

Troubled Assets Relief Program

What about the Troubled Assets?

The logo graphic consists of two parallel diagonal bars. The front bar is a light orange color and the back bar is a light green color. Both bars are oriented from the bottom-left to the top-right.

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On November 25th the Federal Reserve announced two additional initiatives under the Emergency Stabilization and Recovery Act of 2008. Both initiatives are designed to stimulate consumer lending and stabilize consumer-based credit markets. The \$200 billion *Term Asset-Backed Securities Loan Facility* (TALF) is intended to facilitate investors' purchases of consumer ABS products including securities backed by credit card receivables, auto loans, student loans and SBA-guaranteed small business loans. It's possible the program will be extended in the future to include RMBS, CMBS or other asset classes. The second plan sets aside \$600 billion for direct investments in US agency debt and agency-sponsored MBS ("Direct Purchase Program"). Since its creation, TARP has been a moving target. By quickly discarding the troubled asset purchase program in favor of direct investment in commercial banks (and certain other lucky financial institutions), it seems Treasury has concluded that, considering the complexity and scale of the toxic asset problem, it is unlikely the government could commandeer the expertise and infrastructure necessary to evaluate, negotiate and monitor massive holdings of obscure, illiquid assets. But do these new initiatives signal a strategy adjustment or an abandonment of original principles?

WHAT IS TALF?

Designed to foster new borrowing and lending, the Federal Reserve Bank of New York will offer non-recourse loans to prospective investors in eligible ABS. According to the Fed, "...TALF is designed to increase credit availability and support economic activity by facilitating renewed issuance of consumer and small business ABS at more normal interest rate spreads." TALF will provide alternative financing for credit-worthy obligors otherwise locked out of the capital markets due to feeble bank balance sheets, heightened risk aversion and the functional closing of many securities underwriters. The hope is, as bank and consumer balance sheets improve over the next year, there will be a greater willingness and ability of private financing sources to support this activity. Meanwhile, federal funding should serve to mitigate the consequences of widespread financial delevering now leaking into the real economy.

TALF will be open for business through December 31, 2009. Non-recourse, 1-year term loans will be fully secured by triple-A ABS backed by newly originated loans. Loan amounts will equal the assets' market value less an unspecified *haircut* based on price volatility of the asset class. The Treasury will provide \$20 billion of TARP funds as first-loss protection. Lending will be provided through an auction process, based on a spread over 1-year overnight indexed swaps. OIS rates are market-based estimates of the daily average reference rate over the life of the swap. TALF is a meaningful program in the context of the primary market for ABS. Issuance of auto and card paper was \$91 billion and \$166 billion YTD and 2007, respectively. Several unanswered questions, however, make uncertain the program's impact on lending activity and credit spreads. In particular: What will be the haircut structure look like? How will TARP executive compensation rules affect interest from prospective participants?

The goal of the Direct Purchase Plan, wherein the Fed intends to purchase \$100 billion agency debentures (FNMA, FHLMC, and FHLB) and \$500 billion agency pass-throughs (Freddie, Fannie and Ginnie), is "...to reduce the cost and increase the availability of credit for the purchase of homes, which in turn should support housing markets and foster improved conditions in financial markets more generally."

Details on implementation are limited, but purchases are expected to take place over the next several quarters. Initial reaction from market participants, hopeful for instant gratification, was initially positive. Enthusiasm shortly waned as participants recalled disappointed of earlier expectations. Even if Treasury beats the odds and hits its aggressive timetable for developing infrastructure and processes and hiring qualified managers for this large and multifaceted program, three months seems like an eternity in these markets.

WHAT ARE POSSIBLE IMPEDIMENTS?

TALF haircuts and the restriction of financing only triple-A assets means participating banks are expected to retain a considerable first-loss on the risks they originate. This is necessary to align interests of originators, underwriters/arrangers, and the Fed. But details on the haircuts and other terms associated with program have yet to surface, and the risk appetite of prospective bank participants and the margin requirements connected with the origination activities and retained risk may be inconsistent with terms the Fed is willing to offer. It is also unclear what happens at the end of the one-year financing term. As the loans are non-recourse, does this mean repurchasing is optional?

Another key factor to TALF's success is the willingness of consumers and small businesses to borrow. Prospective borrowers are unlikely to look for new loans while their economic circumstances are deteriorating. With rising unemployment, global recession, talk of deflation, and one of the worst financial market performances in history, promoting borrowing and increased leverage will be a challenge. Undoubtedly, there is need for an alternative funding source and better lending terms to stimulate borrowing in this dysfunctional market, but the level of borrower demand cannot be quantified with any confidence.

WHAT ABOUT THE "TROUBLED ASSETS"?

Hank Paulson & Co. has abandoned the strategic principles of TARP. This is probably a good decision. The dimensions and complexity of the problem are simply too large to turn on a bureaucratic infrastructure quick enough to be effective. Additionally, ongoing risk monitoring and management would entail a tremendous quasi-permanent organization. The TALF and Direct Purchase Programs may also be good ideas for thwarting the growing financial crisis before it cripples the real economy. But let's call a spade a spade: TALF is simply sophisticated monetary policy. By purchasing financial assets ("sponsored" by the Treasury through its first-loss), the Fed is ballooning its balance sheet (especially with Direct Purchase Program). Growing the monetary base, and therefore money supply, is probably the right prescription in light of obvious deflationary pressures.

Paulson was on to something, however, with his assessment that the debt capital markets -- that serves an absolutely critical purpose for our economy -- had "seized up". In addition, dealing with toxic assets on bank balance sheets is a critical prerequisite for restoring order. The underlying goal of TARP is to save the economy (including poor homeowners who were "tricked" into taking bad loans), by saving the debt capital markets (the fuel for the real economy) and by saving the banks (commercial and investment).

Many companies rely on C&I loans from commercial banks to fund operations and inventory, and if investment banks fail because of short-term liquidity problems, the entire market apparatus shuts down. Under TARP, the government would remove some of the troubled assets from bank balance sheets directly, and by creating transparency (in respect to the nature and value of troubled assets, as well as banks' holdings) and "price discovery," revive the market for these assets...clearing the pipes for more lending, underwriting and trading.

Transparency in the very opaque market for complex structured products could be expected to induce investors not traditionally active in these securities to commit capital. Introducing clarity in regard to the scale and dimension of the challenges facing the banks, would serve to restore confidence in their institutions future viability and resuscitate private investment and interbank lending on a non-government guaranteed basis.

Treasury discarded TARP for a more interventionist approach once it became evident the problem was far too complex and urgent for such an indirect plan. In just over a month the Government acquired \$150 billion of preferred equity in banks across the country. This strategy is far simpler to formulate and implement (also easier enforce executive pay limits), but still predicated on the idea that saving the banks is the cure. Unfortunately, neither fresh government-sponsored capital nor the liquidity injection of the TALF and Direct Purchase Program will dissipate the black cloud over the banks that are their toxic portfolios. Without confronting this, the capital markets will remain frozen. Banks will remain undesirable counterparties and continue having difficulty rolling short-term debt and further large failures (or government rescues) are likely.

This doesn't mean TARP is the best remedy for the troubled asset problem. In fact, passing the bill had the counterproductive result of taking pressure off institutions to properly value their illiquid assets. The near simultaneous issuance of FASB's *Proposed Staff Position* FAS 157-d (Oct. 9) -- a weak attempt at "clarifying" FAS 157 that was generally misinterpreted as the accounting profession's concession that it would not take a hard line on the requirement that Fair Value of Level 3 assets be a *market measure* -- compounded complacency created by TARP.

FOR MR. PAULSON'S CONSIDERATION

It is up to the Government, in cooperation with international supervisory organizations, independent directors, industry associations, auditors and other key service providers, to take a leadership role in reintroducing into the financial service industry a culture of transparency, responsibility, discipline and accountability.

Transparency - If the private sector won't do it, a government-sponsored transparency platform and/or exchange for securitized assets must be considered. Grossly inadequate transparency (even in good times) hampers investors' ability to gather data – independent valuation, risk measure, legal structure (investor/agents' rights and responsibilities), collateral attributes, collateral manager fitness -- necessary to make a prudent, well-informed decision (the creation and distribution of highly structured products has always been a great example of the *lemons theory*). This has become a profound deterrent to private capital.

The exchange process is also completely out of order (and likely to be for some time, as “broken” assets have always *traded on appointment*). Even when transactions occur, it is nearly impossible to obtain exchange prices.

Second, it is now evident to investors (usually their auditor, and even regulators, sometimes) that traditional sources of market data and research continue to rely on inadequate information, risk diagnostics and valuation models or comes from conflicted parties (e.g. investment banks).

In regard to institutional transparency, more aggressive enforcement of extant disclosure requirements would go a long way toward improving investor confidence and market efficiency. IFRS 7 and FAS 157 outline excellent disclosure requirements, and the November '08 *Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices* from the Basel Committee of the BIS is a great framework for regulating practices and disclosure associated with measuring Fair Value.

Risk Measurement and Valuation - Conventional ratings are wholly inadequate measures of credit risk, especially for structured credit products. A letter grade does not capture the true amount of risk if it only indicates the propensity of a bond to default. Ratings should also predict the timing of default and volatility of losses expected to occur in the event of such a default.

Internal investment guidelines and regulatory risk-based capital calculations having NRSRO credit ratings as the sole or primary diagnostic encourage complacency and the farming out of fiduciary responsibility. Provisions based on simple credit ratings must be supplemented or replaced by risk measures that capture the complete distribution of risk. Regulators and other constituents should do everything possible to encourage the development of internal know-how and quantitative tools.

Best Practices - What's needed, both for working through the current problems and the long run, is encouraging a culture of transparency, responsibility, discipline and accountability. The idea of *best practices* is as old as Ptolemy, but kept alive in recent years only at a handful of professional service companies. Every actor involved in the markets, directly or indirectly, needs to rethink and institute their practices and culture, infrastructure, policies and procedures, method of assigning and monitoring responsibilities, internal controls and disciplinary guidelines. Particularly relevant are practices relating to risk measurement and valuation. More than *expected* risk, metrics need to consider perfect storm events – such as when liquidity disappears and markets become perfectly correlated, or a localized credit problem becoming systemic. Valuation practices, especially for illiquid assets, should be based upon validated theory and robust application, appropriately sanctioned and well documented.

On December 3, 2008 a consortium of securitization trade associations known as the Global Joint Initiative to Restore Confidence in the Securitization Markets published a report entitled “Restoring Confidence in the Securitization Markets.” The study, performed by McKinsey & Co. puts forth a set of eight recommendations and a plan for implementation. This is an excellent example of industry leadership dissecting the problem and putting forth a constructive, realistic roadmap for reopening the securitization markets. The report finds that “without well-functioning and efficient securitization markets, financial growth and economic stability could be impaired. Securitization is an essential, long-standing mechanism used by financial institutions for providing the capital and liquidity required to finance worldwide demand for consumer and business credit.

Given current capital constraints and challenges to distributing securitized products, financial institutions are unlikely over the next several years to have the wherewithal to meet the demand for credit necessary to support robust economic recovery and growth.” The publication also includes a list of “Ten Initiatives Necessary to Increase Transparency” which is interwoven within the context of current regulatory frameworks.

Aside from this new initiative, many other excellent best practices roadmaps already exist; the job is one of aggressive implementation and compliance. Accounting guidance such as FAS 157 (Fair Value), CON 7 (probability weighting projected cash flows) and FAS 115 incorporates the general issues facing fair valuation of assets having contingent cash flow or poor liquidity, if light on the details of how they ought to be applied.

Standards in FAS 163 (expected claims), EITF 99-20 (impairment) and others address the key issues pertaining to fundamental risk, impairment and reserving for these assets. In January 2007, the Fed, Treasury, SEC and other agencies promulgate the *Interagency Statement on Sound Practices Concerning Elevated-Risk Complex Structured Finance Activities*. The Statement defines responsibilities and outlines three steps financial institutions need to take if they are aware that they may have complex structured financial transactions. The three steps include 1) the identification, due diligence and approval process for having the exposure to these instruments, 2) the documentation around those instruments, and 3) general risk management principles for elevated-risk structured financial transactions. Rather than wringing hands over the details of Fair Value calculation (is it appropriate to use a risk-free or risky discount rate, or to discount probability-weighted cash flows? Should one use a liquidity premium on illiquid assets from today’s or last year’s market?), the SEC, AICPA and FASB (and investors) would be better served to emphasize internal infrastructure, policies and fuller disclosure of methodology.

Professional Accountability - Certainly the breaches of faith by some are more serious than the laziness others are guilty of, but no single party or group is solely responsible for the troubles we now face. Through regulatory oversight, the banking and securities industries need to hold managers accountable for their actions or inaction. As for corporate governance, management should be rewarded for their attention, and held accountable for inattention of risk management and valuation duties. Committees should be formed, processes developed, responsibilities assigned, guidelines clearly articulated and enforced. If internal know-how or technology is insufficient for dealing with current or prospective holdings, management needs to make and implement a plan to change this...or get out. In the future, management needs to ensure appropriate risk and valuation tools and policies are in place *before* underwriting or acquiring assets. Moreover, the state of institutions’ capabilities should fully be disclosed for investors within financial statements.