

**Ambac Financial Group, Inc.**  
One State Street Plaza  
New York, NY 10004  
212.668.0340  
Web site: [www.ambac.com](http://www.ambac.com)

***Ambac***

28 October, 2008

Ms. Lindsay Valdeon  
Deputy Executive Secretary  
Department of the Treasury  
1500 Pennsylvania Ave. NW  
Washington, DC

Dear Ms. Valdeon:

**RE: Comment on the Development of a Guarantee Program for Troubled Assets**

Ambac is pleased to comment on the questions posed by the Department of the Treasury with respect to the establishment of a guarantee program for troubled assets.

**BACKGROUND:**

US financial guarantors collectively guarantee \$2.3 trillion in debt of which \$1.4 trillion is US state and municipal debt and another \$250 billion is linked to US mortgages. Ambac founded the municipal financial guarantee industry in 1971 and has grown to be the second largest financial guarantee insurance company. Ambac also has considerable experience operating a secondary market guarantee program, similar to that which the TARP seeks to implement. Ambac is therefore well qualified to comment on the Treasury's proposed Guarantee Program.

Financial market stability and economic stability are tightly linked. Given uncertainty about the depth of the recession and its effects on the consumer, rating agencies and investors have projected dire economic scenarios onto the existing balance sheet assets of companies exposed to consumer credit. These extreme economic scenarios suggest losses that potentially overwhelm the capital base of these asset holding companies. As a result, these companies have been cut off from the capital markets and in turn have cut off their own new loan originations which would help stabilize financial markets and in turn the economy.

In order to help counteract this systemic implosion, the guarantee program should be designed to address issues that cannot be efficiently addressed by the purchase program while minimizing the credit risk to the US taxpayer.

Support that helps to stabilize the US financial guarantors will have an exponentially positive impact for several critical sectors of the US economy:

- states and municipalities seeking to fund essential government services and capital projects;
- banks that hold billions of dollars in exposure to US financial guarantors;
- individual investors who hold guaranteed municipal bonds in their investment and retirement portfolios;
- consumers who benefit from the increased availability of credit for liquidity and funding that results from functioning capital markets; and
- securities issuers who would face adverse liquidity and/or cross default impacts as a result of financial guarantor downgrades or failures.

**RECOMMENDATION:**

The guarantee program should consist of two sub-programs:

- 1) **An excess of loss portfolio guarantee program offered to entities that traditionally buy and hold credit risk.** This group would include US financial guarantors, whose credit ratings have been threatened and whose access to the capital markets has been denied due to the potential volatility of the performance of their portfolios.

An excess of loss portfolio guarantee would provide a guarantee on a specified amount of portfolio losses in excess of a threshold, or “attachment point” in order to free up capital and permit additional generation of credit. The benefits of the excess of loss portfolio guarantee program include:

- efficient utilization of the limited capacity under the Act;
- rapid impact on financial market liquidity and stability;
- substantial financial and operational efficiencies; and
- reduced moral hazard and risk of adverse selection, as guaranteed assets continue to be managed by current holders who have significant knowledge of the assets and a significant interest in mitigating losses.

Alignment of interests may be achieved by providing for risk sharing with the entity receiving the benefit of the guarantee. Such risk sharing could consist of one or more of three elements:

- an attachment point structured to exceed expected losses on the portfolio
- a parallel loss absorption structure, under which the guarantee program would cover a portion, but not all, of the losses experienced beyond the attachment point, for example, the guarantee

program could pay 90% of each dollar of losses, with the beneficiary required to absorb 10% of such losses, and

- a “detachment point” beyond which all risk of loss would revert to the entity benefiting under the guarantee program.

This structure would make the program efficient and attractive to users, with the relatively high attachment point providing a lower requirement for individual asset analysis, rendering administration of the program more cost-effective.

2) **A guarantee program that will directly guarantee existing securities.** The buyer of the guarantee will minimize further potential capital risk due to future rating downgrades of the securities or additional performance deterioration of the underlying collateral.

The guarantee program could also assist in creating market liquidity for performing but otherwise illiquid securities as uncertainty in capital markets has rendered many securities backed by consumer debt illiquid, even when the underlying collateral is fully performing. Student Loan securities, the underlying assets of which are often government guaranteed, are a good example of this phenomenon.

To be effective, the program should limit its exposure to risk by only guaranteeing senior securities and should further limit participation in this program to entities whose participation will assist in meeting the multiple objectives of the Act, *e.g.*, better access for consumers to mortgage loans and/or freeing liquidity that will be used to generate additional lending or guarantees or other extensions of credit.

The program should not guarantee securities if a holder has purchased a security and a credit default swap (CDS) on the same security unless the holder unwinds the hedge and any benefits of the hedge contract are applied to reduce the government’s risk.

Finally, the guarantee program offers flexibility that the purchase program does not, including risk-sharing options. For example, a financial guarantor might seek to obtain a guarantee under the program on mortgage related exposure it holds in its portfolio but structured on a second-to-pay basis. In this construct, the financial guarantor would provide a full guarantee to Treasury. Consequently Treasury would be at risk only if both the underlying securities and the financial guarantor default on their obligations. This approach has the benefits of reducing Treasury’s risk, aligning the interests of the two parties, keeping the securities on balance sheet for the financial guarantor and allowing it to continue to manage the exposure. It also avoids moral hazard and adverse selection.

#### **RESPONSES TO SPECIFIC QUESTIONS:**

##### **1. What are the key issues Treasury should address in establishing the guarantee program for troubled assets?**

Treasury’s overriding objective should be to restore liquidity and the flow of credit in the marketplace, while minimizing ultimate capital outlays. An effective guarantee program must be transparent, with clear criteria defining eligible assets and eligible beneficiary institutions. The program should be simple

to both administer and understand. Simplicity and transparency will enable the guarantee program to have a rapid effect on financial markets, while remaining cost-effective to the Treasury.

### **1.1 Should the program offer insurance against losses for both individual whole loans and individual mortgage backed securities (MBS)?**

The program should offer insurance for MBS, rather than for whole loans. The restoration of liquidity to capital markets will have the effect of allowing financial institutions to trade these financial assets, permitting them to access cash, which can be recycled into the economy in future loans and investments.

Guaranteeing whole loans presents tremendous logistical issues for the coordination and management of such a program, including the need to locate and negotiate with investors and servicers, questions about the accuracy and integrity of records, and the development of procedures for processing claims. Establishing and maintaining an infrastructure to address these issues could require substantial time and would entail considerable cost.

The size of the MBS market is such that focusing on securities alone rather than whole loans should have a significant impact on restoring market liquidity. Current estimates of the outstanding principal balance of 2004 through 2007 subprime and Alt-A MBS alone exceed \$1 trillion.

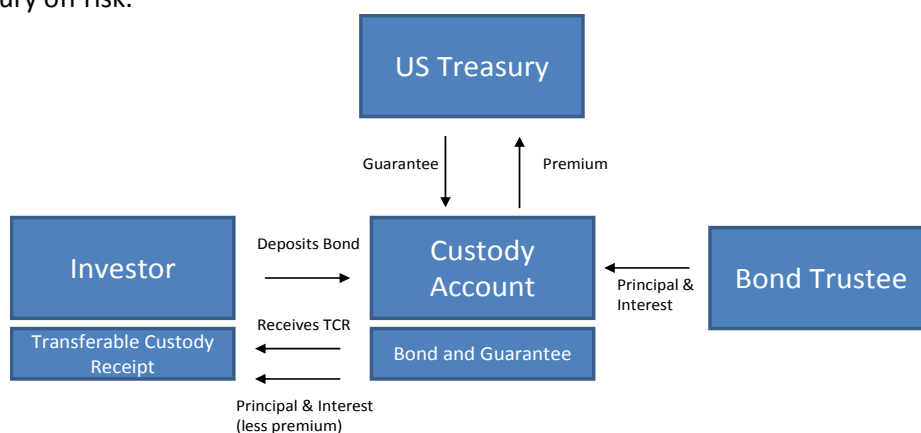
Purchasing whole loans is less likely to rapidly restore liquidity in the marketplace.

### **1.2 What is the appropriate structure for such a program? How should the program accommodate various classes of troubled assets? Should the program differ by the degree to which an asset is troubled?**

As outlined above, it is our view that the Treasury should employ two structures for this program, a portfolio excess of loss guarantee, and a financial guarantee of individual securities.

Excess of Loss: Under the excess of loss structure, the Treasury guarantee would be applied across a portfolio of securities. This concept can be applied to buy-and-hold investors such as pension funds and insurance companies and can also be used to assist financial guarantors. The structure, as described above under "Recommendation," would allow the owner of the risk of the MBS securities and Treasury to agree on a loss sharing arrangement for a portfolio. For example, if a company had exposure to \$10 billion of MBS securities and wished to purchase a guarantee for losses above \$6 billion, the guarantee could be structured to provide that if losses exceed \$6 billion on the portfolio, the Treasury would reimburse the holder of the portfolio for 90% of losses above \$6 billion until the \$9 billion detachment point is reached. The portfolio holder thus retains the risk of loss on the first \$6 billion, 10% of the next \$3 billion, and the entire final \$1 billion on the portfolio of securities. This structure ensures that the original holder has a strong incentive to minimize losses on the securities to the extent possible. Financial guarantors would not only have the incentive but also the capacity to minimize losses as they typically retain control rights in guaranteed MBS.

Financial Guarantee: The financial guarantee structure could be similar to financial guarantors' existing Transferable Custodial Receipt (or "TCR") programs. In this structure, Treasury would insure the repayment of interest and principal on specific senior tranches of MBS or other securities. Eligible securities could include securities already insured by a financial guarantor, or uninsured securities. The diagram below illustrates the structure of the TCR program. The investor seeking a guarantee under this program would deposit the bond into the custody account, which Treasury would establish with a custodian. The custodian in turn would issue a transferable custodial receipt back to the investor and the Treasury issues a guarantee in favor of the custodian for the benefit of the holder of that particular bond. The TCR is a freely tradable instrument that will maintain its guarantee when it is sold, therefore maintaining and enhancing the liquidity of the bond. The holder of the TCR has the ability to terminate the guarantee by depositing the TCR back to the custodian and receiving the bond in its original form, taking Treasury off risk.



Both the excess of loss and financial guarantee programs should adjust price (premium) levels and attachment points in consideration of the distress an asset may be experiencing or is expected to experience. Treasury would use a risk-based capital pricing model, where Treasury will receive the appropriate premium for the level of credit risk assumed.

### 1.2.1 What are the key issues to consider with respect to guaranteeing whole first mortgages?

It is our opinion that individual first lien mortgages should not be eligible for the guarantee program due to logistical challenges described in sections 1.1 and 1.2.3.

### 1.2.2 What are the key issues to consider with respect to guaranteeing HELOCs and other junior liens?

Similarly, it is our opinion that individual HELOC and junior liens should not be eligible for the guarantee program. Securities comprised of these types of loans would be eligible for the guarantee program and the issues are addressed below in section 1.2.3.

### 1.2.3 What are the key issues to consider with respect to guaranteeing MBS?

#### Excess of Loss Program

The most critical issues for the excess of loss program revolve around determining the extent of risk sharing, namely the attachment point, the detachment point, and the ratio of shared losses covered, as

well as issues related to the pricing of the guarantee. In order to properly determine these, a number of subsidiary issues will have to be addressed.

Treasury would need to establish proper processes and procedures for the evaluation of risk and pricing. Analysis of the risks will have to incorporate loan level attributes, plus the use of stochastic loss and cash-flow models. Given time constraints and complexity Treasury should retain third-party MBS experts to perform these critical functions.

Given that Treasury would be taking a risk position senior to that of the existing holder of the MBS portfolio, (that is, the existing holder of the securities will be in the “first loss” position) the need to be as precise in the evaluation of expected loan performance may be reduced relative to that of a first loss risk holder. This structure leaves the existing MBS portfolio holder with the incentives to manage and mitigate losses

Treasury should clearly set out how the program would operate in practice. Once a pool of eligible securities has been identified and an attachment point established a process must be clearly defined for determining what losses are allocated toward the attachment point and when payments are triggered. For example, if the holder sells a security that is part of the covered portfolio, the program should not count the market price loss on that security toward the attachment point threshold.

Treasury will not obtain control rights over MBS or mortgages through the excess of loss program. While Treasury and the financial guarantor or asset holder would be aligned in terms of loss mitigation, they may diverge with respect to other public policy questions such as loan commutations and restructurings to the extent that these initiatives do not result in the lowering expected losses. .

Finally, by effectively placing a cap or ceiling on losses for the MBS portfolio holder investor confidence should be increased, credit ratings should be stabilized, and capital should be freed up to permit credit to flow into the economy.

#### Guarantee of Individual Senior Tranches of MBS or other securities

The first key issue is which securities to cover. We recommend the program be limited to senior and super-senior tranches only. Senior tranches comprise the vast majority of issuance and focusing on the top of the capital structure of various securities will improve program efficiencies while limiting risk. We also note that many subordinated tranches of MBS have already been fully written down, and credit losses (as opposed to mark-to-market adjustments) which have already been taken should not be eligible for the guarantee program.

On an overall basis, the Treasury will require the benefit of extensive MBS expertise, which may best be obtained by retaining qualified third parties under contract. This program would not have the benefit of the large first loss position that the excess of loss program creates. The treasury will have to determine the expected loss on a security-by-security basis and incorporate that expected loss into the pricing structure. Under this program, the Treasury would be analyzing individual securities, rather than a

portfolio of securities and therefore, the need for accurate data and sophisticated loss models is important.

Servicing of the mortgage loans in the specific guaranteed MBS will be important. Loan performance is highly dependent on the effectiveness of the loan servicer. Therefore, much attention has to be paid to the collection and workout activities of these servicers. In the current environment, servicers may be creative with their loss mitigation strategies and this should be overseen by the holder of the risk – the guarantor. Lien position must also be considered. In general, the flexibility to restructure junior liens will be more limited except where first and second liens are managed by the same servicer.

Some of these issues will be diminished if the existing holder of the securities guarantees them and the Treasury's guarantee is therefore second-to-pay. In that case, the existing holder remains fully at risk, reducing Treasury's need to monitor servicing, portfolio management and valuation.

To the extent Treasury's goal is to modify mortgages for the benefit of individual homeowners, a full guarantee that would transfer control rights in the mortgages would best achieve this purpose. In that case, the Treasury would be well-served by guaranteeing mortgage securities already backed by financial guarantors as the financial guarantors hold control rights in entire series, and Treasury may be able to acquire control rights from the financial guarantors. In the case of a bond that does not benefit from a financial guarantee insurance policy individual bondholders vote the percentage share they own, complicating the question of control rights.

#### **1.2.4 What are the key issues associated with guaranteeing financial instruments other than mortgage related assets originated or issued before March 14, 2008 that could be important for promoting financial market stability?**

Holders and originators of non-mortgage assets have suffered during the current illiquidity as financing sources have dried up. The ability to facilitate additional liquidity to non-mortgage holders addresses financial stability from a different perspective than MBS purchases/guarantees and the multiplier effect of reopening prudent consumer lending should be significant. However consumer credit, by volume, far exceeds the capacity of TARP and therefore, to the extent non-mortgage securities are eligible, the program should rely primarily upon an excess of loss structure. The program should be targeted toward marketplace leaders in each asset class in order to be a catalyst for additional lending in the economy. Requiring these companies to retain a substantial portion of the credit risk addresses concerns about potential moral hazard.

An exception to the preference for the portfolio guarantee structure might be made for student loan securities. Many student loan securitizations are structured as auction rate or other variable rate tax exempt bonds. Auction rate markets are effectively frozen, and the cost of debt for such structures has risen dramatically to the point where it substantially exceeds the cash flows available in the structures to service the debt. Yet the underlying student loan collateral, often government guaranteed loans, continues to perform without default. Applying the guarantee program to individual student loan securities, many of which are guaranteed by financial guarantee companies, could create liquidity in student loan markets and free up available credit for future student lending.

The analytical issues are similar to those facing mortgage assets: the determination of appropriate attachment points and premium pricing that protects the US taxpayer but provides liquidity to the asset holder.

### **1.3 What are the key issues to consider with respect to setting the payout of the guarantee?**

The program should only guarantee interest and principal when due pursuant to the terms of the original indentures. As noted in our response to question 3 below, to the extent guarantee claim payments are made on a schedule inconsistent with the terms of the indenture, there could be potential derivative accounting implications for holders of these guaranteed obligations. Stretching out payments to scheduled maturities may also maximize potential recoveries, affording Treasury time to work out MBS and benefit from any cyclical recovery.

Payments on securities guaranteed should be channeled through a limited number of dependable market intermediaries – the trustees under the relevant indentures. This is simple to administer and makes use of experienced institutions which have no financial incentive other than earning administrative fees.

#### **1.3.1 Should the payout be equal to principal and interest at the time the asset was originated or to some other value? What should that value be? What would be the impact of offering guarantees of less than 100 percent of original principal and interest?**

With regard to a portfolio excess of loss guarantee, the guarantee coverage is by definition not equal to 100% of the principal and interest of such portfolio. The determination of the payout amount would be the guarantee program's share of the amount of losses that exceeds the first loss protection afforded by the attachment point and any additional loss sharing agreed with the portfolio holder. With this type of guarantee, a ledger would need to be maintained, and any claims under the excess of loss guarantee would need to be computed based on a referenced portfolio approach, fully considering the agreed-upon risk sharing arrangements.

For individual bond guarantees, the payout should be equal to 100% of the remaining scheduled interest and principal payments at the time the guarantee is obtained from Treasury, and should not be based on the balances at the time of origination. The guarantee should cover the payment of interest and principal in accordance with the terms of the original documentation for the bond being guaranteed. If such bond is already guaranteed by a financial guarantor, then the terms of the Treasury guarantee should mirror the payment requirements under the financial guarantee policy. Guarantees of less than full interest and principal would be difficult to administer and would lack clarity in the marketplace. As discussed below under 1.7, the risk-based premium charged for the guarantee should compensate Treasury for the risk of loss.

#### **1.3.2 Should payout vary by asset class? If so, please describe using the same asset classes as enumerated under 1.21-1.24.**

The guarantee coverage and methodology for computing the payout should not vary by asset class, and should be consistent with 1.3.1 above. Any arbitrary differentiation by asset class would be open to manipulation.

**1.4 What event should trigger the payout under the guarantee? Should the holder be able to present the claim at will or should there be a set date? Should this date differ by asset class? Should this date differ by the degree to which the asset is troubled?**

Payouts should be triggered by credit losses only, not by any market value tests.

For the excess of loss program, the portfolio holder would file claims for actual credit losses incurred according to the risk sharing terms of the guarantee with an agreed-upon frequency, such as monthly or quarterly.

For individual bond guarantees, the Trustee would file a claim for interest or principal shortfalls on a monthly or quarterly basis in accordance with the payment terms of the underlying bond indenture. Individual investors would not present claims directly to Treasury.

The methodology and timing of claims should be consistently applied for all consumer installment debt asset classes, and the treatment should not be different depending upon the degree to which the asset is troubled.

**1.5 Should the holder be permitted to sell the troubled asset with the program guarantee? If appropriate, should asset sales be restricted to eligible financial institutions or should there be no restrictions to promote liquidity in the marketplace?**

For the portfolio excess of loss guarantee, the beneficiary will by definition be the portfolio holder, and the guarantee will not be transferable if a bond or bonds are sold from the reference portfolio.

For individual bond guarantees, a holder should be able to sell the troubled asset with the guarantee, and any holder of a covered security should be able to benefit from the guarantee and the liquidity being created by it. Since a primary objective is to reestablish liquidity in capital markets, investors unwilling or unable to hold guaranteed positions should be permitted to sell into the market. Financial institutions may then redeploy sale proceeds into further lending into the economy. The market is not limited to financial institutions and all participants should benefit from the enhanced liquidity. To the extent that a holder has purchased securities at a discount, Treasury may wish to consider that discount in determining the price of the guarantee.

**1.6 What are the key issues the Treasury should consider in determining the possible losses to which the government would be exposed in offering the guarantee? What methodology should be used to determine possible losses? Does it differ by asset class? If so, please describe using the same asset classes as enumerated under 1.21-1.24. Does it differ by the degree to which the asset is troubled?**

As discussed above, understanding the credit risk of the asset along with the structure of the liabilities is necessary to determine possible losses. However, the degree of the complexity and rigor of the credit

analysis will vary based upon the choice of financial guarantee program – excess of loss or individual securities. A more in-depth understanding of the borrower, the loans, the collateral, and the economic landscape will be needed when a greater level of risk is to be assumed.

Because the excess of loss program and the second-to-pay approach entail relatively remote levels of risk, the level of analysis may not have to be as deep as it would be for individual securities that do not benefit from a guarantee or first loss position that stands before the Treasury guarantee. In all cases, Treasury should work closely with the holder of the MBS risk to jointly determine expected losses. In parallel the Treasury can engage independent third parties to validate ultimate risk, attachment points, and pricing.

Loss analysis and expectations on individual MBS securities will be more complex as expected loss will differ for each security, and as a result there will be a need for MBS expertise. Treasury may have the opportunity to acquire control rights over the securities and the underlying mortgage loans that support the MBS security it has guaranteed. If this is a goal, the “value” of the control rights can be factored into the price of the guarantee. For example, Treasury may price the cost of a guarantee on securities that do not offer control rights at a higher cost than a guarantee of securities that give Treasury control rights.

The expected loss to Treasury should be the same across different asset classes if Treasury’s risk tolerance is a constant. Treasury will have to determine specific risk tolerances and adjust their stochastic modeling and pricing reflect these risk levels.

**1.7 What are the key elements the Treasury should consider in setting premiums for this program? Is it feasible or appropriate to set premiums reflecting the prices of similar assets purchased under Section 101 of the EESA?**

In order to ensure that Treasury and taxpayers are protected, all guarantee pricing, risk sharing, and premium derivation should be risk based. This approach applies to both individual bond guarantees and portfolio excess of loss guarantees.

Premiums on the guarantee should be sized to cover expected loss on each guaranteed security or on the portfolio subject to the excess of loss guarantee, as the case may be. The expected loss can be calculated by using a stochastic model that generates a series of projected outcomes. Each outcome or path projects whether the bond will have a cash flow shortfall, when the shortfall occurs, and the amount of the shortfall. The PV of cash flow shortfalls for each path is multiplied by its associated probability (if 300 paths, then 1/300), and these probability-weighted shortfalls are aggregated to determine the bond’s expected loss. If the Treasury were to guarantee the bond, then the premium would equal the expected loss.

The correlation between different MBS is addressed through the use of a consistent, loan level modeling analysis that uses consistent default transition matrices among like loan types and home price appreciation (“HPA”) projections by region. Although this process suggests a bond by bond quantitative analysis, this service can be contracted out and be brought into use fairly quickly. Given the desire to

avoid adverse selection, to ensure the adequate compensation of the Treasury, and ultimately to protect the taxpayer, a bond-specific analytical approach should be preferable to a mere generic pricing schedule.

The Treasury guarantee should pay in the event that the underlying bond fails to pay scheduled interest and principal. If the guaranteed bond is insured by a financial guarantee insurance policy, Treasury may wish to negotiate the commutation of such insurance policy, perhaps in exchange for the financial guarantor's control rights. If not commuted, the Treasury guarantee should only pay if both the underlying bond and the financial guarantee policy fail to pay.

Expected losses should also drive the pricing of asset sales under TARP, with the reverse auction process providing an efficient tool to determine expected losses. However, because the mechanism will be different, pricing discrepancies are possible between the guarantee and asset purchase programs.

Additionally, even if the expected losses are identical between the two programs, the ultimate pricing result may not be the same between a cash bond purchase price and the guarantee premium level because there is a liquidity component to receiving cash today for a bond sold under TARP versus realizing cash over the life of the asset from the protection of the guarantee. A bondholder may have a stronger preference for receiving cash today and may settle for a present value less than the amount computed under the expected loss approach.

**1.7.1 If use of prices of similar assets purchased under Section 101 of the EESA are not feasible or appropriate, should premiums be set by use of market mechanisms similar to (but separate from) those contemplated for the troubled assets purchase program? How would this be implemented? If not feasible or appropriate, what methodologies should be used to set premiums?**

For individual bond guarantees, the method described above that focuses on a bond by bond expected loss approach is the most appropriate. Given the limited size of the guarantee program, it would seem difficult to establish an effective reverse auction approach to setting a premium on a guarantee similar to that expected to be used by TARP for establishing purchase prices. The lack of an auction approach for the guarantee program may expose Treasury to the risk that holders of securities may attempt to arbitrage the purchase program against the guarantee program. To manage this risk, Treasury must develop appropriate pricing tools and eligibility criteria for securities and institutions under each program, as discussed below under 2.

**1.7.2 Do these considerations of feasibility or appropriateness vary by asset class? If so, please describe using the same asset classes as enumerated under 1.21-1.24. Should the premiums vary by the degree to which the asset is troubled?**

The method described above that focuses on a bond by bond expected loss approach is the most appropriate. While the expected loss will vary by asset class and by bond, the methodology used to determine expected losses would be consistent across asset classes.

## **1.8 How and in what form should payment of premiums be scheduled?**

For individual bond guarantees, premiums may be collected either as upfront premiums paid by the beneficiary of the guarantee, or as installment premiums paid from the cash flows of the guaranteed bond. There are advantages and disadvantages to each method.

### Upfront Premium

The bondholder would pay a one-time fee at the time the guarantee is put in place. No further premium payments would be made by the bondholder or any subsequent holder of the guaranteed bond. In this way, the holder incurs the expected loss up front through the onetime payment of the premium.

Advantages:

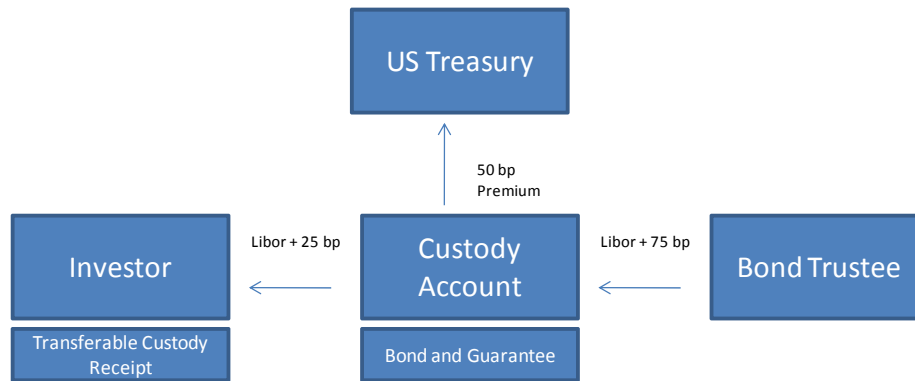
- Treasury is protected from the credit risk (counterparty risk) of the bondholder;
- An upfront payment simplifies premium collection by obviating any need to track premium payments due or bill bondholders for premiums over time;
- Subsequent security valuation and trading mechanics are simplified because the bond would trade based on its outstanding principal, coupon, and prepayment assumptions; and
- Results in immediate recognition of intrinsic loss on the underlying bond by the holder as well as full value of the guaranteed asset on the holder's balance sheet.

Disadvantages:

- An upfront payment reduces cash positions today at the very institutions to which the program is attempting to bring enhanced liquidity and may not be feasible for some cash-strapped holders; and
- Incurring the premium up front may inhibit later cancellation of the guarantee by effectively creating a material economic penalty to cancellation. It is in the interest of all parties for the government guarantee to be dropped as soon as it is no longer needed to maintain market stability and liquidity.

### Installment Premium

Premiums could also be structured so that they are stripped out of cash flows, similar to the way FNMA and FHLMC are paid a fee on a monthly basis. This could be effected using the Transferable Custodial Receipt structure that is outlined above under 1.2. With the bond deposited in the custody account, the custody account would receive the full coupon on the bond; the custodian would divert payment of the premium to the Treasury and pass through a net coupon to the holder of the custodial receipt.



Assets that are deeply distressed, where the expected losses are very high, may not be suitable for an installment approach to the extent ongoing cash flows are insufficient to pay installment premiums. For such securities, some combination of an upfront premium and installment premium may be suitable. Payment of installment premiums implies that the holder will incur the expected loss over time in the form of reduced earnings on the security.

Advantages:

- Makes the cost of the guarantee more affordable for the bondholder, as it is paid over time without an up front cash outlay;
- The bondholder has the ability to cancel the guarantee at some point in the future without economic penalty; and
- Treasury also benefits from cancellation option, as it can be taken off risk.

Paying the premium from bond cash flows avoids exposing the Treasury to counterparty risk. To the extent that ongoing bond cash flows are insufficient to pay installment premiums, the balance should be collected as an up front payment.

Disadvantages:

- There will be the incremental cost of the Custodian if TCR approach is adopted; and
- Treasury must monitor the collection of premium payments over time.

The excess of loss guarantee premium may also be paid either up front or on an installment basis. However because bonds would not be placed into the custodial receipt structure, installment premium structures would expose Treasury to counterparty risk for collection of those premiums. To that extent, Treasury should consider the creditworthiness of the counterparty in determining premiums and the payment plan.

**2. How should a guarantee program be designed to minimize adverse selection, given that the program must be voluntary? Is there a way to limit adverse selection that avoids individually analyzing assets?**

Risk-based pricing for both the purchase and the guarantee program would reduce the risk of arbitrage. In addition, the excess of loss portfolio guarantee and second-to-pay individual guarantee, limit exposure to this risk by aligning interests as between the current holder of the exposure and Treasury.

Participants may seek to arbitrage between sales under TARP and guarantees under the guarantee program. There will be an inherent bias to sell riskier assets and/or assets not paying current interest while seeking guarantees for less risky or currently paying assets. If the auction process used under TARP leads to a different comparable cost than the analytical approach used for the guarantee program, holders may attempt to arbitrage the two programs.

### **3. What legal, accounting, or regulatory issues would such a guarantee program raise?**

The excess of loss portfolio guarantee program presents certain accounting issues:

- The primary considerations for entities which buy and hold credit risk in an unfunded capacity, such as financial guarantors, are as follows: (i) the type of entity issuing the portfolio guarantee may raise reinsurance accounting issues for insurance entities. Having the Treasury establish an insurance entity to execute such guarantees would avoid interpretational questions related to reinsurance accounting; and (ii) control rights ceded by entities to the Treasury for MBS transactions involving special purpose entities may have consolidation implications under new guidance currently being proposed by the FASB, which would amend FIN 46(R).
- The primary consideration for other investors which buy and hold credit risk in a funded capacity is that they may not derive any benefit for holding such a guarantee when evaluating the underlying investment for other than temporary impairment under financial and US insurance regulatory accounting rules.

Potential derivative accounting issues that would need to be addressed by holders of individual MBS guaranteed by the Treasury include: (i) whether the guarantee could potentially make claim payments on a schedule which does not match the original bond indenture; and (ii) having the ability to terminate the guarantee, as described in our response to question 1.2.

### **4. What administrative and/or operational challenges would such a guarantee program create?**

Operational challenges may vary for several reasons, including whether one exercises control rights or is a passive holder and the extent to which risk is retained by the current holder. Treasury will need to monitor the underlying assets and cover payment shortfalls up to the amount of any guarantee. Where Treasury seeks to exercise control rights, Treasury will need to establish surveillance and remediation capabilities, whether in-house or by contracting with third parties.

#### **4.1. What expertise would Treasury need to operate such a guarantee program? Please describe for all facets of the program.**

The level of expertise required will depend on whether Treasury is taking first or second loss exposure, with the latter requiring less oversight as the party retaining the first loss risk will assist in providing some of these functions. Relevant expertise includes:

- The ability to size and price guarantees, including the determination of attachment points and risk sharing measures under the excess of loss program. This may necessitate an understanding of the credit risk characteristics of the loans underlying RMBS which may contribute to default probability, default timing, or severity, including such factors as borrower credit quality, loan terms, and collateral details (*e.g.*, property type, LTV, location);
- Expertise to develop appropriate stochastic models for estimating expected loss;
- Tools and knowledge to limit adverse selection and arbitrage, including knowledge of loan origination practices of various security issuers and knowledge of servicer capabilities;
- Operational, accounting, and legal expertise to ensure proper monitoring of risk exposures, collection of premiums, and payment of claims; and
- Surveillance and remediation expertise to properly monitor the performance of guaranteed securities and portfolios and mitigate the risk of claims where possible.

**5. What are the key issues to be considered in determining the eligibility of a given type of financial institution to participate in this program? Should these eligibility provisions differ from those of the troubled asset purchase program?**

Treasury should seek to ensure fairness and maximize benefits by limiting guarantees to assets or exposures held by institutions that have been “on risk”. To be eligible an institution should have held the risk as of a set date, prior to the TARP.

The guarantee program is best suited to buy-and-hold investors, such as pension funds, commercial banks, or consumer lenders that can still profit from spread earnings on funded assets, or to financial guarantors who would benefit from capping potential catastrophic losses. Limiting the benefits of the guarantee program to such institutions would also allow Treasury to manage the risk of arbitrage between the guarantee program and TARP. The asset purchase program under TARP is better suited to financial institutions that are heavily reliant on wholesale funding and seeking to de-leverage.

**6. What are the key issues to be considered in determining the eligibility of a given asset to be guaranteed by this program? Should eligibility provisions of assets to be guaranteed under this program differ from those of the troubled asset purchase program?**

Eligibility provisions for assets to be guaranteed should be similar to those of TARP.

**7. Assuming the guarantee is priced to cover expected claims, are there situations (perhaps created by regulatory or accounting considerations) in which financial institutions would prefer this program to the troubled asset purchase program? Please describe.**

Guaranteed assets may still generate attractive spread income and could offer upside to holders. Sellers to TARP would forego any future upside and may have limited reinvestment opportunities for sales proceeds.

Financial guarantee insurers hold MBS risk through their bond insurance policies, but do not own the underlying securities. Thus the guarantee program, particularly the portfolio excess of loss structure, would be of more benefit to financial guarantee insurance operations than would the asset purchase program. By enabling financial guarantee insurers to cap their catastrophic losses, the guarantee program would stabilize bond insurer ratings and help restore credibility to their guarantee in the marketplace. This would in turn enable financial guarantee insurers to return to insuring municipal debt issues, which would help re-start the flow of credit to state and municipal issuers and thus benefit the economy as a whole.

Regulatory and accounting considerations will depend on any changes to mark-to-market accounting. Assets sold under TARP will generate immediate proceeds to the seller, crystallize any loss (or gain) and remove the assets from the seller's balance sheet. Guaranteed assets will remain on a financial institution's balance sheet subject to mark-to-market accounting rules. Credit quality is only one element affecting market prices. Even high quality (*i.e.*, guaranteed) MBS can be quite volatile due to changes in interest rates and prepayment speeds.

Entities that have control of the economic outcomes of an asset, whether through control of servicing or through remediation efforts, would prefer a guarantee rather than an outright sale. Finally, the "economic pain" of selling a security at an immediate cash loss may be too much for some institutions compared to purchasing a more limited guarantee and allocating a portion of capital accordingly.

**7.1 Does this preference differ by type and condition of the asset? For what troubled assets might financial institutions choose to participate in the guarantee program rather than sell under the troubled asset purchase program? Is accommodating this choice likely to best promote the goals of the EESA? Does it adequately protect the taxpayer? If not, what design feature should be included to assure these goals are met?**

Participants will be inclined to seek guarantees for securities generating attractive yields and/or securities with perceived upside potential. Highly distressed assets are more likely to be sold under TARP. Participants may also seek to sell assets with greater uncertainty (*e.g.* assets with a high incidence of fraud and limited recourse rights) while seeking guarantees for assets where performance can be assessed with greater certainty. It will be difficult if not impossible to implement a program that eliminates any arbitrage opportunities.

Many entities, such as financial guarantors, will not be able to utilize the purchase program because they do not own the actual asset. Additionally, Treasury may limit eligibility for non-mortgage assets because the volume of such assets to be sold would inefficiently and disproportionately utilize the program's capacity limit. In these situations, and for purposes of addressing adverse selection and moral hazard, the excess of loss guarantee would address the issues that led to the creation of the Act better than the purchase program. For entities that are comfortable with credit risk but need to

generate liquidity, *e.g.*, financial guarantors, the guarantee program would achieve this with minimal credit risk to the taxpayer.

A primary objective of the Act is restoring the efficient operation of credit markets. Guarantees and asset purchases will both help achieve this objective. Setting appropriate risk-based prices for both is an important element of the programs to protect taxpayers.