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KEY COMPONENTS OF AN EFFECTIVE AND JUST BAILOUT PLAN

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Congress should concentrate now on a **short list of crucial features** of any bailout plan that are most important to protect the public interest and ensure success in resolving the financial crisis

1. Equity “Upside” and Voting Power. In return for the undeniable new risks that U.S. taxpayers are taking on, and the poor management track record of leading Wall Street institutions, it is reasonable to insist that they receive an “upside” on the value of participating financial institutions (FIs) themselves as well as on the potential increased value of acquired mortgage-backed assets. This proposal commands widespread support in this panel.

Technically, this could be accomplished by demanding **preferred shares** (with anti-dilution provisions) from any financial institutions (FIs) that receive assistance, as was routinely done by Bank of Japan in exchange for financial assistance during the Japanese bank restructuring of the 1990s, and by the Chilean government during the February 1983 bank nationalization.

Warrants might also be used, as was done in the case of the 1979 \$1.2 billion Treasury loan guarantee to Chrysler. We believe that while warrants are easier to implement, it is vital to insist on actual equity (including voting power). This will provide the Treasury with much more direct influence over management behavior and will be easier to value.

2. Clawback Provisions for Executive Severance Pay. The basic principle here is that for senior FI executives, there should be accountability for some time period even after they leave office – at a minimum, any future compensation or severance that they receive should be subject to stiff taxes or repossession in bankruptcy court. Insisting on compliance with this standard should be a condition for participation in the bailout.

3. Share the Pain.

A. Emergency Taxes. Since this very costly bailout package may severely limit the ability of the Federal Government to afford vital programs like health insurance reform and alternative energy, it is important to deal now with the substantial “tax justice” implications of the bailout.

One way to do so would be to start treating this as the national emergency that it really is, and help ordinary taxpayers pay for it by: (1) eliminating the carried-interest benefits for hedge fund managers; (2) cracking down on offshore havens – no FIs should be permitted to establish subs or place Special Purpose Vehicles (SPVs) in them; (3) imposing at least a temporary increased income tax rate on all people with incomes above \$1 million and on all estates above \$10 million.

B. Compulsory Write-Down/ Debt Reduction of Residential Mortgages.

Given the failure of this summer’s relief packages for ordinary mortgage holders to have much impact, and the fact that foreclosures are still increasing (to a record 100,000+ per month) and that housing prices are still falling in a majority of key markets, this is another essential measure. The debt restructuring should be implemented quickly, affect large numbers of people, and be inversely proportional to mortgage size. It might also be means –tested.

4. Treasury-Created Market for MBS Insurance. As discussed in the draft article below, a very novel idea is that the US Treasury might be able to use current authority to offer mortgage derivative ABX-like insurance at a fixed price per tranche to institutions that hold Mortgage Backed Securities (MBSs). According to Professors Kotlikoff and Merlin, if such a government-backed insurance market were in place, backed by a significant reserve against losses, it might even obviate the need for the entire \$700 billion, while creating a market-based workout alternative.

This could be combined with #1, if FIs were allowed to pay for the insurance with equity or warrants, and it would also have the benefit of helping to recapitalize troubled FIs.

5. Financial Products Safety Commission. This would review and certify the quality of all financial products offered to the general public. Products like zero-down payment mortgages would require special labeling, and might not qualify for government incentives like interest deductibility, access to the government insurance window, and so forth.

6. New “Pecora Commission” (ala 1932): a congressional committee with subpoena power to investigate the root causes of this crisis and recommend further steps. The FBI is now investigating mortgage fraud in more than two dozen companies.

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 cost of buying a safe bond - a Treasury - with the same coupon plus paying 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. The Treasury will be receiving premium payments as it sells the ABX policies -- premiums that it will need to keep in reserve.

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.

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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