



PF2 SECURITIES EVALUATIONS, INC.

Central Pricing Solution for TruPS CDOs



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Note

For simplicity this presentation contemplates TruPS CDOs; however, the concepts are extendable to all security types.

Lessons from the Crisis

- Risks associated with TruPS CDOs increase significantly
- Illiquidity risk
 - There is no “true” traded market for TruPS CDOs
- Credit risk
 - High deferrals / defaults amongst the underlying bank issuers that support the TruPS CDOs
- Arrival of myriad “other” risks
 - e.g., interest rate risk, prepayment risk, documentation risk, legal risk
- Many TruPS CDO bonds can no longer be carried at par; pricing needs to account for all of the above risks

Example of Documentation Risk

External party attempts to purchase some of the underlying assets that support TruPS CDOs at huge discounts.
Read more here: [Piercing the Securitization](#)

Existing Pricing Solutions

- **Self-Pricing**
 - Certain large banks determine the price of their own TruPS CDOs
- **Broker-Dealer (BD) Pricing**
 - Banks obtain pricing from the BDs that sold them the TruPS CDOs
 - In some instances, banks can choose from a range of pricing scenarios offered by the BDs
- **Independent 3rd Party (3rd Party) Pricing**
 - Banks pay 3rd Parties to price their TruPS CDOs

Key Concerns

- **Biased Opinions (or Potential for Price Manipulation)**
 - Banks may price too high to camouflage losses
 - Banks may choose BD prices based on overly optimistic assumptions
 - BDs may price too high to safeguard client relationships
 - BDs may price too high because they hold same / similar TruPS CDOs
 - BDs may price too low because they provide funding to banks holding TruPS CDOs
- **Lack of Transparency, Accuracy**
 - Variables driving TruPS CDO prices are not always disclosed and are often unjustified
 - BDs may apply approximate “matrix pricing” comparison techniques because in-depth analysis can be cumbersome
- **Price Shopping**
 - Poorly incentivized bank executives may search for the party willing to provide the highest prices on their TruPS CDOs

Examples

Go to *“Appendix – Examples of Contentious Pricings”*

Key Concerns

- **Lack of Understanding**
 - Banks may not fully understand the pricing analysis used to derive their OTTI. This renders them unable to discern good from bad 3rd Parties.
- **Taxing Costs**
 - BD pricing often free; but high quality, thorough independent analysis can be expensive (to the extent not shared, the costs associated with 3rd Party pricing may constitute a material burden for smaller banks)
- **Human Resources**
 - Bank examiners may be tasked with monitoring a number of different TruPS CDO pricing methodologies across different parties
- **Resulting Inconsistencies**
 - A certain TruPS CDO bond may be carried at different price by different banks

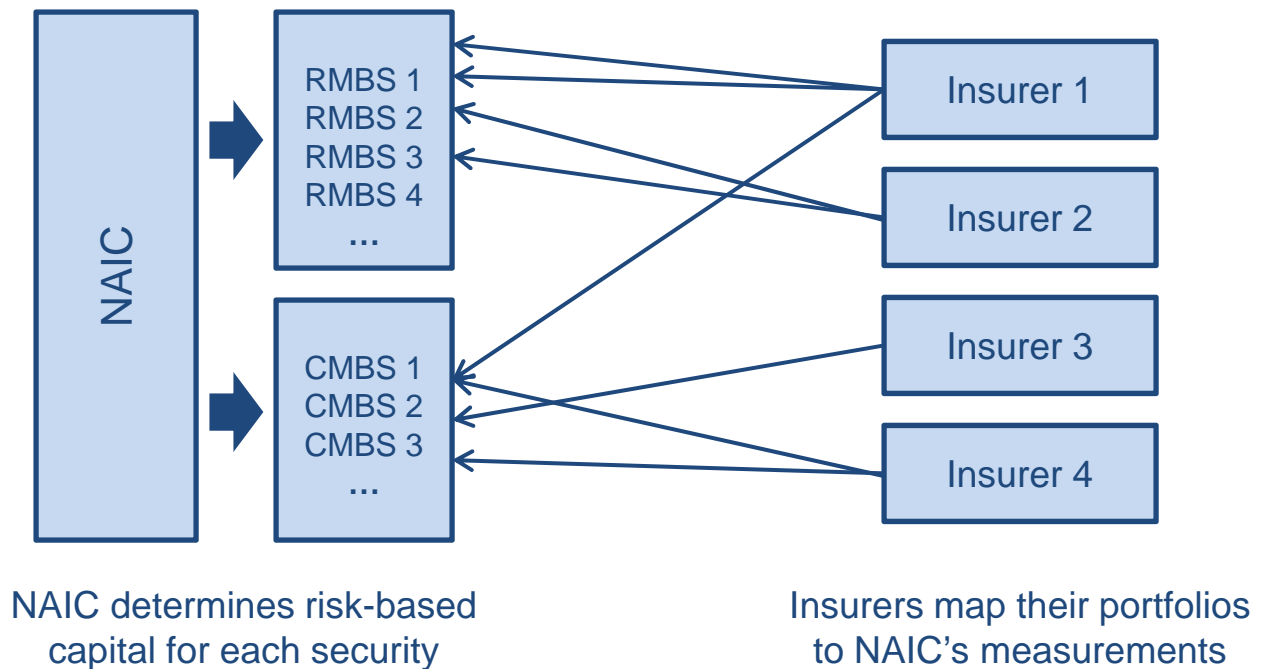
Shared Concerns

According to IOSCO's Technical Committee (Feb. 2011) regulators felt that "firms were overly-reliant on information from rating agencies and price providers."

Read more here: [Final Report on Price Verification of Structured Finance Products](#)

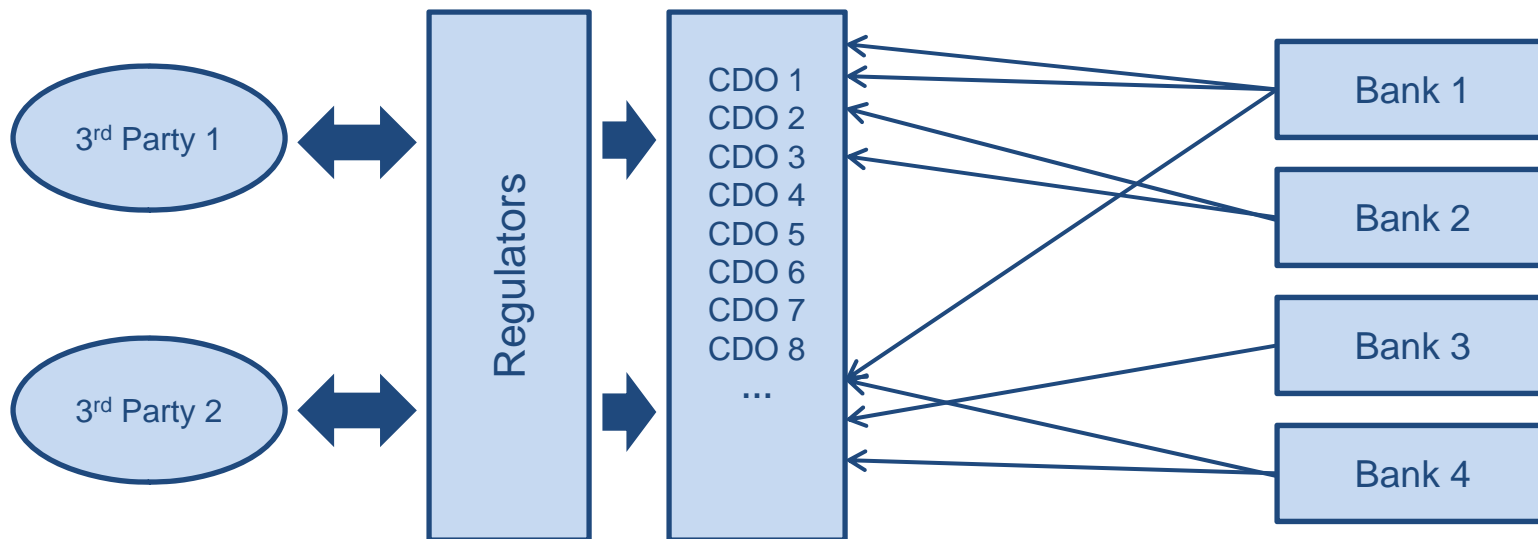
Central Pricing Solution

- Similar to a central pricing solution, National Association of Insurance Commissioners (NAIC) has teamed up with external experts to implement a uniform risk-based capital approach for RMBS (PIMCO Advisory) and CMBS (BlackRock Solutions)
- Several, but not all, of the concerns discussed in the previous slides are eliminated



Central Pricing Solution

- Authorities (e.g., Fed, FDIC, OCC) can create a similar central pricing solution for TruPS CDOs
- Regulators can work with independent 3rd parties on a single pricing methodology and deliver consistent TruPS CDO pricing across all banks



Regulators determine prices, in conjunction with 3rd parties, for each security

Banks map their portfolios to regulator's prices

Key Benefits

- Creation of an enhanced pricing methodology where regulators can contribute their unrivaled insight as to the credit quality of the underlying banks that support TruPS CDOs
- Ability to analyze systematic concerns, in advance, by testing control variables
- Pricing consistency minimizes information asymmetries and promotes liquidity
- Reduced impact of large or unexpected ratings movements (which can lead to forced selling, price fluctuations and even defaults)
- Platform can be extended to provide risk-based capital and reduce or remove over-reliance on credit rating agencies (a directive of the Dodd-Frank Act)

Appendix – Examples of Contentious Pricings

- [Mutual Funds' Muni-Debt Prices Are Questioned \(February 2011\)](#)
- [Legal Woes for Regions Financial \(April 2010\)](#)
- [Under Fire, NIR Group Switches Valuation Firms \(July 2009\)](#)
- [Evergreen Pays Over \\$40 Million to Settle SEC Charges that it Overvalued Mortgage-Backed Investments \(June 2009\)](#)
- [FHLB Executive Who Left Cites Securities Valuations \(April 2009\)](#)
- [“Large Number” of Banks Miss-Marked Assets, U.K. Regulator Says \(August 2008\)](#)
- [Financial Services Authority’s “Dear CEO: Valuation and Product Control” Letter \(August 2008\)](#)
- [The Subprime Cleanup Intensifies: Did UBS Improperly Book Mortgage Prices? Several Probes Expand \(February 2008\)](#)
- [Ex-RBC trader says colleagues mismarked bonds \(October 2007\)](#)
- [Pricing Tactics Of Hedge Funds Under Spotlight \(October 2007\)](#)
- [Deutsche suspends trader over £30 million 'cover-up' \(January 2006\)](#)

Resources

- Websites

- www.pf2se.com
- www.cdodatabase.com

- Research

- <http://www.pf2se.com/Content.aspx?Type=Research>

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