THE WALL STREET JOURNAL.
WSJ.com

OPINION | FEBRUARY 19, 2009

Five Ways to Restore Financial Trust

Government should offer matching funds for IPOs.

By BILL BRADLEY

Restoring trust in the financial system is the key to solving the current economic crisis. Today, people don't trust bankers and banks don't trust other banks because they know that they have assigned totally arbitrary values to the assets on their own books. The result: Banks won't lend because they don't trust they will be repaid.

Increasingly, it seems as if much of the banking and hedge-fund industry in the last decade was a house of cards built by leverage, irresponsible lending and complicated derivative instruments. What began as a limited subprime crisis has morphed into a $33 trillion drop in global stock markets. In such a climate, a $787 billion fiscal stimulus will be wasted unless we clean up banks' books and get them lending again.

What can we do? Here are five suggestions that may help ease the credit crisis, spur economic recovery sooner rather than later, and lay the groundwork for future economic growth:

- *Trust a market approach first to deal with the bad assets*. Given the complexity and opaqueness of derivatives such as collateralized debt obligations, mortgage backed securities, and the $60 trillion of credit default swaps, the best way to set their value is to let independent, knowledgeable investors who are willing to put their own money on the line negotiate the price and buy the toxic assets from the banks.

President Barack Obama's financial team seems to be heading in this direction with its public-private fund for toxic assets. Taxpayers will pay less if individual Americans are allowed to invest alongside the knowledgeable investors, thereby reducing the amount of public money that is necessary. However, banks will incur losses and, depending on their size, the government should temporarily relax capital ratios, give banks more time to write off losses, or recapitalize the banks with oversized losses.

Treasury Secretary Timothy Geithner's decision to send bank examiners and forensic accountants into banks will provide essential information for the public whatever actions follow. True transparency is a necessary condition for getting out of this financial morass.

- *Provide a floor for home mortgages*. Adding to what Mr. Obama proposed on foreclosures yesterday, the federal government should simply offer to insure any delinquent, non-agency residential mortgage for 60 cents on the dollar as long as the mortgage servicing company (under the Troubled Asset Relief Program) takes steps to modify loan terms -- lower interest rates and longer payback period. Once the floor price is set on these delinquent loans, all the derivatives that hang on them like apples on a tree will have a reference price. More importantly, investors will be able to identify the bottom in the real-estate market. Once that happens, some of the $6 trillion now stuffed in money market funds around the world will make its way back into the real-estate and stock markets. Values of all mortgage related assets, derivatives and structured financial products will also probably rise, and more homeowners will be able to stay in their homes.

- *Move mortgages from adjustable to fixed rates to avoid future crises.* For once the federal government needs to get ahead of events. In any home refinancing, the government should offer to subsidize the difference between the ARMs and the current 30-year mortgage. Since interest rates on ARMs and 30-year mortgages are converging, the cost to the government would likely be under $10 billion on the $100 billion of ARMs coming due in the next three years.

- *Invest in new companies.* Stimulus funds should not only rebuild bridges. They also should be invested in new companies that will create the jobs of the future. Some $10 billion of the stimulus package should be used to buy 50% of the initial public offering of every company that filed an approved S-1 registration with the SEC by the time the stimulus package became law. By making it retroactive, the government would avoid picking winners and foreclose weaker companies that are only filing an IPO for the government funds. With a dollar-for-dollar government match in every IPO, the economic effect will be immediate as young companies hire more employees and invest in their business, keeping the U.S. on the cutting edge of change for another generation. Photonics, genomics, new software and alternative energy are every bit as important to America's future as roads and bridges.

- *Strengthen Treasury bonds.* Given the $8 trillion in direct assistance and guarantees we've provided our financial system since this crisis began, the $787 billion in fiscal stimulus Congress just passed, and the existing national debt of nearly $11 trillion, many investors are expecting future inflation. Foreign investors, who own more than 30% of our Treasury debt, may be afraid to buy more. Worse, they may sell what they have, causing the dollar to plummet. To rebuild trust among foreign investors, our government must be willing to cut spending and raise taxes in the next two to three years.

Some say we can get to that when inflation heats up. I say it's too late then. Why will China, Japan, Europe and the Gulf states continue to buy U.S. Treasurys if they believe that the inflationary consequences of America's exploding debt will substantially devalue their investments?

The Obama administration, in the next five months, needs to put forward a plan to make Social Security solid for the next 75 years. It should then propose a strategy to control the costs of Medicare, Medicaid and defense spending, which (along with Social Security and interest on the national debt) will make up 85% of the federal budget by 2015. Mr. Obama should tell the American people that if we fail to do both things -- stimulate in the short term and rein in deficits in the mid term -- there will be no long term for our children.

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