The $700 Billion Question

By ANIL K KASHYAP and JEREMY C. STEIN

HENRY PAULSON, the Treasury secretary, has opened the government checkbook and is poised to spend $700 billion to end the financial crisis. What comes next depends on the precise mission and operating powers he and Congress assign the new Treasury agency that will oversee the bailout. We see four broad possibilities.

First, the agency could act as a deep-pocketed private investor that sees a bargain buying opportunity — Warren Buffett on steroids. This strategy makes sense if one believes that the crisis has caused the prices of mortgage-backed securities to fall far below their fundamental worth, and that pushing them back up to their real value will be enough to restore the health of the financial sector. Under this “fire sale” view, government involvement is needed because no private actor has enough money to be the market-maker of last resort.

If this is Mr. Paulson’s idea, the employees of the new agency should be investment analysts; indeed, we have heard that the government might even outsource some of the work to private bond managers. One virtue of this approach is that it makes the mission of the agency relatively clear cut: it wants to buy low and (eventually) sell high.

Beyond just buying and holding, a second job for the agency might be to restructure the mortgages it acquires. For example, it could reduce required interest payments so that fewer homeowners default on their loans. Done well, this could avoid costly foreclosures, thereby benefiting homeowners while also raising the value of the securities that the government has bought. This sort of restructuring has been difficult until now, because individual mortgages have been sliced and diced, and the pieces widely scattered. However, if the new agency winds up owning a majority of all problem mortgages, reconfiguring them so that interest payments are lower may become practical.

These first two tasks are probably the easiest for skeptics of government intervention to embrace — or at least tolerate. Unfortunately, they may not be enough. The financial sector is now seriously undercapitalized — struggling institutions simply don’t have enough equity to absorb potential losses — and normal lending within the financial system will not resume until this changes.

Consider Merrill Lynch. It found itself in dire straits because it was having difficulty borrowing to finance its holdings of mortgages and other investments. With options running out, it agreed to merge with Bank of America. Upon the announcement of the merger, the borrowing money problem disappeared, even though Merrill was going to use the borrowed money in exactly the same way as before. What was new was that Bank of America had put its substantial capital base on the line.

Accordingly, a third job for the new agency might be to directly subsidize financial firms to increase their
capital. One way to accomplish this would be the agency’s purposefully overpaying — relative to underlying
fundamental values — for the mortgages it acquires. Mr. Paulson initially said he wanted to buy mortgages
only from American companies; although he apparently changed his mind about foreign banks over the
weekend, his original thinking seemed to suggest that he envisions some sort of a subsidy program.

While injecting more money into the financial sector is clearly necessary, doing it this way raises several
concerns. For one thing, overpaying for the mortgages would help the banks’ current debt and stock holders.
This kind of gift to existing investors (with no upside for the taxpayers providing the money) sets a terrible
precedent, surpassing the Bear Stearns and American International Group bailouts, where at least
shareholders saw their stakes largely wiped out.

In addition, there would be considerable scope for corruption in distributing the subsidies. Which types of
mortgages would get the sweetest deals? What if some banks own disproportionately more of these high-
subsidy mortgages? Designing a coherent mission and organizational structure for the agency to minimize
these problems will be challenging, to say the least.

If the agency is to get into the direct subsidy business, which may be inevitable, we prefer that it also take on
the role of a bankruptcy judge. The government should refuse to buy any toxic mortgage assets from a bank
unless it first reaches an agreement with its long-term debt holders to erase some of the debt it owes, perhaps
in exchange for stock.

Beyond the principle involved, eliminating some of the existing debt in this way would help to strengthen the
bank’s balance sheet. If, in addition, the government received some preferred shares of the bailed-out bank as
part of the process (as it did in the A.I.G. rescue), taxpayers might eventually share in some of the gains.
Together, these steps would at least partly limit the gift element of the program.

For now, all we can do is make educated guesses at what Mr. Paulson has in mind. But Congress, which has
to sign that check for him, should demand some clear answers.

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