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The Right Financial Fix

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Fortunately, the Treasury and Fed are looking for a "comprehensive approach to address the illiquid assets on bank balance sheets." Their idea is to swap up to $700 billion in Treasuries for the "toxic" assets, putting a floor on bank losses and leaving the government to hold the risky assets until conditions improve. The big question is the swap rate; i.e., how to price these thousands upon thousands of illiquid securities so that both taxpayers and bank shareowners are fairly treated.

Treasury Secretary Paulson wants to run auctions to determine prices, but this will take time to set up and may be impractical given the highly complex nature of many of the securities involved. Furthermore, those holding the worst securities will be the most eager to sell.

Our answer is to rely on the same pricing mechanism, but not the same prices, used before things hit the fan. In the good old days, mortgage derivatives were priced by reference to the cost of buying default insurance on five tranches of a bundle of 20 standard subprime mortgages. The top tranche (AAA) provided the highest probability of full repayment. The lowest tranche (BBB) had the lowest probability. In between were another 3 tranches. The market for these insurance contacts is called the ABX.

Avant le deluge, you could use ABX prices to figure out what a given tranche of a standard mortgage-backed security was worth. It would simply be the value of a safe bond -- a Treasury with the same coupon -- minus the ABX-determined price for default insurance for that tranche. The reason is that once you had purchased the insurance, you are guaranteed a safe income stream; i.e., you were guaranteed the equivalent of a Treasury bond. More exotic mortgage-backed securities, with now scary initials, like CDO2s, could also be priced using the ABX.

So here's our specific idea. Rather than ask Hank Paulson to determine the price of each and every toxic asset, let's have him simply set prices for the ABX insurance policies (or credit default swaps, as they are called). Right now these insurance policies are selling for crazy prices because nobody can insure against systemic risk. Nobody, that is, except the government. The government is in a unique position to insure against system-wide risk because its own decisions determine, to a very large degree, the extent of this risk.

Were the government to start selling the ABX insurance policies at reasonable prices, our Cinderella mortgage-derivatives market would suddenly wake up and start pricing every mortgage-related security in sight based on these ABX prices. If Hank does this, the market will do essentially all the pricing; Hank will have only a handful of prices to set, not thousands.

But how does Hank set those prices? What's fair? What's fair are insurance policy prices that assumes no system collapse, a modest additional decline in house prices, a mild recession, and modest additional increases in default rates. Yes, these are optimistic assumptions, but that's the economic outcome the government is arranging and it needs to signal its resolve.

Once the five prices are set, Hank can keep the $700 billion in his pocket. What will happen to the banks? With reasonable ABX insurance prices, their toxic assets will take on reasonable values. This will restore their balance sheets and allow them to keep operating. Yes, this will help bank shareholders, but they will still end up far worse off than at the beginning of this crisis. Taxpayers will keep their $700 billion pistol dry for another day, including the potential need to cover possible losses on these insurance polices.

The Treasury will be receiving premium payments as it sells the ABX policies -- premiums it could receive in the form of equity claims, rather than cash, which would further help capitalize the banks.

Playing the ABX market-maker is step one for the government. Step two is reorganizing banks whose capital is still too low even when its "toxic" assets are revalued. This means helping such troubled banks finding a marriage partner. Step three is reregulating the entire financial sector. This includes establishing a Federal Financial Authority that stamps a seal of approval on consumer financial products that it deems to be safe, that rates individual securities, and that audits the books and rates the performance of each and every one of our nation's major companies.

The final step, and the most important, is to require financial institutions to report on line and in fine detail everything they know about the assets they hold. The principle here is simple enough even for Wall Street "geniuses" to understand. If you want to sell the public a product, including your stock, you need to explain what it is.

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