Timothy Geithner's toxic plan

The last-ditch effort to save Wall Street will hurt taxpayers and still require another big bailout down the line

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Treasury secretary Timothy Geithner's latest bank bailout plan is another Rube Goldberg contraption intended to funnel taxpayer dollars to bankrupt banks, without being overly transparent about the process. The main mechanism is a government guarantee that would allow investors to buy junk with a 12-to-1 leverage ratio, where they only risk the downside on their own investment, not the borrowed money.

Ostensibly, this is supposed to reveal the "true" price for junk assets, as investors compete at auctions to buy assets under the new rules. But this story doesn't pass the laugh test. All we will really learn is what price investors are willing to pay for these junk assets when they are given a large subsidy from the government to buy them. In reality, this plan is a way to use taxpayer dollars to get investors to pay far more than these assets are worth in order to give more money to bankrupt banks.

The results will be mixed. Some of the assets undoubtedly have some value. There are, no doubt, shrewd investors who have identified certain assets that they would have been willing to buy from the banks, but instead put off purchasing while they waited for a deal like this. Now these investors will have the opportunity to buy these assets with large subsidies from the government, allowing them to make substantial profits. (It's not clear if President Obama will want to invite this new group of hedge fund billionaires, who got rich off this government programme, for photo ops in the White House Rose Garden.)

A second outcome is that many investors will see the subsidy and decide to dive in, recognising that most of any potential loss will be borne by the government. This route might prove especially attractive for one of the zombie banks, which would effectively have nothing to lose anyhow, since they are already bankrupt. In these cases, the government can expect to take substantial hits, since the investors would bid more than the assets are worth – and the government would be stuck with the eventual loss.

A third result of this path is that the subsidised class of assets would rise in value relative to assets that do not benefit from the government subsidy. This could cause banks that are relatively healthy, and therefore not taking part in this programme, to suffer. With investors opting to buy assets that come with government subsidies, the demand for mortgages or mortgage-backed securities that don't have these subsidies might suffer.

A fourth likely outcome is that even with the subsidies, much of the toxic waste would stay on the banks' books. There is a large gap between the price that investors have been willing to pay for these junk assets – which has been around 30 cents on the dollar – and the price that banks list on their books, which has been 60 cents on the dollar. If the government subsidies raise the price that investors are willing to pay by 50% (a very large increase), then the banks would still have to write down these assets by another 15 cents on the dollar in order to make the sale.

It is likely that the gap between the asking price and the offer will not be closed for a large portion of these assets, even with the government subsidy. As a result, the banks are likely to have several hundred billion dollars' worth of bad assets on their books even after this plan has been put in place. The Obama administration will then be forced to go to Congress with yet another bailout proposal.

It is also worth noting that this is a situation that invites all manner of fraud, since there are very large government subsidies that could be appropriated through clever schemes. The Obama administration assured the public that the Federal Deposit Insurance Corporation (FDIC) will be closely monitoring the programme, but the FDIC does not have the staff or the expertise to effectively track a programme of this size. The situation is complicated further by the fact that many of the big actors are likely to be hedge funds and private equity funds, which are almost completely unregulated in the current environment.

It is hard to understand this plan as anything other than a last-ditch effort to save the Wall Street banks. Unfortunately, Obama seems prepared to risk his presidency on their behalf.