

## How to prepare for the Troubled Asset Relief Program

The Federal Reserve and the U.S. Treasury have undertaken several dramatic maneuvers to help contain the financial crisis. Currently in focus is the Troubled Asset Relief Program (TARP), as of yet the most direct attempt to help ailing markets, comprising a \$700 BN proposal to remove distressed or illiquid mortgage-related assets from financial institutions. The enabling legislation is still a work in progress; the Emergency Economic Stabilization Act of 2008 was dramatically rejected by the House of Representatives this week, but a revised version was approved by the Senate and many observers believe that the bill is likely to be passed into law.

Many important details of the TARP remain unresolved, and indeed the plan itself has yet to receive final approval. However, we believe that now is the time to begin preparing your institution's response.



Prompt action is warranted by the unprecedented impact, complexity, and speed of the changes that the new law will initiate:

- **Impact:** The proposed program will change the economics, risk, and competitive dynamics of the entire industry. Whether or not your institution ultimately decides to participate directly, it will be affected, as new market prices are set and the existence of the program strengthens some hands and perhaps weakens others.
- **Complexity:** Reviewing the full range of eligible assets and putting into place a framework for deciding how and whether to dispose of each is itself no simple task. Moreover, the TARP is not just a new trading partner, and participating in the program is likely to have many more knock-on effects than a simple trade. Understanding the effect participation could have on your institution's earnings, liquidity, risk profile, and governance will be crucial to navigating this new challenge.
- **Speed:** While the new law's cumulative effects on the industry will unfold over a period of years, decisions about your institution's participation will need to be made quite soon. Extremely short time frames to make crucial decisions have been a hallmark of the current crisis, and the Treasury's program will now put every institution in the hot seat.

In order to prepare, we recommend that you start by (1) establishing the management and organization of your institution's response, (2) conducting a bottom-up analysis of your assets' value and risk, (3) assessing the top-level impact of asset sales on your institution and its stakeholders, and (4) agreeing on the high-level principles by which you will later make concrete participation decisions.

We believe that Oliver Wyman is uniquely positioned to help institutions think through and enact a response to this complex problem. As a leading management consultancy to the financial services sector, we have been working with major banks and non-bank financial institutions throughout the crisis on valuing the underlying loans and securities that have been at the core of the crisis, determining whether to hold or sell distressed portfolios, restructuring balance sheet (and off-balance sheet) exposures, and deciding whether to raise additional capital. We bring independent and objective expertise to support your institution in formulating a comprehensive response to the Treasury's plan, from assistance with assigning valuations to understanding financial and strategic impacts – and for competing in the newly re-shaped landscape of global finance.

This document outlines the key issues and questions you should be considering. While there remains significant uncertainty in the ultimate shape of government action, we assume below that a law resembling the current compromise bill will be enacted.

# Summary of the Treasury proposal

Our latest understanding of the asset purchase plan, based on the Senate's bill and earlier Congressional testimony, is that the following key provisions will be included (subject to change as legislation is finalized):

## ■ Scale of funding

- Treasury will have the authority to issue \$700 BN of Treasury securities to finance the purchase of residential and commercial mortgage-related assets
- Of the total, \$250 BN will be immediately available, an additional \$100 BN may be released upon certification that funds are needed, and a final \$350 BN is subject to Congressional approval

## ■ Eligible institutions

- The bill allows any financial institution with significant operations in the U.S. to participate, including banks, broker-dealers, and insurance companies
- In general, many non-U.S. institutions will be eligible
- It is possible that hedge funds, money managers, off-balance sheet conduits and structured investment vehicles could participate directly by selling assets to the Treasury as well

## ■ Eligible assets

- Assets covered in the latest bill include any residential or commercial mortgages (whole loans), or any securitized, structured, or derivative securities related to such mortgages
- The Treasury Secretary also has the discretion to include any other financial instrument

## ■ Asset pricing

- The price of asset purchases will be set through market mechanisms (such as reverse auctions) where possible
- The Treasury Secretary has authority to make direct purchases as well
- In addition to asset purchases, the Treasury will offer a program to insure troubled assets, though the actual use of this program is not mandated

- Taxpayer protection
  - Asset purchases in excess of \$100 MM are to be accompanied by equity participation, through warrants
  - Warrant terms and conditions are yet to emerge, but the Treasury has made it clear that they wish to encourage participation by non-distressed institutions by not making the terms punitive
  - The bill also specifies that any losses ultimately sustained by the program be recouped in unspecified ways from the broad financial industry
  - The FDIC's ability to borrow from the Treasury has been increased to cover the anticipated short-term needs, but it is possible that deposit insurances levies will eventually be increased
- Customers and products
  - The bill requires the Treasury Secretary to implement a plan to mitigate foreclosures and encourage loan modifications
  - The ceiling on FDIC deposit insurance will be raised from \$100,000 to \$250,000 per account
- Governance and accounting
  - The current draft gives the SEC the authority to suspend mark-to-market accounting, specifically the requirements of FASB 157 (note that the SEC has already issued a clarification of 157 that is likely to support the use of internal fair value estimates over "fire-sale" or illiquid market prices in many cases)
  - Certain limits on executive compensation are introduced, with more stringent restrictions in cases where assets are directly purchased from an institution (rather than by auction)
- Other major provisions
  - The version that passed the Senate also includes a variety of tax breaks and credits for businesses and individuals

## Implications of asset sale pricing

The current bill leaves significant details, such as the mechanism and price for asset purchases, to be decided later. Based on the limited information available, we draw two tentative conclusions.

First, the need to balance significant relief to the financial industry with adequate protection for taxpayers has implications for what kind of assets will be attracted into the program. Earlier Congressional testimony indicated that the Treasury would aim to purchase assets whose current market price is well below their long-term economic value. This would alleviate the selling institution of the ongoing volatility in the asset's value, but would also reduce the risk of loss to taxpayers. However, the assets for which this is most clearly true – that prices are not reflective of the true economics – are just those that investors are usually most interested in, and thus those that might be retained by the private market. Therefore, it may be that the TARP will tend to attract assets with the greatest uncertainty in value, those whose likely long-term upside is balanced by large, asymmetric potential downside. Many of the most complex structured assets meet this description.

Second, pricing levels will also affect which types of institutions end up participating. If the Treasury intends to acquire assets at or near current market prices, this will tend to attract assets already being carried at mark-to-market values, as this would not produce additional hits to income and capital for the seller. By contrast, institutions selling assets now being carried at (higher) historic cost would likely need to recognize fresh losses. On balance, this could skew participation toward investment banks and large universal banks, which tend to have larger mark-to-market portfolios.

One further potential consequence is that the addition of a new large buyer and an ongoing transaction process jump-starts private transactions. The TARP could attract more active investment in distressed mortgage assets by providing a short-term floor for prices and thereby giving potential investors more confidence in taking bets on their longer term credit performance.

## Preparing your response

To prepare your response to the proposed Treasury program, we recommend that you initially focus on four key challenges:

- Establishing the **management and organization** of the response process
- Conducting a **bottom-up asset review** to identify which assets to hold and which to sell, based on an objective view of their valuation and economics
- Assessing the **top-level impact** of possible asset sales on your institution's capital structure, funding and liquidity profile, and balance sheet
- Agreeing on the high-level **principles of participation** that will guide your subsequent decisions relating to the program

### A. Management and organization

The first step should be to establish how your firm will organize its own internal process in response to the new law. We expect that each institution's senior leaders will necessarily be involved in the core decisions of whether and how to participate. To support this senior decision-making, information and analysis will need to be integrated across multiple departments. Some firms will elect an existing group to coordinate this multi-department effort, while others will form a new task force to take the lead. The most important goal at this stage is to clearly designate who has responsibility and accountability for the process, and to make sure they are empowered to access the information and resources they need throughout the organization. The response team will need to be able to act quickly. We also recommend that those in charge of driving the decision-making process be positioned to make dispassionate assessments, avoiding undue attachment to legacy business decisions.

### B. Bottom-up asset review

The Treasury's purchases are expected to focus on mortgage-related loans and securities, but ultimately the program could extend across a broader range of asset classes. Institutions will need to review all of their existing on- and off-balance sheet exposures, assessing

the value and risk of each asset. At a minimum, we recommend establishing a process to catalog assets and establish for each major exposure:

- Loss forecasts across favorable, expected case, and stress scenarios
- Long-term economic valuation (analogous to the held-to-maturity view)
- Achievable transaction price in the private market today – this will require consideration beyond simply obtaining the latest “market” price from a pricing service
- Multi-year projection of earnings and capital impact under different scenarios

This analysis will be the primary input into the later process of deciding which assets to sell, what price to sell at, and how to bid in the auction process.

## C. Top-level impact assessment

In addition to the asset-by-asset review, you will need to understand the firm-wide impact of any asset sales under the Treasury’s program. Given a range of different levels of participation, it will be critical to appreciate how your institution will be affected across such areas as:

- Impact of warrants on existing shareholders and overall capital structure
- Effect on funding requirements and liquidity profile
- Changes in accounting treatment and results
- Required changes to governance

Given the dearth of details available now, these assessments will be tentative, but having an established framework for analyzing them will enable swift decisions as the Treasury’s implementation plans emerge.

## D. Principles of participation

While it is too early to begin making concrete, specific decisions on participation, later discussions can be most productive if senior leaders are engaged now to agree on the guiding principles. Such discussions could focus on questions such as:

- What benefits or downsides would asset sales bring, if the simple sale itself was financially acceptable?

- Reduced reliance on short term funding
- Effect on current shareholders
- Impact on creditor and counterparty perception
- Ability to attract additional capital, if needed
- Impact of executive compensation limits and other corporate governance issues
- What signal would participating (or not) send to our investors, creditors, counterparties, and customers?
- What risks do we run by choosing not to participate, given the severe penalties that the government has imposed on institutions seeking last-minute emergency support?
- What factors would limit or prevent our participation in the program?
  - Reputational impact
  - Need to recognize new losses against capital and earnings
  - Shareholder dilution
- What are the criteria for judging our participation in the Treasury program to be successful? How should we define a “win”?
- How is the program going to change the competitive landscape? How will other institutions react, and what impact will it have on them?
- How does the program support or challenge the main elements of our existing strategy?

Establishing an early high-level dialogue on these issues and communicating the results throughout your institution will enable later discussions to be made using a common language and set of goals. This will position you best for rapid, effective decision-making in the coming months.

## Conclusions

The Treasury's proposed plan will have wide-reaching effects on global financial markets, and will directly impact U.S. financial institutions holding significant amounts of mortgage-related assets. Moreover, given the urgency of the current market situation, there is a high likelihood that once legislation is passed by Congress the Treasury will act quickly to attempt to stabilize the market. In order to respond effectively once the plan is set in motion, financial institutions need to begin thinking through the key issues now and formulating contingent plans of attack.

Ensuring that your institution is prepared for this unprecedented government initiative will require a detailed understanding of mortgage credit, structured products, cash flow modeling, and market drivers. Furthermore, the impacts of the program on most firms will necessarily involve significant strategic, organizational, and operational change.

We are monitoring these events closely and working with our clients to both help them maintain a stable near-term business platform and position themselves for later growth. Oliver Wyman is uniquely qualified to assist you in these efforts, given our analytical expertise, extensive knowledge of mortgage securities and market mechanisms, and our track record of assisting financial firms throughout the crisis. Please do not hesitate to contact us to discuss how we can help address your needs.

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