*These suggestions, **[sent to the Treasury & FRB in Oct 2008](#)**, proposed a plan similar to the TALF and PPIP programs, months before Treasury and others came around to the idea. They were mentioned in the **[NY Times Executive Suite column by Joe Nocera](#)** (complete document is available at nytimes.com **[here](#)**). The [Treasury plan](#) was first announced by Treasury Secretary Tim Geithner on **Feb 10, 2009.** The writeup also included the Turbo concept of limiting interest payments and using excess interest to pay down loan principal, which was included in the TALF announcement on Legacy CMBS on **May 19, 2009.***

Suggestions for Additional Steps for Tackling the Credit Crisis

By Malay Bansal

Oct 19, 2008

Several steps have been taken by the Treasury and Federal Reserve to address the current economic crisis. These are important and useful first steps, but as everyone knows, the problems are complex and will require additional action, including steps to tackle the root cause of the problem - declining house prices.

Obviously, any step to stabilize house prices will need to focus on decreasing supply by preventing foreclosures as much as possible, and increasing demand by providing incentives to new home buyers. Making mortgage payments more affordable is key to both. Most efficient will be approaches that help people on the margin – people on the verge of defaulting on their mortgage, or those considering buying a house.

Below are outlines of three suggestions I have for consideration along with other steps being contemplated:

1. **Better use of part of TARP Funds targeted to buy mortgage assets: Treasury can partner with private buyers instead of buying assets itself.**

   - Will increase efficiency by tapping private funds. There is a lot of capital waiting to be invested in distressed assets, but has not been invested yet as prices need to be lower to achieve targeted returns without leverage.

   - Treasury can lend to or partner with private buyers of distressed mortgage assets with terms like the following:

     - Treasury will put up 50% and the private buyer will put up 50%, with Treasury's interest being the senior interest.

     - Funds will be used to buy distressed mortgages and securities at a discount from various large and small banks and financial institutions.

     - Mortgage payments from purchased assets will be used in sequential order to (i) pay 5% interest to Treasury, (ii) 5% interest to the Private buyer, (iii) principal to Treasury, (iv) principal to the Private buyer, and finally (v) all residual to the private buyer as its return for the risk. This ensures that Treasury gets its money back first.

- o The 5% interest for Treasury will apply for 5 years. After that, it will increase by 0.5% every year till it reaches 9%. Interest for private buyer will stay at 5%.

- o Those taking the loan from treasury will need to agree to change mortgage terms to help homeowners including giving borrowers the option to (i) increase loan term by 5 to 10 years, and (ii) prepay loans at any time without penalty (any existing prepay penalties will be waived). Other terms to help homeowners may be included.

- o Treasury will offer mortgage assets from banks for bids. The private buyer with the highest bid will get funds from Treasury. Banks will have option of accepting the highest bid or keeping the assets themselves.

- o This type of plan will allow participation by numerous large and not-so-large investors. Since there will be **multiple buyers competing to buy assets**, with their own capital at risk, the plan would help in determination of fair market prices for distressed assets (instead of a situation in which TARP manager is the only buyer).

- o This program can run in parallel with direct purchases of assets by treasury, or can be used to sell off assets purchased by Treasury at a future date.

2. **Make mortgage principal payments tax-deductible for next 5 to 10 years.**

- o Mortgage interest is already tax-deductible. Making principal also deductible will make it easier for those who want to but are barely able to make their mortgage payments, and those who are considering buying a house.

- o As an example, someone with a $350,000 mortgage and 28% marginal tax rate will save $6,250 over 5 years or $1,250/yr. Over 10 years, savings will be $14,900.

- o Better than a single-shot stimulus payment, since (i) it will provide relief over a longer period of time, (ii) it attacks the root cause of the problem by targeting housing, and (iii) it will benefit local governments by preventing loss of property taxes that will otherwise result from foreclosure.

- o The deduction may be limited to maximum 15 to 20% of total mortgage payment to focus the benefit more towards newer mortgages (after ten years, principal payment is likely to be more than 20% of total mortgage payment), &/or to mortgages issued in certain years to control total cost.

- o The deduction can be phased out above a certain level of AGI to focus the benefit towards those who need it more.

3. **Encourage mortgage modifications to lower monthly payments by extending the mortgage term by 5 to 10 years.**

- o Modify mortgages by increasing the term by 5 to 10 years to lower monthly payment. As an example, monthly payment on a 30 year mortgage with 6.5% rate will decrease by 4.4% (or $1,172/year on a $350,000 mortgage) if term is increased by 5 years. An increase of term by 10 years would reduce monthly payment by 7.4% (or $1,960/year on a $350,000 mortgage).

- o Lowering payment without lowering interest rate may be more palatable from fairness perspective, and should be attractive to lenders if it avoids default. Removing any prepayment penalties should also be part of the modification as much as possible.

On Feb 10, 2009, Treasury Secretary Tim Geithner, in a much anticipated speech, announced the long-awaited toxic asset plan, but the market was disappointed by lack of details and sold off.

Extract from Treasury's 10-Feb-2009 Fact Sheet on the Financial Stability Plan:

FACT SHEET

FINANCIAL STABILITY PLAN

1. Public-Private Investment Fund: One aspect of a full arsenal approach is the need to provide greater means for financial institutions to cleanse their balance sheets of what are often referred to as "legacy" assets. Many proposals designed to achieve this are complicated both by their sole reliance on public purchasing and the difficulties in pricing assets. Working together in partnership with the FDIC and the Federal Reserve, the Treasury Department will initiate a Public-Private Investment Fund that takes a new approach.

- ***Public-Private Capital*:** This new program will be designed with a public-private financing component, which could involve putting public or private capital side-by-side and using public financing to leverage private capital on an initial scale of up to $500 billion, with the potential to expand up to $1 trillion.

- ***Private Sector Pricing of Assets*:** Because the new program is designed to bring private sector equity contributions to make large-scale asset purchases, it not only minimizes public capital and maximizes private capital: it allows private sector buyers to determine the price for current troubled and previously illiquid assets.

NY Times Links:

http://graphics8.nytimes.com/images/blogs/executivesuite/posts/MalayBansalPlan.pdf

http://executivesuite.blogs.nytimes.com/2008/11/07/where-is-fdr-when-we-need-him/?scp=2&sq=Malay%20Bansal&st=cse

Solving the Bad Asset Pricing Problem

Note: This write-up was published on the Seeking Alpha [here](). It was a follow-up to the original suggestions, sent to Treasury & FRB in Oct 2008, which proposed a plan similar to the TALF and PPIP programs, months before Treasury and others came around to the idea.

By Malay Bansal

Feb 5, 2009

The Original TARP plan and the Aggregator Bad Bank ideas both have one major flaw: lack of a mechanism to determine appropriate prices for bad assets. Here is an approach to tackle this pricing issue. This approach also gets more bang for the buck for the Treasury by involving private capital in buying of these assets. More clarity in pricing and involvement of private investors are desperately needed for markets to return to normalcy.

There are already a lot of private investors who have raised significant amounts of money to invest in distressed assets. However, a lot of this cash has not been invested yet. Part of the reason is that they desire lower prices to get their returns to higher target levels than what they can get at present. Sellers, on the other hand, are often not ready to sell at even lower than current prices, especially when they believe that prices are already too cheap based on fundamentals. This has led to a stand-off which is leaving these assets on bank balance-sheets. So long as these assets stay on their balance-sheets and uncertainty about their prices continues, banks facing mark-to-market losses can not focus on restarting lending in these markets again.

Lower asset prices is one way private investors can get higher returns. The other method is if they can get financing for buying these distressed assets. If for example, they can get 50% financing on purchase price of assets, they can buy twice the amount of assets they could buy without the financing, thus roughly doubling their returns (minus the cost of financing). **This will allow them to pay higher prices for assets and still earn their target returns.**

In the current environment, financing is generally not available to investors in these assets. Given that financing can increase returns significantly, it is especially valued by investors at present. And that is what provides the solution to the pricing problem, and can ensure that the banks get the highest prices possible for these assets today, without the risk of any future Mark-To-Market (or actual) losses.

To attract private investors to buy distressed assets, the Treasury <u>**can offer to provide financing to private buyers.**</u> **Prospect of higher returns, especially in an environment where returns on other assets are low, will attract lot of investors to the sector. However, <u>financing will be provided to the buyer who has the highest bid on a given set of assets</u>. That is important. <u>The bidding process creates a mechanism for determining a fair market value for these assets.</u>** This plan will allow participation by numerous large and not-so-large investors, not just a few large investors selected by the Treasury. If the bid is too low and the bidder can make an exceptionally high return, another investor is likely to step in with a higher bid, if the bidding process is transparent and open to everyone. Different investors have expertise in different products. Those with the best expertise in the assets being offered will be able to value these assets and bid more aggressively. <u>Since there will be multiple buyers competing to buy assets, with their own capital at risk, the plan would help in determination of fair market prices for distressed assets</u> (instead of a situation in which TARP/Aggregator Bank manager is the only buyer). This bidding process also <u>**ensures the banks get the highest price possible**</u> for their assets in the current environment. If none of the bids are high enough, the bank is not required to sell, and can retain their assets. This ensures that banks are not forced by the program to sell assets at too low a price. If they choose to sell, their balance-sheet is cleared of these assets, and there is no future claw-back or liability related to these assets for them – the assets will be owned by a third party. They can go on to focus on other things.

Any cash flow received from the assets will be used first to pay interest to the Treasury and the private investors. Then, it will be used to pay principal back to the Treasury. Private investors will not get any of their principal back till Treasury has been paid back completely. The interest paid to private investors will be small (perhaps 4 to 5% range on their invested funds, not the face amount of securities) and will be meant to cover their expenses. Majority of their return will come at the back-end, their higher risk reflecting their higher returns. This priority for paying back Treasury funds first **will protect public funds by decreasing the probability and amount of any potential losses** on these assets.

Also, for home mortgage backed assets, Treasury can help homeowner mortgage-holders facing difficulty by requiring recipients of financing to agree to certain pre-specified steps to help homeowners in loan workouts.

Providing financing, instead of buying assets itself, provides more bang for the buck for the Treasury. As an example, if the Treasury offered 50% financing on AAA assets, and it has $100 Bn allocated to the program, the program will clear $200 Bn of assets from bank balance sheets. If the treasury used the funds to buy the assets itself, it will be able to remove only $100 Bn of assets from the banks' balance sheets. Also, it reduces the risk of loss on these assets for public funds, since Treasury will be paid first and private investors will be bear the loss before the Treasury takes any hit.

Since private investors, who will have their own capital at risk before Treasury's capital, will be buying and managing the assets, the **Treasury will not need to build as big an infrastructure** as it will need if it were to buy the assets itself. **Nor will it need to pay management fees to third-party managers**. Also, by using the private sector, this program **can be ramped up much more quickly**.

To achieve the highest rational prices, the bidding process must allow wide participation by large & small investors (bids should be requested for portfolio sizes that do not discourage small to medium size investors), amount and cost of financing should be known in advance of bidding (will likely be different for different pools and can be announced for each portfolio when it is put up for bid – treasury can even ask for multiple bids for different amounts of financing), and private capital must be at risk while protecting public funds (otherwise plan may face opposition from public).

I had originally included this suggestion among a few I had made to the Federal Reserve and Treasury officials in October after the original TARP plan was announced. I was happy to see the announcement of TALF, which will provide financing for new origination. However, financing for existing distressed assets will help clear the bank balance sheets of these assets, which is needed before banks are likely to increase originating new loans. Also, current Treasury plans do not include the Commercial Real Estate sector. It should be included before the issues in the sector escalate and become much bigger, as it will have significant impact on smaller regional banks that hold a lot of commercial real estate debt.

No single step will solve all the problems. Neither will this one, and it should be one of many approaches. But this approach can be effective since it will start the process for establishing prices for distressed assets, involving private capital in solving the problem, and cleaning up bank balance sheets, which are all prerequisites for eventual return to normalcy in the credit markets.