A preliminary reaction to the PPIP

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By Ricardo J. Caballero

We are not out of the woods yet, but the elements of the Legacy Assets programme are encouraging.

They combine the strengths of the public institutions involved - the US Treasury, the Federal Reserve and Federal Deposit Insurance Corporation - to produce a powerful combination of public equity, loans and guarantees to leverage private capital in the process of thawing frozen financial markets.

The main problem this US programme seeks to solve, as an intermediate step in restarting private lending, is the enormous gap between the price at which banks are willing to sell their legacy loans and securities and what investors are willing to pay for them.

There are three prominent reasons behind this gap. First, there is asymmetric information about the quality of the assets between buyers and sellers. Second, investors are in panic-mode, which is not in small doses due to macroeconomic and political uncertainty. Third, weak banks cannot afford to mark down the assets as this would create a visible capital-hole, and would be the end of a currently viable “don’t ask - don’t tell” recovery strategy.

The first of these reasons is the classic “lemons problem.” It is certainly the most studied of the three problems in economics but it is probably the least important in the context of the new programme: the FDIC and most of the potential managers and buyers have significant expertise in analysing these loans and securities. Moreover, it is always possible to add a “representations and warranties” clause to further protect the buyer against the seller’s misrepresentations.

The second reason, aversion to uncertainty, is a central aspect of the financial crisis. The main antidote for this symptom is the provision of insurance and guarantees. The Legacy Assets programme hits this issue on the spot, particularly through its use of non-recourse loans. These loans have two bundled effects: The first one is to trim the tail-risk. The second one is simply to raise the expected return of private investment. In an environment with strong uncertainty aversion, the former effect is possibly more important than the latter effect. Put options have maximum value and the government is in a unique position to supply them.

The third reason, the capital-hole problem, is also addressed by the Legacy Assets programme through its effect on boosting the bid-price for the loans and securities. However, this price increase may not be enough for some banks. In principle, the Capital Assistance Programme can be used to bridge the remaining gap, but it is not clear at this stage how these two programmes - the Legacy Assets programme and the CAP - are linked.

It would seem useful from the point of view of cleansing the balanced sheets to connect these programmes more directly, softening the CAP’s terms as the bank disposes of more assets. The “exceptional assistance” clause in the CAP may be the natural conduit to link these two programmes for the most extreme cases, but a broader incentive arrangement could also prove useful.

What is the bottom line? The Legacy Assets programme is well-conceived and deserves to be supported. As the Obama economic team has pointed out repeatedly, it is only one of the pillars of the Financial Stability Plan. The next substantive step is the CAP. An important virtue of the Legacy Assets programme that is not shared by the CAP at this moment is that it provides an insurance against aggregate uncertainty.

Through the non-recourse loans and the FDIC guarantees, the Legacy Assets programme (partially) insulates private investors from worsening aggregate conditions. This is highly desirable in the current environment. In contrast, the CAP seems to leave most of this risk on the balance sheets of the banks (except for the component that is removed through the Legacy Assets programme), as it forces banks to self-insure against extreme macroeconomic scenarios through capital over-accumulation.

This is not only an inefficient allocation of risks, but it is unlikely to appease panic-driven investors, who are in the mode of envisioning ever more extreme macroeconomic outcomes. One of the most devastating mechanisms at work at this time is the reinforcing feedback
between bad news in the real economy and bad news in the financial system. Aggregate-insurance severs this negative feedback-loop. The Legacy Assets programme started the job on this front; it is now for the CAP to complete it.

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