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Fixing the Paulson Plan

By DOUGLAS DIAMOND, STEVE KAPLAN, ANIL KASHYAP, RAGHURAM RAJAN and RICHARD THALER | FROM TODAY'S WALL STREET JOURNAL ASIA

The American financial system is in deep trouble. Regulatory moves to guarantee money market funds, the conversion of Morgan Stanley and Goldman Sachs into bank holding companies, and the Treasury's asset purchase proposal have staved off a crisis for now. These hurried actions have also bought us some time to consider what would be an appropriate way to revitalize the system.

Any plan has to fulfill at least three objectives: It has to have a real chance of preventing the deep and prolonged recession that is likely to ensue if the financial system is not recapitalized. It should strive to achieve that first objective at the lowest possible costs to the U.S. taxpayer. And it should not bail out the existing investors to avoid sowing the seeds for the next crisis.

The Treasury plan to buy distressed securities in the marketplace -- proposed this week by Treasury Secretary Hank Paulson -- addresses only the first objective, and only indirectly. As we see it, the real concern about the financial sector is that it is undercapitalized, both because of the losses it has sustained and because of the growing risk aversion of lenders. Undercapitalized financial institutions are forced to try to reduce their assets, and, of course, this means they will make fewer loans, even to the healthy portions of the economy. The credit crunch that inevitably will occur implies lower corporate investment, less commercial and residential construction, fewer students getting college degrees, and in general, a much slower pace of economic growth. To avoid this contraction, levered financial institutions need more capital so that they can continue lending.

The plan attempts to recapitalize financial institutions in three indirect ways. By paying above the market value for illiquid assets (paying the hypothetical "held-to-maturity" value), the Treasury hopes to indirectly recapitalize institutions. By creating a market for illiquid assets and allowing prices to be established, it hopes other private players will enter the market, "liquifying" the market. Treasury also probably hopes that once the illiquid assets are off balance sheets,

institutions will be able to raise capital, and will become more willing to lend.

These are sound intentions, but possibly inconsistent. Paying a hypothetical "held-to-maturity" price will not help the market discover the true price that traders, who don't have the government's long horizons, are willing to pay. Moreover, it is not clear how that hypothetical price will be established through competitive auctions. Finally, of course, taxpayers bear the cost of overpaying (though they get the benefit of a sounder economy), with little or no direct help from the private sector.

There are many additional ways in which things could go wrong. The institutions with the most toxic assets are the ones that have made the worst decisions, and are likely to be the closest to default. While they may get the most relief from selling assets, they are unlikely to turn around and expand their lending quickly (nor should they, given their record). In contrast, relatively healthy financial institutions that probably have the greatest ability to expand lending may not be those getting much of the additional capital in the Treasury plan for they have few illiquid assets to sell.

Modifications to the Treasury plan could help achieve more of the objectives we laid out earlier. As Senator Christopher Dodd has suggested, the taxpayer can get "contingent equity" from sellers that is equal to 125% of any losses the government bears on the assets it purchases from a given bank. This would compensate taxpayers in case the government buys assets at too high a price. We believe this is a useful feature that can both help reduce costs to the taxpayer and also reduce the need to get the price exactly right. But we believe that it might be even better if the Treasury plan was divided into two components -- a plan to "liquify" certain moribund markets, thus allowing financial institutions to sell illiquid assets, and a plan to raise capital levels in financial institutions.

The first could be accomplished by adopting much of the Treasury plan, perhaps with Mr. Dodd's proviso. The Treasury would buy assets through a reverse Dutch auction or some variant, but without any intent to overpay. The idea would be to jumpstart the market by establishing trading prices.

The second component, raising capital, could be achieved in other ways, for example through a mixture of a mandate and an offer of partial government support. The authorities could require all regulated financial institutions, no matter how well capitalized, to present plans to raise 2% of their assets in additional capital over the next quarter to preserve the stability of the financial system. This increased capital will not represent an increase in the permanent level of required capital for bank holding companies, but instead give institutions the extra capital that will allow them to lend.

Why a mandate? Thus far banks have been urged to voluntarily go out and raise capital, and some, including Goldman Sachs on Wednesday, have. But banks,

especially some of the best managed ones, have been hesitant, in part because potential investors might view a bank's approach to the market as reflecting the bank's expectation that it will have to bear additional losses, which will cause them to lose confidence in the bank. The value of mandating this decision is that no individual bank sends an adverse signal to the market when it goes to raise capital.

Implemented collectively, the system would be recapitalized, with those getting the most upside from a healthy system helping pay for it. For those banks that find it difficult to raise capital even after selling assets to the government, the government could express a willingness to take a non-voting senior preferred equity claim, up to, say, half the capital that is required to be raised. It is important, however, that some of the capital be raised from private sources, so that the government is a co-investor, and not seen as a patsy.

It would also be wise to require additional capital, even for well-capitalized institutions. This may seem like penalizing shareholders of well-performing firms. But in fact these are institutions that could use the fresh capital very profitably in buying underpriced assets, making more loans, and taking over weaker financial firms. Well-managed institutions flush with capital will be key to averting a credit crunch, and drawing private institutions into illiquid markets.

The two components of the plan work together. Better-capitalized financial institutions have the capital to bear the losses if they sell assets at market prices. They can also raise new capital more quickly if they have sold off some of their dodgy assets and can present stable balance sheets to prospective investors. Nevertheless, while raising the level of capital in levered financial institutions is important, it need not be subject to the rushed schedule of the modified Treasury plan. It would be best, though, to pass both components together.

We believe our proposals would reinforce the Treasury plan, give it a greater chance of success, and make it appear less unfair in the eyes of the U.S. taxpayer. And if the financial sector is to escape the excesses of regulation that are likely to follow the recent period of under-regulation, it is extremely important that any rescue been seen as fair.

Messrs. Diamond, Kaplan, Kashyap, Rajan and Thaler are professors at the University of Chicago's Graduate School of Business.

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