Even desperate times need the right measures.

We have a full blown panic in financial markets. Any but the safest assets are being heavily discounted. Policy makers have to be thinking in more radical terms than they have done so far to fight the contagion. But that is no reason to do the wrong thing.

There seems to be an impression that the real problem continues to be the liquidity of mortgage backed securities. Hence the proposal to set up a government agency to buy these securities from distressed banks, akin to the role played by the Resolution Trust Corporation (RTC) in the 1980s. There are concerns with this proposal. First, even though the illiquidity of the market for mortgage backed securities, and the substantial markdown in prices of these assets, was responsible for the losses suffered by financial institutions, simply attempting to halt further falls in asset prices will not restore sanity to the financial system. The real problem is the financial system has too little capital. Buying assets at the current depressed market price will not help. And overpaying substantially for these assets will reward the shareholders of the most incompetent or risk-seeking banks, who hold the largest amounts of this now-toxic waste, with the most taxpayer dollars.

The second concern, however, is that because financial firms have too little capital and are unwilling to raise more, a variety of other asset markets risk becoming illiquid as financial firms sell assets. In how many markets can the agency buy assets? And how deep will its pockets be? The danger of overpaying for assets, with too small a war chest, spread too thinly, is that the agency will taken some distressed assets off the hands of a few firms, even while speculators bet on the price falling once the agency has to exit the markets because it runs out of money. And unfortunately, the war chest it will take for any government agency to stabilize markets in the face of speculative attacks can be substantial indeed.

Indeed, there is a critical difference between the proposals making the rounds and the RTC. The government, as insurer of failed thrifts, essentially took over their assets and placed them in the RTC. The main task of the RTC was to sell assets in an orderly manner, not buy them. So the RTC did not have to determine a price at which it would buy assets, or support a falling market – at best it had to hold assets off the market.

I would propose a more direct solution. The need of the hour is to recapitalize the financial system. Why not ask the shareholders of financial firms to do it? Financial firms have been reluctant to raise capital thus far. One difficulty is that an equity issuance may send a negative signal, suggesting to the market that there are more losses to come. It may also be difficult for them to cut dividends to stem the outflow of capital, for such cuts may signal management’s lack of confidence in the firm’s future. Another difficulty comes from what is known as the debt overhang problem: when a highly indebted entity issues equity, much of the value raised effectively bolsters the value of the risky debt. Because of this value transfer, essentially at the expense of existing equity, equity holders are unlikely to look upon a recapitalization favorably. Yet this reluctance is hurting the system, and ultimately, financial firm shareholders.

The public purpose is served by forcing firms to raise capital. Unfortunately, regulators may also be reluctant to force individual firms to raise capital until they are well and truly undercapitalized, for fear of sending wrong signals to the market about their health. But by then it may be too late.

This is why it makes sense to apply force. Consider two measures. First, all levered financial firms (including banks and investment banks – defining who these are is an important but not impossible detail) should be asked to impose a temporary moratorium on dividend payment immediately. Second, all large well-capitalized levered financial firms should make rights offerings (if the rights are offered at a large enough discount to the market price, shareholders will be forced to subscribe) to their shareholders amounting to 2 percent of their risk-weighted assets. The value of mandating these decisions is that no individual bank sends an adverse signal to the market. And implemented collectively, they could recapitalize the system, with those getting the most upside from a healthy system paying for it.

I suggest restricting the rights requirement only to well-capitalized entities. This may seem like penalizing shareholders of well-performing firms. But in fact these are institutions that could use more capital very profitably in buying underpriced assets, and taking over weaker financial firms. Authorities could also reward these firms by facilitating acquisitions, possibly through favorable tax treatment. By contrast, forcing weak firms to issue rights risks tanking an already fragile share price, and is not a risk worth taking at this juncture. These are desperate measures, but if shareholders who stand to gain are not forced to recapitalize the system, the government will be forced to. The former is far better.

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