BusinessWeek

July 8, 2008

Will Treasury's Toxic-Asset Plan Unlock Prices?

By Theo Francis

The Treasury's ambitious plan to buy up billions of dollars in toxic mortgage securities is officially up and running, if more modestly than originally envisioned, and deals could begin closing within a month.

But Treasury officials cast some doubt Wednesday afternoon on how well the program will establish useful market prices for the illiquid securities at the heart of the program — and at the core of the financial crisis.

Under the Public Private Investment Program, private asset managers will buy otherwise illiquid assets using both capital raised from investors and funds provided and lent by the Treasury and the Federal Reserve.

A major point of the program, in the words of one senior Treasury official, is "price discovery." In other words, establishing prices for securities that by and large aren't trading. Once established, those prices could spur further trading without government help, unlocking a still-sluggish $2-trillion secondary market and easing the flow of credit across the land.

But the senior Treasury official indicated Wednesday evening that the agency hadn't decided whether to actually disclose the prices the partnerships ultimately pay for the assets. It does plan periodically to release lists of the program's top 10 holdings. But failing to publish prices would leave that crucial information largely in the hands of a select few: the buyers and sellers, as well as any brokers they use in the transactions. (Floyd Norris at The New York Times pressed the Treasury official on the issue during a phone briefing for reporters.)

"Nondisclosure would seem totally inconsistent with firming up that secondary market," one New York hedge-fund manager says. He drew a parallel to the housing market, where a homeowner can make educated guesses about his own home's value based on nearby sales. But without knowing what the other homes sold for, sales aren't much help to other potential buyers and sellers.

"If they don't publish the pricing for the PPIP, it would be exceptionally odd to me," the hedge-fund manager says.

His worry: the reluctance to publicize prices could reflect Treasury concern that banks and other financial institutions are still massively overvaluing the assets, and don't want to force widespread mark-downs by publicizing low-ball sales. "The transparency will reveal that the stuff still isn't marked right," he says.

A Treasury spokesman didn't respond immediately to questions on the subject Wednesday evening. But in an earlier briefing with reporters, one senior Treasury official said the risk of overvalued securities isn't much of a concern: These assets are supposed to be marked to market –- in other words, any losses reflected in market prices should already be baked into the values at which they're carried on banks'

But one big problem with toxic securities is that many aren't selling frequently -– leaving banks to either model their values using other market data (as so-called Level 2 assets), or arrive at a value by making a variety of assumptions as "Level 3" assets. Either way, there's the potential for over-valuing them, especially without access to any market prices coming out of the PPIP.

Daniel Alpert, managing director of Westwood Capital, says there's one way those prices could filter through to bank balance-sheets anyway: through the banking regulators. Presumably, they'll have access to any pricing data the Treasury doesn't release publicly, and they can make other banks take it into account when balancing their books.

But with concerns about the banking system's solvency not so long past, will they do it? In the midst of a crisis with meltdown looming, it made sense for regulators to go easy on banks to help the healthiest through the worst of it. **That may no longer be true, Alpert says. "The biggest problem we're having is regulatory forbearance."**

At $40 billion -– up to $30 billion of Treasury cash and $10 billion from private-sector investors –- the

program unveiled on short notice Wednesday afternoon was a pale shadow of the grand plan announced in March. Then, Treasury predicted the program would buy as much as $1 trillion of mortgage-related securities and whole loans.

Treasury officials and market analysts say the program would be easy to scale up. "This is a small launch of a program that could be ramped up quickly if things get worse and they really need it," says Jaret Seiberg, a financial-services policy analyst for Concept Capital's Washington Research Group.

But market appetite for the securities program has been tepid, amid fears that tough executivecompensation rules would apply (they won’t, as it turns out) or that Congress and the public would resent it if investors turned a nice profit.

Meantime, easier accounting rules and resilient capital markets left many banks unwilling to risk the steep write-downs that could come with selling their whole loans -- widely regarded as a bigger potential problem than toxic securities. That led the Federal Deposit Insurance Corp. to postpone the launch of that portion of the program. Now, instead of trying to arrange public-private partnerships to buy whole mortgage loans at large in the market, the FDIC will use it to help investors buy loans from already failed banks and thrifts, the agency said Wednesday.

One conspicuous absence in the Treasury’s announcement: Pacific Investment Management Co., or Pimco, the big California bond-trading house that many expected to figure prominently in the list of investment managers named to find the private capital and manage the assets for the PPIP. It seemed like a no-brainer, given the cheer-leading Pimco managing director and bond-market whiz Bill Gross had given the program, and the fact that he is one of the market gurus periodically consulted by Treasury and Federal Reserve officials. But instead, Treasury named nine big investment houses, including BlackRock, Invesco, AllianceBernstein and TCW Group. Pimco says in a brief written statement that it withdrew its application in early June, "as a result of uncertainties regarding the design and implementation of the program."

The statement notes that the company continues to participate in other federal programs, and, it adds, "we continue to believe that it is important for the public and private sectors to work together to resolve the financial crisis and improve the economic outlook."

Curiously, the early-June withdrawal seems to put the decision well before a June 20 article in The New York Times, in which Pimco is cast as a likely participant, and Gross sounds pretty bullish on the program as unveiled to that point by Treasury -— a program that, it turns out, paralleled a proposal Gross had made to the Bush Administration last fall.