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First Trust

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Monday Morning Outlook

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Here's A Plan to Avoid a New RTC

The Treasury Department has told members of Congress that the US faces a financial tsunami if a bill to allow the government to purchase up to $700 billion of toxic financial securities from financial firms is not passed – this week.

Unfortunately, this solution of giving the US Treasury almost unlimited power to buy distressed securities could be avoided if the government made some simple (and temporary) changes to mark-to-market accounting rules. So far, and for many unknown reasons, these changes have been considered off limits.

Why drawing such a hard line in the sand is so important, is a real mystery. Certainly, firms that took excessive risk should be punished. And the US should avoid creating moral hazard whenever it can. But saying; "I told you that you would stay in your room for a whole week if you disobeyed, and I don't care if the house is burning down…you are going to spend an entire week in your room," is absurd. If we are really talking about the end of the world as we know it; who should really care about relaxing the rules for a short time to get us through.

Let's not take this the wrong way. Mark-to-market accounting is a good thing. It makes sense most of the time, and for most financial instruments that are traded frequently, and in the open. But there are special circumstances. And today's financial market problems would meet any definition of the word special.

It is true that home foreclosures have risen, but a vast majority of mortgages are still paying on time. As a result, the market prices of subprime loan pools today have absolutely no relationship to the actual performance of the bonds. If every subprime loan went bad, and banks recovered just 40 cents on the dollar, the bonds would still be worth 40 cents. But the market has pushed bonds well below that level, taking down venerable firms and causing the government to consider draconian solutions.

In other words, mark-to-market accounting, not the reality of the economy or the actual credits, has created much of the financial turmoil that has shaken the world. Imagine if you had a $200,000 mortgage on a $300,000 house that you planned on living in for 20 years. But a neighbor, because of very special circumstances had to sell his house for $150,000. Then, imagine if your banker said you had to mark to this "new market" and give the bank $80,000 in cash immediately (so that you would have 20% down), or lose your home. Would this reflect reality? Not at all. Would this create chaos? Absolutely.

And it is happening all over Wall Street. Merrill Lynch was forced to sell $30.6 billion of illiquid mortgage securities to Lone Star Funds for just $6.7 billion, or 22 cents on the dollar. If it did not sell, these bonds might have fallen to 18 cents and further eroded its capital on a mark-to-market basis. It couldn't take the chance.

But what if Merrill was allowed to hold those securities on its books, without marking them to an illiquid market? The company would not have had to take a $24 billion loss. And maybe investors in Merrill Lynch would not have had to settle for a $29/share buyout from Bank of America, a 60% mark-down from the share price less than a year ago. After all, everyone knows those loans were worth more than 22 cents. The actual performance of the bonds was much better than the price, and Lone Star was able to take advantage of the fact that Merrill was over the proverbial knee of accounting rules.

All of this can be avoided if a system were put into place that allowed private companies to hold these distressed assets. Rather than a centralized holding place, why not use a decentralized one? Why not allow financial firms with structured (Tier 3) assets issued between December 2003 and August 2007 to suspend mark-to market accounting for those assets, and receive government insurance as a backstop? This would be a temporary solution, not requiring any ultimate change in Sarbanes Oxley or mark-to-market accounting rules, and the government could even make money by selling insurance with less risk to the taxpayer than buying them outright.

In essence a firm could sequester, or firewall off these specific assets from the rest of its balance sheet, and either finance this itself, or bring in outside financing. The firm would promise to hold the securities to maturity, or until government insurance was no longer needed when it liquidated the assets. All of these deals could be settled in the private sector, in multiple locations with the government looking over the shoulder of each deal.

If the rules had been relaxed a little bit for these specific assets, Merrill Lynch could have created its own private equity investment fund inside its corporate structure instead of selling at a huge loss to Lone Star, which created its own holding vehicle.

This plan would leave mark-to-market accounting regulations intact. It would be a temporary change in the rules. Its most important attribute is that it leaves taxpayer powder dry for another day. It also allows the private sector to price assets in an environment that is not contrived and will help avoid the loss of, or government takeover of, more private firms.

Even if the Treasury initiates an RTC-type vehicle, the slight changes in the accounting rules for these specific assets should still be made. If a firm does not want to accept the government bid for its distressed assets it would have an alternative. It would also create a level playing field because the Treasury does not have to mark-to-market. A competitive marketplace for these securities would insure the current holders that they would get a price that is not based on a fire sale.

This plan stops the mark-to-market meltdown without undoing the good that mark-to-market accounting has done, protects the taxpayer, stops the losses at financial firms at a crucial time, and therefore helps end the shorting of stock and bonds that has kept the financial system on the rocks without making it illegal. Best of all it keeps the government from a massive and draconian step toward financial socialism.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-24 / 9:00 am	Existing Home Sales - Aug	4.940 Mil	**4.925 Mil**		5.000 Mil
9-25 / 7:30 am	Durable Goods - Aug	-1.8%	**-5.1%**		+1.3%
7:30 am	Durable Goods (Ex-Trans) - Aug	-0.5%	**-1.5%**		+0.7%
7:30 am	Initial Claims - Sep 20	448K	**451K**		455K
9:00 am	New Home Sales - Aug	0.510 Mil	**0.499 Mil**		0.515 Mil
9-26 / 7:30 am	Q2 GDP Final	3.3%	**3.4%**		3.3%
7:30 am	Q2 GDP Chain Price Index	1.2%	**1.2%**		1.2%
8:45 am	U. Mich. Consumer Sentiment	70.5	**72.0**		73.1