Reject Henry Paulson's raw deal - there's a far better solution

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Secretary of the Treasury Henry Paulson has laid out what he says is the emergency fix needed to save our financial system: a $700 billion bailout, essentially in the form of a blank check from the taxpayers to the Treasury enabling it to buy up bad mortgage-backed securities.

Trying to comply with the urgent timetable set by President Bush, Congress is searching for answers: Is the situation really so dire? Is there any alternative? What would be the long-term consequences of this plan?

But so far, almost all are playing on Paulson's turf, assuming that the framework of his bailout plan makes sense, with changes being debated around the edges.

That's a mistake. A bailout is not the answer; something much closer to bankruptcy is.

This much is certain: The financial system is severely undercapitalized - in other words, it has too much debt and too little equity. This makes it very vulnerable to shocks and confidence crises. Many financial contracts are linked to a company's credit rating, which is directly related to its debt-to-equity ratio. When a financial institution is poorly capitalized, a simple rumor that negatively affects the stock price can put the company's very survival at risk.

This is not viable over the long term, and that means an immediate recapitalization of the financial sector - like a blood transfusion - is needed, lest the patient keel over.

The private sector, however, has proven unwilling to purchase new equity in troubled institutions because it fears large losses. That's why one potential solution would be for government to pump money into the financial institutions.

There are three problems with this approach. First is the cost to taxpayers. We don't know what the price tag is, but it could easily run into the 13-digit range. Second is the risk that the government could essentially end up owning the financial sector. Third is the huge subsidy this will provide to the debt holders. You see, since the value of equity provides a form of guarantee that the debt will be repaid, the more equity that's poured in, the more valuable the debt will become. And so, debt trading at 50 cents on the dollar could easily jump to 80 or 90 cents on the dollar. That increase in value is a net transfer of wealth - straight from taxpayers' pockets into the bankbooks of the debt holders.

Paulson is suggesting a variation on this theme: buying up the bad assets of the troubled institutions. This is an indirect way to provide an equity infusion - but it, too, has a fundamental flaw. Namely, it works only if the government overpays for the toxic assets. The cost to the taxpayers will be even larger than in the previous case, without the benefit of any of the upside in case the market recovers.

This is tantamount to socializing the losses while keeping the profits in private hands. Taxpayers beware. This is a raw deal.

There is a better answer: Some form of debt forgiveness. If the face value of half of the debt was forgiven in exchange for some new government authority, the financial sector could be recapitalized at no cost to the taxpayers.

How could such a solution be achieved in a short period of time? I am not a lawyer, but it seems to me that Congress could approve a temporary amendment to the bankruptcy code for financial institutions. Indeed, there is a long tradition in U.S. history of rewriting bankruptcy codes during financial crises.

This time, an amendment would make available to companies a prepackaged bankruptcy in which debt forgiveness could be done overnight. To induce financial institutions to undergo this restructuring, the Fed could condition its provision of liquidity to the completion of the procedure. I doubt that any financial institution would choose to opt out.

If such a simple solution exists, why do we not hear about it? Easy: Wall Street would much prefer to be bailed out with taxpayers' money than to be forced to pay for its own mistakes.

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