



The PPIP: keep banks out

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Should banks with large amounts of troubled assets be allowed to participate as managers or investors in funds set up under the US's public-private investment programme? The way the scheme is currently designed not only permits such banks to take part, but encourages them to do so.

Media reports indicate that some such banks are considering participating in funds established under the administration's programme. Allowing such participation, however, is counterproductive. The effectiveness of the programme would be significantly enhanced if it were prohibited.

The programme's design does not impose restrictions on the participation of such banks as private investors in funds set up under the scheme.

Furthermore, the qualifications for managers making purchasing decisions in these funds encourage, rather than discourage, participation by such banks as managers. In the legacy securities programme, managers must own at least \$10bn in certain mortgage-backed securities and residential mortgage-backed securities. This high bar is one that some of the banks burdened with toxic paper will meet but that some large hedge funds active in this area will be unable to reach.

One problem with allowing banks clogged with troubled assets to participate on the buying side is that it defeats one of the programme's main goals: to cleanse the balance sheets of these banks of troubled assets and thereby remove the uncertainty about the value of these assets that may currently impede the banks' operations.

Allowing these banks to participate on the buying side in the programme's activities will increase, rather than decrease, the amount of troubled assets that the bank owns directly and indirectly. It thus will increase the amount of assets with uncertain value on the banks' books and delay rather than accelerate the banks' return to normal operations.

The second problem with the participation of banks with large holdings of troubled assets on the buying side is that it will exacerbate the misalignment of interests between the private side in funds set up under the programme and taxpayers. To enhance the programme's effectiveness and protect the interests of taxpayers, the interests of the private side - the fund's manager and the private investors affiliated with it - should be aligned with the interests of taxpayers.

Under the current design of the programme, the private side will face asymmetric payoffs, capturing half of the upside but having to bear a smaller share of the downside. Critics have pointed out that such asymmetric payoffs would provide powerful incentives to seek assets with volatile value and over-pay for them. In another [op-ed piece](#), I show how the programme can be redesigned, without discouraging the participation of private parties, to align the interests of the private side with those of taxpayers by providing the private side with the same share of both the upside and the downside.

Even if the programme were redesigned to provide the private side with the same share of the upside and downside, however, banks acting as managers of funds set up under the programme would still have distorted incentives. If a bank holding large amounts of toxic securities is selected as a fund manager in the legacy securities programme, and the fund subsequently pays excessively high prices for troubled assets, the bank might derive from such high prices benefits not shared by taxpayers invested in the fund.

To be sure, the programme's current design prohibits transactions that are blatantly conflicted, barring each fund from purchasing assets from affiliates of its manager or from 10 per cent plus private investors in the fund. To the extent that prices paid for troubled assets affect the valuation of other troubled assets, however, a bank managing a legacy securities fund may have distorted incentives to overpay for troubled assets even when buying them from other banks.

It follows that banks holding significant amounts of troubled assets- the intended sellers under the programme-should not be allowed to participate on the buying side either as fund managers or as investors in funds. Their incentives are likely to be especially distorted, and their buying additional troubled assets either directly or indirectly would go against what the programme seeks to accomplish, both at a significant cost to the taxpayer.

To be sure, participation by banks on the buying side could provide them with significant profits, and thus would strengthen their capital positions. But transferring value to banks holding troubled assets in order to bolster their capital should not be a goal of the programme for buying assets; injection of capital into banks should be made only for consideration in securities and should be targeted at those banks that need additional capital, not banks holding troubled assets in general.

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