



October 28, 2008

The Honorable Neel Kashkari
Interim Assistant Secretary for Financial Stability
US Treasury Department
Washington, DC 20020

Dear Mr. Kashkari:

On behalf of my colleagues at Aon, I would like to submit a response to the request by the U.S. Treasury for a Guarantee Program for Troubled Assets.

Aon is a global leader in Risk Management and Consulting, Insurance Brokerage and Human Capital Consulting. We help clients across the globe to understand and manage risk through a rich network of resources, broad capabilities and deep expertise. We have extensive resources in the actuarial sciences; technology and risk analytics. We are experts in the management of insurance companies; risk pools and other facilities. While we are not experts in the sale or underwriting of securities (except for financial instruments related to insurance risk) our experience and skill and insights are directly relevant to help deal with certain distressed assets.

We have outlined a creative plan that uses a risk pooling mechanism to help deal with the crushing problem of troubled assets. Risk pools have been used for more than a century to deal with risks that were thought to be intractable, including nuclear liabilities.

We have leveraged the global expertise of our firm and believe the risk pool idea has unique features that are hard to ignore:

- The risk pool is largely self-funding and conserves assets that were granted under EESA.
- The pool defers the ultimate valuation of assets into the future, when the passage of time reduces uncertainty.
- The pool does not rely on well functioning capital markets for price discovery and will not flood the market with distressed assets.
- Provides a way for treasury to help manage the capital base of our financial institutions.

I hope that we can provide you with a team to help in this challenging time.

Sincerely,



Gregory Case

President and Chief Executive Officer

Introduction

Aon is pleased to respond to the invitation to present ideas about how to deal with certain types of distressed assets.

Our recommended approach entails the implementation of an insurance program that uses a combination of risk retention, risk pooling and government backstop liquidity. Our proposal is based upon our expertise in the creation of structures that help businesses, government entities and individuals effectively manage risk. We are not experts in the sale or underwriting of securities unrelated to insurance risk.

Who We Are

Aon is a global leader in Risk Management and Consulting, Insurance Brokerage and Human Capital Consulting. We help clients across the globe understand and manage risk through a wide ranging network of resources, capabilities and expertise. We have extensive resources in the actuarial sciences; technology and risk analytics as well as the management of insurance companies, risk pools and other facilities. While we are not experts in the sale or underwriting of securities (except for financial instruments related to insurance risk) our experience and insights are directly relevant to help deal with certain distressed assets.

Positive Effect of an Insurance Mechanism

The economics of a program that provides insurance policies to guarantee timely payment of interest and principal compares favorably to the direct purchase of distressed assets. In its simplest terms, an insurance policy is an asset (or contra-liability) that increases or decreases in value inversely to the valuation of the insured instrument. The insurance allows the asset to remain with the holder and still be insulated from the economic effect of changes in the valuation without requiring the sale of the asset.

Consider the following example: a unit of mortgage backed securities originally purchased for \$100, decreases in value from \$100 to \$85. The value of the insurance policy would now increase from \$0 to \$15. The value of holding the asset following the purchase of the insurance contract would be the sum of the value of the asset *plus* the value of the associated insurance contract (\$100). If the asset was unimpaired and expected to perform, the insurance contract would have little or no value and the associated premium would be relatively small.

Through the issuance of an insurance policy, the payment of principal and interest¹ is guaranteed by the insurer. Within a given contract, the insurer is obligated to stand in the place of the borrowers, and make up for short-falls in interest and principal payments.² The insurance policy serves to insulate an asset holder from the decline in value resulting from the non-payment, or expected non-payment, of principal and interest. It is important to note that the requirement to pay asset holders will take place in periodic increments in the future. There is no need to pay asset holders for the current loss in market value.

¹ There are existing insurance policies as well as specialty insurance companies that issue these “financial guarantee” or “credit enhancement” policies. The market does not have enough capital to offer meaningful coverage.

² It would receive in exchange certain ownership rights.

A properly structured insurance program can provide stability to holders of certain distressed assets³ while using less capital than the direct purchase of assets.

It also has the advantage of providing time for one or both of the following to occur:

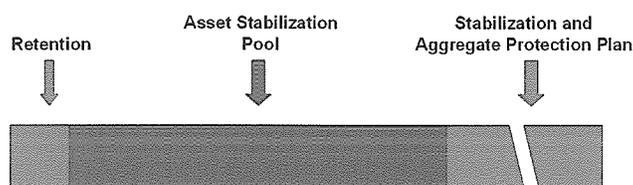
- The underlying assets to rise in value as economic conditions recover.
- Discovery of additional information about the performance of underlying assets through the passage of time. This makes valuation efforts less uncertain as the portfolio of insured assets mature.

Purchasing assets from financial institutions would require significant outlays of capital, and if resold would likely be at a time of economic distress. Asset sales would place a large volume of similar assets in the market within a short time-frame, further depressing prices.

Creating Insurance Capacity – Sustainable Funding

Because the insurance approach defers cash outlays, funds can be raised from the asset holders that are beneficiaries of the policies. Significant insurance capacity can be created from the following elements:

1. **Retention of Loss by the Asset Holder:** asset holders would be required to retain a small percentage (retention) of the short-fall of principal and interest, subject to a maximum annual payout per instrument.
2. **Asset Stabilization Pool (ASP):** asset holders would be reimbursed for a short-fall in principal and interest, once such payments exceed the retention, in any single year from a pool of assets funded by premiums. Premiums, determined using actuarial methodologies, would be paid by participating assets holders.
3. **Stabilization and Aggregate Protection Plan:** The Government can offer a plan to provide for short-term liquidity should the ASP become exhausted. The Government would be repaid through the future collection of premiums.



Precedent for Government Action

There is a precedent government intervention to create insurance capacity for risks that are too large for the commercial insurance market. *The Price-Anderson Nuclear Industries Indemnity Act*, first signed into law in 1957, protects the nuclear industry from claims caused by nuclear incidents. Key features of the Act include:

- The creation of insurance capacity by requiring all members of the nuclear industry to participate in a fund (pool).
- The fund would reimburse the owner of a facility, once its own retention and commercially available insurance was exhausted, by the payment of claims.
- All nuclear facilities are assigned a premium amount. The collection of the premium is deferred until funds are needed to respond to an incident.

³ This approach works for mortgage back securities and other instruments with relatively long maturities and periodic principal and interest. It is less useful in certain types of derivatives, such as credit default swaps with relatively short maturities.

- The Price-Anderson Fund is notional; all assets remain with the individual facilities. Each facility must demonstrate the ability to remit *deferred premiums* to capitalize the fund to respond to an incident⁴.
- The Government caps the maximum cash outlay in any single year and limits the aggregate amount facilities are required to pay if an incident were to occur.
- If a nuclear incident were to exceed the value of the Price-Anderson fund, the President of the United States is required to propose to Congress measures to raise funds and pay claims.

Funding the Asset Stabilization Pool (ASP)

Like Price-Anderson, we foresee the majority of funding coming from the economic beneficiaries of the plan, the holders⁵ of distressed assets. In our conceptual framework, the asset stabilization pool would have relatively low short-term cash needs, since it is only paying the current deficit of principal and interest, not the difference between the original value and the current market value of those assets.

A premium would be determined in advance and much like Price-Anderson, collection will be deferred and *called* only when additional funding is required. Asset holders that choose to participate would need to demonstrate that they have sufficient assets available to meet a deferred premium call. The Government can set these rules to calibrate the impact of this program on a bank's capital base.⁶

Asset holders would be charged premiums determined through sound actuarial methods designed to assign an equitable value to the size and probability of loss over the life of the asset. This method assures fairness between asset holders provided that the method approximates to the *relative risk* of different insured assets, in addition to the actual magnitude of expected loss.

Stabilization and Aggregate Protection Plan

We anticipate that the program will be largely self-funding. As ASP reimburses asset holders for principal and interest deficiencies, it obtains cash through premium calls. It is possible that the needs of ASP require premium calls in amounts that could cause financial distress to certain asset holders. Asset holders would be protected through two government sponsored mechanisms:

- Limitation on the amount of deferred premium called in any single year - the Treasury would establish a maximum deferred premium call per participant. If premium calls reached the maximum amount, the government would contribute amounts above the cap directly into ASP. The Treasury would be repaid via future deferred premium calls.
- Aggregate Liability - the Treasury would establish a maximum value of ASP. At the government's discretion, its intervention in shoring up distressed assets terminates with the exhaustion of ASP. The Government can increase its participation in the plan by issuing a direct guarantee that would provide back-stop liquidity to the ASP once the asset holders are relieved of their burden to contribute due to the exhaustion of the aggregate amount.

Estimating Losses and Setting Premiums

An initial valuation price for each asset would be established at inception (acceptance into the risk pool). The implied shortfall between a similarly structured "performing" asset and the impaired asset under consideration would form the basis of the premium amounts (on a back loaded basis) and adjusted periodically until expiry.

⁴ The notional value of the pool is estimated at approx. \$10 Billion

⁵ This is primarily thought of as U.S. banks, but could include other financial institutions, pension funds, exchange traded funds & etc.

⁶ Strict requirements reduce the amount of capital available for lending activities since it would require the posting of a deferred premium reserve. Alternatively easing up on a reserved requirement would have the effect of encouraging lending activity.

At each annual anniversary an actuarial re-evaluation would determine if the prior estimate needs to be increased or decreased, supported by an additional year's worth of debtor performance data. The remaining risk adjusted premium payments would be recalculated, accordingly.

This actuarial valuation technique is analogous to the recalculation of curtate life expectancy in pension risk pools. It embraces the concept of predictive latency that would be used to determine the final settlement value of the structured instruments.

A significant benefit of this approach is that it relies on the actual performance of the assets, not a market valuation.

The Merits of This Insurance Plan

1. It has smaller short-term cash requirements than an asset purchase plan and is largely funded by the its direct beneficiaries
2. It allows assets to be held at full value as opposed to current depressed market value allowing an asset holder's capital base to grow
3. It gives asset holders the option to hold to maturity or until the economic conditions permit the restoration of value
4. It does not specifically rely on well functioning capital markets for price discovery
5. It prevents opportunistic purchases of depressed assets by predatory investors
6. It creates a mechanism to aggregate and measure risks from certain classes of distressed assets
7. Past precedent: governance, regulatory and oversight mechanisms for existing government sponsored programs provide significant guidance in plan implementation and management
8. It does not flood the market with distressed assets which may have the effect of further depressing asset values
9. The insurance policy counteracts the effects of marking-to-market distressed assets
10. The insurance mechanism provides a framework for managing risks from the securitization of assets in the future. This approach provides both stability and a common platform for measuring and disclosing risk.

Effect of the Plan on Borrowers

The pool is compatible with plans to help borrowers. One feature of this plan is, over time, to create a mechanism to distribute the cost of mortgage defaults to participants. A precondition of participation can be the introduction of a work-out mandate. The Government could provide guidance to banks in renegotiating terms or writing-down of individual mortgages. The securitization of mortgages in tranches results in the interest in a single mortgage being held by a number of asset holders. Participation in the ASP will reconstitute some mortgages and create a mechanism to execute write-downs and restructuring.

Conclusion

We appreciate the opportunity to present our thoughts. The proposal outlines what we believe to be an efficient and creative structural mechanism designed to develop ideas for contributing to an overall solution to this complex challenge.



Submission of Comments

1.0 What are the key issues Treasury should address in establishing the guarantee program for troubled assets?

We believe that the key issues are development of:

- ❖ Premium calculation methodologies that fairly evaluate the intrinsic value without reliance on market pricing
- ❖ A program that is affordable and does not require significant upfront premium or capital contributions from participants (asset holders)
- ❖ Flexible premium pricing methodologies and payment terms allowing the use of repayment data that develops as assets mature
- ❖ Analytic resources and operational capabilities sufficient to effectively manage these complex cash flow instruments over time

It should be recognized that the commercial insurance market does not have sufficient capital to play a meaningful role in solving this problem. Our proposed pooling mechanism therefore does not rely on commercial insurance capacity.

1.1 Should the program offer insurance against losses for both individual whole loans and individual mortgage backed securities?

Yes, the program can apply to both individual whole loans and individual mortgage-backed securities. The insurance program that we describe would be most valuable for holders of mortgage-related securities. There is no reason why the insurance pooling structure cannot apply to a bank (or other financial institution's) portfolio of individual whole loans, as long as there are a sufficient number to permit the use of actuarial based pricing methodologies.

Adequate participation rules must be promulgated to prevent adverse selection (e.g. banks pooling risky mortgages and retaining safe ones).

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?

We believe the pool structure discussed above is the appropriate one, given the constraints that the program be voluntary and self-funding. The program's structure should not differ to the extent that a particular asset is troubled. It accommodates different risk profiles of assets by charging different premiums. Naturally, assets with greater risk will be charged higher premiums.

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

The key issue in considering whole first mortgages is the existence of a critical mass within a financial institution needed to support actuarial-based pricing methodology. Financial institutions that have a significant aggregation of individual whole first mortgages would fit nicely into the proposed program. Institutions that have a portfolio of individual whole loans must be carefully considered in order to prevent adverse selection or "gaming the system".



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

A key issue to consider in insuring (guaranteeing) HELOCs and related assets is the existence of a portfolio large enough to support actuarial based pricing methodologies. We believe that HELOC performance will differ from primary mortgages. Nonetheless, there is sufficient data for us to develop actuarial estimates of loss and determination of premiums.

1.2.3 What are the key issues to consider with respect to guaranteeing Mortgage Backed Securities?

The key issue to consider is the development of appropriate premium levels. The large number of individual loans typically packaged into mortgage-backed securities allows credible statistical analyses of the subcomponent risks. The law of large of numbers makes us confident that the process will yield reasonably accurate actuarial projections.

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?

The key issues associated with guaranteeing financial instruments are the availability of relevant data to support actuarial analysis, and the duration of the assets.

An actuarial approach can be applied to any risk instrument. The relative certainty in the resulting value estimates is dependent upon the credibility of the related underlying data. Relative credibility is generally a function of

- the number of observations,
- volatility of historical development
- heterogeneity of pure premiums amongst the various subclasses of risk

In the specific case of mortgage-backed securities, key risk parameters would encompass loan type, duration, maturity, zip code, and loan-to-value at close, as well as other relevant data points.

The pooling structure that we propose benefits from an iterative pricing and premium calculation. This is possible only with long-lived assets (at least three years). To the extent that assets unrelated to mortgages show these characteristics, the benefits of the program would apply.

For the purposes of the insurance pool, participating institutions may wish to restrict participation to instruments that are related to residential or commercial real estate mortgages or loans. This would not preclude the creation of a separate "virtual pool" using the same methodologies, infrastructure, regulatory and governance framework for other asset categories.

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

The key issue in setting the payout is simply the non-payment of principal and interest due under the terms of the insured assets. Payments are subject to a retained amount which would be borne by asset holders. Once the retention is met, the insurance policy would begin to pay the asset holder for shortfalls in principal and interest.

The insurance policy (guarantee) specifically ignores any market valuation as the basis of payout.



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?

We believe that the program should be prospective and not pay for accumulated deficits of principal and interest. The insurance policy will have the effect of allowing these troubled asset classes to recapture their "held-to-maturity" values, which are expected to be materially greater than their current "mark-to-market" values.

The pool provides for the sharing of risk, which is by nature prospective. To the extent certain events have already occurred, the mechanism is no longer "insurance" but a mechanism to shift cash from one group of participants to another. This is likely to discourage participation in this voluntary mechanism.

The program we outline specifically contemplates a "retention" (an amount of loss that would be retained by the asset holder). Therefore, the guarantee would implicitly be less than 100% of the principal and interest.

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.

No, the basis of the payout should not vary by asset class. Entities that purchased assets with significantly more risk should not benefit disproportionately from an insurance mechanism. Rather than reducing the payout, the plan reconciles the risk differences in two ways:

- ❖ Riskier assets will receive a higher premium charge than less risky assets
- ❖ The retention will cause holders of riskier assets to absorb more losses compared to less risky assets.

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?

The plan is not triggered in response to changes in the market value of the assets, but rather to the shortfall of principal and interest. In this respect, we recommend periodic settlements (quarterly or annual) of claims.

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 market place?

We believe that holder should be able to trade the assets. At time of sale, investors may make the decision to retain the insurance policy (guarantee) and assume the obligation to pay future premiums. Alternatively, an investor may simply choose to purchase the asset and waive the insurance policy. This will be particularly attractive in the future when there is more certainty about the performance of the asset. For liquidity purposes, it is preferable to have a period during which insurance is mandatory.

In the long run, the majority of the liquidity for the insurance program will come from the holders of the assets. Therefore, restricting the plan to eligible financial institutions is workable only to the extent that the plan relies on the ability of asset holders to pay deferred premium calls. We can foresee a practice where non-financial investors purchase assets, but financial institutions manage the securing of assets to

pay future premiums, which is analogous to the way financial institutions manage tax liabilities for non-U.S. investors.

- 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?

To the extent the actuarial-based underwriting process comes reasonably close to estimating annual premiums, the government's long-term exposure to loss should be limited to extending credit to the Asset Stabilization Pool (ASP). In the long run, the ASP is designed to be self-funding. Under the plan, the government would cap the amount of deferred premium collected from participants in any single year and would be reimbursed over time by deferred premium calls. In the interim, temporary deficits may be substantial.

We would provide actuarial analyses detailing the potential for any material deficit losses and their relative likelihood (i.e., confidence levels). By setting a high cap, the government can protect itself from funding losses. A lower cap would have the effect of injecting liquidity into the financial system.

For reasons stated, we would not recommend varying the methodology among different asset types; however, the risk premiums generated by the method will differ by asset class.

- 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 the specific case of mortgage-backed securities, key risk parameters would encompass loan type, duration, maturity, zip code, loan-to-value at close. These parameters provide the structure for a stochastic (i.e., Monte Carlo) simulation model that generates the actuarial estimates of the value of distressed assets. The initial valuations will in turn yield the requisite premium requirements to fund the estimated shortfalls. Under our proposal, participating assets will be analyzed every year using the information that emerges as the assets mature. In this sense, a provisional "price" is established each year and is finalized upon either final maturity of the asset, or upon sale to a non-participating asset holder.

The same inputs used to develop the premium estimates can be employed in establishing prices for the asset purchase provisions of EESA (Section 101). Since they are essentially final, they do not benefit from subsequent valuations.

- 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?

The question implies that premium determination pricing might be based reviewing the valuation of comparable assets. Our recommended approach relies on the actuarial estimate of losses of a particular instrument, not market valuation.

An initial valuation price for each asset would be established at inception (acceptance into the risk pool). At each annual anniversary, an actuarial re-evaluation would determine if the prior estimate should be increased or decreased based upon the additional years' worth of debtor performance data. The remaining risk adjusted premium payments would be recalculated accordingly. This actuarial valuation technique is analogous to the recalculation of curtate life expectancy in pension risk pools.

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 plan contemplates grouping the assets into various pool cohorts dependent upon certain risk characteristics (i.e., duration, size, degree of mark-to-market impairment and etc). Our approach reconciles differences in the risks inherent in different asset classes through the premium pricing mechanism.

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

Premium should reflect the anticipated shortfall in principal and interest through the life of the contract and be reset periodically. Amounts not needed to fund (pay current year's anticipated shortfall of principal and interest) the ASP for the subsequent 12 months will be deferred.

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?

This question highlights the enormous importance of the initial actuarial evaluation of all subject assets. To the extent that these estimates can equitably classify the risk cohorts, adverse selection will be mitigated.

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

- ❖ Legal: We do not foresee any special legal issues. The guarantee or insurance policy is well understood. Financial guarantee policies are a commonly used and accepted tool to manage risk. It is common for municipalities to insure their bonds using financial guarantee policies.
- ❖ Accounting: The relevant accounting pronouncements include
 - Statement of Financial Accounting Standards No. 5 -- *Accounting For Contingencies*
 - Statement No. 113 *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*
 - Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities* permits assets to avoid marking-to-market if an asset is highly correlated with a hedge. This treatment would provide significant benefits to participating financial institutions.

In general, premium payments would be expensed and claims recoveries would offset losses. Firms may be required to establish reserve (liability) for payment of deferred premium amounts, wholly or partially offset by (asset) claims recoveries.



- ❖ Regulatory: There are specific examples of government sponsored pools including *The Price-Anderson Nuclear Industries Indemnity Act* and *Terrorism Risk Insurance Program*. Additional research is required to confirm the Treasury ability to act in supporting this program.

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

The proposed plan does not create insurmountable administrative challenges. We see the challenges in three principal areas:

- ❖ Premium Determination: We believe that there are manageable numbers of instruments requiring actuarial analysis to allow for reasonable premium estimates.
- ❖ Settlement of Loss: Aon has direct experience in systems that manage millions of claims, which are generally more complex than financial guarantee losses. We are confident that we can design and managed a clearance system for claims.
- ❖ Collection of Premium: The same mechanisms used to track interest payments, as well as tax basis of assets, can be employed to collect premium.

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

Treasury would need the following areas of expertise which Aon can assist in building:

- ❖ Risk Analysis: The proposed insurance plan requires the development of risk premiums to provide for defaulted principal and interest payments. This is an actuarial exercise which is less uncertain than developing methods to price the current market value of the assets. Experts in a largely supervisory category would be required to interpret results and oversee a team of actuaries who would be developing the detailed risk premium parameters.
- ❖ Legal: The Treasury Department should develop the legal resources needed to oversee the affairs of a large and complex insurance program.
- ❖ Management & Governance: Treasury would also require general management and administrative resources to deal with operational issues such as vendor selection, management of various outsourced functions including systems and technology, claims administration etc.

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?

We believe the plan should be open to a larger group of participants that may have been contemplated in the asset purchase program. The plan we have described is largely self-funding, with the government providing liquidity to the ASP should deferred premium calls exceed expected levels. Therefore, the solution is scaleable and does not benefit from exclusion of potential participants.

The key eligibility concern would be the ability to pay premium when asked, and to demonstrate the ability to pay deferred premiums in the event of a call.

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?

The following are criteria for inclusion of a particular subject asset in the insurance (guarantee) program:

- ❖ Existence of Data Sufficient to Develop Actuarial Estimates of Premiums: The insurance program is dependent upon the ability to develop probability-based estimates. Therefore, assets must have sufficient numbers of underlying mortgages (or other type obligations) in order to enable the law of large numbers.
- ❖ Assets' Duration: Another cornerstone of the plan is the reduction in valuation uncertainty as the asset matures over time. Assets with shorter maturities do not lend themselves to this iterative re-pricing mechanism.
- ❖ Trigger Events and Subsequent Observations: Certain derivative instruments may not experience sufficient intervening events (i.e. subsequent defaults) to permit the development of reasonable or accurate valuation estimates. For example, it may not be possible to develop reasonable estimates of an instrument that guarantees the residual value of a class of assets with no secondary market.

Provided the above criteria are met, we believe that the insurance mechanism is superior to the asset purchase plan. Assets that fail to meet the criteria would appear to be better suited to participation in the asset purchase plan (Sec. 101).

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.

This highlights the advantage of this proposed risk pooling mechanism.

- ❖ Financial Institutions may prefer to receive credit for the "held-to-maturity" value of these instruments rather than a cash purchase based in a depressed, current market value.
- ❖ Direct asset purchases under TARP may offer financial institutions the ability to profit by selling assets above their economic value.
- ❖ Direct asset purchases present more opportunities to profit from asymmetrical information and thereby may be preferred by some financial institutions.

- 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?

Financial institutions would likely benefit from insuring assets where the "held-to-maturity" value is expected to exceed the current market prices.



We have no specific knowledge of the pricing methodologies that will be used in the asset purchase plan. A purchase of distressed assets at current market value by the Treasury will simply lock-in the financial institutions' losses at current depressed market rates.

Rather than sell these assets at depressed prices, the insurance program allows the financial institutions to realize the higher "held-to-maturity" value and creates equitable alignment of interests whereby the asset holders participate by paying risk premiums to fund the near term shortfall in principal and interest.

The proposed program's key feature is the protection of the taxpayer. The program is largely self-funding and defers final resolution of the value of distressed assets into the future, when there will be more certainty through the simple passage of time.