Plan's Basic Mystery: What's All This Stuff Worth?

by Vikas Bajaj
Thursday, September 25, 2008

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The New York Times

What would you pay, sight unseen, for a house that nobody wants, on a hard-luck street where no houses are selling?

That question is easy compared to the one confronting the Treasury Department as Washington works toward a vast bailout of financial institutions. Treasury Secretary Henry M. Paulson Jr. is proposing to spend up to $700 billion to buy troubled investments that even Wall Street is struggling to put a price on.

A big concern in Washington — and among many ordinary Americans — is that the difficulty in valuing these assets could result in the government's buying them for more than they will ever be worth, a step that would benefit financial institutions at taxpayers' expense.

Anyone who has tried to buy or sell a house when the market is falling, as it is now, knows how difficult it can be to agree on a price. But valuing the securities that the Treasury aims to buy will be far more difficult. Each one of these investments is tied to thousands of individual mortgages, and many of those loans are going bad as the housing market worsens.

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"The reality is that we are not going to know what the right price is for years," said Andrew Feltus, a bond portfolio manager at Pioneer Investments, a mutual fund firm based in Boston. "It might be 20 cents on the dollar or 60 cents on the dollar, but we won't know for years."

While prices of most stocks are no mystery — they flicker across PCs and televisions all day — the troubled investments are not traded on any exchange. The market for them is opaque: traders do business over the telephone, and days can go by without a single trade.

Not only that, many of these instruments are extremely complex. Consider the Bear Stearns Alt-A Trust 2006-7, a $1.3 billion drop in the sea of risky loans. Here's how it worked:

As the credit bubble grew in 2006, Bear Stearns, then one of the leading mortgage traders on Wall Street, bought 2,871 mortgages from lenders like the Countrywide Financial Corporation.

The mortgages, with an average size of about $450,000, were Alt-A loans — the kind often referred to as liar loans, because lenders made them without the usual documentation to verify borrowers' incomes or savings. Nearly 60 percent of the loans were made in California, Florida and Arizona, where home prices rose — and subsequently fell — faster than almost anywhere else in the country.

Bear Stearns bundled the loans into 37 different kinds of bonds, ranked by varying levels of risk, for sale to investment banks, hedge funds and insurance companies.

If any of the mortgages went bad — and, it turned out, many did — the bonds at the bottom of the pecking order would suffer losses first, followed by the next lowest, and so on up the chain. By one measure, the Bear Stearns Alt-A Trust 2006-7 has performed well: It has suffered losses of about 1.6 percent. Of those loans, 778 have been paid off or moved through the foreclosure process.

But by many other measures, it's a toxic portfolio. Of the 2,093 loans that remain, 23 percent are delinquent or in foreclosure, according to Bloomberg News data. Initially rated triple-A, the most senior of the securities were downgraded to near junk bond status last week. Valuing mortgage bonds, even the safest variety, requires guesstimates: How many homeowners will fall behind on their mortgages? If the bank forecloses, what will the homes sell for? Investments like the Bear Stearns securities are almost certain to lose value as long as home prices keep falling.

"Under the current circumstances it's likely that you are going to take a loss on these loans," said Chandrajit Bhattacharya, a mortgage strategist at Credit Suisse, the investment bank.

The Bear Stearns bonds are just one example of the kind of assets the government could buy, and they are by no means the most complicated of the lot. Wall Street took bonds like those of Bear Stearns and bundled and rebundled them into even trickier

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investments known as collateralized debt obligations, or C.D.O.'s

"No two pieces of paper are the same,"said Mr. Feltus of Pioneer Investments.

On Wall Street, many of these C.D.O.'s have been selling for pennies on the dollar, if they are selling at all. In July, Merrill Lynch, struggling to bolster its finances, sold $31 billion of tricky mortgage-linked investments for 22 cents on the dollar. Last November, Citadel, a large hedge fund in Chicago, bought $3 billion of mortgage securities and other investments for 27 cents on the dollar.

But Citigroup, the financial giant, values similar investments on its books at 61 cents on the dollar. Citigroup says its C.D.O.'s are relatively high quality because they were created before lending standards weakened in 2006.

A big challenge for Treasury officials will be deciding whether to buy the troubled investments near the values at which the banks hold them on their books. That would help minimize losses for financial institutions. Driving a hard bargain, however, would protect taxpayers.

"Many are tempted by a strategy of trying to do both things at once," said Lawrence H. Summers, a former Treasury secretary in the Clinton administration. As a hypothetical example, Mr. Summers suggested that an institution could have securities on its books at $60, but the current market price might only be $30. In that case, the government might be tempted to come in at about $55.

Many financial institutions are so weak that they must sell their troubled assets at prices near the value on their books, Carlos Mendez, a senior managing director at ICP Capital, an investment firm that specializes in credit markets. Anything less would eat into their capital.

"Depending on your perspective on the economy, foreclosure rates and home prices, the market may eventually reflect that price. But most buyers are not willing to make that bet right now," he said. "And that's why we have these low prices."

Ben S. Bernanke, the chairman of the Federal Reserve, told Congress on Tuesday that the government should avoid paying a fire-sale price, and pay what he called the "hold-to-maturity price," or the price that investors would bid if they expected to keep the bond till it was paid off.

The government would buy the troubled investments with the intention of eventually selling them back to the market when prices recover.

The Treasury has suggested it might conduct reverse auctions to determine the price for securities that are not trading in the market.

Unlike in a traditional auction in which would-be buyers submit bids to the seller, in a reverse auction the buyer solicits bids from would-be sellers. Often, the buyer agrees to pay the second-highest bid submitted to encourage sellers to compete by lowering their bids for all the assets submitted. The buyer often also sets a reserve price and refuses to pay any more than that price.

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But Mr. Paulson told Congress on Tuesday that the government would use many other means in addition to auctions, suggesting that it would exercise wide discretion over the final prices to be paid.

Financial institutions will have an incentive to sell their worst assets to the government, a risk that the Treasury will have to guard against, said Robert G. Hansen, senior associate dean at the Tuck School of Business at Dartmouth College.

"I am worried that the people who are going to offer the securities to the government will be the ones that have the absolute worst toxic waste," Professor Hansen said. Even so, he added, the government could actually make a profit on its purchases — provided the Treasury buys at the right prices. Richard C. Breeden, a former chairman of the Securities and Exchange Commission, said the auctions could thaw parts of the markets that have been frozen since late last year.

"One of the problems that many institutions are having is finding any bid for some of these assets, even though they are not without value," said Mr. Breeden, who is chairman and chief executive of Breeden Capital Management, an investment firm in Greenwich, Conn.

"What are these assets worth?" asked Mr. Breeden. "Sometimes, because of fear or extreme uncertainty in the markets, you get in a situation in which there are no bids at all, or at least no realistic bids."