Let's Get the Bank Rescue Right
By R. Glenn Hubbard, Hal S. Scott and Luigi Zingales
Published September 24, 2008
Wall Street Journal

The financial system is the heart of our economy and it is in trouble. If we do not fix it soon, we risk a serious recession.

The Bush administration appears to understand the urgency, but the draft legislation it put forward over the past week is cause for concern. Under the administration plan, the secretary of the Treasury would have unprecedented and unfettered power to spend $700 billion in purchasing mortgage-related assets from U.S. and possibly foreign financial institutions. The definition of "financial institution" seems to be expanding to include hedge funds and other investors. While Congress clearly understands the urgency of passing legislation to avoid a financial meltdown, some hard questions need to be answered before taking this radical step.

The administration's announced willingness to take bold action should temporarily stabilize the market. If the Fed continues its aggressive lending and announces that any further failures of institutions would be appropriately handled, there will not be Armageddon. We would then have the opportunity to ponder our next move, without rushing a plan through Congress that will affect both the financial system and taxpayers for decades to come.

Any solution should observe three guiding principles: It should (1) restore the stability of the financial system quickly and at the lowest possible cost to the taxpayer; (2) punish those who are responsible for losses; and (3) address the root cause of the crisis -- the price collapse in the residential real-estate market. In doing so, the solution should respect the rule of law by spelling out the proposal in sufficient detail for the Congress and the electorate to pass judgment. To the extent possible, it should follow proven precedents.

The administration's current proposal fails to meet these principles. The Treasury's plan has three significant problems:

First, there is the central issue of how to price the assets. When the subprime crisis hit in the summer of 2007, the Treasury's first response was to encourage the private sector to create a fund -- the so-called "Super SIV" (structured investment vehicle) -- to buy mortgage-related assets. This proposal foundered due to the difficulty of setting a price for these assets which come in complex and incomparable varieties.

Subsequent efforts to establish a price have not been successful. In fact, markets have frozen up largely due to the difficulty of pricing them. The Treasury plan does create a large and willing buyer, an element missing in the markets until now. But at what price? If Treasury pays close to par, (as Fed Chairman Ben Bernanke seemed to suggest at the Senate hearing yesterday), it is paying far too much. If it pays current prices, no one will sell due to the impact on their capital. If it pulls a price out of a hat, it will be acting arbitrarily. The proposal needs to articulate the price-setting process.

Although a reverse auction has been suggested, with asset holders "bidding" to sell their mortgage-related securities to the Treasury, such an approach raises significant problems. Most significant is the risk posed by asymmetric information regarding the value of these securities.
Because the holders of complex and incomparable mortgage-related securities have more information regarding their worth than does Treasury, Treasury is at a huge disadvantage and will likely overpay. Moreover, there will have to be many auctions of very different securities. All of this will take time to effectuate. These auctions cannot be done next week.

A second issue is whether we are better served by buying assets or institutions. The stand-alone purchase of mortgage-related assets from solvent as well as struggling financial institutions, as contemplated by the current Treasury plan, raises two basic concerns. In principle, why should losses (particularly in solvent institutions) be borne by taxpayers rather than the shareholders and debt holders? The bill put forward by Sen. Christopher Dodd on Monday somewhat mitigates this concern. It gives the Treasury contingent equity or debt interests in the financial institutions from which it purchases distressed assets in the event Treasury loses money on the resale of the assets. The Treasury's plan also provides flexibility to take this approach, and we would urge the secretary to take advantage of that flexibility if this proposal were to pass.

How can we design a transparent asset purchase process that avoids arbitrariness and potential favoritism? Any such process will have to be designed from scratch, because there is no U.S. precedent for such a targeted purchase of bad assets. The Resolution Trust Corporation and the Depression-era Reconstruction Finance Corporation both entailed government ownership of failed institutions.

The final problem is potential cost. The costs to the U.S. economy of inaction are large, with potentially significant drops of economic activity in credit-sensitive sectors and deterioration in the balance sheets of households, financial firms and nonfinancial businesses. The fiscal costs of inaction are also large, including a significant decline in business and household tax receipts, and increased federal spending due to automatic stabilizers.

The fiscal costs of action, however, are substantial. The Treasury has estimated a cost of $700 billion, and some prominent economists have estimated costs exceeding $1 trillion. The actual cost could even be larger. It is estimated that some $1.4 trillion in non-Agency backed mortgage-related securities were outstanding at the end of 2007, not including unsecuritized mortgages.

Efficient institutional design can reduce the share of costs borne by taxpayers, while repairing the financial system's ability to match borrowers and lenders and provide risk-sharing, liquidity and information services. Keeping costs down is important, as such a large increase in taxpayer support will constrain significantly, if not overwhelmingly, the fiscal initiatives of the next president.

Bold action can be designed with lower costs to taxpayers, while accomplishing the goals Treasury Secretary Henry Paulson has laid out. Elected officials should act quickly -- but carefully.

Mr. Hubbard, dean of Columbia Business School, was chairman of the Council of Economic Advisers under President George W. Bush. Mr. Scott is professor of international financial systems at Harvard Law School. Mr. Zingales is professor of finance at the Graduate School of Business at the University of Chicago.