OLIVER WYMAN

Financial Services – Point of View Series: Issue 5

October 24, 2008

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Making the most of TARP: The Supporting Role of Fannie and Freddie

John Colas, Partner in Oliver Wyman, says that while the Troubled Assets Relief Program (TARP) is substantial in size and unprecedented in scope, it is not large enough to purchase and hold all of the distressed assets from all financial institutions' books, and need not be. The success of TARP will lie in how it helps to restore order and confidence to the mortgage markets. This process can be greatly accelerated by acting quickly in partnership with valuation experts and market information providers. Most significantly, the government's conservatorship of Fannie Mae and Freddie Mac gives Treasury access to unparalleled mortgage asset pricing expertise and operations.

Big Enough?

The recently passed TARP provides $700 BN to stabilize the banking system. One of its key components is an effort to purchase distressed mortgage whole loans and related securities. A key question that has emerged is: "Will $700 BN be enough?" Also, in a year during which some recent investments in distressed financial institutions have lost much, or even all, of their value, what must TARP do to stimulate private sources of capital?

Treasury plans to use $250 BN of the $700 BN to make direct equity injections in to banks[1], leaving "only" $450 BN[2]. As seen through various lenses, the diverse measures of distressed mortgage debt exceeds this amount.

The US mortgage market consists of some $11.3 TN of single-family[3] and $3.6 BN of commercial mortgages[4], as measured at face value. The $4.7 TN of mortgages packaged into agency MBS are likely to remain outside of TARP. This leaves $3.8 TN of residential mortgage whole loans and $2.8 TN of private-label MBS; as all categories of whole loans and securities are traded below face value, they are candidates to be sold into TARP. Commercial mortgages and CMBS similarly trade below face value. The riskiest product category, subprime loans, on its own amounts to over $1 TN outstanding. Many loans were securitized and sold to entities such as asset managers and pension funds which do not pose systemic risk. Nonetheless, financial institutions that may need to sell assets to TARP still own a significant portion: some $2.0 TN of single-family, $0.1 TN of multifamily, $0.9 TN of commercial real estate whole loans, and at least $0.3 TN of non-agency MBS[5]. The amount of delinquent mortgages could exceed the size of TARP. Delinquent residential mortgages could be as high as $600 BN[6] at present, along with another $100 BN of multifamily and commercial mortgages. These numbers are likely to rise, given that the real economy is only beginning to turn down; unemployment, which has risen 1.1 percentage points in the last four months[7],

1 US Treasury press release "Treasury Announces TARP Capital Purchase Program Description", October 14, 2008
2 Of the $450 BN, Treasury has unfettered authority over $100 BN, while Congress could, in theory, intervene to prevent it from using the other $350 BN, per § 115(c)
3 Federal Reserve Bulletin 1.54, September 2008. This represents one-to-four-family mortgages
4 Ibid. The $3.6 TN consists of $2.6 TN of non-residential mortgages, $0.9 TN of multifamily mortgages, and $0.1 TN farm mortgages
5 Based on 2008 Q2 call reports of all FDIC-insured depositories
6 Based on the $11.3 BN of mortgage debt outstandings and a 6.41% delinquency rate per the most recent Mortgage Banker's Association quarterly survey, released September 5, 2008.
7 US Department of Labor

is expected to increase further. Similarly, continued declines in residential property prices will increase the number of underwater households, further contributing to delinquencies and foreclosures.

TARP's size is based on purchase prices rather than nominal face values[8], so its $100-450 BN will stretch quite a bit farther, given the extent to which even performing loans trade at a discount today. Jamie Dimon, CEO of JP Morgan Chase, provided this pertinent information during the third quarter earnings call[9].

> *"I'll give you some numbers now. Ready? Prime loans are not really applicable. Alt-A performing about mid 70s, non-performing 40s. That's loans. Alt-A securities, high 20s. Subprime mid-30s. CMBS mid-80s, that's all we are going to give you because it's competitive information."*

This quote illustrates two key points. First, it indicates that the marketplace has misgivings about even performing loans, which certainly makes sense in an environment where literally millions of borrowers have negative equity on their homes. Second, it illustrates that TARP could use $450 BN to buy mortgages with a face value of $1 TN or more. Given the total of distressed assets, even this will not suffice. As a result, TARP will need to generate investor confidence to draw in private capital to relieve the remaining strains on financial institutions' balance sheets.

What To Do?

The choice of actions and mechanisms TARP uses to purchase mortgages will therefore determine whether it can restore investor confidence. Central to this pursuit will be the full disclosure of a pricing mechanism to inform both banks and potential new sources of private capital. A properly constructed auction can avoid the problems that arise if prices are too high (only the government purchases loans, and TARP becomes a bailout with direct subsidies used to recapitalize banks) or too low (few banks are sellers, and they establish marks used by all other banks that reveal, or create, further capital shortfalls and accelerate failures). But equally important is how TARP uses this valuable pricing information. By requiring bidders to provide detailed, standardized information about each lot, purchasing mortgages that span the full range of values along these attributes, and disclosing the market-clearing prices, all remaining holders of troubled assets

8 The Emergency Economic Stabilization Act of 2008 § 115(b)
9 JP Morgan Chase 3Q2008 conference call, October 15, 2008

can establish marks with confidence. This will provide them with the means to produce transparent and credible valuations for their holdings.

Mortgage loans, and securities composed of multiple loans, are extraordinarily complex and heterogeneous. Different loans exhibit considerable variation in a number of key attributes related to the mortgage itself, the underlying collateral, and the borrower. In turn, a typical MBS will consist of several thousand loans, and a prospectus describing how mortgage cash flows are allocated across MBS tranches can easily run to 100 pages. The auction mechanism will need to take this complexity into account. Simple auctions work well for buying and selling largely undifferentiated and easily comparable items. To run an auction involving heterogeneous assets, TARP therefore needs a party that can provide some degree of standardization and transparency.

Bring in the Government Sponsored Enterprises (GSEs)

The government will be well positioned to provide transparency, should it act quickly in partnership with valuation experts and market information providers. Whilst the GSEs have had their own setbacks, their core mortgage credit pricing capabilities are unparalleled and represent a critical means to address the information asymmetries endemic to this crisis. For example, the GSEs have the most robust and detailed home price indices, down to the zip-code level, which they routinely use to estimate the current or mark-to-market loan-to-value ratio for each outstanding loan. This information can then be used to create high quality estimates of future performance for any mortgage product. The GSEs also have some of the most advanced mortgage prepayment analytics in the industry. In addition, through their large servicing oversight operations, the GSEs have unparalleled understanding of the latest trends and conditions in the collections and foreclosure worlds. Finally, as the GSEs will not buy to or sell from TARP, they will not have any real or perceived conflicts of interest.

TARP should require participating mortgage holders to provide it with detailed but standardized information in distressed asset sales or auctions. Afterwards, it should disclose this information for each of the accepted bids and exchanges. By creating a reference sheet, TARP would enable all other mortgage holders, assuming they can compile comparable information about their assets, to value them in the same manner. TARP will need to decide on and publicize macroeconomic scenarios and holding periods for the loans and securities that it purchases. This will then allow other investors to adjust the winning TARP bids as needed when producing their own valuations.

Should TARP follow this path, every party will benefit. Financial institutions would have a much more credible basis for asserting their capital positions than today. Treasury would be able to accelerate the implementation of TARP by taking advantage of the operational and asset pricing capabilities that exist within the GSEs today.

Door #1 or Door #2?

Most importantly, it is in the US economy's long-term interest to minimize the government's active capital participation in the financial services industry. Structured properly, TARP will not only be a source of public capital, but a catalyst for private capital. Any banks requiring public capital will hopefully be in a position to retire such stakes quickly so as to avoid the unintended consequences of prolonged capital flow distortions. The greatest value of TARP will be in attracting private investment to restore full confidence to an industry that cannot exist without it.

Shine the Light

We will continue to learn further details on how TARP will conduct auctions and purchase programs. We believe that these efforts will be best served by engaging the mortgage valuation expertise within the GSEs, insisting on detailed information, and disseminating this fully together with market-clearing prices. Everyone from gospel singers to the Rolling Stones has extolled the virtues of shining the light. A successful program must "shine the light" on valuations to benefit the industry well beyond the direct impact of removing troubled assets.

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