses the planned public-private partnerships the government wants to invest in toxic assets. But your ideas could also be applied to the TALF program, which would invest in new loans.

There are two separate things the government wants to do. One is to buy troubled assets [currently on banks’ balance sheets]. The other is to extend new credit. The public-private investment fund addresses the first issue, while TALF addresses the second. It’s helpful for TALF to have some sort of competitive mechanism so that the government subsidy is reduced to a minimum. For instance, if we want $200 billion in new auto loans to be issued, let’s invite bids and give debt financing only up to the level that’s necessary to get to the $200 billion. That’s different from the current plan for TALF, which requires haircuts of between 8% and 15% depending on the type of investment. The problem is that 15% is not based on a market mechanism, and it may be too low. In other words, the government providing 85% of capital might be too high and constitute subsidizing people who invest.

Q: How might the bidding work exactly for TALF?

Say the government wants to induce $100 billion in new auto loans. The question is what percentage of capital will the government lend. In other words, what will the haircut be? Obviously, if the government is willing to provide 99% of the capital, they will get more than $100 billion. The government should set a level that’s no higher than what’s
necessary to induce $100 billion, and ask private money managers to identify the percentage of capital they would like to fund. For example, Bidder A is willing to fund $10 billion with 50% coming from government credit, and Bidder B is willing to fund $10 billion with 60% coming from government credit, and so on. When the government receives all bids, it can determine the right level of government credit, say 70%, that’s necessary to get to the $100 billion. As long as the value of the loans does not decline to below 70%, the government will get its money back. Auctions are attractive because people are not likely to get into a “bluffing” kind of thinking, because pricing does not depend on what you say, but depends on what marginal buyers are willing to pay. No matter how good or insightful the Treasury’s people are, as long as the haircuts are not based on a market mechanism, there is the possibility that the government could bear excessive cost. But auctions would get it exactly right.

Q: Some financial regulators have suggested that private equity firms and hedge funds pose a systemic risk to the financial system. How then can the government justify welcoming private investors into programs such as these?

The U.S. government believes that we now have less lending than is sufficient and is working to help bring back private sector lending. I’m not sure what the alternatives would be. Everybody wants the private sector to do the lending, and I don’t think anyone wants the lending to be fully done by the government. The question is what’s the most effective and cost-efficient way [to get credit flowing again].

Read more about Bebchuk’s proposals to get new lending flowing again here.