The rescue plan: Direct capital investments would be better for both markets and taxpayers

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Most immediate reactions to the defeat of the emergency legislation in the House of Representatives seem to assume that, facing a choice between approval and government inaction that could bring about a financial meltdown, the House irresponsibly and irrationally opted for the latter. But the defeat of this particular bill hardly leaves us with inaction as the only alternative.

The bill was defeated at least partly because of its inability to gather sufficient public support due to its evident flaws. Congress can and should adopt quickly a bill that would address these flaws and consequently enjoy strong public support.

There is widespread recognition of the depth of the crisis and the need for governmental intervention. Why was the bill nonetheless defeated? Because there is an equally widespread recognition that spending $700 billion on purchasing (and insuring) toxic paper would be a highly flawed form of intervention.

During the week preceding the vote, it has become evident that the government’s contemplated plans for valuing troubled assets would lead to a quagmire. Opposition to the bill grew due to expectations that purchasing toxic paper could well result in massive complexities, large giveaways, and substantial public losses.

At the same time, recognition has grown that, notwithstanding these large costs, the proposed plan would fail to provide the financial sector with capital infusions that would be as immediate, large, and appropriately targeted as needed. Because the bill would provide financial firms with extra capital largely through overpaying for troubled assets (or under-pricing insurance for such assets), it would provide capital only following the consummation of complex and time-consuming processes and cannot be counted on to supply capital where and when it would be most useful.

Suppose that a financial firm runs into trouble, needs a substantial infusion of capital within days, and is viewed by the government as important to save. Even if the rejected bill were in effect at present, it would not provide the government with effective tools to deal with such a situation. For one thing, purchasing the many types of troubled assets the firm may own through the bill’s contemplated valuation procedures would require a long delay.

Consider the government’s recent infusion of capital into AIG. Facing the risk of AIG’s collapse, the government provided $85 billion right away and received in return an agreed upon set of debt and equity instruments. Had the bill passed on Monday and AIG subsequently needed assistance, the funds authorised by the bill might not be usable for...
such capital infusion by the government. Purchasing the large and highly heterogeneous portfolio of troubled assets owned by AIG through valuation processes would not provide an effective and timely form of intervention.

The passage of the defeated bill thus would not have effectively dispelled the financial markets’ worries. To do so, Congress should not reconsider the rejected bill but rather pass an authorisation for the treasury to infuse capital into financial firms. The same big, market-reassuring number can be used: $700 billion. But the bill, which I expect to obtain wide public support, should focus on and permit direct capital investment of the authorised funds.

The Treasury’s direct capital investments should be guided by the objectives of restoring stability to the financial markets and protecting taxpayers. When a firm is solvent and undercapitalised, the Treasury should insist on getting a set of new capital securities that would provide the government with adequate return on its investment.

In cases in which a firm is insolvent and not merely undercapitalised, the Treasury should still be permitted to make a capital investment if it views the firm’s continued operations as necessary to avoid disruption to the financial markets. Taxpayer losses from the legislation would be limited to such cases, and these losses would be kept to a minimum by the government’s investing in such cases only on terms effectively enabling it to take over the firm’s equity.

It would be perfectly fine for Congress to include authorisation to purchase toxic assets in the adopted legislation. But the bill should not contemplate that such purchases would be a primary form for injecting capital to financial firms, and it should allow such purchases only if they are done at fair market value.

Financial markets should be reassured that the Treasury is equipped with the best tools for addressing distress in financial firms and for shoring up these firms’ capital. Congress should move quickly to adopt legislation authorizing the use of $700 billion for infusing capital into financial firms. If it does, Monday’s defeat of the proposal to spend $700 billion on purchasing toxic paper might turn into a blessing.