Superfund Blues

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The market has watched it for a month now. It was showcased first as a brilliant piece of financial engineering; then suspected of being a covert bail-out of Citibank, the embattled giant whose CEO Charles Prince resigned last week; and then decried as futile tokenism. The initiative to create a “Superfund”, technocratically known as ‘Master Liquidity Enhancement Conduit’ (M-LEC), has been discussed by the US Treasury and a handful of key banks since at least the end of September, and is so far the US executive branch’s most prominent response to the ever-worsening credit crisis. But it still has to convince market participants that it can make a difference.

The Superfund would be a private cooperative of the three main US banks (Citi, JP Morgan Chase, and Bank of America) and some other large financial institutions. It would buy securities from structured investment vehicles (SIVs) set up by banks and shaken by the market crisis. SIVs are off-balance-sheet entities, generally domiciled in tax havens, which are contractually required to unwind if the value of their assets drops below certain thresholds of solvency. The present risk is of a downward spiral in the prices of mortgage-based and related securities. A beleaguered SIV may be forced to fire sales, which establishes low price references for comparable securities held by other SIVs, whose unwinding clause is then triggered and which therefore go into receivership and must liquidate their assets, and so on. The hope is that, by purchasing securities from SIVs before they get into serious trouble, the Superfund would ensure reasonably high prices and at the same time rescue SIVs from liquidation, thus averting a downward lurch by means of a clever risk-sharing device.

But this presupposes that the key problem of the current market situation is solved. For some complex securities, there is virtually no liquidity, and therefore no market price. If the buying price chosen by M-LEC is too low, the SIVs may not be saved, and if it is too high, the Superfund itself might risk default. When normal market activity stops, it is tricky to replace it by an artificial buyer of last resort.

The alternative would be to allow prices to fall sufficiently far so that risk-prone investors are attracted back in, even if this means that some individual players lose out. As Alan Greenspan commented, ‘the vultures sometimes are very useful’. By keeping SIVs alive, M-LEC aims to reduce systemic risk but it may also delay market adjustment. Nor is it clear that it can be created rapidly enough to avoid the inevitable. Several SIVs have already gone into receivership or been liquidated, and others will doubtless follow in the coming weeks; but setting up the Superfund could be a matter of months. Moreover, it would only afford a temporary stay of execution, because M-LEC will be able to buy only the better-rated, less risky securities. SIVs would be left holding their low-grade assets to continue their miserable life, with no guarantee of a mid-term solution in the absence of a market upturn.

A failure of the Superfund would have consequences for an already discredited Bush administration. True, the plan requires no expense of taxpayer money nor regulatory change. But Treasury Secretary Hank Paulson, by lending his name to the initiative and actively soliciting support for it in the banking community, has put the administration’s reputation on the line. The current crisis is above all a crisis of confidence. By giving the markets a chance to doubt its judgment in case of M-LEC not delivering, the Treasury is running the risk of deepening a feeling of uncertainty which is presently close to panic.

As a former investment banker himself, Paulson perhaps fell prey to the wish to do something constructive about a difficult market situation. By contrast, the US Federal Reserve has cautiously stood back throughout the M-LEC episode. The position of government in financial crises must be one of last resort. Intervene too soon, and you risk losing your grip on the very levers you may need later, if things turn out even worse than expected.

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N.B. This English translation takes into account developments announced after the French original text was finalized.