

OPINION
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Toxic Assets Were Hidden Assets

We can't afford to allow shadow economies to grow this big.
By **HERNANDO DE SOTO**

The Obama administration has finally come up with a plan to deal with the real cause of the credit crunch: the infamous "toxic assets" on bank balance sheets that have scared off investors and borrowers, clogging credit markets around the world. But if Treasury Secretary Timothy Geithner hopes to prevent a repeat of this global economic crisis, his rescue plan must recognize that the real problem is not the bad loans, but the debasement of the paper they are printed on.



Chad Crowe

Today's global crisis — a loss on paper of more than \$50 trillion in stocks, real estate, commodities and operational earnings within 15 months — cannot be explained only by the default on a meager 7% of subprime mortgages (worth probably no more than \$1 trillion) that triggered it. The real villain is the lack of trust in the paper on which they — and all other assets — are printed. If we don't restore trust in paper, the next default — on credit cards or student loans — will trigger another collapse in paper and bring the world economy to its knees.

If you think about it, everything of value we own travels on property paper. At the beginning of the decade there was about \$100 trillion worth of property paper representing tangible goods such as land, buildings, and patents world-wide, and some \$170 trillion representing ownership over such semiliquid assets as mortgages, stocks and bonds. Since then, however, aggressive financiers have manufactured what the Bank for International Settlements estimates to be \$1 quadrillion worth of new derivatives (mortgage-backed securities, collateralized debt obligations, and credit default swaps) that have flooded the market.

These derivatives are the root of the credit crunch. Why? Unlike all other property paper, derivatives are not required by law to be recorded, continually tracked and tied to the assets they represent. Nobody knows precisely how many there are, where they are, and who is finally accountable for them. Thus, there is widespread fear that potential borrowers and recipients of capital with too many nonperforming derivatives will be unable to repay their loans. As trust in property paper breaks down it sets off a chain reaction, paralyzing credit and investment, which shrinks transactions and leads to a catastrophic drop in employment and in the value of everyone's property.

Ever since humans started trading, lending and investing beyond the confines of the family and the tribe, we have depended on legally authenticated written statements to get the facts about things of value. Over the past 200 years, that legal authority has matured into a global consensus on the procedures, standards and principles required to document facts in a way that everyone can easily understand and trust.

The result is a formidable property system with rules and recording mechanisms that fix on paper the facts that allow us to hold, transfer, transform and use everything we own, from stocks to screenplays. The only paper representing an asset that is not centrally recorded, standardized and easily tracked are derivatives.

Property is much more than a body of norms. It is also a huge information system that processes raw data until it is transformed into facts that can be tested for truth, and thereby destroys the main catalysts of recessions and panics — ambiguity and opacity. To bring derivatives under the rule of law, governments should ensure that they conform to six longstanding procedures that guarantee the value and legitimacy of any kind of paper purporting to represent an asset:

- All documents and the assets and transactions they represent or are derived from must be recorded in publicly accessible registries. It is only by recording and continually updating such factual knowledge that we can detect the kind of overly creative financial and contractual instruments that plunged us into this recession.
- The law has to take into account the "externalities" or side effects of all financial transactions according to the legal principle of *erga omnes* ("toward all"), which was originally developed to protect third parties from the negative consequences of secret deals carried out by aristocracies accountable to no one but themselves.
- Every financial deal must be firmly tethered to the real performance of the asset from which it originated. By aligning debts to assets, we can create simple and understandable benchmarks for quickly detecting whether a financial transaction has been created to help production or to bet on the performance of distant "underlying assets."
- Governments should never forget that production always takes priority over finance. As Adam Smith and Karl Marx both recognized, finance supports wealth creation, but in itself creates no value.
- Governments can encourage assets to be leveraged, transformed, combined, recombined and repackaged into any number of tranches, provided the process intends to improve the value of the original asset. This has been the rule for awarding property since the beginning of time.

- Governments can no longer tolerate the use of opaque and confusing language in drafting financial instruments. Clarity and precision are indispensable for the creation of credit and capital through paper. Western politicians must not forget what their greatest thinkers have been saying for centuries: All obligations and commitments that stick are derived from words recorded on paper with great precision.

Above all, governments should stop clinging to the hope that the existing market will eventually sort things out. "Let the market do its work" has come to mean, "let the shadow economy do its work." But modern markets only work if the paper is reliable.

Government's main duty now is to bring the whole toxic environment under the rule of law where it will be subject to enforcement. No economic activity based on the public trust should be allowed to operate outside the general principles of property law.

Financial institutions will have to serve society and fully report what they own and what they owe — just like the rest of us — so that we get the facts necessary to find our way out of the current maze. They must begin learning to put on paper statements about facts, instead of statements about statements.

Mr. de Soto, the author of "The Mystery of Capital" (Basic Books, 2000) and "The Other Path" (Harper and Row, 1989), co-chairs the Commission on Legal Empowerment of the Poor.

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