World financial markets are being ravaged by uncertainty and fear. The prices of all forms of explicit and implicit financial insurance have skyrocketed and hence, by a basic identity, the prices of risky assets have plummeted or the corresponding markets have disappeared. Nowhere is this scenario more problematic than in institutions with strict capital requirements, such as banks, insurance companies, and monolines. For them, fire sale asset prices quickly wipe out their capital and, simultaneously, destroy their option to raise new capital since equity values implode.

The conventional advice is for these institutions to deleverage and to raise capital. While this is sound advice when dealing with a single institution in trouble, I believe this is exactly the opposite of what we need at this juncture of a massive systemic crisis. Forcing institutions to raise capital, be it private or public, at panic-driven fire sale prices threatens enormous dilutions to already shell-shocked shareholders, further exacerbating uncertainty and fueling the downward spiral. This is self-defeating.

The question then is whether it is feasible to run a (nearly) capital-less financial system until panic subsides. If it is, then a solution to the financial crisis is in sight since it would free up trillions of dollars of hard to raise funds, covering more than even the most extreme estimate of losses.

I believe it is feasible to run such a system for a while, because, essentially, distressed financial institutions need (regulatory) capital for two basic purposes: To act as a buffer for negative shocks, and to reduce their risk-shifting incentives by exposing them to their losses. However these two functions can be replaced, respectively, by the provision of a comprehensive public insurance, and by strict (and intrusive) government supervision while this insurance is in place.

A few days ago the U.K. announced a policy package that almost got it right, by pledging to insure banks’ balance sheets and other private liabilities. Unfortunately, it backfired and caused a worldwide run on financials because it did not dissipate, and even exacerbated, the fear of forced capital raising (or nationalization). The events following Lehman’s demise should have taught us that this fear needs to be put to rest until we can return to normality. Financial institutions are too intertwined to predict with any precision the impact of diluting any significant stakeholder, and the markets are too fearful to feed them more uncertainty. Strong guarantees with strict supervision, and the commitment of no further capital injections at fire sale prices (directly or through convertible bonds) should go a long way in building a foundation for a sustained recovery.

With some dismay, I read that an enormous amount of time is being spent discussing what should be the price of the insurance and the first-loss threshold. It seems to me that given the extreme severity of the crisis and the asymmetries involved in failing in one or the other direction in each of these issues, the answers are rather obvious: The price of the insurance should be very low – say risk-neutral pricing plus 20 or 50 basis points of markup; and the first-loss threshold should be sufficiently low that no new capital will need to be raised in the short run if a loss arises. The second intervention of Citi offers a micro-model of such an intervention, but it needs to be scaled up within each bank and massively across all banks and other key financial institutions. It also needs to be made much more attractive to all systemic financial institutions, even those that are not in deep distress.

What about the taxpayers? The best that can happen to all of us is that the financial crisis ends as soon as possible. This is the first priority, the rest can wait. If the transfer to the financial institutions ends up being too large for society’s taste, then it is always possible for the government to undo some of it through ex-post taxation of excessive earnings. Conversely, if the transfer is too low (the price of the insurance and the first-loss threshold too high), it may well be that we do not get another chance, at great cost not only to financial institutions but also to taxpayers.