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Market based valuations in a cost basis environment Derivatives and other depreciable balance sheet paper



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In a time of economic uncertainty our government is being pushed into an interventionist role in the private marketplace, and while our lawmakers are working fastidiously toward an appropriate response, the legislation being passed is complex and multi-faceted, yet thinly worded and correctly, but hastily considered.

The U.S. Senate on October 1st passed the Emergency Economic Stabilization Act of 2008 aka the Troubled Assets Relief Program (TARP), which details the multi-faceted response discussed above.

In pertinent part, TARP contains:

- *An increase in the statutory limit of the public debt to \$11.3 trillion;
- *A U.S. Government purchase of troubled assets in the order of \$700 billion, funded by the issuance of treasury securities pursuant to Title 31 Ch. 31 of the U.S. Code;
- *An equity stake in financial institutions that sell their troubled assets to the government;
- *Foreclosure mitigation efforts;
- *Executive compensation and corporate governance standards for financial institutions from whom the government buys troubled assets, such as a claw-back on bonuses and payments based upon materially inaccurate information, and a limitation on golden parachutes;
- *A temporary increase in FDIC protection to \$250,000 per applicable account;
- *A patch for the alternative minimum tax;
- *One year extensions of the wind energy production tax credit and the new markets tax

credit;

*An eight year extension of the investment tax credit for solar energy projects; and

*Authority under the securities laws for the SEC to suspend the application of Financial Accounting Standards Board Statement 157. FASB 157 is the mark-to-market accounting standard (MTM) adopted after the S&L collapses of the 1990s. MTM forces financial institutions to value assets based upon the market value of the assets, rather than the purchase price of the assets.

The proposed easing of the MTM rules is a challenging issue, and one that requires deep thought and discussion. MTM has required write-downs well exceeding \$500 billion due to the deterioration in value attributed to mortgage backed assets. Proponents of the suspension of MTM argue that these write-downs have precipitated the market woes we now face. Regulators favor the easing of the MTM rules, as it would lessen the cost of the bailout proposed by TARP, while opponents argue that the current crisis is one of confidence. Accordingly, valuing mortgage backed assets based upon purchase price would lead to illusory balance sheet values and resulting confidence issues. In considering this issue, it must be noted that Wachovia was to be purchased by Citibank for only \$2 billion when it collapsed, yet it had an asset value of \$75 billion.

The underlying goal of TARP seems to be to spend \$700 billion to inject no more than confidence into the marketplace. TARP essentially transfers the "troubled assets" to the US Government, the one entity that currently may be strong enough to hold the assets until a market for these assets recovers. As a result of TARP, financial institutions will have swapped their toxic paper for cash loaned to the U.S. Government by foreign and U.S. investors. The hope is that this will lead to an easing of the credit-crunch we are now facing. But will it? In the short term, cash-rich financial institutions may still be uncomfortable in lending that cash to consumers and businesses, unless confidence, arguably the underpinning of our market, makes them loosen up some capital. This so-called credit crisis may be more appropriately termed a confidence crisis, if not a loss of trust in the financial engineers of our economy. TARP is about restoring trust and confidence, but it proposes spending \$700 billion to do that. Impossible as it seems to value the cost of the troubled assets that now have no market, the market is marking TARP with a cost of no less than \$700 billion, and I would be remiss, to consider easing up those mark to market valuation rules.

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