From: Gary Aguirre
Sent: Tuesday, September 30, 2008 7:08 AM
To: [redacted]
Subject: The bailout bill: Main Street's Gift to Wall Street

[redacted]:

I am requesting that you provide my comments below regarding the bailout bill to Chairman Frank.

The Bill's Aim is to Recapitalize Financial Institutions: the wrong target
Numerous provisions of the bill in one way or another allow Paulson to recapitalize the financial institutions that are holding the distressed mortgages, MBS, and related derivative products. Yet, it is being pitched as a cure for smaller and more temporary illness: lack of liquidity. Considering the exposure on CDS and the thin capitalization of the banks, it is more likely an issue of capitalization. Further, according to the SEC's OIG report on the CSE unit issued on Friday, a former director of the Trading and Market Division has also opined that Bear Stearns failure was due to a lack of capitalization. It should be noted that BSC's potential exposure on CDS was $2.5 trillion, approximately 2000 times its net worth.
Assuming the problem is one of capitalization, the approach proposed by the bill would be a waste of Treasury funds. The correct solution would be something in the order of a gigantic Chapter 11 of the financial institutions in distress. The first step would be to washout of shareholder interests, not re-inflate them at taxpayers' expense. Further, having shot a $700 billion bullet at the wrong target, how easy would it be to convince the public to tackle the real one?
Financial institution with troubled assets would include hedge funds.
Section 3 defines the term "financial institution" to mean any institution…"
Troubled assets include credit default swaps
Section 9 defines "troubled assts" to include "commercial mortgages and any securities obligations or *other instruments that are based on or related to such mortgages*." This would include any derivative including credit default swaps." There are $63.5 trillion in CDS.
The Bill Allows Secretary to make "gifts"
Section 101 allows the Secretary to buy any "troubled assets" on "such terms and conditions as are determined by the Secretary." This language allows the Secretary of the Treasury to make purchases at prices unrelated to the market value—in short a gift. Section 106(C) gives Paulson the same authority when it comes around to selling the assets. In short, he can make gifts when he buys the assets and gifts when he sells the assets.
Treasury would become a writer of credit default swaps (CDSs)
Section 102.(A) (Insurance of troubled assets) provides that the Secretary "may develop guarantees of troubled assets and the associated premiums for such guarantees." Is the Treasury getting into the CDS business? It sure sounds like it. This would make sense since the MBS problem cannot be resolved without dealing with CDS. But no one is talking about this aspect of the bailout.
This raises another question. What about CDS on the bonds of financial institutions? These CDS could still tank the market, but they are not covered by the bill, at least as I read it. But there is another wrinkle. Normally, those issuing CDSs get a healthy fee particularly where there is significant risk. For example, the CDSs were going for approximately $600K on Lehman just before its collapse. Section 102(C) allows Secretary Paulson to set the price (premiums) pretty much at his discretion. Further, I am not sure that the government's exposure on issuing these guarantees is limited under the bill. The amount of the exposure would reduce the $700B fund usable for purchasing assets. I have not found

any language in the bill that would limit the valuation of the guarantees. Could Paulson guarantee a few trillion in CDS? Please keep in mind that the last figure on CDSs was $63.8 trillion.

Section 103. Paulson would have extremely broad discretion.

This discretion, at least in my mind, derives from two different features in the bill. First, the bill explicitly grants broad powers to Paulson and does so with broad language that may have to be interpreted. Section 103 would seem to define Paulson's discretion even broader by describing 9 factors the Secretary should take in consideration in exercising his authority. For example, subsection 6 explicitly allows Treasury funds to be used to recapitalize shareholder interest.

The gang that couldn't shoot straight does an encore.

Section 104 establishes the Financial Stability Oversight Board, which is comprised of the same guys whose ineptitude delivered the crisis.

Paulson may eliminate competitive bidding

Section 107 authorizes the Secretary to bypass competitive bidding if the he believes it is contrary to the public interest. Does Blackwater have a financial services unit? Also, the Secretary would not inform congress until 7 days after the deed is done.

We'll get to conflicts of interest later, much later

Section 108 provides that the Secretary will issue the regulations and guidelines "as soon as practicable after the day of the enactment…" Shouldn't this be done beforehand?

"A rose by any other name would smell as sweet"

Section 113(B)(1) allows the Secretary to make purchases at the lowest price the Secretary determines to be consistent with the purposes of this act. Why wouldn't he just make the purchases at the lowest price? If a financial institution is willing to sell at $60, why should he pay $70?

The Treasury's rights to obtain warrants are ephemeral

Section 113(D)(1)(A) provides the Secretary may receive warrants in the stock in the financial institution transferring the troubled assets, where it is a registered entity. This will be valueless if the entity is insolvent, which many may be. Unregistered entities, e.g. hedge funds, would give debt to the Treasury. Again, I believe one major flaw in the entire bill is its failure to give the Treasury the status of the debtor. Why wouldn't the Treasury demand debt in registered financial institutions? According to the NYT article on the Swedish bailout, the loan feature was critical.

Transparency: spin or reality?

Section 114 allows the Secretary to decide whether or not to disclose to the public off-balance-sheet transactions. So far, neither the Fed nor the SEC has been very transparent about the money going to Bear Stearns and J.P. Morgan.

Any bill should provide for public disclosure as a check-and-balance. As you know, I have FOIAed both the Fed and the SEC for the records relating to the CSE failure on Bear Stearns. The Fed tells me that they can release few or no records of the assets received by the Treasury as security for the Treasury's loans to Bear Stearns and J.P. Morgan in the sum of $55B because the window is in the private part of the Fed. The SEC's FOIA response is another roadblock: there are 43 requests for confidentiality and I need to pony up about $10K. Until all of this information is disclosed publicly, I seriously doubt that investors will trust the balance sheets of financial institutions. Keeping off-the-balance sheet transactions in the shadows helps hide the insolvency of our banks.

A license to mislead

Section 132 takes transparency a step further. It blesses misleading financial statements. It would allow financial institutions to use cost accounting to increase the value of assets. Let's suppose that a company purchased a mortgage-backed-security at $100. By mark-to-market, it has a value of $65. The actual market is $30. By allowing mark-to-market to be dropped, the financial institution can create a grossly misleading financial statement by using its cost basis. Ballooning the balance sheets of distressed financial institutions will never win back investor confidence.

Praying for recoupment

Section 134 is another section that misleads the public. It is being pitched as if the Treasury was going get paid back. It is merely a statement of a future intention legally binding on no one. This phony language should be replaced by a legally enforceable debt instrument running in favor of the Treasury.

Sincerely,

Gary Aguirre