

Letter: How to Drink the Sub-Prime Kool-Aid

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Dear Editors:

Suppose you have 10 glasses of Kool-Aid in front of you, but one has poison in it. Would you choose to drink from a random glass? Probably not. If the server of the Kool-Aid offers you a particular glass, you would be even less likely to drink. But if you poured all the glasses into a bucket, stirred the mixture, and then poured the diluted mixture back in the glasses, you might be willing to take a sip ... at least for the right price.

The situation with auctioning mortgage-backed loans is similar. Nobody really knows how much they are worth, but the owner of the securities probably has the best idea. As Lawrence Ausubel and Peter Cramton point

out, this asymmetric information can lead to an adverse selection problem if the sellers can choose which securities to offer to the government auction. Then the sellers will offer the worst securities.

Ausubel and Cramton advocate grouping securities into separate, but related bundles, and auctioning off fractions of the face value. This is certainly appropriate, but there still may be an issue with the choice of which securities a seller may decide to offer for sale.

One way to deal with this problem is to do exactly what is suggested above: dilute the subprime Kool-Aid by mixing the securities. In practice, this can be done by randomizing the choice of securities that are offered. For example, the government could

consider a bundle of all of the mortgage-backed securities issued in 2006 that a given bank holds, and then take a random sample of these securities to offer for sale. Such randomization would avoid the adverse selection problem and would lead to a more viable auction.

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REFERENCES AND FURTHER READING

Ausubel, Lawrence M., and Peter Cramton (2008) "Auction Design Critical for Rescue Plan," *Economists' Voice*, 5(5): Art. 5. Available at <http://www.bepress.com/ev/vol5/iss5/art5>.