



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

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- 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

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- **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 3<sup>rd</sup> Party (3<sup>rd</sup> Party) Pricing**
  - Banks pay 3<sup>rd</sup> 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 3<sup>rd</sup> 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 3<sup>rd</sup> 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

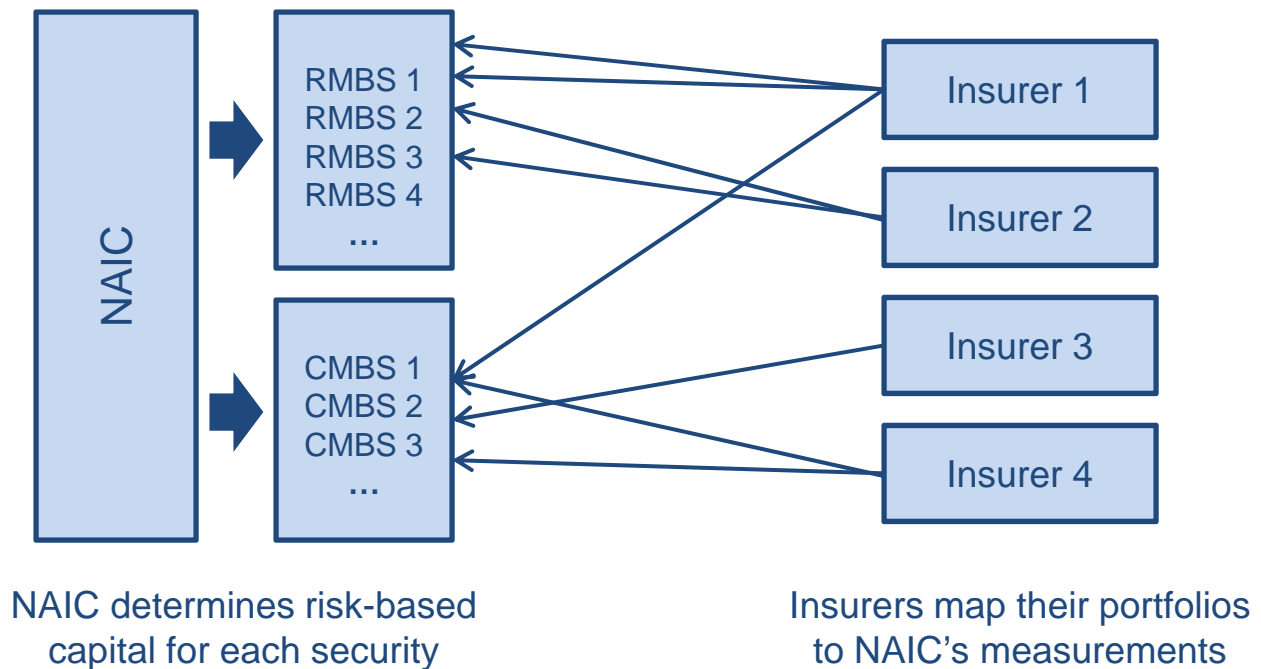
## Shared Concerns

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](#)

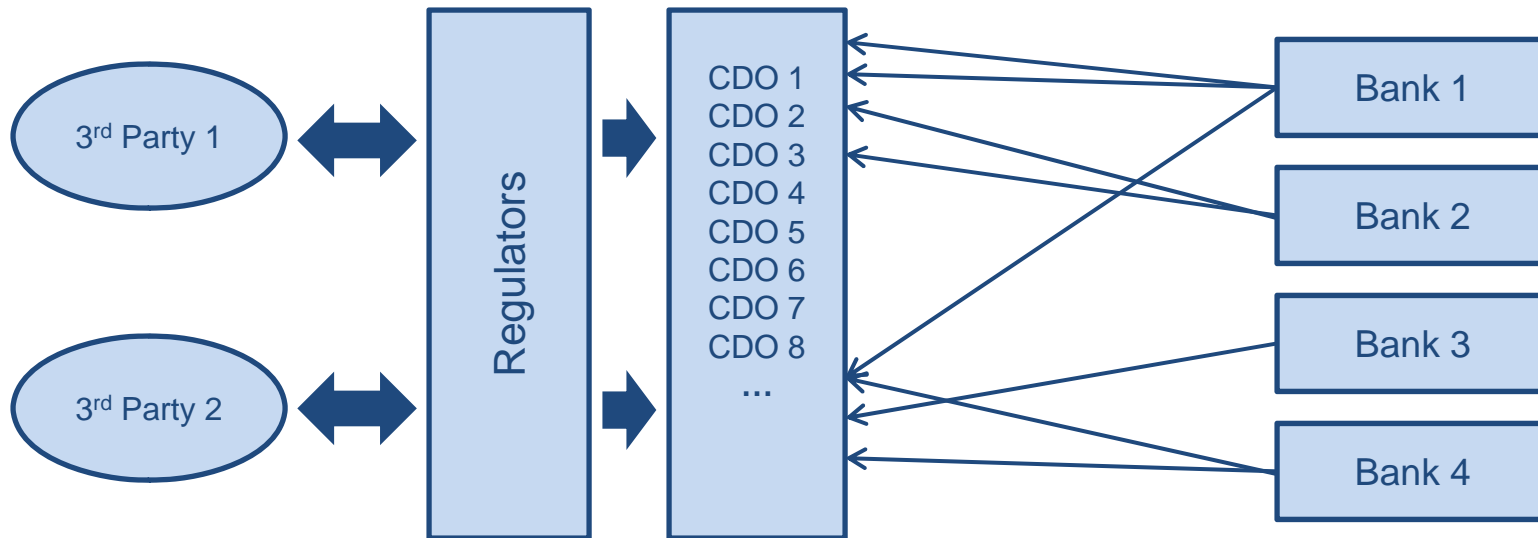
# Central Pricing Solution

- 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 3<sup>rd</sup> parties on a single pricing methodology and deliver consistent TruPS CDO pricing across all banks



Regulators determine prices, in conjunction with 3<sup>rd</sup> parties, for each security

Banks map their portfolios to regulator's prices



# Key Benefits

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- 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

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- [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

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- Websites
  - [www.pf2se.com](http://www.pf2se.com)
  - [www.cdodatabase.com](http://www.cdodatabase.com)
- Research
  - <http://www.pf2se.com/Content.aspx?Type=Research>

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