Report to Congress Pursuant to Section 102 of the Emergency Economic Stabilization Act

12/31/2008

This report fulfills the requirement under section 102 of the Emergency Economic Stabilization Act (EESA) for the Treasury Department to report to Congress within 90 days of the passage of the bill on the insurance program established under Section 102(a).

Asset Guarantee Program

Treasury is exploring use of the Asset Guarantee Program to address the guarantee provisions of the agreement with Citigroup announced on November 23, 2008. Under the agreement, the Treasury Department will assume the second-loss position after Citigroup on a selected group of mortgage-related assets.

As required by section 102(a), Treasury established the Asset Guarantee Program (AGP). This program provides guarantees for assets held by systemically significant financial institutions that face a high risk of losing market confidence due in large part to a portfolio of distressed or illiquid assets. This program will be applied with extreme discretion in order to improve market confidence in the systemically significant institution and in financial markets broadly. It is not anticipated that the program will be made widely available.

Under the AGP, Treasury would assume a loss position with specified attachment and detachment points on certain assets held by the qualifying financial institution; the set of insured assets would be selected by the Treasury and its agents in consultation with the financial institution receiving the guarantee. In accordance with section 102(a), assets to be guaranteed must have been originated before March 14, 2008.

Treasury would collect a premium, deliverable in a form deemed appropriate by the Treasury Secretary. As required by the statute, an actuarial analysis would be used to ensure that the expected value of the premium is no less than the expected value of the losses to TARP from the guarantee. The United States government would also provide a set of portfolio management guidelines to which the institution must adhere for the guaranteed portfolio.

Treasury would determine the eligibility of participants and the allocation of resources on a case-by-case basis. The program would be used for systemically significant institutions, and could be used in coordination with other programs. Treasury may, on a case-by-case basis, use this program in coordination with a broader guarantee involving one or more other agencies of the United States government.

Justification

The objective of this program is to foster financial market stability and thereby to strengthen the economy and protect American jobs, savings, and retirement security. In an environment of high volatility and severe financial market strains, the loss of confidence in a financial institution could result in significant market disruptions that threaten the financial strength of similarly situated financial institutions and thus impair broader financial markets and pose a threat to the overall economy. The resulting financial strains could threaten the viability of otherwise financially sound businesses, institutions, and municipalities, resulting in adverse spillovers on employment, output, and incomes.

Determination of Eligible Institutions

In determining whether to use the program for an institution, Treasury may consider, among other things:

1. The extent to which destabilization of the institution could threaten the viability of creditors and counterparties exposed to the institution, whether directly or indirectly;

2. The extent to which an institution is at risk of a loss of confidence and the degree to which that stress is caused by a distressed or illiquid portfolio of assets;

3. The number and size of financial institutions that are similarly situated, or that would be likely to be affected by destabilization of the institution being considered for the program;

4. Whether the institution is sufficiently important to the nation's financial and economic system that a loss of confidence in the firm's financial position could potentially cause major disruptions to credit markets or payments and settlement systems, destabilize asset prices, significantly increase uncertainty, or lead to similar losses of confidence or financial market stability that could materially weaken overall economic performance;

5. The extent to which the institution has access to alternative sources of capital and liquidity, whether from the private sector or from other sources of government funds.

In making these judgments, Treasury will obtain and consider information from a variety of sources, and will take into account recommendations received from the institution's primary regulator, if applicable, or from other regulatory bodies and private parties that could provide insight into the potential consequences if confidence in a particular institution deteriorated.

TARP Accounting and Treasury's Loss Position

Treasury generally achieves a greater impact per TARP dollar absorbed by taking an early loss position over a narrow interval of losses rather than a late loss position over a larger range of losses.

Treasury's purchasing authority under TARP is reduced by the total value of the guaranteed asset less the cash premium received, where the premium is equal to the expected loss on the guaranteed asset. If the Treasury collects a non-cash premium – for example, preferred shares – the TARP purchasing authority is reduced by the entire value of the guarantee until the preferred shares are sold and converted to cash.

These accounting rules imply that if guarantees for two assets of different values have the same expected loss, the larger asset will be more TARP-intensive to insure. For example, suppose Treasury has the choice between guaranteeing two different assets, one of which is worth $50 and has a 10 percent chance of losing all of its value and the other of which is worth $10 and has a 50 percent chance of losing all of its value. For the sake of simplicity, the premium in this example will be paid in cash. If the premium received equals the expected value of the losses to TARP from the guarantee (thereby meeting the statutory requirement), Treasury would collect a $5 premium for guaranteeing either asset. However, the TARP purchasing authority would be reduced by $45 for the guarantee on the first asset (the $50 covered minus the $5 premium) and just $5 for the guarantee on the second asset (the $10 covered minus the $5 premium). Although the net expected payouts of the two guarantees are equal, the second guarantee is more valuable per dollar of TARP absorbed: covering the first asset uses $9 of TARP per $1 of expected loss, whereas the second asset uses only $1 of TARP per $1 of expected loss. Because of this feature of TARP accounting under Section 102 of the EESA, Treasury in using the AGP will generally take a relatively early loss position over a narrow range of losses to provide the greatest protection per TARP dollar absorbed.

Other Potential Asset Guarantee Programs

Treasury is reviewing options for the development of other programs to insure troubled assets pursuant to the legislation. Two design considerations will be important factors for any potential program developed under Section 102:

(1) Accounting under the TARP purchasing authority: The TARP purchasing authority is reduced dollar-for-dollar by the amount guaranteed less the premiums received; the expected net payout from the program is not considered for this purpose. This means that insuring an asset under section 102 has almost an equivalent impact on the TARP purchasing authority as purchasing the same asset (Section 102.c.4).

(2) Adverse selection: Information on the credit risk underlying a particular asset, notably complex assets such as mortgage backed securities, can often be understood only through intensive research—and even then, the risk will ultimately depend on outcomes such as future home price appreciation that can be forecast only

imperfectly. If an insurance program were to offer a set premium for a specific asset class – even one that is narrowly defined – it could well be the case that only the holders of assets for whom the premium was either appropriate or underpriced would buy insurance. By construction, the credit risk associated with the securities that would actually be insured at any given premium would be higher than the premium would cover. Individually pricing the assets – a resource-intensive endeavor – is the only way of achieving an expected net payout of zero. In practice, this means that setting the pricing of the insurance premiums will inevitably require particular assumptions and judgments; the ex-post financial outcome involved with the guarantees could deviate substantially from the ex-ante actuarial analysis—for better or for worse.

To assist in the consideration of programs under Section 102, the Treasury issued Federal Register Notice (Docket # TREAS-DO-2008-0018 posted 10/16/2008). Treasury asked for comment on programs consistent with Section 102 of the Emergency Economic Stabilization Act of 2008 (EESA). Treasury particularly invited comments on the appropriate structure for such a program, and whether the program should offer insurance against losses for both individual whole loans and individual mortgage backed securities (MBS), as well as the payout and triggering event, estimation of losses, and setting the appropriate premium. A summary of the comments received is attached next as an Appendix to this report.

Appendix: Summary of Responses to Request for Comments

Treasury received 85 responses to the Request for Comments from a wide variety of respondents, including individuals, academics, financial institutions, municipalities, and trade groups. Many submissions chose to urge the eligibility of the represented group to EESA-related programs rather than to outline an insurance program structure.

The responses to the Request for Comments largely envisioned a standard insurance program, in which the Treasury would offer a guarantee on some portion of the principal and payments from a security in return for a premium. The respondents recognized the difficulty associated with setting prices for these premiums, but argued that in order to avoid adverse selection, premiums for the securities must be priced either individually or on pools of homogeneous assets. Several respondents commented that a guarantee program could offer greater flexibility than asset purchase programs in structuring time-limited or partial support (by incorporating loss-sharing, for example).

Respondents expressed differing view along two important dimensions of the program: the assets that should be eligible and the share of the assets that should be insured.

Proposed structure of guarantee

Most respondents focused on guarantees of existing individual loans or MBS. In guaranteeing whole loans, Treasury would receive insurance premiums and pay the insured (the owner of the mortgage loan) for a realized loss relative to principal and future interest payments due on the mortgage loan. Factors that would affect the premium include the degree of loss coverage (co-pay), the size of the deductible, and loan characteristics.

In guarantees of pools of existing loans owned by financial institutions, Treasury could, in exchange for a premium, purchase any loan that reaches a certain level of delinquency at a predetermined price. Alternatively, Treasury could offer to share loss on a loan, once the institution carried the loan through appropriate workout adjustment including foreclosure.

Other proposed structures included:

- Limiting participation in the insurance program to institutions that successfully execute a private capital raise.
- Conditioning participation on foreclosure mitigation efforts.
- Guaranteeing securitizations of whole loans or MBS
    - In return for a fee, Treasury would purchase existing loans or MBS pools, issue securities backed by these assets, and guarantee principal and interest on securities if an institution that issued the loans in the pool defaults.

- This could be made operational through an SPV set up to purchase and hold the assets and issue short- and medium-term obligations against them, with Treasury guaranteeing the performance of the SPV securities.

- This securitization and pool guarantee could be applied to shorter-term securities that are also troubled due to market seizure, for example asset backed commercial paper (ABCP).

- There is a question of whether this satisfies the statute, which states that the guarantee must apply to assets originated before March 14th, 2008. The guaranteed assets, in this case, would be payments from a securitized pool issued through the SPV, not the assets underlying these pools.

- Guaranteeing severe loss for insurance entities holding portfolio credit risk. For example, rather than guaranteeing individual assets, the program could compensate holders of MBS or mortgage loans for losses in excess of a threshold in exchange for a fee.

- Issuing derivatives correlated with the performance of an existing index of mortgage-related credit. For example, the Treasury could sell put options on the ABX index, or link payout to an existing house appreciation index such as the Case-Shiller index. This structure allows institutions to hedge their exposure to aggregate risk associated with the assets in their portfolios but not asset-specific risk.

    - For the institutions' capital position to be improved by this program the derivatives must qualify as "highly effective" hedges – their performance must be highly correlated with the performance of the hedged assets.

Eligible assets

Respondents generally commented that the guarantee should be offered where it may be more efficient than asset purchase under Sec. 101. Respondents suggested that performing but illiquid assets – such as senior tranches of non-agency residential and commercial MBS, performing whole mortgage loans, ABS (credit card, auto loans, and student loans), auction rate securities (ARS), and municipal bonds – would be most suitable for such a program.

The assets that received the most attention were whole residential loans and residential MBS.

Determining risk and pricing premiums

Respondents uniformly agreed that – no matter which assets are insured in this program – pricing is a monumental task that will almost certainly have to be contracted out. Respondents suggested that Treasury use the methods and models standard in the industry to determine risk. No feasible alternative to individually pricing the assets was offered.

Payout

Most respondents suggested paying out 100 percent of principal and expected interest, or some portion thereof. Arguments in favor of each were as follows:

100 percent of principal and expected interest: The higher the guarantee the government provides, the more liquidity and confidence will be restored to the market. Most respondents favoring this structure argued that the 100 percent guarantee should be applied to the current value of the asset, on an expected cash-flow basis, rather than the original value of the asset.

A portion of the principal and expected interest: Guaranteeing less than 100 percent ensures that the participating institutions share in the loss, thus incentivizing them to pursue all their loss-mitigation options. Institutions holding whole loans and MBS with deductibles or other loss-sharing mechanisms would be far more likely to attempt to restructure those loans.

Respondents suggested either guaranteeing a fixed percentage of the original value of the asset, regardless of the current expected cash-flows, or guaranteeing a fixed percentage of the current value of the asset, as measured on an expected cash-flow basis.

Several respondents suggested that the level of guarantee should reflect the broad risk characteristics of the asset class. For example, a higher level of coverage should be available for senior tranches of MBS than for junior tranches, and residential mortgages should be insured at a higher level than incomplete residential development projects.

Setting premiums

Premiums should reflect the risk of default and total losses for the insured assets. Respondents agreed that premiums will vary for different classes of assets to reflect the risk and total credit loss associated with that asset class. The majority of respondents recommend pricing the premiums either on an asset-by-asset basis or on a homogeneous pool of assets and periodically re-evaluating the assets and premiums as the program continues.

The premiums can either be paid up front as a lump sum or periodically. Respondents cited the flexibility of periodic payments as a desirable feature; the premium can be adjusted based on long term performance, actual loss, and improvements.

Market value of the guarantee

Respondents argued that making the guarantee transferable is essential to establishing liquidity to the market this guarantee program is targeting. The guarantee should be attached to the asset and transferred to the asset's new owner when the asset is sold.

Administrative issues
Management of the program, including premium setting, determination of institution and asset eligibility, and extensive monitoring of guaranteed institutions and assets will be complex and resource-intensive. Most proposals recommend Treasury seek outside expertise in accounting, insurance, pricing, and administration.