

## **An Open Letter to Dept of Treasury III**

Dear Mr. Henry Paulson

Once again, I must start this missive by thanking you for structuring a solution that matches many of the key points I made in my previous two letters. But now that we are standing at the abyss and this weekend will be "Crunch Time" for a deal, let me outline a few more thoughts to help you separate the wheat from the chafe.

Here is a story to simplify the point:

I am at home and I leave a snack on the kitchen table. I turn my back for a moment and the dog jumps on the chair and snatches the food. I am about to run after the greedy canine and give it a good whack when my wife scolds at me: "What are you doing.....it's just a dog. What did you expect??" Stunned into silence, I sullenly go the refrigerator to make another snack.

While I am certainly NOT calling the Financial community a pack of dogs, I hope you can see my point. If you place a steak in front of a starving person, do not be surprised when the steak disappears.

This segues neatly into my main point, for any venture to succeed, whether business or personal, financial or athletic, the risks and rewards must be proportionally matched. This is precisely why the GSEs were always doomed; their risk/reward structure was bifurcated. The private market (shareholders/managers) had a disproportionate share of the upside versus the public market's (USGovernment/taxpayers) share of the downside.

What does this mean for your plan? Let me state categorically that a USGovernment intervention into the Financial Markets of sufficient size to "shock the markets" is a requirement. We need to create a Firewall a mile wide and a mile deep so as to convince all participants that the US Financial System cannot become ruinously impaired. And its size must be larger than the combined

firepower speculative of the “Financial Bears”. So now the only detail is its structure.

A number of “Market Wizards” have written open letters to you in the press this week; some insightful, others are transparently self-serving. Let me suggest the key quality that will ultimately determine its long-term success.

The Plan needs to transparently and proportionately balance the personal gains and losses of all participants. If the USTreasury pays to high price for “toxic bonds”, then the equity holders of the seller benefit too much. If executive pay is capped too low, then Financial CEOs will be motivated to not participate and pass on a greater loss to the Taxpayers down the road.

**The rule is simple:** *Everybody acts rationally from their own point of view.*

I did not say this would be easy, but it is consistent with the core American value of hard work, personal responsibility and then let the markets do their magic. The US has succeeded precisely because we have a clear set of rules (legal system) that are enforced in a transparent fashion (public court system).

Some suggestions:

- 1) Let Warren Buffett lead the process. Since his investments are as broad as the overall economy, his primary vested interest is to save the Financial System. This dovetails with the main goal of the program. Moreover, both Wall Street and Main Street will trust him.
- 2) Both sides need “skin in the game”. As such, the USGovernment must receive some sort of equity participation that is aligned with senior management. It can be warrants, straight equity or senior preferred shares. What is required is that neither side has a motivation to “game the system”.
- 3) Punish the bad guys (Fat Cats) later; there will be plenty of time for that after this mess is cleaned up. Initially make sure that profits are the greatest for actions that reduce negative pressure on assets (both Financial and Real).
- 4) Don't overtax or disparage the profits created from the program. It was the possibility of oversized profits that sourced the capital to solve the last banking crisis in 1989//1992.

As large as this problem seems, it is NOT wildly larger than the S&L mess. Via the RTC program, we absorbed \$250 Billion in losses on a solely domestic economy of about \$6 Trillion. Proportionally to today's \$40 Trillion global

economy, that number would be about \$1.7 Trillion. I am not saying that we will incur losses that great. What I am saying is that we have successfully tackled a problem of this magnitude before, and in our financial lifetimes.

The MAD (Mutually Assured Destruction) strategy succeeded in the 1970s/1980s because it reasonably made sense. It was beneficial for both sides to build large arsenals and then to never use them. **Both sides acted rationally from their own point of view.** If this Plan creates rational motivations that maximize financial profit (for buyers and sellers) as well as ego gratification (so politicians on both sides can claim credit), then the plan will succeed as gravity pulls an apple to earth.

Good luck this week-end,

Best Regards,

Harley S. Bassman

***PS: As a reminder, this letter solely represents my personal opinion***

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