Paulson Plan Compared with Kotlikoff-Mehrling Plan
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Three possible pricing structures can be contemplated: distress prices (current), support prices, and normal prices (pre and post crisis). The table below shows the relationship between the price paid for the bond under the Paulson Plan and the price paid for the insurance under KM. In each case, the two prices add to 100. The price of insurance is high when the price of the bond is low, and vice versa.

	Price of Riskfree	Price of Risky Bond	Price of Insurance
Distress Prices			
AAA tranche	100	70	30
BBB tranche	100	5	95
Support Prices			
AAA tranche	100	80	20
BBB tranche	100	10	90
Normal Prices			
AAA tranche	100	95	5
BBB tranche	100	90	10

The Paulson Plan involves outright purchase of $50bn worth of bonds in each tranche. Maximum loss in each tranche is thus capped at $50bn. The table below shows how the KM plan could be devised to achieve exactly the same maximum loss, in each of the three pricing scenarios. The key is to insure the face value of the bonds that the Paulson Plan would purchase outright.

Case 1: Distress Prices

	Paulson Plan		KM Plan	
	Face Value of Bonds purchased	Maximum Loss	Insurance Premiums received	Maximum Loss
AAA tranche	71.43	50	21.43	50
BBB tranche	1000	50	950	50

Case 2: Support Prices

	Paulson Plan		KM Plan	
	Face Value of Bonds	Maximum Loss	Insurance Premiums	Maximum Loss

	purchased		received	
AAA tranche	62.5	50	12.5	50
BBB tranche	500	50	450	50

Case 3: Normal Prices

	Paulson Plan		KM Plan	
	Face Value of Bonds purchased	Maximum Loss	Insurance Premiums received	Maximum Loss
AAA tranche	52.6	50	2.6	50
BBB tranche	55.6	50	5.6	50

Observations:

1. In each scenario, the downside exposure of the taxpayer is exactly the same. If the bonds go to zero, then under the Paulson plan you lose what you paid. Under the KM plan you lose the face value of the bond minus the premiums paid.
2. In each scenario, the upside exposure of the taxpayer is exactly the same. If the bonds go to par, then under the Paulson plan you gain the difference between par and what you paid. Under the KM plan you get to keep all the premiums and don't pay out any claims.

Further Observations:

1. The Distress Prices do nothing to recapitalize sellers of the distressed assets. If these prices are chosen, then recapitalization could be included in the plan by accepting preferred stock as payment for the insurance.
2. The Support Prices help to recapitalize the sellers and support markets during distress times. As the economy returns to normal however no one will want to be paying these prices, and private insurers will step in charging lower prices.
3. Support Prices near Distress levels will attract very little demand, but they may provide backstop for recovery of private market insurance at a more attractive price. Support Prices near Normal levels will attract a lot of demand, and crowd out any potential private insurance.
4. Insurance of the AAA tranche is largely insurance against systemic risk, which should be the government job, so for the AAA tranche we want support prices nearer normal.