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First Trust

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Economic Commentary

Following Our Plan

> *"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.*
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> *"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."*
> **First Trust, Monday Morning Outlook: Here's A Plan To Avoid a New RTC, 9/22/2008**

Once again, and over a weekend, the federal government has made huge decisions in its continuing battle against financial market mayhem. This time the Federal Reserve, Treasury and the FDIC have put taxpayer money at risk to backstop a $306 billion pool of assets held by Citigroup.

As we have seen many times in the past few months, the government continues to modify its efforts. And the deal struck with Citi last night provides some new twists. In essence, the new deal is very similar to the insurance proposal we suggested back in September (see key paragraphs from our proposal above).

However, rather than insure the assets directly and collect a premium, the Treasury and FDIC, with help from the Fed, will take a shareholder friendly amount of preferred stock and some warrants, in payment for insuring 90% of losses above $29 billion on the carved-out assets. This arrangement gives Citi room to breathe.

An open question is how Citi will be forced to account for the assets. It appears that an auditor looking at this arrangement could argue that the maximum loss Citi could suffer on the pool of assets is $56.7 billion. We get this by adding: (1) the maximum up-front loss Citi would have to directly absorb ($29 billion) plus (2) the uninsured 10% of the remaining assets ($306 billion minus $29 billion), which equals $27.7 billion. In turn, a maximum potential loss of $56.7 billion on a $306 billion pool of assets means the lowest price Citi would have to put on the assets is 81.5 cents on the dollar.

In other words, Citi would not have to write down the value of these assets any more than an additional 18.5%. This helps Citi avoid being destroyed by mark-to-market accounting and short-sellers. The backing of government insurance will help stop any further catastrophic erosion in prices.

By letting Citi hold these securities the federal government has dramatically reduced the prospects of another fire sale of assets ($306 billion in this case). The potential of this fire sale, because of mark-to-market accounting requirements, had undermined the valuation of many financial firms as well as prices for many closed-end funds. As a result, this move by the Treasury will help support these share prices

While the intervention is good on the surface, it is really just a convoluted financial arrangement to avoid the damage caused by forcing firms to mark assets to "fair value" in the midst of a financial tsunami.

If homeowners in Montecito, CA were forced to mark their homes to market when forest fires were one mile to the east of them and the Santa Ana winds were blowing hard, many would have been bankrupt. But, when the winds shifted and came from the ocean, these homeowners were made solvent again. What's worse is that in the case of the financial system, mark-to-market accounting can actually make the Santa Ana winds blow harder.

In the middle of a fire-storm, marking assets to market erodes capital unnecessarily, which in turn hampers lending, which in turn hampers the economy, which in the end undermines asset values. This vicious cycle will never end until the system stabilizes. Unfortunately, mark-to-market accounting keeps the system from stabilizing. Short-sellers know this and have kept the pressure on in many ways.

This is the real reason for the new and improved version of the Treasury bailout. And Citi has now been given a distinct advantage over its competitors. The arrangement only fixes the problem for Citi. No other institution will be allowed to keep its troubled assets on its books at 81.5 cents, so mark-to-market mayhem will continue.

The only way for any other banks to take advantage of such an arrangement is to agree to the same terms as Citi. Those terms include stringent executive pay rules and a virtual halt on dividends to common stockholders.

Why the government will not force a suspension of mark-to-market accounting, but is willing to contort itself using taxpayer funds to get around the problems that it causes, is still a huge mystery. It would be a real shame if this is all about face-saving politics. Politicians, and the Financial Accounting Standards Board, are unwilling to agree that their push to mark-to-market accounting, which they argued would make the world more transparent and safe, is actually causing a great deal of the damage.

Today's problems of subprime mortgages are much smaller than those of the 1980s, when oil loans, Latin American debt and the S&L's threatened the banking system. But mark-to-market accounting has thrown gasoline on the fire and unlike the 1980s, the entire economy is at risk. We remain convinced that 70% of the problems faced by the US financial system in the past year would have been avoided if the SEC had suspended mark-to-market accounting rules. Maybe this weekend's contortions from Treasury will shine a brighter spotlight on the problem.

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