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Recapitalising the banks is not enough

by *Laurence Kotlikoff, Perry Mehrling and Alistair Milne*

The infusions of equity in a score or so of major banks will help prevent a deep and prolonged world-wide recession. So will the Fed's new Money Market Investor Funding facility, and similar guarantees provided in some other countries, which support unsecured short-term borrowing by top-rated financial institutions.

But these steps won't help most banks to get back to their main job – lending to households and businesses. For banks to lend, they must borrow and doing so, on any scale, requires collateral. Collateral today is in terribly short supply because trillions of dollars in AAA or better senior structured credit securities, including top-tranche mortgage-backed securities, are no longer being accepted.

Even securities that will pay off under the most dire scenarios are being tarred, and thus valued, as “toxic” in today's marketplace. The best way for governments to jump-start the banking system is by restoring the value of this collateral. They can do this by selling insurance against default on the good toxics, those which still merit AAA ratings, and by purchasing the bad collateral.

These securities are like tainted baby formula. They need to be removed from the shelves in order to restore customer faith in all the other products for sale. This can easily be done since they are now worth relatively little and will sell at low prices in the proposed reverse auctions. Buying up the good toxics is a different story. Outright purchase would require huge and immediate government outlays. In contrast, selling insurance on the good toxics requires no short-term outlays.

Nor need this sale of insurance policies drain banks of their badly need cash; governments could sell their insurance in exchange for preferred stock. This insurance would provide a government backstop on losses, making the securities once again easily traded and valuable collateral.

It would also reverse much of \$1 trillion mark-to-market bank losses on US structured credit exposures reported in the current IMF *Global Financial Stability Report*. Insurance of tail risk on good “toxic” assets is better than guarantees on bank wholesale borrowing. It eliminates investor fear of extreme loss, without forcing governments to guarantee all bank liabilities.

This, in turn, allows the private sector to compete for the returns from absorbing the remaining part of the risk distribution. A key to making this policy work is selling the insurance at reasonable prices, ie at premiums that would prevail in a mild recession. This may sound like a give-away to bank owners, but if the premiums are set right, they would be cheaper than the private market now offers, but more expensive than will prevail once the economy returns to normal, ie they should priced

high enough in order to provide governments with a reasonable expected return on their underwriting and low enough to actually deliver the goods, namely preventing a deep and prolonged global economic downturn.

The point of the proposed insurance is to put a floor under the value of the best quality structured credit products. We suggest a maximum loss of 10 per cent, so investors cannot lose more than 10 per cent of their promised income stream. This means that the securities being insured will sell for at least 90 per cent of what a safe Treasury bond would cost delivering the same expected income stream.

There is good precedent for this proposal, namely the successful creation of Brady Bonds by US Treasury Secretary Brady in 1989, which provided a range of US government guarantees (and haircuts) on Latin American government and bank-issued debt, which were in default and, thus, could not be used by solvent financial institutions to collateralise their own borrowing. Once the Brady Bonds were swapped for the prevailing toxics, credit in Latin America because to flow again.

The current case is no different. Once existing credits start trading again, new credits will become possible, and as new credit starts flowing, the real economy will recover. Private insurance can help. Insurance by the monolines and AIG was a key element in the pre-crisis system of structured finance.

Government backstop insurance is the key element needed now. But as the crisis wanes, governments should let private insurers re-enter the market to insure first-tier losses and provide insurance only against true cataclysmic, systemic risk.

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