

An Evaluation of TARP

Opinion

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\$700B approved by congress, and \$350B spent already at the direction of Mr. Paulson. The second tranche already requested to be spent at the direction of the Obama economic team, lead by Mr. Geithner.

Troubled Asset Relief Program (or "TARP") was originally conceived and sold to congress as a program to stabilize the financial system (not necessarily the economy, as they are in fact different). This stabilization was to be achieved primarily through the purchase of "toxic" debt securities, which were tied to pools of single family mortgage loans. But the program was also to include relief for struggling homeowners, which was probably one of the primary reasons that congressional democrats got on board so quickly in supporting the program.

Although crafted and approved relatively quickly, the program gave Mr. Paulson at the Treasury Dept. significant latitude to attack the crisis both from the top down (by purchasing "bad assets" from the banks thus removing them from their balance sheets) and from the bottom up (by assisting homeowners and restructuring the mortgage loans that presumably are components of the "bad assets" themselves).

It seems that the financial system was frozen because banks and investment banks had no credible method of evaluating the amount of toxic assets that each other held, so lending ground to a halt as no one institution could know who the next Lehman Bros. would be! Obviously, this is what happens when the normal systems in place such as debt ratings, regulators and auditors fail to properly value assets. When the system breaks down, there is no credible source to determine and assess any institutions' financial strength or in this case weakness. So again, by Treasury buying the toxic assets, even at a discount, the institutions could jettison them and leave their balance sheets with only the non-toxic assets, which presumably the market could value and then be in a position to assess the financial viability of the enterprise.

Somehow, in the implementation phase the plan changed rather dramatically. Surprisingly, Mr. Paulson used most of the \$350B to purchase preferred stock in banks. There were of course also investments in AIG and the auto companies. But glaringly absent, were purchases of troubled assets and relief for homeowners. This of course somewhat angered congressional democrats, especially those who supported the TARP primarily because they thought struggling homeowners would be helped.

In defending his actions, Mr. Paulson noted that the preferred stock investments were a quicker way to improve the bank's balance sheets by immediately pumping liquidity into the system. He also felt that there were too many toxic assets and that the \$700B would not really make a dent in the problem, which is of course more than a little scary. As far as the homeowners, he indicated that there were

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already programs in place to assist struggling homeowners, which congressional democrats of course did not accept as an effective substitute.

As time has carried on, we now know that these preferred stock investments were highly politicized and in some people's opinion distributed in an extremely unfair manner – National City comes to mind. Furthermore, it seems that the banks receiving the TARP funds often used them to purchase treasuries. Somewhat of a round trip I suppose.

On the bright side, at least in the short-term there has been some thawing of the credit markets. But it now appears that many of the larger banks' losses are mounting and that they may need additional government funds to survive. In fact, there is now talk about the possibility of nationalizing some of the banks, at least temporarily.

The Obama team is still formulating their plans, but it seems they are considering going back to the original plan – purchasing toxic assets and assisting homeowners. They also seem to be considering insuring the value of the toxic assets as opposed to purchasing them.

The plan for purchasing the toxic assets is now being called the “bad bank – good bank” model. So the government would form a new publicly owned bank that would purchase, and ultimately dispose of the toxic assets, leaving the existing bank with just its good assets, hence the “good bank”.

Homeowner relief is obviously a very politicized area. Ms. Bair at the FDIC has proposed, over the objections of Mr. Paulson, that an Indy Mac protocol be used to modify mortgage loans in default. In short, she proposes to reset monthly payments to 31% of the borrower's income and have the government guarantee 50% of any losses on the modified loans. She has estimated a cost of \$24B for such a program. Actual statistics on re-defaults of modified mortgage loans however portray a pretty bleak picture. As such, Ms. Bair's estimates seem woefully short. It would seem that some program along these lines will in fact be instituted; there is just too much political pressure in this area.

Although it may sound nice, helping homeowners is not the answer to the current crisis. There is really only one way to truly fix, as opposed to just delaying the resolution of this situation. For that answer, we look across the Pacific Ocean to our friends in Japan. If anyone in Washington DC would bother to notice, Japan has recently come out of a 10-year financial melt-down that although not exactly the same as ours would certainly seem to be worth examining in terms of setting our own public policy.

In several observers' opinions, Japan did not start to come out of its crisis until it openly and comprehensively analyzed, and then properly and clearly valued its own troubled assets. Once this process of establishing and implementing a well understood and credible valuation protocol for troubled assets was completed, institutions could then again understand and rely upon the financial reporting and regulatory system. Confidence was reestablished, and business could proceed.

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It would seem that we must undertake the same process. At the core of this crisis are single family home and condo mortgage loans. We must undertake the painstaking process of establishing a valuation methodology and then valuing them, yes one by one. This is not a complex job; it is just a really big job.

Once the underlying real estate in each securitized loan pool is valued, the value of each pool will be known. The more complex, but certainly do-able task is then to value the sliced and diced investments in the pool (CMO's, CDO's, interest strips, etc.) to determine who is "in the money" and "who is out". Once completed, the institutions holding the toxic debt investments can write them down to the value established through the valuation protocol.

This recommendation obviously raises questions about the application of "mark to market" accounting rules, and whether they should be applied in the valuation protocol. Again, we are not suggesting that the toxic assets be marked to their current market value today, which is arguably very small given the lack of knowledge regarding the underlying mortgage loans. Rather we are suggesting that these underlying loans and in some cases real estate (for current and projected bad loans) be valued. We would strongly suggest that current liquidation value (effectively "mark to market") not be set as the valuation methodology. Rather, a cash flow estimation approach would seem to be more appropriate. Certainly, for current and projected bad loans, a conservative projection for loan modifications and foreclosure sales should be used. But even in this approach, an orderly sale process could be assumed over a liquidation approach.

The key is not that the exact best valuation methodology be identified and employed, rather the most important factor is that the methods being used are transparent and easily understood. Investors can then add their own risk premiums in determining what to pay for such assets.

Once valued, the toxic assets will no longer be toxic; they will be like any other asset with a well understood value supported by a well understood valuation methodology. The asset will then be saleable to the government or private institutions and investors.

Government will certainly have to provide additional loans to support some banks in the interim. The Paulson approach may be as good as any for this additional money.

The task is large, but it must be done by someone at sometime. We can't just leave these assets on the books of the banks and investment banks without knowing their value for forever, can we?

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