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Plan B

After pointing a gun to the head of Congress, threatening a financial meltdown in case his plan was not approved, Treasury Secretary Hank Paulson has finally arrived at the only logical conclusion: his plan will not work.

Desperate for a Plan B, Paulson is slowly warming to the suggestion of many economists: inject some equity into the banking system. Unfortunately, it is too little and too late. The confidence crisis currently affecting the financial system is so severe that only a massive infusion of equity capital can reassure the market that the major banks will not fail, recreating the confidence for banks to lend to each other. The piecemeal approach of 100 billion today, 100 billion tomorrow used with AIG will not work. It will only eat up the money, without achieving the desired effect—without reassuring the market that the worst is over. Simply stated, nothing short of a 5% increase in the equity capital of the banking system will do the trick. We are talking about 600 billion. Unfortunately, even if the government is willing to spend this kind of money, there are three problems.

First, to restore the necessary confidence, a capital infusion needs to reduce a financial institutions' risk of default to trivial levels. This implies transforming the existing, outstanding debt (roughly two trillion if we just count the long-term bonds) into safe debt. A large fraction of the equity injected will not go to generate new loans, but to provide this insurance to the existing debtholders. How much? We can estimate it by looking at the credit default swaps, which provide us with the cost of insuring the debt against default. At yesterday's prices, the cost of insuring the two trillion of outstanding long-term bonds outstanding would be more than 300 billion. Consequently, half of the capital the Government will invest in banks will not go to increase new loans, but to bail out Wall Street investors.

Second, a capital infusion does not address the root of the problem, which stems from the housing market. If homeowners continue to default and walk away from their houses, the banking sector will continue to bleed and additional equity infusions will be needed. More importantly, the very bailout plan, and the animosity it generates, will

induce more homeowners who are sitting on a house with a negative equity value to walk away. Many of them will think: “Why do I have to play by the rules when Wall Street does not?”

This leads us to the third and most important problem. If we bail out Wall Street, why not bail out Detroit (probably another 150 billion) and Main Street? In fact, Senator McCain has already talked about buying out the defaulted mortgages to keep people in their homes. Even if we limit ourselves only to the subprime mortgages, we are talking about \$1.3 trillion. Where do we stop?

We need a different solution: a Plan B. A plan that minimizes the money the Government uses in bailing out Wall Street and Main Street to save our precious dollars for a stimulus package, which will be essential to restarting the economy.

Rescuing Main Street

Suppose that you bought a house in California in 2006. You paid \$400,000 with only 5% down. Unfortunately, during the last two years the value of your house dropped by 30%; thus, you now find yourself with a mortgage worth \$380,000 and a house worth \$280,000. Even if you can afford your monthly payment (and you probably cannot), why should you struggle to pay the mortgage when walking away will save you \$100,000, more than most people can save in a lifetime? However, when the homeowner walks away, the mortgage holder does not recover \$280,000. The foreclosure process takes some time during which the house is not properly maintained and further deteriorates in value. The recovery rate in standard mortgage foreclosures (which will not take place in the middle of the worst crisis since the Great Depression) is 50 cents per dollar of the mortgage. I am generous in estimating that under the current conditions it might recover 50 cents per dollar of the appraised value of the house; right now, it is only 37 cents per dollar of the mortgage, which given a house appraised at \$280,000 equals only \$140,000 for the mortgage holder. In other words, foreclosing is costly for both the borrower and the lender. The mortgage holder gains only half of what is lost by the homeowners, due to what we economists call underinvestment: the failure to maintain the house.

In the old days, when the mortgage was granted by your local bank, there was a simple solution to this tremendous inefficiency. The bank forgave part of your mortgage;

let's say 30%. This creates a small positive equity value—an incentive—for you to stay. Since you stay and maintain the house, the bank gets its \$266,000 dollars of the new debt back, which trumps the \$140,000 that it was getting through foreclosure.

Unfortunately, this win-win solution is not possible today. Your mortgage has been sold and repackaged in an asset-backed security pool and sold in tranches with different priorities. There is disagreement on who has the right to renegotiate and renegotiation might require the agreement of at least 60% of the debt holders, who are spread throughout the globe. This is not going to happen. Furthermore, unlike your local bank, distant debt holders cannot tell whether you are a good borrower who has been unlucky or somebody just trying to take advantage of the lender. In doubt, they do not want to cut the debt for fear that even the homeowners who can easily afford their mortgage will ask for debt forgiveness.

Here is where government intervention can help. Instead of pouring money to either side, the government should provide a standardized way to re-negotiate; one that is both fast and fair. Here is my proposal.

Congress should pass a law that makes a re-contracting option available to all homeowners living in a zip code where house prices dropped by more than 20% since the time they bought their property. Why? Because there is no reason to give a break to inhabitants of Charlotte, North Carolina, where house prices have risen 4% in the last two years.

How do we implement this? Thanks to two brilliant economists, Chip Case and Robert Shiller, we have reliable measures of house price changes at the zip code level. Thus, by using this real estate index, the re-contracting option will reduce the face value of the mortgage (and the corresponding interest payments) by the same percentage by which house prices have declined since the homeowner bought (or refinanced) his property. Exactly like in my hypothetical example above.

In exchange, however, the mortgage holder will receive some of the equity value of the house at the time it is sold. Until then, the homeowners will behave as if they own 100% of it. It is only at the time of sale that 50% of the difference between the selling price and the new value of the mortgage will be paid back to the mortgage holder. It seems a strange contract, but Stanford University successfully implemented a similar

arrangement for its faculty: the university financed part of the house purchase in exchange for a fraction of the appreciation value at the time of exit.

The reason for this sharing of the benefits is twofold. On the one hand, it makes the renegotiation less appealing to the homeowners, making it unattractive to those not in need of it. For example, homeowners with a very large equity in their house (who do not need any restructuring because they are not at risk of default) will find it very costly to use this option because they will have to give up 50% of the value of their equity. Second, it reduces the cost of renegotiation for the lending institutions, which minimizes the problems in the financial system.

Since the option to renegotiate offered by the American Housing Rescue & Foreclosure Prevention Act does not seem to have been stimulus enough, this re-contracting will be forced on lenders, but it will be given as an option to homeowners, who will have to announce their intention in a relatively brief period of time.

The great benefit of this program is that provides relief to distressed homeowners at no cost to the Federal government and at the minimum possible cost for the mortgage holders. The other great benefit is that it will stop defaults on mortgages, eliminating the flood of houses on the market and thus reducing the downside pressure on real estate prices. By stabilizing the real estate market, this plan can help prevent further deterioration of financial institutions' balance sheets. But it will not resolve the problem of severe undercapitalization that these institutions are currently facing. For this we need the second part of the plan.

Rescuing Wall Street

The plan for Wall Street follows the same main idea: facilitating an efficient renegotiation. The key difference between the Main Street and Wall Street plans is in the ease of assessing the current value of the troubled assets. It is relatively easy to estimate the current value of a house by looking at the purchase price and at the intervening drop in value (per the Case and Shiller index). In banks, however, the lack of transparency makes this estimation very difficult. To avoid having to come up with this estimate, which would be a difficult process and one fraught with potential conflict of interests, we

are going to use a clever mechanism invented twenty years ago by a lawyer economist, Lucian Bebchuk.

The core idea is to have Congress pass a law that sets up a new form of prepackaged bankruptcy that would allow banks to restructure their debt and restart lending. Prepackaged means that all the terms are pre-specified and banks could come out of it overnight. All that would be required is a signature from a federal judge. In the private sector the terms are generally agreed among the parties involved, the innovation here would be to have all the terms pre-set by the government, thereby speeding up the process. Firms who enter into this special bankruptcy would have their old equityholders wiped out and their existing debt (commercial paper and bonds) transformed into equity. This would immediately make banks solid, by providing a large equity buffer. As it stands now, banks have lost so much in junk mortgages that the value of their equity has tumbled nearly to zero. In other words, they are close to being insolvent. By transforming all banks' debt into equity this special Chapter 11 would make banks solvent and ready to lend again to their customers.

Certainly, some current shareholders might disagree that their bank is insolvent and would feel expropriated by a proceeding that wipes them out. This is where the Bebchuk mechanism comes in handy. After the filing of the special bankruptcy, we give these shareholders one week to buy out the old debtholders by paying them the face value of the debt. Each shareholder can decide individually. If he thinks that the company is solvent, he pays his share of debt and regains his share of equity. Otherwise, he lets it go.

My plan would exempt individual depositors, which are federally ensured. I would also exempt credit default swaps and repo contracts to avoid potential ripple effect through the system (what happened by not directing Lehman Brothers through a similar procedure). It would suffice to write in this special bankruptcy code that banks who enter it would not be considered in default as far as their contracts are concerned.

How would the government induce insolvent banks (and only those) to voluntarily initiate these special bankruptcy proceedings? One way is to harness the power of short-term debt. By involving the short-term debt in the restructuring, this special bankruptcy will engender fear in short-term creditors. If they think the institution might be insolvent, they will pull their money out as soon as they can for fear of being

involved in this restructuring. In so doing, they will generate a liquidity crisis that will force these institutions into this special bankruptcy.

An alternative mechanism is to have the Fed limit access to liquidity. Both banks and investment banks currently can go to the Federal Reserve's discount window, meaning that they can, by posting collateral, receive cash at a reasonable rate of interest. Under my plan, for the next two years only banks that underwent this special form of bankruptcy would get access to the discount window. In this way, solid financial institutions that do not need liquidity are not forced to undergo through this restructuring, while insolvent ones would rush into it to avoid a government takeover.

Another problem could be that the institutions owning the debt, which will end up owning the equity after the restructuring, might be restricted by regulation or contract to holding equity. To prevent a dumping of shares that would have a negative effect on market prices, it is enough to include a norm that allows these institutions two years to comply with the norm. This was the standard practice in the old days when banks, who could not own equity, were forced to take some in a restructuring.

The beauty of this approach is threefold. First, it recapitalizes the banking sector at no cost to taxpayers. Second, it keeps the government out of the difficult business of establishing the price of distressed assets. If debt is converted into equity, its total value would not change, only the legal nature of the claim would. Third, this plan removes the possibility of the government playing God, deciding which banks are allowed to live and which should die; the market will make those decisions.

Tomorrow is too late

The United States (and possibly the world) is facing the biggest financial crisis since the Great Depression. There is a strong quest for the government to intervene to rescue us, but how? Thus far, the Treasury seems to have been following the advice of Wall Street, which consists in throwing public money at the problems. However, the cost is quickly escalating. If we do not stop, we will leave an unbearable burden of debt to our children.

Time has come for the Treasury secretary to listen to some economists. By understanding the causes of the current crisis, we can help solve it without relying on public money. Thus, I feel it is my duty as an economist to provide an alternative: a

market-based solution, which does not waste public money and uses the force of the government only to speed up the restructuring. It may not be perfect, but it is a viable avenue that should be explored before acquiescing to the perceived inevitability of Paulson's proposals.