Transparency

Visibility into the Financial Sector Since the Crisis

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Transparency

- What Went Wrong?
- What Have We Fixed?
- What’s Left?

Transparency – What Went Wrong?

- Complexity and Models
- Securitization Machine
  - Asset values
- Lending
  - Mortgage lending
- Off-Balance Sheet Treatment
  - Front-loading earnings and leaving outstanding risks
- Liquidity

Securitization – Logarithmic Complexity?

- **Not inherently evil** — A way of matching particular risks with the investors that desire that level of risk
- **Role specialization** — Loan originator, packager, investor
  - **Shadow Banking** — With role specialization, a larger and larger portion of financial services activity moves away from banks
  - **New Lenders** — Rise of the mortgage broker, subprime lenders, newly ascendant thrifts
  - **New Funding Sources** — Bond, money market, other funds
  - **New Gatekeepers** — CDO managers, financial guarantors
- **Incentives** — How does each institution get paid? How does it pay its people?
- **The Dark Secret** — Most asset managers compete primarily on marketing and distribution. In other words, performance is a secondary issue.
- **Who Safeguards Your Money?**

Mortgage Lending

- **From Bank-centric to Securitization-driven**
- **New Products, New Uses**
  - Subprime Loans
  - Option ARMs
  - HELOCs
  - Second Liens
- **A Positive Feedback Cycle**
- **Traditional Metrics Begin to Fail Us**
  - Delinquencies
  - Historical Loss Rates
  - Loan-to-Value

Failure of Traditional Metrics – Washington Mutual

- **The Portfolio (Disclosed end of 2005)**
  - **Option ARMs – 31% of Portfolio**
  - **Home Loans > 80% LTV – 4% of Portfolio**
  - **HELOCs > 80% CLTV – 5% of Portfolio**
  - **Interest Only – 5% of Portfolio**
- **Traditional Metrics**
  - Nonperforming loans – 0.55%
  - Net charge-offs – 0.11%
- **Stunning Revelations**
  - Option ARM loans were underwritten with incorrect debt to income ratios
  - "Risk mitigation activities include proactive risk management strategies such as **redesignating Option ARM loans from held in portfolio to held for sale…."**

Off-Balance Sheet Treatment

- **Gain on Sale Accounting**
  - Let's take all of tomorrow's profits – today
  - By the way, we're still on the hook if those profits aren't realized
- **Model Error**
  - Are losses on subprime loans going to be 4.7% or 5.5%?
  - What about 40%?
- **Incentivizes Production**
  - When gains are taken for loans sold, the market rewards companies that increase production
  - The spread off of assets is a more durable source of income
  - Removes funding constraints and allows more bad lending

Transparency – What Have We Fixed?

- Lending
  - Mortgage risks
- Securities Holdings
  - Level 1 – Level 3: Reveals Valuation Techniques
- Off-Balance Sheet Treatment
  - Gain on sale accounting is largely dead
  - End of liquidity support agreements
- Capitalization

Capitalization

- We have come a long way in building a more resilient banking system
- Leverage ratio is a simple, hard rule, but doesn't exist in isolation
  - Loan Loss Reserves are not included, but protect equally against future losses – the accounting for these is going to become much more conservative in the future
  - Tangible common equity – your best defense against losses – now excludes future profits due to FAS 166, 167.
  - Just look at Citigroup:

	YE06			Today
	Reported	**Proforma**		
Loan Loss Reserve	8,940	22,340		21,938
Tangible Common Equity	74,906	66,606		161,517
Tangible Assets	1,840,441	2,035,741		1,853,534
Leverage Ratio	4.07%	3.27%		8.71%
TCE + LLR / TA	4.56%	4.37%		9.90%

Transparency – What Risks Remain Unaddressed?

- Roles and Responsibilities
  - With banks supplanted as the ‘owners’ of financial assets, where does the buck stop?
- Interest Rates
  - Modeled Risk vs. Inherent Risk
- Lending – Where do nontraditional payment terms exist?
- Derivatives – Notional vs. Fair Value; Equal and offsetting

Roles and Responsibilities

- Fundamental shift in ultimate owners of financial assets
  - Banks → Asset Managers
  - Delineate everyone's responsibility in originating, packaging, purchasing these assets
  - Fundamental failures existed at every point in the chain
    - Originators: Mortgage brokers, New Century, Countrwide
    - Securitizers: Wall Street
    - Asset Gatherers: Hedge funds, Mutual funds, CDO Managers
    - Facilitators: Regulators, Local Governments
      - Example: Local lien registration vs. Current mortgage model

Interest Rates

- Emerging from one of the longest bull markets in bond history
  - Yields steadily declined for decades, trend may start to reverse in the future
- As a financial statement user, what do I know about the bond portfolio?
  - Original cost of the bond (amortized cost) and current fair value
- What about what I'm owed?
  - If I pay $105 for a bond with a $100 par due to an above-market yield and it pays off faster than expected, I stand to lose that entire $5 premium
- This same issue affects loan portfolios as well