
❖ Horizon Asset Management, Inc. ❖

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An Alternative To The Paulson “Bailout” Plan

Recognizing that the structure of the \$700 Billion Rescue Bill offers some opportunities for enhancement, Murray Stahl offered his idea of what would be a more efficient approach. This alternative plan was sent to Ben Bernanke, Henry Paulson, Hillary Clinton (who politely responded) and various members of Congress. In light of many inquiries regarding the credit crisis, we thought the clients of Horizon would be interested to hear Murray’s thoughts. The following is a description of “The Stahl Plan.”

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The “Stahl Plan”

Part 1

The Rescue Bill has been represented, in the popular media and in congressional discourse, as a “bailout.” Certainly, \$700 billion of taxpayer funds would be at risk. Fortunately, the funding requirement can be largely avoided, and the objective of the bill achieved, simply by securitizing the troubled mortgages.

The object of the \$700 billion funding allotment is to raise the mark-to-market value of troubled assets and thereby restore the banks to a properly capitalized status. Instead, Congress could appropriate \$4 billion to purchase a random selection of these assets from banks and other financial institutions, segregate them into a series of investment pools and convert them into Exchange Traded Funds to be listed on organized exchanges. Financial institutions with related expertise would manage these investment pools on behalf of the United States subject only to the constraint that the portfolios consist of either the newly created Exchange Traded Fund Assets or fixed income vehicles issued by agencies such as Fannie Mae and Freddie Mac.

This would have the advantage of placing into the public domain a random cross section of troubled assets that would receive broad scrutiny from regulators, the investment community and the public.

It should be observed that, at the moment, even genuinely AAA subprime paper trades at approximately 50 cents on the dollar, with yields to maturity of nearly 15%. This is a preposterously low trading level, except these assets are non-tradable since the entire Mortgage-Backed securities market is frozen at the moment. The establishment of publicly traded diversified vehicles with such high yields to maturity would naturally invite the interest of broad segments of the global investment community.

Further packages of mortgages into Exchange Traded Funds could be overseen by the banking industry under the auspices of a newly created Exchange Traded Fund Committee under the supervision of the Secretary of the Treasury and the Chairman of the Securities and Exchange Commission. As assets are packaged into Exchange Traded Funds, a given bank will simply receive, in exchange for the assets, units of the Fund. If the banks require liquidity, the banks could then sell these units in the global marketplace.

Here comes the best part. Each Exchange Traded Fund, so structured, should charge an appropriate administrative fee. A portion of the Fund fees should be remitted to the United States Treasury as a facilitation fee so that the public may benefit from the assistance rendered to the private financial sector. Since the standard life of a mortgage is measured in decades, this would ensure a steady stream of income to the United States government for many years to come. For example, if ultimately \$4 trillion of mortgages were

securitized, the United States Government would actually receive perhaps 10 basis points, or \$4 billion per annum, as a revenue source. The \$700 Billion outlay would be avoided, the \$4 billion public investment would be repaid and the people would enjoy an ongoing revenue stream.

In order to provide a transition period, the mark-to-market accounting rule otherwise known as FAS 157 should be temporarily suspended until such time as a viable public market has been established with proper price discovery. Since the cash flows of these assets would imply much better pricing than the mark-to-market models, capital market stability would follow.

This plan would create other benefits as well. As should be self-evident, an entirely new segment of the financial services industry, which would necessarily employ many people and create much needed revenue for the United States Treasury, would evolve.

More importantly, it would also diminish the likelihood of future financial crises. The Exchange Traded Fund mechanism, as a practical matter, restores bank access to capital so that a given bank is not totally dependent upon its ability to fund. A bank could always sell its fund units or create new units by conversion of mortgages to units. It would be possible for a bank to gradually deleverage in an orderly manner if required to do so by a regulatory authority. Therefore, this would place in the hands of the FDIC an important tool to assure bank capital adequacy, because it could not merely require a bank to deleverage, but actually have at its disposal an enabling mechanism, apart from seizure of the institution. At the current time, a regulatory authority that wished a bank to deleverage would probably need to forbid a bank from making new loans. If the Exchange Traded Market were sufficiently deep and rich, in principle, a bank could deleverage in a matter of days. This could even be accomplished gradually if such were found to be a more desirable course of action.

The following outlines the Stahl Plan:

A Resolution to the Credit Crisis of 2008

I. Introduction

Proposed Revision to HR 3997

As you know, the most controversial portion of HR 3997 is the \$700 billion funding allotment to purchase Level III assets from banks. The object of this portion of HR 3997 is to raise the mark-to-market value of these assets and thereby restore the banks to a properly capitalized status. It has been represented in the popular media, as well as in congressional political discourse, as a “bailout.” In any event, it is difficult to deny that \$700 billion of taxpayer funds is placed at risk. The funding requirement can be largely avoided and the objective of HR 3997 be achieved by undertaking the following actions.

II. Proposed Actions

1. Congress shall appropriate for the use of the Secretary of the Treasury the sum of \$4 billion.
2. These \$4 billion would be used to purchase a random selection of Level III assets from banks and other financial institutions at the discretion of the Secretary of the Treasury.
3. Level III assets would be then segregated into a series of six pools structured along the lines of the well-known ABX indices (e.g., AAA, AA, A, BBB, etc.).
4. The pools would be converted into Exchange Traded Funds and be listed on organized exchanges.
5. The Treasury Secretary will engage the services of ten respected managers with expertise in areas such as Mortgage-Backed Securities.
6. The Treasury Department will award each of the ten managers the mandate to manage these assets on behalf of the United States. It should be noted that, on the day of establishment, each manager would be given an identical portfolio composed of the aforementioned Exchange Traded Fund assets. The managers would be free to alter their portfolios as desired subject only to the constraint that the portfolios consist of either the newly created Exchange Traded Fund Assets or fixed income vehicles issued by agencies such as Fannie Mae and Freddie Mac.
7. This would have the advantage of placing into the public domain a random cross section of Level III assets that would receive broad investment as well as public scrutiny.
8. The Securities Exchange Commission should be empowered to enforce rather rigorous disclosure requirements about these Funds.
9. It should be observed that, at the moment, even genuinely AAA subprime paper trades at approximately 50 cents on the dollar, with yields to maturity of nearly

15%. This is a preposterously low trading level, except these assets are non-tradable since the entire Mortgage-Backed securities market is frozen at the moment.

10. The establishment of publicly traded diversified vehicles with such high yields to maturity would naturally invite the interest of broad segments of the global investment community. It cannot be sufficiently stressed that the object of a public listing of such paper is to attract and mobilize global capital.
11. The banking industry should establish an exchange-traded Fund committee under the supervision of the Secretary of the Treasury and the Chairman of the Securities and Exchange Commission. The object of the committee will be to select further quantities of Level III assets to be packaged into Exchange Traded Funds. As Level III assets are packaged into Exchange Traded Funds, a given bank will simply receive, in exchange for Level III assets, units of the Fund. If the banks require liquidity, the banks could then sell these units in the global marketplace. The actual sale of fund units should, as a generalization, be left to the discretion of the individual banks.
12. Each Exchange Traded Fund, so structured, should charge an appropriate administrative fee. The level of fees established should be determined by the Treasury Department. A portion of the Fund fees should be remitted to the United States Treasury as a facilitation fee so that the public may benefit from the assistance rendered to the private financial sector.
13. Since the standard life of a mortgage is measured in decades, this would ensure a steady stream of income to the United States government for many years to come. For example, if ultimately \$4 trillion of mortgages were securitized, the United State Government would actually receive perhaps 10 basis points, or \$4 billion per annum as a revenue source. These funds could then be put to use as Congress determines.
14. In order to provide a transition period the mark-to-market accounting rule otherwise known as FAS 157 should be temporarily suspended until such time as the Treasury Department, in consultation with the SEC, determines that a viable public market has been established with proper price discovery.

III. Advantages

1. Transparency would lead to a measure of capital market stability and alleviate much public anxiety. By virtue of the Exchange Traded Fund mechanism, the investing and institutional public will obtain a great deal of information about the state of the mortgage market, since the cash flows of these assets would imply much better pricing than the mark-to-market models currently employed.
2. This would create, as should be self-evident, an entirely new segment of the financial services industry, which would necessarily employ many people and create much needed revenue for the United States Treasury.

3. This effectively preserves the structure and intent of the FAS 157 mark-to-market requirement with a deep and rich price discovery mechanism. Consequently, FAS 157 would operate much as its original creators had envisaged.
4. The Exchange Traded Fund mechanism, as a practical matter, restores bank access to capital so that a given bank is not totally dependent upon its ability to fund. A bank could always sell its fund units or create new units by conversion of mortgages to units. It would be possible for a bank to gradually deleverage in an orderly manner if required to do so by a regulatory authority. Therefore, this would place in the hands of the FDIC an important tool to assure bank capital adequacy, because it could not merely require a bank to deleverage, but actually have at its disposal an enabling mechanism, apart from seizure of the institution. At the current time, a regulatory authority that wished a bank to deleverage would probably need to forbid a bank from making new loans. If the Exchange Traded Market were sufficiently deep and rich, in principle, a bank could deleverage in a matter of days. This could even be accomplished gradually if such were found to be a more desirable course of action.

IV. Concluding Remarks

The object of regulation should be to enable the market mechanism to function. It is one of the great ironies of recent weeks that Lehman Brothers found itself unable to sell even AAA-rated Mortgage-Backed paper; yet its stock, although it had declined to a virtually worthless level, never stopped trading and indeed trades to this very moment. In order for the capital markets to properly function, an orderly venue for the exchange of securities needs to be established. Once all the participants understand the rules, the market mechanism will work, as is evident from scrutiny of the continuous trading market of the equities of those companies that find themselves unable to sell any type of fixed income paper.

Stahl Plan Part II

The obvious deficiency of Stahl Plan Part I is that many months will be required in order to orchestrate the construction and listing of suitable Exchange Traded Funds comprised of Mortgage-Backed Securities held by banks. The obvious virtue of the Stahl Plan in success mode is that the Exchange Traded Funds, once constructed and listed, are likely to appreciate above the current mark-to-market of the mortgage paper underlying the ETF now held by banks. Consequently, the current leverage of an undercapitalized bank would work in its favor since all mark-to-market appreciation will serve to expand shareholders equity and hence reduce financial leverage.

Another approach to enhance the value of the measures enacted by Stahl Plan Part I would be to permit managers selected to manage the treasury program to invite their existing client base or new clients to pool private capital with the Treasury program. In this scenario, once a market is established, the newly tradable mortgage-backed paper in ETF form might well be attractive to the outside capital of the world and, if this is so, a liquid market might be created without very much further participation by the United States government. In such an instance, the United States government would have, by investing its initial capital, started a new branch of the investment management industry. The United States government should, under such circumstances, retain a five-basis-point carry. In this aspect of the newly created money management program, the funds generated by this action for the credit of the United States might well be used to fund health insurance subsidy payments for poor unfortunate persons.

In order to solve the timeline problem the following action is recommended. The United States Treasury, with the approval of Congress, should undertake to grant tax-exempt status to any short-term debt instrument for which the creditor voluntarily undertakes to grant the debtor a thirty-day extension of principal payment. During the extension period, interest derived from those debt instruments will be tax-exempt. Such tax exemption should be made renewable at the option of the creditor, provided that the debtor is given the additional thirty-day principal payment extensions. This program should lapse at the end of five years. The purpose of this program is two-fold. First, it immediately and dramatically lessens the liquidity pressure on short-term borrowers. Second, it increases the market value of existing short-term debt that voluntarily participates in the program. The increased values would necessarily be reflected in the quarterly bank mark-to-market and thus, given the existing financial leverage of the banks, the higher market values of such newly tax-exempt debt instruments would increase shareholders equity.

Sincerely,

Murray Stahl
Chairman/Chief Investment Officer
Horizon Asset Management, Inc.