The new Geithner plan is a flop

BY LUIGI ZINGALES

Wednesday, March 25th 2009, 4:00 AM

On Monday, the market rallied 7% at the announcement of Treasury Secretary's Timothy Geithner's plan to deal with banks' toxic assets. Should taxpayers celebrate as well? The answer is a resounding no. Geithner's plan is just a more risky and cagey version of the original plan by his predecessor, Henry Paulson: to buy toxic assets. Not only is it as likely to fail as his predecessor's, but it is also likely to create major political unrest.

The premise underlying both plans was that banks were facing a temporary liquidity problem: Many mortgages and related securities allegedly were trading below their long-term values, making banks appear insolvent. According to this view, it would be enough to inject liquidity into this market to make valuation return to its "fundamental" level, restoring the health of banks. Hence the idea to pump the government's money into this market to fix the problem.

As banks know well, however, no debtor on the verge of bankruptcy would ever admit to being insolvent; he will always perceive his own problem as a temporary liquidity one. The credibility of this position depends on the duration of the "liquidity" problem and on the existence of legitimate reasons to think that the long-term value has not dropped.

When Paulson first asked Congress for money from the Troubled Assets Relief Program, several indexes of subprime, residential, mortgage-backed securities were trading around $65 a share. Now they are trading around $30. With delinquency approaching 12% and house prices down almost 30% and falling, these losses seem more than temporary illiquidity. Even Citigroup analysts, when they judge other banks, estimate losses on subprime loans at 25% to 40% and losses on credit cards at 26% to 38%.

In other words, these problems are about as temporary as General Motors' ones. In the automakers' case, the government has used a tough-love approach, asking all the various stakeholders (including the bondholders) to make concessions. For the banks, on the other hand, Geithner has asked for concessions from no one. In fact, he has even grandfathered the managers' bonuses, while offering taxpayers' money to make bondholders and shareholders whole.

It's no surprise the market rallied. It loves to be rescued at taxpayers' expense. And it's no wonder that hedge funds endorsed the plan; they love the subsidy Geithner is providing. Between the money lent by the Federal Deposit Insurance Corp. and the money invested by the Treasury, hedge funds can buy assets for $100 - when they invest only $7. In this way, they retain 50% of the upside and only $7 of the downside. To them, it is almost free.

The irony of the plan is that it seems to replicate the same excesses that brought the crisis - carrying enormous economic and political risk.

So, what happens now?

The worst-case scenario is that the assets are really worth what the currently illiquid market thinks they are worth. In this case, the Treasury, but in particularly the FDIC, will face enormous losses. Had Paulson applied this strategy in late September, the Treasury would now be facing losses equal to 47%. On a trillion-dollar investment, we are talking about $470 billion in losses.

The best-case scenario is that the value of the toxic assets bounces back so that the government recovers all its money and the hedge funds become filthy-rich.

Even in this happy scenario, however, there is a very serious political problem: How would taxpayers react when they find out that those who reap the biggest benefits of this program are the very same people who created this mess to begin with? Because let's realize this now: The most savvy buyers of toxic assets will certainly be those who created them.

If you think that the revelation of AIG lavish bonuses has shown all the rage of the American people, think again. When former subprime lenders will become the new billionaires, we run the risk of a populist revolution.

Zingales is a professor at the University of Chicago Booth School of Business.