MEMORANDUM

TO: STACEY DION, OFFICE OF THE REPUBLICAN LEADER
FROM: FINANCIAL SERVICES COMMITTEE REPUBLICAN STAFF
DATE: SEPTEMBER 30, 2008

Following the failure of the Emergency Economic Stabilization Act to pass the House, Ranking Member Bachus instructed us to provide leadership with input on possible alternatives that might form a basis for attracting the necessary Republican support to pass the measure. What follows are our recommendations for your consideration. We are available at your convenience to discuss these items further.

Proposal on Covered Bonds

Problem:

Fundamentally, there are only three ways to effectively deal with the immediate problem of the illiquid assets clogging the balance sheets of financial institutions: the government can purchase the mortgage-related assets (Treasury plan), the government can insure the mortgage-related assets (part of the Republican alternative that has been incorporated in the bill), or the government can lend to the financial institutions that are not otherwise able to borrow money because of the mortgage-related assets on their books. Going forward, the addition of a lending proposal described below could serve as a workable replacement for the "Purchase and Insure" plan, or, alternatively, could supplement this plan. Such an approach could help address the central criticism of the Treasury plan: that the government is purchasing worthless assets in a "bailout" of the very people who created and profited from the problem.

Solution:

Authorize Treasury to invest in securities issued by "Financial Institutions" as defined in the bill, which are similar to structured covered bonds which would offer the benefits of a senior debt obligation and cover pools of financial assets. These bonds would have the following characteristics:

- Treasury would lend a set amount for a fixed term and interest rate;
- The loans would be secured by a perfected security interest in a pool of assets assembled by the financial institution;
- The loans would be further secured by a lien on all the assets of the financial institution for any failure to pay or deficiency in recovery from the primary collateral;
- The assets comprising the collateral pool would remain on the balance sheet of the financial institution;
- The assets would be managed by the financial institutions;
- Treasury would have a senior position even in the event of insolvency of the financial institution.

Rationale:

This approach would answer several criticisms of the plan rejected on September 29:

- The pricing issues would be mitigated. There would be no purchase so price would be less of an issue. The issue would be whether the collateral is sufficient for the amount loaned, which is lessened by the dual collateral coverage.
- The reverse auctions would be eliminated, removing the difficult issue of homogenous asset pool selection.
- The financial institutions could assemble a diverse pool of assets which would facilitate the packaging of illiquid assets.
- This would work with a wide variety of asset classes.
- Institutions would be discouraged from submitting overvalued assets because any shortfall would subject their equity to risk under the dual security collateralization.
- Cost to the taxpayer is minimized because Treasury would receive interest at a rate that will provide a reasonable return on its investment.
- Cash would be injected into the financial institutions just as if the assets were purchased.
- The governments' exposure would be fixed by the term of the bonds.
- The illiquid assets will require active management. Under this proposal, there would be no question of conflict of interest by the asset managers selected by Treasury, because the assets would remain on the books of the financial institutions and be managed by them.
- There would be less of an issue over financial institutions selling their worst assets to the government as in the original plan. If they do not manage the assets securing the government's interest properly, they will suffer when the bond term expires and they must repay the government from their other resources.
- The dual recourse collateral mitigates the risk that the government will receive less than par value in the event of an issuer default.
- Responsibility for the risk of the government not being repaid rests where it belongs, with the financial institution getting the benefit of the liquidity injection and in an amount consistent with the benefit it received.
- This plan would presumably be scored much lower than the previous plan since it is an investment, not an expenditure. The cost is the reasonably calculated expected loss on the investment, which is lessened since it has dual recourse collateral protection.

One of the benefits of this approach is its simplicity in comparison to other alternatives. This is not a bailout since nothing is purchased. There is only a very well secured loan. The "covered bonds" approach addresses both the liquidity and capital aspects of the credit crisis. Economists do not agree whether MBS is a liquidity problem (the assets are money-good, but cannot be borrowed against in the near term) or a capital problem (the assets are worth significantly less than their par value and the banks need to recapitalize). By beginning as loans against the "impaired assets," the plan targets the liquidity problem without the government having to assume the risk that the assets turn out to be worth much less than par. If it turns out that the loans have very little value, the government's security interest in the institution's equity permits the government to turn its "loan" into an equity stake in the bank, permitting the institution to be recapitalized in exchange for an equity stake in favor of the government.

While we believe that this approach has certain advantages relative to the asset-purchase and insurance alternatives that are in the current version of the rescue legislation, like those proposals, it carries certain shortcomings that will need to be addressed and mitigated. In considering the viability of the covered-bonds approach, Members should be aware of the following risks:

- *Difficulty in valuing the "impaired assets*." As with the asset-purchase and insurance proposals, difficulty in determining the value of the assets may raise some workability issues. Given that these assets are to be collateral for government loans, taxpayers are at risk if the value of the collateral is insufficient to ensure repayment. This risk is mitigated, however, by the fact that loans will not be for the full amount of the collateral, and that the institution's equity further secures the loan. Moreover, the fact that the institution's equity secures the loan provides an incentive for the institution's management to refrain from borrowing more than the value of assets will secure.
- *Crowding out other investors and lenders*. Given that the government will be taking a security interest in both the "impaired assets" and the institution's equity, other lenders may be reluctant to lend because their interests would always be junior to the government.

Proposal on Federal Deposit Insurance

Problem:

Private individuals and businesses are withdrawing funds from depository institutions because they fear they will lose amounts above the current $100,000 FDIC coverage limit. This not only removes the withdrawn deposits from the banking system – reducing the amount of credit available to fuel economic growth – but causes institutions to conserve capital needed to survive a "run on the bank."

Solution:

To shore up confidence in the banking system and prevent bank runs, raise the federal deposit insurance coverage limit applicable to transaction accounts from $100,000 to ***[$250,000]*** *for two years. To pay for this new federal guarantee, the Government would contribute* ***[$5,000,000,000]*** *to the deposit insurance fund from the $700 billion authorized by the Emergency Economic Stabilization Act. To the extent such funds are ever needed, they would only be available to insure deposits in excess of $100,000 and below $250,000. Any leftover amounts would be returned to the Treasury after two years.*

Rationale:

Because bank runs can undermine even healthy institutions, it is important in the current unsettled environment to provide maximum reassurance to depositors. This short-term proposal is an ideal way to help prevent hasty capital outflows and promote confidence in the banking system. It is not a comprehensive solution but it will help keep capital in banks and promote lending, thereby addressing the root cause of the credit crunch that has begun inflicting damage on the real economy. It limits risk because the program sunsets after two years. It supplements the insurance fund without imposing additional fees on banks. It reassures depositors who are worried that they will otherwise have to make decisions about their money too quickly.

Although raising insurance levels might make depositors less careful in choosing where to deposit their money, this temporary proposal would actually provide incentives to act prudently. With the knowledge that large deposits are safe, individuals and small business owners will be less likely to panic. They will not withdraw deposits simply because others are withdrawing theirs.

Increasing deposit insurance coverage levels obviously raises the costs to the FDIC when a bank fails, which would normally require higher premium assessments on the banking industry to cover the greater losses and ensure that the Deposit Insurance Fund remains well capitalized. Because imposing higher deposit insurance premiums at this point in the economic cycle would be extremely counter-productive, this proposal would direct some portion of the $700 billion which Treasury has requested for its Troubled Asset Relief Program to the Deposit Insurance Fund, to be available to pay the larger losses that will result from higher levels of insured deposits. Banks would pay nothing for the additional coverage. This proposal is designed to keep as much capital in banks as possible in the short-term while encouraging rational behavior in the long-term.

Finally, in addition to increasing Federal deposit insurance levels, it would be worthwhile to consider a corresponding increase in the amounts insured under the Securities Investor Protection (SIPC) program, which is a U.S. investor's first line of defense in the event a brokerage firm fails, owing customer cash and securities that are missing from customer accounts. SIPC provides that customers of a failed brokerage firm receive all non-negotiable securities -- such as stocks or bonds -- that are already registered in their names or in the process of being registered. At the same time, funds from the SIPC reserve are available to satisfy the remaining claims of each customer up to a maximum of $500,000. This figure includes a maximum of $100,000 on claims for cash.

From a political standpoint, raising deposit insurance coverage levels addresses the concern that the package that failed to pass the House earlier this week tilted too far in favor of Wall Street and did too little for Main Street. Higher coverage limits will protect small business deposits used to meet payroll and other expenses that are currently uninsured, encouraging them to keep their deposits in banks that can in turn use the funds to meet the credit needs of consumers and businesses in their communities. Higher FDIC coverage also benefits individuals seeking "safe haven" for their savings and retirement funds.

Proposal on Private Sector Participation Authority

Problem:

The taxpayer bears the entire burden of the $700 billion purchase authority provided to the Treasury Department in the Emergency Economic Stabilization Act.

Solution:

Require the Treasury Department to allow the private sector to participate in the reverse auctions for troubled assets on a pro-rata basis to reduce taxpayer burden.

Rationale:

Congress' goal should be, wherever possible, to keep the troubled assets of financial institutions in private hands and to minimize taxpayer burden. To encourage private capital to participate in the reverse auctions, the Treasury should permit private entities to purchase assets at the reverse auctions that Treasury will be administering for troubled assets. This makes the process more transparent, and would make the pricing of the assets more accurate.

In creating the reverse auction, Treasury would solicit private entities to participate alongside Treasury as additional purchasers for the troubled assets. For each $50 billion tranche, any private entity would be able to participate, but the tranche would not exceed $50 billion, which reduces Treasury's participation in each tranche. Private sector participation would aid in price discovery; prevent the Treasury from purchasing over-priced assets; and help reduce taxpayer exposure.

Other Proposals

In addition to the three proposals outlined above, we wanted to submit the following concepts for your consideration, recognizing that it would be very difficult to accommodate them at this late stage of the process:

Mandatory debt-for-equity swaps for insolvent financial institutions. Rather than asking taxpayers to step in to buy these toxic assets off their books, the market solution would be a streamlined corporate reorganization or bankruptcy procedure that forces the financial institutions that imprudently invested in MBS or retained the riskiest tranches of mortgages they securitized to realize the losses on these impaired assets in exchange for equity or warrants in favor of the purchasers of these assets. Taxpayer funds need not be involved in this process — instead, the government sets a value on these assets (whether through some constructed auction mechanism, some averaging of "mark-to-market" and "hold-to-maturity," or some mark-to-model computer program), the financial institution holding the MBS writes down to that value. To the extent that this write down leaves the financial institution undercapitalized, the financial institution would be required into enter into a debt-for-equity swap with its creditors, imposing some semblance of market discipline on the financial institution and its creditors without requiring taxpayer money. Although respect for free market principles cautions that contractual obligations between the financial institutions and their creditors should be sacrosanct, what we are witnessing is a market failure that requires a governmental force to break through the blockages that are clogging the system.

Temporary relief from mark-to-market accounting. To relieve pressure on the capital reserves of financial institutions, Congress could mandate the temporary suspension of mark-to-market accounting for certain kinds of assets, which would help halt the deleveraging of assets at fire-sale prices which has turned into a self-reinforcing cycle of declining asset values. Congress could require the SEC to suspend mark-to-market accounting in favor of a rule that would give relief to troubled financial institutions yet still provides objectivity and transparency to investors and creditors.

Facilitating transparency and comparability in the MBS market. The crisis of confidence that has seized up the credit markets is grounded in the impenetrability and opacity of the securities based on residential mortgages. Because lenders and investors cannot assess the quality of these assets, they have refused to buy them or lend against them. Government can help remove some of the opacity surrounding these securities by creating a clearing house through which financial institutions holding these securities can provide all relevant information — such as vintages of underlying mortgages, default rates, computer models used to value these securities — to potential investors. Government can help facilitate the transmission of information and the price discovery by offering objective and impartial methods and models to help private market participants assess the quality of these assets.