

# Subprime Superfund

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The Treasury's involvement in the so-called "superconduit" -- in which a group of banks will establish a fund for the purchase of mortgage and other asset-backed securities -- has produced two kinds of reactions. One is fear that a government bailout of the big banks is under way, the other is puzzlement that any good could come from a group of banks purchasing more of something that they already have in excess.

The fears are misplaced. The possible beneficiaries of this plan go well beyond the banks themselves.

The objective of this fund is simple: price discovery. All markets struggle to establish the clearing price, the point at which buyers and sellers are willing to trade. When there is great uncertainty about a product's value, buyers back off because they can't assess the risks, and would-be sellers fear unnecessary losses if they sell at too low a price. In these circumstances, the market may grind to a halt, and that is exactly what has occurred in the market for asset-backed securities. No one knows how much the pools of mortgages or other assets that back these securities are actually worth. As a result, the market for many asset-backed securities -- especially mortgages -- is moribund.

Enter the superconduit. With a substantial wad of cash, the contributing banks can help to discover the price at which trading will take place. It's not a mysterious process. The bidding starts low and there are no sellers (holders think the assets are worth more). The bid continues to rise until the supply of securities starts to flow. That's at least the beginning -- a substantial number of holders think their mortgage or other asset-backed securities are worth at least that much.

At that point, it may no longer be necessary to continue the fund's activities. A market may have ignited; the confidence of buyers and sellers may return; the vulture buyers stop circling and enter bids. The price may be much lower than what it was two months ago, but it's a real price, reflecting in one number all the risks that buyers and sellers think they can foresee at that moment in time. This is not science. We're in the realm of art, where the differing estimates of value by buyers and sellers eventually converge.

Despite the Treasury Department's involvement, this is not a bailout. The Treasury does not have the powerful regulatory authority that made the Fed's involvement in the Long-Term Capital Management hedge fund look like a government-mandated financial rescue. Moreover, Treasury has no funds with which to effect a bailout or to make good on a guarantee.

Why, then, are the banks doing this? The discovery of a price for hundreds of billions of dollars of asset-backed securities and commercial paper is very much in the banks' interest. If they did not think of this themselves, they should have. Without a readily visible market price, two things will happen in the weeks and months ahead. As the financing underlying the asset pools comes due, the lenders will refuse to roll over their loans. The borrowers -- be they structured investment vehicles established by banks, pension funds or other institutional investors -- will have to repay. Forced to sell the assets, they will take whatever they can get and supplement it with their own funds.

The losses will be larger than necessary -- not because the value of the assets is low, but because they are being dumped at distress prices. In addition, the holders of these securities will then have to face their auditors as the year end approaches. Auditors seldom offer a sympathetic ear, and they are not rewarded anymore for imaginative solutions. They will want the asset-backed instruments to be marked down to the distress price, the only price they can find on the record. Finding a market price through the superconduit will thus save the banks and other holders of these securities from an excessive writedown and the accounting losses that will result.

If it makes so much sense for the banks, why is the Treasury involved? The full story isn't known, but a good guess is that the deal needed an honest broker. Banks are like cats; they aren't easily herded. Their culture is aggressive competition. Someone has to bring them together, and J.P. Morgan is long gone. Given the importance of the asset-backed securities market to the health of our economy, it would have been irresponsible of the Treasury to refuse.

Over time, the market would have righted itself without the superconduit. The bottom fishers who bought at distress prices would profit as others recognized the true value of the securities that were dumped; the price would gradually rise to the clearing level. Meanwhile, however, without a liquid market for the assets they create, originators of mortgages, credit-card loans and other loan facilities would reduce the availability of credit, raise their rates, or both. The economy might enter recession. So a few banks trying to stimulate price discovery for their own benefit could well produce benefits for us all.

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