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NEWS ANALYSIS

Paulson's toxic-loan plan never got started

The Treasury chief's decision formalizes October policy shift on massive bailout fund. Some observers worry about inconsistent signals.

By Michael A. Hiltzik

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Treasury Secretary Henry M. Paulson's decision to abandon plans to buy troubled bank assets shows that he has come to two conclusions about what was once the chief focus of the government's $700-billion bailout:

The first is that it wouldn't work. The second is that the economists and financial experts who agitated to have capital injected directly into the banking system now appear to have been right all along.

Paulson announced Wednesday that the federal government would formally abandon plans to buy troubled mortgage-backed securities from banks and other big investors to instead focus its efforts on thawing credit markets.

The shift, however, had been in place since last month. A week after the package was passed by Congress on Oct. 3, Paulson began signaling that the thrust had changed and that much of the $700 billion instead would go toward providing capital to banks by investing in their preferred shares.

That action might be compared to replacing a gravely ill patient's slow intravenous drip with a shot of adrenaline into the heart. The stock market rallied, and over the next few weeks the capital injections intensified and talk of the asset purchases ebbed.

"The surprise content of the announcement today is precisely zero," Georgetown University finance professor Sandeep Dahiya said Wednesday. "This is not a change of policy, but a recognition of a policy that's already happened."

At the start of this week, only $60 billion still remained to be spent from Congress' initial $350-billion outlay, and the asset-purchase program still had not been established.

Although Treasury's change of course has aligned the U.S. more closely with Britain and continental Europe, where direct recapitalization of banks has become the standard response to the financial crisis, it has raised new doubts about the U.S. bailout.

These include concerns about Paulson's inconsistent direction. The Treasury secretary originally presented the plan to buy toxic mortgage-based investments under the Troubled Asset Relief Program as the only conceivable solution to bank failures, then vehemently resisted congressional attempts at modification.

"This was a major piece of legislation," observed Campbell R. Harvey, professor of international business at Duke University. "TARP was what people were voting on, and now he announces that TARP is not going to be TARP."

Another concern is that Paulson and Congress are failing to specifically define the purpose of TARP. Originally the program was aimed at troubled banks, particularly those whose failure might undermine the domestic or global financial systems.

On Wednesday, however, Paulson said the remaining TARP funds would be directed at "both banks and non-banks" with troubled holdings; at non-bank credit markets that have stagnated, such as those for credit card receivables, auto loans and student loans; and at the housing market to stem the risk of foreclosure. These categories represent a dramatic expansion, and arguably a dilution, of the program.

"It's much too broad and much too vague," said Lee Ohanian, an economics professor at UCLA.

Paulson, moreover, previously approved spending TARP funds to help bail out insurance company American International Group Inc.

Congress, meanwhile, has begun to eye TARP as a pool of cash available for bailouts of automakers and, potentially, other failing industries.

"The big worry right now is that every industry in trouble in the recession will be in line," said John H. Cochrane, a professor of finance at the University of Chicago Booth School of Business.

He argued that TARP eligibility should be limited to institutions whose failures would pose "systemic risk" -- that is, their collapse would reverberate throughout the domestic and international economies.

Some economists contend that in abandoning the asset purchase plan outright, Paulson may have swung the bailout's pendulum too far.

"There should be a two-pronged approach of reducing banks' exposure to troubled assets and injecting equity," Harvey said.

Almost immediately after Paulson unveiled the plan in September, critics said the government would find it almost impossible to set a price for the banks' troubled assets that was low enough so that taxpayers would not be cheated by overpaying for them but high enough to significantly improve the banks' health.

Because most of the mortgage-backed securities at issue were custom-crafted from thousands of individual home loans, setting purchase prices was bound to be a complex and imperfect process.

The purchase plan also seemed to require a large bureaucracy, comprising asset managers from Wall Street, government managers exercising oversight in Washington and officials setting standards for everything from pricing to ethics rules.

"It was very complicated operationally," said Georgetown's Dahiya. "The equity infusion requires no infrastructure; you just write a check. Asset buying requires thousands of people, hundreds of businesses. It simply couldn't get done in time."

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A major switch in bailout strategy

Treasury chief Paulson, above, jettisons the plan's centerpiece: buying up troubled mortgages. A19