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Geithner's Plan: Loopholes Galore

Here are five ways hedge funds and investment banks may exploit Treasury's toxic-assets plan

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It has been a little less than two weeks since Treasury Secretary Timothy F. Geithner unveiled the details of his project to restore banks to financial health. But analysts say hedge funds and investment banks are already looking for ways to exploit the complex web of auctions, public-private partnerships, and government guarantees proposed by Treasury to cleanse banks' books of toxic assets. "It's a highly gameable system," says H. Peyton Young, an Oxford University economist and a senior fellow at the Brookings Institution in Washington. "It's very difficult to write rules that are going to prevent self-dealing behavior."

Geithner's goal: entice investors to buy up the billions of dollars' worth of subprime mortgages, underwater commercial property loans, and other shaky securities that weigh down the banks' books. The partnerships will bid at auction for the dodgy parts of the banks' portfolios, hoping to get a big enough bargain that they can resell the assets later at a profit.

With their balance sheets restored to health, goes the theory, the banks will lend again. Investors who team up with Uncle Sam get a chance to make a fortune with very little risk: The government will provide half the equity, and the partnerships can juice returns by borrowing more funds on attractive terms from the Federal Reserve or by securing private-sector loans whose repayment is guaranteed by the Federal Deposit Insurance Corp.

Besides the generous terms, the partnerships have loopholes big enough for an investment banker to drive his Ferrari through. The basic problem: Everyone gets to play. Banks selling dubious assets can finance their sale to the partnerships, investors can buy debt from banks in which they own shares, and on and on. Strictly speaking, there's nothing wrong with much of this. But many of the strategies to exploit the partnerships increase the chance that the feds will overpay for the debt, sticking taxpayers with the bill.

Government officials say they plan to head off abuses as they iron out the program's final rules and argue that competition will also play an important part. "When programs are competitive, it becomes more difficult to game, because the outcomes are more uncertain," says Jim Wigand, the FDIC's deputy director of resolutions and receiverships. But with so many twists, gaming the system may prove hard to block completely. Here are five possible tricks:

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Banks may be able to finance the sale of their own troubled loans, lending money to the public-private partnerships that buy the assets. A bank's loan to the partnership would be buttressed by an FDIC guarantee. Administration officials confirm that the Treasury may allow such seller financing. The move essentially replaces junky mortgages on the bank's books with an FDIC-guaranteed loan. With its risks so limited, the bank has every reason to pass off its weakest assets as better than they are, argues Fuqua School of Business finance professor Campbell R. Harvey. "They will want to unload the worst possible things at the highest possible price," he says. "And if they're doing the financing, it's even more likely that they will be able to do that." Government officials say they will charge more for loans used to buy the riskiest assets.