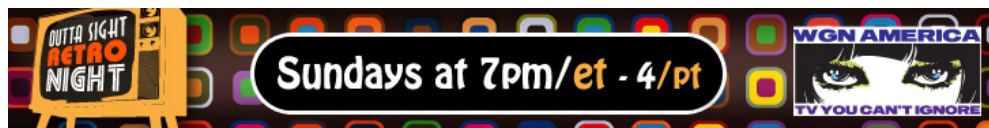


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NEWS ANALYSIS

Government's bailout path a maze of unknowns

Treasury will have a tough time divining the value of the complex mortgage securities and ensuring a fair deal for taxpayers.

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Now comes the hard part.

With congressional passage of the bailout bill Friday, the financial industry's focus will shift to the mechanics of the deal: How exactly does the government plan to spend up to \$700 billion to buy troubled loans from banks?

The measure gives the Treasury Department up to 45 days to set up the acquisition system, and so far Treasury Secretary Henry M. Paulson has said little about how he planned to implement his new authority. In a statement Friday, Paulson said Treasury would move rapidly but "methodically" to use its "broad set of tools."

Securities experts say the system needs to minimize the possibility that certain firms would be favored at the expense of others -- especially given Paulson's ties to Wall Street as the former chairman of Goldman Sachs Group Inc.

"Someone who controls \$350 [to] \$700 billion can determine who survives and who doesn't," said Lawrence E. Harris, a finance professor at USC and the former chief economist of the Securities and Exchange Commission. "That's a massive amount of power that has the potential for, if not fraud, then favoritism and blind mistakes."

So far, the most detailed indications of Paulson's intentions came in his testimony last month before the Senate Banking Committee.

At that time, he said Treasury would hire five to 10 outside asset managers, presumably from Wall Street, and suggested that one possible approach would entail financial institutions bidding against one another to offer their troubled assets to the government. In one scenario, known as a reverse auction, the companies would reduce their bid prices until they hit a mark the government would accept.

The agency would do "a certain amount of experimentation," Paulson said.

Pricing the assets

Still unknown is how Treasury might compensate its outside asset managers. One investment firm, Newport Beach-based Pacific Investment Management Co., known as Pimco, offered to conduct the auctions for free -- if its competitors agreed to do the same. Treasury has not publicly responded.

Harvard Law School professor Lucian A. Bebchuk suggested in a recent paper that the government divide its fund into, say, 20 equal portions and promise the manager of each a set percentage of the profit generated by his or her purchases over time.

"The competition among these 20 funds would prevent the price paid for these mortgage assets from falling below fair value," he wrote, "and the fund managers' profit incentives would prevent the price from exceeding fair value."

It isn't known whether Treasury will try to give the asset managers specific guidelines on pricing, although both Paulson and Federal Reserve Chairman Ben S. Bernanke have argued that the troubled mortgage loans owned by banks would be worth more if they could be held to maturity than if they were forced onto the market now in a fire sale.

That gives the Treasury a rationale for paying banks more than current valuations, on the assumption that it will make a profit down the line. But such prices might expose the Treasury to charges that it is unfairly subsidizing the banking industry with overpayments.

Economists, bond traders and securities brokers say the process is certain to be vastly more complicated than a simple auction. The reason is that the assets to be purchased are a far cry from the objects customarily sold on EBay or, for that matter, the complex financial instruments traded on futures exchanges.

As a result, USC's Harris points out, questionable deals could easily slip under the radar. "If a security's worth \$10 million and you pay \$30 million for it, who'd ever find out?"

Even Treasury officials acknowledge that they can't judge the asset values on their own. "We don't have that expertise here," a Treasury representative said this week, explaining why the agency planned to appoint outside managers.

On the selling block will be at least 100,000 individual mortgage-backed bonds and other troubled securities along with a larger number of individual mortgage loans, according to a recent report by New York-based NERA Economic Consulting.

Before making their purchases, trading experts say, Treasury officials or their agents will have to develop a working model of the exotic mortgage securities' true value -- what they're worth given their probable cash flow to maturity.

"They're extremely complex," said Campbell R. Harvey, a finance professor at Duke University. "To get this operational is not going to be quick, and there are many layers of execution risk."

Unbundling unknowns

The so-called mortgage-backed securities that have pushed some of the nation's biggest financial institutions to collapse consists of home loans that were bundled together and sold to investors. Each security is a unique package of loans from different parts of the country, with different borrower characteristics. The potential for unpleasant surprises is ever-present.

"You're always worried that the person selling it knows more than you do, that they've seen something in the cash flows and they know a problem's brewing," said Brad W. Setser, a former Treasury official who is now a fellow at the Council on Foreign Relations.

To take a typical example, consider a \$1.7-billion mortgage security marketed by Countrywide Financial Corp. in March 2004.

The portfolio encompasses 7,554 mortgages. About one-fifth are for California homes, most carry adjustable rates and fully one-third are "stated income" loans -- that is, the borrowers were not required to document their incomes.

Evaluating the portfolio requires diving into a 200-page prospectus brimming with tables showing the range of the borrowers' credit scores (more than half with low scores between 600 and 500), the range of applicable interest rates on the loans, the loan-to-value ratios on the underlying properties and 16 other variables, all disclosed to help buyers calculate the likelihood of delinquencies and foreclosures in the package.

A buyer would also want to subject the portfolio to a "stress test" -- model how the delinquency rate might change given movement in housing prices and overall economic conditions.

These factors are likely to enter into Treasury's calculation of the price it wants to pay for the securities. But they're not the only complications.

Another is the need to act quickly. "The difficulty of the task argues for proceeding slowly and building up expertise," Setser said. "But the need to unfreeze the market may demand speed in getting money out the door."

Conflicts of interest

Some provisions Congress added to Paulson's original bailout plan, many of which were ostensibly designed to protect taxpayers' interests, will further complicate the process. The final bill allows government officials to take equity stakes in institutions that sell their troubled assets to the Treasury and impose limitations on executive compensation. Both represent costs that the selling institutions will tend to consider in setting their sale prices on the assets.

Then there's the oversight mechanism Congress imposed. Among other things, it requires Treasury to make the details of every transaction public. That's an admirable effort to create transparency for the bailout program, but it won't make the buying and selling of the securities any easier.

"The financial and political conflicts, together with the prospect of second-guessing, will make this a Sisyphean task," said George L. Ball, chairman of the brokerage Sanders Morris Harris Group and former president of E.F. Hutton Group.

One important consideration will be guarding against conflicts of interest among the government-appointed money managers.

On the face of it, that will be a challenge because bond-trading firms participate in the market for themselves and clients and often manage their own portfolios of mortgage-backed securities. The value of those holdings will be influenced by the prices set through the government program.

The management firms considered likely to seek a role include Pimco, New York-based BlackRock Inc., and Pasadena-based Western Asset Management, all of which manage fixed-income portfolios worth hundreds of billions, including holdings in mortgage-backed securities.

BlackRock is 49% owned by Merrill Lynch & Co., which is being acquired by Bank of America Corp. Merrill has extensive holdings of mortgage securities, which would arguably rise in value if the government pegged its purchases at a relatively generous price.

On the other hand, Pimco and BlackRock also have programs to acquire distressed securities. That means they might benefit if the Treasury purchased similar assets at the low end of the price scale, which might lower the prices the two firms themselves pay.

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