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The Paulson Sale

As the cost of the credit panic becomes clearer, Americans are furious and have every right to be. The political and financial classes created this mess, and now taxpayers are being asked to save the day. We wish there were a way around this outcome, but the price of doing nothing now is likely to be far higher both for taxpayers and the cause of free markets.

The reality is that last week we had a global panic that included a flight from even basic financial assets like money-market funds and commercial paper. This was not Hank Paulson's invention. Panics are real events. If allowed to become crashes, they can have terrible economic consequences. We were lucky to forestall a crash last week, but the underlying sickness has to be addressed to avoid a recession, perhaps even a deep one.

The core of that sickness is a large capital hole in the financial system, and private capital alone can't fill it. A variety of mortgage securities are underpinned by housing assets that are falling in value. Those losses are real and will have to be written off eventually.

Private capital is vital but won't be forthcoming as long as no one knows what those assets are worth and which firms might fail. *Public* capital will be needed to refinance the banking system, whether through the FDIC or some other mechanism. Anyone who thinks otherwise doesn't understand the extent of this problem.

Treasury Secretary Paulson's plan would address the core sickness of those toxic securities. The point is to create a market when one doesn't exist, as well as a holding capacity and time to work out the assets. Real-estate securities are inherently sticky. Yet on bank balance sheets, they must either be written down or held like a ball and chain that inhibits other lending. The Treasury has the luxury of patience to buy and hold securities until they rise in price when home prices stabilize.

In that sense, the \$700 billion isn't spending per se, like Medicare, but will

instead be used to purchase these troubled assets. The risk to taxpayers is real, to be sure, especially because Mr. Paulson isn't telling anyone how Treasury intends to buy the assets. His concept of a "reverse auction" would let banks bid securities against a Treasury offer of cash -- say, \$50 million. This is better than a flat-price purchase, but it still puts banks in a superior bargaining position based on what they know about the assets.

The better idea is an open auction. This would let private buyers join Treasury in bidding for bank securities. Taxpayers wouldn't have to buy all bad securities first, and, as the market develops, those that Treasury does buy would rise in price. Treasury could even make money on the resale.

Deriding bailouts is politically potent, but the truth is that taxpayers are at risk whether or not the Paulson plan passes. The Federal Reserve's balance sheet is distended with crummy collateral, plus an \$85 billion loan to AIG and a \$29 billion guarantee for Bear Stearns securities. More bank failures are likely, as housing prices keep falling. Moonlighting as a bailout agency isn't the Fed's job and only undermines its credibility on the dollar. The Paulson plan puts these taxpayer obligations where they belong -- with the Treasury.

Another misconception is that the credit problem will vanish if only Treasury suspends "mark-to-market" accounting -- as if those bad assets wouldn't still exist. The banks themselves would know they still have this bad paper and aren't likely to engage in much new lending. Investors also don't trust the bank marks now; imagine what they'll think if the U.S. declares that cooking the books is official policy. Mark-to-market has surely contributed to this mess and needs to be revisited. But to toss it aside wholesale now would risk turning banks into the zombies of Japan's lost decade.

Another weird objection is that the program will have no "oversight." Hello? Within a month, the problem would be too much oversight, as Congress tries to second-guess every asset purchase and sale. That's especially true if Treasury were to try and use these purchases to "recapitalize" the banks by overpaying for the assets.

Mr. Paulson has to understand this will never fly politically. Unless Treasury buys assets at the market price and in a transparent way, Congress will bludgeon him or his successor for every transaction that looks like a steal for Wall Street.

There is a better -- and more transparent -- way to put public capital into the banks while protecting taxpayers: through the Federal Deposit Insurance Corp. The FDIC has long had the power to handle failed banks. But in 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA) that limited the FDIC's ability to provide assistance to struggling but still solvent

banks.

The exception is when there is a risk to the entire financial system. In that case, the President, Treasury Secretary and two-thirds of the Fed board can authorize such open-bank aid. The current moment would seem to qualify. Yet the White House has so far refused to trigger this exception and let the FDIC work with the likes of Wachovia, Morgan Stanley, and others before they crash and burn.

Whether or not the Paulson plan passes, President Bush should sign the FDICIA waiver. This would allow Treasury and the FDIC to inject new capital into banks early enough to prevent failures; in return, the feds could impose some discipline in the form of management dismissals and preferred stock or warrants that would protect taxpayers when the banks recover. This also beats the Congressional idea of attaching taxpayer warrants to the Paulson plan, which will be much harder to administer to hundreds of banks as opposed to one at a time through the FDIC.

Even if the Paulson plan passes Congress, this needs to be part of the strategy to stabilize the financial system. And if the Paulson plan fails on Capitol Hill, this is the only Plan B around.

Don't get us wrong. While the Paulson plan has risks in both design and execution, we support it as a way to defend the larger financial system if it can be passed in clean enough form to create a market. The plan has the potential to work better than Mr. Paulson made it sound with his dour salesmanship Tuesday that this is all "embarrassing for the United States of America." That isn't the way to inspire confidence among the American people.

What Americans deserve to hear is that, despite 13 months of credit turmoil, our resilient economy is still standing; and that this \$700 billion will be the best money Congress appropriates this year if it prevents a recession and crash.

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