

If the problem is trust, then the solution is insurance

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In all likelihood, by the time you are reading this the US government will have a new balance sheet to work with, perhaps as large as \$700 billion. What should it do with it? \$700 billion buys a lot of assets, but it would buy a lot more insurance, and insurance is what the system needs.

Credit insurance is what made the world go around, back when it was going around. And lack of insurance is what is making the world freeze up. We conclude that the government needs to be in the credit insurance business. Instead of issuing Treasuries to purchase assets outright, it should issue credit insurance policies as the liability of the new \$700 billion entity.

These policies could be insurance on particular assets or on a class of assets issued by identifiable names. They could be credit default swaps on individual assets, or on collections (or indices) of assets. They could be insurance on super-senior tranches, or very junior tranches. The price of the insurance would depend on the risk.

For example, suppose you own a BBB mortgage backed security, the liquidation value of which is 5. An insurance policy that guarantees payment at par may then be worth 95. Suppose you own a super-senior CDO tranche, the liquidation value of which is 70. An insurance policy that guarantees payment at par may then be worth 30.

But how, you ask, are troubled asset holders going to come up with the money to pay for insurance? Where are they going to get the 30, much less the 95? They get it by issuing equity shares, let us say preferred shares, to the Treasury. The pool of all these shares is then the pool of assets that the Treasury has available to make good on its insurance contract promises.

From the point of view of the individual firm, such an arrangement increases their assets by the value of the insurance and increases their liabilities by the value of the shares. By buying insurance, they turn their risky assets into riskless assets. By issuing shares they recapitalize their balance sheets.

From the point of view of the Treasury, such an arrangement increases assets by the value of the shares and liabilities by the value of the insurance. It is a simple swap of IOUs, and the Treasury can keep doing these swaps up to \$700 billion if necessary.

Sounds magic? In fact it is nothing more than a generalization of what the Treasury did with AIG. AIG had written a lot of credit insurance policies, and then the credit tsunami hit. By taking an 80% equity position in AIG, the government in effect took over the costs involved with these insurance policies (a liability) in return for an equity stake (common equity in this case, not preferred).

Here is how the math works. Suppose the government buys super senior assets outright at 70 using the new Treasury balance sheet. It could buy 700 billion dollars worth, and it would fund this purchase by issuing a similar quantity of Treasury bills. If instead the government sold insurance on the super senior tranche, it could sell \$700 billion worth and use the proceeds to acquire \$700 billion in preferred equity, an asset not a liability.

Notice that the Treasury plans allow you to buy 1 trillion face value worth of the super senior bonds, because you are buying at 70. But insurance policies worth \$700 billion would cover assets with a face value of $700/30=2.33$ trillion. More bang for the buck.

That works however only at the top of the risk structure. If instead the new Treasury entity buys BBB securities at 5 it could buy $700/5=14$ trillion dollars worth face value outright. If it used the insurance mechanism, that insurance would cover a face value of only $700/95=736.8$ billion.

The conclusion is simple. In balance sheet terms, the most efficient way to backstop the value of the top rated securities is to write insurance policies on them. And the most efficient way to backstop the value of the low rated securities is to purchase them outright.

In the first case we need to set the price of the insurance. In the second case we need to set the price of the asset. But from an economic point of view these are exactly the same problem, since the price of insurance plus the price of the risky asset should equal the price of a riskfree security such as a Treasury bill.

Not only is the pricing problem the same, but so is the net exposure. If you insure the supersenior tranche you lose if the tranche falls in value. If you buy the BBB tranche you lose if the tranche falls in value. The economics is the same, even if the most efficient balance sheet exposure is different.