

Joshua Rosner
646/652-6207
jrosner@graham-fisher.com

Please see the attached note for full details:

An Urgent Agenda for Reactivating the Financial Sector

“The process of deflation exaggerated itself; beginning at any point it doubled back, so that lack of confidence caused hoarding and hoarding caused lack of confidence; or reduction in prices caused stoppage of manufacturers and stoppage of manufacturers, causing more unemployment, eliminated more potential buyers and forced prices down; or withdrawals of... [foreign capital] ...reduced the amount of credit which hastened deflation which caused hysteria which brought about renewed hoarding. It had always been assumed that inflation was the more dangerous process because it reduplicated itself so rapidly; but our experience with deflation shows that when control is lacking, it is as easy to fall ten thousand feet as to jump ten. As an expanding country, the United States has been inflationist almost all its life, but inflation has, fortunately, not always meant unsound money; of this our memories are vague”

- Gilbert Vivian Seldes, 1933

Executive Summary:

Given unprecedented failure of the system of financial intermediation and ongoing solvency issues at intermediaries it appears monetary stimulus alone will not be able to divert the economy from a path of deflation, The problems will require coordinated policy initiatives targeted at:

- ✓ *The need to provide immediate, ongoing, massive, unsterilized, expansion of the monetary base. How much is enough? The Fed should consider targeting the TIPS market at least until rates of inflation a year forward and beyond have turned positive.*
- ✓ *A need to allow the clearing of impaired assets and to recognize losses and then to recapitalize banks accordingly (wipe out equity first) and thus restore investor trust that the remaining formal banking system is now substantially healthy.*
- ✓ *The immediate need to jumpstart the intermediation of private capital through securitization markets. “NGSEs” should be created to support intermediation and create new industry standards in:*
 - *Structures (simply tranced as opposed to being created in the image of CRA ratings scales – i.e. perhaps only 3 tranches...);*
 - *Contracts (pooling and servicing, appraisal, third party origination purchase...);*
 - *Definitions (such as standards of delinquency or default...)*
 - *Disclosures (loan level data minus identifiers);*
 - *Pricing and valuations (either through an exchange or real time delivery to repository).*
- ✓ *The need for fiscal stimulus and capacity building in the infrastructure and workforce.*

(Time is Tight: We Must Run Not Walk)

For several years analysts have been heralding problems in the credit markets that could result in a downward spiral and risk to the mechanisms of economic funding,¹ it was argued that housing was not the origin of the dislocation but rather “the shrinkage in the RMBS (residential mortgage backed securities) sector is likely to arise from decreased funding by the CDO markets as defaults accumulate...Decreased funding for RMBS could set off a downward spiral in credit availability that can deprive individuals of home ownership and substantially hurt the U.S. economy.”^{2,3}

The misdiagnosis of the root of the current economic problems risks continued misapplication of the wrong medicines. As a result, without a broader program to counter deflation, we will be trapped in a ongoing negative feedback loop where stabilization of housing fails as commercial activity weakens, stabilization of capital

¹. See Joseph R. Mason & Joshua Rosner, How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?, Working Paper, Feb. 15, 2007 [hereinafter *Mason & Rosner February 2007*], at 36 (“The potential for prolonged economic difficulties that also interfere with home ownership in the United States raise significant public policy concerns. Already we are witnessing restructurings and layoffs at top financial institutions. More importantly, however, is the need to provide stable funding sources for economic growth. The biggest obstacle that we have identified is lack of transparency. The structural changes noted in Part I.A largely went unnoticed by MBS investors until only recently. We explain that those changes went unnoticed largely because of the existing complexity and valuation difficulties underlying today’s MBS markets. High yields in MBS in the past several years led to a massive infusion of CDO “hot money” into the MBS sector in an environment similar to that of the thrift crisis of the late 1980s. Like the thrift crisis and its aftermath, therefore, recent events not only threaten these institutions, but also threaten the U.S. consumer and taxpayer as well. Perhaps of greater concern is the reputational risk posed to the U.S. capital markets—markets that have historically been viewed as among the most transparent, efficient, and well regulated in the world. The economic value of mortgage securitization and the risk transfer value of CDO issuance support their further use. However, there should be significant resources allocated to building the regulatory framework surrounding their structuring, issuance, ratings, sales, and valuation. We believe that efforts to provide transparency to these new product areas can foster stability while maintaining liquidity to the underlying collateral sectors and supporting further meaningful financial innovation and capital deepening. At present, even financial regulators are hampered by the opacity of over-the-counter CDO and MBS markets, where only “qualified investors” may peruse the deal documents and performance reports. Currently none of the bank regulatory agencies (OCC, Federal Reserve, or FDIC) are deemed “qualified investors.” Even after that designation, however, those regulators must receive permission from each issuer to view their deal performance data and prospectus’ in order to monitor the sector. Significant increases in public access to performance reports, CDO and MBS product standardization, and CDO and MBS securities ownership registration can help decrease the existing over-reliance on ratings agency inputs to rate and ultimately value the securities and reducing the valuation errors inherent in “marked-to-model” (rather than marked-to-market) portfolios. SEC Regulation AB was a (late) start for ABS and MBS. Overall, however, the U.S. economy needs an efficient public CDO market that allows transparent open market repricing of market risk and outside research into new securities and funding arrangements. U.S. homeowners and consumers deserve stable and efficient funding to support their pursuit of the American dream.”).

². For more information, see WM Financial Strategies, “Subprime Glossary,” available at: <http://www.munibondadvisor.com/SubprimeGlossary.htm> (It may be useful to review terms “RMBS - Residential Mortgage-Backed Securities: In the context of subprime lending refers to subprime residential mortgage-backed securities. Subprime RMBS tranches often account for a high proportion of the collateral backing SF CDOs” and “SF CDOs - Structured Finance Collateralized Debt Obligations: CDOs backed primarily by asset-backed securities and mortgage-backed securities.”).

³. *Mason & Rosner February 2007, supra note 1, at*IBID p 33

markets fail as the real economy weakens, and financial institutions decline as commercial enterprises weaken.

Present efforts to contain the crisis, although welcome, fail to grasp the root of the problem. In this sense, the government's rational and laudable current programs—including loan modifications, interest rate reductions, and large unsterilized expansions of the money supply—are all meaningless if the basic tools for financial intermediation are absent.

Even if we succeed in efforts to restore bank solvency, remove troubled assets from their balance sheets, provide banks with capital to lend, and artificially stimulate demand, we will still have to reignite capital market demand for credit at levels above the level which depository institutions can support. In 2007 nearly one trillion in financing was provided by asset backed markets, funding that was beyond that provided by the traditional banking system – a system that, through staff reductions, has also reduced origination capacity.

Unless we aggressively expand the monetary base, separate bad assets from good, redesign and rebuild asset backed securities markets (ABS) and expand fiscal stimulus aimed at wage growth, the loss of this credit capacity will almost certainly drive significant and continued deflation. Such a result cannot be allowed to happen and the government must say so positively. As part of that agenda, government should specify some metrics for the success of their ability to change expectations from a dangerous self-feeding expectation of deflation. It seems fair to consider TIPS as a useful gauge, the Fed should consider targeting the 1, 2 and 3 year implied inflation rates in the TIPS market as a market measure of their success in defeating unacceptable expectations of deflation.

Please see the attached note for full details: