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How TARP Could Play Out For U.S. Financial Institutions

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(Editor's Note: The original version of this article was published earlier today. It is being republished to clarify the dollar amounts in the first bullet point.)

The draft proposal of the Troubled Assets Relief Program (TARP) hammered out in Congress on Sept. 29, 2008, is in some ways modestly less aggressive than what the Treasury initially proposed. However, in other ways, we believe the current version adds provisions that could more directly benefit the housing market itself rather than just the securities markets. On balance, we believe it should provide a welcome boost to market sentiment.

This is a summary of its main provisions:

- The Federal government initially can hold up to \$350 billion of troubled residential or commercial real estate related obligations, including securities and loans, and the program is open ended about potentially including other obligations. The President can raise that amount to \$450 billion and then to \$700 billion. Congress would need a two-thirds majority to overturn that decision, so it's unlikely that a political wrangle will hold up the moneys. A broad range of financial institutions are eligible to participate in the plan, including U.S. regulated financial institutions, credit unions, pension plans, municipalities, and foreign institutions with significant U.S. operations.
- Over the next two years, financial institutions may be able to buy insurance for mortgage-related assets purchased before March 2008 in exchange for premiums paid into the Troubled Assets Insurance Fund. These premiums are intended to be priced to cover all future claims to be made against the insurance fund.
- There will be restrictions on top executive pay for institutions that sell more than \$300 million of assets at auction. No top executive hired after the sale can receive a so-called golden parachute for the next one to two years. Executive incentive pay over \$500,000 will not be tax deductible.
- Participants in either the purchase or insurance programs must grant the government warrants, nonvoting stock, or preferred stock if they are public companies or senior debt if they are private.
- Banks under \$1 billion in size with capital that was significantly affected by losses on GSE preferred stock can be recapitalized through this program. Also, the losses will be treated as ordinary income rather than investment losses for tax purposes, which will help those that have no investment income to offset.
- The SEC will have the right to suspend FAS 157 mark-to-market rules for certain institutions if it deems that to be appropriate in the public interest.
- The bill is designed to encourage loan modifications and debt forgiveness. It would allow the government to use loan guarantees and credit enhancements to encourage such modifications. Servicers of the securities purchased would be encouraged to modify loans and aid homeowners to avail themselves of HOPE Now, the administration's existing plan to encourage mortgage loan modifications.
- An oversight board—consisting of the Federal Reserve Board, the SEC, Treasury, HUD, and the Federal Housing Finance Administration—will oversee the disbursement process and provide reports on its effectiveness. There will also be regular accounting of the budgetary impact and projections of gains and losses to the budget as well as a special inspector general to insure adherence to the principles of the plan.
- After five years, if there appear to be shortfalls or losses to the budget from this program, financial institutions—whether or not they participated in the plan—will be asked to make payments to recoup those losses

by legislation to be crafted at the time.

- The limit on public debt is raised to \$11.5 trillion to accommodate the borrowing requirements of this program.
- The program will remain in effect indefinitely, until the last asset is sold and insurance claims paid out.

In addition, the bill requires certain studies to be undertaken that could lead to sweeping changes in accounting and regulation:

- The Treasury must review the U.S. regulatory system for financial institutions, including GSEs and OTC swaps clearing, and make recommendations for change by April 2009.
- There will be a study on the role played by margin rules and margin borrowing in the current financial crisis.
- The SEC, FRB, and the Treasury will study the effect of FAS 157 on bank balance sheets and failures in 2008, its effect on the quality of information to investors, and the advisability of amending the rule.

As we wrote in our article "Will The U.S. Treasury Plan Help Restore Normality To The Financial Markets?," published on Sept. 24, 2008, on RatingsDirect, we believe the plan has the potential to help establish pricing levels for mortgage securities. By providing liquidity for the securities, it may avoid the possible fire sale of assets that could then affect prices for similar securities. The encouragement for loan modifications provides further impetus for existing initiatives on loan modification programs. We believe it could, at the margin, also serve to reduce foreclosures, which can weigh heavily on house prices in the neighborhoods where they occur.

We believe the key to the program's success is how the purchase pricing will be determined and the level at which insurance premiums will be set. If the prices are too low, then fewer institutions will participate—unless they have already written down the assets. From remarks made by Chairman Bernanke last week, we believe that the preference will be to set them at something between current distressed market values and their economic values if held to maturity (the so-called intrinsic values).

Significantly, the plan does not address that market participants, using equally reasonable projections of future cash flows, arrive at widely varying estimates of intrinsic values for many types of troubled assets. This issue is most pronounced in securities that use high structural leverage, such as CDOs, and subordinate tranches of mortgage securitizations. For such securities, small differences in the projected performance of the bottom-level, underlying assets can translate into very large changes in estimates of intrinsic value. Greater clarity about how assets will be priced under the plan should become available when the Treasury publishes program guidelines under Section 101(d) of the plan.

The plan's intent will be to maximize participation in the plan to help increase liquidity in the financial system. Certainly, the intent of the bill is that taxpayers should not lose money. The provisions that shortfalls for the government will be made up by the general financial services industry demonstrate that the intent is that the price be at least the economic value if held to maturity. Lower prices would limit participation in the plan. As a result, we believe the pricing will likely be gauged on the basis of the receptivity of the sellers.

For those that have marked the securities to a distressed market price, there could be an immediate gain. They would incur the restrictions on executive pay and have to give the government equity stakes. We do not believe the executive pay restrictions are onerous, as they apply only to new hires who leave after a year or two. For those that have not yet recognized embedded losses, the plan might help restrict the amount of their losses.

The plan—if passed—will take at least a few weeks to implement. With the passage of more time, we will gain better

insight into whether the plan will be sufficient to help firm up pricing and restore confidence in the financial institutions' solvency and thereby forestall further losses and liquidity issues for banks. Much will likely depend on market psychology in the ensuing period. We do not expect that the plan will be a panacea for further loan-quality issues for banks. The plan appears to be aimed more at providing liquidity and benchmark pricing rather than recapitalizing banks or minimizing their losses.

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