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How to Pay Less For Distressed Financial Assets

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Treasury Secretary Henry Paulson is seeking authorization to spend $700 billion of taxpayers' money on "troubled assets" owned by financial firms. We're told his plan is the only way to stabilize the financial markets. But the plan, as proposed to Congress, can be improved to be both less costly and a better stabilizing force for the markets.

The redesign should have three elements. First, the Treasury should only buy troubled assets at fair market value. Second, the Treasury should be allowed to purchase, again at fair market value, new securities issued by financial institutions needing additional capital. Third, to ensure that asset purchases are made at fair market value, the Treasury should buy them through multibuyer competitive processes with appropriate incentives.

If troubled assets are purchased at fair market value, taxpayers might get an adequate return on their investment. And the Treasury's official statements say that "The price of assets purchased will be established through market mechanism where possible, such as reverse auctions."

But the draft legislation grants the Treasury full authority to pay higher prices, potentially conferring massive gifts on private parties. The final bill should not permit this.

Adding this fair market constraint by itself may leave us with concerns about the stability of some financial firms. Because falling housing prices depressed the value of troubled assets, some financial firms might still be seriously undercapitalized even after selling these assets at today's fair market value. That is, of course, why the Treasury wants the power to overpay. It wants to be able to improve the capital position of firms with troubled assets, restore stability and prevent creditor runs.

But the best way to infuse additional capital where needed is not by giving gifts to the firms' shareholders and bondholders. Rather, the provision of such additional capital should be done directly, aboveboard. While the draft legislation permits only the purchase of pre-existing assets, the final legislation should permit the Treasury to purchase new securities issued by financial firms needing additional capital. With the Treasury required to purchase securities at fair market value, taxpayers will not lose money also on these purchases.

Furthermore, this direct approach would do a better job in providing capital where it is most useful. Why? Because simply buying existing distressed assets won't necessarily channel the capital where it needs to go. Allowing the infusion of capital directly for consideration in new securities can do so.

Finally, how do we ensure that the government does not pay excessive prices for troubled assets or new securities issued by financial firms? The proposed legislation allows the Treasury to conduct purchases through in-house operations, outside delegation, or any other method it chooses. It would be best, however, to direct the Treasury to operate through agents with strong market incentives.

Suppose the economy has illiquid mortgage assets with a face value of $1 trillion, and the Treasury believes that buyers with $100 billion would be enough to bring the necessary liquidity to this market. The Treasury could divide the $100 billion into, say, 20 funds of $5 billion, and place each fund under a manager who does not have conflicting interests.

Each manager could be promised a fee, say 5%, of the *profit* his fund generates -- that is, the difference between the fund's final value and the $5 billion initial investment. Competition among the fund managers, armed with the needed liquid funds and motivated by their 5% fee, would produce prices set at fair market values.

Revising the Treasury plan in the ways just described would do a far better job of protecting taxpayers' interests, and restoring financial stability, than what the Treasury initially proposed.

Mr. Bebchuk is a professor of law, economics and finance at Harvard Law School. This op-ed is based on his just-issued white paper, "A Plan for Addressing the Financial Crisis."

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