Financial events moved like a firestorm the last three weeks easily jumping the firebreaks put in place by the Federal Reserve and the Treasury. Saving most financial institutions requires a quick and decisive responsive program that strikes at the source of the financial implosion.

I. Problems
   a. The credit market is frozen.

   Financial institutions (FI) borrow short and lend long. Short maturity debt has the least senior claim on assets. Lenders to FIs—other FIs and outsiders—fear that the institution may default. The fear is based on facts, Lehman, Bear-Stearns, and Wachovia failed. The spread between the 3-month Libor (interbank lending rate) and the 3-month T-Bill rate hit a 25 year high of 3.87% after the House passed the TARP on Friday 10/03. More importantly the outstanding value of short term interbank debt plummeted. FIs don’t know value of other institutions and a premium of $4 per thousand doesn’t make it worthwhile to investigate opaque assets and complicated counterparty obligations. The “risk premia” cannot clear markets with asymmetric information.

   b. Most FIs are illiquid but not insolvent.

II. A Plan to directly address these problems.

   a. To restore the interbank (FI) lending market and control moral hazard,
      i. Guarantee the short maturity debt (Fed Funds, and CDs) of the FIs that join the Plan
      ii. impose a capital requirement on all FIs in the Plan

   The guarantee eliminates counterparty risk. Government guaranteed FI short maturity debt is default free.

   The capital requirement eliminates, or at least mitigates, the moral hazard problem introduced by the guarantee. With no capital requirement FIs have an incentive to borrow at the default free rate and buy risky assets with higher average returns. FIs that are close to insolvent have the greatest incentive to buy the riskiest assets. If the risky investment pays off, then they are solvent. If not, they likely would have failed anyway. This happened with a vengeance in the S&L fiasco in the 1980s.

   In contrast to this plan, the TARP approved by Congress focuses on buying toxic assets from FIs. Unloading some toxic assets doesn’t eliminate counterparty risk and will not thaw the market in a time of crisis. The TARP would have to guarantee FIs against default to assure lenders. To control moral hazard TARP would have to regulate all FI behavior, i.e., nationalize the FIs.
The debt guarantee plan is similar to the Futures Exchange Clearinghouse guarantee that makes trading among anonymous agents feasible. The Futures Exchange Clearinghouse guarantees delivery and payment on futures contracts so that traders don’t have to worry about counterparty risk. To give traders an incentive to perform the exchanges requires that they post margins, i.e., capital requirements. Banks now have risk based capital requirements. These should be extended to all FI that want the debt guarantee (and maybe all capital requirements should be increased because the world got riskier—margin requirements depend on price volatility.)

If the FI fails—cannot meet its debt obligations or the capital requirement—then Gov’t (Fed, I presume) takes control of the FI. The Futures Market Clearinghouse takes control of a client’s account if he cannot meet the margin call.

b. Part b
   i. The Gov’t offers to provide capital to the FIs that join the plan for some interval—say, three months—for an equity share.

The capital requirement forces the FI to have a stake in the outcome. Undercapitalized FIs benefit most from the guarantee. But, undercapitalized FIs must give up a share of equity ownership to participate in the Plan.

I propose a kinder-gentler form of the Warren Buffet model. Buffet infused Goldman-Sachs with $5 billion in capital. In return he got $5 billion in preferred stock with a 10% dividend rate plus warrants that give him the right to buy $5 billion of Goldman stock for a strike price of $115 a share (the price on the day of the deal.) That’s a pretty tough deal—but, not so tough that Goldman, arguably the premier investment bank, refused it.

The Plan should be similar, but probably less demanding. If taxpayers put their funds at risk, then they should get a warrant that gives them a share in the appreciation if the FI prospers. They should also get some interest on the capital they provide, but 10% seems like a lot. Remember the goal is to restore a vibrant private financial market at the minimum cost to taxpayers.