# Investment Watch

1st Quarter, 2009

## Toxic Asset Waste

Can the Obama administration's new program clean up the ***Toxic Asset Waste***, shore up big banks' balance sheets and finally end credit market paralysis? These obstinate ***Toxic Assets*** were born out of the subprime mortgage crisis which has submerged much of the world into a deep recession. Our economy is heading into its 17th month of recession, the lengthiest slowdown since the Great Depression.

America's anger is justified. The ***Toxic Assets*** were created by the misguided ingenuity of our youthful, Wall Street financial engineers who created complex securities based on lax underwriting strategies, and then they were wrongly labeled as safe investments by our financial gatekeepers, the rating agencies.

Since the summer of 2007 when the housing bubble burst, precipitating the subprime mortgage meltdown, extraordinary efforts, not only by our government's leaders here at home, but by those across the globe, have been unable to purge our financial institutions of these ***Toxic Assets*** and unable to unlock the frozen credit markets.

These ***Toxic Assets*** precipitated the demise of Wall Street's specialty brokerage and small independent investment banking system. Our nation's banking system underwent a lifetime of consolidation in a few months last fall, now resulting in a few older traditional, more highly regulated bank holding companies. Planned U.S. regulatory reforms will subject these bigger banks to stricter oversight and regulation.

On March 23rd, the new Treasury Secretary, Timothy Geithner, announced the administration's long-awaited **P**ublic-**P**rivate **I**nvestment **P**rogram **(PPIP),** the latest in the alphabet soup of governmental programs designed to "lay the foundations for economic recovery." Stock prices soared more than 7% after the program was unveiled, "capping", as reported by Bloomberg, "the market's steepest two-week gain since 1938, as investors speculated that the Obama administration's plan to rid banks of toxic assets will spur growth." Time will measure the effectiveness of the new program.

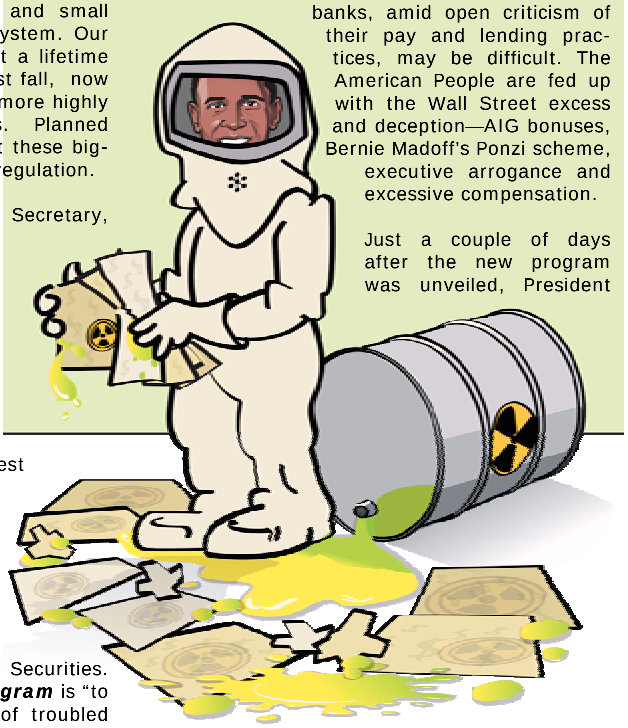
**PPIP** magically transformed these Toxic Assets into Legacy Loans and Securities. The goal of the ***Legacy Loans Program*** is "to cleanse the bank balance sheets of troubled legacy loans and to reduce the overhang of uncertainty." The goal of the ***Legacy Securities Program*** is "to restart the market for legacy securities, allowing banks and other financial institutions to free up capital and stimulate the extension of new credit."

**PPIP** is a necessarily complex program to deal with these complex loans and derivative securities. It is intended to attract private funds to purchase the Legacy Loans and Securities via 50/50 partnership between public and private investors. **PPIP** is a coordinated effort by the Treasury, the Federal Reserve and the Federal Deposit Insurance Corp (FDIC).

**PPIP** is no *pipsqueak*. Its foundation is the financial strength of the Treasury's $75 - $100 billion of unused assets of the Troubled Asset Relief Program (TARP) which ran aground amid worries that taxpayers would overpay for the ***Toxic Assets***. The FDIC must persuade the banks to sell their Legacy Loans. Many banks believe their Legacy Loans will have significant value once the credit markets calm. But due to a *"mark-to-market"* accounting rule, they feel that the Legacy Loans are valued at low, fire-sale prices which hurts their balance sheets.

The FDIC, through loan guarantees and its examination process of the bank's fiscal soundness, must convince these banks to participate in the program. With financing from the FDIC, along with the Federal Reserve, **PPIP** will be able to leverage the TARP money into $500 billion worth of purchasing power with the potential to expand $1 trillion.

One of the key elements of **PPIP** is to lure the top bankers and private investors to partner side-by-side with the taxpayer to buy up these ***Toxic Assets*** that are choking the flow of credit. Cooperation from the banks, amid open criticism of their pay and lending practices, may be difficult. The American People are fed up with the Wall Street excess and deception—AIG bonuses, Bernie Madoff's Ponzi scheme, executive arrogance and excessive compensation.



Just a couple of days after the new program was unveiled, President Obama called the heads of the nation's 15 largest banks to the White House. The credit crisis and an ailing US economy combined to make them strange bedfellows. They discussed the Public-Private Investment Program, stricter regulation of the financial system and the stickier issues such as compensation. The bankers pledged broad support for **PPIP**, the bank-bailout program, and vowed to work with the White House to revive the economy. But some have openly bristled over the president's tough rhetoric and the public's criticism over their pay and their lending practices.

### Public-Private Investment Program

***Three Basic Principles to buy Toxic Assets***

- ***Maximizing the Impact of Each Taxpayer Dollar:*** First, by using government financing in partnership with the FDIC and Federal Reserve and co-investment with private sector investors, substantial purchasing power will be created, making the most of taxpayer resources.
- ***Shared Risk and Profits With Private Sector Participants:*** Second, the Public-Private Investment Program ensures that private sector participants invest alongside the taxpayer, with the private sector investors standing to lose their entire investment in a downside scenario and the taxpayer sharing in profitable returns.
- ***Private Sector Price Discovery:*** Third, to reduce the likelihood that the government will overpay for these assets, private sector investors competing with one another will establish the price of the loans and securities purchased under the program.

*Source: U.S. Dept of the Treasury PIP Fact Sheet 3/23/2009 above excerpt and all quotes unless otherwise noted.*

The Wall Street Journal headline read ***"Bankers and Obama Establish an Uneasy Truce."*** Also Journal noted, *"Many [bank] participants have been openly hostile toward Democratic initiatives in Washington…. The bankers pledged to work constructively with the administration on a host of fronts, from selling bad assets, to proposed public-private partnerships to overhauling the financial regulatory system."*

So the ground rules have been set! The subprime crisis toppled America from the heights of prosperity just 17 months ago into a severe recession. The lingering ***Toxic Asset Waste*** has blocked the flow of credit, the lifeblood of our economy, and has exacerbated all efforts to revive growth. Credit markets are built on trust. Lack of trust has stifled credit, making this economic downturn even more severe.

Now is the time to work together to repair our nation's financial system. The Public-Private Investment Program is a partnership between taxpayers and our financial institutions. This partnership requires trust and trust is essential to restart lending and to grow our economy. Trust in the resilience of the American people and our economy to clean up the ***Toxic Asset Waste*** and lay the foundation for recovery.

*March 31, 2009*

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