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A Fix for Geithner's Plan

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With the world's attention shifting to London and the upcoming Group of 20 summit, it's possible that the Treasury's proposal for dealing with banks' "troubled assets" will become old news. It shouldn't. The administration plans to provide as much as $1 trillion to privately managed funds that will buy troubled assets, which is indeed the best way for jump-starting this market. But it is important to add to the program a mechanism that would prevent excessive subsidies to private parties and keep costs to taxpayers at a minimum.

The first government plan to purchase banks' toxic assets, put forward by then-Treasury Secretary Henry Paulson, was withdrawn after objections that Treasury wouldn't be able to value the assets. In a white paper issued last September, "A Plan for Addressing the Financial Crisis," I proposed using privately managed and competing funds as an alternative and argued that such funds would better set prices for these sorts of assets.

The program that Treasury Secretary Timothy Geithner announced last week will lead to the creation of such competing funds. It is structured to produce a market with a significant number of potential sellers facing a significant number of potential buyers.

But while the program is intended to partner public and private capital, the partnership it sets up is quite unequal. As things stand, the private side -- the private manager and investors possibly affiliated with it -- would capture 50 percent of the upside but would bear a disproportionately small share of the downside, contributing as little as 8 percent of the fund's capital.

Treasury officials believe that because private parties have not thus far established funds dedicated to buying troubled assets, favorable terms are needed to induce their participation. This logic is reasonable, but it is important to keep the government subsidy at a minimum. Without any market check, the terms set by the government could substantially overshoot what is necessary to induce private participation and end up imposing large and unnecessary costs on taxpayers.

A program of public-private funds should be designed to minimize costs to taxpayers. To attain this objective, the government should base the terms of participation on a process in which private managers compete to be in the program.

If the private side were to contribute only 8 percent of the capital, the government should seek to keep the highest fraction of the upside that would be consistent with inducing such participation. To this end, potential private managers would submit bids indicating the minimum share of the fund's upside that each manager would be willing to accept for an 8 percent investment, as well as the size of the fund that the manager would establish if accepted into the program. Treasury officials should then set the share of the upside going to the private side in each of the funds under the program at the lowest level consistent with establishing funds that collectively have the aggregate target capital.

Alternatively, assuming that the private side's share of the upside is fixed at 50 percent, the government should seek to get the largest possible contribution of private capital. Under this scenario, managers would submit bids indicating both the size of the fund each manager would establish and the maximum fraction of the fund's capital that the manager would commit to raising privately in return for 50 percent of the upside. Based on the bids, the government would set the fraction of capital provided by the private side at the highest level consistent with establishing funds that have the target amount of aggregate capital.

This second scenario would not only keep the government's subsidy at a minimum but would also induce the largest amount of private capital, thus conserving some of the government gunpowder that the program's current design would use. Because many banks might well remain undercapitalized even when their assets are valued fairly, restarting the market for troubled assets won't make these banks healthy; rather, it will make clear the need to recapitalize them and might require the government to inject substantial sums of additional capital.

Establishing privately managed funds that are financed with both private and public capital offers the best approach to restarting the market for troubled assets. Adding a market mechanism for setting the level of government subsidy is necessary to reduce the program's cost to taxpayers and would leave the government with the most ammunition for the tasks that still lie ahead.

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