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REPORT

Bailout Bill Offers Few Clues for Valuing Assets for U.S. Purchase

BY STEVEN MARCY, BNA STAFF EDITOR

The U.S. government is on the verge of embarking on the largest asset purchase in history in a bid to revive credit markets, but the legislation authorizing the bailout offers precious little information on how the purchase will work or how those assets will be valued for determining an acceptable purchase price.

Actual implementation depends on approval by the House of Representatives, which is expected to consider the plan Oct. 3. The Senate approved it Oct. 1.

How the government values or prices those assets will determine the attractiveness in the market of those assets—and similarly configured ones that institutions continue to hold and hope to eventually sell. It will also determine any potential loss or gain that taxpayers will realize on their $700 billion outlay when the government eventually resells the securities into the market.

The bill would establish the Troubled Assets Relief Program (TARP) to buy, hold, and eventually resell the illiquid assets. It also gives the Treasury secretary running the program wide latitude and very little guidance on methods to determine an acceptable price for securities being offered. The legislation says the Treasury secretary will publish "guidelines" specifying:

- "mechanisms for purchasing troubled assets,"
- "methods for pricing and valuing troubled assets,"
- "procedures for selecting asset managers," and
- "criteria for identifying troubled assets for purchase."

The bill also says the government should strive to use "market mechanisms" for acquiring the assets, and suggests ways of doing so could be auction and reverse auction processes. It says the mechanisms the government devises should be "reasonable" and "reflect the underlying value" of the securities acquired.

The bill includes disclosure requirements obligating the Treasury secretary to reveal within seven days of a commitment made to purchase troubled securities: the assets to be bought, their counter-parties, the pricing mechanisms used and the justification for the mechanism used, and the price to be paid.

Overall, the trick is for the government to walk a fine line between offering a sufficiently attractive price to the securities' holders so that trading can be rejuvenated while also avoiding paying so much that taxpayers recover too little money on the securities' ultimate resale.

"If you end up paying too little to these institutions, which mark-to-market accounting might drive you to, you're not giving them the support that they need," Sen. Robert Bennett (R-Utah) told government officials at the Sept. 23 Senate Banking Committee hearing on the plan. "If you end up paying too much, then there's no upside potential for the taxpayer when the time comes for you to liquidate these. And the details of how you find the right balance here are the ones that all of us need—you, certainly, as much as we—all of us need to understand better."

The struggle to develop value evaluation procedures comes against a backdrop in which many lawmakers view the Financial Accounting Standards Board's requirements for valuing financial instruments, Statement of Financial Accounting Standard 157, *Fair Value Measurements*, as having pushed values down to such low levels that no one was willing to buy or sell them. This, they contend, largely created the present illiquid market and frozen credit markets. The bill explicitly authorizes the Securities and Exchange Commission to suspend FAS 157. More than 60 lawmakers from both parties wrote the SEC Sept. 30 urging that it immediately suspend FAS 157 (*please see related article*).

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Despite the vagueness in the bill, congressional testimony has revealed hints at how the TARP program could work, and accounting experts have described to BNA some of the issues the government must consider in valuing the securities to determine what price to pay for them.

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Charles Mulford, an accounting expert at the Georgia Institute of Technology, and Timothy Lucas, a consultant at Lucas Financial Reporting and formerly the Financial Accounting Standards Board's chief of research, told BNA the valuation task will be ''daunting.''

Lucas is also a member of BNA's Accounting Policy and Practice Series advisory board.

'Daunting' Plan Leaves Little Room for Error. The plan is for the government to use the $700 billion to take illiquid assets and hold them until the market recovers so they can be resold back into the market in an orderly fashion.

Mulford said that in an illiquid market where there have been no recent trades for a security, the government ''must rely on a valuation model as a starting point.'' That model in the cases of complex, derivative securities backed by mortgages and collateralized debt should be structured to try to calculate ''a risk-adjusted present value of cash flows that could be received.'' Once a present value number is calculated, the securities evaluation would ''adjust for the lack of liquidity that presently exists,'' he said.

Initial Appraisals Most Difficult. Mulford said that government evaluators must unwind the securities to ''get a look at the underlying mortgages—what is the stream of principal and interest coming from these mortgages,'' and ''if mortgages are not being paid, I think they would have to get an appraisal of the underlying collateral'' and ''ultimately what is driving that collateral.''

While it will be a daunting task to appraise millions of mortgaged properties and assets, Mulford said that it could be possible to group a number of similar assets under a single appraisal. Securities that are stitched together from several asset types probably must be completely unwound for appraisal, he said.

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''The first few are going to be the hardest'' tranches of securities to appraise for purchase, Mulford said. ''But once you have prices, you can use those early prices to help you figure out what to do with similar securities that come later.''

One of the biggest tasks will be ''how to figure what classes of assets to make bid tenders for,'' Lucas said.

Lucas suggested the government might try something like a ''Dutch auction,'' but in this case the government would start with a low asking price, and gradually move upward until a securities holder agrees to sell. At that point, all those offering securities for sale in the tranche at or below that sales price would receive that price until the total amount of money the government apportioned for that particular sale is exhausted.

Sensitivity Analysis on Loan Performance. Lucas also said he expects the government to try to discover the cash flows in an attempt to decide on a fair purchase price. ''They ought to be able to get some information on the loans, and do some analysis.'' If the government can get enough information and ''get to the lower bounds'' of where performance on loans that underly a security starts to appear to be a problem, ''maybe you can then arrive at an answer'' on what an acceptable price for that security is, he said.

Treasury Secretary Henry Paulson told the Senate Banking Committee Sept. 23 that different approaches for acquiring the securities will be tried for different classes of assets depending on the department's assessment of them. He said the government will need wide flexibility in exercising its acquisition and liquidation discretion, but suggested one possible method would be a ''reverse auction,'' in which the securities holder offers a sales price rather than the purchaser making a price bid. The government could then select the security tranche to be purchased from the offered sale price.

Neither Paulson nor Federal Reserve Chairman Ben Bernanke, also testifying at the Senate hearing, said whether the proposed plan would bind them to accept the lowest price offered, nor did they say whether they wanted the authority to restructure the securities after the government's purchase to make any opaque risky features of them more transparent and easier to understand when they are eventually offered for resale.

Despite calls from many quarters to do so, Bernanke made clear that fair-market accounting and valuation principles would not be abandoned for a hold-to-maturity value when making decisions at what prices to buy the securities. However, he also indicated Treasury would try to use fair-value methods to arrive at a purchase price that in some way reflected hold-to-maturity value.

Lack of Market Keys to Determine Price. ''One suggestion that's been made is to suspend mark-to-market accounting and use banks' estimates of hold-to-maturity prices,'' Bernanke said. ''Many banks support this. But doing this would only hurt investor confidence because nobody knows what the true hold-to-maturity price is. Without a market to determine that price, investors would have to trust the internal estimates of banks.''

''So let me come to the critical point,'' Bernanke said. ''I believe that under the Treasury program auctions and other mechanisms could be designed that will give the market good information on what the hold-to-maturity price is for a large class of mortgage-related assets. If the Treasury bids for and then buys assets at a price close to the hold-to-maturity price, there will be substantial benefits. First, banks will have a basis for valuing those assets and will not have to use fire-sale prices. Their capital will not be unreasonably marked down.''

However, neither Bernanke nor Paulson in their Senate Banking Committee testimony provided any precise details or elements of what those auctions or mechanisms would look like or how they would precisely work.

Bernanke at a Sept. 24 hearing of the congressional Joint Economic Committee said that the government would not structure the program, including through the government's sheer size with its market weight of $700

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billion, to overly benefit the financial institutions and other entities trying to dispose of the impaired securities.

''The presence of a large buyer would obviously raise prices above the fire-sale level,'' Bernanke said. ''However, I am not advocating that the government intentionally overpay for these assets. Rather, what I'm saying is that it's possible for the government to buy these assets, to raise prices, to benefit the system, to reduce the complexity, to introduce liquidity and transparency into these markets, and still acquire assets which are not being overpaid for in the sense that under more normal market conditions, and if the economy does well, most all of the value can be recouped by the taxpayer.''

Bernanke indicated how the government arrived at the size of the bailout by pointing out that the $700 billion represents about 5 percent of the $14 trillion total of residential and commercial mortgages outstanding, and they are currently running at a loss rate of about 5 percent.

Very Different Process for Treasury. International economic consulting firm NERA in a Sept. 27 analysis of the legislation, *Buying the Bad Stuff: Implementation Considerations for the Paulson Plan*, said the auction practices Treasury uses to buy the securities could be very different from the practices used when Treasury is offering U.S. debt instruments for sale. Treasury offers homogenous debt instruments for sale; in the bailout, it probably will be grouping assets for sale with some disparity, NERA said.

''There are likely at least 100,000 individual mortgage-related securities, obligations, and other instruments outstanding, with many further divided into multiple rated tranches, and there are vastly more outstanding whole loans,'' the NERA analysis said. ''Attempting to mirror the auction for U.S. government securities by pricing such assets individually or very tightly specifying the assets to be priced as one would require an impractically large number of auctions.''

With an expected finite budget of $700 billion, Treasury must ''apportion this budget among the different packages in such a way that there is genuine competition for each of them,'' NERA said. ''If Treasury were committed to purchasing the entire quantity offered of a given package, no sane bidder would submit a realistic bid; each could bid high, knowing that Treasury would purchase regardless. The program would not only run out of money fast but cause the government to overpay.'' That means Treasury must announce a set quantity of securities it is willing to buy for each auction ''to ensure [securities] holders will compete to sell,'' NERA said.

NERA suggested that multiple round auctions for a tranche of assets that Treasury is willing to buy might create the best outcome. However, one drawback is the increased time such auctions take, and ''time may well be in short supply'' in the current credit crunch environment, the firm said.

''The advantage of a multiple-round format is that it can aid in price discovery,'' NERA said. ''Bidders can learn how much supply is offered at various prices and refine their valuations of the asset being auctioned. This benefit is especially relevant in the current context, where uncertainty over the value of the assets is at the heart of the crisis.''

Multiple-round auctions proceed with offerors of the securities being given information about the volume offered at a particular price in each round until Treasury is willing to buy, NERA said. ''The process continues, with the auctioneer successively stepping down the price until one is reached at which bidders are willing to offer just the quantity that the auctioneer has precommitted to purchase,'' the firm said.

If the auctions are structured to attract a large number of bidders for each auction, they could determine ''the prices at which auctioned assets would trade and at which institutions continuing to hold those assets would value their positions,'' NERA said. That in turn ''might throw enough sunlight onto the valuation of mortgage-related products to jump-start the stalled over-the-counter markets, sparking them to get back into the business of price discovery,'' the firm said. ''This might be the best of all possible outcomes, as it would conserve public cash once private markets began digesting the product that today no one can sell.''

The firm also warned that ''to maximize the prospects for this sort of outcome, it is essential that all auction results be publicly disseminated.''

''The poor transparency that has characterized markets for many mortgage-related assets to date must give way to total transparency (at least with regards to the market-clearing price and quantity traded, if not the price and quantity of individual bids) if the taxpayer and financial markets are to derive all the benefit that they might from the auction program,'' NERA said.

☐ *The NERA analysis is at http://www.nera.com/image/Buying_the_Bad_Stuff_Paulson_0908.pdf.*