Tragedy in the Making in Washington and on Wall Street: The Canadian Solution

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> "When troubles come, they come not single spies, but in battalions." Shakespeare (1564-1616)

> "The liberty of a democracy is not safe if the people tolerate the growth of private power to the point where it becomes stronger than the democratic state itself. That in its essence is fascism — ownership of government by an individual, by a group or any controlling private power." Franklin D. Roosevelt (1882-1945), 32nd US president

> "Our economy is facing a moment of great challenge. … We're in the midst of a serious financial crisis." George W. Bush, September 24, 2008

The Washington gridlock about finding a solution to the subprime financial crisis in the United States is turning into a tragedy, seemingly because of a fundamental lack of understanding and communication about the causes of this financial crisis and the most efficient way to solve it. The nature of the crisis, the economic consequences if it is not solved, and how it could be solved without costing the government and U.S. taxpayers a single penny has not been properly explained to Congress and to the U.S. population.

Indeed, in this election period, there is a clear danger that the financial crisis is not going to be solved properly by the U.S. government and by Congress, and that there will be dire economic consequences in the months and years ahead, not only for the United States but also for the world economy. A similar subprime crisis has been solved in Canada, without costing the government and Canadian taxpayers a single cent. Although such a solution, i.e. transforming most of the subprime mortgage-back securities into medium term debentures, would have to be adapted to the peculiar American situation, this can be done.

The Canadian solution

In August 2007, it was discovered that Canada, just as the U.S., had a subprime mortgage-backed securities problem. Since the Canadian economy is more than ten times smaller than the American economy, the magnitude of the problem was also smaller, but it was nevertheless acute.

Indeed, Canada's subprime mortgage market was a smaller proportion of the total mortgage market than in the U.S. and mortgage defaults have not been as prevalent in Canada as in the United States. For instance, there has not been a housing bubble burst in Canada. Overall, risky mortgage-backed paper constituted, about 5 per cent of the total mortgage market, while in the U.S., subprime mortgage paper constitutes about 20 per cent of the total mortgage market, and mortgage defaults have been rising dramatically.

Nevertheless, there was some $32 billion (CAN) of non-bank asset-backed commercial paper in Canada. When this market became illiquid after August 2007, as a consequence of the global credit crisis that originated in the U.S., a restructuring committee was assembled in Canada by large pension plans, Crown corporations, banks and other businesses holding the bulk of $32 billion in non-bank asset-backed commercial paper (ABCP) in order to find a solution to the liquidity problem. (Large Canadian banks covered the asset-backed commercial paper that were on their books or in their money market funds). This was the Pan-Canadian Investors Committee for Third-Party Structured ABCP, chaired by a Toronto lawyer, Mr. Purdy Crawford, and created after a proposal that originated from the large Quebec pension fund, the Caisse de dépôt. This was the Montreal proposal.

The committee ended up proposing to restructure the frozen and illiquid securities into longer-term securities. It proposed that ABCP notes, initially intended as low-risk and short-term debt, be exchanged for new replacement notes or debentures that would not mature for years (seven or nine years) while earning interest originating from the underlying primary mortgages. The plan was approved by a Canadian court last June and is scheduled to close by September 30, after Canada's Supreme Court refused to hear an appeal against the plan.

The plan was designed to prevent a forced a fire sale of the asset-backed paper and to restore confidence in the Canadian financial system, especially in the money market funds. And it did all that without the government risking a penny of taxpayers' money.

Of course, those entities that had invested in what they believed to be liquid and relatively high-yield 30- to 90-day debt instruments had to accept new notes maturing within nine years, but most of them thought that this was better than the alternative of outright liquidation. Those investors can hold the newly-issued notes to maturity or they can try to trade them in the secondary market. A market for asset-backed securities was thus indirectly created where none existed before.

What lesson can be drawn for the current U.S. predicament?

The U.S. Problem: Real danger of a cascading debt-deflation spiral

The financial crisis is much more severe and much more widespread in the U.S. than in Canada. Therefore, a large scale Canada-like solution would have been, most likely, unrealistic. Could hundreds of American banks and pension funds get together to restructure the illiquid mortgage-backed paper? This is doubtful.

However, the principles behind the Canadian solution can be retained and the mortgage-backed securities could be restructured into longer-term securities carrying interest. But because of the size and complexity of the American financial system, this would have to involve the U.S. government as an intermediary.

In the U.S., for example, the mortgage market (residential and commercial) is about $14 trillion, that is a size equal to the annual gross domestic product (GDP). Overall, the U.S.'s total interest-bearing debts are now a staggering $51 trillion (consumer, corporate and government debt), that is to say a level of total debt more than three and a half times the annual GDP. For decades in the past, the ratio of debt to GDP was about 1.0. This shows the extent of American current over-indebtedness.

In the short run, however, there are two urgent problems faced by the U.S. economy that must be solved with as little economic perturbation as possible.

First, there is the most urgent problem of solving the overhang of illiquid mortgage-backed securities which were created as the equivalent of liquid commercial paper. They must be urgently aligned more closely with the more long term mortgages downstream they are based on. Since much of this illiquid mortgage-backed paper is found in the $4 trillion money market funds market, there was and there still is the danger of a run on such funds in the coming days and weeks if investors fear for the safety and liquidity of their balances. A collapse of the market in money market funds would be equivalent to the banking collapse of the 1930's, since this is where companies park most of their required cash flows in the short run.

The second American financial problem is related to the approximately $2.7 trillion in municipal securities outstanding, a large proportion of which have been relying on a bond insurance system that is teetering on the brink of collapse. The U.S. Treasury partly solved this problem temporarily when it announced on Tuesday, September 16, that it had loaned $85 billion (for two years) to the largest world insurance company, American International Group (AIG), in exchange for a 79.9 percent stake in the company, thus avoiding a formal bankruptcy filing for AIG. This was, of course, after announcing that the U.S. Treasury promised to inject some $200 billion in the government sponsored Fannie Mae and Freddie Mac in preferred shares, in order to solidify their mortgage lending operations and their $5.3 trillion joint debt.

The Bush administration's proposal to create a fund of $700 billion to buy back illiquid mortgage-backed paper does not seem to have been structured in a manner that would avoid an outright subsidy to the American banking sector. If it were to be used to recapitalize private banks, this amount would be too small. This need not be. In fact, much of the legitimate fear that many Americans have that large amounts of public money are going to be used to subsidize Wall Street firms can be avoided, and the amount required to restructure the subprime-based securities market could be considerably reduced.

Indeed, there is a way for the U.S. Treasury to play an intermediary role in restructuring most of the illiquid mortgage-backed paper that creates so many problems today, not the least would be the possible collapse of large segments of the U.S. financial system.

Since time is of the essence, Congress could approve the creation of a U.S Government Mortgage Restructuring Trust (MRT), designed to exist for a twelve-year maximum period, that is, until 2020. Such a government trust could buy back, at a fair market value (including a substantial discount to reflect poor liquidity and poor marketability), illiquid but still solvent mortgage-backed securities, held by banks or money market funds.

Simultaneously, the government trust would have the power to reissue mortgage-backed debentures with a maturity of nine years or less and carrying interest financed by the underlying mortgages thus acquired, and in an amount large enough to cover at least the initial cost of acquisition. The Fed and its twelve regional banks, plus Fannie Mae and Freddie Mac, could play an important role in creating a liquid secondary market for such government-backed securities. Because of this reissuance feature, the $700 billion guarantee initially proposed by Sec. Henry Paulson could be reduced, possibly to a more palatable level of $250 billion.

Such an operation would relieve the U.S. banking system from short-term mortgage-backed securities that are presently de facto frozen, because there is no market for them. It would also allow American savers and investors to include in their IRAs or 401(k) plans safe and profitable investments. Moreover, it would provide capital to the mortgage market and help turn the housing slump around.

And, what's more, such a debt restructuring operation need not cost the government and American taxpayers a single penny, in the end. To the contrary, the program can be structured in such a way as to generate a fair return on the government's initial investment.

Simultaneously, a regulatory ban on the issuance of any new securitized mortgage-backed paper could be issued. The same could apply also to the dangerous practice of elevating the credit rating of certain bonds or debentures through reliance upon the credit-default (insurance) market. These were the two main corrosive "innovations" which have resulted in the present financial mess.

Moreover, such a restructuring plan could be kept simple and totally transparent.

In conclusion, this is something that the Bush administration and the U.S. Congress might want to consider if they hope to get out of the ideological and political deadlock they have talked themselves into.

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