THE WALL STREET JOURNAL.
WSJ.com

OPINION | FEBRUARY 4, 2009

We Can Do Better Than a 'Bad Bank'

And we already have the resources to recapitalize lenders.

By GEORGE SOROS

The Obama administration should come out of the gate with a comprehensive economic program that has two pillars in addition to a fiscal stimulus package. One would prevent housing prices from overshooting on the downside by making mortgages cheaper and more available and reducing foreclosures to a minimum; the other would enable banks to resume lending by adequately recapitalizing them. It would take several months to implement the program and a further period before it impacts the economy. But in the meantime, people could see that there is a way out, and that would help mitigate the severity of the downturn.

Adequate recapitalization of the banking system now faces two seemingly insuperable obstacles. One is that former Treasury Secretary Henry Paulson has poisoned the well by the arbitrary and ill-considered way he implemented the $700 billion Troubled Asset Relief Program (TARP). As a result, the Obama administration feels it cannot ask Congress for more money at this time. The other is that the hole in the banks' balance sheets has become much bigger since TARP was introduced. The assets of the banks -- real estate, securities, and consumer and commercial loans -- have continued to deteriorate, and the market value of bank stocks has continued to decline.

It is estimated that an additional $1.5 trillion would be required to adequately recapitalize the banks. Since their total market capitalization has fallen to about $1 trillion, this raises the specter of nationalization, which remains politically and even culturally unpalatable.

Consequently, the Obama administration plans to use up to $100 billion from the second tranche of TARP funds to establish an aggregator bank, or "bad bank," that would acquire toxic assets from the banks' balance sheets. By obtaining 10-to-1 leverage from the balance sheet of the Fed, the bad bank could have $1 trillion at its disposal. That is not sufficient to cleanse the balance sheets of the banks and restart lending, but it would bring some welcome relief.

The bad bank could serve as a useful interim measure, except that it will make it more difficult to obtain the necessary funding for a proper recapitalization in the future. It will also encounter all kinds of difficulties in valuing toxic securities, and it will serve as a covert subsidy to the banks by bidding up the price of their toxic assets. This will generate tremendous political resistance to any further expenditure to bail out the banks.

For these reasons it would be a mistake to take the "bad bank" route, especially when there is a way to adequately recapitalize the banks with currently available resources. The trick is not to remove the toxic assets from the banks' balance sheets but instead put them into a "side pocket," as hedge funds are doing with their illiquid assets. The appropriate amount of capital -- equity and unsecured debentures -- would be sequestered in the side pocket.

This would cleanse bank balance sheets and transform them into good banks but leave them undercapitalized. The same $1 trillion that is now destined to fund the bad bank could then be used to infuse capital into the good banks.

Although the amount needed to recapitalize the banks would be more than $1 trillion, it would be possible to mobilize a significant portion of the required total amount from the private sector. In the current environment, a good bank would enjoy exceptionally good margins. Margins would narrow as a result of competition, but by then the banking system would be revitalized and nationalization avoided.

The scheme I am proposing would minimize valuation problems and avoid providing a hidden subsidy to the banks. Exactly for that reason it is likely to encounter strong resistance from vested interests.

Losses would first accrue to holders of shares and debentures; only if losses exceed a bank's capital would the FDIC be liable for the deficiency, as it is already. Shareholders would be severely diluted, but they would be given tradable rights to subscribe to the good bank, and if there is a positive residue in the side pocket it would also revert to the good bank, giving shareholders the benefit of any subsequent appreciation.

The fact that debenture holders may lose money will make it more difficult to sell bank debentures in the future. But that is as it should be: Banks should not be as highly leveraged as they have been recently.

In addition to restarting bank lending, my scheme would resolve the moral-hazard issue for years to come. The banking industry is accustomed to turning to the state in a crisis and effectively demanding a bailout on the grounds that financial capital has to be protected to ensure the proper functioning of the economy. Given the aversion to state ownership of banks, this form of blackmail has always worked, and indeed helped create the financial crisis we're in today. The Obama administration ought to resist this blackmail and adopt the scheme outlined here.

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Printed in The Wall Street Journal, page A13