<u>How To Fix Our Banking System</u>
The "Genesis" Plan

by Karl Denninger
karl@denninger.net

It is clear that we must act to stabilize our financial markets. What is also clear is that if we act imprudently we will destroy our financial markets and system instead of saving it, and are likely to usher in a Depression.

What Henry Paulson and Ben Bernanke have proposed will do the latter, not the former.

The root cause of the current lack of trust in our financial markets is threefold:

1. Nobody can trust a balance sheet. This is due to off-balance-sheet vehicles (which were supposed to be banned after ENRON) and "Level 3" assets, which nobody can analyze the true valuation of, as identification of the claimed assets and their valuation models are undisclosed.

2. Credit Default Swaps (CDS) are "over the counter" (OTC) transactions with no margin or capital supervision. As a consequence nobody knows if their "counterparty" can pay. In fact huge percentages of these people can't pay – but nobody knows who they are.

3. Leverage. The SEC removed broker/dealer 12:1 leverage limits in 2004. Every firm that has failed – all five (Fannie, Freddie, Bear Stearns, Lehman and AIG) had leverage far in excess of 12:1. The draft bill is even more dangerous as it accelerates a provision intended to go into effect in 2011 that allows Ben Bernanke to <u>**increase**</u> financial firm leverage by dropping reserve requirements on banks to <u>**zero**</u> should he so choose. **It is excessive leverage that got us here in the first place, and this bill actually makes it worse.**

The solution to the trust issues in our financial system is elegant and it will work.

1. Force all off-balance sheet "assets" back onto the balance sheet, and force the valuation models and identification of individual assets out of Level 3 and into 10Qs and 10Ks. Enact this requirement beginning with the 3Q 2008 reporting period which begins next month. Total taxpayer cost: $0.00

2. Force all OTC derivatives onto a regulated exchange similar to that used by listed options in the equity markets. This permanently defuses the derivatives time bomb. Give market participants 90 days to get this done; any that are not listed in 90 days are declared void; let the participants sue each other if they can't prove capital adequacy. Total taxpayer cost: $0.00

3. Force leverage by all institutions to no more than 12:1. The SEC intentionally dropped broker/dealer leverage limits in 2004; prior to that date 12:1 was the limit. Every firm that has failed had double or more the leverage of that former 12:1 limit. Enact this with a six month time limit and require 1/6th of the excess taken down monthly. Total taxpayer cost: $0.00

Once 1-3 are put in place then send in the OTS and OCC examiners and look at every financial institution in the United States. All who are insolvent and unable to raise private capital immediately are forced through receivership where the debt is converted to equity and existing equity is wiped out.

With the CDS monster caged the systemic risk is removed, the bondholders provide the cushion for recapitalization (as it should be) and the restructured firm emerges with no debt while the former bondholders are now the owners (of the equity) in the resulting firm.

With a clean balance sheet the restructured firms remain in business and open the next morning able to raise and attract capital.

For the few firms that have an insufficient debt-holder capital cushion to successfully complete this process, we are left with two options – a capital infusion or liquidation. There will be few of these and in fact each of those firms is a regulatory failure, as we should have never permitted a firm to become so far "underwater" that the bondholder's capital is insufficient to capitalize a restructuring.

For those firms, give the FDIC (or if an insurance company, the appropriate state and federal regulatory authorities) primary control. As the CDS monster has been caged, the primary threat is now loss to state and federal guarantee programs. If these regulators deem that this firm's liquidation would result in an unacceptable loss to the system's guarantee programs then recapitalize the firm as follows:

- The government shall be issued senior preferred debt ahead of all other debt and equity in the capital structure, paying a floating coupon of 3 month LIBOR + 8% adjusted quarterly, in an amount sufficient to bring regulatory capital above minimum limits.

- All dividends are suspended for as long as the preferred remains outstanding, and during that period no employee of the firm may receive any form of compensation exceeding that of the President of the United States for a corporate officer, and no more than that of a United States House member for any person who is not a corporate officer. At the issue of the preferred stock all outstanding deferred compensation, including options, are deemed cancelled.

- The firm may retire the preferred at its option by repurchasing it at the issue price.

- The appropriate regulator shall have primary authority to "call" the above debt issue at any time and force bankruptcy (along with recovery of invested amounts) should the firm fail to execute an effective turn-around plan.

Finally, drop the silly shorting restrictions. Liquidity in the market stinks and this is a big part of why. Start prosecuting aggressively the rumors and other manipulation that leads to stocks **both** rising and falling.

This plan will instantaneously stabilize the credit markets as balance sheets will be transparent, the CDS monster will be permanently de-fanged, leverage will be returned to reasonable levels and the forcibly restructured firms will have no debt on their balance sheets and be able to access the capital markets. Firms that would fail once they have disclosed their true liabilities and result in unacceptable insurance program costs will be recapitalized with a reasonable expectation of the taxpayer not being stuck with the bill. Systemic risk will be removed.

Best of all, it will require zero taxpayer dollars with few exceptions, and for those instances where taxpayer dollars are required the amount of taxpayer risk would be small and well-protected.

This plan is very similar to what Janet Tavakoli proposed on September 25th in an open letter released on the web.[i] Ms. Tavakoli is an internationally recognized expert in these matters, is an adjunct professor of derivatives, and is widely published.

This and other alternatives **<u>must</u>** be examined before our nation embarks on what may be a disastrous path.

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[i] http://www.tavakolistructuredfinance.com/TSF8.html