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On Focus and In Depth

Viewpoint: Tarp Needs More Securities Marking Clarity

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The SEC's latest clarifications on fair-value measurement rules give banks and other financial firms substantial wiggle room in valuing assets like collateralized debt obligations and subprime mortgage-backed securities. The upshot is that firms can mark their securities substantially higher than could be otherwise supported by indicative broker quotes or independent pricing services. Firms can also ignore any prices from recent transactions in these securities if, in management's judgment, they reflect distressed or disorderly sales.

Which numbers should trading counterparties and public investors believe: management's higher-than-market valuations or independently produced valuations, some of which are based upon observed transactions? And why does it matter which marks are used?

The breakdown of the unsecured interbank lending market in September reflects the banking system's solvency crisis. Indeed, the Treasury's investment of the first $250 billion of Troubled Asset Relief Program funds in newly issued shares of preferred stock of individual banks addresses the solvency crisis directly. In contrast, banks sinking in troubled assets get no true relief from phony marks, even with the SEC's seal of approval. Moreover, basic banking relies on lending backed by accurately valued collateral. Thus, eliminating mark-to-myth is a crucial step in the banking crisis recovery process.

How hard is it to mark illiquid securities? We get some insight by examining how traders mark high-yield ("junk") corporate bonds. Most high-yield corporate bonds trade infrequently in thin, illiquid markets. Indeed, many individual issues are held mainly as long-term investments in insurance company portfolios and trade very rarely after an initial distribution period.

I recently co-authored a study of the differences among the price marks that different mutual funds simultaneously place on identical bond issues. Additional market transparency helped shrink the variation among fund marks. For a representative high-yield bond, our dispersion measure fell 50% after the introduction of the Financial Industry Regulatory Authority's Trade Reporting and Compliance Engine system. Trace collects trade details from dealers in the over-the-counter corporate bond market and then disseminates transaction price information. Dispersion decreased even for bonds that were not initially included in the list of reporting securities.

Now structured financial products like CDOs are much more opaque than high-yield bonds. It's likely that any post-trade price transparency of the type generated by Trace would substantially improve mark precision.

Thus, the toxic securities purchase component of the Troubled Asset Relief Program has the potential to solve two major problems confronting our financial system. First, Tarp will let firms dispose of suspect securities. Such dispositions will allow investors to more easily value the remainder of the firm and decide whether to inject new capital. Tarp's potential to help here is real. Recall that John Thain was initially criticized for dumping Merrill Lynch's toxic securities for pennies on the dollar. While Merrill disposed, Lehman Brothers stood pat. Subsequently, Bank of America passed on iffy Lehman and agreed to buy Merrill Lynch.

Second, Tarp will also help by providing an orderly mechanism to value all of these securities if true price discovery takes place. The reverse auctions must include some large private-sector investors and use a single-price process determined solely by this group. The final price should be determined such that the private sector buys, say, 10% of each auction. Strong hands in the private sector will step up if they know that 90% of the positions being bought will end up with a long-term passive investor (the U.S. taxpayer) buying at the same price. The prices determined in these auctions should then be used to mark all identical and related security positions remaining on the books across the industry.

The Federal Reserve bought nearly $30 billion of product doing its bit to facilitate JPMorgan Chase's purchase of Bear Stearns. To its credit, the Fed has already committed to reporting an aggregated valuation for this portfolio on a quarterly basis. But it should also make public a listing of the individual securities it purchased and the prices paid for each, and then commit to provide post-trade transactions price reports on any future dispositions of its holdings. In the meantime, as we wait for Tarp's reverse auctions, the Fed should show us where its investment manager is marking the individual securities. More secrecy isn't the answer to our problems. Shed a little light.

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