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The Geithner-Summers plan, officially called the public/private investment programme, is a thinly veiled attempt to transfer up to hundreds of billions of dollars of US taxpayer funds to the commercial banks, by buying toxic assets from the banks at far above their market value. It is dressed up as a market transaction but that is a fig-leaf, since the government will put in 90 per cent or more of the funds and the “price discovery” process is not genuine. It is no surprise that stock market capitalisation of the banks has risen about 50 per cent from the lows of two weeks ago. Taxpayers are the losers, even as they stand on the sidelines cheering the rise of the stock market. It is their money fuelling the rally, yet the banks are the beneficiaries.

The plan’s essence is to use government off-budget money to overpay for banks’ toxic assets, perhaps by a factor of two or more. This is done by creating a one-way bet for private-sector bidders for the toxic assets, then cynically calling it “private sector price discovery”. Consider a simple example: a toxic asset with face value of \$1m pays off fully with probability of 20 per cent and pays off \$200,000 with probability of 80 per cent. A risk-neutral investor would pay \$360,000 for this asset.

Along comes the government and says it will finance 90 per cent of the investor’s purchase and, moreover, do so as a non-recourse loan. Non-recourse means the government’s loan is backed only by the collateral value of the toxic asset itself. If the pay-out is low, the loan is defaulted and the government ends up with the low pay-out rather than full repayment of the loan.

Now the investor is prepared to bid \$714,000 (with rounding) for the same asset. The investor uses

\$71,000 of his/her own money and \$643,000 of the government loan. If the asset pays off in full, the investor repays the loan, with a profit of \$357,000. This happens 20 per cent of the time, so brings an expected profit of \$71,000. The other 80 per cent of the time the investor defaults on the loan, and the government ends up with \$200,000. The investor just breaks even by bidding \$714,000, as we would expect in a competitive auction.

Of course, the investor has systematically overpaid by \$354,000 (the bid price of \$714,000 minus the market value of \$360,000), reflecting the investor’s right to default on the loan in the event of a poor pay-out of the toxic asset. The overpayment equals the expected loss of the government loan. After all, 80 per cent of the time (in this example) the government loses \$443,000 (the \$643,000 loan minus the \$200,000 repayment). The expected loss is 80 per cent of \$443,000, equal to \$354,000.

The idea of “private sector price discovery” is therefore flim-flam. There would be price discovery if the government’s loan had to be repaid whether or not the asset paid off in full. In that case, the investor would bid \$360,000. But under the Geithner-Summers plan the loan is precisely designed to be a one-way bet, for the purpose of overpricing the toxic asset in order to bail out the bank’s shareholders at hidden cost to the taxpayers.

The banks could be saved without saving their shareholders – a better deal for taxpayers and without the moral hazard of rescuing shareholders from the banks’ bad bets. Most simply, the government could provide loans to buy the toxic assets on a recourse basis, therefore without the hidden subsidy. Alternatively, the plan could give the taxpayers an

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equity stake in the banks in return for cleaning their balance sheets. In cases of insolvency, the government could take over the bank, the much dreaded nationalisation, albeit temporary. At the end of the Bush administration, Congress voted for the \$700bn (€517bn, £479bn) troubled asset relief programme (Tarp) on the assurance the taxpayer would get fair value for money (for example, by taking equity stakes in the rescued banks). The new plan does not offer that.

Tim Geithner, Treasury secretary, and Lawrence Summers, director of the White House national economic council, suspect that they cannot go back to Congress to fund their plan and so are raiding the Federal Reserve, the Federal Deposit Insurance Corporation and the remaining Tarp funds, hoping that there will be little public understanding and little or no congressional scrutiny. This is an inappropriate institutional use of the Fed, the FDIC and the Tarp. Mr Geithner and Mr Summers should at the very least explain the true risks of large losses by the government under their plan. Then, a properly informed Congress and public could decide whether to adopt this plan or some better alternative.

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