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The Paulson Plan Will Make Money For Taxpayers

By **ANDY KESSLER**

In 1992, hedge-fund manager George Soros made \$1 billion betting against the British pound. In 2007, John Paulson's Credit Opportunities fund correctly bet against subprime mortgages, clearing \$15 billion for the year and \$3.7 billion for him. Warren Buffett is now hoping to make big money on Goldman Sachs.

But these are small-time deals. My analysis suggests that Treasury Secretary Henry Paulson (a former investment banker, no less, not a trader) may pull off the mother of all trades, which could net a trillion dollars and maybe as much as \$2.2 trillion -- yes, with a "t" -- for the United States Treasury.

Here's what's happened so far. New technology like electronic trading meant that Wall Street's bread-and-butter business of investment banking and trading stocks stopped making much money years ago. So investment banks took their enormous capital and at first packaged yield-enhanced, subprime mortgage loans into complex derivatives such as collateralized debt obligations (CDOs). Eventually and stupidly, these institutions owned them for themselves -- lots of them, often at 30-to-1 leverage. The financial products were made "safe" by insurance products known as credit default swaps, a credit derivative from companies such as AIG. When housing turned down, the mortgages and derivatives were worth a lot less and no one would lend Wall Street money anymore.

Then the piling on started. Hedge funds could short financial stocks and then bid down the prices of CDOs stuck on Wall Street's balance sheets. This was pretty easy to do in an illiquid market. Because of the Federal Accounting Standards Board's mark-to-market 157 rule, Wall Street had to write off the lower value of these securities and raise more capital, diluting shareholders. So the stock prices would drop, which is what the shorts wanted in the first place. It was all legit.

There is a saying on Wall Street that goes, "The market can stay irrational longer than you can stay solvent." Long Term Capital Management learned this lesson

10 years ago when it got its portfolio picked off by Wall Street as its short-term financing dried up. I had thought the opposite -- hedge funds picking off Wall Street -- would happen today. But in a weird twist, it's the government that is set up to win the prize.

Here's how: As short-term financing dried up, Fannie Mae and Freddie Mac's deteriorating financials threatened to trigger some \$1.4 trillion in credit default swap payments that no one, including giant insurer AIG, had the capital to make good on. So Treasury Secretary Henry Paulson put Fannie and Freddie into conservatorship. This removed any short-term financing hassle. He also put up \$85 billion in loan guarantees to AIG in exchange for 80% of the company.

Taxpayers will get their money back on AIG. My models suggest that Fannie and Freddie, on the other hand, are a gold mine. For \$2 billion in cash up front and some \$200 billion in loan guarantees so far, the U.S. government now controls \$5.4 trillion in mortgages and mortgage guarantees.

Fannie and Freddie each own around \$800 billion in mortgage loans, some of them already at discounted values. They also guarantee the credit-worthiness of another \$2.2 trillion and \$1.6 trillion in mortgage-backed securities. Held to maturity, they may be worth a lot more than Mr. Paulson paid for them. They're called distressed securities for a reason.

Now Mr. Paulson is pitching Congress for \$700 billion or more to buy distressed loans and CDOs from the rest of Wall Street, injecting needed cash onto balance sheets so that normal loans for economic activity can be restored. The trick is what price he will pay. Better mortgages and CDOs are selling for 70 cents on the dollar. But many are seriously distressed (15-25 cents on the dollar) because they are the last to be paid in foreclosures. These are what Wall Street wants to unload the quickest.

Firms will haggle, but eventually cave -- they need the cash. I am figuring Mr. Paulson could wind up buying more than \$2 trillion in notional value loans and home equity and CDOs for his \$700 billion.

So the U.S. will be stuck with a portfolio in the trillions of dollars in bad loans and last-to-be-paid derivatives. Where is the trade in that?

Well, unlike Mr. Buffett or any hedge fund, the Treasury and the Federal Reserve get to cheat. It's not without risk, but the Feds, with lots of levers, can and will pump capital into the U.S. economy to get it moving again. Future heads of Treasury and the Federal Reserve will be growth advocates -- in effect, "talking their book." While normally this creates a threat of inflation and a run on the dollar, and we may see dollar exchange rates turn south near term, don't expect it

to last.

First, with Goldman Sachs and Morgan Stanley now operating as low-leverage bank holding companies, a dollar injected into the economy will most likely turn into \$10 in capital (instead of \$30 when they were investment banks). This is a huge change. Plus, a stronger U.S. economy, with its financial players having clean balance sheets, will become a safe haven for capital.

Europe is threatened by an angry Russian bear. The Far East, especially China, has its own post-Olympic banking house of cards of non-performing loans to deal with. Interest rates will tick up as the economy expands -- a plus for the dollar. Finally, a stronger economy driven by industry instead of financials means more jobs, less foreclosures and higher held-to-maturity payouts on this Fed loan portfolio.

You can slice the numbers a lot of different ways. My calculations, which assume 50% impairment on subprime loans, suggest it is possible, all in, for this portfolio to generate between \$1 trillion and \$2.2 trillion -- the greatest trade ever. Every hedge-fund manager will be jealous. Mr. Buffett is buying a small piece of the trade via his Goldman Sachs investment.

Over 10 years this could change the budget scenario in D.C., which can also strengthen the dollar. The next president gets a heck of a windfall. In the spirit of Secretary of State William Seward's purchase of Alaska for \$7 million in 1867, this week may be remembered as Paulson's Folly.

Mr. Kessler, a former hedge-fund manager, is the author of "How We Got Here" (Collins, 2005).

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