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# Hank Paulson's $125 Billion Mistake

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By Steven Pearlstein
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It was only a few weeks ago that most right-thinking economists and left-leaning bloggers were jumping on Treasury Secretary Hank Paulson for his plan to jump-start the markets in asset-backed securities by having the government buy them up at auction. Much better, they argued, to use the $700 billion to "recapitalize" the banking system, just as Gordon Brown was doing in Britain. Even the Federal Reserve thought that a better idea.

So Paulson changed course, called in the nine biggest banks and "forced" them as a group to accept $125 billon in new capital. The critics patted themselves on the back for having been right all along.

Now, many of the same people are shocked -- shocked! -- to discover that the banks aren't using the money to make new loans to households and businesses, as they had assumed, but are using it to maintain dividend payments to shareholders, pay this year's bonuses to executives and traders, or squirrel it away for future acquisitions.

I hate to say it, but I told you so. Sprinkling money around a highly fragmented banking system when markets were panicked and everyone was scrambling to reduce leverage was always akin to shoveling sand against the tide.

Certainly there are situations in which capital injections are necessary. In Britain, for example, there are only a handful of banks that matter, and those had their capital so depleted that there was no choice but to pour money into them, on onerous terms and with lots of strings attached. And certainly, as with PNC's purchase of National City, a dose of government capital can grease the takeover of a weak bank that might have otherwise failed and required government intervention.

But making modest investments in dozens of banks, whether they needed it or not, produces little for the public beyond the small profit for the Treasury. What it does do, however, is open the door for every politician and populist to second-guess every decision and expenditure the banks make, based on the false assumption that everything they do is with "our money."

Paulson's first mistake was in allowing himself to be diverted from his original strategy, which stood a good chance of establishing reasonable and credible market prices for asset-backed securities -- a necessary first step in attracting other buyers back into those frozen markets. That would take tremendous pressure off all banks, insurance companies, hedge funds and bond insurers, most of which now can't raise capital because nobody can even guess what the assets on their books are worth, forcing accountants and auditors to assume the worst. It also would get liquidity to those institutions that most need it.

Paulson's second mistake was buying into the silly idea that it was crucial to attract all the big banks into the program so that any bank that might really need the money could avoid the stigma of having to ask for it. That's a surprising stance from a Treasury that claims to trust markets and encourage transparency. Nor does it square with recent evidence that investors are quite capable of sniffing out weak financial institutions long

before managements come clean.

Moreover, in trying to persuade banks that don't need the money to take it, the Treasury has wound up offering everyone the same sweetheart deal that gives the government little say in how the money is used or how the banks are run. That's particularly dangerous in the case of weaker banks, which might be tempted to take big risks in the hope of recouping past losses or to divert money to shareholders and executives before the inevitable government takeover.

In the case of some of the stronger banks, however, much of the carping about bonuses and dividends and refusal to lend are a bit overblown.

These are, after all, large institutions with many activities, some of which make money even as others lose it. Paying the bonuses to successful employees is not only fair but is also necessary to attract and retain top talent. It hardly serves the interest of taxpayers if all the banks they invest in wind up losing top talent to all the banks they didn't.

Moreover, banks like J.P. Morgan, Wells Fargo, State Street and the newly chartered Goldman Sachs remain highly profitable and well-capitalized. It ought to be up to them to decide whether to use those profits to add to capital reserves or pay them out in dividends and executive bonuses. We might not like their choices, or their values, but this is still a market economy, and these are still shareholder-owned companies. The industry hasn't been nationalized just yet.

It is also useful to remember that the way banks make money is to lend it out, not hold it in the vault or invest it in low-yielding Treasury bonds. Hoarding is not generally a winning strategy for maximizing share prices or executive bonuses. It is also useful to remember what got us into this mess in the first place. If banks are using their new capital to reduce their own leverage, or are more cautious about whom they lend to, that's probably a good thing.

Perhaps the worst part of this misguided effort to recapitalize the banking system is that it has prompted other industries to line up for similar sweetheart deals. Automakers, insurers, auto finance companies and local governments are already besieging the Treasury, and you can be sure that others are refining their pitch. One can only hope that the terms of future deals will be sufficiently onerous that going to the Treasury will be become a last resort, not a first instinct, for industries in trouble.

*Steven Pearlstein will host a Web discussion at 11 a.m. today athttp://washingtonpost.com. He can be reached atpearlsteins@washpost.com.*

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