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Recommendations for the Public-Private Investment Program

Implementing the Treasury Department's Plan to Clean up the Toxic Asset Mess

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Introduction and Summary

The U.S. Treasury Department's Public-Private Investment Program unveiled on March 23 will—it is hoped—finally solve the problem of “toxic assets” held by banks. These mortgage loans, mortgage-backed securities, collateralized debt obligations, asset-backed securities, exotic credit derivatives, and other credit instruments have significantly deteriorated in value over the past two years due to poor underwriting and weak economic conditions. This has left holders of these assets, including our nation's largest financial institutions, teetering on the brink.

The nation needs healthy financial institutions performing their much-needed role in the economy as providers of credit, and for that to happen these bad assets must be dealt with. The Treasury's PPIP plan—pronounced “Pee-Pip” in the corridors of finance in Washington and Wall Street—is the Obama administration's effort to address this problem after the stumbling attempts of the Bush administration.

A major obstacle to dealing with the toxic asset problem is how to determine what these assets are worth. How much value these assets have actually lost is a question of much debate. And devising a mechanism for ascertaining the correct prices is no easy task. The challenge is rooted in the murkiness surrounding these toxic assets. In the case of mortgages, the quality of the underwriting can be unknown and the future of the housing market and the length and depth of the recession certainly are. The same problems plague securities created from these mortgages, but it is even worse for these securities because of the more complicated nature of their relationship with the value of the underlying assets.

PPIP is designed to finally get the value of these assets right by creating a well-functioning market where buyers and sellers set prices through their transactions. This will in theory establish where the banks stand through a combination of getting the assets off their books through the market and providing a sound basis for setting the value of the assets they retain.

Although the Treasury has announced the general structure of PPIP, there are still a number of details to be fleshed out. Of utmost importance is addressing how the program will interact with the administration's efforts to address the housing crisis. PPIP has the potential for undermining those efforts if not implemented with this concern in mind. In addition, there are a number of aspects of implementation—including which institutions

are allowed to participate, the availability of information regarding transactions under the program, and performance metrics—which could have an important affect on investor and public confidence in the program and, ultimately, its effectiveness.

PPIP is designed to address the toxic asset issue by creating public-private partnerships that allow the cash-strapped private sector to participate in the marketplace for these so-called “legacy” assets—the term used by Treasury for toxic mortgages and securities—thereby resolving the question of pricing by establishing demand for the assets of which there is all too much supply. Whether PPIP will succeed remains to be seen. Because the program is a partnership with the private sector much depends on how the private sector responds, something that cannot be predicted with certainty. And how taxpayers fare with the program—which puts great sums of taxpayer dollars at risk while also offering opportunity for gain—depends on how the private market prices these assets and the future of the housing market and the economy in general.

If Treasury addresses a number of key issues still to be resolved, we believe that PPIP has a better chance of delivering on its promise to protect taxpayers, resolve the toxic assets problem, rebuild credit markets, and help the economy recover from the recession which began in December 2007. As implementation of PPIP proceeds, we believe it is important that the administration:

- Ensures moving mortgages off the books of lending institutions doesn’t adversely affect the opportunities for mortgage modification—both to allow responsible homeowners facing mortgage-payment problems to avoid unnecessary foreclosures and to ensure that holders of mortgages choose modification over foreclosure where that will maximize the value of the mortgages they hold.
- Limits the holders of large quantities of toxic assets from participating in the PPIP investment vehicles that will purchase these assets.
- Applies appropriate standards for private fund managers chosen to purchase toxic assets from financial institutions.
- Makes transaction information readily available to ensure an efficient, fast-moving market.
- Sets up performance metrics to determine if the program is working as conceived.
- Provides the general public with information as the program proceeds.
- Includes the broad public in the benefits from any windfall profits.
- Ensures the amount of debt financing provided by taxpayers is not too high as Treasury fleshes out the amount of leverage it will provide as part of PPIP.

It is certainly a widely shared hope that PPIP will succeed for taxpayers, for financial markets, and for the economy. The reaction to the proposal has been mixed—with some optimistic and others deeply skeptical. The suggestions for implementation described here will make success more likely. But it is also true that if the PPIP approach doesn’t work then even more intrusive government intervention will be required to address the severe challenges in our financial sector.

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