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A commission-free PPIP

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By Ricardo J. Caballero

The most effective antidote for the devastating role of uncertainty in financial markets is some form of public insurance or guarantee. One of the great virtues of the PPIP (public private investment programme) for Legacy Assets is that it provides such a guarantee to potential investors in these assets, and by so doing, it boosts their bid-prices thus facilitating the removal of troubled assets from banks' balance sheets.

The reason a cleansing of banks' balance sheets is desirable is not for the sake of selling assets (a point missed by those who complain that recent changes to the mark-to-market rules are contrary to the PPIP objectives), but because by removing the uncertainty associated with these assets from banks' books, their own fears will subside and they will then be willing to assume more new risks through lending. That is, again, the problem is one of dealing with the extreme and freezing caution triggered by uncertainty.

The PPIP, as designed, has to deal with two layers of uncertainty: that of the investors and that of the banks. As I have argued before, a more direct mechanism is to insure the assets of the banks directly, as the British have done .

The main advantage of this direct approach over the PPIP is that it gives all the benefit of the insurance mechanism to the distressed banks rather than sharing the benefits with outside investors. By doing so it also helps with the recapitalisation of the banks. (The current system may do just the opposite and hence it needs to be complemented by a more generous Capital Assistance Programme.) The advantage of the PPIP, on the other hand, is that it solves the thorny issue of how to price these legacy assets (or the insurance) as it brings in, as partners, private sector experts who assess the value of these assets.

But there is an obvious way of getting the best of both worlds: Let the main banks be among the investors (and managers) in these legacy assets.

Banks are without-a-doubt the best qualified to value other banks' assets, and thus their participation in the PPIP not only as asset sellers but also as asset buyers offers a low-hanging fruit. To see the point, imagine an abstract scenario where two similar (in terms of their asset composition) banks swap their troubled assets; but by doing so they receive the PPIP implicit guarantee (which would require setting up some sort of SIV). In such a case, banks would simply be swapping high risk assets with low risk assets (or partially guaranteed assets), thus increasing the banks' lending capacity.

This compromise solution could raise the concern that these risks will remain on the balance sheets of the banks, having been just swapped around. Clearly though, this concern misses the point, namely, that the PPIP's main virtue is its built-in insurance arrangement. Thus, the compromise solution is just a way of focusing this same insurance directly where it provides the maximum benefit, without having to pay a big commission to hedge funds and other non-bank private investors for their valuation services.

Interestingly, this compromise solution is spontaneously emerging from the private sector within the context provided by the PPIP, and hence there is no need to implement substantial new plans. "All" that is really needed is a curbing of the political system's kneejerk reactions.

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