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The Trickle-Up Bailout

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The theory underlying the bailout plan stalled in Congress is that rescuing the finance industry will restore market stability and that the benefits will eventually trickle down to average Americans. Thus, solving the subprime mortgage crisis has morphed into a much larger challenge: reassembling the architecture of the financial markets, which seemingly requires giving the Treasury secretary nearly a trillion dollars and extraordinary latitude to pick winners and losers.

There is an easier and more politically palatable fix: Pay off all the delinquent mortgages.

The financial crisis is a liquidity crisis, yes, but it is ultimately a product of homeowner failures to pay. Unless this fundamental problem is fixed, we will continue to see -- and need to treat -- the symptoms. The proposed bailout ignores this. Yet the sum being demanded from taxpayers is almost certainly more than sufficient to pay off all currently delinquent mortgages.

If the government did this, all the complex derivatives based on these mortgages would be as good as U.S. Treasuries. Their fair value would jump to 100 cents on the dollar, rescuing teetering financial institutions. The credit markets would be resuscitated overnight. Foreclosures would stop.

Some will argue that it is grossly unfair to pay off the mortgages of borrowers who took risks and lost. In other words, why should my profligate neighbor be rewarded for overleveraging himself?

Because such unfairness is a small price to pay to avoid a rapid transition to a socialist economy, the collapse of our financial system (and its related global implications) and a frightening shift of economic power toward the executive branch. Why shell out $700 billion to Wall Street dealmakers and the companies they managed into this mess? Wouldn't it be preferable for individual homeowners to benefit directly?

Implementation could follow the example of the Home Owners' Loan Corp., which in the 1930s issued new mortgages to a quarter of American homeowners. The government could offer to refinance all mortgages issued in the past five years with a fixed-rate, 30-year mortgage at 6 percent. No credit scores, no questions asked; just pay off the principal of the existing mortgage with a government check. If monthly payments are still too high, homeowners could reduce their indebtedness in exchange for a share of the future price appreciation of the house. That is, the government would take an ownership interest in the house just as it would take an ownership interest in the financial institutions that would be bailed out under the Treasury's plan.

All this could be done through the Federal Housing Administration, with the help of Fannie Mae and Freddie Mac, which have the infrastructure to implement this plan rapidly. An equity participation structure would prevent thousands of foreclosed homes from being dumped on a strained housing market and would allow prices to reach a new equilibrium that is based on realistic demand for houses rather than on easy money or impending foreclosures.

Like the administration's proposal, this plan would result in the government owning assets. But these assets would be real estate, not complex derivatives whose true value would take weeks to discern. Homeowners would become partners with the government in resolving the crisis.

When Congress returns, lawmakers are likely to modify and then pass the administration's bailout proposal. They should consider ways to implement this bottom-up solution. Combining this approach with the government's proposal could greatly benefit taxpayers. Yes, the government's swift purchase of illiquid securities would stabilize compromised financial institutions and the credit markets. But the notion that taxpayers would benefit in the long run is pure speculation, particularly if the government overpaid for the securities. On the other hand, once a government-sponsored refinancing wave kicked in, the full value of the securities in the government's portfolio would be restored, and they could be sold off in an orderly manner, with Uncle Sam taking profits that would cover the cost of the bailout.

The public is rightly concerned that the administration's bailout would benefit only powerful financial institutions. No matter how it's done, rescuing the financial system is a large, complex gamble.

This solution would start by helping ordinary Americans and would quickly spill over to revive the financial markets. Directly addressing the underlying cause of the crisis would help ensure that we would not be facing the same crisis again down the road. While Wall Street has only recently felt the bite of foreclosures and delinquencies, communities across the nation will face greater financial and social fallout if the foreclosure crisis continues.

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