CDS Backstop is the Answer
September 21, 2008

It is of course good news that the Treasury and Fed are looking for a "comprehensive approach to address the illiquid assets on bank balance sheets." Their first idea seems to be to buy the assets outright, using the proceeds from an emergency issue of Treasury securities, perhaps as much as $700 billion. In this way, financial institutions could replace their illiquid assets with Treasuries, and so put a floor on their losses, leaving the government to hold the risky assets until conditions improve. The biggest operational challenge of such a plan is clearly the challenge of pricing all these illiquid securities.

One way to address this challenge is to start by recognizing that very many of the assets in question were priced, at the time of initial sale, by reference to the index swap prices on the various tranches of the ABX.[*] An individual mortgage backed security tranche that was rated AAA was priced by reference to the AAA index swap, and similarly a AAA CDO tranche. Assuming we can trust the ratings, and also the pricing model used to create the original price—both big assumptions to be sure—we might be inclined to use this same procedure to price the assets now. But can we trust the index swap prices? There are good reasons to think that we cannot.

So long as dealers were willing and able to make a two way market in index swap contracts, the liquidity in the ABX was transferred to liquidity in related contracts. Today however everyone wants to buy insurance and no one wants to sell, and dealers are in no position to take the imbalance on to their own balance sheets. The consequence is falling index prices. We could use these distress index prices to set the prices at which the government offers to buy, but then the only takers would be holders who are themselves sufficiently distressed that they absolutely must sell. If the point is to get the assets off of private balance sheets, offering a distress price would seem not to be the way to go.

There is another way. The price of a risky asset should be equal to the price of a riskfree asset plus the price of insuring the risky asset. Rather that setting the price for each risky asset individually, by reference to the price of insurance set in the index credit default swap market, we might work in reverse by setting the price of insurance. Indeed, it might make sense to focus on the price of the very highest rated index swap, and let the market determine the lower tranche prices as a spread over this basic price. Focusing on the AAA tranche makes particular sense because the risk involved in the highest tranche is almost entirely systemic risk, which cannot be diversified away and hence is not really insurable except by the government (as the problems at AIG have recently reminded us).

The government could set the price on the AAA index swap by offering to sell insurance in unlimited amounts at a fixed price. This price would then feed through into the price of AAA rated mortgage backed securities as well as AAA CDO tranches, and also (with a market-determined spread) into the price of lower rated securities and CDO tranches. In this way, we can move all the prices by setting one price.

Even more, by using the government to create a two-way market in the AAA swap, we will be creating the conditions for recovery of the private two-way market in lower tranche insurance. That means that the liquidity in the AAA contract will be

[*] See BIS report "Credit Risk Transfer" (July 2008).

extended to liquidity in lower tranches, and from there on to related contracts. And if this happens, then it might not be necessary for the government to purchase any assets at all, and we can save $700 billion. By acting in effect as market maker of last resort (as Willem Buiter might say) in one key market, the government can support the market in general.

Sounds like magic? In fact a CDS backstop is nothing more than a more focused version of Treasury's current idea to swap Treasury bills for individual risky assets. The net exposure involved in such a swap of assets is exactly the same as a credit default swap written on the individual asset. Rather than using an actual $700 billion dollars to manufacture what are in effect default swaps on individual securities of widely varying risk, we could write a notional $700 billion dollars worth of index default swaps on the highest rated index, and that might be all we need to do. This would put a floor on the AAA index, and that floor would be translated throughout the entire system of private balance sheets without a single asset having to be transferred to the government balance sheet.

No doubt it will take time to set up the apparatus needed to make this system operational, and in the meanwhile there will be a need for continued intervention to treat emerging problems in individual institutions. But in the long run, we want to be thinking about measures that support markets, not measures that support individual institutions. In this respect, the great virtue of the CDS backstop is that it can (and should) be a permanent part of our financial system, not just an ad hoc crisis measure. Indeed the lack of such an explicit backstop is arguably one of the fundamental causes of our current crisis.

Why are we in the mess we are in? One reason is that private agents wrote contracts that promised to insure against systemic risk, contracts that were mispriced to be sure, but also contracts that they never should have made. For lack of an explicit government guarantee, we got an explicit private guarantee that could not hold and, as we are now realizing, an implicit government guarantee that was not priced. An explicit, priced, government guarantee is a key foundation stone of a future reconstructed financial system, as well as a key element of current crisis intervention.

Perry Mehrling
Professor of Economics
Barnard College, Columbia University

Home Phone: 617-244-6352
Cell Phone: 617-285-3551