Lucian Bebchuk on the PPIP

The Washington Post
By Ezra Klein
July 9, 2009

Banking expert Lucian Bebchuk is watching the halting, stumbling start to Tim Geithner's Public Private Investment Program and wondering why it had to be this way:

What happened? Banks' balance sheets do remain clogged with toxic assets, which are still difficult to value. But the willingness of banks to sell toxic assets to investment funds has been killed by decisions of accounting authorities and banking regulators.

Earlier in the crisis, banks' reluctance to sell toxic assets could have been attributed to inability to get prices reflecting fair value due to the drying up of liquidity. If the PIPP program began operating on a large scale, however, that would no longer been the case.

Armed with ample government funding, the private managers running funds set under the program would be expected to offer fair value for banks' assets. Indeed, because the government's funding would come in the form of non-recourse financing, many have expressed worries that such fund managers would have incentives to pay even more than fair value for banks' assets. The problem, however, is that banks now have strong incentives to avoid selling toxic assets at any price below face value even when the price fully reflects fair value.

A month after the PPIP program was announced, under pressure from banks and Congress, the U.S. Financial Accounting Standards Board watered down accounting rules and made it easier for banks not to mark down the value of toxic assets. For many toxic assets whose fundamental value fell below face value, banks may avoid recognizing the loss as long as they don't sell the assets.

Even if banks can avoid recognizing economic losses on many toxic assets, it remained possible that bank regulators will take such losses into account (as they should) in assessing whether banks are adequately capitalized. In another blow to banks' potential willingness to sell toxic assets, however, bank supervisors conducting stress tests decided to avoid assessing banks' economic losses on toxic assets that mature after 2010.

The stress tests focused on whether, by the end of 2010, the accounting losses that a bank will have to recognize will leave it with sufficient capital on its financial statements. The bank supervisors explicitly didn't take into account the decline in the economic value of toxic loans and securities that mature after 2010 and that the banks won't have to recognize in financial statements until then.

Together, the policies adopted by accounting and banking authorities strongly discourage banks from selling any toxic assets maturing after 2010 at prices that fairly reflect their lowered value. As long as banks don't sell, the policies enable them to pretend, and operate as if, their toxic assets maturing after 2010 haven't fallen in value at all.

Investors participating in the PPIP have said that the government's funding will allow them to pay 5 to 10 percent more than they normally would for these assets at this point. But even that markup is too much of a markdown for the banks: They're hoping they can wait out the recession and let the value of these assets rise by quite a bit more before they sell. And it's possible they can. But if things take a turn for the worse, the continuing presence of those assets at the center of the banking system will be exactly the problem it was eight months ago.

What'll be interesting, Bebchuk says, is to watch the FDIC auctions later this summer. The government agency will be selling the legacy assets it acquired when taking over some of these ailing banks, and the degree to which they're marked down at auction will give us some insight into the degree to which the banks would see their holdings marked down at auction. We'll have a rough idea, in other words, of the losses they would suffer under PPIP. "In the meantime," writes Bebchuk, "it must be recognized that the curtailing of the PIPP program doesn't imply that the toxic assets problem has largely gone away; it has been merely swept under the carpet."

By Ezra Klein | July 9, 2009; 9:35 AM ET