

## Using the PPP to Separate good banks out of bad banks

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The Geithner plan, announced on Feb. 10, did not specify how the public/private partnership (PPP) will be used to buy troubled assets. Here is an idea. By following this, we can separate substantially all the potentially toxic assets from the balance sheets of major financial institutions. What remains will be undercapitalized for many, but with toxic assets removed, it will be relatively easy to attract new investors.

The idea is very much similar to [what George Soros proposed in the \*Wall Street Journal\* \(Feb. 4, 2009\)](#). We can create what he calls a “side pocket” using PPP. This is also similar to what Japan did sixty years ago, as I discussed in [my blog on June 3, 2008](#).

First, the range of potentially toxic assets must be specified. It is better to be as comprehensive as possible at this point. We should at least include all the residential and commercial mortgage loans, credit card and other consumer loans, and all the securities that are at least partially derived (directly or indirectly) from these loans.

Second, we set up an investment fund through public/private partnership for each major financial institution that participates in this program. To participate in the program, a bank commits to sell all the potentially toxic assets specified in the first step. This is to prevent banks from unloading just worst assets they have, although such an incentive is mitigated in this scheme as I explain below.

Third, the price of an asset is set as the same as its value that the bank carried on the balance sheet as of a certain date (say February 10, 2009). Let us call the date the X day. Since different financial firms may have somewhat different valuations of the same assets, setting up one investment fund for each bank becomes important.

Fourth, in exchange for the potentially troubled assets, a bank is paid in shares in the investment fund. This allows the investment funds to complete the purchase of troubled assets with minimum upfront cost for the taxpayers. The value of the fund share is set equal to the bank stock price on the X day. Since the fund basically takes the bank’s valuation at the face value, this mitigates the problem of a bank trying to unload worst assets only.

Fifth, banks are required to dispose the fund shares by distributing those to the bank shareholders and some debt holders if necessary, through share swap or debt-equity swap. I

am not sure about the legal constraints for such exchanges. Implementing this step may require some legal changes.

The point here is to remove the exposure to potentially toxic assets completely from the bank balance sheet. What I suggest may not be the most practical or efficient way to achieve this. For example, it may be more practical to swap the current bank bonds with bonds that the fund issues and to attach government insurance to those bonds. I am sure lawyers can find a way to implement this with minimum legal changes.

After the step #5, what remain on the bank balance sheets will be the normal assets and the debt (and some equity if the exposure to potentially toxic assets was extremely low). The equity will be low or non-existent but the quality of assets will be good.

Finally, as step #6, the banks are required to raise capital so that they will be well capitalized. With clean balance sheets, there will be private sector investors who are willing to buy shares in these newly revived financial firms. The government can help by being ready to provide public capital if necessary.

Although some details need to be worked out, this seems to be a promising approach to remove all the potentially toxic assets from the balance sheets of major financial institutions with small additional cost to taxpayers.