

Practice Alert: Q&A: Sale of Troubled Assets

On October 3, 2008 the Treasury began implementing the multibillion dollar financial rescue plan called the “Emergency Economic Stabilization Act of 2008” (hereafter the Act). The Act provides up to \$700 billion in funding for the Troubled Assets Relief Program (TARP) – which allows for the purchase of certain troubled assets by the government using taxpayer dollars – in an effort to protect home values and other assets, preserve homeownership, and promote economic growth. This extraordinary situation calls for a bold, thoughtful strategy. Company leadership must think critically about several top issues prior to a sale to the TARP.

With these business leaders in mind, Huron Consulting Group developed the following top-level Q&A to address strategy, pricing, and accounting concerns surrounding troubled asset sales.

1. What are the first steps?

Conduct a quick diagnostic to design a strategy and build a business case for selling or retaining troubled assets. A diagnostic includes, among other things, formulating a strategy to manage the auction process, balance sheet modeling to determine fundamental value and fair value, and stress testing the models to reflect a range of potential economic outcomes.

2. What type of assets can be purchased by the TARP?

While mortgages and mortgage-based securities will be the largest group of assets purchased, the Act essentially allows the Treasury to buy assets like student loans and credit card debt off the books of financial institutions.



The Act does, however, limit the purchase of assets from financial institutions with “significant operations” in the United States, but excluding any central bank of, or institution owned by, a foreign government. The Act has already been interpreted to include the purchase of assets held by U.S. affiliates of foreign financial institutions.

3. How will the price of troubled assets be determined?

The Act does not provide details on the methods for pricing and valuing assets. The mechanisms for purchasing troubled assets, along with the criteria and pricing details, will be provided when program guidelines are published by the Treasury (the earlier of two days prior to the first purchase of troubled assets or 45 days after the enactment of the Act).

Section 113 of the Act, in addition to allowing for direct purchases by the Office, provides authorization for the Secretary to encourage private sector participation in the purchase of troubled

assets and the use of market mechanisms such as auctions and reverse auctions. Participants in auction and reverse auctions programs typically behave in a predictable pattern. It is essential to understand the pattern in order to have a sound bidding strategy. Effective auction strategies will allow financial institutions to optimize the proceeds from the auction(s).

4. How will companies account for troubled asset sales and warrants issued under GAAP?

Financial institutions will derecognize troubled assets from the balance sheet if the transfer meets all of the relevant criteria for sale accounting and will recognize a gain or loss for the difference between the cash received and the aggregate of (a) the carrying amount of the financial asset and (b) the fair value of the warrants issued. On an ongoing basis, financial institutions will mark the warrants issued to fair value and will recognize changes in fair value through earnings. Because the government has

the right to require a financial institution to issue debt or another redeemable instrument if the institution's shares are no longer listed, the financial institution will classify the warrants as a liability on the balance sheet.

5. How will the Act impact mark-to-fair value accounting?

While the Act does not change mark-to-fair value accounting rules, it does:

- a) Provide authority to the SEC to suspend the application of SFAS 157 if the Commission determines it is necessary or appropriate in the public interest and is consistent with the protection of investors. Since the SEC has always had the statutory authority to override an FASB standard, this provision of the Act is of no great significance.
- b) Require the SEC to conduct a study on mark-to-fair value accounting standards to consider the effects of the standard on financial institution balance sheets, the impact of the accounting on bank failures, and the impact of the standards on the quality of information available to investors.

6. How will TARP impact mortgage servicing?

The Act provides great latitude to the Secretary to enter into contracts with mortgage servicers. Additionally, Sections 109 and 110 of the Act indicate that the Secretary and Federal property manager will implement a plan that seeks to maximize assistance for homeowners. The Secretary will coordinate with other federal government entities to identify opportunities for the acquisition of troubled assets that will facilitate their ability to improve the loan modification process.

7. How will the oversight provisions in the Act impact market participants?

The activities and performance of TARP and its agents or representatives will be evaluated by the Comptroller General as well as a Special Inspector General. The scope of oversight will include, among other things, the following:

- Foreclosure mitigation;
- Cost reduction;
- Whether it has provided stability or prevented disruption to the financial markets or the banking system; and
- Whether it has protected tax payers.

Oversight reports are due regularly and no less than every 60 days to the appropriate congressional committee.

The Act raises a variety of issues relating to risk management, valuation, servicing, and accounting. Huron's financial experts are equipped to address these issues and can provide further insight regarding the TARP and the sale of troubled assets.

For further information or to discuss topics presented in this piece, please contact a member of the Huron TARP team below.

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